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Health Care**Back to Basics:****Financing Options for Weaker Hospital Credits**

This fall, credit rating agency Standard & Poor's issued a report expressing concern over the credit risks of nonprofit health care providers with speculative-grade ratings. While few small hospitals carry actual credit ratings, many would be considered speculative-grade (BB+ or lower) if they did. The overall commentary on the perceived risk in these potential borrowers serves as a reminder of the importance of understanding a hospital's complete credit profile, as well as the various financing options available to weaker credits.

S&P states in September's "U.S. Not-for-Profit Health Care 2007 Speculative-Grade Medians" that because of "worsening conditions in the acute-care sector in 2008 and beyond, it will be difficult for many speculative-grade credits to improve their operations and balance sheets, invest in plant, and recruit physicians." Community and rural hospitals have long struggled in these areas, but renovations and replacement hospitals can be financed responsibly, provided the hospital completes a thorough evaluation of its strengths and weaknesses, understands its financial options, and monitors the markets to make sure it is creating the most optimal capital structure.

Know Your Hospital

Hospitals must evaluate their strategic plans and their funding needs in tandem to accurately determine their best financial options. The first steps toward acquiring funding of any kind are performing an assessment to determine needs and evaluating credit strengths.

A hospital's credit strength or financial health is the single most important

factor in determining its cost of capital. Comprehensive explanation of the credit profile can help creditors understand a hospital's risk level more accurately and alleviate their concerns. Any strategies to improve the hospital's financial health should be noted clearly, including strategic focus on operational improvements (e.g. reduction in the number of beds, if applicable), or a focus on outpatient services if a market demands it.

Investors and credit enhancement providers will review both quantitative and qualitative factors to measure an organization's credit strength. Quantitative factors define a hospital's ability to repay the debt, and they place the hospital within a broad credit range. Qualitative factors determine long-term financial viability and refine the hospital's position within that credit range.

Know Your Options

S&P notes that financial ratios including days cash on hand, debt to capitalization and cash to debt for speculative-grade nonprofit health care providers have increased slightly. They suggest this means some hospitals may not be taking on additional debt to continue to improve because they have limited access to capital.

Community and rural facilities, as a lower-credit group, do have fewer options. S&P states that these facilities may have to rely on "more expensive or more restrictive financing, including FHA insurance" and bank loans.

Additional options, however, can be affordable even for weaker credits. These can be tailored to smaller facilities, and offer considerable benefits such as long

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amortizations and financial flexibility. Letters of credit, U.S. Department of Agriculture loans, and FHA mortgage insurance are generally available even to lower credits. Further, unenhanced bonds and even bond insurance can be viable options for speculative-grade credits in the current market. More information on these and other options can be found at www.lancasterpollard.com.

Unenhanced Bonds

Unenhanced (rated or unrated) revenue bonds sold on the credit profile of the borrowing entity have become more widely accepted by investors, though unrated offerings face a more limited market. They are supported solely by the borrower's credit characteristics. The bonds will tend to trade at a broader range of interest rates depending on the market's perception of risk at the time of the sale. Unenhanced bonds typically are structures as fixed-rate serial and term maturities with a final amortization of 25 to 30 years from the date of issuance. The financing normally prohibits prepayment for ten years.

Health care borrowers generally pay a premium over other borrowers when issuing bonds, known as a credit spread. Credit spreads started widening in 1999 and remained wide until mid-2006, when they narrowed sharply. This narrowing brought the cost of fixed-rate borrowing for a small hospital with the equivalent of a "BBB" rating closer to that of an "A" rated facility. In late summer 2007, however, spreads began widening again, and constant monitoring of the markets is necessary to ensure the most efficient borrowing option is chosen.

Letters of Credit

Letters of credit are enhancements bought from a rated bank by a borrowing hospital. They let the hospital issue bonds at the bank's credit strength, thus providing a lower interest rate. They can provide more flexibility than many other options, but banks can be hesitant to extend credit. A bank could refuse to issue a letter of credit for a viable hospital project if it lacked a branch near the hospital, if the credit request was too large, or if the bank was unfamiliar with the hospital's operations.

Letters of credit carry renewal risk, as most are issued for three- to five-year terms, much less time than the full bond amortization. These renewals can serve as opportunities to negotiate a better rate for the borrower, or less restrictive terms, should the hospital's credit improve. Letters of credit also offer more flexibility than many options because the debt can be paid off whenever the borrower desires, without penalty.

FHA Mortgage Insurance

The use of FHA Section 242 mortgage insurance has been expanding across the country from its historical nexus in New York. The program's total portfolio remains small - nine new loans were closed in 2006 - but

its benefits are considerable.

The program offers borrowers the opportunity to issue bonds at an "AAA"-equivalent rating. Interest rates are fixed, which can be very appealing in a low interest rate market. Borrowers have 25 years to pay back FHA mortgage-insured loans, a relatively long amortization that gives hospitals better opportunities to service the debt. No financial guarantees are required by parent or affiliated entities, and a high loan-to-value ratio can minimize up-front cash requirements. FHA-insured obligations are non-recourse to the borrower, meaning the loans are backed solely by the borrower's real estate and other assets. For a hospital that is part of a system, this structure provides minimal risk because the parent organization is not liable for the debt of the facility being financed.

USDA Community Facilities Program

The USDA offers direct and guaranteed loans and grants under its Community Facilities program. They are available to nonprofit rural organizations serving communities of under 20,000. The pool of money for the direct loans and grants is limited, but the loan guarantee program historically has not used its total obligation capacity.

A USDA loan can be for up to 100 percent of the cost of the project, and 90 percent of it is guaranteed. While the loan is designed for building new and improving existing facilities, it can be used toward refinances under certain conditions. Borrowers have up to 40 years to pay off the loans. Interest on these loans is taxable, though there has been discussion about guaranteeing tax-exempt loans. Typical loan amounts under this program have tended to be less than those made under the FHA Sec. 242 program because funding is limited to the amount appropriated by Congress. There is, however, no maximum loan amount.

Have an Alternative Plan

The financial option that starts out as the most efficient may not always remain the best choice, depending on market shifts during the financing. Some structures can take longer than others, leaving time for the markets to move more. The health care credit spread and investor sentiment change constantly, and the benefits of taxable or tax-exempt, unenhanced or enhanced financing options will change, sometimes enough to make switching structures worthwhile. Further, any change to internal credit profile factors can impact a financing. Banks can change their minds. Know your backup options, and know what it would take to make each of those options your best choice.

Continual reinvestment in a community or rural facility is necessary in a constantly-changing health care environment. While lower-credit facilities certainly face challenges in accessing capital, programs and options designed for these facilities can help them afford to stay modern while protecting their long-term financial health.