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Not-for-Profit Hospitals Shunned Bond Market in 2014.

Hospital bond issuances fell to their lowest level in more than a decade last year as not-for-profit providers scaled back their capital spending despite low interest rates and eager lenders.

"Most of our clients have made a deliberate effort to pull back on major capital projects," said Pierre Bogacz, managing director at HFA Partners. "We've seen a lot of them keeping these projects on the backburner."

Instead of investing in traditional brick-and-mortar building projects, many health systems are focusing their attention on upgrading their information technology systems. These projects are not only less expensive, but they have a relatively short lifespan before providers must make the next upgrade. That makes them better-suited for a 10- to 15-year bank loan than for a bond issuance with a 30-year amortization schedule, Bogacz observed.

In an otherwise stable municipal bond market, the value of healthcare bond issuances in 2014 fell 16% compared with the previous year, according to data from Thomson Reuters. Only borrowers in the education sector had a similar pullback.

The total value of long-term bond offerings from healthcare providers was only $24.3 billion last year compared with $28.9 billion in 2013, and marked the lowest level of activity since 2001's $23.4 billion in offerings.

"It's not a situation where hospitals aren't investing," Bogacz said. "It's a situation where they're not investing so much that they need to go out and borrow."

Healthcare providers have pulled back on projects that require new funds as they grapple with reimbursement cuts and decreased patient volume, said Cormac Cullen, a healthcare analyst at Fidelity investments.

"Debt, especially additive debt, can limit their flexibility," he said.

But even refinancings in the beginning of the year suffered because of the complex relationship between yield curves on municipal bonds and Treasury bonds.

"Lower interest rates aren't the end of the story," Cullen said. "Both of those two different dynamics are affecting debt issuances."

When a borrower wants to take out debt before it's allowed to be redeemed, it can do so by setting up an escrow account that is typically funded with U.S. Treasuries. The Treasuries are purchased with the proceeds from the refinancing offering and used to make payments on the older bonds.

Therefore, it wasn't until the Treasury yield curve flattened that there was an uptick in refundings in the fourth quarter, said Kevin Ramundo, a municipal portfolio manager at Fidelity.

Nine not-for-profit healthcare providers have filed official statements for bond offerings on MuniOS through Jan. 9. In contrast, just seven healthcare issuers filed official statements for offerings during the entire month of January 2014.

Of this year's nine healthcare issuances, all but one plan to use the proceeds for refundings. Only Lakeland (Fla.) Regional Health Systems is planning to use the proceeds from its $180 million offering to finance a new Women's and Children's Pavilion; build a new inpatient rehabilitation facility; and expand its emergency department, operating suites and cancer center.

Although the debt market typically drives the M&A market in the for-profit healthcare sector, the same is not true on the not-for-profit side, so the slowdown is not a sign that providers will pull back on their deal-making activity.

Most not-for-profit deals do not require up-front cash. Moreover, if not-for-profit providers can't access the bond market for their capital needs, they're more likely to seek out a partner, Cullen said.

Yet the decline in borrowing contrasts with the optimism from lenders, who note that the debt markets are wide open to healthcare borrowers. "They're ready to go—but the hospitals aren't," Bogacz said. "And it takes two to tango to issue debt."

It also comes as hospital financial metrics are improving; cash on hand is continuing to climb while leverage, or the amount of debt that providers have, has fallen, Bogacz said.

But then there's the question of how much longer providers can defer major projects. That may give a boost to the hospital bond market this year, especially if interest rates begin to rise.

"That could be a good opportunity for hospitals to pull the trigger on something they've been considering," Bogacz said. "I think it's going to be a wake-up call for hospitals that don't have a sense of urgency. But that's a big if—it really depends on what the Feds are going to be doing."

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