PEARL CREEK
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Capital Formation | John Franklin

15 WEEKS IN – THE BOND MARKET RE-ENGAGES6.18.20

Introduction

It is remarkeble how quickly market sentiment can change. Since our last market upate three weeks ago, the appetite for non-rated senior living bonds by institutional investors has become real as evidenced by the first non-rated tax-exempt senior living transaction getting completed since the COVID-19 crisis began.

This Update will provide some insight as to why institutional investors of long term fixed rate tax-exempt bonds may be re-engaging with the senior living sector and some specifices on the transaction that got done. We hope this update provides useful information for senior living providers in understanding the undercurrents driving this very positive turnaround in the tax-exempt bond market.

Three Weeks Ago

Because no senior living borrowers had come to market with a fixed rate bond issue since mid-March, the only proxy the market had for determining the interest rate at which a new senior living deal could get done was to look at secondary market trades and "high yield" deals in other sectors. Non-rated senior living secondary trades were occurring between 5.20% to 7.70%, which was a very wide range indeed.

Light at the End of the Tunnel

However, when we looked at other high yield sectors, we were seeing light at the end of the tunnel. In early May a BBB rated Hospital transaction was sold with a 20 year rate of 4.30%, only 250 basis points over the MMD index. We then saw a BBB+ rated Hospital deal get priced at an interest rate of 4.0%, only 210 basis points over the MMD index. And the light at the end of the tunnel became brighter with the completion of a traditional non-rated charter school transaction at 5.75%, 400 basis points over the MMD index. This caused many of us to scratch our heads. Why were investors re-engaging with other sectors, but not the senior living sector?

What Has Changed

Liquidy - Over the past four weeks, we have continued to see money flowing into tax-exempt mutual funds, with a four week total of $7 billion. This is creating the liquidity the market needs. In addition, July 1 is a huge redemption and interest payment date, meaning that bond funds will have even more cash to spend. At some point, funds have to put that money to work. And with little supply, they are beginning to re-engage with senior living credits.

Flight to Quality - During the earlier days of COVID-19, investors were willing to sacrifice higher interest rates in return for safety. However, now that things are stabilizing, investors are looking to do some "opportunistic investing," which means that investors are willing to sacrifice safety for higher returns if they believe that certain credits are good bets. PCA believes that well-managed senior living communities that exhibit good liquidity, few cases from the virus, and have maintained good morale with both residents and staff are now being seen as good bets by investors.

Portfolio Risk - Unfortunately, the senior living industry has been harshly portrayed by the national media, creating a negative outlook, which has spilled over into both for-profit and non-profit senior living sectors. This is expecially true for senior living REITs. Although many asset classes have rebounded during the last month, senior living REITs have not. Their stock prices have not bounced back with the rest of the equity market. However, ***investors are beginning to differentiate credits within the senior living industry*** instead of avoiding senior living credits altogether. Like REITs, those non-profits that have a diversified product mix with not as much dependence on skilled nursing will be seen as better credits than those who are not diversified and have a lot of skilled nursing exposure.

The Federal Reserve

Other than investors differentiating specific credits within the senior living industry, I think the Fed's decision last week to hold interest rates near zero through 2021 and potentially through 2022 is driving investors to seek yield, and causing them to re-engage with the senior living sector. The Fed's response has been an unparalleled level of agreement in its outlook for monetary policy. All 17 current Fed policymakers see the key overnight interest rate, or federal funds rate, remaining near zero through next year, and 15 of 17 see no change through 2022.

Even in the depths of the 2007-2009 financial crisis and recession some policymakers raised a cautionary

flag about the need for higher interest rates to guard against inflation. There is no such debate this time. The Fed's preferred measure of inflation is expected to be a weak 0.8% this year, compared to the central bank's goal of 2%, and rising to just 1.7% at the end of 2022.

Most recent projections start to show just how long it might take for inflation to be a concern again. Fed officials see the unemployment rate falling to 6.5% at the end of 2021 and 5.5% at the end of 2022 - still a full 2 percentage points above where it was at the end of last year, representing millions of lost years of work and wages.

The US core consumer price index has fallen for three consecutive months for the first time in history, triggering worries that deflation could become ongoing. The index, which excludes food and energy, declined 0.1% in May, 0.4% in April and 0.1% in March, according to the Bureau of Labor Statistics.

If the Fed has unparalleled agreement that interest rates should remain low for the next two and a half years, what do you think bond investors are thinking? Well, they might be thinking that they should do some "opportunistic investing." Enter stage left our first fixed rate senior living deal in three months.

Rose Villa

Like many senior living borrowers who were expecting borrowing rates near 4.0% before COVID-19 hit, Rose Villa, a slightly less than 400-unit single-site Life Plan Community in Portland, Oregon, had to put its bond financing on hold when the fixed rate bond market shut down. And like other borrowers, Rose Villa began to look at an "all bank" financing as a way to move forward. In the current market, "all bank" financings are getting done well below 3.0%. A case in point - the recently completed $100 million "all bank" financing for Lenbrook Square in Atltanta was completed at an interest rate well below 2%. However, because Rose Villa could not meet the loan-to-value ratio required by banks, an "all bank" financing was not an option. As a result, Ziegler, Rose Villa's investment banker, decided to test the fixed rate tax-exempt bond market.

The Transaction

As the final phase of a three-phased multi-year repositioning effort, the proceeds of the $79 million financing were being used to build 42 new ILUs, provide below building parking, expand common areas, and replace a 40 unit healthcare center. Rose Villa had a historical 1.68x debt service coverage ratio and 361 days cash on hand. With an assumed 35 year interest rate of 5.75% in the preliminary official statement ("POS"), Rose Villa was projecting a 1.38x debt service coverage ratio and 364 days cash on hand.

Ziegler mailed the POS June 8 and held an investor webinar on June 11, and priced the transaction yesterday, June 17. Marketing of the deal went extremely well with over 30 investors participating in the transaction, allowing an aggressive call feature of 102% in five years declining to 100% in year seven.

Because the transaction was over-subscribed, the underwriter was able to push borrowing yields down to 4.52% for the10 year maturity, 5.03% for the 20 year maturity, 5.23% for the 30 year maturity, and 5.34% for the 35 year maturity. These rates are well below most recent trades in the secondary market, indicating that secondary trades as little as two weeks ago were not indicative of appetite building in the primary market.

In Summary

The take-away is that due to the factors noted earlier, the high yield tax-exempt bond market is healing faster than expected. That is especially good news for the senior living industy and potential borrowers. PCA believes that the liquidity issues that hurt the tax-exempt bond markets earlier in the year are reversing and will become a positive as money continues to flow into tax-exempt mutual funds.

A bit of caution - borrowers who are over-leveraged, are poorly managed, or have little cash cushion may still have difficulty accessing the bond market.

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