THE BOND BUYER

Ohio's Mercy Joins High-Rated Hospitals' Return To Market

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CHICAGO - Mercy Health, Ohio's largest health care provider, is hitting the market with $400 million of bonds this week, joining a handful of higher-rated hospitals that have started to return to the capital market after years of delaying deals.

The Cincinnati-based system, until last year named Catholic Health Partners, has 23 hospitals and 15 long-term health care facilities across Ohio and Kentucky. It carries AA-minus rating in a 'yieldy' sector with a median rating of A.

With $2.1 billion of debt, Mercy is one of the better known names in the health care sector. It comes to market following sizable deals by Indiana University Health and Trinity Health, both well-known providers with similar ratings.

"I think there is somewhat higher issuance coming from the higher-rated guys, as well as some higher issuance sizes," said George Huang, director for municipal securities research at Wells Fargo. "You've probably seen more double-A and high-A-plus level credits come to market this year."

The system heads into a market that has already seen nearly double the amount of non-profit health care volume as the same period last year. Health care issuance in general has been anemic for several years as the sector - which all three ratings agencies keep on negative outlook - faces a myriad of challenges, including the implementation of national health care reform and lower-than-normal patient volume.

Part of the volume bump comes from relatively low interest rates in the bond market as a whole, as well as years of delayed projects as infrastructure aged, market participants said.

"I think folks are starting to feel a little more comfortable and have a sense of how national reform has played out and have some visibility on how it's going to play out in the next three years," said Matt Caine, managing director at Illinois-based SOLIC Capital Advisors, a leading healthcare investment banking and financial restructuring advisory firm.

"I think it's going to be the haves, those who can borrow the money, the Mercys, the Trinitys, realizing there's a bit of window to produce some issuance in the bond market," Caine said.

The first quarter of 2015 has seen 32 health care deals compared to 15 for the first quarter of 2014, according to Caine. Sector issuance during the first quarter of this year reached $4.4 billion compared to $3.5 billion for the same period of 2014.

Another reason for the small market rush early in 2015 could be an upcoming Supreme Court ruling that could derail national health care reform.

The decision in King v. Burwell, expected in late June, challenges a part of the federal health care law that provides tax credits to individuals who buy insurance on the national exchange.

An adverse ruling against the administration would not affect the 13 states - including Ohio - that run their own state exchanges. But it could mean a loss of tax credits for people who live in states with federal exchanges, reducing the number of insured people by as much as eight million people.

"If the Supreme Court strikes down premium subsidies for the federal exchange, it would be adverse for the hospital sector as well as the health care insurance sector," Huang said. "We saw a little bit of this rush to market three years ago [ahead of the court's ruling on the legality of the Affordable Care Act]," he added.

Mercy raised the issue of the court's ruling in the investor risk section of its preliminary bond documents.

"Some project that such loss of coverage would indirectly cause significant increase in health care costs nationwide, which would have negative financial implications for [Mercy]," the documents say.

Despite the early bump, Huang said he expects health care volume to come down during the year, due to interest rate movement as well as ongoing uncertainty tied to reform and continued low patient volume.

Mercy is selling the bonds in three separate deals: $152 million of refunding and new-money tax-exempt bonds issued through Allen County, Ohio; $100 million of tax-exempt adjustable-rate short-term bonds, also issued through Allen County; and $150 million of taxable new-money bonds.

The floating-rate notes will be held by investors with no put options for a period of likely five to seven years before a mandatory tender, according to offering documents.

Approximately $200 million of the tax-exempt fixed- and floating-rate bonds will be used to finance capital improvements, including a $75 million renovation of Cincinnati's Jewish Hospital and a $70 million renovation at Anderson Hospital. Mercy will also use the proceeds to replenish its liquidity reserves and to refund a part of bonds originally issued in 2010.

The deal is expected to price Wednesday. JPMorgan is senior manager on all three deals with Morgan Stanley also on the team.

Peck, Shaffer & Williams, a division of Dinsmore & Shohl LLP, is bond counsel. Chicago-based Ponder & Co. is financial advisor.

Mercy has reported stable operating performance, consistent margins and good liquidity that features 202 days of cash on hand, according to Moody's Investors Service, which rates the system A1.

The system recently partnered with HealthSpan Partners, an Ohio non-profit that operates insurance plans, employs doctors and holds a 30% interest in Summa Health System, an Akron provider that Mercy partnered with in 2013.

The partnership is part of Mercy's push into the health insurance business, and the move that has a significant influence on the system's "organization and strategic direction," according to Standard & Poor's. Both S&P and Fitch Ratings have AA-minus and stable outlooks on the system.

Fitch notes that Mercy has grown rapidly over the last six years, with total operating revenue rising 44% since 2009 to reach $4.5 billion in fiscal 2014.

As of December 31, 2014, the system had $701 million of adjustable rate bonds, including variable-rate demand bonds, direct purchase bonds and auction-rate securities, according to bond documents.

Mercy has interest-rate swaps with a notional value of just under $520 million. JP Morgan is the counterparty on all its swaps, according to Moody's, which warned that the single counterparty exposes Mercy to concentration risk.

Analysts said the system plans to unwind a total of $400 million of the fixed-payer swaps, and that $305 million had been unwound as of March 31, 2015, with the remainder expected after this week's deal.

The swaps and variable-rate bonds are cited as possible investor risks in the provider's bond documents.

Like many health care issuers, Mercy's bond documents include several pages of risks to investors. Beside specific credit risks, others include: an uncertain reform and regulatory environment; federal budget cuts; pressure on state budgets, which could lead to Medicaid payment cuts; and the growth of high-deductible health care plans, which are thought generally to contribute to lower patient volume and higher bad debt.

Despite the uncertain environment and years of anemic issuance, Mercy's bonds should sell well in a market still hungry for the extra yield typical in the hospital sector and with strong credit fundamentals.

"Mercy won't have too much trouble," Caine said. "They're a well-known name with $4.5 billion in revenue and a significant presence throughout Ohio. They certainly have the financial wherewithal to issue these bonds and they should be well-received by the market."

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