February, 2014

REVENUE BOND OVERVIEW

HEALTHCARE HOSPITAL ISSUES

In our most recent *Municipal Market Update – Outlook for 2014,* we identified two sectors that fall under the category of revenue bonds that we believe are opportunities for investing in the tax-free space, the healthcare sector and airport sector. While not the traditional, essential services revenue bonds that SAC has historically invested in, these sectors are exhibiting attractive risk-adjusted returns for our tax-efficient portfolios.

Municipal revenue bonds—which make up close to 60% of the $3.7 trillion muni market and unlike GO bonds, are backed by a specific tax source instead of a full faith and credit pledge from state or local government general funds. Municipal revenue bonds are paid from a specific **revenue** source, such as a hospital or sewer system.

Our focus is first on muni bonds backed by revenues from essential services—especially systems with mature service areas with a built-out population in communities with strong residential customer bases, access to job centers and above-average household income levels. By "essential services," we mean public enterprises with an effective monopoly on their service areas, where customers generally need those services even in a weak economy. In a slowly expanding economy, revenue bonds—in particular those backed by essential services users can't do without, such as water or sewer—can complement GO bonds for investors looking to diversify their muni portfolios.

While not essential services these other sectors have common factors to vital services such as, they are necessary services and have high costs of market entry. Our focus is therefore on strong credits, in sectors whose volatility and uncertainty can result in opportunities for market yield premiums.

Compared to essential service bonds, the healthcare sector tends to have more business risk than other tax-exempt municipal sectors, with the exception of the larger more established systems. Unlike water and sewer systems, hospitals generally operate in an environment without a natural monopoly.

Additionally, a large share of not-for-profit (NFP) hospital revenue can come from reimbursements for services from commercially insured patients, reimbursements for publicly insured patients (such as Medicare and Medicaid), or self-pay from patients lacking insurance. We therefore limit our exposure in this sector to large, well run and efficient obligated groups with large market share and high liquidity. We target credits with the resources and management strength to deal with the challenges confronting the sector.

As a result of healthcare reform, hospitals are facing $300 billion in reductions to Medicare through 2019.This reduction in Medicare—one of the primary reimbursements for NFP hospitals—may put pressure on hospital revenues. The federal government anticipates that many uninsured patients will become insured via the health insurance exchanges, thereby mitigating some of this reduction. The goal is for patients previously covered by Medicare and Medicaid—which tend to have lower reimbursement rates—to be insured via the exchanges, which are anticipated to have higher reimbursement rates.

The Congressional Budget Office (CBO) estimates that seven million individuals will participate in the exchanges in 2014, but so far, the numbers have been far lower than expected. In the short term, if enrollment continues to lag, increases in the insured population may not be enough to offset the negative effects of reductions to Medicare. That could result in lower revenues for hospitals, which would be a negative for bondholders.

The ACA has longer-term positives for hospitals. It's not all bad news for NFPs over the long term. For example, the proportion of individuals aged 65 or older is expected to grow by 39% from 2010 to 2020, the largest increase for any cohort the U.S. census tracks. Generally speaking, older individuals are most in need of health care and this increase should result in a larger client base for hospitals. Over time, the ACA may also lead to a greater number of insured individuals and potentially higher reimbursement rates for hospitals over the longer term.

Additional metrics that are considered in valuations:

- Profitability as it relates to large capital expenditure plans and strategic initiatives
- Operating performance relative to debt levels
  Infrastructure cost and IT Investments
- Payor mix as it relates to Medicare/Medicaid
- Pension Funding
- Ratings A-AA

Examples of 2 healthcare bond issuers and the metrics we evaluate:

1) **Inova Health System** (Aa2/AA+ Stable)
   The obligated group is based in Falls Church, Virginia and operates a full range of health care services throughout the greater Washington DC area and Northern Virginia. The system controls 7 acute care hospitals on 5 campuses and a comprehensive ambulatory and non-acute care network.

   - 55% market share of a broad and affluent service area with low unemployment
   - Inpatient admissions/discharges: 96,849
   - $2.4 billion operating revenue
   - 8.7% operating margin
   - $2.9 billion unrestricted cash
   - 521 days of cash on hand
   - 183% cash to debt
   - .5 times maximum annual debt service coverage
   - 2.8 times debt to cash flow

2) **BayCare Health System** (Aa2 Stable/AA Stable)
   The system operates 10 hospitals in the Florida counties of Pinellas, Hillsborough, and Pasco, including the cities of Tampa and St. Petersburg. The flagship hospital is St. Joseph's, a 986 bed tertiary facility located in Tampa, which includes a trauma center, a comprehensive stroke center, a 157-bed women's hospital, and a 186 bed children's hospital.

   - Largest provider of acute care in the Tampa-St. Petersburg metro area, the fastest growing in Florida, with a 36.9% market share
   - Inpatient admissions/discharges: 124,272
   - $2.4 billion operating revenue
   - 6.4% operating margin
   - $1.6 billion unrestricted cash
   - 311 days of cash on hand
   - 188% cash to debt
   - 7.3 times maximum annual debt service coverage
   - 2.2 times debt to cash flow

Both of these systems have long track records of strong performance in very competitive markets, and are the kind of credits that we consider to provide yield enhancement with little marginal increased risk.