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## OVERCOMING WALL STREET: SEVEN STEPS TO BETTER BOND PRICING

By Kerry Rudy and David Johnson

Perched at his trading station, Ziegler's senior high-yield bond trader, Howard Manning, watched a major health system's bond offering unfold with a numbing familiarity. "Here we go again," he exclaimed to no one in particular.

The major health system was in the market that day to price a large bond issue, whose proceeds will fund its ambitious campus transformation program. Manning thought the proposed interest rate on the system's term bond was too high. Recently, Ziegler had traded a \$6.3 million block of similar system term bonds at a yield 75 basis points lower than the proposed yield on the new term bonds. Manning followed the major health system's credit closely and wondered about the proposed pricing for their new bonds, "Nothing has occurred in the market to justify this high pricing level!"

A 25-year municipal market veteran, Howard Manning is an intellectual, data-driven trader. He tracks all secondary market trades in tax-exempt healthcare bonds and his data is legendary within Ziegler. Pricing credit risk is his specialty and he knew instinctively that the major health system's bonds offered exceptional value for investors. Manning tried to buy a block of similar system bonds at 15 basis points below the new issue's pricing level. There were no sellers or even indications of interest. He concluded the market value for the major health system's long-term bonds was 25-30 basis points lower than the levels offered by the issue's underwriters. Twenty-five basis points will cost the major health system several hundred thousand dollars in higher annual interest costs. The underwriters locked-in a small yield decrease in the final pricing. Almost immediately, investors began trading the term bonds actively in the secondary market, taking quick profits on the bonds they had just purchased.

As the above case study indicates, an investor's value comes at the borrower's expense. When underwriters underprice bonds, investors rush to buy the cheap securities and many "flip" them the next day for a quick profit. In our view, this pricing approach is happening too frequently, driving up debt costs for healthcare providers. Ziegler analyzed the 32 tax-exempt, fixed rate healthcare bonds priced during the first half of 2009. Immediately after pricing, twenty-eight (88%) of these issues traded actively in the secondary market. Moreover, they traded an average of 11 basis points lower in yield.

Bond pricing in 2009 is the least efficient in years. Raymond James's national sales manager is quoted in a July 8 *Bloomberg* article, "Buy-and-Hold Muni Investors Make Bonds Disappear" describing the pricing of Build America Bonds as follows (*italics added*), "underwriters made certain to *price the bonds at levels that clearly represented value*... This novelty of *quick value-capture* created a magnet that drew investors and traders into the chasm like moths to a neon sign." Let's explore what healthcare borrowers can do to improve the pricing on their bond issues.

### IMPROVING EXECUTION

Justice Felix Frankfurter famously noted, "Sunshine is the best

disinfectant." Our hope is that shining a light on current pricing inefficiencies will improve the pricing of healthcare bond issues. As Howard Manning would exhort, "We can do better!" Even in today's difficult market, healthcare borrowers can manage a successful bond offering in concert with their underwriters and financial advisors. It requires diligence, openness and a willingness to challenge entrenched behaviors. Bond placement is not rocket science. Increasing demand for a bond issue leads to more effective placement and lower interest rates. Here are seven steps to help lower your bond yield:

- **Get Serious about Investor Relations:** Involve the CEO. Consider an annual meeting and quarterly conference calls. Practice state-of-the-art disclosure. Answer questions when asked. Don't hide bad news. Building trust and a reputation for honesty pays dividends with investors.
- **Issue Quarterly Disclosure/Consider Independent Research:** Greater transparency and access to information enable investors to gain more comfort with a health system's credit. Independent research (as distinguished from desk research and rating agency reports) can enhance this benefit by offering alternative opinions and consolidating relevant credit information.
- **Conduct Pre-market Investor Calls/Meetings:** Directly engaging investors prior to the bond sale focuses investor attention and generates positive sales momentum. Most pre-market activity centers on large mutual funds. Creating forums to engage smaller institutional and individual investors can literally yield lower interest costs.
- **Cater to "Directed Retail":** This large investor class is emerging as an important source of demand for tax-exempt healthcare bonds. Directed retail refers to investors who purchase on behalf of small groups of individual investors and for their own accounts. Investors in this class include bank trust departments, wrap accounts and money managers. Directed retail purchasers prefer bonds with shorter maturities where large institutions often have less interest.
- **Pursue Retail:** Engage brokerage firms with the ability to sell bonds to individual investors. Adjust the offering to make particular maturities attractive to retail buyers. Sell serial bonds. Conduct a one-to-two day retail order period prior to initiating institutional sales. Broad retail sales solidify an offering, reduce placement pressure and position the underwriter to be more aggressive with institutional buyers. As a result, strong retail placement lowers interest rates.
- **Establish Effective Distribution Rules:** Require the senior managing underwriter to establish syndicate rules, membership and compensation to reward co-managers that generate real orders for bonds. Avoid block orders that lead to quick profit-taking (aka "flipping"). Don't shut out retail investors. Include provisions that encourage "directed retail" orders during the retail order period.

- **Monitor Secondary Market Trading:** This is particularly important immediately following the bond sale when quick profit-taking occurs. Require the senior manager to report in writing on secondary market trading during the first week after bond pricing.

The Adventist Health System (AHS) follows most of these practices. They set the industry standard for investor relations, including hosting well-attended annual meetings for their bankers and investors. Their effort pays dividends. In mid-June, AHS priced a \$330 million transaction over two days. After aggressive pre-marketing, the retail order period generated over \$100 million in orders, including \$30 million-plus in "directed retail" orders. A large institutional order book withstood pressure to raise yields in a declining market. In fact, AHS reduced long-bond yields by three basis points while the market (MMD) increased by four basis points. Overall, AHS achieved the best bond pricing this year for an "A1" rated healthcare bond issue based on interest rate spread to the "Aaa" MMD index. Secondary market trading in AHS's bonds followed normal patterns that existed prior to 2009 with minimal changes in bond yields. There was no "flipping" to earn quick profits.

President Reagan reduced his negotiating philosophy with the Soviet Union to three simple words "trust, but verify". Healthcare borrowers should employ the same philosophy when engaging the capital markets. Trust that making the effort to inform investors proactively will increase interest and facilitate efficient bond pricing in both the primary and secondary markets. Verify that underwriters and financial advisors conduct the bond sale process to maximize investor demand by fully engaging retail, directed retail and institutional buyers.

There is an old Ziegler saying: "Bonds are sold and not bought." During boom times when liquidity was ample and buyers plentiful, healthcare bonds almost sold themselves, but that certainly is not true today. Health systems, along with their bankers and financial advisors, have to sell the credit story with enthusiasm to all buyer groups. From this, greater bond demand and lower bond yields will follow.