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TREASURY AND CAPITAL MARKETS

Capital Markets 2018 Wrap-Up and Trends to Consider for 2019

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2018 was a year of transition in healthcare finance, driven by tax reform-related adjustments and the Federal Reserve's ongoing migration to higher rates. 2019 will offer new challenges, but also will reflect the impact of currently visible trends and issues. Four key issues to track in 2019 include market conditions, capital and credit considerations, relative value, and capital structure risk considerations.

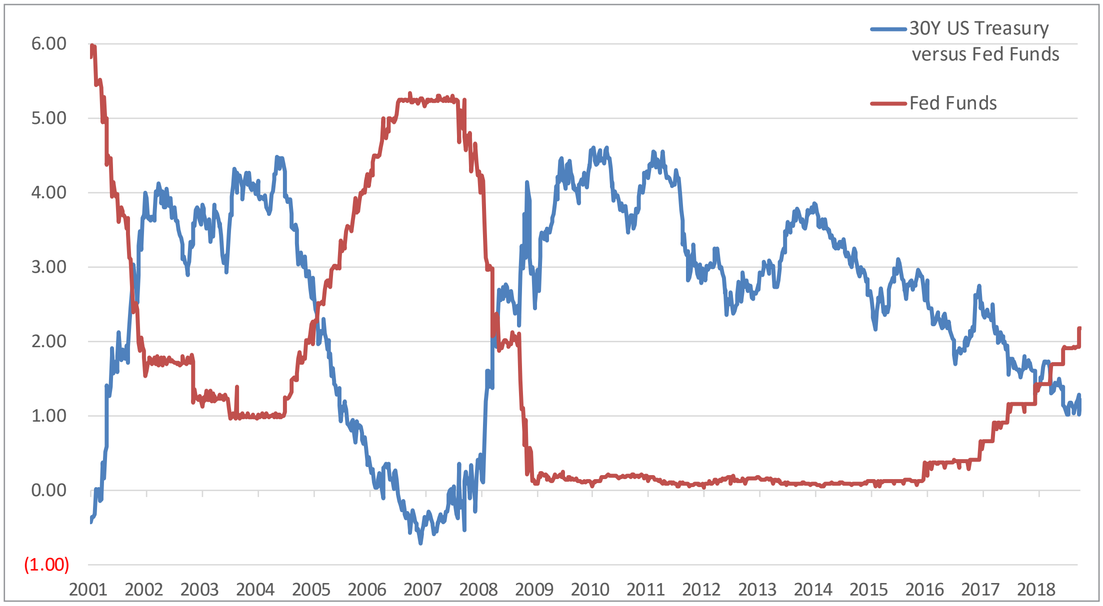
Market Conditions

After eight separate rate hikes, the federal funds rate is now at 2.25 percent, up from 0.25 percent during the almost seven post-credit crisis years. In response to improving U.S. economic performance, the Federal Reserve has signaled that it expects another 0.25 percent rate hike in December 2018 and then incremental movements to 3.00 percent in 2019 and 3.50 percent in 2020. The Fed is pursuing these hikes with the goal of finding the right balance between fueling growth and containing inflation.

One interesting aspect of the rate environment has been the flattening of the yield curve (Exhibit 1). As the Fed raised short-term rates, long-term rates have moved—but not as much. If this holds, long-term investors, which feel the consequences of inflation the most, will either signal that they do not share the Fed's concerns about inflation or are motivated by other considerations. Significant single-day moves in longer-term treasuries posted in the early days of October, so perhaps our animal spirits really are awakening and we are headed to higher rates paired with a "normal" curve.

EXHIBIT 1. TOTAL CURVE SPREAD OVER TIME

Source: Kaufman, Hall & Associates, LLC.



The yield curve consideration for 2019 is tied to questions about the pace and impact of our journey to higher rates:

1. Will the Fed hold to its indicated pace of rate hikes, and if so, how will the yield curve respond?
2. After 10 years of "never seen that before" movements in the global fixed-income markets, is history still a decent guide for making yield curve-driven decisions?
3. Is it likely that we may once again head into a relatively short duration, flat-curve environment, or are we in for a different experience?

Curve shape is important because it influences matters ranging from capital structure composition to trade opportunities. A flat-curve environment supports several capital structure tilts:

- ***The issuance of fixed-rate debt:*** All things being equal, a flat yield curve offers a lower reward for incurring the risks that accompany unhedged floating-rate debt. This dynamic is supported by the continued low level of absolute interest rates. Of course, issuers continue to access floating-rate debt to achieve and properly manage their debt portfolios, either to reach a fixed-to-floating target or to maintain a synthetic fixed structure.

- ***The incurrence of long-duration, fixed-income liabilities (bonds or swaps):*** Flat curves mean the cost to extend fixed income duration is relatively low (i.e., low spread between 10-year and 30-year rates). Again, when combined with relatively low absolute rates, there is a bias to incur longer-term liabilities.

- ***The use of forward-starting products (bonds or swaps):*** A flat yield curve reduces the carry costs associated with forward-starting positions and makes delayed delivery structures more appealing. Swap-based forward structures are fairly easy to implement, but the development to watch is the forward period that can be achieved using bond-based structures.

- ***The use of specific trading strategies:*** A "constant maturity swap" is representative of the opportunity to take a trading position against curve shape. With this product, an organization pays one-month or three-month LIBOR and receives a percentage of the five-year or 10-year constant maturity swap. As the curve flattens, the organization can lock in a relatively higher ratio. Once that higher ratio is locked in, increasingly positive cash flows will be generated as the yield curve reverts to a more normal, upward slope.

Capital and Credit Considerations

Similar to the capital markets, the strategic and operating environment confronting healthcare organizations remains in transition, with risks embedded in operations, a changing competitive environment, and investment requirements that impact both balance sheet and operating resources. Despite these issues, the amount and diversity of capital available is impressive. Traditional bond investors remain supportive across all rating classes, and the sector continues to attract strong participation across capital pools, such as real estate, equipment, and other types of specialty investors.

A consideration rolling into 2019 is whether the healthcare industry will retain this access to diversified capital pools or whether funding will be adversely impacted by an improving U.S. economy or organizational operating challenges. The issue is especially important with the bank sector, given that direct and contingent products are critical to the support of most floating-rate debt portfolios held by hospitals and health systems. Non-bank floating-rate products are available, but they have been less reliable or require structured products that are seen as either too complex or risky for organizations to embrace. Bank reliance remains a risk factor for the industry, making the identification of alternative strategies an important consideration.

Another question is whether the industry is positioned to take advantage of all available types of capital. One representative issue is whether the facilities and equipment portfolios carried on healthcare balance sheets are properly sized and capitalized. If these portfolios are too large, resource deployment may be inefficient. This scenario is not acceptable in an increasingly strained operating environment, where efficiency in resource deployment is critical. The best solution would be to monetize the excess investment for redeployment into higher-returning activities. A solid understanding of the composition and strategic role of current asset portfolios is required for organizations to reach a reasoned point of view around whether the portfolio is over- or undersized and how best to respond.

Relative Value

Another consideration going into 2019 is the relative value between tax-exempt and taxable instruments and how this impacts borrowing activity. A reduction in the issuance of fixed-rate, tax-exempt debt occurred in 2018. This drop was expected following the elimination of advance refunding transactions under the 2017 tax reform act. Whether the reduction was not material enough or some other forces are in play, the reduction in municipal supply seems to have had a muted impact on the relative value of long-duration, tax-exempt instruments. For many organizations, this has continued to provide economic support to the issuance of taxable debt at the longer end of the yield curve.

Different relative value "action" has occurred at the front end of the yield curve—where better net cost performance periodically emerged from structures like put bonds, or put bonds paired with short-duration, fixed-receive swaps to create synthetic floating-rate debt. Market-driven opportunities come and go, so it is important to determine on the front end whether the organization is interested so it can position itself to respond.

Capital Structure Risk Considerations

Floating-rate debt is a critical part of the capital structure of most healthcare organizations, so tracking relevant trends remains important going into 2019. Attention should be paid to true or core variable-rate debt, but also to the role that quasi floating-rate strategies, such as basis swaps, can play in managing capital structure risk and cost. The relevant considerations remain the amount of capital structure risk the organization should take and the mechanisms used to create the target exposure.

In the floating-rate product world, most attention has been responding to the decline in corporate tax rates from last year's tax reform and how those lower tax rates impact the economic appeal of bank direct-purchase transactions. The decision confronting organizations is whether to:

- Remain in the private market structure, with the advantage of not having to do a public offering
- Transition back to a structure that requires a public debt offering, such as variable-rate demand bonds
- Use structured products, including various interest-rate swaps, to create the exposure

This last factor—the use of structured products—is critically important. The 2007 credit crisis created significant capital structure dislocations, with some particular challenges attached to fixed-pay swap portfolios. The challenge for every healthcare organization going forward is compartmentalizing the past experience to make good and reasoned decisions about the current use of interest-rate swaps and other structured products.

No different than considering the use of hedge funds or alternatives in investment portfolios, derivatives and other structured products can create the opportunity to pursue the cost benefits of floating-rate exposure while managing underlying risk exposures. Organizations that have *significant* floating-rate exposure likely need to manage their bank exposure, and they may be able to realize an improved risk position by using alternative structures. Organizations that have *minimal* floating-rate exposure may be able to reduce cost through the use of swaps or other products that allow the introduction of targeted risks.

Going Forward Into 2019

The defining characteristic of healthcare is change—across operations, strategies, and the balance sheet—and 2019 will offer more of the same. The sector has enjoyed extended access to abundant, low-cost, and relatively low-risk capital. Access, cost, and risk will change in 2019, and it will be interesting to see by what degree—both in isolation and relative to each other. The answers will shape all of the year's capital structure and transaction decision making and execution.

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This article is a preview of the Capital Finance column, which will appear in the December 2018 issue of *hfm* magazine, published by HFMA.