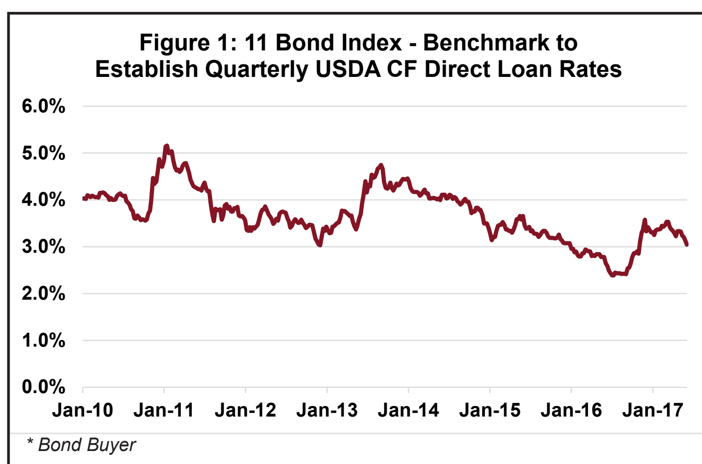
Federal Funding Spotlight

USDA Community Facilities Direct Loan Program

The United States Department of Agriculture (USDA) is growing its role as a funding partner for health care and senior living providers located in rural areas of the country. While many providers are navigating uncertain futures, one area that seems to be on solid footing is health care infrastructure financing. In sync with the new administration's policy to enhance infrastructure investments, funding for USDA's Community Facilities (CF) direct loan program grew in federal fiscal year (FFY) 2017 and may be further expanded in FFY 2018.

The CF direct loan program is intended to be combined with private sector capital to form public-private partnerships (P3s) to fund hospitals, clinics, long-term care, assisted living, and other projects considered to be essential to the economic and social well-being of rural communities. Direct loans have fixed rates and terms up to 40 years. Over the past year, rates have ranged between 2.375% and 3.375% (Figure 1). Combined with other sources of capital such as tax-exempt bonds and USDA CF guaranteed loans, the low rates and long amortization offered by the direct loan program enables rural providers to make needed investments in facilities that they might otherwise be unable to afford.



Funding History

Funding for the direct loan program has increased almost tenfold in the past ten years from approximately $290 million in 2007 to $2.6 billion for FFY 2017. Although preliminary, USDA's budget for FFY 2018 is expected to be at or greater than $3 billion. Increases in funding for the direct loan program have been offset by reductions to the CF guaranteed loan program.

Current Priorities

Despite a growing budget, demand for funding is expected to outstrip supply this year and in 2018. To prioritize and rank projects, USDA is implementing a priority scoring process outlined in Rural Development (RD) Instruction 1942A Guide 26. The project selection criteria assigns points to loan applications based on the following factors: population (smaller areas score higher), health impact, area median income, type of project and discretionary points from the state director. Also, projects that exemplify USDA's P3 goals by including other sources of permanent capital (tax-exempt bonds, fundraising, etc.) will be given preference.

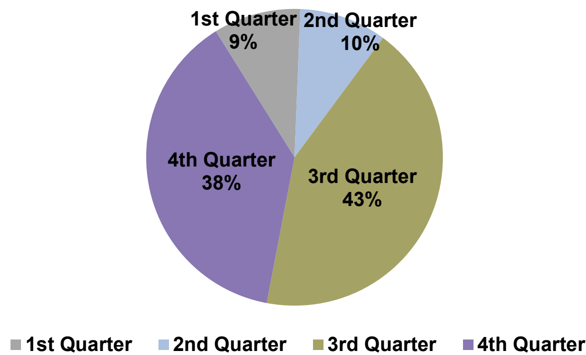
Timing Issues

Few commitments are issued in the first quarter of USDA's fiscal year (Figure 2). This is because approximately 90% of USDA's direct loan budget is initially allocated to the state offices to fund small projects. In early April (the midway point of the FFY), the national office recaptures a portion of unused funds from the states for commitments. States keep 50% of their annual allocation to spend in the second half of the year while excess funds are used by the national office for loan commitments. In early August, the national office typically pulls back all remaining unspent funds from the states in order to make a final round of commitments before the annual "use it or lose it" budget appropriation expires on September 30. Projects not funded in a particular fiscal year wait in line (per USDA's priority scoring system outlined above) until commitment authority is received the following fiscal year.

Best Practices

When seeking a USDA loan, the following steps are crucial in making sure the project gets off on the right track:

- Consult with an advisor or banker early in the process



* Commitments received by Lancaster Pollard & Co. clients from 2011 to 2016.

to screen preliminary project plans for feasibility and to identify sources of capital. Thorough advising on the project and sculpting a P3 plan of finance are viewed favorably by USDA.

- Multi-track financing options in case USDA direct loan funding is not available within the timeframe needed to meet project timelines. Incorporating alternates in the project scope also gives providers flexibility to respond to changes to the plan of finance.
- Consider issuing tax-exempt bonds for interim construction financing. Interest rates (including fees) are generally lower than USDA direct loan rates, and USDA requires all construction projects over $50,000 to utilize interim financing.
- Interact early with the state's rural development office to discuss eligibility requirements, special initiatives, and project funding needs.

Successful Financing

USDA is quickly becoming one of the country's largest sources of capital for rural health care and senior living loans. Below is an example of a hospital that utilized a partnership between providers, USDA and other capital market participants.

Ringgold County Hospital (RCH) is a county public hospital located in the small community of Mt. Ayr, Iowa. It is a designated critical access hospital (CAH) that operates 16 acute-care and swing beds. In 2008, RCH undertook a replacement facility project funded through the USDA CF guaranteed loan and direct loan programs. Because the blended interest rate of the USDA CF guaranteed loan was at a very high cost of capital compared to current interest rates, leadership sought to refinance the CF guaranteed loans in 2016. However, refinancing was considered to be nearly infeasible due to the hospital's credit profile and prepayment penalties.

Because of the high amount of total long-term indebtedness to RCH's capital position, the refinancing was only achievable at attractive terms if USDA RD agreed to subordinate its direct loan to the new investors. The hospital's lender took this into consideration and proposed requesting that USDA RD subordinate its direct loan security interests to allow RCH to refinance its guaranteed loan with bank qualified, tax-exempt bonds.

The process to reach an agreement with USDA to subordinate its security position was extensive and complex. The lender provided a detailed analysis and proposal and demonstrated the refinancing would achieve each of the objectives initially proposed, despite changes to the capital markets following the November 2016 elections.

The outcome was a refinancing structured as two bond issuances to utilize the small issuer bank-qualified exception, which significantly reduced the interest rate. The bonds were privately placed with a regional bank that understood the risks and opportunities associated with rural CAH providers. Further, the refinancing will create several million of interest savings over the life of the loan. Debt service savings are expected to help the hospital strengthen its balance sheet liquidity position and accelerate principal redemptions. Ultimately, the $15.3 million financing positions RCH well for the future and improves its fiscal outlook.

This recent transaction exemplifies the flexibility and pro-deal approach of USDA. Although there are still challenges the program faces due to the amount of time it takes to secure loan commitments, it is clear that USDA is being proactive in its efforts to make health care infrastructure financing more efficient and effective.

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