Who Says Financing Has To Be Conventional

Ohio Hospital Association
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Offering Financial Advice and Solutions to Health Care, Senior Living, and Housing Providers.
Items for Discussion

- Capital Markets Update
- Alternative Funding Options
- Successful Outcomes
- Q&A
Capital Markets Update

- Bond yields have decreased and credit spreads remain stable
- Lack of supply in the municipal market has led to attractive pricing
- Financial Regulation is starting to be implemented
- Governmental programs continue to provide solid execution
- Consolidation, consolidation, consolidation
- While the commercial banking sector has rebounded, there have been recent downgrades of some prominent banking names
- 10-Year UST has moved from 1.75% last May to approximately 2.55% today
- The Fed continues its tapering initiative
**Target Fed Funds Rate**

High = 20.00%
May 1981

Average since 1971, 5.66%
Average since 1984, 4.29%

05/08/2014, 0.25%

Source: Bloomberg

Financing Progress
10 Year US Treasury Yield

- **High**: 15.68% on 9/25/81
- **Low**: 1.45% on 6/1/2012
- **Average since 1962**: 6.53%
- **Average since 1984**: 5.88%

Source: Bloomberg
Healthcare Sector Overview

- 2013 performance was mostly stable to slightly negative
- Downgrades exceeded upgrades for the first time in 3 years
  - Balance sheets strengthened
    - Well performing investments
    - Prudent capital investment
    - Refrain from issuing new debt
  - Profitability metrics trended negative
    - Effective cost cutting
    - Flat to declining inpatient volumes
    - Smaller year-over-year rate increases
- Increased volatility of outlook changes
- Mergers and affiliations were a major theme
Rating Agency Outlook - Negative

- Standard & Poor’s Ratings Services
  Ratios will gradually decline due to incremental pressures due to health care reform and more difficulties controlling expenses

- Moody’s Investors Service
  Transition to a value-based reimbursement system will be highly disruptive as volume and reimbursement will decline with no offsetting increase in admissions

- Fitch Ratings
  Guarded outlook due to narrowing operating margins as expense reductions will likely fail to keep pace with reimbursement and volume declines

Financing Progress
Historical Healthcare Issuance

- Overall issuance has been down significantly since the peak in 2008
  - 2008 spike was due largely in part to the need to refinance existing auction rate securities into a more stable funding mechanism
- 2013 saw a fractured market with little to no new money offerings
- Lack of total supply creates a market opportunity for borrowers preparing to enter the marketplace

Source: The Bond Buyer
Trends in Hospital Finance
Shrinking LOC Supply - Banking Environment

- Credit / Banking crisis significantly reduced the number of A1/P1 rated LOC providers
  - Majority of buyers of LOC backed VRDBs require an A1/P1 rating
  - Significantly shrunk the universe of qualified LOC providers
  - 2008’s credit / banking crisis highlighted the contingent liabilities present in the structure (i.e. liquidity risk)
- Ongoing uncertainty about the impact of healthcare reform and federal / state budgetary concerns
- All factors above produce credit selectivity among the smaller universe of qualified providers
- Demand / Supply imbalance increases LOC pricing
Access to Capital

- Municipal bond insurance has all but disappeared
- Impending Basel III regulations will make it less desirable for banks to provide letters of credit for bond enhancement
- Federal enhancement through the FHA Section 242 mortgage insurance program
  - Can provide “AAA/AA” rating of the U.S. Government but takes much longer
- Momentum has shifted to a direct purchase of bonds
  - Eliminates the need for an underlying bond rating or a highly rated commercial bank
  - Flexible: Interest rate can be fixed or variable
  - Commercial banks have money to loan
  - No public disclosure required (less time and money), although this is becoming a hot issue
## Private Placements - Bank

<table>
<thead>
<tr>
<th>Description</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Tax-Exempt bonds structured and privately placed (sold) to Banks as opposed to the Letter of Credit enhanced bond structure</td>
<td>• Limited public disclosure and administrative paperwork</td>
<td>• Must fit with bank’s needs</td>
</tr>
<tr>
<td>• Can be structured as “multi modal”</td>
<td>• Flexible terms</td>
<td>• Limited long term fixed-rate options</td>
</tr>
<tr>
<td>• Bank-qualified designation can increase bank interest in buying</td>
<td>• Draw-down construction bonds can reduce costs</td>
<td>• Difficult for projects &gt;$35M</td>
</tr>
<tr>
<td>• Competitive Bidding is recommended</td>
<td></td>
<td>• Refinance risk (3-10 Yr. Term)</td>
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SIFMA vs LIBOR
## Unenhanced Fixed Rate Bonds

<table>
<thead>
<tr>
<th>Description</th>
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<tbody>
<tr>
<td>• Tax-Exempt bonds issued to the market on provider’s own credit strength</td>
</tr>
<tr>
<td>• Rated or Non-rated</td>
</tr>
<tr>
<td>• Term: 25-35 years</td>
</tr>
<tr>
<td>• Rates: Credit Driven</td>
</tr>
<tr>
<td>• Interest rate is based on a hospital’s credit profile.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Pros</th>
</tr>
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<tbody>
<tr>
<td>• No enhancement fees</td>
</tr>
<tr>
<td>• Fully amortizing structure</td>
</tr>
<tr>
<td>• Fixed rate for life of the loan</td>
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</tbody>
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<table>
<thead>
<tr>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Prepayment limitations</td>
</tr>
<tr>
<td>• Locks in current credit profile</td>
</tr>
<tr>
<td>• Debt service reserve fund</td>
</tr>
<tr>
<td>• Large interest rate gap between investment-grade and non-IG borrowers</td>
</tr>
</tbody>
</table>
Historical Healthcare Yields

Data Copyright @ 2014 Thomson Reuters, Municipal Market Data - 800-367-8215
Healthcare “BBB” Fixed Rates

Source: Bloomberg Financial, The Bond Buyer
### FHA Insured Mortgage – FHA Section 242

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>For new construction, renovation and refinance</td>
<td>AAA / AA interest rates (&lt;4.50%)</td>
<td>Must meet financial qualification tests</td>
</tr>
<tr>
<td>For hospitals of all sizes</td>
<td>MIP is a flat 0.5% annually</td>
<td>Longer lead time to close</td>
</tr>
<tr>
<td>A mortgage loan made by a private sector mortgage lender, insured by FHA / HUD</td>
<td>Special criteria for CAHs</td>
<td>Davis-Bacon union wages</td>
</tr>
<tr>
<td>Term &amp; Amortization: 25 years</td>
<td>Up to 25 years amortization</td>
<td></td>
</tr>
<tr>
<td>Key Qualifiers –242 Program</td>
<td>No renewal risk</td>
<td></td>
</tr>
<tr>
<td>• New mortgage must contain at least 20% new money uses</td>
<td>No financial covenants</td>
<td></td>
</tr>
<tr>
<td>• Aggregate positive operating margin or last three fiscal years</td>
<td>Non-recourse</td>
<td></td>
</tr>
</tbody>
</table>
Agency, FHA 242f

- **Just re-released 02/04/2013**
- Like 242, a mortgage loan made by a private sector mortgage lender, insured by FHA / HUD. However, 242f is a refinance directed program.
- “AAA / AA-like” Offering
- Term & Amortization: 25 years
- Rates: Approximately 3.75%
- Key Qualifiers – 242f Program
  - New mortgage must be at least 80% refinance
  - Aggregate positive operating margin or last three fiscal years
  - Average 1.40x coverage over last three fiscal years
  - Must meet 3 of 7 tests all focused on interest savings and the disadvantages of an applicant’s current structure ("need tests")
**USDA PROGRAMS**

<table>
<thead>
<tr>
<th>Community Facilities Program</th>
<th>Business &amp; Industry Program</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Direct and guaranteed loans</td>
<td>• Guaranteed loans for projects that create or save rural jobs</td>
</tr>
<tr>
<td>• Terms up to 40 years</td>
<td>• $10 million max (up to $25M for special circumstances)</td>
</tr>
<tr>
<td>• 90% guaranteed</td>
<td>• For areas with populations of &lt;50,000 people</td>
</tr>
<tr>
<td>• 2013 Direct funds limited</td>
<td>• Fixed rates for up to 30 years</td>
</tr>
<tr>
<td></td>
<td>• Up to 90% guarantee</td>
</tr>
<tr>
<td></td>
<td>• 2% upfront guarantee fee, plus 0.25% fee annually</td>
</tr>
<tr>
<td></td>
<td>• Fixed or variable rates</td>
</tr>
<tr>
<td></td>
<td>• Loans are taxable</td>
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</tbody>
</table>

- Fixed or variable rates
- No min/max loan amount
- For populations of <20,000
- One-time 1% guarantee fee
- Loans are taxable
Berger Health System (Circleville, OH)

- Community based public hospital with threshold investment grade (BBB- to BB+) ratios

- Existing Structure - $15MM in LOC enhanced bonds with a swap
  - 7 Year Fully Amortizing Structure
  - Make Whole Penalty through 2015
  - Interest Rate 3.87% through 2015

- Objective:
  - Match asset lives with debt financing
  - Mitigate Interest Rate Risk
  - Fund new projects
Berger Health System (Circleville, OH)

- Elected to go out to market for re-structuring alternatives. They explored:
  - FHA 242 – Good candidate, but inability to grant a mortgage
  - Limited Tax General Obligation Bonds
  - Tax-Exempt Unenhanced – Threshold investment grade ratios and large swap market to market made other options more favorable
  - **Bank Placement = Chosen alternative. Achieved a 7 year term / 20 Year final maturity with a fixed rate (2.67%) and limited call provisions. The hospital refunded the existing bonds plus $8.5MM for new projects. Total par amount $24MM**
Wood County Hospital (Bowling Green, OH)

- Community Hospital with financial ratios consistent with high end investment grade peers

- **Existing Structure** = LOC enhanced bonds with a swap
  - LOC expiring
  - Current LOC priced attractively (<1.00%),
  - provided by a large institution

- **Objective:**
  - Address Renewal Risk
  - Eliminate Bank Credit Risk
  - Take advantage of historically low interest rate environment
  - Fund new projects
Wood County Hospital (Bowling Green, OH)

- In advance of the expiration the hospital elected to go out to market for restructuring alternatives driven by their stand alone strength and the supply / demand factors in the LOC market. They explored:

  - FHA 242 – Good candidate, but the process would take longer
  - Bank Private Placement – Considered, but the hospital’s stand alone investment grade strength and improving bond markets warranted accessing more permanent debt
  - **Tax-Exempt Unenhanced Bonds** = Chosen alternative. $54MM issue rated Ba2 (BBB equivalent) with a total interest cost of 4.60%. The hospital refunded the existing bonds plus new money for Student Health Center & hospital based projects
Summary / Questions

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Appendix: Debt Structures

Typical Debt Structure

Unenhanced
- Rating: A, BBB, N.R.
- Interest Rate: Fixed
- Bank Placements

Credit-Enhanced

Letter of Credit
- Rating: AA, A
- Interest Rate: Var. or Fixed

Agency
- Rating: AAA/AA
- Interest Rate: Fixed or Variable
- FHA / USDA / FNMA

Bond Insurance
- Rating: AAA, AA, A
- Interest Rate: Var. or Fixed

Tax-Supported
- City or County owned borrowers
<table>
<thead>
<tr>
<th>Investment Banking</th>
<th>Mortgage Banking</th>
<th>Investment Advising</th>
</tr>
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<tbody>
<tr>
<td><strong>Lancaster Pollard &amp; Co.</strong></td>
<td><strong>Lancaster Pollard Mortgage Company</strong></td>
<td><strong>Lancaster Pollard Investment Advisory Group</strong></td>
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<tr>
<td>• Debt Underwriting</td>
<td>• FHA-Insured Mortgage Loans</td>
<td>• Arbitrage Assessment</td>
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<tr>
<td>• Financial Consulting</td>
<td>• GNMA Issuer/Servicing</td>
<td>• Asset-Liability Management</td>
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<tr>
<td>• Financial Derivatives</td>
<td>• Mortgage Loan Servicing</td>
<td>• Capital Structure Optimization</td>
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<tr>
<td>• Mergers &amp; Acquisitions</td>
<td>• USDA-Guaranteed Mortgage Loans</td>
<td>• Fiduciary Investment Consulting</td>
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<tr>
<td>• Private Placements</td>
<td>• Fannie Mae Multifamily &amp; Affordable &amp; Seniors</td>
<td>• Project Fund Management</td>
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<tr>
<td>• Remarketing</td>
<td>• Housing Lender/Servicer</td>
<td>• Risk Management Advising</td>
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<td>• Bond Sales &amp; Trading</td>
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*Financing Progress*