KNOW THE RISKS: BANK DIRECT PLACEMENTS

Bank direct placements have become a common source of capital for our not-for-profit hospital borrowers in the past decade. As was the case with auction rate bonds, certain floating rate products, structured derivative products, and others, it is important to consider and actively manage the latent risks associated with bank direct placements.

Through its analysis of the credit worthiness of a borrower, the rating agencies review a borrower’s capital structure and evaluate certain risks associated with bank placements: acceleration risk, renewal risk and the associated contingent liability. In addition, other concerns have been voiced by the investing community over the lack of transparency with respect to covenant packages and event of default triggers. While these are important concerns, there are other risks from the borrower’s perspective that are not regularly discussed and recent developments in the market increase these risks.

“YIELD MAINTENANCE” OR “YIELD PROTECTION” PROVISIONS

Nearly all large-bank direct placements contain provisions aimed at maintaining the bank’s level of profitability on its direct placement in the event post-issuance circumstances erode the bank’s return. It is not always apparent when and under what circumstance a bank can enforce this provision, but many are outside of a borrower’s control.

Briefly, some events that can affect the bank’s total return include, but are not limited to:

- **Bank Credit Risk.** A deterioration in the bank’s credit situation and/or rating can cause its funding costs to increase. The bank can pass the increased cost to the borrower, but there is no provision to allow the opposite to occur.

- **Regulatory Changes in the Banking Industry.** An increase in the capital reserve associated with the placement. The cost of the additional reserve requirement can be passed on to the borrower.

- **Corporate Tax Risk.** Since many tax-exempt placements are derived formulaically based on a taxable index (typically LIBOR, which will be discussed later) and adjusted for a bank’s presumed tax rate (e.g., 65% multiplied by like-tenored LIBOR or perhaps 75% of LIBOR, etc.). In the event corporate tax rates decline (which the Trump administration has made a priority), banks will have the right to increase their adjustment factors, perhaps retroactively, thereby increasing the interest rate on its direct placements.

All of these considerations are applicable to both fixed and variable rate placements.

MAKE-WHOLE PROVISIONS

Make-whole provisions associated with fixed rate bank direct placements are aimed at making the bank’s profitability consistent through the loan’s commitment period even in the event the borrower wishes to terminate early. Again, if the borrower wishes to terminate early due to lower interest rates, a merger, etc., the calculation to make the bank “whole” is formula-driven. If the result of the calculation is in the bank’s favor, the borrower owes a payment. On the other hand, if the result of the calculation is in the borrower’s favor, it gets nothing and pays nothing. This is the “one-way” nature of the make-whole.

When this provision is coupled with yield maintenance, it becomes even more concerning. Consider a situation where a bank enacts its right to increase the interest rate on a loan through the yield maintenance clause. Now, the borrower wishes to exit the relationship and move on to a more beneficial product or lender, but the current placement has a make-whole. If the initial placement were longer-dated, the make-whole could be very punitive. In this scenario, the borrower is essentially trapped with the initial lender and the increased costs.
While we believe banks will continue to offer tax-exempt direct placements to not-for-profit borrowers, the product, like so many others before it, will likely face an evolution and the less apparent risks should be well understood by borrowers upfront and contingency plans considered.

LIBOR PHASE-OUT
The next consideration is the London Interbank Offered Rate or LIBOR. As has been well documented, LIBOR has been subject of market manipulation by some of the financial institutions instrumental in setting the rate. LIBOR has been widely relied upon in the financial markets to set interest rates on everything from credit card debt, car loans, and home loans to more complex not-for-profit tax-exempt loans and highly structured financial derivatives.

Recently it has been reported that LIBOR will be phased out by 2021 and there will be a new reference rate to replace U.S. Dollar LIBOR. In June 2017 the U.S. Alternative Reference Rates Committee voted to adopt an index to be based on short-term repurchase agreements backed by Treasury securities. Adoption of the new rate will be strongly encouraged, which brings about uncertainty in the market, and specifically to the topic at hand. As the reference rate on a borrower’s fixed or floating rate direct placement is replaced, it will have unknown consequences and may adversely affect a borrower’s rate as the market acceptance of the new index takes hold and liquidity builds to a similar level as LIBOR.

THE CALL FOR TRANSPARENCY AND RECENT DEVELOPMENTS
There is continuing effort to bring transparency to the direct placement market. In March 2017, the Municipal Securities Rulemaking Board (MSRB) released a statement regarding the SEC’s Proposal to Improve Bank Loan Disclosure. In the SEC’s proposal, it voted to advance a proposal to amend Rule 15c2-12 under the Securities Exchange Act of 1934 to include two additional required disclosures, both related to bank placements. The SEC voted to include disclosure regarding:

- Incurrence of a financial obligation of the issuer or obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the issuer or obligated person, any of which affect security holders, if material; and

- Default, event of acceleration, termination event, modification of terms, or other similar events under the terms of the financial obligation of the issuer or obligated person, any of which reflect financial difficulties.

The MSRB has advocated for these changes since 2012. While this amendment seems appropriate to most every analyst and portfolio manager, we have heard from many bank lenders that they strongly prefer to keep their covenants and other terms private. If the additional 15c2-12 provisions are adopted, or if the much-debated concept of mandating bank loans be assigned a CUSIP number pick back up, banks may re-evaluate their participation in this market, forcing borrowers to find alternative sources for capital.

While we believe banks will continue to offer tax-exempt direct placements to not-for-profit borrowers, the product, like so many others before it, will likely face an evolution and the less apparent risks should be well understood by borrowers upfront and contingency plans considered.
ABOUT THE AUTHORS

John Hanley joined Ziegler in 2003. As managing director and head of healthcare finance, he is responsible for the management and direction of the healthcare practice line. John has more than 20 years of experience providing a broad range of capital market solutions and strategic, financial advisory services to clients throughout the country. His clients consist of large regional healthcare systems and independent community hospitals.

Over his career, John has structured a diverse number of tax-exempt and taxable debt solutions. In addition, he has provided unique and innovative capital solutions for complex projects, which include the use of off-balance sheet financing and sale-leaseback structures. Most recently, he has spent a considerable amount of time on strategic planning discussions with clients resulting in his participation in acquisitions.

Prior to joining Ziegler, John was a co-head of healthcare for the investment banking division of National City Bank. He received his B.A. from the University of Detroit in Michigan.

Scott Winter joined the healthcare team at Ziegler in 2011. As a managing director, he provides strategic, quantitative, and analytical advice relating to the capital needs of clients throughout the healthcare services industry. Scott has extensive experience structuring various types of fixed and variable rate bond issues, implementing debt management, and hedging strategies through the use of derivative products, and assisting with mergers, acquisitions, divestitures and affiliations. He has served a variety of healthcare organizations in the Midwest including multi-state hospital systems, stand-alone community hospitals, specialty hospitals, for-profit physician groups, and long-term care companies.

Prior to joining Ziegler, Scott held investment banking positions with PNC Capital Markets and A.G. Edwards & Sons; prior to his career in investment banking, he was a research associate at a Midwest equity research boutique.

Scott received a B.S. from Miami University and a Masters in business administration from Cleveland State University. He is a CFA Charterholder, a member of the CFA Institute, and the CFA Society of Cleveland. Additionally, Scott is a member of Northeast Ohio chapter of the Healthcare Financial Management Association and serves on the Board of Directors of the Catholic Community Connection, a collaborative organization that brings together Catholic healthcare, human services and education in northeast Ohio.
ABOUT ZIEGLER HEALTHCARE

Ziegler is a premier investment bank to community and regional healthcare providers. For over 80 years, we have been assisting these organizations with creative, tailored financial solutions for their capital needs. Specializing in healthcare, Ziegler offers an array of services including investment banking, financial risk management, merger and acquisition services, as well as capital and strategic planning.

WHO WE ARE

As a premier investment bank to community and regional healthcare providers, Ziegler prides itself on its narrowed healthcare focus and innovative approach to capital sourcing. With more than 100 years of experience, Ziegler is a recognized leader in the healthcare sector throughout the U.S.

Since our first healthcare financing in 1928, Ziegler has become an industry leader in underwriting tax-exempt healthcare bonds across the care continuum, including health systems, hospitals, long-term care providers, physician group practices/clinics, senior living facilities and healthcare services organizations. We work with providers of all sizes and credit ratings by providing innovative and tailored solutions to meet the challenges of continuously changing healthcare and financial environments.

PRODUCTS & SERVICES

Ziegler has developed a suite of innovative products and services that accommodate the most complex financings for virtually every type of hospital and healthcare organization.

• Tax-Exempt and Taxable Bonds
• Alternative Financing Structures
• Strategic Partnerships and Sell-Side Advisory
• Buy-Side Advisory
• Valuations
• Research

CLIENTS WE SERVE

• Community Hospitals
• Critical Access Hospitals
• Multi-State and Single-State Health Systems
• Tertiary Care Hospitals
• Academic Medical Centers
• Physician Practices

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