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How Will Evolving Capital Markets Impact Your Debt Structure Decisions Going Forward?

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Welcome to the first of a continuing series of capital markets updates, intended to help our clients and friends understand marketplace conditions and their capital structure implications going forward.

A Look Back

Significant cross currents in the late 2000s led to the 2007-2009 Credit Crisis, subsequently setting in motion lower interest rates in the U.S. and worldwide. Factors fueling the downward trend in rates included the Federal Reserve's accommodative monetary policy, a global flight to quality and safety in U.S. Treasuries, lower expectations for corporate earnings, limited earnings multiples for equities, and a general aversion to risk.

These conditions have made many healthcare borrowers favor fixed-rate debt. Locking in "historically low" long-term interest rates could be achieved without incurring excessive capital structure risk, and so the popular trend has been to pursue this strategy. Even for borrowers with policy parameters outlining a target mix of fixed-rate and variable-rate debt, clients often have elected to exceed the fixed-rate target in favor of the issuance of "never-to-be-seen-again" interest rates for traditional fixed bonds. Additionally, as fixed rates have trended lower with the passage of time, borrowers have been able to replace legacy fixed debt with less expensive fixed bonds through current and advance refundings.

Additionally, for many borrowers that issued variable-rate debt before the Credit Crisis, much of that debt was swapped to fixed with long-dated interest rate hedges. Notwithstanding the desire to take advantage of near-zero short-term interest rates, many borrowers have maintained legacy swap positions to avoid the substantial termination payments often required for negative swap valuations.

Many healthcare borrowers now have a combination of fixed-rate debt and some variable-rate debt hedged by legacy swap positions.

Heading into Deeper Waters?

After a long hibernation, the "animal spirits may be awakening." U.S. jobs growth has begun to post higher numbers in recent months, and business confidence has increased substantially. A new administration in Washington D.C. appears to have invigorated the equity markets, at least for now, with the Dow approaching 21,000. The Federal Reserve raised short-term rates by 25 basis points in March with consensus expectations on the horizon for two more rate hikes in 2017. The 10-year Treasury, which is 2.40 percent, is now 28 percent higher than the day before the November presidential election.

While these trends demonstrate pronounced shifts in economic and market conditions, the lingering effects of the Fed's massive balance sheet expansion portends that we will face long-term structural issues. The Fed stockpiled $4.5 trillion through several rounds of quantitative easing[1] bond-buying and other accommodative measures designed to boost the economy. Minneapolis Federal Reserve President Neel Kashkari recently dissented against the hike of short-term interest rates, citing a lack of plans for dealing with the Fed's massive balance sheet.[2]

A broader degree of uncertainty and risk now may be present or appearing in the market. Changes expected under the new administration with U.S. policies on taxation, national and global defense, immigration, the environment, healthcare reform, and other areas are contributing to what some people express as a sense of global volatility, and others express as the promise of economic growth.

Questions that healthcare management teams should be discussing at this time include:

- How much capital structure risk can and should our organization carry given the broader market for opportunities and risks?
- How does our appetite for capital structure risk change, and what are the appropriate products available to organizations along the credit spectrum?
- What capital structure flexibility may we need, given merger opportunities, cost improvement initiatives, changes in asset use, and other strategic needs?
- What interconnections should we be tracking related to volatility between our investments, debt portfolio, and operating performance?
- How should organizations manage existing swap positions in a rising long-term rate environment?

Principles that guide capital structure management remain intact. Financial executives must identify/quantify the organization's appetite for risk, and suggest how the "risk budget" is allocated among competing investment opportunities. A diversified portfolio of products and markets reduces overall capital structure risk. Enterprise risk and other analytics are vital to shaping that portfolio and the ratings achieved to support the desired cost of capital. Policies, such as with swaps, should be in place, but they should leave room for pursuit of market opportunities within the organization's risk-tolerance bandwidth. Inclusion of means to identify and hedge risks are integral to high-quality policies.

Strategic market conditions may put a premium on having a flexible capital structure. Given the possibility of increased volatility, board-level education and buy-in to the policies and their practical applications are critical. As always, please let us know if we can be of assistance.

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References

[1] "Quantitative easing" is a monetary policy that was used by the Federal Reserve from 2008 to 2014. It involved the Fed's purchase of longer-dated Treasury and mortgage-back securities as a means of influencing rates and keeping markets liquid by increasing the money supply.

[2] Belvedere, M.J.: "Lone Fed Hike Dissenter Neel Kashkari: We Shouldn't Fix What's Not Broken." *CNBC,* Mar. 20, 2017. http://www.cnbc.com/2017/03/20/feds-Kashmir-says-his-vote-against-rate-hike-is-based-on-lack-of-inflation.html (accessed Mar. 23, 2017).

