INITIAL IMPACT OF CORONAVIRUS ON CAPITAL MARKETS

Introduction

The past few weeks have been an extraordinary time for everyone and for every industry, especially the hospital and senior living sectors. The tax-exempt bond and bank private placement markets have been no exception. I have spent the past several days talking to banks, investment banks, and investors. The following is a summary of what I have gleaned from these various conversations.

The Bond Market

First, let's discuss the bond market. During the past year, tax-exempt borrowers, especially non-rated senior living providers, have been fortunate due to a record run of over 52 weeks of weekly cash in-flows to bond funds averaging about $1.6 billion per week. This created record low interest rates in the tax-exempt bond market, with interest rates on 30-year non-rated senior living transactions approaching 4.0 percent.

That ended three weeks ago due to the Coronavirus crisis when investors began to pull money out of tax-exempt mutual funds for the first time in a year. For the week of March 16th, the market had a record $12.2 billion of outflows from tax-exempt bond funds. That $12.2 billion figure surpassed the previous record by three times. This led to a complete lack of liquidity in the market, causing the 10-year tax-exempt MMD index (AAA rated index used by the market as a benchmark for tax-exempt interest rates) to reset 118 basis points higher (worse) over the course of the week. The tax-exempt new issue market was effectively closed.

However, the tax-exempt bond market is proving to be very resilient, although at much higher interest rates for borrowers, especially borrowers with lower or non-existent credit ratings. For the week of March 23rd, the tax-exempt market was buoyed by the emergence of crossover buyers due to the imbalance of treasury yields and municipal bond yields, news out of Washington that a stimulus package was forthcoming, and the potential for the Fed to buy municipal bonds. For the week, the 10-year MMD was lower (improved) by 145 basis points versus last Friday.

If the current tone continues, most investment banking firms expect new issues to pick up the week of March 30th, although the pace may be a bit slow due to borrowers gearing back up to produce the needed disclosure documents. Any recovery will be slow, and could be volatile, especially for the high yield sector. As we saw after the Great Recession of 2009 and 2010, it took some time for institutional investors to buy non-rated senior living deals – with the first sizable senior living deal ($75 million Galloway Ridge, NC) finally coming to market in October of 2010 – a full 18 months after congress passed a stimulus package.

A handful of smaller tax-exempt deals are getting done, but at much higher interest rates than before the Coronavirus crisis. For example, as mentioned earlier, prior to the crisis, non-investment grade senior living deals were getting done in the 4.15% to 4.40% range for a 30-year maturity. One of the deals that did come, a $85 million AA+ rated hospital transaction (March 25th), got priced at a 4.17% interest rate on the 30-year maturity. Two months ago, that same transaction would have priced below 3.0%. That makes it anyone's guess as to where a non-rated senior living transaction would price. Under current conditions, underwriters cannot perform "Price Discovery" on high yield transactions.

Goldman, trading senior living bonds during this period of uncertainty, has seen bonds across the credit spectrum trading in the secondary market at much wider credit spreads to the MMD index than in recent months. Because of this, it is difficult to determine the longer-term ramifications for the senior living sector once the markets get back to functioning at a more normal level.

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One thing is for certain. Due to the Seattle and New Orleans incidents, buyers perceive greater risk in senior living bonds than in other high yield sectors, which means that credit spreads will not come down to pre-coronavirus levels any time soon, if ever.

The Bank Market

During the past five years, senior living providers have also benefited greatly from the keen interest many banks have shown in the senior living sector. During the past year especially, those banks were lending at record low rates and credit spreads in order to compete with the long-term fixed rate bond market. Now that the fixed rate bond market is experiencing disruption, the banks now have more leverage, and they know it.

Here are some key takeaways that providers should keep in mind in the current environment when dealing with banks.

- Banks have capital to lend and are open for business
- Banks are going to look at ***balance sheet liquidity*** as a key metric when deciding to lend due to: 1) the recent equity market correction and, 2) the need for cash to weather a possible difficult upcoming operating environment
- Most new loans are for lines of credit to help entities establish a secondary source of liquidity so that they do not have to liquidate a stock portfolio at the worst possible time
- Banks are willing to lend for smaller expansions and restructurings, but will look critically at larger expansions
- Greenfield projects are a no-go for most banks given the current environment
- Priority will be given to existing clients with "full relationships"
- Most banks underscored the importance of working with borrowers who have worked to maintain a strong relationship, even if the bank was not the primary lender in the past
- Banks will ask how COVID-19 will impact occupancy and operations and determine whether a borrower has the wherewithal to make it through a prolonged downturn
- For the first time in a long time, some banks are adding LIBOR floors to their loans, meaning that the interest rate at which you borrow will not go below a certain level
- Finally, expect overall credit spreads to be wider, lengths of commitment to be shorter, and covenants to be more restrictive

In Summary

Think of any financing that is being currently contemplated as a tactical move instead of a long-term strategy. Like all markets, the tax-exempt bond and bank markets run in cycles, and borrowers should not lock in a long-term structure in the current high rate environment unless the structure provides a flexible and low-cost exit strategy. This may mean that bank financings are now a much more attractive option than they were two or three months ago.

If you are looking to bring a deal to market now or in the near future, a number of factors should be considered before making a decision to do so. In addition, as providers continue to focus on operations, including the safety of residents, use this an opportunity to establish new or larger lines of credit with your bank partners. As you do so, do not hesitate to reach out to your trusted advisors for assistance.