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Stepping back: How has access to capital changed?

Organizations that need to issue debt in the near future will have to look to new and creative ways to access capital

by Tanya K. Hahn, CPA

Day-to-day, minute-to-minute focus on the capital markets can make it harder to see where we are today compared to where we were at the height of (one hopes) the market fallout in the United States. The capital markets—which include long-term securities such as stocks, bonds and mortgages—have obviously not stabilized. Yet there has been some improvement since a low point in 2008, when investors were playing hot potato with variable interest rate bonds, and some banks turned away depositors and borrowers and closed their doors—permanently.

Borrowers with outstanding debt and those planning on issuing bonds or notes in the near future are in a slightly better position in summer 2009 compared to fall 2008, though they may look wistfully back at 2007. The overall landscape of both variable-rate bonds/notes and fixed-rate debt has changed (see the glossary of terms on page 54 for explanations), and much of this can be understood through changes in the banking world over this short period of time.

Banking on change

Many banks had a wake-up call last fall when variable-rate bonds failed to find buyers due to higher perceived risk, and the banks had to extend cash for draws on their letters of credit. At the time, these financial instruments (which guarantee repayment) were supporting billions of dollars in floating-rate debt. Never in the history of this financing structure had the markets and the affected banks had such widespread draws on letters of credit.

What happened? Since floating-rate debt instruments are meant to be short-term investments ranging from one day to nine months in maturity, letters of credit are used to provide liquidity to buyers/investors of this kind of debt. If an investor decides to cash out of the investment and another investor is unavailable or unwilling to risk capital to

purchase the debt, a draw is made on the bank letter of credit to pay the selling investor at the stated date. This is known as a Remarketing Draw, and the bonds are “failed bonds” or “failed remarketed bonds.” For banks, draws on letters of credit create a cash drain, and this may have produced (and continue to produce) more capital constraint for these institutions, in addition to the fallout and negative financial impact from sub-prime mortgages. Numerous banks have subsequently experienced credit rating declines or have been placed on negative watch by the rating agencies as a result of declining financial performance.

This situation contributes to a spiraling chain reaction. As part of this complex spiral, a bank’s strength or perceived strength—or lack thereof—impacts the decisions of investors who purchase bonds or notes backed by letters of credit. These investors are primarily money market funds, which focus on short- to medium-term maturity investments. Many of these funds are forbidden, either legally or by their credit criteria, from holding more than a certain amount of bonds from lower-rated banks. If a bank is downgraded or potentially may be downgraded, investors may be less likely to buy debt backed by that bank, or they may require a higher interest rate for the greater perceived risk of that bank’s letter of credit.

In an attempt to shore up the market’s perception of their credit risk, some banks are now trying to reestablish their capital and liquidity positions by removing what they see as riskier loans and investments from their balance sheets. With weaker borrowers utilizing the letter of credit structure and/or in the midst of failed remarketed bonds, banks have taken this opportunity to:

- charge higher fees;
- require movement of deposits to their institutions;

Resource

Making the Decision to Finance: A Primer on the Borrowing Ability of Nonprofit Organizations

Author: Gerald M. Swiacki

Lancaster Pollard & Co., 2005

* Available at www.lancasterpollard.com/assets_LPC/WP/NP-I-Borrowing-Ability.pdf

- offer shorter repayment terms; or
- require restructuring of debt into traditional bank debt (loans) at higher rates and shorter terms.

In some cases, existing letters of credit are not renewed or extended. All of these situations may create serious cash flow disruptions or even default for borrowers.

The good news is that the majority of variable-rate bonds are again finding buyers. The letter of credit structure has functioned in this last year exactly as intended—as a stopgap for borrowers. But after their recent experiences with these bonds, banks are now looking at borrowers through a new lens. Institutions are being judicious with extending capital in the form of letters of credit for all types of borrowers. This increased scrutiny of borrowers has tightened the credit and bond markets, and limited access to necessary capital for renovation and improvement projects for long-term care providers to seniors centers across the country.

The borrowers getting their deals done with bank letters of credit are typically very strong and often have stand-alone investment-grade ratings. Investors who buy these bonds and notes are looking not just at the rating of the bank

Continued on page 54

Stepping back: How has access to capital changed?

Continued from page 53

involved in the transaction, but also at the liquidity and credit strength of the borrower in relation to the size of the transaction. Right now, bigger and stronger is not just better; it is almost all that is out there.

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

Current impact on letters of credit and variable-rate debt

Borrowers with existing letters of credit and variable-rate debt are overall in decent shape. Variable interest rates reset based on an underlying index. Since variable-rate debt carries a short-term interest rate, it should be the lowest cost of capital available in an environment where short-term rates normally are lower than long-term rates. In fact, the 15-year average interest rate on 7-day variable-rate debt is less than 3%, and the current weekly underlying index is less than 0.5%. In the height of last fall's liquidity crisis, the variable-rate tax-exempt index spiked to *almost 8%*. Today, variable-rate tax-exempt bonds are being remarketed with interest rates ranging from 0.5% to around 4%, based on the letter of credit bank and region of the country.

The difference between the high end and the low end, however, is dramatic. Bonds enhanced (or supported) by the largest and highest credit-rated bank letters of credit reset weekly at an interest rate of 0.5–0.75%, while some bonds supported by regional bank letters of credit are resetting weekly in the 2–4% range. Interest rates can vary widely even for two different organizations using the same bank's letter of credit, depending on individual investor perception of that bank's credit risk.

Strong borrowers currently paying higher-than-market interest rates may have opportunities to replace their letters of credit with ones from a higher-rated bank, resulting in a potentially lower interest cost. Many borrowers will be better off remaining with their current letter of credit provider, and working proactively with this bank to ensure the instrument stays in place and receives a timely renewal—even if it means paying a higher annual fee. Although few new deals are getting done, rates on variable-rate debt enhanced by existing letters of credit are low in comparison to fixed-rate transactions.

A borrower should seek advice from a financial advisor or investment banker if a letter of credit will expire within the next year to 18 months, or if the bank's willingness to work with the borrower has changed. Many letter of credit borrowers should be in a good place, however, with rates as low as they are based on weekly interest rates.

Market impact on interest rate swaps

With borrowers paying higher interest rates because of negative investor perceptions of their letter of credit bank, the current economic climate is creating a disconnect between “swaps” used to mitigate increases in interest rates. An interest rate swap is essentially an agreement between a borrower and a counterparty to exchange interest rates for a defined period of time.

In a fixed-rate swap, a borrower with a floating (variable) interest rate pays a fixed interest rate to a counterparty. In return, the counterparty pays the borrower a floating rate based on one of two indices: SIFMA (Securities Industry and Financial Markets Association) or LIBOR (London Interbank Overnight Rate). The floating rate received from

Continued on page 56

Glossary of terms

Bank-qualified, tax-exempt term loan/bonds: These tax-exempt, debt instruments meet the Internal Revenue Service designation under Section 265 of the Internal Revenue Code, which provides favorable tax treatment to designated banks/financial institutions that purchase these bonds or provide loans to organizations eligible for tax-exempt debt. The borrowing organization usually benefits from a lower interest rate on their debt for the first 10–12 years due to the federal tax benefit the bank obtains from structuring or buying this debt instrument.

Fixed-rate debt: This debt instrument carries an interest rate that does not change over the life of the transaction, which could be for a period of one year or more.

Interest rate swaps: Interest rate swaps are transactions used to manage exposure to changes in interest rates, and are separate and distinct from the debt issued or investment instrument on the organization's balance sheet. The swap is an agreement to pay either a fixed or floating rate to another party for a defined period of time based on an agreed upon dollar amount (the notional amount) and index (often SIFMA or LIBOR), in return for either a fixed or floating rate to be received from this counterparty.

Letter of credit: Issued by a bank, savings association or credit union to provide a guaranty of debt repayment, this financial instrument has a fixed initial term of 3–7 years, carries an extension clause, and has a maximum dollar amount associated with it. The borrower agrees to pay the bank an annual fee for the use of this guaranty for as long as the guaranty is needed.

Variable-rate bond/note: This debt instrument carries an interest rate that changes either daily, weekly, monthly, quarterly or on some other short-term time frame, usually less than a 5-year period. Also known as floating-rate debt.

Stepping back: How has access to capital changed?

Continued from page 54

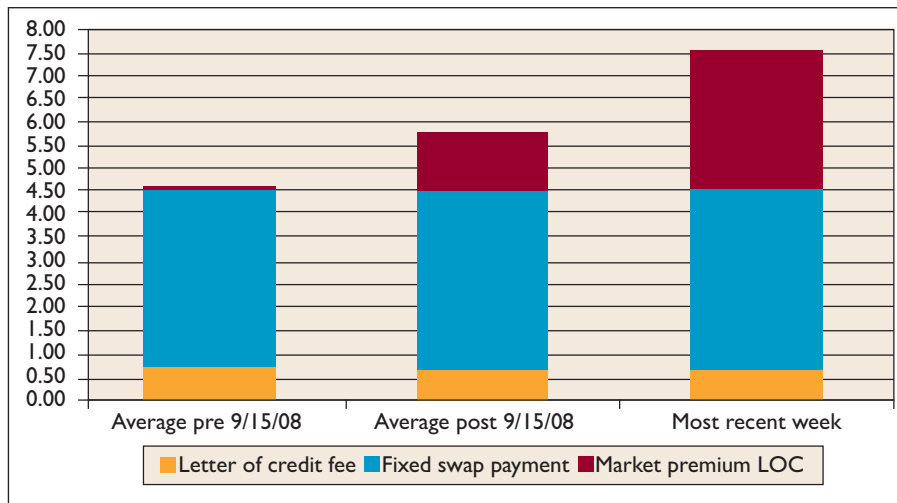


Figure 1. The pre- and post-September 2008 impact experienced by organizations using fixed interest rate swaps

the counterparty approximates—and therefore cancels—the floating rate paid by the borrower to bond investors. The net result is that the borrower pays a regular fixed amount every month.

Post-September and more recently, borrowers are paying a higher interest rate to investors not because the base indices have increased (which they have not), but because the market is demanding a higher rate for the bank letter of credit risk. This is called “basis risk.” The higher market premium is *not* reimbursed by the swap counterparty, however, which adds unplanned and unbudgeted costs for the borrower. In some cases the extra expense could be an effective interest rate as much as 3–4% points higher, thereby negatively impacting cash flow, financial covenants, and more. Figure 1 above illustrates the impact to borrowers.

Given the limited ability of borrowers to replace their current letters of credit, it is prudent for organizations to understand this temporary solution and budget appropriately for the extra interest expense. Those that have a strong relationship with their letter of credit bank may be able to negotiate a lower letter of

credit fee to compensate for the current market premium caused by the bank’s downgrade.

Current impact on fixed-rate debt

Many borrowers that issued fixed-rate debt in recent years should have locked in low rates and be well positioned to weather this market.

New fixed-rate, tax-exempt revenue bond issues have been few and far between since last fall, and the issuance of fixed-rate debt has not heated up to the levels anticipated at the close of 2008. Long-term investors in tax-exempt bonds and taxable loans have reduced liquidity and hence a limited ability to purchase new issues of debt. Willing investors are demanding a higher rate of return (interest rate) for perceived higher-risk borrowers in sectors such as healthcare and healthcare-related entities, senior living, and affordable housing entities. In contrast, some highly rated governmental borrowers, which are perceived to be lower risk, are paying a lower interest cost.

Borrowers looking to use fixed-rate debt for a current project often have a 10-

year prepayment penalty period (during which they will be penalized if the debt is paid in full). In the current environment, these organizations may have the ability and desire to negotiate a different, shorter prepayment penalty period in return for paying a higher interest rate to investors. This option may attract potentially more investors to the transaction. It also provides future financing flexibility to refinance sooner when the markets have settled down to more normal liquidity and capital access levels.

What now, and what next?

Several financing strategies are still viable for new debt issuances, or for refinancing troubled debt. The Federal Home Loan Bank is able to guarantee letters of credit for their member banks, many of which are small and do not have their own credit ratings. As a result, borrowers can turn to their local banks for a cost of capital similar to that usually available to larger, rated organizations. US government enhancement programs also remain a strong option for hospitals, senior living, and affordable housing projects.

Examples include the Federal Housing Administration Sections 242, 232 and 221(d) mortgage insurance programs for hospitals and senior living organizations. In addition, Department of Agriculture guaranteed loan programs may prove beneficial if a project is in a rural setting. These initiatives include the Community Facilities program for nonprofits, for example, and the Business and Industry programs for for-profit owners and operators.

Nonprofit providers also may consider doing a bank-qualified, tax-exempt term loan, and build in plans to refinance down the road. When tax-exempt bonds or loans are bank-qualified, banks can deduct 80% of their cost of buying and carrying them. These institutions pass along the savings to borrowers through a reduced interest rate.

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Normally, only \$10 million in bonds or loans can be designated bank-qualified by any single bond issuer (usually the local municipality) in one year, and these bonds must be issued for qualified tax-exempt obligations. The American Recovery and Reinvestment Act increased the amount of bank-qualified bonds or loans that can be issued in 2009 and 2010 to \$30 million and applied this new limit not to the bond issuer, but to the actual borrower. The Act also created a temporary rule that allows banks to purchase more of these designated loans. This increased limit should expand the number of issues that are eligible for bank-qualified designation and the number of buyers for tax-exempt bonds or loans, helping to push interest rates down.

Finally, organizations that are strong within their sector could consider paying to get an independent credit rating from a rating agency, possibly enticing investors by setting their transaction apart from a nonrated deal.

Many borrowers who issued debt recently are in a good position. Those who need to issue debt in the near future, however, will have to look to new and creative ways to access capital. Borrowers can ensure their best access to capital by working with an investment bank or financial advisor who understands and monitors how banks and various enhancement options are viewed by investors, as well as what new options are coming available. ☞

Tanya K. Hahn, CPA, is a senior vice president with Lancaster Pollard, which provides financial advisory and debt financing services for senior living expansion, renovation, acquisition, new construction and refinance. Hahn can be reached at 614-224-8800 or thahn@lancasterpollard.com.

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Page 9
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Page 11
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Pages 84–85
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