PEARL CREEK
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Capital Formation | John Franklin

12 WEEKS IN – A BOND MARKET UPDATE 5.28.20

Introduction

This Capital Markets Update will focus excusively on the fixed rate tax-exempt bond market. With so much information currently being disseminated, misconcpetions are bound to occur. We hope this update provides concise information to assist senior living providers in understanding some dynamics currently driving the tax-exempt bond market.

The Fixed Rate Bond Market Then

The last capital markets update PCA posted was near the end of March. At that time, we had three weeks of COVID-19's impact under our belts. Unfortunately, those three weeks were ugly for the tax-exempt fixed rate bond market, especially during the week of March 16th, a week in which the market had a ***record $12.2 billion of outflows from tax-exempt bond funds, three times the previous record.*** This led to a complete lack of liquidity in the market, causing the industry interest rate benchmark (30 Year MMD) to reset 118 basis points higher (worse) over the course of the week and roughly 200 basis points higher than its record low in early March. The tax-exempt bond market was effectively closed.

The Fixed Rate Bond Market Now

We are now 12 weeks into the COVID-19 pandemic and the tax-exempt bond market is slowly healing with several highly rated (A rated to AAA) deals getting done. This is due to bond funds finally experiencing cash in-flows for three of the past five weeks, with $1.8 billion of cash coming in to invest during the past week alone. In addition, the Fed announced a plan to buy up to $500 billion of municipal bonds. As a result, the tax-exempt MMD index has improved for AAA borrowers, with the 20 year and 30 year MMD spot rates improving considerably to 1.49% and 1.70% respectively, just 30 to 40 basis points higher than the all-time lows just before COVID-19 struck.

Because the market seems to be stabilizing somewhat at near all time lows, a misconception is occurring. One Life Plan Community CEO asked "If the bond market received $1.8 billion of cash to invest last week, and AAA tax-exempt interest rates are near all time lows, why can't we issue tax-exempt bonds now?" That is a fair question.

The following four factors are at play:

Lack of liquidity – remember, since mid-March, tax-exempt bond funds have lost $38 billion of cash to invest, even with the recent inflow.

Flight to quality - during volatile markets, investors prefer higher rated (AAA and AA) credits.

Portfolio risk - the senior living sector is currently seen as a high risk sector due to COVID-19

Fed Program - the Fed Buying Program is directed to help municipalities, not 501(c)3s.

Lack of Market Liquidity

Despite predictions that the unemployment rate may approach 20% and second quarter gross domestic product could drop by the largest amount ever, perhaps as much as 40%, many asset classes have rebounded during the last month. The Dow Industrials rose 11% and the S&P 13%. The corporate bond market has also rebounded, even for those firms with the lowest investment grade ratings with 10 year low rated (Baa) corporate yields falling to 4.15%, even with a predicted default rate of over 7.0%.

And despite a historic default rate of 0.09%, individual investors have pulled their money out of municipal bond funds due to the negative news around municipalities possibly going into bankruptcy, creating a lack of liquidty for tax-exempt bonds. The municipal bond market, because it is so small, is highly impacted by supply and demand dynamics. With little money to invest, municipal bond funds cannot buy, creating lower demand for tax-exempt bonds, which causes interest rates to go up, especially for lower rated credits.

This low liquidity phenomenon in the tax-exempt bond market is even pushing some highly rated 501©3 Hospital systems and Universities to issue taxable corporate bonds instead of tax-exempt municipal bonds. Examples include Northwestern University, which just completed a $300 million taxable bond financing, and Stanford University, which just completed a $750 million taxable bond financing. OhioHealth just issued $424 million of 40 year taxable bonds at an interest rate of just 3%. With such attractive rates, highly rated nonprofits are issuing much more taxable debt right now.

Flight to Quality

During times of uncertainty as we are currently experiencing, investors are willing to sacrifice higher interest rates in return for safety. We saw this play out with global investors understandably turning to the safety of U.S. Treasuries. The same is true in the tax-exempt bond market. As the tax-exempt bond market stabilizes, high quality credits (AAA to A) will be the first to have the opportunity to access the market, as we have seen.

Portfolio Risk

Investors not only look at individual credit risk, they also look at portfolio risk – what industries should they be invested in. Unfortunately, some industries, including the senior living industry, have been harshly portrayed by the national media, creating a negative outlook, which has spilled over into the tax-exempt bond market. Many well-managed senior living communities, exhibiting excellent financial metrics, few cases from the virus, a stable staff, and residents who are relieved to be in a safe environment, cannot access the bond market now.

The Fed Buying Program

Unfortunately, the Fed's announcement that it will buy up to $500 billion of municipal bonds is meant to act as a liquidity facility for state, city and counties by buying short term notes. Therefore, it is having little impact on bonds with longer term maturities and no impact for 501© 3 borrowers.

Light At the End of the Tunnel

Because no senior living borrowers have come to market since mid-March, the only proxy we have in terms of where a new senior living deal might get done is to look at where bonds are trading in the secondary market. For non-rated senior living credits, we are seeing trades between 350 basis points and 600 basis points over the AAA MMD index, which would translate to interest rates of 5.20% to 7.70%, which is a very wide range!

In addition, these trades could be misleading because secondary trades are usually much smaller in size than a new bond transaction, which may have trouble getting sold due to a lack of buyers with enough liquidity and appetite for senior living portfolio risk. However, we are seeing a light at the end of the tunnel, with a few high yield deals getting done.

In early May a small BBB rated Tennessee Hospital transaction was completed at a spread of 250 basis points over the MMD index, creating a 20 year rate of 4.30%. More recently, Baptist Memorial Health Care, a BBB+ healthcare system in the Southeast, came to market with a $273 million financing, priced at a spread of MMD plus 210 basis points, creating an interest rate of around 4.0%, which is extremely promising.

Last week saw the successful sale of a non-rated $16.5 million Charter School transaction that came to market at approximately 400 basis points over MMD, creating a 30-year interest rate of 5.75%. However, there is a caveat. Because of the perceived negative impact COVID-19 on the senior living sector, charter schools are seen as a less riskly investment than senior living communities.

In Summary

As mentioned in our March Market Update, any bond market recovery for the high yield sector (BBB- and lower) will be slow, and could be especially volatile for the senior living sector.

It took 18 months for the tax-exempt bond market to feel comfortable buying senior living deals after the Great Recession of 2008 and 2009. I do not think it will take nearly that long again. Those expecting widespread payment defaults and bankruptcies as a result of this pandemic are likely to be disappointed. Most non-profits in many sectors largely entered the current recession on solid financial footing. There will be exceptions. Borrowers who are over-leveraged, are poorly managed, or have little cash cushion will have difficulties.

We believe that while the headlines remain negative, the nonprofit senior living sector will lag other sectors in accessing capital via the fixed rate tax-exempt bond market. We will endeavor to keep you informed as to how the bond market evolves.