Municipal Bonds

Mid-Atlantic Association for Financial Professionals

Municipal Capital Markets Group
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Speakers

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The Basics

- What is a Bond?
  - ✓Loan made by a Bondholder to a borrower, paid back with interest, e.g., a U.S. Savings Bond.
- Person receiving interest income ALWAYS pays taxes on the interest earnings unless they buy a MUNICIPAL BOND.

What is a Municipal Bond?

- Municipal Bond – A debt obligation of a state, city, county, redevelopment agency, housing authority or other political sub-division or public body or instrumentality of a state.

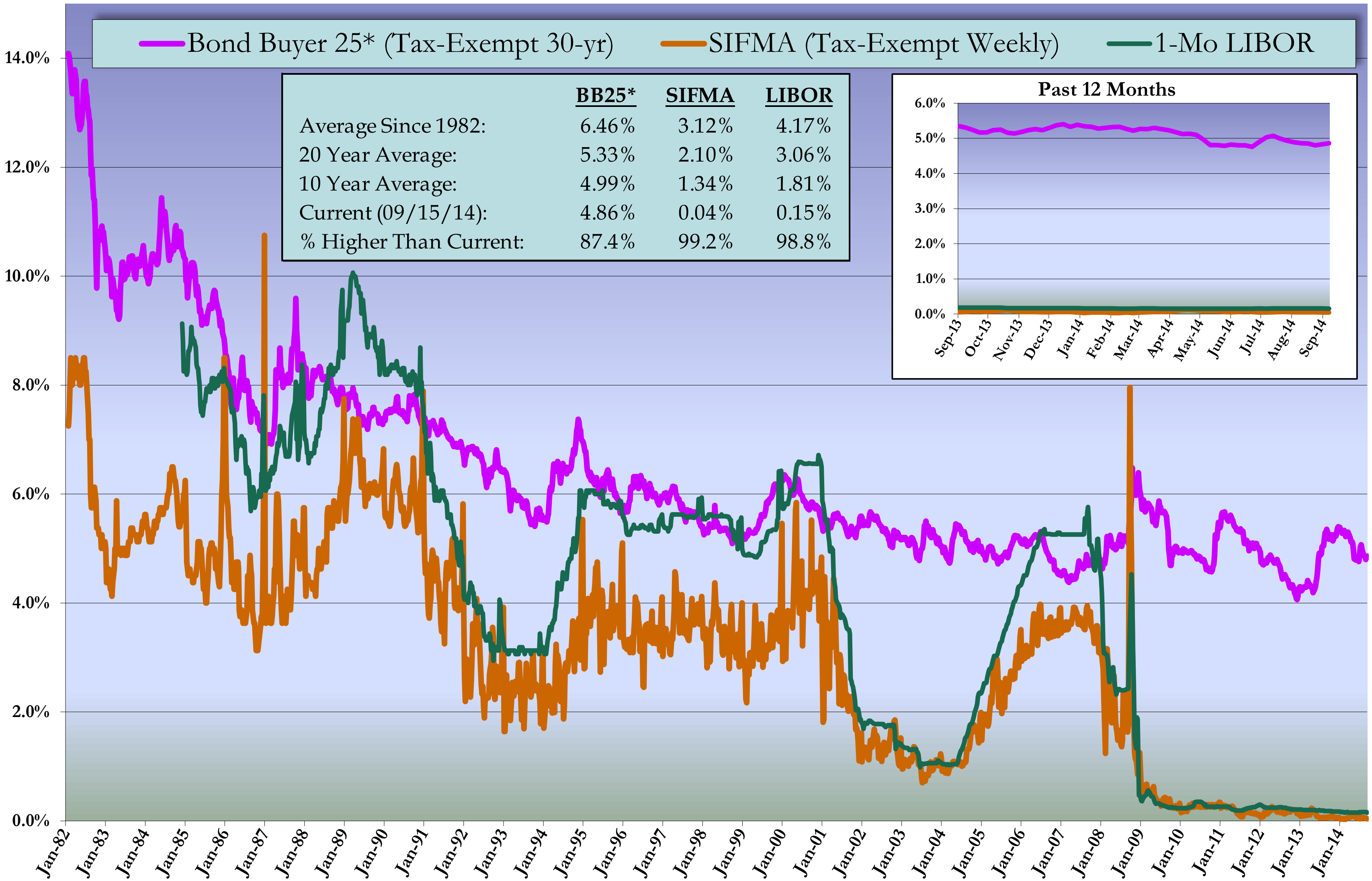
  - ✓ Bonds issued by the federal government are <u>not</u> municipal bonds.

  - ✓ Bonds issued by Section 501(c)(3) corporations are <u>not</u> municipal bonds.

    - ➢ Section 501(c)(3)s can issue bonds to finance their activities, but those bonds are taxable.

    - ➢ Section 501(c)(3)s can have a municipal issuer issue its bonds on a tax exempt basis and lend proceeds to the (c)(3) for certain charitable purposes.

Historical Interest Rates Comparison



Section 103 of Internal Revenue Code

- Provides that interest on municipal bonds is excluded from gross income for federal income tax purposes.

- Most states also exempt interest on muni bonds issued in that state from state income taxation.

  - ✓ Often, the municipal issuer uses the proceeds itself for general public purposes, such as roads, water and sewer systems, police and fire departments, schools and other publicly owned facilities.

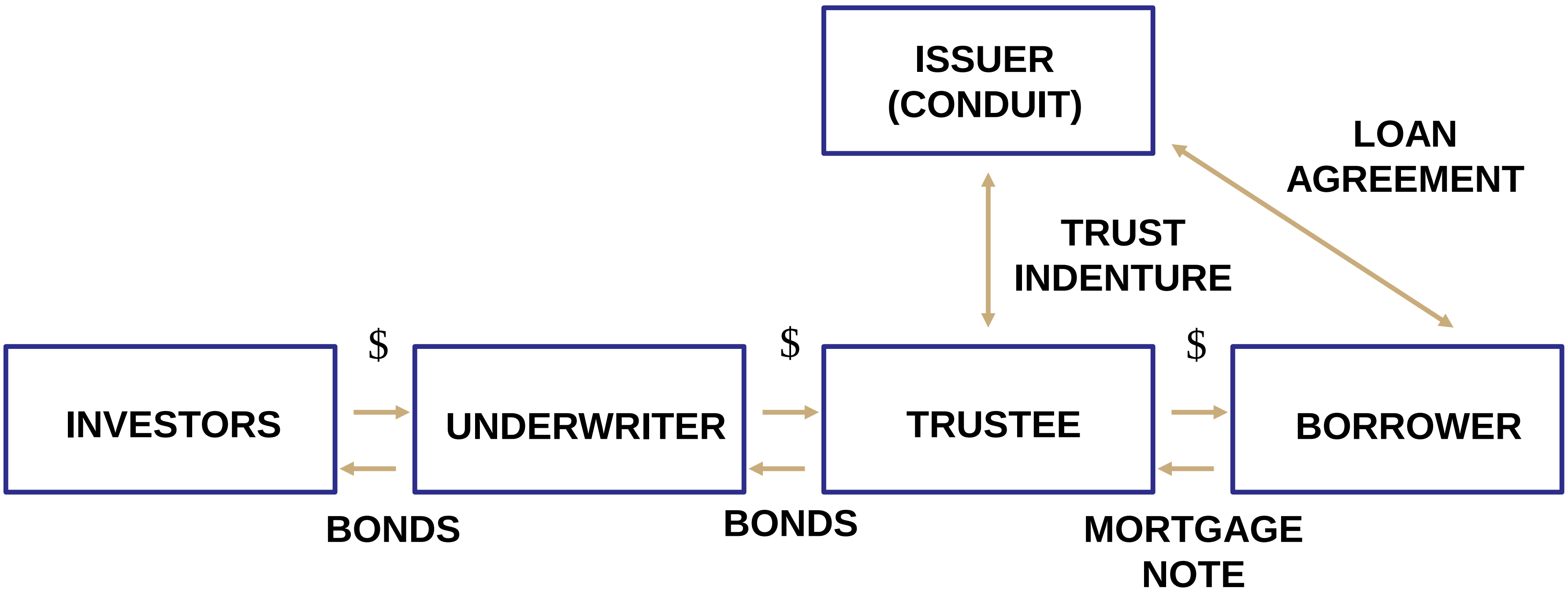
  - ✓ These bonds are often backed by the general credit of the municipal issuer and are called general obligation bonds or sometimes are backed only by revenues from a certain public enterprise and are called revenue bonds.

The availability of such tax or other benefits may be conditioned on meeting other requirements.

Section 103 of Internal Revenue Code (cont.)

- In other cases, a municipal bond issuer may loan the proceeds to a non-governmental borrower – a profit-motivated entity such as a developer or a Section 501(c)(3) nonprofit corporation – which agrees to use the proceeds to finance an activity which has a specified beneficial public purpose.
- Such approved purposes include airports, certain educational facilities, docks and wharves, pollution control, certain privately owned water systems, industrial development, certain single-family housing and certain affordable and seniors rental housing facilities.
- In 1986, these “quasi-public purpose” bonds were labeled “private activity bonds,” and Congress limited the volume of such bonds which could be issued by each state to stem growing a revenue drain the federal treasury.
- These bonds are generally not backed by the general credit or revenues of the municipal issuer, which serves as a mere “conduit” to lend the tax exempt bond proceeds to the owner of the “quasi-public purpose” facility.

Basic “Conduit” Financing Structure – Non Credit-Enhanced



Types of Bonds

- Bank Qualified Bonds
- Traditional Fixed Rate Bonds
  - ✓Enhanced
  - ✓Rated
  - ✓Non-Rated
- Variable Rate Bonds

Tax-exempt Fixed Rate Bonds

- Interest rate is fixed to maturity (maximum maturity typically 30 years)
- Maximum maturity determined by the Borrower
- Bonds may be sold based on the strength of the Borrower without the need for credit enhancement
- Long-term commitment
- Rate premium to fix for the long term
- Bonds typically cannot be pre-paid for a 10-year period

Recent Market Conditions

- Interest rate updates on 30-year maturity:
  - ✓ 34 basis point increase since January 2013
- Through June 2014, supply is at approximately $179 billion, which is down approximately 17% from same time last year
- Weekly supply is low, averaging $5 billion
- Positive mutual fund inflows for 28 of the first 35 weeks in 2014
- YTD net inflows are $5.9 billion
- Weaker growth for the first half of 2014 has dimmed hopes that the Fed will move rates
- 30-year indicative interest rates:

  BBB: 4.40%

  A: 4.05%

  AA: 3.80%

Sources: Thomson Reuters; MMD

Holders of Municipal Debt

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013*
TOTAL DEBT OUTSTANDING	**2,821.20**	**3,019.30**	**3,189.30**	**3,424.80**	**3,517.20**	**3,672.50**	**3,772.10**	**3,719.40**	**3,714.40**	**3,721.10**
HELD BY:										
Households	1,522.90	1,600.70	1,635.60	1,673.60	1,720.90	1,827.90	1,871.70	1,806.80	1,657.00	1,647.10
Mutual funds	293.8	311.2	343.9	371.6	389.4	478.8	525.5	541.2	627.4	641.2
Money market funds	322.3	349.1	392	496.6	509.5	440.1	386.7	357.3	336.7	309.6
Closed-end funds	89.1	89.3	89.3	91.2	77.9	81.2	81.6	82.5	85.8	85.5
Exchange-traded funds	0	0	0	0.6	2.3	5.9	7.6	8.6	12.3	12.5
Nonfinancial corporate businesses	31.8	32.1	28.1	29.2	26.2	27.1	23.9	22.5	34.8	28.5
Nonfarm noncorporate businesses	4.3	4.4	5.8	5.3	4.9	5.1	5.6	5.7	5.8	5.8
Government-sponsored enterprises	44.6	39.7	36.1	33.3	31.3	29.1	24.9	21	17	33.5
State & local government general funds	5.7	6.9	8.3	10	10.4	11.5	12.8	12.9	12.1	12.1
Rest of the world	26	29	34.4	45.1	51	58.7	71.7	70.3	65.4	59.2
U.S.-chartered depository institutions	147.8	166.1	190.1	202	221.9	224.3	254.6	297.3	363.1	390.3
Foreign banking offices in U.S.	0	0	0	0	0	0	0	0	0	0
Banks in U.S.-affiliated areas	0.3	0.5	1.3	2	2.5	3.5	2.5	3.4	2.6	2.7
Credit unions	0	0	0	0	0	0	0	3.2	4.2	5
Property & casualty insurance companies	267.8	313.2	335.2	371.3	381.9	369.4	348.4	331	327.6	330.4
Life insurance companies	30.1	32.5	36.6	41.4	47.1	73.1	112.3	121.6	131.2	132.8
State & local government retirement funds	2.5	1.6	1.6	1.5	1.3	1.4	2.2	3.1	5	5.8
Brokers & dealers	32	42.9	50.9	50.1	38.7	35.4	40	30.9	26.6	19
ISSUED BY:										
State & local governments	2,438.20	2,579.20	2,679.60	2,825.60	2,842.70	2,954.90	3,023.60	2,970.00	2,964.30	2,970.40
Short-term	44.2	42.5	34.3	51.2	55.8	63.6	63	52.3	56.1	39.4
Long-term	2,393.90	2,536.70	2,645.20	2,774.40	2,786.90	2,891.30	2,960.60	2,917.60	2,908.20	2,931.00
Nonprofit organizations	197.6	212.7	229.1	250.2	259.5	265.4	263.2	255.5	241	235.7
Nonfinancial corporate businesses	185.4	227.3	280.6	349	415	452.2	485.4	493.9	509.1	515

*Figures for 2013 are as of June 30, preliminary and seasonally unadjusted. Dollar amounts are in billions of dollars. Components may not add to totals because of rounding. Source: Federal Reserve Board, Flow of Funds Accounts, Flows and Outstandings, Second Quarter 2013

Source: Bond Buyer

Bond Issue Participants

- Issuer
- Issuer's Counsel
- Bond Counsel
- Financial Advisor / Municipal Advisor
- Borrower's Counsel
- Underwriter
- Underwriter's Counsel
- Trustee and Trustee's Counsel
- Rating Agency

Hospital Sector Discussion Topics

- Health Care Credit Themes
  - ✓ Rating Agency Outlook
  - ✓ Credit Trends
- Access to Capital

Rating Agency Key Hospital Credit Themes

- All three rating agencies assign the hospital sector a negative outlook:
  - ✓ Declining inpatient volumes, increased use of high-deductible health plans and reimbursement pressures from payors has led to declining profitability
  - ✓ Harder-to-find cost savings…low hanging fruit gone
  - ✓ Uncertainty about the Affordable Care Act
- Management critical to navigate the changing environment
- Strategic partnerships will continue…scale matters

Negative Outlook Narrative

"…**negative sector outlook reflects the forces of pressure** weighing on the sector (lower reimbursement, suppressed inpatient volumes, higher deductible plans and additional spending cuts) as it enters this potentially historic period of change"

Fitch, *December 11, 2013*

"The **negative outlook is due to a multitude of factors**, including: top line revenue constraints, the impact of health care reform readiness activities, soft demand, and emerging changes to the payment environment"

Standard & Poor's, December 10, 2013

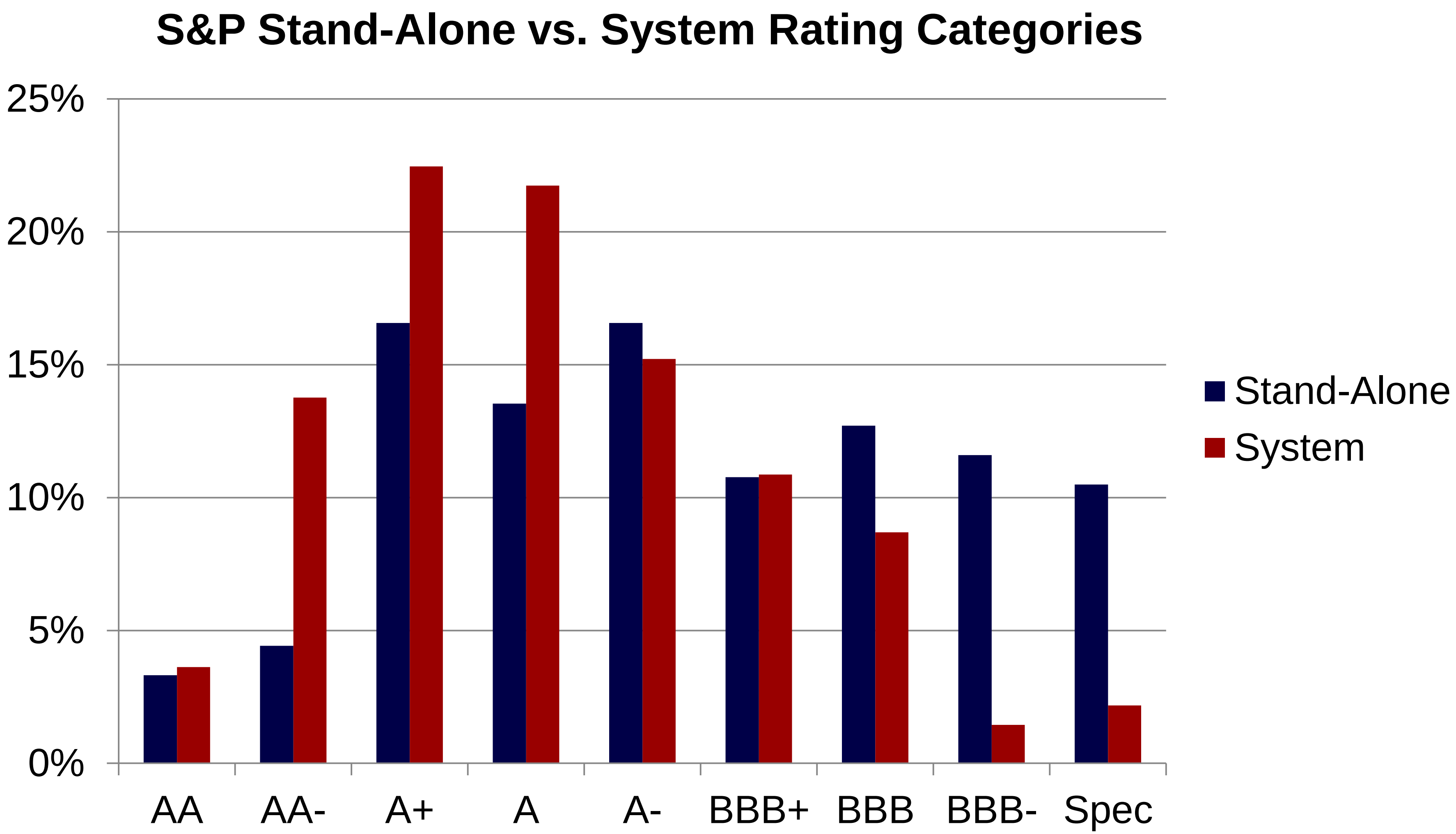
"Our **sector outlook for not-for-profit hospitals remains negative** reflecting the challenging operating landscape over the next 12-18 months as patient volumes shrink and revenue growth slows"

Moody's Investors Service, November 25, 2013

Why Does a Credit Rating Matter?

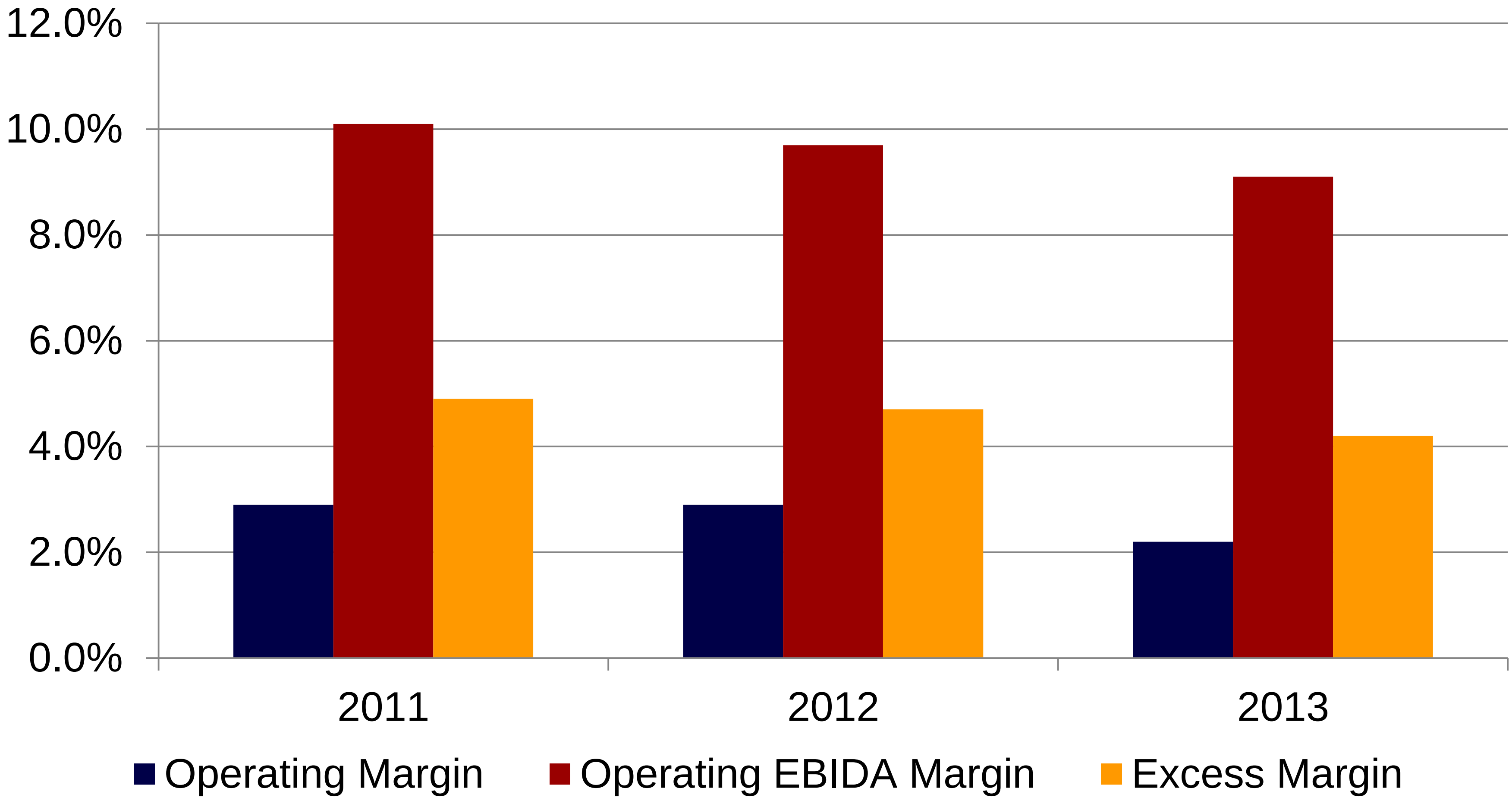
- Stronger organizations have improved capital market and borrowing opportunities
  - ✓ "A" vs. "BBB" rated credits' historical interest rate spread range typically 75+ bps
  - ✓ Broader access to a variety of debt options
- Stronger organizations are market consolidators
- Stronger organizations can make strategic investments and tolerate a longer "pay-back"

Scale Matters



Source: S&P

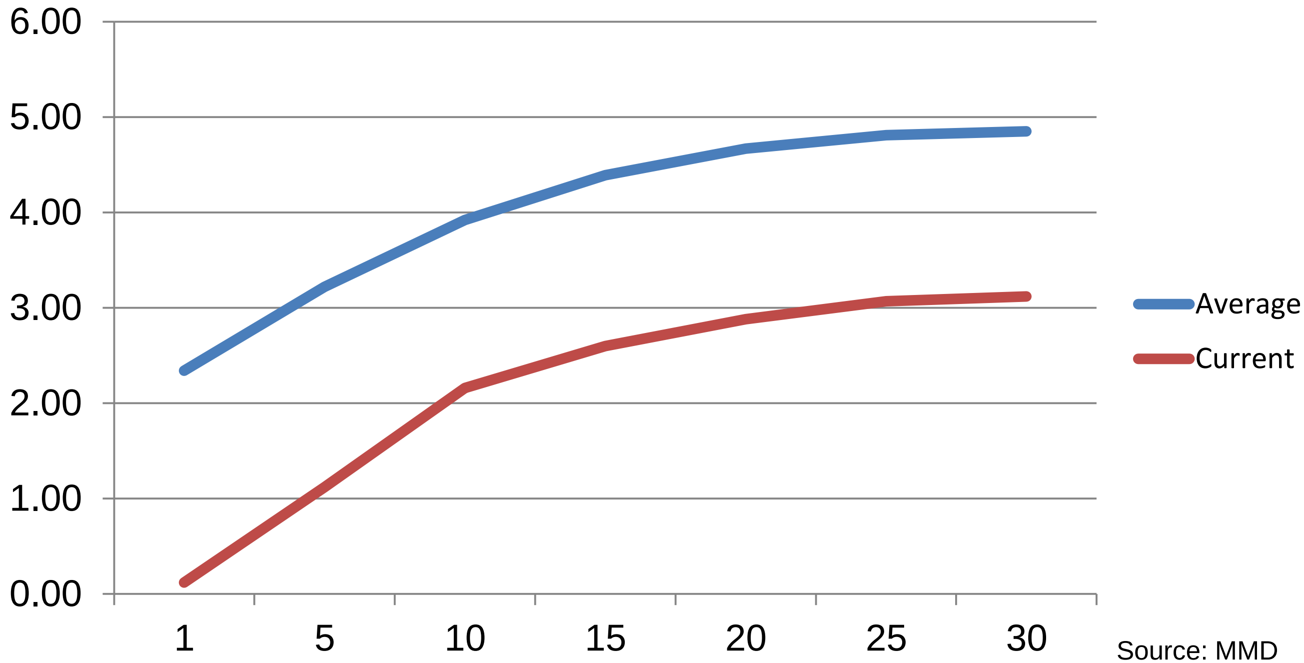
Standard & Poor's System Profitability Trends



Source: S&P

“AAA” Municipal Yield Curves

- “AAA” Municipal Market Data yield curves are below historical averages.
- Healthcare long-term fixed rate issues are priced as a spread to the AAA index.



Source: MMD

Data Since 1993	1	5	10	15	20	25	30
Record Low	0.18	0.62	1.47	1.80	2.10	2.42	2.47
Record High	4.95	5.60	6.15	6.65	6.85	6.90	6.95
Average	2.34	3.22	3.92	4.39	4.67	4.81	4.85
Current (9/5/2014)	0.12	1.12	2.16	2.60	2.88	3.07	3.12

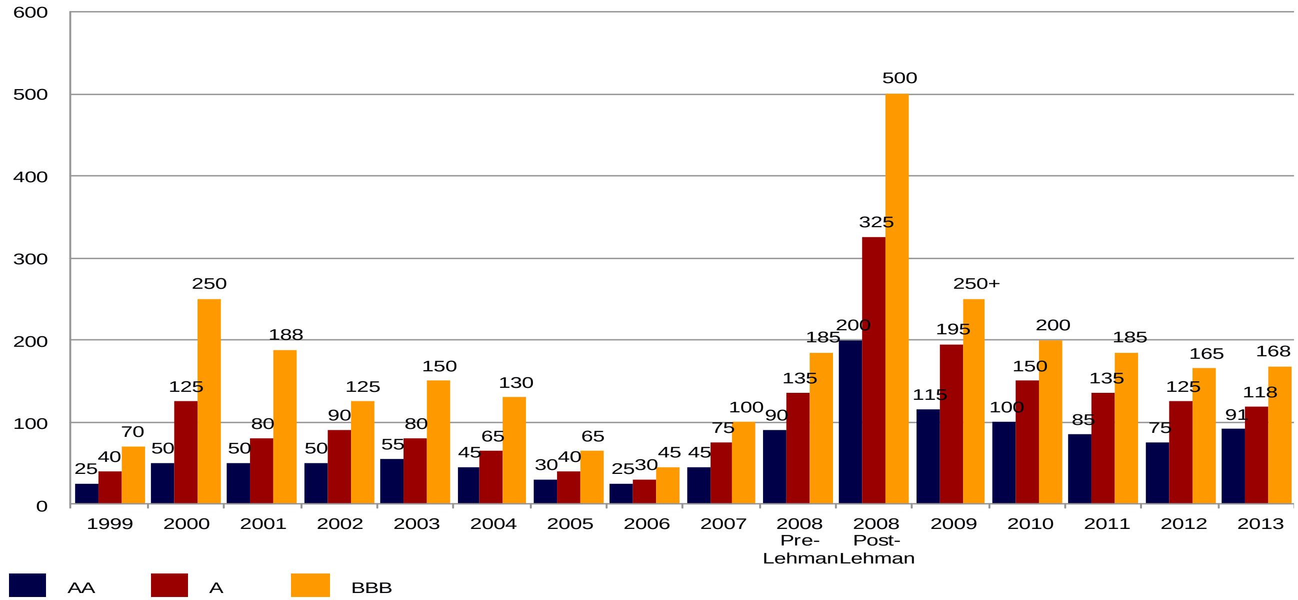
✓ *“MMD” is the Municipal Market Data index that tracks yields on “AAA” rated municipal securities. Municipal securities are priced as a spread off “AAA” MMD based upon underlying credit and market conditions.

Hospital Spreads & Yields

- Credit premiums have trended lower from the post Lehman Crisis.
- Long-term municipal rates are attractive.
- Investors are looking for “yield” which is driving demand.
- Acute care providers have been lowering balance sheet risk by reducing short-term debt with long-term fixed rate bonds or extending the term for the remaining short-term debt.

Estimated Healthcare Spreads to “AAA” GO Bonds by Rating Category*

(bps)



*“MMD” is the Municipal Market Data index that tracks yields on “AAA” rated municipal securities.

Source: MMD

Indicative 30-Year Acute Care Yields			
Rating	**2007**	**2009**	**2014**
AA	4.87%	5.81%	3.80%
A	5.17%	6.61%	4.05%
BBB	5.42%	7.16%	4.40%

Investments: • Are NOT FDIC-Insured • Have NO Bank Guarantee • May Lose Value

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Questions and Thank You