## Muni Buyers Bedazzled by Junk-Bond Yields Let Protections Slip.

A hospital in Hagerstown, Maryland, sold more than $260 million of tax-exempt bonds on Wednesday without a debt service reserve fund, a standard backup for such offerings.

Two weeks earlier, HealthEast Care System in St. Paul, Minnesota, issued $142.5 million of bonds and placed $147 million more with commercial banks that can ask for immediate repayment if the company misses financial metrics. That would leave the other investors vulnerable should the system's finances deteriorate.

Municipal issuers including hospitals, charter schools and retirement communities are selling bonds without some protections typically demanded as investors seek returns over safety with interest rates close to the lowest levels since the 1960s. High-yield bonds have outperformed the broad municipal market since the start of 2014 luring a net $10.5 billion of cash to tax-exempt funds that buy the debt.

"Issuers don't need to provide protections to bondholders, because the funds need to put the money to work," said Carol Flynn, a money manager who helps oversee $25 billion at Deutsche Bank AG's wealth management-unit. "It's supply and demand, really."

**Weak Covenants**

Flynn said she's avoiding lower-rated muni bonds with limited protections, instead favoring A and AA rated issues that provide more relative value.

High-yield munis have gained 0.83 percent this year, beating the broad market's 0.06 percent decline, Bank of America Merrill Lynch data show. Last year, lower-rated debt returned 12.8 percent, compared with a 9.8 percent gain.

The inflow into high-yield municipal bond funds since the start of last year, represented about 18 percent of total assets on Wednesday, according to data compiled by Bloomberg. The funds can include some lower-rated investment-grade securities.

Even as $1.2 billion was withdrawn from the funds in May and June while the market braces for Federal Reserve to raise interest rates, covenants aren't being strengthened.

Meritus Medical Center, which runs a 251-bed acute-care hospital in Hagerstown, about 65 miles northwest of Baltimore, priced $263.3 million of debt Wednesday. Bonds maturing in 30 years yielded 4.38 percent, or 1 percentage point more than top-rated municipal bonds with similar maturities. The bonds were offered without a debt service reserve.

**Not Bothered**

Thomas Chan, chief financial officer at Meritus didn't respond to a request for comment. Douglas

Davenport, CFO at HealthEast said investors placed 11 times as many orders as were bonds available in longer maturities and weren't put off by commercial banks' ability to require immediate debt repayment if financial covenants were breached. "It didn't seem to bother them at all," Davenport said.

Low- and non-rated borrowers have been jettisoning standard security provisions like mortgage liens, which give bondholders the right to foreclose on property in the event of default, and reserves the issuers can tap if they don't have enough cash to service debt.

"The only way to force those protections back in would be if the deals couldn't get sold," said Josh Gonze, who helps oversee $10 billion in munis at Santa Fe, New Mexico-based Thornburg Investment Management.

**Rare Defaults**

Defaults in the $3.6 trillion municipal market are rare. About 0.2 percent of hospital bonds are in default, compared with 0.005 percent of general obligations, according to Concord, Massachusetts-based Municipal Market Analytics. The rates for retirement projects and charter schools are higher, at 5.4 percent and 1.83 percent, respectively.

The $9.3 billion investors plowed into U.S. high-yield muni funds in 2014 was the second-highest ever, according to Lipper.

It's unclear how many borrowers in the municipal market — whose high-yield issuers include Indian tribes, toll roads and some private companies — have weakened investor protections.

Last month, fund managers clamored to get a piece of Albert Einstein Healthcare Network's $453.5 million bond deal even though the system had 99.5 days of cash and also didn't include a reserve as security. Money managers placed more than three times as many orders as bonds available, allowing the Philadelphia-area health-care provider to cut yields, said Chief Financial Officer David Ertel.

**Less Cash**

The cash Albert Einstein had available on March 31 was lower than the median for hospitals in the BBB rating category, according to a May 8 report from Fitch Ratings. The company is rated Baa2 by Moody's Investors Service.

"We had 53 separate institutional investors, so very widely distributed, very widely accepted in terms of both the pricing and in terms of the security covenant package," said Ertel.

Investing a debt service reserve in lower-yielding government securities would be a "financial drag," Ertel said.

A portion of the bonds from Albert Einstein's May sale that matures in 30 years yielded 4.72 percent at issue and has since declined to 4.57 percent in secondary trading.

Einstein paid a spread of about 1.3 percentage points more than benchmark municipal bonds to issue the debt, less than the 1.32 points charged to the similarly rated Boston Medical Center, which had a reserve fund for a bond issue in April.

In January, Peninsula Regional Medical Center, a hospital on Maryland's eastern shore, sold about $127 million of debt with a provision allowing the issuer to pledge accounts receivable for other loans, subordinating the rights of bondholders.

**Pledging Receivables**

That practice is “highly objectionable,” said Jim Murphy, who oversees, T. Rowe Price Group Inc.’s $3.4 billion Tax-Free High Yield Fund. “They’re saying they reserve the right to effectively prime you and give that collateral to another lender,” Murphy said. “We’re seeing it more and more.”

The importance of receivables as a security pledge was highlighted in the 2007 bankruptcy of Pascack Valley Hospital in northern New Jersey, Murphy said. When Pascack filed, it had about $19 million in accounts receivables and about $79 million of debt, he said. The security helped boost bondholder payouts to 60 cents on the dollar, he said.

Murphy passed on Peninsula’s bonds, which also weren’t secured by a mortgage.

**‘Kicking Themselves’**

Other hospitals in Maryland include provisions in their bond documents allowing them to pledge accounts receivable to new loans, said Bruce Ritchie, chief financial officer at Peninsula. Debt secured by receivables can’t exceed 25 percent of total claims for payment.

The deal was five to six times oversubscribed, Ritchie said. “There was appetite for our bond issue in the market with the covenants written the way they were written.”

In Boca Raton, Florida, a startup retirement community borrowed $190 million in unrated bonds last year without having final building permits from the county.

Construction on the Sinai Residence, a 237-unit continuing care retirement community that will feature rooftop gardens and a spa, is about 65 percent complete, said Mel Lowell, chief operating officer of the Jewish Federation of South Palm Beach County. The units are sold out and there’s a waiting list.

The project had a letter from officials giving conditional approval for the permits if minor items were addressed, Lowell said. Thirty-five-year bonds that were sold at 98.5 cents on the dollar traded at an average of 112 cents on Wednesday.

Investors who balked at the bonds are “kicking themselves in the tuchas now,” said Lowell, using the Yiddish word for rear end.

**Bloomberg**

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**June 24, 2015 — 9:00 PM PDT**