today's trends in capital financing
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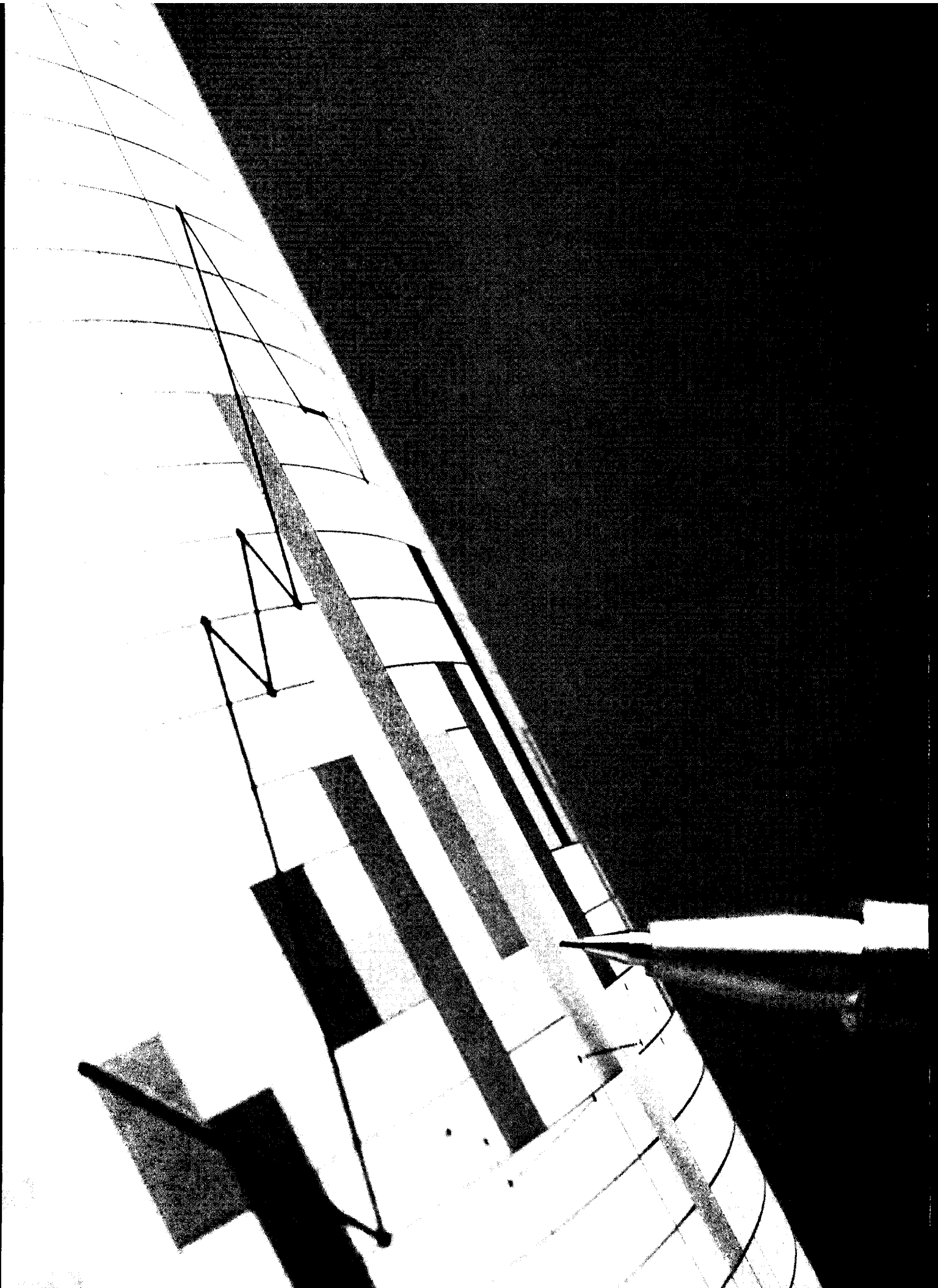

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today's trends in capital financing

Funding for capital projects is readily available to health systems of all sizes in 2013, but providers should conduct risk analyses before moving forward.

The year 2012 saw not-for-profit health systems continuing to review their capital structures and find ways to finance needed capital expenditures. As in the past, their spending projects were focused predominantly on facility improvements, new technology, and the funding of important strategic initiatives. A major trend in 2012, likely to continue in 2013, was the emergence of financing vehicles offering low cost of capital, increased flexibility, and quicker access to funds. Nonetheless, a good deal of uncertainty persists in the market and in the industry as a whole. Amid general industry and regulatory pressures, healthcare borrowers should proceed with care, performing rigorous analysis and stress testing before seeking access to the capital markets.

Market Environment

The volume of public offerings for healthcare borrowers increased slightly in 2012. The debt was issued primarily to convert variable rate debt, refund higher interest-rate debt, and develop new strategic capital projects. Investor interest remained robust at all rating levels in health care—the result of a steadily declining volume of new issues during the previous four years.

This pattern has continued in 2013, with the expectation that interest rates across the curve will remain low as borrowers continue to refund debt for interest cost savings. New money issuance also is likely to remain steady, because healthcare organizations must fund strategic capital needs while preserving liquidity.

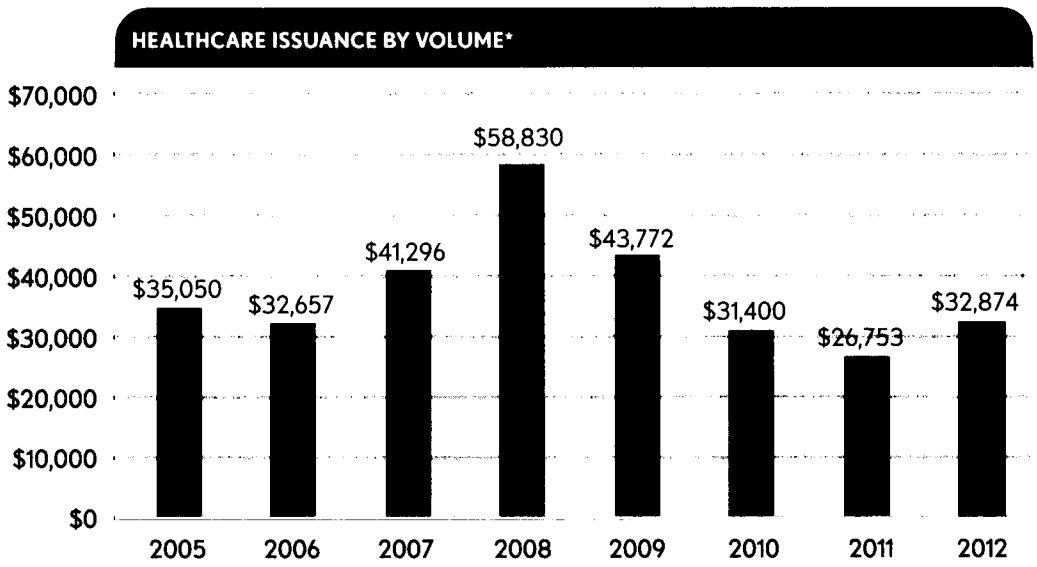
Despite the relatively strong market, the healthcare industry remains challenged due to the slower rebound of the nation's economy, the trend of declining patient volumes, pressures on reimbursement, and the overall uncertainty of healthcare reform. Facing an environment of increased competition and rapid consolidation, a number of providers have been compelled to pursue partnerships to prepare for the anticipated challenges ahead.

To overcome these obstacles and build themselves into stronger, more efficient care providers,

AT A GLANCE

A health system's approach to capital access in the coming year should include an in-depth analysis of different financing options, including:

- **Tax-exempt fixed rate bonds**
- **Tax-exempt variable rate bonds**
- **Taxable bonds**
- **Direct purchases**
- **New financing products**



* Dollars in millions.
Source: Thomson Reuters (Jan. 14, 2013).

health systems across the country are reevaluating their financial and capital risk profiles and taking advantage of different financing vehicles to satisfy their internal risk thresholds.

Risk Analysis and Mitigation

A primary focus for management teams is to reduce and mitigate risk and to diversify existing capital structures. Indeed, many health systems are willing to accept what might seem to be a weaker financial profile, and the risk of rating pressure that goes with it, to achieve strategic and capital profile objectives. Health systems are using flexible financing products that are free of the typical limitations of traditional tax-exempt bond issues. This flexibility allows them to respond quickly to the constantly changing environment, where strategic opportunities require swift and decisive action.

Health system leaders are thoroughly reviewing existing debt and swap portfolios to determine appropriate levels of interest-rate, tax, put, renewal, market, and counterparty risk exposure. This level of analysis is not new for larger health systems, but it is now being embraced by systems of all sizes, and the cost and interest rate associated with accessing the capital market—although still important factors in the decision-making process—are no longer the only drivers. Many systems are forgoing the lowest cost of capital in favor of the most stable risk-adjusted solution.

Notwithstanding the healthcare reform environment and associated desire to reduce risk, capital is readily available for health systems of all sizes, and the diversity of options allows them to balance risk, cost, and operating flexibility as they evaluate the most suitable alternatives.

Financing Alternatives

Concomitant with assessing their costs, risks, and resulting capital and financial profile, most health systems approach access to capital by evaluating five types of financing options.

Tax-exempt fixed rate bonds. Publicly issued fixed rate bonds constitute the most popular form of

financing for health systems. Given the minimal risk of these bonds, both compared with other financing options and in the current low-interest-rate environment, fixed rate bonds remain a fixture in the municipal market. This form of debt is available to organizations of all ratings and sizes; the borrower need only be willing to pay the costs. The stability of setting specific costs for a determined period and knowing when the interest payments will come due is appealing to both investors and health systems.

The tax-exempt nature of these bonds has caused demand for them to remain strong among both institutional and retail investors. During the past 10 years, except for a brief time during the financial crisis, access to fixed rate bonds has not been disrupted.

Despite their benefits, fixed rate bonds have limits and disadvantages, including a higher cost of capital, a higher cost of issuance, underwriting fees, investor call protection, and public disclosure requirements. Nonetheless, fixed rate bond issues are still highly preferred and the most common option for capital access. Compared with other financing vehicles, fixed rate bonds are viewed favorably by both rating analysts and investors due to their comparatively lower level of perceived risk and overall market access.

Tax-exempt variable rate bonds. The market for variable rate debt continues to be strong, although market volume has decreased significantly during the past few years. Current market rates make variable rate debt an attractive option for health systems looking for the lowest cost of capital. Variable rate demand bonds (VRDBs), in particular, are appealing because they not only offer a lower cost of capital, but also are more easily refundable.

However, these financing options require more in-depth analysis than is needed with fixed rate bonds because they carry a higher level of risk. Health system leaders should carefully consider the debt profile risks associated with VRDBs, for example, including bank exposure, put risk, remarketing risk, tax risk, and overall market risk. Another concern is that rating agencies are carefully scrutinizing variable rate products and are utilizing new metrics, such as cash to putable debt, to assess the risk and possible portfolio exposure.

The increased interest in these taxable bonds is due to various factors, perhaps the strongest being the lack of restriction on the use of proceeds.

These concerns have not deterred many health systems from pursuing these financing options. A number of organizations have determined that they can manage and hedge the risks while taking advantage of the benefits of variable rate debt.

Taxable bonds. Taxable bond issues have gained popularity among not-for-profit healthcare issuers recently. A number of large taxable issues were sold in 2012, and this trend continued in the first quarter of 2013.

The increased interest in these bonds is due to various factors, perhaps the strongest being the lack of restriction on the use of proceeds. Compared with tax-exempt bond issues, which have a number of limitations and restrictions, taxable bond proceeds may be used for any corporate purpose. Health systems therefore are free to use the funds for any number of different strategic initiatives, including the purchase of assets that do not qualify for tax exemption, such as facilities used by privately employed physicians and their employees, and the financing of short-lived assets, such as IT.

Moreover, because taxable bonds are not issued through a conduit authority, they often require fewer approvals and ongoing fees. Current market conditions also are favorable due to tight spreads between taxable and tax-exempt rates.

Health systems should consider a number of factors when weighing the benefits of taxable bonds. They are public offerings, requiring full offering documentation and ongoing public disclosure to investors. Investor presentations and meetings are typically required to market these bonds and ensure that potential buyers are fully educated on the health system.

An important concern is that taxable bond issues are typically issued in minimum sizes of $250 million, which makes them *index eligible*—i.e., eligible to be included in the Barclays Capital U.S. Long Credit Index, the standard benchmark index for managers of long-duration taxable portfolios. Issues that are below this threshold may incur an additional pricing penalty to remain appealing to investors.

Taxable bonds are either not callable or have only make-whole call provisions, meaning the borrower mast pay a lump sum derived from a formula based on the net present value of future interest payments that will not be paid because of the call. Therefore, to refund the bonds, the borrower must pay the investors the anticipated interest through maturity. This requirement makes the bonds, in effect, economically noncallable—an aspect that should be given serious consideration because it could impact future flexibility.

Direct purchases. Also referred to as *bank-bought bonds* or *direct lending*, direct purchases have become among the most popular ways for health systems to access capital. Due to inconsistent reporting, exact numbers for the total volume of direct-purchase transactions in 2012 are not available. However, it is safe to assume, based on the level of market activity, that this type of activity constituted 25 to 30 percent of healthcare financing volume.

Direct purchases can be structured at either fixed or variable rates, and can be either taxable or tax-exempt, depending on the use of the proceeds. A direct-purchase agreement is arranged directly between a bank and the borrower and, therefore, does not require any public disclosure or ratings, which streamlines the timing and overall cost of the financing.

Direct-purchase agreements are also structured for terms of three to 10 years, providing better protection against put risk than is offered by other variable rate products. There is a renewal risk once the term expires, but the long lead time allows for manageable planning. Renewal dates also can be staggered, further mitigating renewal risk with multiple series. Moreover, direct purchases reduce an organization's exposure to credit risk. Unlike letters of credit (LOCs) and standby bond purchase agreements (SBPAs), direct purchases are not affected by a bank's rating, and the bonds will remain outstanding until the expiration of the term of purchase.

The pricing for direct purchases is based on a credit spread, so lower-rated organizations will pay more for these agreements. However, direct purchases are available to organizations across the rating spectrum. This type of financing differs from a typical public deal in that there often will be multiple banks offering terms, making it possible to negotiate pricing before entering into an agreement. In normal circumstances, organizations with existing banking relationships through either treasury functions or credit will find that their banking partners are motivated to maintain these relationships and will work hard to provide

attractive pricing. Health systems should undertake a request-for-proposal (RFP) process, either formal or informal, to ensure competitive pricing and terms before selecting one or more banks.

Health systems should be aware of a number of potential pitfalls when considering direct purchases. As mentioned previously, the pricing for a direct purchase is based on the health system's credit, and pricing escalators are often built into the agreement, resulting in stepped-up rates if the health system is downgraded.

Direct purchases also may require additional covenants and reporting requirements, which senior leaders should review carefully to assess the impact on the health system's debt and capital profile and vet within the document before executing an agreement. These elements include early termination provisions, additional bond tests, limitations on strategic initiatives, provisions for bank access, events of default, and acceleration provisions. Some banks also may expect additional ancillary business as a part of the agreement. Many of these concerns are manageable and can be favorably negotiated, but it is important to address them before the bank or banks give final credit approval.

New financing products. A number of new products are being introduced gradually to the market. Some attempt to address the issues related to the implementation of Basel III. Part of the Basel III accord requires banks to hold reserves that offset their contingent liabilities, such as LOCs and SBPAs. As banks build their reserves, their costs will go up, which could result in higher fees for borrowers. Although these conditions have recently been loosened somewhat, banks remain focused on these potential requirements and are formulating new products that provide flexibility to avoid future higher fees. Other products focus on mitigating put, remarketing, or renewal risks.

Fortunately, capital remains accessible for health systems at most rating levels.

One such product, publicly offered floating rate notes (FRNs), has been successfully implemented during the past several years and is regaining popularity in the market. FRNs are a variable rate product that is typically indexed to either a percentage of the London Interbank Offered Rate (LIBOR) index or the Securities Industry and Financial Markets Association (SIFMA) index plus an additional credit spread. The coupons on these variable rate bonds reset quarterly. One benefit of FRNs is that they are not supported by a bank liquidity facility and therefore do not expose the borrower to bank or liquidity. However, FRNS do require public disclosure and typically have a put date that exposes the borrower to renewal risk.

It is likely that these new products will continue to emerge and that not-for-profit healthcare systems will continue to benefit from them as these organizations and their advisers consider new ways to access the capital markets. The new financing alternatives will likely take some time to achieve a large market presence and significant volume, however, as they are typically initially targeted to higher-rated organizations to build up their appeal to investors. In effect, this approach has created an "invisible rating floor," whereby organizations at a lower rating level are prevented from accessing the new products to maintain the products' appeal for those investors that currently hold the paper.

Rating Agency Concerns

Managing rating analyst concerns and determining potential "hot buttons" continue to be

important parts of the decision-making process for health system leaders who are analyzing financing alternatives. Rating agencies are becoming increasingly conservative in their reviews of health systems. They are placing greater emphasis on the overall stability of a health system's profile and on the extent to which different types of debt and mixes of products are exposing the health system to potential market pressures.

In addition to the typical reviews of financial performance, market position, management initiatives, patient volume, and physician partnerships, recent rating agency commentary on the industry mentions capital profile and debt mix as integral parts of the rating process. Rating analysts are cautious not to recommend any specific structures or debt mix, as their role in the market is not to provide guidance to borrowers. However, they do analyze and report on the risk profiles of health systems compared with those of their peers, and they often identify outliers and underscore them as credit concerns where appropriate. In general, the rating agencies continue to have concerns about the market and maintain a negative view on the healthcare industry.

Key Features of a Successful Strategy

Given the nation's challenging economic environment, 2012 provided evidence of the resiliency of the not-for-profit healthcare industry as the sector continued to enjoy access to the capital markets. However, not-for-profit health systems will continue to face the headwinds of an ongoing weak economy, declining inpatient volumes, increased competition, and the uncertainties surrounding healthcare reform. Because of these pressures, systems should prepare to move quickly to take advantage of strategic opportunities while carefully assessing the risks associated with these opportunities.

Fortunately, capital remains accessible for health systems at most rating levels. Allowing leadership teams to choose products that best meet their organizations' financing and strategic needs to invest in their facilities and remain competitive. Determining the level of risk to which an organization should be exposed in its capital profile and managing and balancing that risk with the organization's capital and strategic needs are considerations that will continue to challenge leadership teams. Risk assessment models and evaluation methods can be important tools for healthcare borrowers and their advisers to make the most informed and educated decisions.

The future of the capital markets under healthcare reform is hard to predict, but controlling costs with a balanced capital profile and developing the ability to proactively pursue partnerships and market opportunities, all while maintaining flexibility, clearly appear to be optimal strategies. ●

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