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Health Care

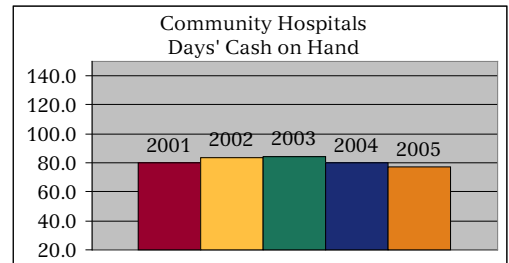
by Bill Wilson

Reviewing the State of the Capital Markets for Community and Rural Hospitals

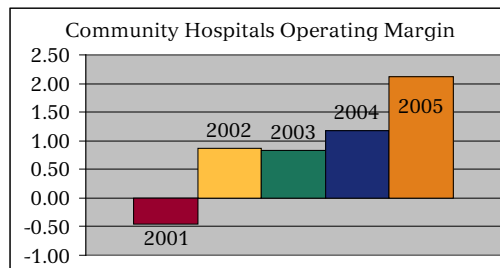
With many community and rural hospitals replacing Hill-Burton-era facilities, Lancaster Pollard recently held a Webinar examining the state of the capital markets for these projects in the Midwest. Several key trends are driving the flow of capital to these facilities. The financial condition of these hospitals is strengthening, and the overall interest rate environment for health care providers remains low. These trends are influencing the cost of capital across the country and creating an excellent borrowing environment for community and rural facilities, a sector often overlooked in analyses examining either only large systems or only Critical Access Hospitals.

Strengthening Financial Condition

Although dozens of factors can influence an individual hospital's debt capacity, three basic areas are reviewed by investment banks and investors. The first is profitability, which provides feedback on a facility's operations and ability to pay back borrowed funds. The second is liquidity, which represents the financial cushion an organization has available to weather unexpected storms. Finally, overall balance sheet leverage provides context for an organization's financial flexibility.



The days' cash on hand ratio is often used as a measure of a hospital's liquidity. Days' cash on hand levels for community and rural hospitals nationwide have remained steady at about 80 days. Although this level remains below investment-grade, an average ratio is in most cases sufficient to obtain capital at reasonable interest rates. Interestingly, this liquidity figure has not increased correspondingly with profitability. This discrepancy suggests many hospitals are reinvesting profits in their physical plant rather than taking on additional debt.

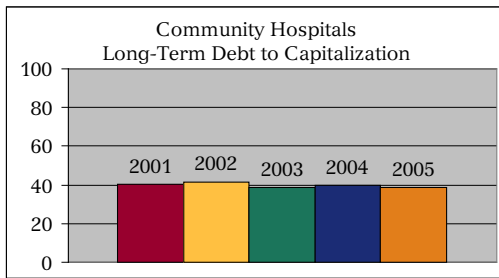


Profitability, represented by operating margin, has experienced a significant upward trend over the past five years. Reflective of the success of the critical access program and other productivity gains, this key indicator suggests operations are significantly improving.

Similar to the liquidity trend, overall balance sheet leverage, as represented by debt to capitalization, has remained steady since 2001. Tax-exempt bond data suggest that there may soon be an up-tick in this ratio, but current ratios indicate that many smaller hospitals

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may be underleveraged and have significant balance sheet flexibility.

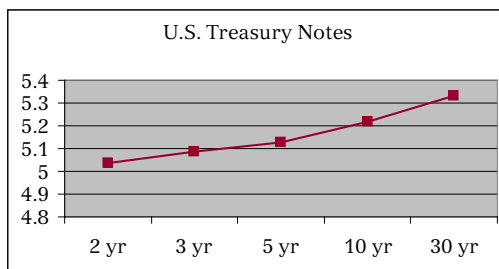


The financial strength of a community or rural hospital is a key determinant of its borrowing capacity and which options are affordable. With financial ratios stable, and in some areas strengthening, many hospitals are well-positioned to take advantage of external market factors.

Favorable Overall Interest Rate Levels

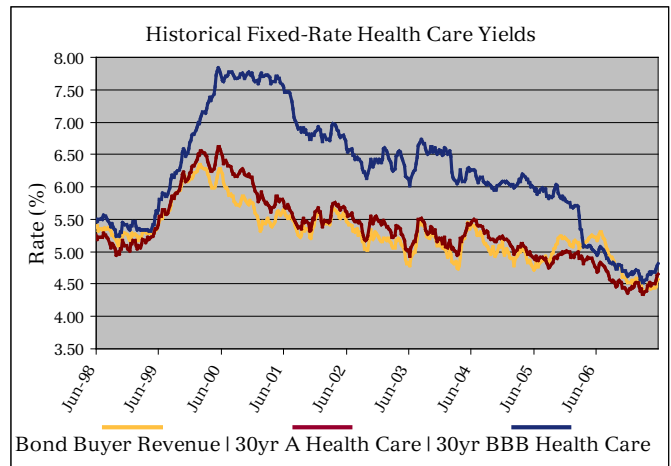
Two major factors influencing interest rate levels for community and rural hospitals have been the low overall interest rate environment and the tremendous amount of liquidity in the market. Although community hospitals have no control over these factors, they can certainly benefit from them in the near future.

The interest rate yield curve shown below has recently returned to a more “normal” shape after 16 months of being inverted, a situation where investors received higher interest rates for short-term maturities. The Federal Reserve had been very active in raising short-term interest rates from 2002 to 2006, but the limited inflationary and economic pressures have kept long-term interest rates at historically low levels, as the difference in yield between long- and short-term maturities has remained fairly low.



In addition to low interest rate levels, many hospitals have benefited from the tremendous amount of liquidity in the capital markets, meaning investors with excess cash are looking for higher returns. Community and rural hospitals in particular have been identified as a sector where investors can receive additional investment return with acceptable additional risk.

As a result, the credit spread between lower-rated health care credit and the general municipal market has tightened so much in the past two years that it is nearly non-existent. Under current conditions, com-



munity and rural hospitals may be able to borrow at interest rate levels previously only available to urban and investment-grade facilities.

Conclusion

As it stands, today’s good macroeconomic conditions and low interest rates have created an excellent borrowing environment for community and rural hospitals. Combined with a strengthening credit profile, opportunities exist to replace outdated facilities and modernize delivery options. Lancaster Pollard will continue to monitor and report on these key conditions.

Narrow spreads may continue for some time in this interest rate environment, especially as investors search for a larger yield component of total return and corporate earnings remain healthy. But credit spreads will widen again, as they did in 1999, and the yield curve will revert to its typical state. The question is what will cause the pendulum to swing, and whether it happens before community hospitals take advantage of the markets and act on their capital plans.

Ratio trend analysis is focused on CMS’s Medicare Cost Report database from 2001 to 2005, the latest year for which complete data is available. “Small” or “community” hospitals are defined, for research purposes, as less than \$70 million in annual net patient revenue

This capital market conditions analysis is derived from Lancaster Pollard’s ongoing financial advisory, underwriting, remarketing and derivative services for more than 40 community hospital clients. Information contained in this publication should not be the basis of any management decision without proper counsel by a qualified financial professional. To explore the market factors and financial ratios affecting your hospital explicitly, contact the Lancaster Pollard office nearest you or e-mail info@lancasterpollard.com to request a meeting.