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Providing comprehensive capital funding solutions to health care providers

- Taxable/Tax-Exempt Bonds
- Loan Syndications & Placements
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Lancaster Pollard Mortgage Company is a Fannie Mae/GNMA/HUD-FHA/USDA approved lender.
Lancaster Pollard & Co. is a registered securities broker/dealer with the SEC and a member of FINRA, MSRB & SIPC.
Tax-exempt, fixed-rate bonds issued publicly via the municipal bond market, often called tax-exempt munis, were nearly always the traditional choice for providing nonprofit organizations, including hospitals and health systems, one of the most cost efficient methods of accessing debt. It used to be a foregone conclusion by hospital leadership that munis were the way to go to fund big ticket capital projects.

But that, of course, was before the collapse of financial markets and before health care reform when the Affordable Care Act became the law of the land.

All borrowers, including nonprofit organizations, desire the lowest cost of capital with the most flexible terms. Now, because of market conditions, a nontraditional funding structure may be a more attractive option for refinancing existing debt or for financing new capital projects of hospitals and health systems. Hospitals are looking strategically at a variety of financing structures, either fixed or variable rate or a combination of both, including publicly issued tax-exempt and taxable bonds as well as privately placed tax-exempt or taxable bonds.

Why Tax-Exempt Bonds?

For nonprofit organizations, tax-exempt bonds are still an attractive option for accessing capital at lower interest rates, but the structuring of that debt requires a strategic approach. Hospitals can issue bonds publicly, primarily through a broker-dealer, by selling bonds directly to retail and institutional investors or by offering bonds on a private placement basis to banks or other financial institutions.

As long-term debt goes, fixed-rate, tax-exempt municipal bonds are the most common method of accessing capital for hospitals. Bonds and notes represent an obligation of the borrower to pay interest to the investor in return for the lending of capital over a given period of time. In turn, tax-exempt bonds offer investors in middle and higher tax brackets a taxable equivalent yield that can exceed the yield on investment-grade corporate bonds. As tax rates climb, for example, individual filers making above $200,000 (or $250,000 for joint filers) are subject to a 3.8% surtax under the new health care law. While this tax applies to ordinary income, distributions, capital gains, dividends, and interest income, it does not apply to income derived from tax-exempt bonds.

Bonds can be rated or unrated. The ratings—assessed for a fee by rating agencies, such as Standard & Poor’s, Fitch Ratings and Moody’s Investors Service—range from AAA to C and can change based on changes to a hospital’s financial situation or other economic conditions.

The interest rate is determined by conditions in the capital markets and is influenced significantly by the credit characteristics of the borrower, security provisions provided to bondholders and the financing structure. Ratings suggest to investors the amount of risk involved in purchasing a particular bond. AAA to BBB- bonds are considered “investment-grade.” Unrated or low-rated bonds are often referred to as “speculative-grade,” “junk” or “high-yield” bonds. The higher the bond rating, the stronger the hospital’s perceived ability to repay the principal and interest associated with the bond and the lower the interest rate the hospital must pay to offset investor risk.

Rated and unrated bonds generally can be sold or structured with or without credit enhancement. Unenhanced bonds are marketed solely on the strength of the borrower, while credit-enhanced bonds typically use enhancement vehicles such as mortgage insurance, letters of credit (LOC) or bond insurance. The reason a borrower would desire a form of credit enhancement would be to obtain a lower interest rate on the bonds.

Knowing what debt service will be paid for a specific period of time offers hospitals the comfort of stability. Typically, these bonds provide issuers with an attractive cost of capital and limited risk, which can offset the required issuance fees. They are generally accessible to hospitals and health systems of all ratings and sizes—a borrower just needs to be willing to pay the cost of debt based on its particular credit profile.

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Limitations of Tax-Exempt Bonds

On the other hand, there are several limitations of fixed-rate, tax-exempt bonds that hospital leaders need to consider carefully, including higher transaction costs, qualifications for tax exemption, limited options for credit enhancement, continuing disclosure, and investor call protection.

A primary concern for a hospital is that a tax-exempt issue costs more because of fees for issuance, underwriting and compliance. Costs are based on the structure and the complexity of a proposed financing, which can increase a borrower’s cost of capital. Underwriting fees range from just a few basis points to 2% of the bond’s par amount, depending upon the deal size, hospital credit profile and whether it is for a refunding or for financing a new project. Legal and accounting fees can run $15,000-$60,000 each for an underwriter’s counsel, bond counsel, hospital’s counsel, and auditors. Credit rating agencies typically charge $15,000-$30,000 for a rated financing. Additionally, some municipal issuers charge fees to serve as conduit issuing authorities. Fees vary widely from market to market, so it falls upon the borrower to be aware of the fees charged in its area.

Tax-exempt bonds have more restrictions about what is eligible to be funded and qualified for tax-exempt purposes, which results in more regulation and greater IRS scrutiny. At least 95% of bond proceeds must be used for hard assets (land and depreciable property) owned and used by the nonprofit hospital. For example, a medical office building that is equally owned by a partnership between a nonprofit hospital and a for-profit physician group would not be eligible to be funded with tax-exempt bond proceeds under IRS guidelines, but a medical clinic staffed by employed physicians of a nonprofit hospital would be eligible. Also, the weighted average maturity of a tax-exempt bond issue may not exceed 120% of the average life of the assets financed by the bonds, so hospitals should use caution when exploring financing options for equipment and working capital.

Credit enhancement shifts risk from the borrower to the enhancement provider, which traditionally makes bonds less risky to the investor and potentially more affordable to borrowers. Credit enhancement can be provided by either commercial institutions, such as banks in the form of a LOC and bond insurers, or a public entity, such as a federal government agency. However, LOCs have become more expensive and more difficult to obtain or renew since the Great Recession as a result of bank downgrades, and new and pending capital requirements, such as the Basel III Accord. Bond insurance was a frequently used form of credit enhancement before the financial collapse of 2008, but bond insurers have largely disappeared today. There are no AAA-bond insurers and only one active insurer in the health care sector. However, for FHA Mortgage Insurance, hospitals often opt for taxable securities over tax-exempt to avoid paying the large negative arbitrage amount related to the construction fund and the debt service reserve fund at closing.

Hospitals that issue bonds publicly are subject to Securities and Exchange Commission (SEC) Rule 15c2-12 on continuing disclosure. Larger borrowers that regularly tap the capital markets for tax-exempt debt financing are well versed on post-issuance compliance requirements, but small or irregular issuers of debt may be surprised to learn the type and extent of information they must disclose once a transaction is completed. Rule 15c2-12 requires nonprofit borrowers to submit annual disclosures, typically financial audits and operating information, to the Municipal Securities Rulemaking Board (MSRB) through the Electronic Municipal Market Access (EMMA®) website at emma.msrb.org. The type of information that needs to be disclosed and when it is needed is specified in a continuing disclosure agreement. In addition, certain events that could impact bondholders also need to be disclosed within 10 business days of occurrence. The following is a sample list from MSRB:

❯❯ Principal and interest payment delinquencies
❯❯ Non-payment related defaults
❯❯ Unscheduled draws on debt service reserves reflecting financial difficulties
❯❯ Unscheduled draws on credit enhancements reflecting financial difficulties
❯❯ Substitution of credit or liquidity providers, or their failure to perform
❯❯ Adverse tax opinions or events affecting the tax-exempt status of the security
❯❯ Modifications to rights of security holders
❯❯ Bond calls and tender offers
❯❯ Defeasances
❯❯ Release, substitution or sale of property securing repayment of the securities
❯❯ Rating changes
❯❯ Bankruptcy, insolvency or receivership
❯❯ Merger, acquisition or sale of all issuer assets
❯❯ Appointment of successor trustee

Continuing disclosure rules do not generally apply when bonds are offered on a private placement basis to a minimum number of accredited investors in denominations not less than $100,000. Other rules apply, so consult with your broker-dealer, financial advisor and/or counsel.

Investor call protection, a defined prepayment schedule for investors, can prevent the issuer from forcing early redemption despite market improvements that could lead to refinancing opportunities. What this boils down to is that investors, regardless of bond financing or commercial options, have a minimum number of years to benefit from the security—no matter how low interest rates drop.
Capital Markets in Review

The Municipal Markets Data (MMD) curve hit a 40-year low in late 2012 as increased demand drove up health care bond pricing. This resulted in compressed borrowing spreads across the credit spectrum as interest rates moved inversely to price. In addition, the relatively low supply of health care bonds increased the demand from institutional investors, such as tax-exempt mutual funds. With those favorable conditions, nonprofit hospitals and health systems rushed to take advantage of the resulting low rates to fund strategic projects or restructure outstanding indebtedness to realize significant debt service savings.

However, in the spring of 2013, the economy began to show signs of recovery. There was enough improvement to prompt then Federal Reserve Chairman Ben Bernanke, who also was chairman of the Federal Open Market Committee (FOMC), to address the media at the conclusion of the committee's two-day meeting on June 19. In this press conference, he stated that the Federal Reserve could begin to taper the monthly open-market purchase of $85 billion of mortgage-backed securities and treasury securities—the quantitative easing program currently in place. This announcement resulted in a sharp sell-off in the bond and equity markets and led many investors and economists to believe a decrease in the rate of asset purchases would be announced at the conclusion of the FOMC’s September meeting.

However, contrary to popular consensus, the committee voted 9-1 to continue the pace of asset purchases at its September meeting. Bernanke cited a slow recovery in the labor market and the fiscal uncertainty in Washington as the primary drivers behind the decision to delay tapering. As an example, the bond markets rallied after the announcement, with the 10-year U.S. Treasury yield falling to 2.7% from 2.85% the previous day.

As the FOMC December meeting approached, bond markets anticipated a tapering announcement as evidenced by the yield on the 10-year Treasury note rising to 2.92%. During the meeting, Bernanke announced that the quantitative easing would begin to slow with a $10 billion reduction of monthly securities purchases beginning in January. While stock markets soared—the S&P 500 rose 1.66%—Treasury yields responded more gently as bond market participants already anticipated this move for many months. The announcement came six months after Fed Chairman Ben Bernanke first referenced the “tapering” of bond purchases.

Depending on whether the economy improves to a greater extent than the expected 2.25%-2.5% as forecasted by economists, the Fed could taper more quickly. On the other hand, if the economy underperforms, the Fed may put tapering on hold, thereby triggering a rally in bonds.

Overall, while fixed health care rates have remained volatile since the collapse of the financial markets in 2007, tax-exempt variable rate index (SIFMA) has settled at historic lows, trading at or under 15 basis points (0.15%) for 2013 and continuing into 2014. According to The Bond Buyer’s annual offering data, total U.S. bond sales were up 31% in 2012 because of historically low interest rates coupled with the increased volume of refundings—the first year that 2002 issues, a high volume year, became callable. As the year’s total bond sales of $376 billion were only slightly less than the 10-year average of $386 billion, it looked as if the market had begun to return to normal issuance levels as the U.S. economy continues to recover.

However, 2013 took a step back, with issuance dropping 12% to $329.8 billion. Investors who stayed in the tax-exempt market faced steep losses. With rising interest rates, spurred by the Fed’s announcements of tapering, bond prices fell. Additional blows that slowed the growth of the muni market included: the city of Detroit declaring bankruptcy in July, which raised concerns that it may default on its bond obligations; the financial crisis in Puerto Rico, which came to light in August and revealed that its struggling economy wasn’t covering its high debt load; and massive outflows from municipal bond funds. It is expected, however, that these situations will stabilize or improve in 2014. In fact, munis closed during 2013 above the historical average, with yields at 95% or more than those of Treasuries of comparable maturities.

Long-term concerns of the market continue into 2014, potentially muting growth. These issues, which could erupt at any time, include:

- Whether municipalities can continue to service their debt along with addressing any unfunded pension or health care liabilities.
- An increased focus on the muni market by the SEC for violations of securities laws. The agency has stepped up its enforcement actions highlighting the importance of municipal bond disclosure.
- Adoption of tax reform, which could limit the tax exemption for bonds. Although possible, it is very unlikely to be enacted this year. Most market participants believe President Obama will continue to include a 28% cap on the value of the tax exemption for munis in his 2015 budget. Although, if the federal government did limit or eliminate the tax exemption on bonds, it would cost nonprofit hospitals and health care organizations $5.8 billion to $16 billion every year in additional interest expenses, according to the National Association of Health and Educational Facilities Finance Authorities.
- Medicare and Medicaid reimbursement cuts as well as penalties imposed on hospitals for not meeting ACA requirements would increase the perceived risk of bonds issued by health care providers, pushing interest rates higher.
- New revenue cycle challenges posed by higher deductibles and out of pocket limits on many insurance policies.

Municipal Outlook—Factors in Play

It has been a rocky road to recovery for the municipal bond market. The 2012 muni market rebounded from the previous year’s total bond sales, which were at the lowest levels in a decade.
On the good news front, an improving economy is generating more tax revenue for municipalities. The Rockefeller Institute released a report stating that second-quarter state tax revenue increased 9 percent, on average, compared with the same quarter of 2012. In fact, tax revenue has been increasing for 14 consecutive quarters since the end of 2009. To underscore this strong growth, *The New York Times* reported that the municipal bond default rate was below 1 percent.

Another sign of stability is that bank holdings of municipal bonds grew to a record amount. According to *Bloomberg Politics*, commercial lenders hold about $390 billion of munis—about 10.5% of the market, a 4.5% increase from three years before. Although industry experts say that if the Fed’s liquidity requirement proposal to exclude local bonds from easy-to-sell assets is adopted, it could affect the way local bonds are accounted for in bank portfolios and reduce demand.

Assuming there are no major surprises in store for 2014, it is likely this year will be similar to 2013, with above-average volatility and muted returns for investors. The 10-year Treasury note, largely considered the barometer for long-term, fixed interest rates, could rise to 3.5% as the economy’s growth rate picks up, with the potential to hit 3.75%, according to many economists. But rates may be checked if the economy falls short of growth expectations and/or the Fed holds from further tapering of asset purchases.

As a hospital evaluates funding alternatives for its capital projects it is critical for its leadership team to recognize that access to capital is ultimately determined by a combination of microeconomic factors, such as a hospital’s credit profile, and macroeconomic factors, such as the state of the capital markets, and that today’s funding capabilities are markedly different from the not so distant past.

While tax-exempt, fixed-rate privately placed bonds and taxable bonds have increased in popularity for hospitals and health systems in the past year due to tightening of the health care spreads, the tax-exempt municipal bond market will continue to be a stalwart for high volume, long-term debt.

### Notable Requirements for Tax-Exempt Bonds

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Details of Requirement</th>
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<tr>
<td>95% Test</td>
<td>At least 95% of the bond proceeds must be used for land costs and depreciable property.</td>
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<tr>
<td>3-Year Spend-Down</td>
<td>Bond proceeds must be substantially spent within three years of issuing the bonds.</td>
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<tr>
<td>Maximum Allowable Weighted Average Maturity</td>
<td>The weighted average maturity of the bond issue may not exceed 120% of the reasonably expected weighted average economic life of the assets financed.</td>
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<tr>
<td>2% Maximum for Issuance Costs</td>
<td>No more than 2% of bond proceeds may be used to pay bond issuance costs.</td>
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<tr>
<td>25% Maximum to Acquire Land</td>
<td>Except for 501(c)(3) bonds, no more that 25% of the bond proceeds may be used to acquire land.</td>
</tr>
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<td>Required Inducement Legislation</td>
<td>501(c)(3) Bonds–A similar, but less stringent, requirement applies to 501(c)(3) bonds. In fact, nonprofit organizations may adopt their own internal resolution (referred to as a reimbursement resolution) to preserve the eligibility of incurred expenditures prior to receiving a formal inducement resolution.</td>
</tr>
<tr>
<td>Annual Dollar Limits by State and Accessing Allocation from State Volume Cap</td>
<td>501(c)(3) and Refunding Bonds–Allocation is generally not required for these bonds.</td>
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<tr>
<td>Required Public Hearing</td>
<td>Except for certain refunding bonds, there must be a public hearing on a proposed financing before the bonds can be issued.</td>
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14-Day Notice–Generally, notice of the public hearing must be published in a local newspaper at least 14 days prior to the hearing.