

Focus on

SENIOR LIVING FINANCE

WHITE PAPER I

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Financing Options for
Nonprofit Senior Living
Organizations

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Financing Options for Nonprofit Senior Living Organizations

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FINANCING OPTIONS FOR NONPROFIT SENIOR LIVING ORGANIZATIONS

Michael Ashley, Vice President, and Brendan Healy, Vice President

The demand for new and expanded services in America's senior living facilities is expected to increase as the senior citizen population grows from six million to 20 million by the year 2050. Baby Boomers, who will be the next generation to utilize such facilities, are expected to look for facilities that will enhance their quality of life as they continue to remain active throughout their elderly years. Long-term care providers have recently adapted to changes in payer models and are continually seeking methods to increase their marketability by remodeling the interior and exterior of their facilities, adding service lines, converting units to private rooms, and expanding therapy space. Additionally, competitive pressure continues to increase from other nonprofit and for-profit organizations, particularly in the assisted living and memory care space. Therefore, the need to access capital to meet these changing demands is as important now as it will be in the future.

Today's new long-term care residents are generally older, have higher activity levels, and have a greater need for dementia and memory care units. More residents are also seeking community-like settings, putting pressure on organizations to transform their traditional institutional environments into this increasingly popular model of care. Providers also face the continuous need to enhance technology by adopting electronic health records and adding features such as motion detectors and health monitoring devices as well as wireless service for tech-savvy residents. Repurposing or repositioning facilities and modernizing physical plants and technology will require capital expenditures.

This paper is designed to demystify several long-term financing options for nonprofit senior living providers and describe the advantages and disadvantages of each to help their organizations fulfill their missions and operate in perpetuity. First, as a necessary preamble to the discussion of various financing options, this paper outlines the relationship between a provider's strategic plan for future operations and its financial plan. Then, capital funding options are discussed. Each option is a viable financing vehicle in normal market conditions. However during a major economic downturn, such as the one that began in 2008, providers are more challenged to find cost-effective and term-favorable funding solutions. In such risk-averse markets government agency loan programs, like FHA mortgage insurance, may be a compelling funding alternative, as other finance options are temporarily sidelined or their effectiveness is temporarily diminished. In these times advice and perspective from your trusted advisor is of the greatest value.

Further, an organization has the opportunity to issue debt on its own, or with commercial or agency credit enhancement, and each option is detailed in this paper. Therefore, the paper also explains how nonprofit senior living organizations are perceived by creditors and investors. Part II outlines specific long-term debt financing options, and Part III rounds out the financing structure discussion by highlighting the critical role financial risk management plays in an organization's financial plan. Finally, several appendices provide technical insights.

Funding a nonprofit senior living organization's growth through the most appropriate financing methods helps ensure the proper maintenance of its capital structure. A strong capital structure is at the foundation of an organization's credit strength and, as such, is critical to its ability to optimally fund organizational growth, generate operating income, and deliver enhanced services.

Part I Integrating Strategic Plans and Capital Financing

Accessing capital requires the precise matching of an organization's financial plans with its strategic plans and an informed, unbiased understanding of an organization's ability to borrow. Whether a provider chooses to build or acquire a facility, expand or renovate existing facilities, or refinance outstanding indebtedness to improve cash flows, its strategic plans and credit strength will determine its financing options.

Moreover, the tax-exempt status of nonprofit organizations provides alternatives to traditional financing options. In addition to exclusion from income and property tax levies, as well as sales tax, the government allows nonprofit organizations to borrow money through the issuance of debt for certain specific purposes and pay interest to investors that is free from taxation. This is referred to as tax-exempt financing and can result in a less expensive cost of capital relative to other debt options, including conventional bank loans.

Strategic Plans

Providers must evaluate their strategic plans and their funding needs in tandem to accurately determine their best funding options. The first step towards securing funding of any kind is performing an assessment to determine capital needs and understand credit strengths and weaknesses.

A strategic plan outlines an organization's long-term mission, including any anticipated changes to infrastructure and services in the context of the demands of the markets the organization serves. Strategic plans should be reviewed regularly and updated as needed. Markets change constantly, and long-term strategic and expansion plans should focus on the market's needs and an organization's unique ability to meet them.

A well-crafted financial plan matches a provider's financial resources to the elements of the strategic plan by quantifying available capital and outlining a capital allocation plan both among facilities and within facilities. The capital allocation plan should be integrated into a strategy to manage assets and liabilities so the organization not only accomplishes its strategic objectives, but improves its capital structure—and hence its credit strength.

The financial plan quantifies capital available from existing internal and external sources. Internal sources include operations, monetization (sale) of assets, cash and investments; while external capital includes philanthropy, operating and capitalized leases, and long-term debt. This paper focuses on methods to access long-term debt as part of an integrated strategic and capital plan.

When borrowing, senior living providers and their advisors balance long- and short-term goals with creating an optimal capital structure that will maintain or improve their organization's credit profile. Some borrowers, for example, prefer to make larger equity (cash) contributions to reduce the amount of debt necessary to fund a project. While reducing the amount of borrowed capital may initially seem desirable, such actions often have an offsetting negative impact on liquidity, resulting in a less desirable credit profile. Over-reliance on debt, on the other hand, can also strain an organization's resources. These decisions can affect the organization for decades, making it critically important to understand the funding options available and the impact each will have on the organization. The organization's leadership team's ultimate goal is to develop a finance strategy that maximizes the benefits of access to the capital markets and minimizes the cost of such capital.

It is important to recognize that the process of creating an optimal capital structure is fluid and requires thorough analysis. Reliance should be placed on professionals with

a comprehensive understanding of the impact of financial decisions on asset management, liabilities and cash flow. Finally, a key point must be kept in mind when refining an organization's capital strategy: Nonprofits are designed to operate for the long-term. They do not have the same goals as for-profit corporations, which often have exit strategies, and their financial strategies should reflect their mission to serve in perpetuity. Advisors should help organizations understand this key difference and take advantage of opportunities to improve overall credit strength and long-term fiscal strategies.

Recognizing Strengths and Weaknesses: The Credit Profile

A senior living organization's credit strength or financial health is the single most important factor in determining its cost of capital and the flexibility of the terms associated with that capital, including collateral, term/amortization, financial covenants, ancillary business and guarantees.

Organizations with strong financial health have greater ability to repay debt, so they tend to be more appealing and less risky to credit enhancement providers or investors who buy bonds. Investors balance their risk with interest rates and financing terms. Therefore, the stronger the credit profile, the lower the interest rate on the financing and the

more favorable the terms of the financing for the organization (Figure 1).

Traditionally, investors relied on rating agencies such as Standard & Poor's (S&P), Moody's, and Fitch Ratings to assign a rating to a debt issue. However, the opinions of rating agencies, while very useful, cannot be considered in a vacuum. The ability of an organization (or its advisor) to directly communicate its credit attributes to potential investors and credit enhancement providers now has an even greater impact on its ability to access capital and the cost/terms of that capital.

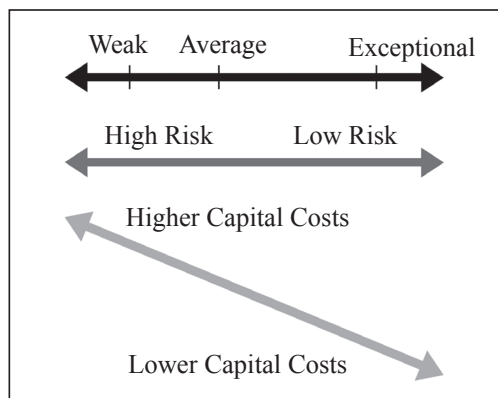
Investors and credit enhancement providers review both quantitative and qualitative factors to measure an organization's credit strength; quantitative factors define a borrower's ability to repay debt, and they place a borrower within a broad credit range. Qualitative factors determine long-term financial viability and refine the borrower's position within that credit range.

Financial ratios that demonstrate financial performance are used in quantitative analyses. These ratios can be generally grouped into three categories: capital structure, liquidity, and profitability. Appendix A: Definition of Ratios, provides a list of notable ratios and their definitions. The following ratios tend to be relied upon most frequently when assessing creditworthiness:

- Debt Service Coverage
- Days Cash on Hand
- Operating Margin
- Debt to Capitalization
- Cash to Debt

A credit assessment that considers only quantitative financial ratios, however, is inadequate. Credit analysis is both science

Figure 1: Credit Profile and Funding Cost



and art and goes well beyond the organization's financial statements. Qualitative factors such as management, local economic factors, demographic changes, competition, and technological capabilities are important aspects of the credit profile as well. Particular attention will be given to board members' competence and independence as well as management's experience and proven skill sets.

Ignoring these qualitative factors can give an organization and the credit markets an incomplete picture of its credit profile and financial options. For example, an organization with strong financial ratios located in a highly competitive or struggling metropolitan area may find accessing capital more difficult than its financial ratios suggest. Conversely, a well-articulated qualitative analysis of an organization's market position or area demographics may allow it to access capital at a lower cost than its quantitative profile might suggest. Appendix B: Factors in a Long-Term Care Organization Credit Analysis, highlights important considerations in assessing creditworthiness.

Summary

In order to appropriately meet the demands of its market and continue its mission in perpetuity, a senior living provider should develop a detailed strategic plan outlining the short-term and long-term needs of the organization. A key component of the strategic plan is the financial plan. The organization should assess its internal and external sources of capital and determine what external capital needs, if any, it may have in the future. Access to capital will be determined by the overall credit profile of the organization. After assessing its credit profile, a provider can work with its financial professional(s) to determine the optimal way to leverage its strengths and/or use strategic enhancements to improve its position on the credit continuum, thus achieving optimum flexibility and cost of capital.

Part II Financing Options For Nonprofit Senior Living Organizations

The Capital Markets for Long-Term Care Providers

Before outlining traditional and alternative sources of capital for nonprofit senior living facilities, it is necessary to address the current state of the capital markets for long-term care providers. Beginning in mid-2011, the availability of capital for senior living and healthcare projects has been steadily improving compared to the low period following the 2008 downturn.

By way of background, long term care providers witnessed historic changes to the financial markets beginning in 2008. Events such as the collapse of auction-rate bonds and the subsequent, collective downgrade of bond insurers, the restructuring of Wall Street (i.e., Bear Sterns, Lehman Brothers, etc.) and historically high spikes in tax-exempt variable rates, created an unattractive borrowing market. However the markets have been improving and interest rates for highly-rated investment grade senior living providers have been consistently decreasing over the past 18 months. This reversal can largely be attributed to significant inflows of investor capital into municipal funds, resulting in increased purchases of tax-exempt bonds. As a result, credit spreads (the incremental interest rate paid for projects with higher risk) between BBB-rated senior living providers and higher rated municipal credits have narrowed, and are more in line with historic levels.

With an emerging abundance of capital available in today's market, bank financing bears some consideration as well. Private placements of tax-exempt bonds with a bank, or utilizing a bank's creditworthiness to enhance bonds through a letter of credit structure are options to explore.

Of note, bank private placement transactions have recently become a preferred option to the letter of credit structure in many cases. One reason for this shift is the pending higher capital requirements banks must set aside in reserves as mandated by the Basel III global regulatory standard, negatively impacting the letter of credit structure. As such, commercial enhancement via a letter of credit has generally become scarcer and more expensive for senior living borrowers.

As a senior living provider evaluates funding alternatives for its capital projects it is critical for its leadership team to recognize that access to capital is ultimately determined by a combination of microeconomic factors (i.e., the organization’s credit profile) and macroeconomic factors (i.e., state of the capital markets), and today’s funding capabilities are markedly different than the not so distant past.

Traditional Sources of Capital

External funding options are composed of gifts, operating and capitalized leases and long-term debt. Gifts include grants and community donations. Grant pools, even at the federal level, are highly competitive, and funding is limited. And while community donations can potentially provide a significant source of capital and demonstrate community support for senior living projects, access to funds is often limited and unpredictable, and large undertakings often require additional financing because gifts may not meet total funding needs.

Long-term debt, usually tax-exempt bonds or taxable notes, is a popular choice for providers to access capital. Bonds and notes represent an obligation of the borrower to pay interest to the investor in return for the lending of capital

Figure 2: Bond Ratings

	Explanation	S&P	Fitch
Investment-grade	Highest rating, capacity to repay extremely strong, highest quality	AAA	AAA
	Very strong capacity to repay, differs slightly from AAA, high quality	AA	AA
	Strong capacity to repay/more susceptible to change in circumstance/economic conditions, upper medium grade	A	A
	Adequate capacity to repay, adverse economic conditions may lead to weakened capacity to repay, medium grade	BBB	BBB
NON-Investment-grade	Speculative characteristics, less near-term vulnerability to default	BB	BB
	Capacity to meet payments, greater vulnerability to default, speculative, low grade	B	B
	Current identifiable vulnerability to default, poor to default	CCC	CCC
	Weak credit quality, highly speculative	CC and below	CC and below

over a given period of time. The interest rate is determined by conditions in the capital markets and is influenced significantly by the credit characteristics of the borrower, security provisions provided to bondholders, and the financing structure.

Typically, interest paid to investors on bonds is taxable by federal, state and local governments. However, by issuing bonds through a governmental or municipal entity, it is possible for an investor to receive interest income not subject to taxation. Thus, the bondholder will charge a lower rate to realize the same after-tax return they would otherwise achieve on a similar taxable investment. This benefit is passed along to nonprofit borrowers in the form of reduced cost of capital. See Appendix C: Basics of a Tax-Exempt Bond Issuance, for a diagram of a bond transaction, and Appendix D: Typical Costs in a Bond Issuance, for the costs associated with the transaction. Generally tax-exempt bond proceeds can be used to acquire, construct or renovate depreciable assets and purchase land. Certain costs related to the issuance of the bonds can also be included as an

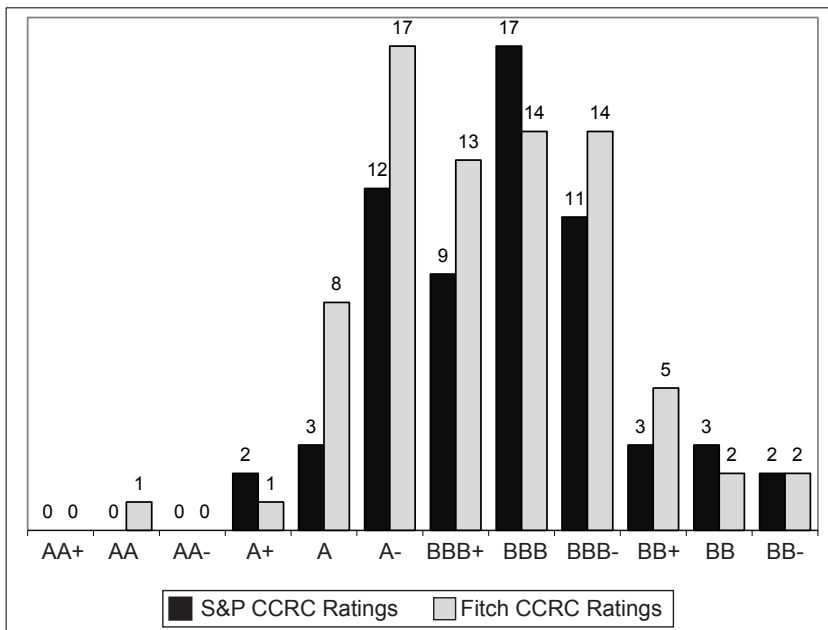
eligible use of proceeds.

Although the restrictions for issuing tax-exempt debt are numerous, the potential savings can be considerable. Additionally, it should be noted that anything deemed ineligible to be financed with tax-exempt bond proceeds can be funded with other forms of debt, including a term loan, line of credit, taxable notes or cash. For a more complete understanding of what type of bonds can be issued and for what purposes, please see Appendix E: Notable Requirements for Tax-Exempt Bonds.

Bonds, whether taxable or tax-exempt, can be rated or unrated. The ratings, established by rating agencies such as Standard & Poor's (S&P) and Fitch, range from AAA to C, as shown in Figure 2, and can change if the borrower's financial situation changes.

Rating agencies charge a fee to assign ratings to borrowers' bond offerings. Ratings suggest to investors the amount of risk involved in purchasing a particular bond. AAA to

Figure 3: CCRC Rating Dispersion*: S&P vs. Fitch



*Reflects financial performance for 2011

Figure 4: S&P and Fitch Median Ratio Dispersions for CCRCs

	S&P Nonprofit CCRCs ¹ “BBB”	Fitch Nonprofit CCRCs ² “BBB”
Profitability Ratios: Operating Ratio (%)	93.0	97.2
Excess Margin (%)	3.0	5.5
Liquidity Ratios: Days Cash on Hand	340.8	369.0
Cushion	8.8	6.6
Cash to Debt (%)	73.0	50.9
Capital Structure Ratios: Historical DSC (EBITDA)	1.1	2.0
Debt to Capitalization	81.3	58.7
Average Age of Plant (years)	11.6	10.4

¹S&P median numbers taken from “Senior Living Providers’ Median Financial Metricsw Held Steady in 2011,” which reflect financial performance for 2011. Data is based on CCRC ratings.

²Fitch median numbers taken from “Fitch 2012 Median Ratios for Not-For-Profit Continuing Care Retirement Communities,” which reflect financial performance for 2011. Data is based on CCRC ratings.

BBB bonds are considered “investment-grade.” Unrated or low-rated bonds are often referred to as “speculative-grade,” “junk bonds” or “high-yield bonds.” The higher the bond rating, the stronger the borrower’s perceived ability to repay the principal and interest associated with the bond, and the lower the interest rate the borrower must pay to offset investor risk.

S&P and Fitch continue to deliver the most effective ratings for nonprofit senior living. Figure 3 shows a comparison between S&P and Fitch’s ratings for nonprofit CCRCs, and Figure 4 illustrates the difference in the two agency’s ratio dispersions.

Rated and unrated bonds generally can be sold either without any additional enhancement and marketed based

Figure 5: Sources of Capital

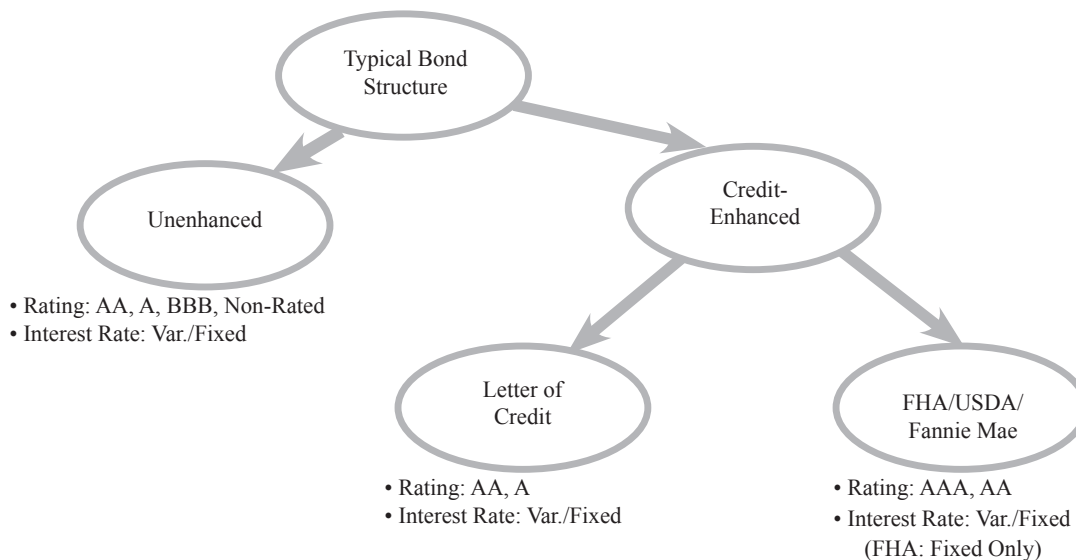
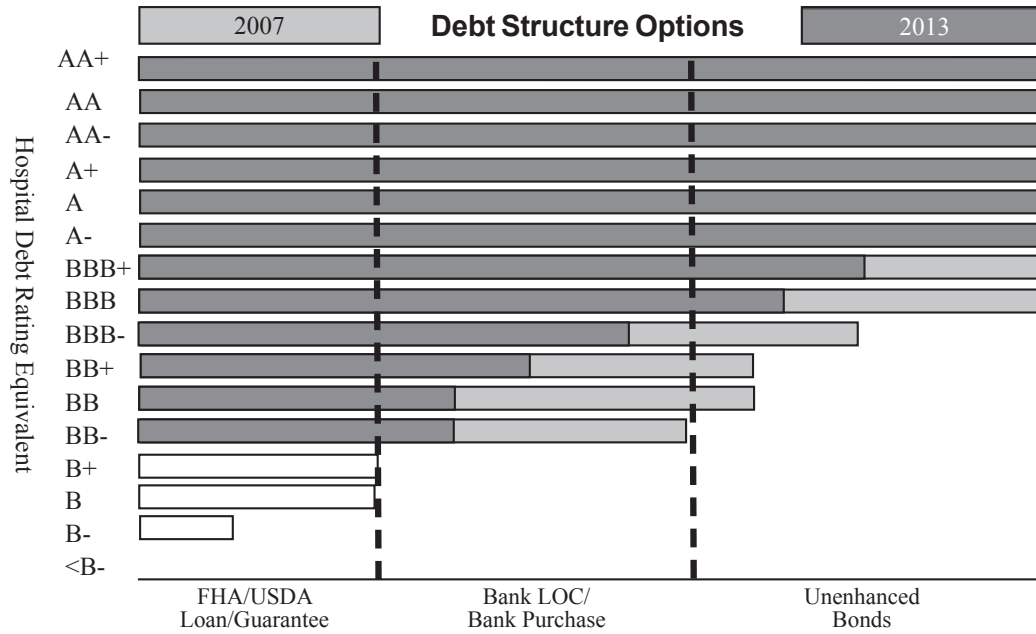


Figure 6: The Credit Continuum



on the strength of the borrowing entity or credit-enhanced using vehicles such as mortgage insurance and letters of credit (Figure 5).

Credit enhancement makes mortgage notes and bonds less risky to the investor and potentially more affordable for the organization. Enhancement does not change the credit rating, but changes the rating on the debt, potentially allowing the borrower lower interest rates. Credit enhancement can be provided either by commercial institutions, such as banks and bond insurers, or a public entity such as a federal government agency or government sponsored entity.

Borrowers with stronger credit profiles generally have more financing options than organizations with weaker financial profiles (Figure 6). Providers often will choose to access the capital markets using some form of credit enhancement when the interest rate savings is greater than the cost of the credit enhancement.

If a senior living provider decides to issue long-term debt, the first step is to select a financial professional to guide the

process. The investment banker/advisor a provider selects should have long-term care and capital market experience as well as expertise in the full range of financial options available to nonprofit senior living facilities. Boutique firms that specialize in senior living may be as, or more, capable than large Wall Street, or “bulge bracket,” firms at obtaining the lowest cost of capital because they can be knowledgeable in a wide variety of structures to fund a specific industry rather than a few structures to fund many industries. Depending on the situation, it may be desirable to employ more than one underwriter, called a syndicate, to complete a debt sale to take advantage of the individual strengths of each firm to minimize capital costs and maximize distribution to investors. Other parties central to the transaction can be found in Appendix F: Key Participants in Nonprofit Senior Living Financings.

Each provider must evaluate its situation to find the optimal funding option for its organization, as no two situations are alike. Only after a thorough financial analysis and a clear understanding of its current credit profile should the organization’s leadership team move to evaluate its capacity

to take on new debt, refinance existing debt or implement other long-term strategies to bridge the gap between the strategic plan and internal resources. Due consideration should be given to all available financial options, as the effectiveness and benefits change with interest rates, fees and other market factors. The option which initially seems the most cost-effective may actually be more expensive in the long term. To avoid costly, time-consuming changes in strategy, borrowers can also consider using a “multi-track” financing approach in which various scenarios are analyzed, and often pursued, concurrently. This way, an organization that needed to change its financing option midway through the process would already be part way down the path of a secondary option rather than back at the beginning.

A) The Rating Process

A nonprofit senior living organization with investment grade financial ratios may desire to secure a public credit rating. A credit rating quantifies the borrower’s financial strength in the form of a type of letter grade. Ratings are provided by two primary rating agencies: Fitch and Standard & Poor’s.

The process for securing a credit rating takes approximately 30 to 45 days, and typically begins about 60 to 90 days prior to the bond issue closing. To begin the process, the provider’s financial advisor or investment banker will forward the organization’s credit information to the selected rating agency(ies). This information will include the organization’s historical financial data, financial projections (if any), project plans, demographic information, management and board biographies, and other data detailing its credit profile. The information will also likely include draft bond documents.

The rating agency will complete a preliminary review of the information and then hold an in-person meeting where the organization’s management, with the aid of its financial advisor or investment banker, will present its credit profile.

This is either held on site at the facility or at the rating agency offices. The presentation provides an opportunity for the rating agency analysts to ask questions regarding the organization’s financial performance, proposed projects and other credit characteristics. If the organization has any potentially negative credit characteristics, it is important to demonstrate how management has, or is, correcting them as it provides an opportunity to display management talent. In addition, all positive credit characteristics need to be highlighted for the rating analysts. Following the rating presentation and any subsequent conference calls, the rating agency’s credit committee will make a rating determination.

The rating determination will be detailed in a rating report and included in the organization’s bond offering documents which are available to investors and/or credit enhancement organizations. The rating agency will revisit the rating report on at least an annual basis upon receipt of the borrower’s audited financials for the life of the bonds and upgrade, downgrade, or affirm the credit rating after its periodic review. Additionally, it will assign a positive, negative or stable rating outlook. It is important to proactively manage this process in order to maintain, or possibly seek an upgrade, in the rating. If the organization hopes to finance future projects in the public debt markets, maintaining its investment grade rating is imperative. See Figure 2 on page 9 for information on ratings.

If the rating offered by the agency would be detrimental rather than helpful, the organization can choose not to publish the rating and instead issue non-rated bonds. Depending on the rating agency and capital market conditions at the time, non-rated bonds may result in a lower cost of capital than non-investment-grade rated bonds. This market analysis can be performed and explained by the provider’s advisor or investment banker.

B) Unenhanced Bonds

Nonprofit senior living facilities with excellent credit strength may choose to issue bonds without additional credit enhancement.

Investor acceptance of unenhanced, rated or unrated, bonds sold on the credit profile of the borrowing entity fluctuates based on credit market conditions. Unenhanced debt offerings are supported solely by the borrower's credit characteristics. Bondholders are typically provided collateral in the form of a first mortgage and lien on property assets, a pledge of the organization's revenues and a lien on trustee-held reserves, including a debt service reserve fund. Appendix G: Security and Covenants, provides additional information on security provisions.

Figure 7: Unenhanced Bonds

Unenhanced Bond Characteristics	
Tax-Exempt	Yes
Fixed-Rate Option	Yes
Variable-Rate Option	No
Est. Max Term	30 Years
Est. Max Amortization	30 Years
First Mortgage Required	Typically
Non-Recourse	No
Debt Service Reserve Fund	Yes
Prepayment Penalties	Yes
Underlying Rating	Optional
Enhancement Renewal Risk	No
Ongoing Financial Covenants	Yes
Structuring & Closing Timeline	150 Days

Unenhanced bonds are commonly structured as fixed-rate with various intermediate maturities and a final term of 25 to 30 years from the date of issuance (Figure 7). The financing normally includes pre-payment penalties in the first ten years, commonly called the call feature or lock-out period.

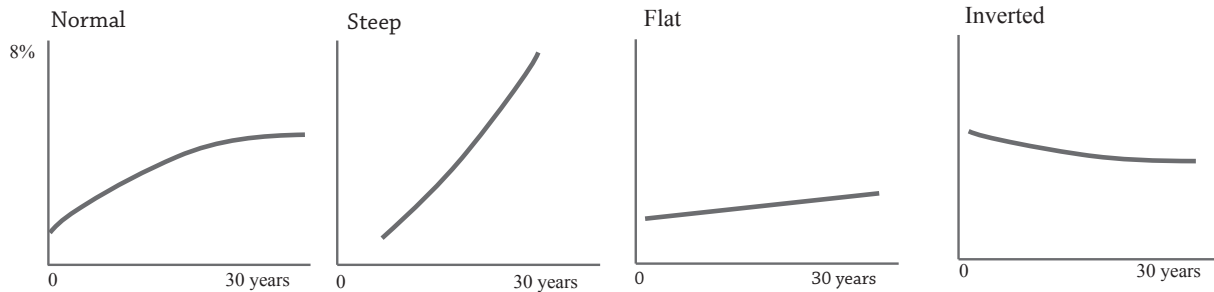
These penalties are included to protect the investors who have an expectation that their fixed-income investment will pay interest for a number of years. They can be structured in a number of ways from "hard-locks," meaning a period in which no pre-payment can occur, to scaled penalties (i.e., 5% in year five, 4% in year six, etc.) where pre-payment can occur, but an incentive exists to allow the bonds to remain outstanding. Most tax-exempt nonprofit senior living bonds include a feature called a sinking fund that leads to principal being redeemed each year, similar to a traditional home mortgage, to avoid a large balloon payment or the need to refinance at maturity, a common feature in the taxable corporate bond market. Sinking funds are paid to a Trustee who assigns bonds to be redeemed with those funds. Since sinking funds are planned in the Bond Documents there is no pre-payment penalty associated with sinking fund payments even if the payment occurs during a pre-payment hard-lock or penalty period.

Since bond investors rely on the credit strength of the borrowing entity to assess repayment ability, considerable due diligence must be conducted by finance team members and extensive disclosure provided to investors in the official statement. This may include a market and financial feasibility study conducted by a recognized accounting firm experienced in assessing similar projects, examination by a rating agency, as well as full disclosure of the organization's operations and historical financial results. There is also a requirement for ongoing disclosures of information to rating agencies and/or investors through a Nationally Recognized Municipal Securities Information Repository (NRMSIR), such as Bloomberg LP.

Factors to Consider

Borrowers who issue bonds and notes on their own merit do not have to pay fees to use credit enhancement provided by a bank, bond insurer or government agency; but they

Figure 8: Yield Curve Examples



may find capital more expensive over time and be subject to higher or longer prepayment penalties, potentially more restrictive covenants and other investor requirements. This option may be more or less appealing to borrowers depending on the bond offering's size, its prospective rating and market interest rate levels. Unenhanced bonds have been a viable source of funding for senior living providers for decades and for many years were the only long-term bond option available. Its suitability depends on credit spreads, yield curves, and investor appetites. Your finance professional should be able to articulate the circumstances to consider this option.

Two of the most important considerations when determining whether to use unenhanced bonds at any point in time are the yield curve and credit spreads.

The Yield Curve

The yield curve indicates the time risk an investor assumes when purchasing a debt obligation. Figure 8 demonstrates several examples of yield curves. A "normal" yield curve depicts an environment in which the cost to borrow funds for a shorter period (e.g., five years) is less than the cost to borrow funds for a longer period (e.g., 30 years) reflecting the lower risk of principal payment default associated with a shorter time horizon. Normal curves also vary in steepness, or the slope of a curve. A steep slope reflects a large

difference between perceived short and long-term risks, and therefore, interest rates, while a flat curve indicates that the cost to borrow funds in the short term is the same as the cost of long term funds. Yield curves can actually become inverted where the cost to borrow short-term funds is higher than the cost of long-term funds. Both flat and inverted curves frequently occur during periods where central banks are employing "tightening" policies, wherein a central bank, such as the US Federal Reserve Bank, uses tools at its disposal to make funds for lending less available in an effort to slow economic growth. In flat and inverted curve environments, long-term borrowing becomes more attractive to borrowers relative to shorter term alternatives. Nonprofit senior living facilities that issue a relatively large amount of debt can take advantage of a yield curve in any environment through the judicious use of serial and term bonds. Term bonds are traditional tax-exempt bonds where a stated maturity occurs at some date in the future and sinking fund payments redeem some value of the total maturity each year and serial bonds are issued in a series with a full maturity occurring in every year of the serial bond series in lieu of a sinking fund. In a normal yield curve environment an organization may save a significant amount in interest expense by issuing more than one series of bonds as opposed to a single term bond with sinking fund redemptions.

The Credit Spread

Credit spreads reflect the additional borrowing cost associated with borrowers with different ratings. Credit spreads are usually described as a margin to an index (i.e., Treasuries, Bond Buyer Revenue [BBR], SIFMA, LIBOR swaps, etc.) or highly rated bonds in a similar category (i.e., AA+ rated bonds). When credit spreads are wide (i.e., the borrowing cost of a lower-rated borrower is notably higher than the cost of capital for a higher-rated borrower) some of the enhancement techniques described below become particularly attractive because the cost of the enhancement is less than the cost savings associated with obtaining a higher rating. Conversely, when credit spreads are narrow (i.e., the borrowing cost of a lower-rated borrower is near the cost

for a higher-rated borrower) the benefit of enhancement may be low and unenhanced bonds become a relatively more attractive option for all borrowers. Credit spreads are usually particularly pronounced for longer-term issues and fluctuate over time.

Bank Loans, Private Placements and Bank-Qualified Bonds

Another source of unenhanced capital comes from traditional commercial bank loans in the form of real estate or equipment term loans. These products are readily available from local and national banks. Interest rates associated with these loans can be fixed or variable. Long amortizations, similar to traditional bonds, can be obtained, but a lender is

Case Study: Unenhanced Fixed-Rate Tax-Exempt Bonds

Background and Challenges

St. Leonard, in Centerville, Ohio, is a subsidiary of Franciscan Services Corp, which originally bought and rehabilitated the property using floating-rate tax-exempt bonds enhanced by a bank letter of credit (LOC) and underwritten by Lancaster Pollard. With rates very low for years after purchase, the structure became one Franciscan Services favored. The campus offers a full continuum of senior care and housing services, including a 120-bed licensed nursing center, 71 assisted living units and 324 independent living units. Of the campus' 240 acres, 97 are developed. St. Leonard's next project would expand nursing and assisted living capacity and build a new wellness center and maintenance building.

Financial Solution

St. Leonard is very strong financially; it could have covered the debt service for the project without including income from any of the 81 planned new units. It

again sought to use a letter of credit and variable-rate debt synthetically fixed using swaps. But the project was coming to fruition in mid-2009, the height of bank downgrades. Despite St. Leonard's strong performance, no bank would offer an affordable LOC. Lancaster Pollard evaluated FHA mortgage insurance, but HUD financing would have required complex bifurcation of the property's cash flow and limited flexibility by mortgaging the entire campus—even the undeveloped acreage. Equity contributions would have been higher than those achievable via other alternatives.

Lancaster Pollard and St. Leonard continued to monitor the markets and debt options, waiting through the icy winter to avoid holding construction debt on the balance sheet when ground couldn't be broken. As the credit markets reopened for investment-grade projects, Lancaster Pollard pursued a credit rating for St. Leonard, dual-tracking this process with

continued evaluation of LOC banks. As a result of the process St. Leonard received a BBB- rating from S&P, creating the opportunity to access the fixed-rate debt market at a reasonable interest rate.

Outcome

St. Leonard ended up with a \$41.1 million fixed-rate tax-exempt financing with a 30-year term. The property has no LOC bank downgrade risk, refinance risk, or balloon payment risk. It is in a permanent, safe, and affordable structure that provides stability for the next 30 years. The 30 new nursing units and 51 new assisted living units will contribute additional revenue, and the campus will be enhanced by the new wellness center and maintenance building. The proposed expansion will be built expanding on the currently developed 80 acres. St. Leonard also used the bond proceeds to refinance nearly \$14 million in outstanding debt.

Case Study: Bank-Qualified Private Placement

Background and Challenges

Mennonite Home Communities of Ohio (MHCO) was founded in 1955 by local Mennonite churches. MHCO provides a continuum of care, including independent living apartments and duplexes, assisted living units and skilled nursing care at two closely located campuses, Mennonite Memorial Home and Maple Crest. The MHCO Board of Directors wanted to provide more resident-centered care by building six 10-bed Green House® facilities on a nearby third campus. A departure from traditional skilled nursing and assisted living facilities, the smaller Green House model provides a home-like environment to deliver skilled professional

services to long-term-care residents. Additionally, the MHCO board also wanted to fund renovations of the Mennonite Memorial Home.

Financial Solution

Lancaster Pollard, realizing the scope of the entire project was too large in light of the tight credit market at the time, suggested to the client that the project could be accomplished in phases and to finance just two houses initially. Because MHCO had little existing debt, Lancaster Pollard conservatively structured the \$7.7 million, tax-exempt bond issue with a 25-year amortization as a bank-qualified FlexNoteSM, resulting in a competitive

10-year fixed rate note of just above three percent. In addition to the Green House project, the bonds funded the renovation to the main campus and refunded an existing indebtedness.

Outcome

With the construction of two smaller homes, MHCO will be able to keep its commitment to offer a familiar and comfortable environment for its residents while taking on an appropriate amount of debt for the organization at a low fixed rate. Renovations to the Mennonite Memorial Home primarily will create private units with full baths and two new dining spaces as well as other upgrades.

usually only willing to commit to provide the funding for a limited period (5 to 10 years) creating the need to refinance or pay down outstanding principal at maturity. Furthermore, many lenders are unwilling to commit to fixing the rate of the loan for its entire period.

Tax-exempt bonds can be privately placed with financial institutions such as local banks, regional banks, and specialized financial institutions. Small banks may not be able to purchase the entire bond amount, but the investment banker may be able to identify multiple banks to each buy a portion of larger debt issuances (generally required for financings over \$20 million). This structure may allow the senior living provider to reduce issuance costs and potential time to market, but it is usually not viable for larger issues where better execution is obtained using other options. Privately placed bonds are singularly negotiated with one or a select group of investors, so depending on market conditions, disclosure requirements can sometimes be minimized and covenants made more flexible (Figure 9).

When tax-exempt bonds are “bank-qualified,” banks can

deduct 80% of their purchase and carrying costs and can pass along the savings to borrowers by way of a reduced interest rate. The bonds must be issued for qualified tax-exempt obligations. Currently, only \$10 million in bonds can be designated bank-qualified by any single bond issuer (often the local municipality) in one year, and the bonds must be issued for qualified tax-exempt obligations. Providers may be able to phase projects over multiple years if

Figure 9: Private Placements (May Be Bank-Qualified)

Bank-Qualified Private Placement Characteristics	
Tax-Exempt	Yes
Fixed-Rate Option	Yes
Variable-Rate Option	Yes
Est. Max Term	25 Years
Est. Max Amortization	25 Years
First Mortgage Required	Yes
Non-Recourse	No
Debt Service Reserve Fund	No
Prepayment Penalties	Conditional
Underlying Rating	No
Enhancement Renewal Risk	No
Ongoing Financial Covenants	Yes
Structuring & Closing Timeline	90 Days

a project is over \$10 million or if a portion of the issuer's bank-qualified limit has already been committed. If the local municipality has already met its limit for the year, providers in some states can seek out other qualified issuers with remaining bank-qualified bond capacity, for example a nonprofit organization or certain state or county agencies.

Commercial banks are also able to provide providers with short-term, tax exempt loans to begin work on projects with the expectation that this loan will be taken out by a longer-term financing. This type of financing would be used in lieu of a bond anticipation note (BAN). A BAN is a government-issued, short-term interest-bearing debt instrument that will be paid off by the proceeds from another bond sale soon to be issued. The willingness of a financial institution to provide a short-term loan or investors to purchase BANs depends on the provider's credit profile and the relative certainty of the short-term loan/BAN takeout financing. Rating agencies have been scrutinizing both of these credit attributes when rating BANs. Direct placements and bond anticipation notes are commonly used to finance construction projects with USDA Community Facility Direct Loan take-outs.

BANs carry some risk to an organization; for instance, if BANs are issued and markets or operations change significantly from the assumptions made at the time of the BANs, it may become costly to issue longer-term bonds. A provider may prefer to wait for a more opportune time to issue bonds, but the maturity of the BANs could force it to borrow in longer-term markets or face significant penalties from the lending institution in the form of higher rates on a short-term loan, prohibitive financial covenants, and other operational restrictions. The primary benefit of a BAN is its ability to provide capital that allows project work to begin without the multi-month delay usually associated with issuing tax-exempt bonds.

C) Commercial Enhancement

Nonprofit senior living providers also have the option to obtain a commercial enhancement in order to secure lower interest rates on their bonds with a letter of credit.

Letters of Credit

A letter of credit issued by a commercial bank is an obligation to make principal and interest payments in the event the borrower is unable to make payments. With that credit support, an organization can issue bonds backed by the bank's credit strength at correspondingly lower interest rates. Borrowers pay letter of credit banks a fee to utilize this option. The cost of a letter of credit is largely driven by the perceived credit risk of the organization and typically includes a one-time upfront fee along with an annual charge. Letters of credit are usually issued for three- to five-year terms and can be renewed or substituted, while the bonds they enhance have variable interest rates and generally amortize over 20 to 30 years (Figure 10). Letter of credit structures provide more flexibility than many other options, but banks may be hesitant to extend credit. The project and the obligor's credit profile must fit into the underwriting requirements of a commercial bank. Letter of credit structures were common until the financial crisis of 2008 and its subsequent fallout. The number of banks issuing letters of credit has declined as banks were downgraded after the crisis and because of higher capital requirements mandated by the Basel III global regulatory standard.

There are two types of letters of credit, stand-by and direct-pay. A stand-by letter of credit is used when an organization utilizes its own high investment grade rating to back the bonds (unenhanced), has sufficient liquid assets to cover the principal amount of the bonds, and is comfortable providing a self-guarantee for payment of the bonds if necessary.

Figure 10: Letters of Credit

Letter of Credit Characteristics	
Tax-Exempt	Yes
Fixed-Rate Option	Yes
Variable-Rate Option	Yes
Est. Max Term	30 Years
Est. Max Amortization	30 Years
First Mortgage Required	Typically
Non-Recourse	No
Debt Service Reserve Fund	No
Prepayment Penalties	No
Underlying Rating	No
Enhancement Renewal Risk	Yes
Ongoing Financial Covenants	Yes
Structuring & Closing Timeline	120 Days

The stand-by letter of credit provides liquidity support to the bond issue, a requirement of buyers of variable-rate bonds. Liquidity support refers to the mechanism available to quickly pay off principal and interest in the event of a “put,” or the cashing out of one investor and resulting need to pay that investor quickly, or in the event of a failed remarketing or resale of bonds in the market. Alternatively, a direct-pay letter of credit provides credit enhancement and liquidity support. Investors receive normal principal and interest payments from the commercial bank providing the letter of credit and the commercial bank is immediately reimbursed for debt service payments by the organization. Direct pay letters of credit are commonly used for low investment grade or non-investment grade organizations where the investor demands assurance that payment will not in any way rely on the credit strength of the underlying organization if it does not have sufficient liquidity to cover the entire principal amount of the bonds.

Bonds issued with a letter of credit are called variable rate demand bonds (VRDB), and as the name implies, the rate on the bonds is variable and in most cases resets at a regular frequency, typically every day or week. In periods of low short-term interest rates it is not uncommon for these

bonds to bear a coupon of under 1%. The downside to these potentially low interest rates is that investors need to be assured that they can liquidate their positions on short notice. Remarketing agents are responsible for coordinating the sale (remarketing) of VRDBs to investors.

When the interest rate spread between taxable and tax-exempt interest rates is minimal, the Federal Home Loan Banks’ (FHLB) authority to provide letters of credit for taxable transactions affords nonprofit senior living providers the ability to work with unrated or low-rated community banks and gain access to the usually high-investment-grade ratings of a FHLB. A FHLB letter of credit provides up to a 10-year term and its annual fees (in addition to the annual fee paid to the participant member bank(s)) are relatively low, currently ranging from approximately 20 to 45 basis points depending on the FHLB and letter of credit structure. However, FHLB member banks are required to post collateral with the FHLB equal to the amount of the letter of credit, making this option overly restrictive for some member banks. Additionally, community banks often have low lending limits that may prohibit them from providing all of the required letter of credit capacity.

D) Agency Enhancements

In recognition of senior living facilities’ essential roles in society, the federal government created several funding and credit enhancement programs to assure that these facilities can access capital in order to continue their missions, evolve with changing technology, and remain competitive and viable. Government agency enhancements put the full credit support of highly rated federal agencies behind senior living facilities’ loans and bonds, making them more attractive (less risky) to potential investors.

FHA Mortgage Insurance

The Federal Housing Administration introduced its Section 232 mortgage insurance program in 1934 for long-term care facilities. Since then more than 4,000 mortgage insurance commitments have been issued for more than \$16 billion in all 50 states. Project sizes have ranged from tens of thousands of dollars to more than \$65 million dollars and participants range from small, independent facilities, to some of the country's largest operators. Borrowers taking advantage of this type of credit enhancement must work with FHA-approved mortgage lenders to complete the funding.

In 2008 changes were introduced to streamline all section 232 programs, including 232, 232/223(f), 232/223(a)(7) and 232/241(a). Control of the program was moved from HUD field offices and placed under the exclusive control of the Office of Residential Care Facilities (ORCF), a subsidiary of the Office of Healthcare Programs, a division of the

Figure 11: FHA Mortgage Insurance

Advantages	Disadvantages
Long-Term Fixed Rate	Longer Deal Cycle
Low Cost of Capital	Higher Upfront Costs
No Financial Covenants	Limited for Independent Living
Fully Amortizing	No Equity Extraction
No Risk-Based Pricing	
High Leverage Point	
Fully Assumable	

Department of Housing and Urban Development, where a select team experienced in long-term care processes the applications. LEAN processing streamlined the HUD review timeframe by creating standardized checklists, statements of work for third parties, certifications and templates for use in assembly of the application package. Over the last several years, the HUD programs have been in high demand for nonprofit and for-profit borrowers, as unstable market conditions have created a lack of traditional financing alternatives, interest rates have reached historic lows, and

Figure 12: FHA Sec. 232 Mortgage Insurance

FHA Sec. 232 Mortgage Insurance Programs Characteristics				
	Sec. 232	Sec. 232/223(f)	Sec. 232/223(a)(7)	Sec. 232/241(a)
Tax-Exempt	Yes	Yes	Yes	Yes
Fixed-Rate Option	Yes	Yes	Yes	Yes
Variable-Rate Option	No	No	No	No
Est. Max Term	40 Years	35 Years	Remaining term of existing FHA Mortgage*	40 Years
Est. Max Amortization	40 Years	35 Years	40 Years	40 Years
First Mortgage Required	Yes	Yes	Yes	Yes
Non-Recourse	Yes	Yes	Yes	Yes
Debt Service Reserve Fund	No	No	No	No
Prepayment Penalties	Yes	Yes	Yes	Yes
Underlying Rating	No	No	No	No
Enhancement Renewal Risk	No	No	No	No
Ongoing Financial Covenants	No	No	No	No
Structuring & Closing Timeline	6-7 Months	4-5 Months	3-4 Months	6-7 Months

* Term extensions are available with HUD approval.

borrowers have embraced many of the advantages to HUD financing that cannot be achieved with traditional financing alternatives (Figure 11).

All 232 mortgage insurance programs offer borrowers the opportunity to issue debt at a AAA-equivalent rating and take advantage of the lower interest rates that accompany these higher credit ratings. Interest rates are fixed, which can be very appealing in a low long-term interest rate environment. Furthermore, the FHA mortgage insurance is non-recourse to the parent organization, allowing it to segregate the debt of one of its facilities; and, its high loan-to-value ratio can minimize up-front cash requirements. Lastly, there is no limit to the amount of debt the program will insure, so long as the provider can prudently support the debt repayment (Figure 12).

The FHA 232 program is available to licensed skilled

nursing, assisted living and board and care facilities with limited independent living units to fund new construction, or substantially renovate existing facilities. Organizations that utilize this program can borrow up to 95% of the appraised value for new construction projects, or 100% of rehabilitation costs for substantial rehabilitation projects. To qualify for the FHA 232 program, borrowers must have a minimum debt service coverage ratio of 1.05. An organization has up to 40 years to repay the principal of an FHA 232 mortgage-insured loan following the construction term. Borrowers using an FHA 232 loan for construction or substantial rehabilitation will be subject to Davis-Bacon prevailing wages.

The FHA 232/223(f) program is intended to be used for the purchase or refinance of licensed skilled nursing, assisted living and board and care facilities with limited independent living units, along with moderate repairs and improvements.

Case Study: FHA/HUD Sec. 232 New Construction

Background and Challenges

Beth Sholom Lifecare Community was founded in Richmond in 1946 as the first Jewish home for the aged in Virginia. It operates a 116-bed nursing home (The Home), a 112-unit affordable housing community (The Woods), and a 60-unit assisted living facility (The Gardens). As part of its ongoing evolution, the organization was looking to expand after having recently recapitalized and renovated The Woods. Constructing more assisted living and memory care units presented an opportunity to meet the demand of a long waiting list while also redirecting traffic flow to realize an enhanced campus atmosphere.

Beth Sholom had limited equity as well as space in which to grow. With the credit markets tight and the need for enhanced leverage, FHA financing was recognized

as the best option for new debt. However, the land designated for Parkside was already encumbered.

Financial Solution

As the servicer on one of the existing HUD loans, Lancaster Pollard helped negotiate a partial release of the mortgaged property. Beth Sholom was able to create a new tax parcel for Parkside adjacent to The Home. Easements for the shared use of operational infrastructure (e.g., commercial kitchen) were included to utilize existing resources as well as avoid unnecessary and costly redundancy. During the underwriting process and while preparing the application for mortgage insurance, Lancaster Pollard realized that construction costs were considerably higher than expected based on valuation and other comparisons. The firm advocated for competitive bidding of the project, which

resulted in a \$2.7 million reduction and significantly reduced the equity requirement. Ultimately the firm was able to obtain \$13.1 million in taxable fixed-rate notes insured by the FHA/HUD 232 program for construction and permanent financing of the units.

Outcome

Parkside - only the second nonprofit new construction financing completed nationwide under LEAN processing - will contain 73 assisted living and memory care units. The money saved by managing costs has been reallocated for redesign of the campus, new landscaping throughout, and to facilitate future development of the community. Once the project is completed, Beth Sholom will be poised for the next step of its evolution.

Case Study: FHA/HUD Section 232 Renovation

Background and Challenges

Lakeview Lutheran Manor is one of three nursing homes operated by Lutheran Social Services of Michigan (LSSM), the largest faith-based nonprofit organization in the state and a long-time client of Lancaster Pollard. Originally built in 1963, Lakeview was in need of modernizing. In addition, demographic changes had reduced the demand for skilled-nursing beds in the market. LSSM sought to renovate the building to provide the highest standards of care for Lakeview's residents as well as improve marketability and cash flow to support the organization's mission.

Along with the challenges created by a tight credit market, the facility needed to be released from a collateral pool formed as part of a previous bond issue. Separately, one of LSSM's goals was to increase its amount of fixed-rate debt relative to its variable-rate debt.

Financial Solution

Lancaster Pollard, with its intimate knowledge of LSSM's debt structure, worked closely with the organization to move Lakeview's debt out of the aforementioned bond issue. Given the organization's goal of increasing its amount of fixed-rate debt as well as the low long-term interest rates and tight credit markets, Lancaster Pollard recommended using a long-term, fixed rate debt offering insured by the HUD Sec. 232 Program.

However, the facility was reducing rather than adding beds—an unusual scenario in the FHA 232 construction program. Understanding and being able to justify this type of project as well as successfully modeling future cash flow based on a new payor mix and occupancy projections were critical to HUD's approval.

Outcome

Lancaster Pollard obtained HUD mortgage insurance at a long-term fixed rate over 4% to finance the \$3.9 million renovation of Lakeview Lutheran Manor, which will save LSSM \$36,000 a year versus the operator's budget and assist in the organization's goal of a 75:25 ratio of fixed- to variable-rate debt.

When the project is completed, the nursing home will have four wings renovated and two wings razed. The new floor plan will include creating new administration and therapy areas where resident rooms and a dining area were once located. Lakeview will then be able to operate at a 133-bed capacity with an improved payor mix and occupancy rate.

Organizations who utilize the FHA 232/223(f) for acquisition can borrow 90% of the acquisition price or appraised value; and, those seeking to refinance can borrow the lesser of 100% of the cost to finance, or 90% of the appraised value. Nonprofit borrowers must meet a minimum debt service coverage of 1.05 to qualify for the mortgage insurance program. In addition, an organization has the lesser of 35 years, or 75% of the remaining useful life of the facility, to repay the debt. A borrower cannot submit an FHA 232/223(f) firm application to refinance a newly constructed facility until three years after receiving the certificate of occupancy. However, if a facility has been recently renovated or expanded, the debt is immediately eligible for refinance, so long as the organization did not more than double the square footage or number of units in the facility.

The FHA 232/223(a)(7) program is available for licensed skilled nursing, assisted living and board and care facilities with limited independent living units to refinance an existing FHA mortgage. Clients can borrow 100% of the cost to refinance up to the principal balance of the original loan. To qualify, the borrower must meet a minimum 1.05 debt service coverage. The term of this mortgage must not exceed the remaining term of the existing FHA mortgage, but like the others, it is a fixed rate and non-recourse loan. However, HUD may approve a term of up to 12 years beyond the remaining term of the existing mortgage if it is determined that the longer term is necessary to ensure the economic viability of the project.

The FHA 232/241(a) loan is a supplemental loan to finance additions or renovations on current HUD insured projects.

Case Study: FHA/HUD Section 232/223(f) Refinance

Background and Challenges

Norwood Crossing, a 263-bed skilled nursing and assisted living facility in the Norwood Park neighborhood of Chicago, was founded more than a century ago by Chicago's Norwegian-American community.

After completing a 55-bed assisted living addition in 2009, the organization had an outstanding \$19.9 million construction loan as well as a swap on the construction loan with a negative mark-to-market value totaling nearly \$1.2 million. In addition, it had completed more than \$800,000 of capital improvements within the past 12 months.

Financial Solution

Norwood Crossing sought to refinance the outstanding debt to obtain a lower fixed interest rate. The organization also

wanted to finance ongoing improvements as well as to be reimbursed for previous capital projects. After assessing financing options, Lancaster Pollard structured and funded a \$21.1 million mortgage loan insured through the FHA Sec. 232/223(f) program.

During the closing process, Lancaster Pollard had to navigate around HUD's new nonprofit regulatory agreement requirement, which restricts the borrower's distribution of excess cash flow. One way to avoid this potentially burdensome requirement would be to separate the nonprofit's organizational structure into a property company and an operating company; however, because Norwood Crossing is located in Illinois, this tactic would jeopardize its property tax exemption. Lancaster Pollard sought a more beneficial outcome for its client. The firm ne-

gotiated with HUD officials to allow Norwood Crossing to use its excess cash flow as long as six months of debt service was kept on hand, thereby enabling Norwood Crossing to maintain its organizational structure and preserve its property tax exemption.

Outcome

The transaction resulted in refunding Norwood Crossing's variable-rate debt with a 30-year, fully amortizing, fixed-rate debt structure. The refinance reduced the nonprofit's interest rate by 4.32 percentage points, resulting in annual debt service savings of about \$625,000. Norwood Crossing also used loan proceeds to reimburse itself \$345,000 for previous capital improvement projects as well as fund \$100,000 in additional capital projects.

Nonprofit organizations that utilize this program can borrow the lesser of 95% of cost or appraised value. The appraisal for an FHA 232/241(a) loan will evaluate the as-complete value of the project, as well as the addition-only value. The FHA 232/241(a) loan will be limited to the lesser of: the

as-complete value minus the principal outstanding on the first FHA loan; or 95% of the addition-only value. Nonprofit borrowers must meet a minimum debt service coverage of 1.05 to qualify for the mortgage insurance program, and have the lesser of 40 years, or 75% of the remaining useful

Figure 13: FHA Sec. 232 Programs' Timing*

Stage	Timing (Months)		
	FHA 232 and 232/241(a)	FHA 232/223(f)	FHA 232/223(a)(7)
Pre-Application & Project Planning	--	2.5	1 - 1.5**
Initial Firm Submission and Project Planning	2	--	--
Initial Firm HUD Review	1	--	--
Final Firm Application Prep/Submission	2	1	1
Final Firm HUD Review	1	--	--
Closing Phase-Initial Endorsement	1	1	1
Total estimated time to closing	7	4.5	3 - 3.5

* Timelines vary based on a project's specific circumstances. Estimate does not include HUD queue, time may differ depending on queue length at time of submission.

**Pre-application for 232/223(a)(7) is approximately one month, and one and half months if a PCNA is required.

life of the facility, to repay the debt. If the first FHA loan was an FHA 232 loan then the FHA 232/241(a) loan will be subject to Davis-Bacon prevailing wages. However, if the first FHA loan was an FHA 232/223(f) loan, then the loan will not be subject to Davis-Bacon prevailing wage requirements.

Issuing debt through any of the FHA 232 mortgage insurance programs can save organizations a considerable amount of debt service over time, however the time necessary to apply for the program (Figure 13) and the upfront costs (Figure 14) should be taken into consideration as

part of the funding option analysis. Additionally, an annual premium expressed as a percentage of the remaining principal balance is required. The premiums range from .55% to .77%, depending on the 232 program type, a relatively small fee given the extent of the credit enhancement.

All FHA insured mortgages are guaranteed by the full faith and credit of the United States government. While an FHA-insured mortgage carries essentially no credit risk to the bondholder, it does not guarantee timely, problem-free payment and is therefore not in and of itself ratable and marketable as a AAA security without additional upfront

Figure 14: FHA Sec. 232 Programs' Cost Estimates

Stage	Cost Estimate	
	FHA 232 and 232/241(a)	FHA 232/223(f) and 232/223(a)(7)
Pre-Application & Project Planning		
Third party reports	--	\$25,000-\$30,000
Legal Structure	--	TBD
Initial Firm Submission and Project Planning		
Market Study	\$8,000-\$12,000	--
Phase I	\$2,500-\$5,000	--
Appraisal	\$8,000-\$12,000	--
Survey & Title	TBD	--
Preliminary plans and construction cost	TBD	--
Initial Firm HUD Review		
FHA Application Fee*	.30% of mortgage amount	.30% of mortgage amount
Final Firm Application Prep/Submission		
Architectural/cost review	\$7,500-\$12,500	--
Full plans/specs	TBD	--
Final plan development/specifications/price	TBD	--
Soil Report	TBD	--
Closing Phase-Initial Endorsement		
HUD inspection fee	0.5% of mortgage amount	1% of cost of repairs
Initial MIP	1% of mortgage amount	1% of mortgage amount
Working capital escrow**	2% of requested loan amount	TBD: Varies from state to state
Initial operating escrow**	Based on appraiser/lender lease-up assumptions	Up to 3.5%
Minor moveable escrow**	\$450 per unit	--
Title insurance	Varies from state to state	--

* Half refunded if project is rejected at initial firm application, or if borrower finds the conditions of commitment unfavorable

** Non-mortgageable costs, can be funded with cash or a letter-of-credit

Case Study: FHA Sec. 232/223(a)(7) Mortgage Insurance

Background and Challenges

Baptist Homes, Inc. owns a skilled nursing facility and assisted living facility on its main Springhurst Pines campus in Louisville, Kentucky. It also owns independent living cottages and satellite assisted living properties. The organization's leadership stays abreast of market changes to capitalize on interest rate shifts and refinance opportunities. This awareness enabled the organization to capitalize on 2006 market conditions and refinance its floating-rate bond issue into an FHA-insured structure. As interest rates dropped again, Lancaster Pollard pointed out the opportunity to

further reduce Springhurst Pines' interest rate. But the property's existing FHA lender had shifted its focus to non-health-care transactions and was not qualified to operate under new FHA LEAN processing.

Financial Solution

Lancaster Pollard was brought on board to refinance Springhurst Pines' outstanding debt using \$9.2 million in GNMA mortgage-backed securities insured by the FHA Sec. 223(a)(7) program, which is designed specifically to refinance existing FHA-insured loans.

Outcome

The new interest rate is over a percentage point lower than the rate achieved just a few years ago. Baptist Homes will save over \$36,000 annually in debt service payments, proving that properties that allow their debt structures to be dynamic can substantially improve their cash flow performance just by being aware of and willing to act on market shifts. The interest rate is fixed for nearly 30 years and the debt structure is non-recourse to the rest of the organization.

deposits. Under certain circumstances, an FHA-insured loan may be wrapped into a GNMA mortgage-backed security, which carries a AAA rating and is a highly marketable debt instrument. The publicly-offered tax-exempt bond market expects and requires bonds to be issued in whole at closing. When reinvestment rates are very low,

construction fund negative arbitrage produces an extreme drag on new construction tax-exempt bond transactions. See Appendix I: Arbitrage for the Nonprofit, for more information. By contrast, the taxable GNMA market is accustomed to draw-down funding in which purchasers of GNMA securities commit at the time of initial endorse-

Case Study: Combination of Private Placement and FHA Sec. 232/223(f) Mortgage Insurance

Background and Challenges

National Church Residences, one of the nation's largest nonprofit providers of senior housing, formed the Traditions Healthcare Obligated Group in 2005. The obligated group originally consisted of five health-care campuses throughout the state of Ohio. In 2012, National Church Residences approached Lancaster Pollard with the following objectives for the group: fund future projects, attain reimbursement for previous projects, refund debt associated with the acquisition of Legacy Village and Heritage Day Health Centers and begin reducing its variable-rate debt exposure.

Financial Solution

After reviewing alternatives, Lancaster Pollard competitively bid the direct placement of \$19.7 million in Series 2012 tax-exempt variable-rate bonds to accomplish all but the last of National Church Residences' objectives. As part of the financing, National Church Residences and Lancaster Pollard added the two aforementioned entities to the group. Additionally, the bond proceeds refunded the bridge note related to the acquisition of Legacy Village and the Series 2002 and 2007 Heritage Day Health Centers bonds. Further, the bonds will fund several projects, including the expansion and renovation of the Mill Run campus, a new rehabilitation-only skilled nursing facility

on the Legacy Village Campus and the expansion of the Chillicothe campus.

To reduce variable rate exposure Lancaster Pollard is now in the process of restructuring a portion of the obligated group's tax-exempt debt by refinancing one of the health-care campuses with the FHA 232/223(f) program.

Outcome

Ultimately, the privately placed Series 2012 Bonds and the FHA 232/223(f) refinance will serve National Church Residences' long-term goal of maintaining an appropriate balance of variable-rate and fixed-rate exposure for its obligated group.

ment, to fund mortgage loan advances in installments as they are made, and interest only accrues on amounts previously funded. These factors can dramatically reduce construction fund carrying costs, though some up-front deposits may still be required in some situations. When deciding to issue taxable or tax-exempt bonds, a provider should rely on an experienced advisor to fully analyze the options.

It is important to note that there are often strategic advantages to utilizing a combination of several different financing vehicles. Many nonprofit senior living providers have several facilities or several healthcare campuses within their organization, and it is common to see a portion of the organizational debt in traditional tax-exempt bond structures and a portion of the debt in long-term agency-enhanced structures. An organization should work with a financial professional to determine the optimal capital structure to serve its strategic goals and mission.

Fannie Mae Seniors Program

The Fannie Mae Seniors Housing Program provides funding for the acquisition or refinance of single-entity independent living and/or assisted living facilities (with limited skilled nursing beds or Medicaid revenue), using intermediate and long-term fixed or variable rate non-recourse loans (Figure 15). Once the underwriting is complete, Fannie Mae loans are either purchased by Fannie Mae or converted to a Fannie Mae mortgage-backed security and sold as a Fannie Mae guaranteed loan. Borrowers have up to 30 years to repay the principal of Fannie Mae loans; however, balloon maturities are available as early as five years (Figure 16). The program allows nonprofit providers to borrow a maximum of 75 percent of the value of the project when using fixed and variable rate notes and 80 percent of the value of the project when using Fannie Mae bond credit enhancement.

To qualify for the Fannie Mae program the entity key prin-

Figure 15: Fannie Mae Seniors Programs

Fannie Mae Seniors Housing Characteristics	
Tax-Exempt	Yes
Fixed-Rate Option	Yes
Variable-Rate Option	Yes
Est. Max Term	18 Years
Est. Max Amortization	30 Years
First Mortgage Required	Yes
Non-Recourse	Limited
Debt Service Reserve Fund	No
Prepayment Penalties	Yes
Underlying Rating	No
Enhancement Renewal Risk	Yes
Ongoing Financial Covenants	Yes
Structuring & Closing Timeline	120

cipal must be a well-capitalized, stable, on-going business concern that is expected to remain financially healthy to support the property and meet the requirements over the life of the loan. Typically, in a nonprofit transaction, the entity's assets and net-worth are expected to exceed the minimum acceptable level of an individual in the key principal role. Moreover, Fannie Mae requires that participants in the transaction have at least five years' experience with similar properties as well as own and/or operate five or more like properties. In addition, the average debt-service coverage ratio for variable rate loans with terms of a minimum of ten years must be equal to or greater than 1.15 for independent

Figure 16: Fannie Mae Seniors Programs

Advantages	Disadvantages
Efficient Timing	Eligibility Requirements
Low Cost of Capital	Balloon Maturity
Limited Financial Covenants	Limited for Skilled Nursing
Limited Recourse	Limited for Medicaid Revenue
No Risk-Based Pricing	No Construction Financing
Equity Extraction Option	
High Leverage Point	
Fully Assumable	

living facilities and 1.20 for assisted living facilities. Similarly, the average debt-service coverage ratio for fixed rate loans with terms of a minimum of ten years must be equal to or greater than 1.30 for independent living facilities and 1.40 for assisted living facilities. While there is no requirement a property must have been completed for a certain time period prior to obtaining a Fannie Mae loan, the property must be stabilized as evidenced by 90% occupancy levels for 12 months for assisted living facilities, and 15 months for independent living facilities.

U.S. Department of Agriculture Programs

The USDA offers its Business & Industry and Community Facilities loan programs through its Rural Development office.

The Business & Industry program guarantees loans made by eligible lenders to benefit rural areas. The program's primary purpose is to create and maintain employment and improve the economic and environmental climate in communities of less than 50,000. Although there is no minimum loan amount, loans are generally limited to a maximum of \$10 million. The Business & Industry program guarantees up to 80% of the debt on projects of \$1 million to \$5 million and up to 70% for projects from \$5 million to \$10 million. High-priority projects of \$10 million or less may be eligible for guarantees of up to 90%. Interest rates can be floating or fixed for up to 30 years.

The Community Facilities program provides grants, direct loans, and loan guarantees for the construction and renovation of projects in communities of 20,000 or less. A loan guarantee can cover up to 90% of a loan amount with a term of up to 40 years, and interest rates can be floating or fixed. There is no maximum loan amount for guaranteed loans.

Both guarantee programs can be used for new construction

Figure 17: USDA Programs

Advantages	Disadvantages
Long-Term Financing	Limited for Refinance
Low Cost of Capital	Only for Rural Communities
Limited Financial Covenants	Only the Permanent Financing Post-Construction
Fully Amortizing	Not 100% Guaranteed
No Risk-Based Pricing	Personal Guarantees Often Required
High Leverage Point	
Fully Assumable	

or substantial rehabilitation, and the Community Facilities program can be used for refinancing if at least 50% of the total transaction is new money. But neither program is effectively a construction financing vehicle, as the loan guarantees are put in place only after construction is complete. Hence, USDA programs should be considered permanent financing vehicles, and short-term Bond Anticipation Notes or traditional bank loans are often issued to fund construction (Figure 17).

Summary

Nonprofit senior living providers have a plethora of options to meet the capital needs of their strategic missions, from traditional bank loans and tax-exempt bond issues, to agency enhanced mortgage loans. There is no perfect financing vehicle, as there are distinct advantages and disadvantages to every structure. Providers can work with their financial professional(s) to determine the financial structure or combination of structures that best serves the needs of the organization, while also providing financial flexibility and an efficient cost of capital.

Part III
Risk Management

Interest Rate Risk Management

Variable rate debt structures provide borrowers access to a low cost of capital because the interest rate on the bonds is based on the short end of the yield curve (i.e., daily, weekly, monthly). Assuming a normal up-sloping yield curve, variable rates may be significantly lower than fixed rates. For example, April 2013 indices showed that the 30-year fixed rate for an A-rated health care provider’s tax-exempt issuance could be 3.87%, compared to a weekly reset rate of 0.22% (based on the seven day SIFMA Index). Variable-rate debt also provides borrowers flexibility, as there are typically no prepayment provisions. This is counter to traditional fixed-rate bond issues, which tend to have a lock-out and/or prepayment penalties for the first 10 years. Although there are many benefits to variable-rate indebtedness, funding capital projects via variable-rate debt exposes organizations to interest rate risk. Specifically, if variable rates rise, the organization’s interest expense will increase. A long-term care organization will be able to adequately tolerate only a limited amount of interest rate risk depending on its liquidity position and net cash flows. Therefore, it may be in the best financial interest of the organization to mitigate interest rate risk through the use of derivatives. Of note, state-specific statutes may limit or preclude an organization’s ability to use interest rate derivatives.

Derivatives are financial instruments designed to trade away interest rate risk to other financial counterparties. Those financial counterparties primarily include investment banks and commercial banks. There are three primary types of interest rate derivatives: caps, floors and swaps.

Interest Rate Cap

An interest rate cap is created when an organization enters into a contract with a financial counterparty to ensure the variable rate the facility pays to bondholders will not exceed a certain interest rate level. The financial counterparty agrees to assume that interest rate risk in exchange for an upfront fee. The fee paid by the organization to the counterparty is determined by the interest rate cap level and the term of the cap. The higher the probability the cap will be pierced, the higher the fee. For example, a 5% cap for 20 years will be more expensive (higher fee paid to counterparty) than a 7% cap for three years.

Interest Rate Floor

An interest rate floor is created when an organization enters into a contract with a financial counterparty that gives the counterparty the right to benefit from interest rates below a certain rate level. The financial counterparty pays an upfront fee to a provider for this transaction. The higher probability the floor will be pierced, the higher the fee. For example, a 3% floor for 20 years will be more expensive (higher fee paid to hospital) than a 1% floor for three years.

Figure 18: Rate Caps and Floors

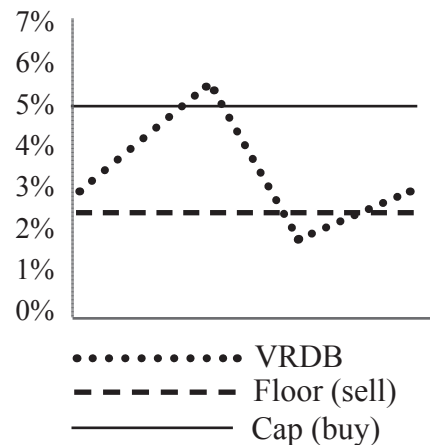
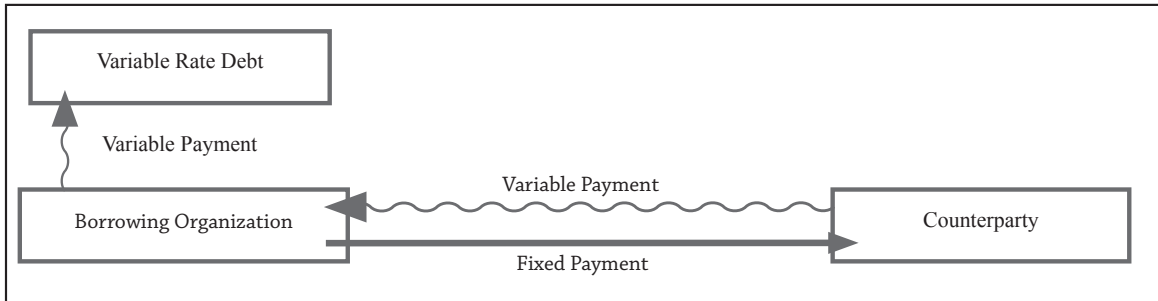


Figure 19: The Pieces of an Interest Rate Swap



A common motivation for a hospital to sell a floor is to raise the cash to purchase a cap. As illustrated in Figure 18, this transaction (sell floor, buy cap) creates an interest rate “collar.” In this scenario, the hospital is protected from paying interest rates above the interest rate cap level but has given up the benefit of variable rates below the interest rate floor.

Interest Rate Swap

Swaps are financing vehicles that can synthetically “fix” a floating interest rate, thereby stabilizing cash flow and mitigating exposure to interest rate swings.

How Does an Interest Rate Swap Work?

An organization with variable-rate debt pays a different amount in interest each period as rates reset. In hedging the debt with a swap, the borrower pays a fixed amount each month to a counterparty in exchange for receipt of a variable-rate payment that approximates the borrower’s interest payment on its debt. The variable-rate payment from the counterparty to the borrower is usually based on either of two interest rate indices, SIFMA (Securities Industry and Financial Markets Association, formerly Bond Market Association) or as a percentage of one-month LIBOR (London Interbank Offered Rate). The variable cash flow received by the borrower roughly offsets the borrower’s variable payment. The counterparty then receives a fixed payment

from the borrower, thereby synthetically fixing the interest rate. There is no exchange of principal; only payment of net interest expense is impacted (Figure 19).

How Much, For How Long?

Interest rate swaps can be arranged for any term as they are independent of the underlying debt and are very flexible. They can (and should) be independent of letter of credit enhancements, or banks that issue letters of credit. Swaps can be restructured or retired at any time to match the organization’s hedging or interest rate risk management strategy, and they carry no direct prepayment penalty. However, swaps do have value (as measured by the mark-to-market valuation), and therefore, borrowers can receive or pay the current fair market value if the swap is terminated early.

Understanding how much to swap, and when, means working with an investment banker to determine how much variable-rate risk exposure an organization has over a period of time, and at what point variable-rate levels would become too high and too risky in light of debt covenants, the operating budget and other factors. A provider does not need to hedge more, or longer, than the time and amount necessary to ensure appropriate risk mitigation. For example, an organization with \$20 million in cash and short-term fixed income securities and \$100 million in variable-rate debt potentially has only \$80 million of exposure to variable

interest rate risk; the risk on the other \$20 million in debt would be roughly canceled out by investment returns of the cash and fixed-income securities.

The keys to most effectively utilizing swaps are:

1. Identifying the net variable interest rate risk exposure and determining whether, and how much, to hedge.
2. Tapping into a swap's flexibility and tailoring it to specific cost, timing and existing debt limitations.

Asset-Liability Management

Asset-liability management is a critical component of financial risk management. Long-term care providers too often manage their assets and liabilities in separate silos, and do not consider the impact of one on the other. In doing so, losses in the investment portfolio can trip debt covenants, which can negatively affect the organization's operations and access to capital. In order to reduce this risk, providers can implement a liability-driven investing approach, which requires them to identify liabilities, determine risk tolerance, and develop an asset allocation strategy that matches their risk tolerance.

All institutions, including long-term care providers, have embedded liabilities. For those with outstanding debt, debt covenants are one such embedded liability. Debt covenants are financial or operational tests a provider agrees to meet during the life of a financing transaction, are negotiated during the debt structuring process, and are different for every transaction; examples include financial covenants such as maintaining a minimum number of days' cash on hand, or a maximum debt-to-capitalization ratio. Operational covenants may include the placement of a negative pledge on certain assets or the requirement to report financial and operational statistics within a specific timeframe. To protect investors, many bond and loan agreements contain

provisions for corrective action and/or fees in the event an organization violates a debt covenant (e.g., requiring a defaulting provider to engage a management consultant and implement any recommended strategies). These covenants represent embedded liabilities; as such, the organization should manage its assets relative to its liabilities to avoid potentially tripping a debt covenant.

Despite the importance of asset-liability management, providers often manage assets without considering the impact on liabilities. For example, an organization might increase its exposure to equities in order to increase returns within its investment portfolio; however, if the stock market collapses, its liquidity may decline leading to a debt covenant violation, such as the minimum number of days cash on hand required. A liability-driven investing approach provides providers with a framework necessary to manage assets relative to liabilities.

In order to implement a liability-driven investing approach, long-term care providers must first determine their risk tolerance, which defines how much fixed income-like volatility is required based on their embedded liabilities. Although each asset class has certain characteristics that make it unique, all asset classes display one of two types of volatility: equity-like volatility or fixed income-like volatility. The primary purpose of assets with equity-like volatility, such as U.S. and non-U.S. equities, commodities, real estate investment trusts, and non-investment grade bonds, is to increase returns within the investment portfolio. Conversely, the primary role of assets with fixed income-like volatility, such as investment grade bonds and Treasury Inflation-Protected Securities (TIPS), is to reduce the volatility of returns within the investment portfolio. Once an organization determines its risk tolerance (e.g., how much fixed income-like volatility its liabilities demand), it can develop a specific asset allocation policy that provides an acceptable level of volatility within the aggregate invest-

ment portfolio.

Over the years, various academic studies have shown that asset allocation is the key driver of return volatility. A study of the asset allocation of 91 large pension funds, published in 1986 by Gary Brinson, Randolph Hood, and Gilbert Beebower, found that, “Investment policy dominates investment strategy (market timing and security selection), explaining 93.6% of the variation of total plan returns.” Additionally, Roger Ibbotson and Paul Kaplan’s 2000 study of the asset allocation of 94 U.S. balanced mutual funds and 58 pension funds found that “asset allocation explains about 90% of the variability of a fund’s return over time.” As a result, providers should focus on asset allocation, including the allocation to fixed income-like volatility, as a means to reduce the volatility of returns within their investment portfolio.

Volatility can be reduced within an investment portfolio by adding asset classes that have a low correlation with asset classes already held in the portfolio. Correlation, which ranges from negative one to positive one, is a statistical measure of how two assets move in relation to each other. For example, two assets with a correlation of positive one move in lockstep in the same direction, so that if one asset gains 5%, the other asset will gain 5% as well. Conversely, two assets with a correlation of negative one will move in the opposite direction, so that if one asset gains 5%, the other asset will lose 5%. Although correlations can change over time, research has shown that investments such as commodities, Treasury Inflation-Protected Securities (TIPS), real estate investment trusts (REITs), emerging market stocks, and high-yield bonds have historically had relatively low correlations with U.S. stocks and bonds. Given that many organizations currently have investment portfolios comprised mostly, if not entirely, of U.S. stocks and bonds, adding assets with low correlations should reduce the volatility of returns within the investment portfolio.

Long-term care providers can lower the volatility of returns within their investment portfolios by developing asset allocation policies linked to their embedded liabilities. As such, this application of liability-driven investing (i.e., asset-liability management), can reduce the likelihood of the provider violating a debt covenant.

Recognizing the need to address the liabilities in the development of an asset allocation plan is the first step to reducing the risk in the organization. The second step is to know that the needs of each organization are unique, and that an asset allocation plan is different from one provider to the next. When it comes to managing a risk budget, there is no “one size fits all.” The last step is knowing that asset-liability management within any organization is a fluid process, and must be monitored continuously to reflect the provider’s changing capital needs, the interest rate environment, and the risks and opportunities in investment markets.

Summary

Managing risk is essential to a long-term care provider’s financial health, and can be achieved through the use of derivatives and asset-liability management. A knowledgeable investment banker/financial advisor can help an organization determine its risk tolerance and develop strategies to mitigate it.

Notes:

APPENDICES

Appendix A: Definition of Ratios

Liquidity

Days Cash on Hand: Unrestricted cash and investments / daily cash operating expenses

Cushion Ratio: Unrestricted cash and investments / maximum annual debt service (MADS)

Cash to Debt: Unrestricted cash and investments / (long-term debt - current liabilities)

Current Ratio: Current assets / current liabilities

Profitability and Operational

Operating Margin: (Total operating revenues – total operating expenses) / total operating revenues

Excess Margin: (Total operating revenues – total operating expenses + non-operating revenues) / (total operating revenues + non-operating revenues)

Cash Flow (EBIDA) Margin: (Total operating revenues – total operating expenses + interest expense + depreciation + amortization) / (total operating revenues + non-operating revenues)

Capital Structure and Cash Flow

Debt Service Coverage*: (Total operating revenues – total operating expenses + non-operating revenues + interest expense + depreciation + amortization) / MADS

Debt to Capitalization: (Long-term debt - current liabilities) / (long term debt – current liabilities + unrestricted net assets)

MADS as % of Total Revenue: MADS (Maximum Annual Debt Service) / total revenue

* The most widely used ratio in the capital markets, this measures the ability to make debt payments from ongoing operations. The denominator is always the maximum annual debt service, but the numerator can be known by several different terms including “net operating income,” “net income available for debt service” or simply “net available.”

Appendix B: Factors in a Long-Term Care Organization's Credit Analysis

Financial Operating History: Generally, three to five years of audited financial statements are necessary for an accurate credit evaluation, which will include margin, trend and debt service coverage analyses. Stable or growing profitability from operations is desired with minimal reliance on non-operating revenues to meet the ongoing and routine capital needs of the organization. Significant deviations from year-to-year performance or within specific accounts will need to be addressed by management. Non-operating revenues evidencing community support (either tax-supported or charitable contributions) are viewed favorably.

Financial Position: Particular attention is given to liquidity and capital structure. Highly leveraged organizations will be perceived as being a higher credit risk. Organizations with little or no liquidity will be viewed negatively even in the absence of long-term debt. Long-term care facilities with balance sheet liquidity will be assessed to determine the scope of investment policies and adherence to them. Investment strategies that produce more consistently stable returns will be preferred. The quality of accounts receivable will be reviewed by aging and payor source, as will the organization's procedures for accounting of contractual allowances, bad debt allowances and write-offs.

Financial Feasibility: Financial projections will be important for those projects that may substantially impact revenues or expenses. Underlying feasibility assumptions will be reviewed against historical operating metrics, and substantial variances between the two will need to be well supported.

Organization Background/Strength of Management & Board: The organization's history and length of service to the community will be evaluated. The industry experience of key management personnel will be considered, as will their tenure with the organization. Evidence of proactive efforts to address facility challenges or opportunities will be viewed favorably. The quality of management's financial and operational reports and frequency of review by management and the board will be evaluated. The educational and professional background of board members will be reviewed, with a diverse make-up and active participation in strategic initiatives viewed positively.

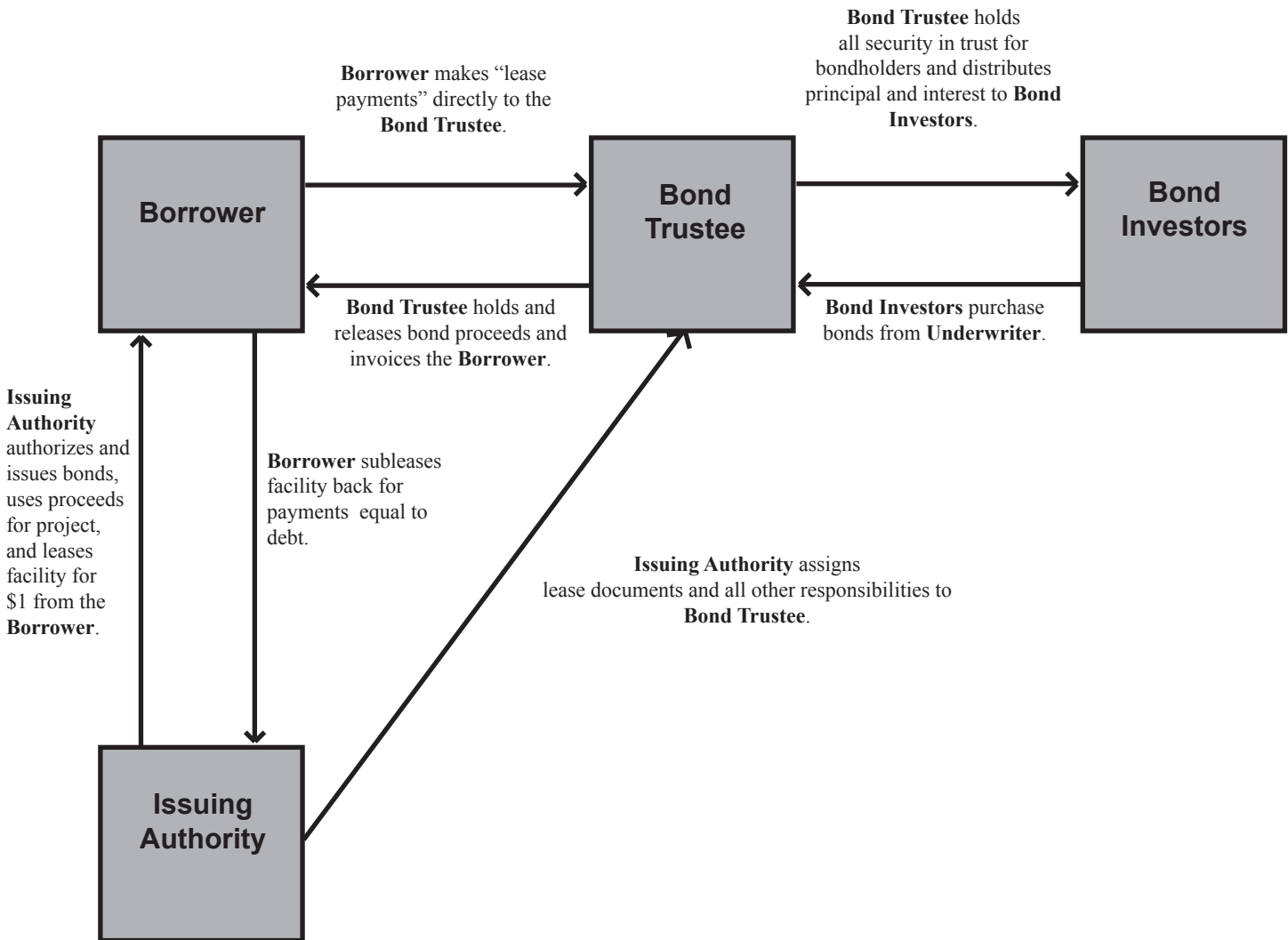
Utilization and Payor Mix: A three- to five-year historical review of utilization metrics by service line will be conducted with stable or growing trends viewed favorably. Adverse utilization trends will need to be addressed by management with plans to improve market share or implement facility downsizing. The payor mix will be reviewed over a similar period to identify favorable or negative trends.

Physical Plant and Market Area Characteristics: The age and physical and functional obsolescence of the facility will be considered along with any plans for improvement. Projects involving rehabilitation of existing structures will need to demonstrate a plan to minimize disruption to operations. Construction risk due to potentially rising construction costs and change orders will need to be minimized through contractual arrangements and/or adequate balance sheet reserves. The site of the existing or proposed facility will be evaluated for ingress/egress, opportunities for expansion, marketing visibility, proximity to ancillary services and profile of the surrounding community. The primary and secondary market demographic and socioeconomic characteristics will be evaluated to determine opportunities for profitable growth. The market share of the organization versus competing area organizations will be determined as well as comparisons by size, physical plant and service lines.

Litigation History and Claims Exposure: A review of historical and pending claims as well as management plans to mitigate future claims will be conducted. The types and amounts of liability coverage will be reviewed to determine adequacy to meet pending or potential future claims.

Collateral: The type, amount, and quality of security that can be provided to creditors (bond investors or lenders) will be evaluated in light of other credit characteristics. Priority revenue pledges will be preferred, as will first lien mortgage and security interests in real estate and personal property of the facility. Parity security interests with other creditors will be viewed less favorably, although not as poorly as subordinated lien positions.

Appendix C: Basics of a Tax-Exempt Bond Issuance



Appendix D: Typical Costs in a Bond Issuance

Time of Costs	Type of Cost/Description
Up-Front Issuance/Closing Costs	<p>Attorney Expense:</p> <ul style="list-style-type: none"> • Bond Counsel • Borrower’s Counsel • Underwriter’s Counsel • Credit Enhancement Counsel <p>Up-Front Fees:</p> <ul style="list-style-type: none"> • Underwriter’s Discount • Printing Costs for Disclosure Documents and Bonds • Trustee Acceptance Fee (if applicable) • Issuer’s Fee (if applicable) • Credit Enhancement Origination Fee (if applicable) • Bond Rating Fee (if applicable)
Periodic Costs	<ul style="list-style-type: none"> • Annual Trustee Fee • Annual Credit Enhancement Fee (if applicable) • Annual Remarketing Fee (if variable-rate debt) • Rating Fees (if applicable) • Annual Issuer Fees (if applicable)

Appendix E: Notable Requirements for Tax-Exempt Bonds

Requirement	Details of Requirement
95% Test	At least 95% of the bond proceeds must be used for land costs and depreciable property.
3-Year Spend-Down	Bond proceeds must be substantially spent within three years of issuing the bonds.
Maximum Allowable Weighted Average Maturity	Maximum allowable weighted average maturity. The weighted average maturity of the bond issue may not exceed 120% of the reasonably expected weighted average economic life of the assets financed.
2% Maximum for Issuance Costs	No more than 2% of bond proceeds may be used to pay bond issuance costs.
25% Maximum to Acquire Land	Except for 501(c)(3) bonds, no more than 25% of the bond proceeds may be used to acquire land.
Required Inducement Legislation	501(c)(3) Bonds – A similar, but less stringent, requirement applies to 501(c)(3) bonds. In fact, nonprofit organizations may adopt their own internal resolution (referred to as a reimbursement resolution) to preserve the eligibility of incurred expenditures prior to receiving a formal inducement resolution.
Annual Dollar Limits by State and Accessing Allocation from State Volume Cap	501(c)(3) and Refunding Bonds – Allocation is generally not required for these bonds.
Required Public Hearing	<p>Except for certain refunding bonds, there must be a public hearing on a proposed financing before the bonds can be issued.</p> <p>14-Day Notice – Generally, notice of the public hearing must be published in a local newspaper at least 14 days prior to the hearing.</p>

Appendix F: Key Participants in Nonprofit Senior Living Financings

Asset Manager: This position is sometimes referred to as an “Investment Manager” or “Money Manager” and is responsible for assisting an organization in properly investing financial resources to gain consistent returns over time based on a particular investment allocation and strategy.

Bond Counsel: An attorney retained by an issuer to provide a legal opinion that the issuer is authorized to issue the proposed securities, has met all legal requirements necessary for issuance, and that interest on the proposed securities will be exempt from taxation. Bond Counsel also prepares many legal documents related to the proposed issuance and will advise the issuer regarding authorizing resolutions, the trust indenture, official statements, validation proceedings and litigation.

Bond Insurer: Provides bond insurance to assure the full and timely payment of all interest and principal over the life of the bonds. These organizations typically are paid an up-front fee that is calculated on total interest and principal over the life of the bonds.

Bond Trustee: Usually a bank trust department that acts on behalf of the bondholders. The trustee controls specific funds created for the bond issue, controls disbursement of bond proceeds, and is responsible for enforcing remedies and taking actions on behalf of bondholders in the event of default. The trustee also receives debt service payments from the borrower and acts as paying agent. The trust indenture outlines the trustee’s fiduciary responsibilities and bondholders’ rights.

Borrower’s Counsel: Represents the borrower in the transaction, frequently drafts necessary disclosure statements about the borrower, and issues opinions on behalf of the borrower and on the legality of its actions regarding the bond issue. Additionally, borrower’s counsel ensures that the appropriate documentation of board approval is obtained and that properly authorized individuals are executing the necessary documents. Finally, borrower’s counsel issues the opinion regarding the borrower’s compliance with any outstanding regulations and/or laws.

Commercial Banker: Also referred to as a commercial lender or relationship manager, this person works for the letter of credit bank offering a number of commercial banking products (checking and saving accounts, cash management services, payroll services, lines of credit, etc.) and may suggest term loans as an alternative to tax-exempt bond financing.

Credit Enhancer: Institutions willing to use their credit and financial strength to enhance the financial strength of a bond issue or mortgage loan. The typical credit enhancer is a letter of credit bank (most common), bond issuer, or governmental agency.

Financial Adviser: May be retained by either the borrower or issuing authority to assist in developing a plan of finance and to evaluate the pricing and final structure of the bond issue. A financial adviser can become involved in a financing at any point in the process. In most instances, the investment banker will generally act in this capacity.

Investment Banker or Underwriter: Responsible for structuring and managing the financing and selling the bonds or mortgage loan. The underwriter buys the bonds from the issuer or issuing authority and sells the bonds to investors. Although these terms frequently are used interchangeably, a distinction should be made between investment banker and underwriter – investment bankers structure the financing while underwriters distribute the securities to the investing public.

Issuer or Conduit Authority: This entity is specific to municipal or tax-exempt bond financings. Usually a governmental division, or at least a quasi-governmental agency, it issues the tax-exempt bonds for a project. These bonds are exempt from certain taxes depending upon where they are issued, who issues them, and the tax status and residence of the bondholder. The issuer can either be a special government entity created solely to issue tax-exempt bonds or be the city, county, or state in which the project resides.

Issuer's Counsel: Represents the issuer (issuing authority). Bond counsel frequently acts as issuer's counsel.

Letter of Credit Bank: Provides a letter of credit (usually a "direct pay letter of credit") that is drawn on by the trustee to make principal and interest payments to bondholders.

Letter of Credit Bank Counsel: Represents the letter of credit bank by preparing and reviewing all documents involving the letter of credit bank and the reimbursement agreement between the borrower and the bank.

Mortgage Banker: A mortgage banker originates, sells and services mortgages in the mortgage market. This entity is necessary when utilizing some of the government enhancement programs.

Purchaser's Counsel: Represents institutional investors or purchasers on certain unenhanced and unrated issues that are considered riskier by the investor community. Counsel reviews all documents and may occasionally negotiate terms, covenants and other items on behalf of the investor.

Rating Agency: Makes an independent determination as to the likelihood the bond will be repaid in accordance with its terms. The most well-known rating agencies are Standard & Poor's and Fitch IBCA. The intent of ratings established by the agencies is to allow investors to quickly assess a borrower's financial strength without having to personally study financial statements.

Trustee's Counsel: Represents the bond trustee and often is the Bond Counsel in a transaction.

Underwriter's Counsel: Represents the underwriter and prepares the official statement. Drafts the bond purchase agreement.

Appendix G: Security and Covenants

Bondholders almost always expect some security for their investment. This means that the payment of interest and principal is based on more than the borrower's promise to pay and is supported or secured by additional items. The underlying credit of the borrower will be the primary determinant of the types of security that will be required for a financing. An investment banker's skill, reputation in the financial community, and the ability to negotiate on behalf of the borrower can affect those requirements. Security normally includes a first mortgage and security agreement, a pledge of gross revenues, a debt service reserve fund and additional loan covenants.

Security:

First Mortgage and Security Agreement: Bondholders generally expect a first mortgage on the project being financed with tax-exempt bonds. The mortgage is similar to a home mortgage and provides the bondholder certain rights, including foreclosure in the event of default. The lien is documented through a first mortgage and security agreement filed in the county in which the property is physically located. On some higher-rated transactions, a first mortgage may not be required. In this case, a negative lien (where the borrower agrees not to encumber the facility with other liens) will be given as security.

Pledge of Gross Revenues: The borrower must pledge all of its gross revenues for payment of debt service on the bonds. This pledge is considered an important part of the security package. Most tax-exempt bond issues are called revenue bonds rather than mortgage bonds because the revenues of the project being financed are the primary source of bond repayment.

Debt Service Reserve Fund: It is customary for a bond issue without credit enhancement to include the funding of a debt service reserve fund that can be used for principal and interest payments to the bondholders if the borrower is unable to pay. It normally equals the maximum annual debt service of principal and interest to be paid in any year during the life of the bonds.

Additional Covenants:

The legal documents associated with a bond issue include an agreement ("covenant") by the borrower to pay all interest and principal due on the bonds. In addition to this fundamental repayment requirement, other business terms provide added security for the bonds. Covenants, like other components of an issue, are negotiable. It is important to balance the interests of the parties involved so as to give the bondholder some degree of control and allow the borrower enough flexibility to operate.

Ratio or Financial Covenants: These covenants refer primarily to the financial performance of the borrower and some of the more common are listed in Appendix A: Definition of Ratios. These usually are set at minimum standards and generally are the easiest way to provide early warning of financial trouble. Covenants related to liquidity ensure that the borrower always has cash available for operations and debt service in the event of a revenue shortfall or cash flow shortage. The debt service coverage ratio is probably the most widely used ratio covenant because it measures the ability to make debt payments from ongoing operations.

Additional Indebtedness: Bondholders do not want borrowers to incur additional debt indiscriminately and thereby weaken their ability to pay debt service on the bonds. Therefore, borrowers usually must agree to covenants restricting their actions in this area. Guidelines or formulas can be negotiated in the covenant that will allow the borrower to incur some additional indebtedness without the bondholders' permission.

Insurance Covenants: These covenants will require that minimum standards for insurance be maintained on assets on which the investor is holding a security interest and/or are relied upon by the borrower to generate revenue. This enables the borrower to rebuild/replace damaged assets, make available sufficient funds to service debt, and ensure that the bond-

holder is protected with respect to its reliance on value of the collateral.

Maintenance Covenant: A maintenance covenant refers to the continuous upkeep of a facility or property to help maintain the value. Again, this is important during a bond issue when the investor is holding a first mortgage on the property as a guarantee for the loan.

Financial Statements: There always will be a need to review the borrower's audited financial information to ensure compliance with ratio covenants.

Appendix H: Terms and Participants Associated with Financing Alternatives

All-in Interest Cost: Representation of the total true cost of the financing including all interest rates and fees paid.

Arbitrage: Generally, transactions where the same security is bought and sold in different markets at the same time for the sake of the profit arising from a price difference in the two markets. Arbitrage, with respect to the issuance of tax-exempt debt, usually refers to the difference between the interest paid by the borrower and the investment income earned by acquiring higher-yielding securities.

Asset: Any valuable item that is owned by an organization and is available to generate income or cash.

Balance Sheet: Often referred to as the “Statement of Financial Position,” it is a snapshot in time and shows the accumulated values in dollars of assets and liabilities as of a given date. It is important because of its ability to track the balance of assets, liabilities and net assets (equity). The strengths and weaknesses of an organization are easily ascertained from this financial statement.

Bank Qualified Bond: The designation given by a single bond issuer to a public purpose bond offering for a qualified tax-exempt obligation. When banks purchase these bonds they can deduct 80% of their purchase and carrying costs and can pass along the savings to borrowers by way of a reduced interest rate. Only \$10 million in bonds can be designated as bank-qualified annually by any single issuer.

Basis Point: Short reference to 1/100 of 1 percent. For example, the difference between 5.25% and 5.50% is 25 basis points.

Bond: Proof of an issuer’s obligation to repay a specified principal amount and interest – at a predetermined rate or in accordance with a formula — on certain dates. Bonds do not represent ownership, but rather are a type of loan and thus considered senior securities. Interest on a tax-exempt bond is exempt from federal income taxation and may be exempt from state or local taxation in the jurisdiction where issued.

Bond Anticipation Note (BAN): A government-issued, short-term interest-bearing debt instrument that will be paid off by the proceeds from another bond sale soon to be issued. BANs are issued to obtain interim financing for projects that will eventually be funded on a long-term basis by a future bond issue.

Bond Buyer Revenue Index (BBR): A tax-exempt market index composed of highly rated tax-exempt, fixed-rate, revenue bond obligations with an average maturity of 30 years. The index serves as a benchmark that is accepted industry wide. The index allows for an efficient way to regularly monitor the long-term, tax-exempt, revenue bond market.

Bond Purchase Agreement: This is a legal document between the borrower, underwriter, and issuing authority that obligates the underwriter to purchase the bonds at agreed-upon interest rates and with specific terms.

Bond Transcript: All legal documents associated with the offering of a new tax-exempt bond issue.

Broker-Dealer: A person or firm that not only handles transactions for customers, but also buys securities for its own account and then sells those securities to customers for a profit. A brokerage acts as a broker (or agent) when it executes orders on behalf of clients, whereas it acts as a dealer (or principal) when it trades for its own account.

Callable Bond: A bond permitted or required to be redeemed before the stated maturity date at a specific price, usually at or above par, by giving notice of redemption in accordance with the terms in the trust indenture.

Cap: The highest interest rate that can be paid on a floating rate bond over a specified period of time.

Capitalized Interest: A portion of the proceeds of an issue set aside to pay interest on the bond or loan during the construction period. Capitalization refers to the treatment of the interest cost because it is added to the basis or cost of the asset for accounting purposes.

Closing: The meeting of concerned parties involved in a new bond issue during which the requisite legal documents are executed and proceeds are delivered for use by the borrower.

Co-Manager: A broker-dealer that is a member of a group formed temporarily for the purpose of handling a large transaction that would be hard or impossible for the entities involved to handle individually. This group is called a syndicate. Syndication allows companies to pool their resources and share risks.

Collar: An upper and lower limit on the interest rate that can be paid on a floating rate bond over a specified period of time.

Conduit Financing: Bonds, usually tax-exempt, issued by a governmental unit to finance a project to be used primarily by a third party engaged in private enterprise. The taxing authority of the governmental unit does not secure the bonds. The bonds do not constitute an obligation of the governmental unit. Reliance for repayment is placed on revenues generated from the project.

Corpus: A term used to describe an income-producing asset, usually stocks or bonds, as contrasted to the income — such as interest — derived from it.

Cost of Capital: The financial expenditure required to borrow money. This includes, but is not limited to, issuance costs, attorney fees, credit enhancement (as applicable), and interest payments.

Costs of Issuance: The expenses associated with a financing transaction, including such items as printing, legal fees, rating agency fees, underwriter's discount and others.

Coupon: The interest rate on a fixed income security, determined upon issuance, and expressed as an annual percentage of the principal amount.

Credit Enhancement: An additional source of security for a bond or loan that comes in the form of a letter of credit from a commercial bank, private bond insurance, and government mortgage insurance and loan guarantees.

Debt Service: The series of payments of interest and principal required on a debt over a given period of time.

Debt Service Coverage: Expressed as a percentage, the amount of annual available cash flow divided by the annual debt service requirement. Debt service coverage is a primary indication of the safety or credit quality of an issue, or a borrower's ability to repay its debt.

Debt Service Reserve Fund: A fund created to cover a portion (usually one year) of debt payments on behalf of an organization should it not be able to pay out of regular revenues. This account usually is funded at closing from bond or loan proceeds to provide added security for the investor. Additional deposits may be required depending on the loan structure.

Defeasance: Termination of the rights and interests of bondholders, which usually occurs in connection with the refunding, refinancing or payoff of an outstanding issue.

Derivative: A financial instrument purchased or sold to manage the interest rate risk associated with an underlying security to protect against fluctuations in value. Borrowers utilize these instruments in the forms of caps, collars and swaps.

Direct Loan (In reference to USDA's community facilities program): A loan made directly by USDA to provide permanent financing for the development or improvement of essential community facilities in rural areas and towns of up to 20,000 in population. Loans and guarantees are available to public entities such as municipalities, counties, and special-purpose districts, as well as to non-profit corporations and tribal governments.

Discount: The amount by which a bond's par-amount exceeds its market price.

Endowment: A permanent fund bestowed upon or created by an institution, made up of cash, securities and other investments to be used for a specific purpose. It is considered an asset of the organization, and income from investments is used to build the corpus and/or supplement operating expenses.

Feasibility Study: A report of the financial practicality of a proposed project and its financing, which should include estimates of revenues to be generated and expenses to be incurred and a review of the physical, operating, economic or engineering aspects of the proposed project.

Financial Industry Regulatory Authority (FINRA): The Financial Industry Regulatory Authority is responsible for governing business between brokers, dealers and the investing public. By consolidating these two regulators, FINRA aims to eliminate regulatory overlap and cost inefficiencies.

Fixed Rate: A rate of interest that does not change during the entire term the debt is outstanding.

Floating (or Variable) Rate: A method of determining the interest to be paid on a bond by reference to an index, or according to a formula or some other standard of measurement, at stated intervals.

General Obligation Bond: A municipal bond backed by the credit and "taxing power" of the issuing jurisdiction, such as a municipality or hospital district, rather than the revenue from a given project.

Ginnie Mae Mortgage-backed Security: A mortgage note which is backed by the full faith and credit of the U.S. government, just like U.S. Treasuries. The mortgages securitized as Ginnie Mae mortgage-backed securities (MBSs) are those guaranteed by Federal Housing Administration (FHA), the Veterans Administration (VA) and the Rural Housing Administration (RHA). Ginnie Mae's backing guarantees the timely payment of principal and interest from approved issuers (such as mortgage bankers, savings and loans, and commercial banks) of qualifying loans. The Government National Mortgage Association – GNMA - (Ginnie Mae) is a U.S. government corporation within the U.S. Department of Housing and Urban Development (HUD).

Guaranteed Loan (In reference to USDA's community facilities program): A guaranteed loan protects investors from a default by a borrower because it is guaranteed by a third party, such as USDA. In the case of a USDA community facilities guaranteed loan, USDA may guarantee up to 90% of any loss of interest or principal on a loan made by USDA to develop essential community facilities in rural areas and towns of up to 20,000 in population. Loans and guarantees are available to public entities such as municipalities, counties, and special-purpose districts, as well as to non-profit corporations and tribal governments.

Interest Expense: Money a borrower pays a lender or investor for use of the loan or bond proceeds.

Investment-grade: A term used to define those bonds with a relatively high level of credit quality. Bonds rated Baa or higher by Moody's or BBB or higher by Standard & Poor's and Fitch are considered investment-grade bonds.

Issuer or Issuing Authority: Empowered under federal law to issue conduit tax-exempt bonds. The proceeds from the sale of these bonds can be used to provide low-interest loans to 501(c)(3) nonprofit organizations and other qualified

borrowers/activities as allowed under the Internal Revenue Code.

Lead Manager: An investment bank or other financial services firm that has the primary directive for organizing a debt offering. The lead Manager will usually work with other investment banks to establish a syndicate, and thereby create the initial sales force for the bonds. These bonds will then be sold to institutional and retail investors. See also Senior Manager.

Letter of Credit: A letter of credit issued by a commercial bank is an obligation to make bond payments if a borrower cannot. With that support, a borrowing organization can issue bonds backed by the bank's credit strength. This credit enhancement can make borrowing more affordable for organizations that wish to issue bonds, but have limited credit strength.

Liability: A financial obligation, debt, claim or potential loss.

Liquidity: The ability of an asset to be converted into cash quickly and without any price discount.

Lock Period: The number of days, generally 30 or 60, during which the agreed-upon interest rate on a pending mortgage loan cannot be changed. In a rising interest rate environment the lock period helps borrowers manage the risk that interest rates may rise above what they are able and willing to pay.

Master Trust Indenture: The Master Trust Indenture is the foundational bond document that outlines the baseline covenants associated with the bonds and the requirements under which a borrower can issue one or more series of bonds.

Mortgage: A debt instrument that is secured by the collateral of specified real estate property and that the borrower is obliged to pay back with a predetermined set of payments. Mortgages are used to make large real estate purchases without paying the entire value of the purchase up front. Other terms for mortgages are "liens against property" and "claims on property."

Mortgage Insurance: In the context of this white paper the Federal Housing Administration, generally known as "FHA" or "HUD," provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. FHA insures mortgages on seniors housing and care properties and hospitals. FHA mortgage insurance provides lenders with protection against losses as the result of borrowers defaulting on their mortgage loans. The lenders bear less risk because FHA will pay a claim to the lender in the event of a default. Loans must meet certain requirements established by FHA to qualify for insurance.

Nonrecourse Debt: A type of loan that is secured by collateral, which is usually property. If the borrower defaults, the issuer can seize the collateral, but cannot request further compensation from the borrower even if the collateral does not cover the full value of the defaulted amount. The borrower does not have personal liability for the loan if it is non-recourse.

Note: In contrast with a bond, a note commonly refers to a taxable security or loan.

Obligated Group: The assets and revenues of affiliated entities, which for credit purposes, can serve as security for the associated debt.

Official Statement: The document prepared for or by the issuer that discloses to prospective investors material information on the security being offered for sale, including the purpose of the financing, how the debt will be repaid and the borrower's financial information.

Par Bond: A bond selling at its face value or maturity value.

Premium: The amount by which a bond's par-amount is less than its market price.

Prime Rate: The interest rate that commercial banks charge their most creditworthy borrowers.

Private Placement Bond: The sale of securities to a relatively small number of select investors as a way of raising capital. Investors involved in private placements are usually large banks, mutual funds, pension funds and other financial firms. Private placement is the opposite of a public issue, in which securities are made available for sale on the open market.

Pro forma: A presentation of financial data that reflects an "as if" scenario incorporating projected financial performance.

Put (or Tender Option) Bonds: Obligations that grant the bondholder/investor the right to require the issuer/borrower or a designated third party to purchase bonds, usually at par, either periodically, at certain times prior to maturity or upon the occurrence of specified events or conditions.

Qualified 501(c)(3) Bonds: Tax-exempt bonds can be issued for certain organizations. The most common qualified organization is a nonprofit entity that has been established for charitable purposes. If a project furthers the mission of such an organization, it generally qualifies for tax-exempt financing.

Ratings: Evaluations of the credit quality of securities and/or borrowers usually made by independent agencies. Ratings are intended to measure the probability of the timely repayment of principal and interest. Ratings are initially made prior to issuance and are periodically reviewed for confirmation or amendment if the borrower's credit position has changed.

Ratio: A formula used to compare different measures of an organization's performance. The three main types of health care financial ratios are profitability, liquidity and capital structure. Benchmark ratios are specific ratios that constantly are used to measure performance of one organization against another.

Refunding: A procedure whereby an issuer refinances an outstanding bond (refunded bond) by issuing new bonds (refunding bond). There generally are two reasons for doing this: to reduce interest costs or to remove burdensome or restrictive covenants imposed by the terms of the bonds being refinanced. There are two types of refundings: current and advance. A current refunding refers to the ability to retire the refunded bonds within 90 days of closing the new issue. An advance refunding requires proceeds of the new issue to be used to purchase other obligations that are then deposited in escrow. These escrowed obligations mature in sufficient amounts and at appropriate times to provide funds to pay interest and principal of the prior issue when due or callable.

Reimbursement Agreement: An agreement between the borrower and letter of credit bank describing the reimbursement obligation of the borrower for draws on the letter of credit. Also contains other credit terms typically found in loan agreements.

Reimbursement Resolution: An official statement enacted by the directors of an organization that allows the organization to reimburse capital expenditures between the resolution date and the issuance of tax-exempt bonds. The earlier this is done the more reimbursements may be made out of the tax-exempt debt financing.

Remarketing: A formal re-underwriting/re-selling of a bond issue that has been "put" by an investor. The remarketing agent typically is responsible for periodically resetting the interest rate on floating/variable-rate transactions.

Revenue Bond: A type of bond in which the issuer pledges to repay the bondholders with revenues generated by the operations of the project financed.

Securities Industry and Financial Markets Association (SIFMA): A seven-day high-grade market index composed of tax-exempt, variable-rate debt obligations. The index serves as a benchmark that is accepted industry-wide. The index allows for an efficient way to regularly monitor the short-term tax-exempt market.

Senior Manager: An investment bank or other financial services firm that has the primary directive for organizing a debt offering. The senior manager will usually work with other investment banks to establish a syndicate, and thereby create the initial sales force for the bonds. These bonds will then be sold to institutional and retail investors. See also Lead Manager.

Serial Bonds: A series of bonds with individual annual maturities and individual interest rates. These bonds usually mature in the first 10 to 12 years of a financing.

Sinking Fund: A structured plan to accumulate cash for the purpose of redeeming a fixed portion of bonds. This may comprise a portion of or the entire issue, and is in accordance with a fixed schedule detailed in the trust indenture or reimbursement agreement. This helps an organization create level debt service over time rather than having to pay it all off at the maturity.

Swap: An exchange of streams of payments over time according to specified terms. The most common type is an interest rate swap, in which one party agrees to pay a fixed interest rate in return for receiving an adjustable rate from another party.

Syndicate: A professional financial services group formed temporarily for the purpose of handling a large transaction that would be hard or impossible for the entities involved to handle individually. Syndication allows companies to pool their resources and share risks.

Term Bond: A bond with a single final maturity date and single interest rate. All or a large part of an issue of bonds may be sold as one or more term bonds. Term bonds usually have mandatory annual payments called sinking fund payments.

Trust Indenture: A contract between the issuer and the bond trustee that sets forth the obligations of the issuer to the bondholders. Such contract includes specific repayment, collateral, default and bond fund provisions.

Yield Curve: A graph plotting market yields on bonds of equivalent quality but different maturities at a given point in time. The structure of interest rates as reflected by the yield curve will vary according to market conditions. A normal or positive yield curve results when short-term securities have a lower interest rate than long-term securities. An inverted or negative yield curve results when short-term rates exceed long-term rates. A flat yield curve exists when short- and long-term rates are approximately the same.

Yield Maintenance: A prepayment premium that allows investors to attain the same yield as if the borrower made all scheduled mortgage payments until maturity. Yield maintenance premiums are generally in effect for the first ten years of a loan and are designed to make investors indifferent to prepayment. Furthermore, it also makes refinancing unattractive and uneconomical to borrowers during the yield maintenance period.

Appendix I: Arbitrage for the Nonprofit

The primary reason for issuing bonds is to provide funding for capital expansion projects. Additional benefits include the possibility of increased cash flow to the organization and the ability to structure long-term capital objectives through comprehensive asset/liability management planning. Borrowing on a tax-exempt basis allows an organization to invest cash that would have otherwise been used for the project and obtain a return to offset, and in some instances exceed, its cost of capital. This is referred to as arbitrage.

Tax-exempt financing is beneficial to organizations without extensive assets because it makes borrowing money for expansion and rehabilitation more affordable by offering low interest rates. Organizations with very strong balance sheets or large endowments also find it advantageous because of the possibility to realize returns in excess of the interest expense and arrange rate structures to hedge investment risk.

The general population is encouraged to avoid incurring debt and paying unnecessary interest expense. Nonprofit organizations are different because they can counter the interest payment costs with returns earned through investments. Borrowing at tax-exempt rates and investing at taxable rates is usually an opportunity to realize a positive spread. There are some stipulations and regulations governing these transactions, but this is a legal way to help offset the cost of capital.

Variable-rate debt having a maturity of less than one year is priced at the shortest end of the yield curve and resets regularly throughout the life of a loan. This means that rates and associated debt service payments will change as the market fluctuates. On the other hand, fixed-rate debt is set at the date of issuance for the entire term and is based on rates further out on the yield curve. This locks in debt service and eliminates the risk of interest rates rising.

Fixing rates may on the surface appear to be the more prudent approach, but it is not always the most cost-effective option. Typically, the correct decision for a nonprofit organization requires analysis of assets and liabilities to create a management plan and adopt an appropriate debt policy. The goal is to develop a method of matching investment income with debt service so that a change in rates will not have a negative impact on the operating budget.

The percentage of debt and assets which pay or earn interest at fixed and floating rates is usually established after assessing risk tolerance and investment return goals. The following are two fundamental arbitrage strategies:

1. Utilize fixed rates for both debt and assets. Invest the assets in maturity-matched, taxable, U.S. Government fixed-rate investments. The net cash flow to the organization is the interest earned on the taxable bonds less the cost of the borrowing.
2. Utilize floating rates for both debt and assets. Invest the assets in taxable, U.S. Government investments with similar rate terms as the debt. While there may be temporary fluctuations, the net cash flow to the organization is the interest earned on the taxable bonds less the cost of borrowing.

When interest rates (both long- and short-term) are relatively low, there is very little difference between the economic values of these two options. Neither will create enough spread to generate significant additional revenue. However, when rates rise, the spread expands, and the result can be considerable additional investment income for the organization using floating rates for both debt and assets.

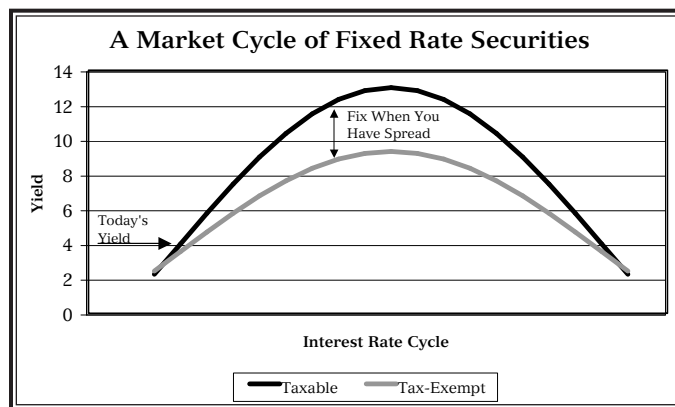
Historically as rates rise, the taxable rate rises much faster than the tax-exempt rate. This is shown in the diagram on the following page.

The strategy is to fix both debt and assets at a point during the market cycle that allows the organization to realize an acceptable spread and create riskless arbitrage. The result is positive investment returns that translate into additional cash flow to the organization for the remaining life of the debt.

The takeaway from all this: individuals and for-profit entities generally benefit from fixed-rate financing, but nonprofits are different. Nonprofits must overcome the initial impulse to fix rates, establish a certain debt service and eliminate exposure to a rising rate environment. This does not consider the entire situation and focuses too myopically on the liability side of the equation. Nor does this view consider the perpetual income earning nature of most nonprofits.

Nonprofit organizations can borrow at some of the lowest costs in the capital markets. Additionally, most of these entities have positive financial assets available for investment. This combination (low cost and tax-free return) allows for the possibility of arbitrage.

A more complete analysis of the situation, which includes both sides of the balance sheet (assets and liabilities), can result in the development of new policies yielding long-term financial benefits to the nonprofit organization.





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