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Feature*by Tanya K. Hahn***Stepping Back: How has access to capital changed?**

Day to day, minute to minute focus on the capital markets can make it harder to see where we are compared to where we were a few months ago at the height of (one hopes) the market fallout. The markets have obviously not stabilized. Yet there has been some improvement since a low point in October, when investors were playing hot potato with variable-rate bonds, and some banks turned away depositors and borrowers and closed their doors – permanently.

Borrowers with outstanding debt or who plan to issue bonds or notes in the near future are in slightly improved positions in February 2009 compared to fall 2008 (though they may look wistfully back at 2007). The overall landscape of both variable-rate bonds/notes and fixed-rate debt changed considerably in the past few months. Much of this can be understood through changes in the banking world over this short period of time.

Banking on change

Many banks had quite a wake-up call last fall when variable-rate bonds failed to find buyers, and banks had to extend cash and credit in connection with draws on letters of credit that were enhancing billions of dollars in floating-rate debt. Never in the history of this financing structure had there been such widespread draws on letters of credit. Already reeling from the fallout and negative impact to their financial positions from sub-prime mortgages, many banks realized too late how vulnerable they had left themselves by lending more than they could safely support in both capital and liquidity.

Many banks have since had their credit ratings downgraded by rating agencies as a result of declining financial performance.

This situation is part of a spiraling chain reaction. As part of this complex spiral, a bank's strength impacts the decisions of investors (primarily money market funds) that purchase bonds/notes backed by letters of credit. Many of these funds are legally forbidden from holding more than a certain amount of bonds from lower-rated banks. If a bank is, or might be, downgraded, investors may be less likely to buy debt backed by that bank, or they may require a higher interest rate to offset perceived risk.

Therefore some banks, often mid-size regional banks, are trying to reestablish their capital and liquidity positions and attempting to shore up the market's perception of their credit risk by removing what they see as riskier assets from their balance sheets. In some cases, this has resulted in banks asking borrowers to pay loans back, sometimes on technical violations of debt agreements that normally would prompt a warning rather than loan termination.

Current Impact on Letters of Credit and Variable-Rate Debt

In February, variable-rate bonds are again finding buyers. The letter of credit (LOC) structure functioned exactly as intended as a stopgap for borrowers, but the fall 2008 invocation of banks' responsibility to take on these bonds has left banks looking at borrowers through a new lens. Increased scrutiny of borrowers has tightened

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the credit markets and limited access to necessary capital for renovation and improvement projects.

Reflective of this, the borrowers getting their deals done with bank LOCs are typically very strong or may have stand-alone investment-grade ratings. Investors who buy these bonds and notes are also looking not just at the rating of the bank involved in the transaction, but also at the borrower's liquidity and credit strength in relation to the transaction size. Bigger and stronger, right now, is not just better, it is almost all that is getting done. Big banks are doing big deals with highly-rated borrowers.

Local community banks should not be forgotten, however. Many of these escaped the fallout of the subprime mortgage crisis and were not as leveraged as their regional bank counterparts. They are often still strong and willing to participate in financings.

Borrowers with existing LOCs and variable-rate debt are overall in decent shape. In the fall, variable rates spiked to at least 8% at the height of the liquidity crisis. Now, variable-rate, tax-exempt bonds are generally being remarketed at less than 3% depending on the LOC bank and region of the country. The difference between the high and the low ends of the remarketing range, however, is dramatic. Large national banks' bonds are resetting at 0.25 to 0.50%, while regional banks are resetting in the 2 to 3% range. An individual bank's LOC interest rates can vary widely depending on different investors' perceptions of that bank's credit risk.

Stronger borrowers paying higher-than-market interest rates may have opportunities to replace their LOCs with ones from a higher-rated bank, potentially lowering interest cost. However, many borrowers will be better off staying with their current LOC provider and working with the bank to ensure the LOC stays in place and is renewed, even if it means paying a higher annual bank fee. Rates on existing LOC-enhanced, variable-rate debt are low compared to fixed-rate transactions, but few new deals are getting done due to banks' judicious allocation of capital and liquidity. Some banks are charging more for the risk they are taking, setting higher covenants and requiring the movement of substantial banking business to them in return for use of their capital.

A borrower should seek advice from its financial adviser or investment banker if the borrower's LOC will expire within two years, or if the bank's willingness to work with the borrower has changed. Most LOC borrowers, however, should be in a good place, with rates as low as they are.

Current Impact on Fixed-Rate Debt

Many borrowers that issued fixed-rate debt in recent years should have locked in very low rates and be in a good position to weather this market.

Few new fixed-rate health care and housing deals have closed since the fall, and fixed-rate debt issuance has not heated up to the levels anticipated at the close of 2008. Long-term investors in tax-exempt bonds and taxable loans have experienced reduced liquidity and hence a limited ability to purchase new debt issues of debt. Willing investors are demanding a higher rate of return (interest rate) for perceived higher-risk borrowers, like health care and housing entities, in comparison to governmental borrowers who can rely on tax revenue for debt repayment and are perceived as lower risks.

Borrowers looking to use fixed-rate debt for a current project often have a 10-year prepayment penalty period. In the current environment, they may have the ability and desire to negotiate a shorter prepayment penalty period in return for paying a higher interest rate to investors. This serves to attract potentially more investors to the transaction and also provides future financing flexibility to refinance when the markets have settled down.

What Now, and What Next?

Several financing strategies are still viable for new debt issuances, or for refinancing troubled debt. The Federal Home Loan Bank can wrap LOCs for its member banks, many of which are small and lack their own credit ratings. This lets borrowers turn to their local banks for a cost of capital similar to that usually available only to larger, rated organizations. Government enhancement programs, such as the FHA Sections 242, 232 and 221 mortgage insurance programs, also remain strong options for hospitals, senior living, and affordable housing projects. Health care and housing providers also may consider doing a straight term loan with a bank, building in plans to refinance later down the road. Finally, organizations that are strong within their sector could consider paying to get an independent credit rating from a rating agency, possibly enticing investors by setting their transaction apart from a non-rated deal.

Many borrowers who issued debt recently are in a good position. Those who need to issue debt in the near future will have to look to new, alternative and creative ways to access capital. Working with an investment bank or financial adviser who understands and monitors how banks and enhancement options are viewed by investors, and what new options are coming available, will provide the borrower the best access to capital.