Borrowing has been inexpensive in recent years. The historically long period of low interest rates has enabled many hospitals and health systems to execute advance refundings of existing bonds, either to obtain economic savings or to alter the organization’s capital structure to better reflect a desired risk profile or a merged credit structure.

An advance refunding is the most common form of refinancing an existing bond when the call date is more than 90 days away. This tax-exempt refinancing may occur only once in the life of the debt associated with the underlying financed projects.

In this low-rate environment, investors are adjusting to the new rate realities in the instrument’s economics. The security and covenants they now require are historically favorable and offer not-for-profit healthcare borrowers “cleaner” and reasonably flexible indentures. Moreover, due to the demand for paper, lower-rated credits have better market access to advance refunding. Public deals now occur for sub-investment-grade credits, which was not always possible in the past.

Finance executives considering an advance refunding often have a difficult choice in exercising this important strategy. Factors a finance executive must consider include the state of the current market, future expectations, the organization’s financial situation (both now and going forward), management’s capacity for such an effort, and the range of savings that might occur if the decision is made to wait.

Specifically, not-for-profit healthcare borrowers wrestle to balance two options:

> Lower the cost of capital and potentially update associated security and covenants now, while the market is advantageous
> Await a potentially better refinancing situation later

Numerous market-based concepts or tools may sway the decision of executing an advance refunding.

**Lower Coupons**

Given the endurance of low rates, investors buying tax-exempt debt show signs that they are receptive to coupons for longer-term bonds structured lower than the historic standard of 5 percent or greater. Among pricings that occurred Jan. 1, 2016, through Sept. 14, 2016, coupons were less than 5 percent for 44 percent of term bonds.

Couponing structure plays an important role in “all-in” cost of capital for the hospital borrower. A lower coupon results in lower yield to maturity, which in turn lowers the probability that the borrower will exercise the early call option—

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a. Thomson Reuters’ municipal market data (MMD)—the benchmark rate for the municipal bond market—is down to about 2 percent since its high of more than 4 percent in the fall of 2013 and 8 percent in 1986.
b. Refundings within 90 days are considered current and may be done with no limit. When a call date is in the future, a borrower must fund an escrow to service the debt until the date when the bonds may be called away from the investors. Tax-exempt refundings involving an escrow beyond 90 days are currently limited to one per the life of the project financed.
c. Kaufman Hall analysis of data from proprietary database of public tax-exempt fixed-rate transactions.
traditionally set at year 10 for longer maturities. Investors traditionally prefer coupons around 5 percent for protection against price gains and losses over time. The lower market yields relative to the coupon rates result in an upfront premium. A side effect of offering an original issue premium is that it gives borrowers a further incentive to refinance early and eliminate the higher-cost coupon, which can turn a 30-year bond into a 10-year commitment.

Borrowers may be able to obtain lower coupons when advantageous, which allows them to preserve the low cost of capital for longer periods. This option is increasingly possible because the yield required by investors for such structures is becoming less prohibitive. The overall cost may be lowered in the near term should a borrower not mind assuming the risk of a future refinancing implied with higher-premium, higher-coupon bonds. A thorough breakeven analysis prior to bond pricing can indicate whether a lower coupon is beneficial. Like other diversifiable elements, coupon structure should be considered in light of the greater portfolio.

**Efficiency Ratio**

Many finance experts focus on efficiency ratios in connection with an advance refunding. Although efficiency ratios have several forms, all forms aim to assess the now-versus-later concept for accessing refinancing savings. It is generally best to avoid adherence to just one approach. All things being equal, savings should increase over time because escrow cost is reduced. However, negative arbitrage factors already are “baked in” to the present-value savings numbers. Rather than focusing solely on the efficiency ratio, scenario analyses that use differing times (e.g., delay) and rates (e.g., market- or spread-influenced) are recommended. The efficiency ratio is helpful in describing a particular nuance of a transaction but should be viewed in a broader context.

**Flexible Call Options**

Hospital borrowers who wish to preserve their ability to call advance refunding bonds early without the use of taxable debt may be able to use a special call provision. In addition to the traditional 10-year call option, borrowers may be able to use a call structure that is designed to accelerate the call-option date and create a current refunding (i.e., no restriction to calling the bonds). The structure is not a savings panacea but is useful for borrowers needing flexibility for various reasons.

**Note Substitutions and Short-Dated Calls**

Given the high level of consolidation activity in the industry, some organizations are waiting to take advantage of refunding savings until mergers occur. On a case-by-case basis, additional flexibility may be gained with the introduction of certain factors to new bonds or perhaps through factors already present in existing bonds.

In the case of note substitutions, borrowers can alter master trust indentures without the common consent requirement of the majority of bondholders if certain requirements are met. Otherwise, short-dated calls effectively shorten a potential escrow period and mitigate economic barriers to a refunding when needed. Of course, both methods must be in place in order to provide flexibility, so preparing now could pay dividends later.

The low-rate environment is advantageous for advance refundings. The experience of others with such refundings offers valuable perspective on the tradeoffs between moving now to refund while the market is advantageous or waiting for a potentially better refinancing situation later.

d. “Refunding” bonds are the new bonds used to finance the escrow of the prior “refunded” bonds.

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