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Senior Living

by Kass K. Matt

Why Refinance Senior Living?

Financing structures may have fixed interest rates, lock borrowers out of prepaying debt, or lock them into debt covenants. Yet a property's strategic plans, the local and national economies, and other internal and external credit factors are far from "fixed" or "locked." Changes in the markets, in the financial sector itself, or to the property can provide impetus to update a debt structure through a refinance. So when the closing documents are signed and put on a shelf, the next step may be ... to watch for refinancing opportunities. A senior living provider that conscientiously evaluates the lending landscape will create opportunities to improve its current financial position and its future financial flexibility. Identifying these opportunities requires understanding why a property might refinance.

Reduce Interest Rate

Borrowing cost is most obviously expressed by the interest rate paid on debt, making it one of the easiest opportunities to see: Refinancing a \$10 million, 30-year loan from 7.5% to 6.5% would save \$2.4 million in interest over the life of the loan, or \$1 million in today's dollars given a present value discount of 3%, all other elements remaining equal. Despite market turmoil, interest rates remain at attractive levels.

Change Amortization

Many facilities have understandably taken advantage of low short-term interest rates for years. However, now that many lenders have called term loans, and other short-term debt structures have become scarce, it is extremely important to match asset and liability

duration to manage capital and liquidity risk. A property with a useful life of 30 years, for example, should consider seeking a loan that can be paid down over a similar term, rather than a short-term loan with a balloon payment.

Reducing debt service payments via a longer amortization can free up funds for other projects. Improving cash flow and liquidity can positively impact the financial ratios that contribute to an organization's ability to access future capital. Properties financed with federal programs will have to ensure that any use of debt service savings complies with the program.

Mitigate Risk

Campuses that provide services at multiple levels of care may benefit from insulating facilities with higher operational risk by carving them into separate debt elements. Lenders perceive certain facilities as riskier than others, meaning that those facilities will be financed at higher interest rates. If a campus has properties of varying risk financed together in one portfolio, the higher-risk elements may drive up the interest rate on the entire debt structure.

For example, a continuing care retirement community may choose to separate, or carve out, the financing of a nursing facility that depends on governmental reimbursement from the financing of an independent living community with private-pay residents. Similarly, a community with one building with lower occupancy may choose to finance that building separately.

In these cases, refinancing with federal

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mortgage insurance via the Department of Housing and Urban Development can be appealing. Depending on their goals, borrowers may use the HUD/FHA Section 232 program for new construction or substantial rehabilitation, or the Section 232/223(f) program for refinancing, acquiring projects that do not need major upgrades, or as part of an asset-liability matching strategy. Both are non-recourse, meaning neither the property owner nor the campus as a whole would be financially liable for debt carved out under the program.

Extract Equity

Multi-facility owners may want to refinance to leverage up properties and take advantage of high senior living valuations and low interest rates. Extracting equity from properties can help savvy multi-property owners use existing facilities as financial resources to facilitate future development. The equity released can provide for additional investment in existing properties or capital for new construction, or be otherwise used as the owner desires. This strategy has become more difficult in the current markets, however, because of challenges in finding credit to leverage up the properties.

Change Covenants

Debt covenants are minimum financial requirements a borrower agrees to with a lender. The lender may require that the property maintain certain liquidity or coverage ratios, for example. Falling below agreed-upon levels may trigger a default and may result in increased fees and more onerous requirements. Weaker credits typically face stricter debt covenants to protect investors against default. Strict covenants can severely hamper a senior living campus, impeding its ability to spend on renovation or otherwise hindering flexibility.

But as a property's credit profile changes, it may be able to refinance with more accommodating terms. For example, improved occupancy following a renovation may improve the credit profile. A change in the lending bank's financial situation, too, may give a property leverage to ease debt covenants. Short of a complete refinance, a property also may be able to renegotiate covenants with the existing lender.

If a letter of credit is being utilized, replacing the letter of credit, or renewing through a different bank, also could meet the goal of easing debt covenants without a complete refinance. With the Federal Home Loan Bank's ability to back member banks' letters of credit, borrowers now have the option to seek credit enhancement from local banks, rather than only from highly-rated regional or national banks that may hesitate to extend credit enhancements in this tumultuous market. Be wary, however, in tight credit markets: covenants may actually be stricter on a new debt issuance. In these markets, HUD, again, can often offer less restrictive fi-

nancial covenants, but they come with federal oversight.

Change the Structure

Sometimes, though rarely, macro capital market issues can cause a financial structure to become very inefficient, as evidenced in early 2008 when the auction-rate bond market failed. Many borrowers utilizing these structures were forced to refinance to reduce interest rates that had spiked to as high as 15 to 20% when the auctions failed. Also in 2008, some local banks called their term loans to raise cash, causing long-term care facilities to seek refinancing options. Further, many providers have had to refinance variable-rate debt because their letter of credit banks were downgraded.

A balloon payment also may prompt a refinance, where the property has a large lump sum to pay off in a short period of time.

Beyond changing the financing structure, senior living borrowers may also use refinances to change the organization of the campus itself. Refinancing can combine multiple buildings or properties under a single debt issuance, reducing administrative burden. Refinancing also can untie collateral that may be obligated in a debt issuance. If a property has expanded several times, but all new construction was obligated to old debt, a refinance can separate that collateral so it can be obligated toward future financings. This can help properties prepare for future projects by improving the campus' liquidity position and making collateral available.

But ...

Borrowers should not consider themselves pinned into a structure once it is in place; in fact, most debt issuances are either refinanced or paid off early rather than being carried to term. But refinancing costs money, and that cost depends on the financial strategy utilized: HUD costs can be as much as 3 to 5% of the refinance, and this money must be paid up front. Non-federal programs may have lower up-front costs, but may not offer the covenant flexibility or long-term fixed interest rates of HUD. The property's goals, financial strength, bank position, and general market conditions all will impact the efficiency of refinancing.

Constant evaluation of the property's long-term and short-term goals, and regular conversations with attorneys and investment bankers familiar with market conditions, will help borrowers shift their strategies to take advantage of market conditions, and internal and external credit factors.

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