LANCASTER POLLARD

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Financing Progress

Health Care

by Jason Dopoulos

An Option for the Ages: *Market turmoil has put federal hospital mortgage insurance in the spotlight. Here's why it should stay there.*

Much of the recent discussion of federal hospital mortgage insurance has tended to be directed toward smaller facilities that lacked a wide variety of financing options. Rather than being painted as a financing option for a limp economy, however, the Section 242 program should be considered as part of any hospital's financing discussions – under any market conditions. Its competitive fixed interest rates, 25-year amortization and nonrecourse nature make it an excellent choice for small independent hospitals, but also for larger facilities and for systems.

For larger hospitals in particular, FHA 242 may have been off the radar for several decades, especially since the program has only recently become more well-known outside the Northeast, where transactions have historically been concentrated. Started in 1968, the federal hospital mortgage insurance program under the Department of Housing and Urban Development (HUD) has insured nearly $15 billion in hospital loans. Transaction sizes run the gamut from less than $1 million to a $756 million deal completed in early 2009, the largest mortage loan ever insured by the FHA 242 program. The average loan size of active Section 242 loans completed through September 2008 is $85.6 million.

While smaller hospitals may look to hospital mortgage insurance because of its non-risk-based pricing and ability to offer access to investment-grade ratings, larger hospitals can find answers to additional issues within its structure.

Filling the Bond Insurance Void

Bond insurers were the go-to source of credit enhancement for larger hospitals and systems because of their ability to provide fixed or floating interest rates, amortizations of 20 to 30 years, and AAA ratings. As a premium option, and typically less expensive than a bank letter of credit, bond insurance was generally available to facilities that could independently achieve an investment-grade rating of BBB or higher.

When the markets turned, bond insurers were caught in the vortex of sub-prime mortgages, collateralized mortgage obligations, and derivative contracts which required collateral posting. Due to a combination of these forces, every AAA bond insurer has been downgraded. Hospitals were left with a void where once they had a reliable source of credit enhancement for fixed or floating rate debt.

Federal hospital mortgage insurance, however, fills that void, with amortizations of up to 25 years after construction completion and fixed interest rates. Because FHA programs are not risk-based, the rating on the debt will not change with investor senti-

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ment: FHA 242 insured debt is always the equivalent of at least AA resulting in higher credit ratings than most hospitals currently have or could hope to achieve.

Isolating Riskier Debt

While it may not always make the most sense for a hospital or system to finance its debt using hospital mortgage insurance, the FHA 242 program is a way to issue debt with a high investment grade rating in a difficult environment, one that has included downward pressure on hospital margins and increased balance sheet scrutiny.

As a non-recourse financing option, hospital mortgage insurance can be used to isolate balance sheet risk by carving out properties from more credit worthy parent corporations or obligated groups. A system with an underperforming facility may choose to finance that property separately in order to strengthen the balance sheet and potentially expand the debt capacity of the system as a whole. Should the riskier project run into trouble, the parent system is not liable for the debt.

As of July 2009, the FHA 242 program can also provide financing for acquisitions, spin-offs or refinancing transactions that do not include rehabilitation or new construction. As an acquisition vehicle, a system could acquire a hospital without disrupting the system's credit rating. The system could thereby maintain its debt capacity and credit profile for other capital projects, maintaining ratings on current debt and giving the system flexibility into the future.

The maximum FHA 242 mortgage is 90% of replacement cost. However, the current land value and net book value of property, plant, and equipment is counted toward the estimated project costs which can minimize or eliminate the cash equity required. For example, if a hospital with $50 million in debt, wanted to undertake $20 million in capital improvements, and had a current net book value of $70 million it could borrow up to $81 million, which is 90% of its replacement cost of $90 million. In this scenario, the hospital would not be required to provide any equity to secure FHA 242 mortgage insurance for any project with a mortgage loan less than $81 million.

The combination of the current economic conditions and constant stress about state and federal reimbursements could drive more independent facilities to seek to be acquired, and larger hospitals should be aware of the FHA 242 program as a facilitator of these partnerships.

Refinancing

Up through June 2009, the Section 242 program could be used to refinance debt only if 20 percent of the mortgage amount was used for new construction projects. This new money requirement made it difficult for some facilities to afford to utilize the program to refinance its debt, particularly in the current economy.

On July 1, however, the new money requirement was eliminated and the Section 242/223(f) program was created as a refinance-only option for hospitals of all sizes that need to achieve permanent financing, reduce interest rate risk, isolate debt on a balance sheet, or exit troubled banking relationships.

Hospital mortgage insurance has historically been seen as a more cumbersome way of acquiring capital, but significant changes have streamlined the process and removed some of the "big bureaucracy" stigma. A select experienced FHA team including former hospital CEOs, CFOs and private sector healthcare consultants now processes the applications. Processing times have been significantly reduced over the past couple of years, and a new initiative to implement "LEAN" processing, following Toyota's principles of efficiency, is in progress. Additionally, HUD has a "Fast Track" process for hospitals that meet certain financial criteria, which can further compress the application timeline.

65 E. State St., 16th Floor
Columbus, OH 43215
Phone: (614) 224-8800
Fax: (614) 224-8805

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