Focus on HEALTH CARE FINANCE
White Paper I

Financing Options for Nonprofit Rural and Community Hospitals

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Chairman and CEO
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About Lancaster Pollard

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Financing Options for Nonprofit Rural and Community Hospitals

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The challenges faced by today’s health care providers are as great as at any time in our nation’s history. Aging baby boomers and increasingly diverse populations create demands for new and different services. Clinical procedures continue to evolve, as do diagnostic techniques and communication technologies that create new opportunities to partner with nearby – and not-so-near – facilities. Strong finances and up-to-date facilities and equipment mean better physician attraction and retention, improved community perception and assurance that a hospital will serve its region for the long term. Considerable investment and reinvestment is critical to the survival of the small hospitals that serve the majority of the nation, many of which were built under the federal Hill-Burton program before helicopter flights, advanced outpatient services, modern diagnostic services and Medicare payment procedures changed the options and challenges hospitals have in providing health care.

Hospitals around the country are in a constant state of renovation in order to stay competitive and provide the best technology and equipment. In a recent survey sponsored by the Healthcare Financial Management Association, nearly one in four CFOs surveyed expected to build a new hospital in the next five years, and three out of four expected their hospitals’ capital spending to increase in the next five years. However, many hospitals, especially those in smaller communities, often cannot access the capital necessary to make those critical renovations and upgrades. Although profitable, many rural hospitals do not meet the high benchmarks bond rating agencies require to earn investment-grade ratings and are unable to raise the funds on their own.

This paper is designed to demystify several programs available to nonprofit community and rural hospitals. It outlines the relationship between a hospital’s strategic plan for future operations and its financial plan before explaining how these hospitals are seen as borrowers. Hospitals have opportunities to issue debt on their own or with commercial or federal enhancements; each is covered in this paper. Part II elaborates on financing options and several appendices provide technical insights.

Rural and community hospitals are like rivers running through small early American towns. They sustain regions and encourage growth as well as physical health, and if they dry up or close down, towns can suffer economic and population setbacks. Although the rate of rural hospital closures has slowed with the Critical Access Hospital designation and other programs, hospitals must continue to have access to the low-cost funding they need to provide the best service possible.
PART I
Integrating Strategic Plans and Capital Financing

Accessing capital requires the precise matching of financial plans with strategic plans and an informed, unbiased review of an organization’s ability to borrow. Whether a hospital chooses to build a replacement facility, renovate an existing facility or refinance to improve cash flows, its plans and its credit strength will determine eligibility for a variety of funding options.

Strategic Plans

Hospitals must evaluate their strategic plans and their funding needs in tandem to accurately determine their best financial options. The first steps toward acquiring funding of any kind are performing an assessment to determine needs and evaluating credit strengths.

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 market 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 community’s needs and a hospital’s ability to meet them.

A well crafted financial plan matches a hospital’s financial resources to the elements of the strategic plan by quantifying available capital and outlining a capital allocation plan. The capital allocation plan should be integrated into a strategy to manage assets and liabilities so the hospital 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. 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, hospitals and their advisers balance long- and short-term goals with creating an optimal capital structure that will improve or maintain the 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, also can strain hospital resources. The ultimate goal is to develop a finance strategy that maximizes 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 a professional with a comprehensive understanding of the impact of financial decisions on asset management, liabilities and cash flow.

A key point must be kept in mind when refining a hospital’s capital strategy: Nonprofit hospitals are designed to operate for the long term. They do not have the same goals as for-profit corporations, and their financial strategies should reflect their mission to serve in perpetuity. Advisers should help hospitals understand these differences and take advantage of opportunities to improve credit strength and long-term fiscal strategies.

Recognizing Strengths and Weaknesses: The Credit Profile

A hospital’s credit strength or financial health is the single most important factor in determining its cost of capital. Organizations with strong financial health have more ability to repay debt, and so tend to be more appealing and less risky to investors and lenders who buy bonds and make loans. Investors and lenders balance their risk with interest rates. The better the credit profile, the lower the interest rate on the financing, and the less capital costs over time.

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

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

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

A credit assessment that considers only quantitative financial ratios, however, is inadequate. Credit analysis is both science and art and goes well beyond the basics of assets, liabilities and profitability. Qualitative factors such as management, local economic factors, demographic changes, technological capabilities, location and medical staff characteristics play into a hospital’s credit profile. Particular attention will be given to board members’ competence and independence as well as management’s experience and ability.

Ignoring these qualitative factors can give a hospital and the credit markets an incomplete picture of the hospital’s credit profile and its financial options. For example, a hospital with strong financial ratios located hundreds of miles from a major metropolitan area may find accessing capital more difficult than its financial ratios suggest. Conversely, a well-articulated qualitative analysis of a hospital’s long-term viability could help it secure bond insurance even if its credit profile is slightly below the usual credit profile required for such enhancement. Appendix B: Factors in a Hospital Credit Analysis covers important considerations in assessing creditworthiness.

After completing the credit profile, a hospital can work with its financial professional to determine the best way to leverage its strengths and/or use strategic enhancements to improve its position on the credit continuum to achieve lower interest rates and less expensive capital.

Rural and Community Hospitals as Borrowers

Community and rural hospitals are often at a natural disadvantage for borrowing money. They generally have a limited service area, slower population growth, fewer assets, physician recruiting challenges and lower credit ratings. They also often compete with large urban hospitals for patients and staff and struggle with the perception that large urban hospitals offer better health care. These challenges are illustrated in figures 2 and 3. Figure 2 uses Standard & Poor’s hospital credit ratings to illustrate that of the relatively few small hospitals rated by S&P, most fall into the mid- to low “BBB” categories, while the majority of the large hospitals S&P rates are in a range from “A” to “BBB+.” Figure 3 shows that smaller hospitals must have substantially stronger financial ratios to receive the same credit rating as a larger hospital.

With the right guidance, however, most rural and community hospitals are able to efficiently access capital. Many are able to fund their growth and renovations with conventional revenue bonds, either credit-enhanced or unenhanced. In addition, the federal government recognizes small hospitals’ financial challenges and has established programs to enhance community and rural hospital credit so they can borrow at lower interest rates. Part II discusses these debt structures.
Figure 2: S&P Rating Dispersion: General Hospital vs. Small Hospital

*S&P Ratings Update July 20, 2005 *Small hospitals defined as Net Patient Revenue of $50 million or less

Figure 3: S&P’s Median Ratio Dispersion

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<th>Profitability Ratios</th>
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<td>Cushion</td>
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<td>MADS/Revenues</td>
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<td>Debt to Capitalization</td>
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<td>Average Age of Plant (years)</td>
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</table>

2 S&P Small Hospital median numbers taken from “Small Hospital Ratios Show Signs of Stability” which reflect financial performance for 2002.
Part II
Financing Options for
Rural and Community Hospitals

Sources of Capital

External funding options are composed of gifts, operating and capitalized leases and long-term debt. Gifts include grants and community donations. While these options can provide a significant source of capital and demonstrate community support for hospital projects, access to funds often is limited and unpredictable. Grant pools, even at the federal level, are highly competitive, and funding is limited. Community donations can be unreliable as the economy shifts, and large undertakings often require additional financing because gifts may not meet total funding needs. Many states offer grant and other financial programs specific to community and rural hospitals, and hospitals should investigate local government opportunities as part of their analysis of options.

Long-term debt, usually tax-exempt bonds or taxable notes, is a popular choice for hospitals that need to access capital. Bonds and notes represent an obligation of the borrower to pay interest to the investor in return for the lending of money over a given period of time. The rate of interest 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.

Bonds can be rated or unrated. The ratings, established by organizations such as Standard & Poor’s and Moody’s, range from AAA down to C or D and can change if the borrower’s financial situation changes. Rating organizations charge a fee for borrowers to assign ratings to their bond offerings. Ratings suggest to investors the amount of risk involved in purchasing a particular bond. AAA to 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 better the borrower’s gauged ability to repay the bond, and the lower the interest rate the borrower must pay to offset investor risk. See Appendix C: Rated Bonds for more information on ratings.

Rated and unrated bonds generally can be sold either (1) without any additional enhancement and marketed based on the strength of the borrowing hospital or (2) credit-enhanced using vehicles such as bond insurance, mortgage insurance and letters of credit (Figure 4).

Figure 4

Typical Bond/Note Structure

- Rating: AAA, A, BBB, None
- Interest Rate: Var./Fixed

Unenhanced

Credit-Enhanced

- Rating: AAA, AA, A
- Interest Rate: Var./Fixed

FHA/USDA

- Rating: AAA, AA
- Interest Rate: Var./Fixed

Bond Insurance

- Rating: AAA, AA, A
- Interest Rate: Var./Fixed

(FHA: Fixed only)
Credit enhancements make mortgage notes and bonds less risky to the investor and more affordable to the hospital. Enhancements do not change the hospitals’ credit ratings, but change the rating on the debt, allowing hospitals to borrow at lower interest rates as if they had better credit characteristics. Enhancements can be provided either by commercial institutions, such as banks and bond insurers, or a public entity such as the federal government.

The market appeal of mortgage notes, like that of bonds, can be improved with credit enhancements such as insurance. Mortgage notes are long-term loans in which the borrower offers the project being mortgaged as collateral for the loan.

Borrowers with stronger credit profiles have more financing options, while organizations with weaker financial health have fewer options (Figure 5). The latter often will choose to access the capital markets using some form of credit enhancement.

If a hospital decides to issue long-term debt, the first step is to select a financial professional to guide the process. Some borrowers choose to hire both a financial adviser to structure the debt and an underwriter to purchase and sell the debt and assist in capital decisions and implementation. Many investment banking firms, however, can effectively provide both services, creating a seamless and singular process that often saves the organization time and money. The final investment banker/ adviser choice should have health care and capital market experience as well as expertise in the full range of financial options available to rural and community hospitals. Other parties central to the transaction can be found in Appendix D: “Key Players in Hospital Financing.”

Each hospital must evaluate its situation to find the best funding option, as no two situations are alike. Only after a thorough financial analysis and a clear understanding of the current credit profile should hospitals move to evaluate their 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 that may initially seem the most cost-effective may actually be more expensive in the long term.

A) Unenhanced Bonds

Hospitals with excellent credit strength may choose to issue bonds without additional credit enhancement.

Unenhanced (rated or unrated) revenue bonds sold on the credit profile of the borrowing entity have become more widely accepted by investors, though unrated offerings face a more limited market. They are supported solely by the borrower’s credit characteristics. The bonds will tend to trade at a broader range of interest rates depending on the market’s perception of risk at the time of the sale. Bondholders are typically provided as security a first mortgage and lien on property assets, a pledge of gross revenues of the organization and a lien on trustee-held reserves, including a debt service reserve fund. Appendix E: Security and Covenants provides additional information on security provisions.

Unenhanced bonds typically are structured as fixed-rate serial and term maturities with a final amortization of 25 to 30 years from the date of issuance. The financing normally prohibits prepayment for ten years, commonly called the call feature or a lock-out period.

Since bond investors rely primarily 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 can include a market and financial feasibility study conducted by a recognized accounting firm experienced in assessing similar projects.

Directly to the Market

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 federal provider, but they may find capital more expensive over time or be subject to longer lock-out periods, potentially more restrictive covenants or 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.

This option usually is not financially attractive to smaller hospitals because their generally weaker credit profiles, distance from metropolitan markets and lack of name recognition in the bond markets tend to result in higher interest rates, which in turn can make the cost of borrowing more expensive. Investors without ties to the community may not take the time to understand why the bonds are being issued and are not likely to take on a perceived higher-risk investment without being rewarded with a higher interest rate.

Bank Loans and Private Placements

Another source of borrowed funds 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 across the country. Interest rates can be fixed or variable. In small communities with smaller local banks, the size of the loan often is restricted by the bank’s lending limits and the types of credit risk a particular bank is willing to accept.

Tax-exempt bonds also can be privately placed, often with the local bank. This structure often allows a local bank to stay involved with the hospital, and those bonds that cannot be placed locally can be sold outside the community to surrounding institutions.

B) Commercial Enhancements

Hospitals also have the option to obtain commercial enhancements to obtain better interest rates on their bonds. These include letters of credit and bond insurance. Bond insurance, in particular, often is not available to community hospitals with more modest financial means and generally smaller transactions.
Letters of Credit

A letter of credit issued by a commercial bank is an irrevocable obligation to make bond payments if a borrower cannot. With that support, a hospital can issue bonds backed by the bank’s credit strength at correspondingly lower interest rates. Borrowers pay letter of credit banks to access this option. The cost of a letter of credit is largely driven by the perceived credit risk of the hospital and typically includes a one-time fee along with an annual service charge. Letters of credit usually are issued for three- to five-year terms and can be renewed or substituted. Bonds usually have variable interest rates and generally amortize over 15 to 25 years.

Once a hospital obtains an acceptable letter of credit, it can issue tax-exempt bonds that carry the same rating as the letter of credit provider. The primary benefits of this approach are lower costs of issuance and somewhat lower annual debt service when compared to some other structures. The process for obtaining a letter of credit generally is shorter than that of other enhancement options, and up-front closing costs are relatively low. Hospitals also may have the opportunity to leverage existing local bank relationships and can issue supplemental or additional debt.

Letter of credit structures can provide more flexibility than many other options, but banks can be hesitant to extend credit. The project and the obligor’s credit profile must fit into the conservative underwriting requirements of a commercial bank. A bank could refuse to issue a letter of credit for a viable hospital project if it lacked a branch near the hospital, if the credit request was too large, or if the bank was unfamiliar with the hospital’s operations.

Bond Insurance

Bond insurance, like a letter of credit, is a credit enhancement that guarantees that investors will be paid even if the hospital cannot make its scheduled payments. This generally allows the hospital to access capital at much lower interest rates than it could have without enhancement.

Several companies offer this option, among them AMBAC, MBIA, FGIC, Radian and ACA. Each bond insurer has its own credit rating. Their individual appetites for certain credit risks also will vary a great deal, as will the market’s acceptance of bonds enhanced by their insurance. These factors must be taken into consideration when evaluating bond insurance credit enhancement options.
Case Study: Letter of Credit

San Luis Valley Regional Medical Center is an 80-bed essential care nonprofit hospital serving a diverse rural population of about 45,000 in south-central Colorado. Management and the Board of Directors initiated a plan to modernize the campus and add services to support the community’s private practice physicians.

The hospital had strong cash reserves, modest profitability and liquidity, and had never used debt financing. The hospital and its financial adviser/underwriter, Lancaster Pollard, reviewed funding options and determined that issuing unenhanced bonds was financially unattractive, and the hospital’s credit profile was not strong enough for bond insurance companies.

Instead, San Luis Valley leveraged its strong qualitative strengths to access a letter of credit, which was ultimately less expensive and faster than federal mortgage insurance. The hospital’s large market share, an active recruiting process, and its status as a major regional employer made it attractive to the letter of credit bank. The letter of credit’s flexibility also was desirable, as the hospital plans to execute its strategic infrastructure and service updates in phases.

The hospital was able to issue $11.4 million in tax-exempt, variable-rate bonds at a rating of “AA/A-1+” and maintain its strong cash reserves. San Luis Valley will use the financing to expand its ambulatory surgery services, build a new rehabilitation unit, upgrade mechanical systems and remodel. As part of the process, the hospital re-aligned physician relationships to better support its doctors and the community they serve.

The Process for Issuing Tax-Exempt Debt Using Letter of Credit (LOC) Enhancement

<table>
<thead>
<tr>
<th>Description of Action</th>
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<tr>
<td><strong>Internal Financial Analysis (5 weeks)</strong></td>
<td>1</td>
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<tr>
<td>Information Gathering</td>
<td>2</td>
</tr>
<tr>
<td>Create Credit Profile</td>
<td>3</td>
</tr>
<tr>
<td>Submit to LOC Banks</td>
<td>4</td>
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<tr>
<td><strong>External Financial Analysis (3 weeks)</strong></td>
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<tr>
<td>Discuss Proposals</td>
<td>6</td>
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<td>Select LOC Bank</td>
<td>7</td>
</tr>
<tr>
<td>Finalize Terms with LOC Bank</td>
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<td><strong>Closing (5-7 weeks)</strong></td>
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<td>Initial and Final Documentation</td>
<td>10</td>
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<tr>
<td>Issue Bonds</td>
<td>11</td>
</tr>
<tr>
<td>Transfer Funds</td>
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</table>
Bond insurance generally is available to hospitals that independently can achieve an investment grade rating of BBB or better. It can be used for both fixed-rate and variable-rate structures. Generally it is less expensive on an annual basis than the letter of credit option. The cost, however, must be paid up front, and bond insurance may not be the most cost-effective option for hospitals that expect to pre-pay their bonds or restructure the debt before the final scheduled maturity. Bond insurers tend to be more receptive to longer amortizations (20 to 30 years) than banks providing letters of credit. Unlike banks, insurers generally will insure projects regardless of geographic location, and they tend to focus on larger projects when compared to letter of credit banks.

C) Government Enhancements

In recognition of small and rural hospitals’ essential places in their communities, the federal government created several funding and credit enhancement programs to assure that these hospitals continue their missions, evolve with changing technology, and remain competitive and viable. The Federal Housing Administration (FHA) and the U.S. Department of Agriculture (USDA) have special enhancement programs that allow for longer amortizations and lower interest rates. Government enhancements put the full support of federal organizations behind these hospital loans and bonds, making them much more attractive (less risky) to potential investors.

U.S. Department of Agriculture Community Facilities Program

The USDA offers three funding options under its Community Facilities program: guaranteed loans, direct loans and grants. All three are designated for nonprofit rural organizations that provide health care, public safety or other such services to communities with populations of less than 20,000. Multiple options can be used for a single project. In fiscal year 2004, the USDA provided 36 loans and three grants to 28 hospitals, for a total of $147 million.

The funds can be used to build, enlarge or improve essential facilities including hospitals and clinics. Funds also can be used to buy new equipment required for operation. “Essential facilities,” as defined by the government, provide a public service to the local community and are necessary.

Case Study: Bond Insurance

After serving the residents of northwest Ohio for more than 100 years, Blanchard Valley Regional Health Center (BVRHC) found itself at a crossroads. Although financially stable, BVRHC’s board and senior management recognized that remaining an independent nonprofit hospital in the decades ahead would require additional resources. The 258-bed hospital’s capital plan called for a new inpatient pavilion, the renovation and expansion of the surgery area and additional infrastructure improvements.

Underwriter Lancaster Pollard created and presented a comprehensive credit profile of the hospital and its future plans that was instrumental in obtaining credit enhancement and substantially lowering the cost of capital on the $110.9 million financing.

The credit profile sufficiently articulated BVRHC’s strong qualitative strengths to secure “AAA” bond insurance despite rating agency concern that the additional debt would reduce the hospital’s credit rating to a level at which bond insurance cannot usually be obtained.

Ultimately, the underwriting process produced multiple funding options, and BVRHC selected “AAA” rated, bond-insured, variable-rate, tax-exempt bonds with derivative products designed to mitigate an increase in interest rates.

A thorough knowledge of the bond markets is essential to minimize a hospital’s cost of capital. The use of variable-rate bonds with an interest rate hedge agreement provides millions in interest savings over the life of the issue, when compared to the alternative “BBB”-rated unenhanced bonds.
for orderly community development. Applicants must be unable to obtain funds from commercial sources at reasonable rates and terms.

Direct loans and grants often provide the most economical financing terms and allow facilities to proceed with financing on their own, but having a financial adviser remains key to creating a successful long-term financial plan because the pool of grant and direct loan money is limited, and additional funding sources often are required in conjunction with the direct loans and grants. Local governments, special-purpose districts, nonprofit corporations and tribal governments compete heavily each year for these funds. Priority is given to projects that serve low-income communities and projects serving populations of 5,000 or fewer.

**USDA Guaranteed Loans**
The guaranteed loan program historically has not used its total obligation capacity. It enables hospitals and other community facilities in rural areas to finance capital projects with loans guaranteed by Community Programs, a division of the Rural Housing Service, part of the USDA’s Rural Development mission area.

Since the loan is guaranteed by the full faith and credit of the U.S. government, the market for these loans is strong, resulting in low interest rates for the hospital. Guaranteed loans must be administered through a USDA-approved lender such as a qualified mortgage and investment banking company. An approved lender will guide the hospital through the process and should take on much of responsibility for submitting and tracking the application so hospitals can focus on their operations.

The USDA program has several advantages not shared by either traditional bond issuances or other federal programs. The loan can be for up to 100 percent of the cost of the project, and 90 percent of that loan is guaranteed. While the loan is designed for building new and improving existing facilities, it can be used toward refines under certain conditions: Refinancing must be secondary to construction, and the organization’s creditors must be unwilling to extend or modify terms that would make a new loan feasible.

Borrowers have up to 40 years to pay off the loans, thereby reducing the annual debt service or allowing them to borrow more than they may have been able to if they were subject to a shorter amortization schedule. A USDA guaranteed loan generally is subject to a prepayment lock-out period.

Interest rates may be fixed or variable and are determined by the lender and borrower, subject to Rural Development’s review and approval. Interest on loans guaranteed under this program is taxable, though legislation to allow the USDA Community Facilities Program to guarantee tax-exempt loans is pending.

Typical loan amounts under this program have tended to be less than those made under the FHA Sec. 242 mortgage insurance program because funding for the program is limited to the amount appropriated by Congress. There is, however, no maximum loan amount.

The government charges a one-time fee of 1 percent of the guaranteed loan amount, payable at loan closing. A financial feasibility study by a third party may be required if the project is a new facility or if it considerably alters the credit profile of an existing facility.

The lender generally will require that borrowers pledge collateral as security for the loan. This could include such assets as real estate, equipment, taxpayer support and a revenue pledge.

Federal loans come with federal oversight. Borrowers generally are required to contribute to an escrow account for real estate taxes (if applicable), insurance and replacement reserves. The USDA also requires annual audited financial statements.

Before being considered for a USDA guaranteed loan, the borrower must identify a lender that is eligible to participate. Many investment and mortgage banks and community banks are USDA-approved lenders. An experienced lender also will be able to perform qualitative and quantitative analyses to determine the best financial structure for a community or rural hospital.
Applicants go through a two-stage process. The government suggests allowing about 45 days for the first stage, during which USDA Rural Development field offices determine eligibility. The time necessary for the second stage, application processing, depends on the project’s scope, an environmental review and any legal issues, typically taking from two to seven months.

FHA Sec. 242 Mortgage Insurance

The Federal Housing Administration started its mortgage insurance program in 1968. Most of the nearly $10 billion in loans have been issued in the Northeast, though administrators are concentrating on familiarizing regional Housing and Urban Development offices with the program and diversifying its geographic reach. Borrowers taking advantage of this type of credit enhancement must work with FHA-approved mortgage lenders to complete the process.

The FHA Sec. 242 program generally is available to fund new facilities, acquisitions or the substantial renovation and modernization of existing projects. Hospitals may refinance debt through the 242 program as long as at least 20% of the insured funding pays for new projects.

The program offers borrowers the opportunity to issue bonds at an “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 interest rate market. Borrowers have 25 years to pay back FHA mortgage-insured loans, a relatively long amortization that gives hospitals better opportunities to service the debt. No financial guarantees are required by parent or affiliated entities, and a high loan-to value ratio can minimize up-front cash requirements.

FHA-insured obligations are non-recourse to the borrower, meaning the loans are backed solely by the borrower’s real estate and other assets. For a hospital that is part of a system, this structure provides minimal risk because the parent organization is not liable for the debt of the individual facility being financed.

There is no limit to the amount of debt the program will insure, so hospitals may be able to borrow extensively provided they can support the debt repayment. The 242 program allows hospitals to borrow up to 90 percent of the value of the project. Project value for the program is calculated in such a way that the debt available in some cases can meet 100 percent of the actual project cost.

St. Mark’s Medical Center in La Grange, Texas, was financed with the FHA Sec. 242 program. It replaced the aging Fayette Memorial Hospital, which originally was built in 1920 and moved in 1967 under Hill-Burton. Expansion was not possible; the property, like many in small towns, was landlocked. The new 45-bed, 93,000-square-foot St. Mark’s facility increases La Grange and surrounding communities’ access to the latest diagnostic equipment as well as specialty ambulatory, cardiology and oncology services.

St. Mark’s credit profile was not strong enough to access traditional financing or private credit enhancement. Borrowing without an enhancement would have resulted in prohibitively high interest rates, and getting financial help by partnering with a for-profit health system was rejected because the community wanted the hospital to remain independent.

St. Mark’s worked with Lancaster Pollard to finance its project with the FHA hospital mortgage insurance program. Using the Sec. 242 program, St. Mark’s was able to issue $26 million in tax-exempt bonds with the equivalent of an “AAA” rating. Further, it was able to borrow the full cost of the project and limit its HUD-required cash equity contribution to less than $50,000.
## FHA Sec. 242 Timeline & Expenses

### Estimated Timeline

<table>
<thead>
<tr>
<th>Period</th>
<th>Months</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Project Planning (3 months)</strong></td>
<td></td>
</tr>
<tr>
<td>Market demand assessment</td>
<td></td>
</tr>
<tr>
<td>Proforma financial projections</td>
<td></td>
</tr>
<tr>
<td>Master planning</td>
<td></td>
</tr>
<tr>
<td><strong>Pre-Assessment Phase (1 month)</strong></td>
<td></td>
</tr>
<tr>
<td>HUD receives basic project information</td>
<td></td>
</tr>
<tr>
<td><strong>Pre-Application Phase (1 month)</strong></td>
<td></td>
</tr>
<tr>
<td>Washington, D.C. visit</td>
<td></td>
</tr>
<tr>
<td><strong>Application Phase (6 months)</strong></td>
<td></td>
</tr>
<tr>
<td>Complete/submit full application</td>
<td></td>
</tr>
<tr>
<td>HUD processes application</td>
<td></td>
</tr>
<tr>
<td>Final plan development/specification/price</td>
<td></td>
</tr>
<tr>
<td><strong>Closing Phase (1 month)</strong></td>
<td></td>
</tr>
<tr>
<td>Funding documentation and debt issuance</td>
<td></td>
</tr>
</tbody>
</table>

### Estimated Expenses

<table>
<thead>
<tr>
<th>Period</th>
<th>Months</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Project Planning (3 months)</strong></td>
<td></td>
</tr>
<tr>
<td>Market demand assessment</td>
<td>$5,000-$15,000</td>
</tr>
<tr>
<td>Pro forma financial projections</td>
<td>$15,000-$25,000</td>
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<tr>
<td>Master planning</td>
<td>$25,000-$50,000</td>
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<tr>
<td><strong>Pre-Assessment Phase (1 month)</strong></td>
<td></td>
</tr>
<tr>
<td>HUD receives basic project information</td>
<td>$2,500-$5,000</td>
</tr>
<tr>
<td><strong>Pre-Application Phase (1 month)</strong></td>
<td></td>
</tr>
<tr>
<td>Washington, D.C. visit</td>
<td>$2,500-$5,000</td>
</tr>
<tr>
<td><strong>Application Phase (6 months)</strong></td>
<td></td>
</tr>
<tr>
<td>Complete/submit full application</td>
<td>$50,000-$125,000</td>
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<tr>
<td>Financial projections</td>
<td>Project-specific</td>
</tr>
<tr>
<td>Architectural schematics</td>
<td>$15,000-$25,000</td>
</tr>
<tr>
<td>Additional out-of-pocket costs</td>
<td>0.15% of mortgage amount</td>
</tr>
<tr>
<td>HUD processes application</td>
<td>Project-specific</td>
</tr>
<tr>
<td>Final plan development/specification/price</td>
<td></td>
</tr>
<tr>
<td><strong>Closing Phase (1 month)</strong></td>
<td></td>
</tr>
<tr>
<td>HUD initial fee</td>
<td>0.65%</td>
</tr>
<tr>
<td>Financing expenses</td>
<td>2-5.5%</td>
</tr>
</tbody>
</table>

*Note: Depending on HUD underwriting and loan-to-value limitations, all listed expenses may be eligible for reimbursement at closing.*
Project value calculations can include existing assets in addition to the actual project costs of new financing or construction. If the entire project cost is 90 percent or less of the project value, then the 242 program can fund the entire project cost.

To qualify for the Sec. 242 program, a facility must principally be an acute care hospital that derives less than 50 percent of its revenues from chronic convalescence, drug and alcohol treatment, epileptic treatment, nervous and mental deficiency and tuberculosis treatment. Average operating margins must be positive, and the average debt-service coverage ratio must be equal to or greater than 1.25 for the previous three years. Recently approved Critical Access Hospitals have the option of recasting their historical financial statements to enhance their qualifications.

Loans insured by the FHA program are secured by a mortgage and pledge of revenues related directly to the project. Subject to attainment of certain debt-service coverage and liquidity levels, hospitals utilizing the program may transfer excess cash flow to parent health systems or hospitals, which can be an attractive feature for those organizations.

Issuing debt through the FHA 242 mortgage insurance program can save hospitals a considerable amount of money, but initial costs and the time necessary to apply for the program should be taken into consideration as part of the funding option analysis. Hospitals must pay a one-time fee of .8% of the loan amount. The annual premium is .5% of the remaining balance, a relatively small fee given the extent of the credit enhancement and “AAA”-rated debt. Hospitals must have the financial capacity to make monthly payments to a mortgage reserve fund.

Federal programs are not the fastest way to access money, and hospitals must be willing to wait for approval from HUD. Hospitals will be asked to provide financial statements from the last five years, operating statistics, business plan and a description of the project that needs funding, among other requirements.

FHA Sec. 242 Mortgage Insurance for Critical Access Hospitals

For the most part, the Critical Access program is the same as the regular FHA Sec. 242 program, but these small, rural facilities are entitled to special underwriting provisions that increase their chances of qualifying for the program.

Critical Access Hospitals may qualify for FHA Sec. 242 insurance even if more than half of their services are dedicated to drug and alcohol treatment, chronic convalescence or other services described above that prevent general hospitals from using the FHA Sec. 242 program. The government also streamlines the application process to speed up consideration.

Critical Access Hospitals still, however, must meet the requirements that the average operating margin be positive over the past three fiscal years and the average debt-service coverage ratio exceed 1.25 to 1 for the same time. This is where the special provisions make a significant difference.

Hospitals that only recently received their Critical Access Hospital designations and cost-based Medicare reimbursement are allowed under the program to calculate their historical pro forma debt service coverage ratio as if they had been receiving the full cost-based reimbursement for the last three years. Not every Critical Access Hospital will qualify; even with the special provisions, careful evaluation of finances is essential when applying.
Bucyrus Community Hospital serves a region of about 25,000 people in north central Ohio. The 25-bed hospital offers emergency treatment, inpatient and outpatient services, charity care, and smoking cessation and nutrition programs. It was certified as a Critical Access Hospital in 2003.

Hospital leadership learned community perceptions were deteriorating as residents were willing to drive to larger hospitals for what they perceived as more advanced treatment. Board members developed a long-term plan for survival that included a major overhaul to better meet patient expectations and attract staff. They decided to renovate the 95-year-old building, which was important to the community whose investment had supported past capital projects.

Bucyrus, like many smaller hospitals, did not have the credit profile to secure unenhanced debt funding on its own, nor could it obtain commercial credit enhancements. The FHA Sec. 242 mortgage insurance program offered several benefits that made it Bucyrus’ best option. The hospital would not have qualified for the traditional FHA 242 program because it did not have positive historic operating margins. As a Critical Access Hospital, however, the program allowed Lancaster Pollard to recast Bucyrus’ financials as if it had been receiving cost-based Medicare reimbursement for the three years previous to its federal mortgage insurance application. This dramatically improved Bucyrus’ financial picture, giving it positive operating earnings and the debt service ratio it needed to qualify for the enhancement.

Bucyrus was able to borrow the entire project amount because of the way the 242 program calculates its loan-to-value ratio. Bucyrus’ project cost was $26.8 million, meaning it would have had to come up with $2.68 million (10 percent) in additional funding. But with the $5.9 million value of the existing physical plant, property and equipment, Bucyrus’ project value increased to $32.7 million. Ultimately it borrowed nearly $26 million. Bucyrus strategically chose to invest some of its own money in the renovation to assure its operating margins could handle the debt service and keep the hospital financially stable in the long term.

The FHA 242 program was an ideal fit for the hospital’s long-term plan to strengthen its reputation and improve its services. Bucyrus funded renovations and three major additions, including a new main entry and more patient-friendly waiting area, new operating and emergency rooms and a new oncology department. The renovations will keep the hospital competitive and reassure community members that it will continue serving them in the best way possible.

**Summary**

The financing options for nonprofit rural and community hospitals can be complex and confusing. Each financing structure has a unique set of characteristics that will likely be perceived to have both desirable and undesirable qualities. Each option must be evaluated with input from a knowledgeable investment banker/financial adviser and in concert with the unique credit profile of the hospital and its long-term strategic plans.
Appendices
Appendix A: Definition of Ratios

### Liquidity

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Days Cash on Hand</td>
<td>Unrestricted cash and investments / daily cash operating expenses</td>
</tr>
<tr>
<td>Cushion Ratio:</td>
<td>Unrestricted cash and investments / maximum annual debt service (MADS)</td>
</tr>
<tr>
<td>Cash to Debt:</td>
<td>Unrestricted cash and investments / (long-term debt - current liabilities)</td>
</tr>
<tr>
<td>Current Ratio:</td>
<td>Current assets / current liabilities</td>
</tr>
</tbody>
</table>

### Profitability and Operational

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Margin:</td>
<td>(Total operating revenues – total operating expenses) / total operating revenues</td>
</tr>
<tr>
<td>Excess Margin:</td>
<td>(Total operating revenues – total operating expenses + non-operating revenues) / (total operating revenues + non-operating revenues)</td>
</tr>
<tr>
<td>Cash Flow (EBIDA) Margin:</td>
<td>(Total operating revenues – total operating expenses + interest expense + depreciation + amortization) / (total operating revenues + non-operating revenues)</td>
</tr>
</tbody>
</table>

### Capital Structure and Cash Flow

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt Service Coverage*:</td>
<td>(Total operating revenues – total operating expenses + non-operating revenues + interest expense + depreciation + amortization) / MADS</td>
</tr>
<tr>
<td>Debt to Capitalization:</td>
<td>(Long-term debt - current liabilities) / (long term debt – current liabilities + unrestricted net assets)</td>
</tr>
<tr>
<td>MADS as % of Total Revenue:</td>
<td>MADS / total revenue</td>
</tr>
</tbody>
</table>

* 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 Hospital 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 common-size 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. Hospitals 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 hospital’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, including but not limited to the impact on Critical Access reimbursement. 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.

Service Lines and Medical Staff Characteristics: A review of the primary and specialty service lines and how they have changed over time in response to market demands will be conducted. The admitting characteristics of medical staff will be evaluated over a two- to three-year period. Although more challenging in smaller hospitals, heavy concentration of admissions among one or two physicians may be viewed negatively. The active medical staff’s age, board certification (if any), length of practice and association with the hospital will be evaluated. New physician recruitment programs will be assessed for effectiveness.

Utilization and Payor Mix: A three- to five-year historical review of utilization metrics by bed type 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. Managed care contracts with commercial payors will be reviewed to determine pricing power.

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 constructions 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 hospital versus competing area hospitals will be determined as well as comparisons by size, physical plant, service lines, and active medical staff. Referral, patient transfer and other relations with larger tertiary hospitals will be reviewed.

**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 hospital. Parity security interests with other creditors will be viewed less favorably, although not as poorly as subordinated lien positions.
Appendix C: Rated Bonds

Ratings on bonds can be achieved in several ways. Bonds can be rated based on the strength of the borrower, or they can be rated because they are backed by another organization that has a published credit rating. The most common example of a backing by another organization is a letter of credit. If a rated bank agrees to stand behind a hospital’s bonds, the bonds will receive the same rating as the bank.

Ratings fall into two general categories: investment grade and non-investment grade. These groupings are significant because many institutional investors can purchase only investment grade securities. Thus, there is a broader market for distribution of a bond that has an investment grade rating. This results in a lower interest rate for the borrower.

Issues rated in the four highest categories, “AAA,” “AA,” “A” and “BBB,” generally are recognized as investment grade. Debt rated “BB” or below generally is referred to as “high yield,” “speculative grade” or “junk bonds.” The following chart identifies the relative credit strength of each possible rating category.

<table>
<thead>
<tr>
<th>Explanation</th>
<th>S&amp;P</th>
<th>Moody’s</th>
<th>Fitch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest rating, capacity to repay extremely strong, highest quality</td>
<td>AAA</td>
<td>Aaa</td>
<td>AAA</td>
</tr>
<tr>
<td>Strong capacity to repay, differs slightly from AAA, high quality</td>
<td>AA</td>
<td>Aa</td>
<td>AA</td>
</tr>
<tr>
<td>Strong capacity to repay/more susceptible to change in circumstance/economic conditions, upper medium grade</td>
<td>A</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>Adequate capacity to repay, adverse economic conditions may lead to weakened capacity to repay, medium grade</td>
<td>BBB</td>
<td>Baa</td>
<td>BBB</td>
</tr>
<tr>
<td>Speculative characteristics, less near-term vulnerability to default</td>
<td>BB</td>
<td>Ba</td>
<td>BB</td>
</tr>
<tr>
<td>Capacity to meet payments, greater vulnerability to default, speculative, low grade</td>
<td>B</td>
<td>B</td>
<td>B</td>
</tr>
<tr>
<td>Current identifiable vulnerability to default, poor to default</td>
<td>CCC</td>
<td>Caa</td>
<td>CCC</td>
</tr>
<tr>
<td>Highest speculation</td>
<td>CC</td>
<td>Ca</td>
<td>CC</td>
</tr>
<tr>
<td>Lowest quality</td>
<td>C</td>
<td>C</td>
<td>C</td>
</tr>
<tr>
<td>Payment in default, default</td>
<td>D</td>
<td>DDD</td>
<td></td>
</tr>
<tr>
<td>In arrears</td>
<td></td>
<td>DD</td>
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</tr>
<tr>
<td>Questionable value</td>
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<td>D</td>
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</tr>
</tbody>
</table>
Appendix D: Key Players in Hospital Financings

**Asset Manager:** This position is sometimes referred to as an “Investment Manager” and is responsible for assisting an organization in properly investing financial resources to gain the greatest return. The long-term opportunity is for a nonprofit organization to invest any endowment or excess cash reserves to capitalize on the arbitrage opportunity available when issuing tax-exempt debt.

**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 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 person 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 Moody’s Investor Services, Standard & Poor’s and Fitch IBCA. Ratings established by the agencies 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 E: 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 a promise to pay by the borrower 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 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. 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 bondholder 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 F: Terms Used in Financing

**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.

**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 prede-termined 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 jurisdic-tion where issued.

**Bond Buyer Reserve (BBR):** A 30-year high-grade market index comprised of tax-exempt, fixed-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 long-term tax-exempt market.

**Bond Market Association (BMA):** 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.

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

**Bond Transcript:** All legal documents associated with the offering of a new issue or financing transac-tion.

**Callable Bond:** A bond the issuer is permitted or required to redeem 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 that is 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.
Closing: The meeting of concerned parties involved in a new issue during which the requisite legal documents are executed and proceeds are delivered for use by the borrower.

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.

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 organi-
zation, 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.

**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.

**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.

**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.

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

**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.

**Pro forma:** A presentation of data that reflects an “as if” scenario. A newly designated Critical Access Hospital can restate its financial statements for the three years previous to its designation as if it had been receiving cost-based Medicare reimbursement.

**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 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 issuer’s credit position has changed.

**Ratio:** A formula used to compare different measures of an organization’s performance. The three main types of 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:** 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.

**Serial Bonds:** A series of bonds with individual annual maturities and individual interest rates. Usually these bonds 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. 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.
**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.
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