Trends in Hospital Finance

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Table of Contents

- Capital Markets Overview
- Financing Strategies and Trends
- Common Financing Structures
- Case Studies

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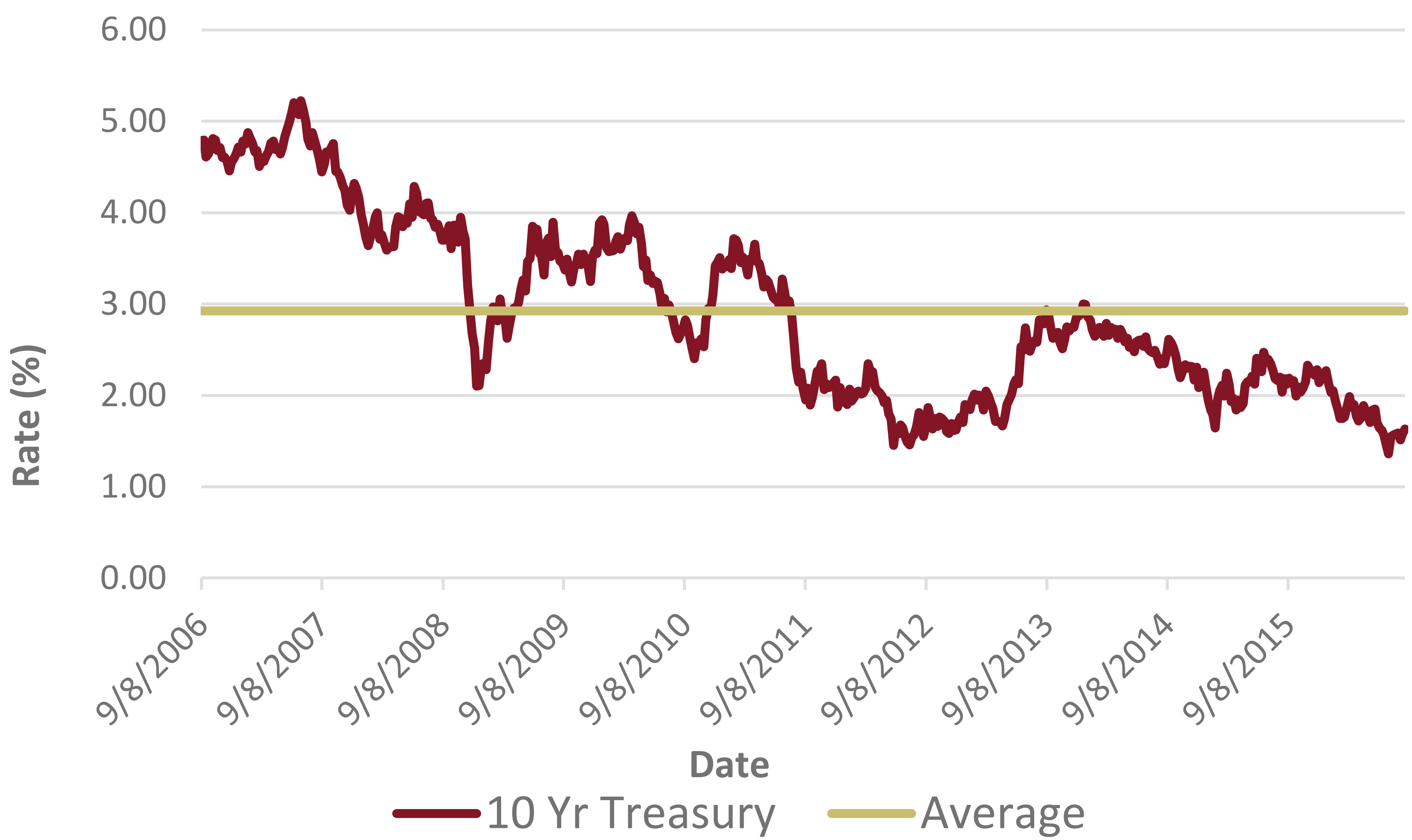
Capital Markets Overview

Capital Markets Update

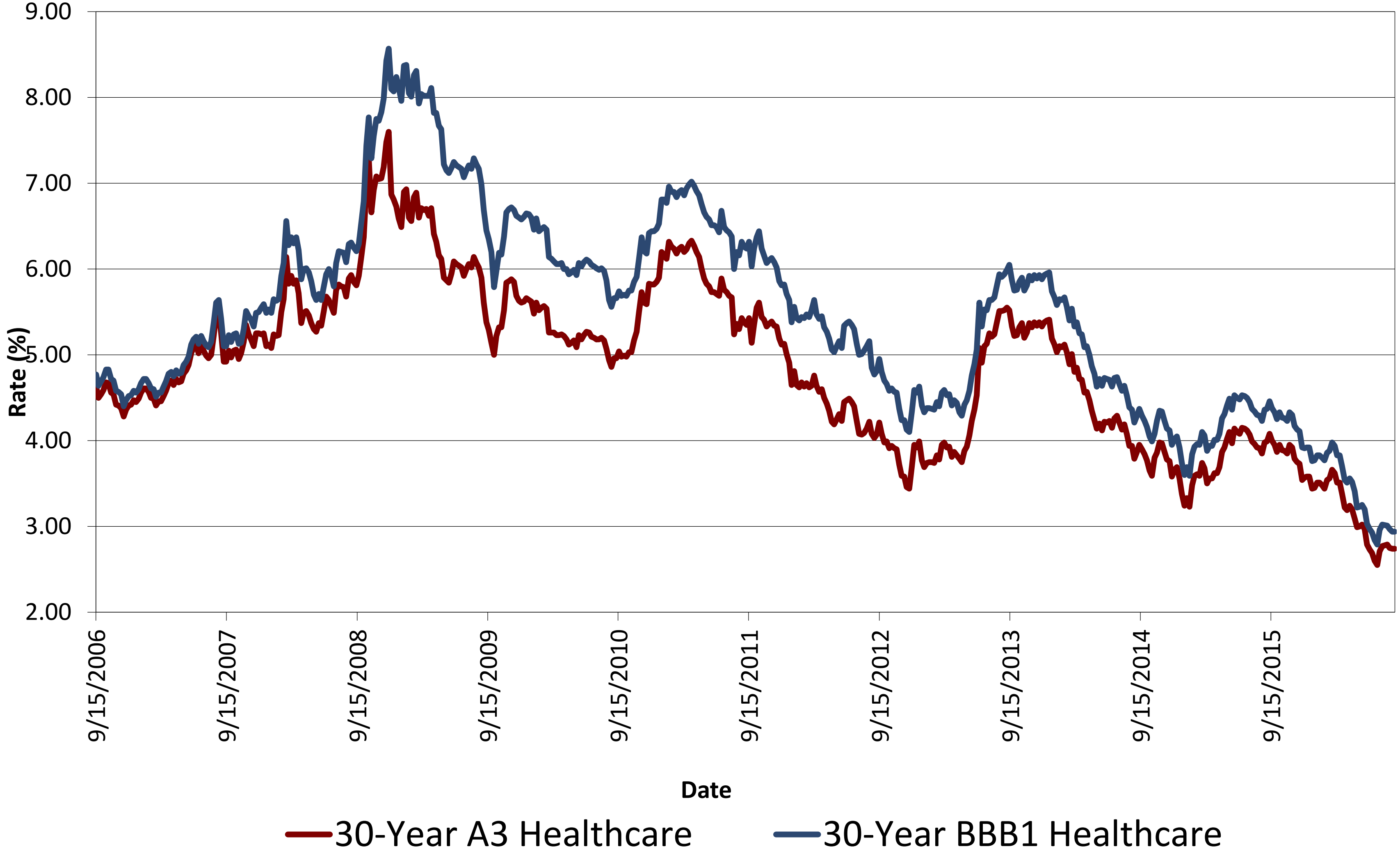
- As a result of continued global pressures, the overall U.S. equity markets were mostly down in 2015
- The Federal Reserve implemented the first interest rate hike in eight years in December
- Municipal bond volume in 2015 was at its highest level in 5 years
- The general market shift is towards fixed-rate, committed capital
- Municipal borrowing rates are near historical lows
- Credit and sector spreads have compressed

Capital Markets Update – 10 Year UST



Source: Bloomberg LP

Capital Markets Update – Healthcare Spreads



Source: Bloomberg LP

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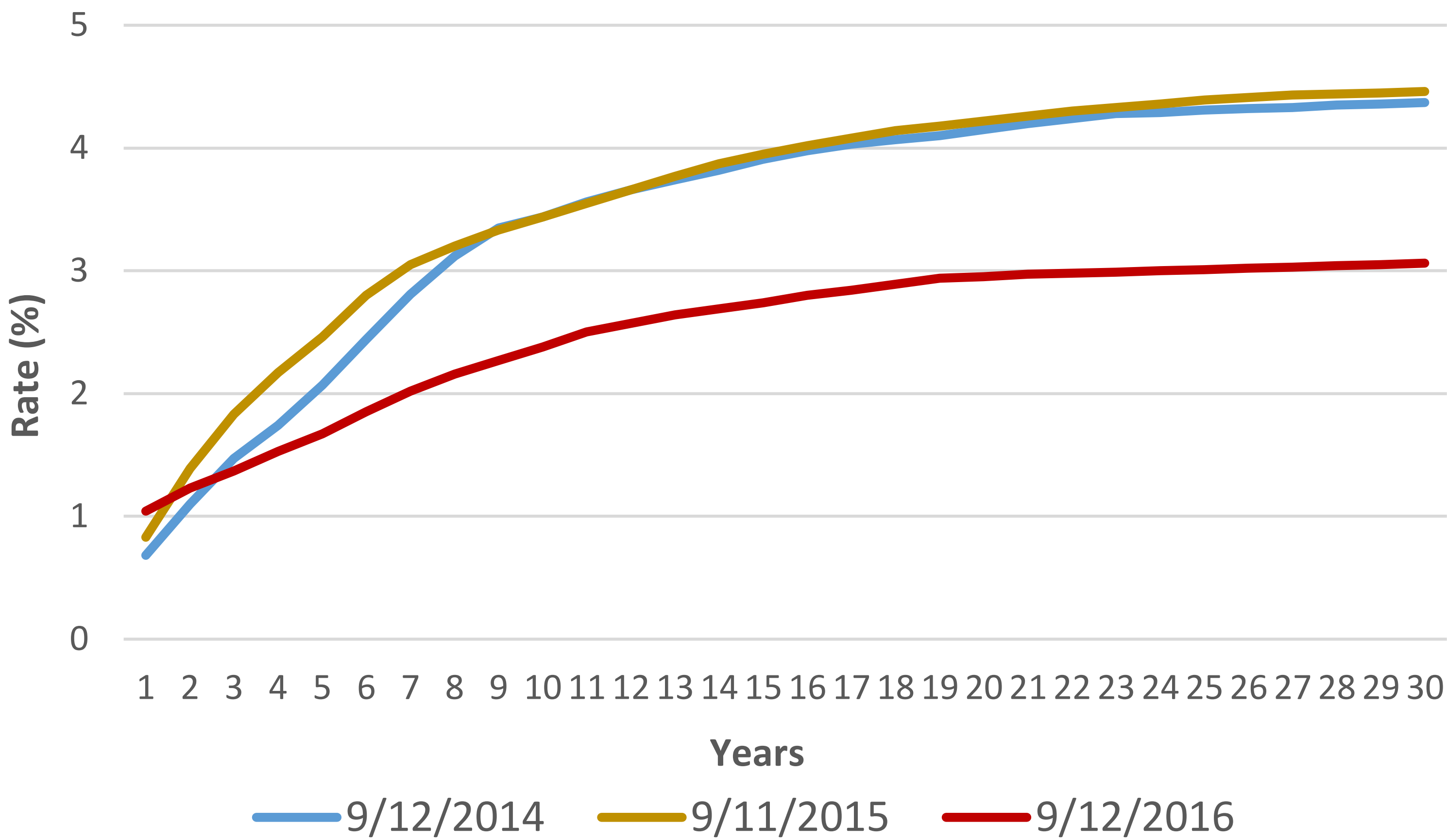
BBB+ Rated Healthcare Yield Curve



Source: Bloomberg LP

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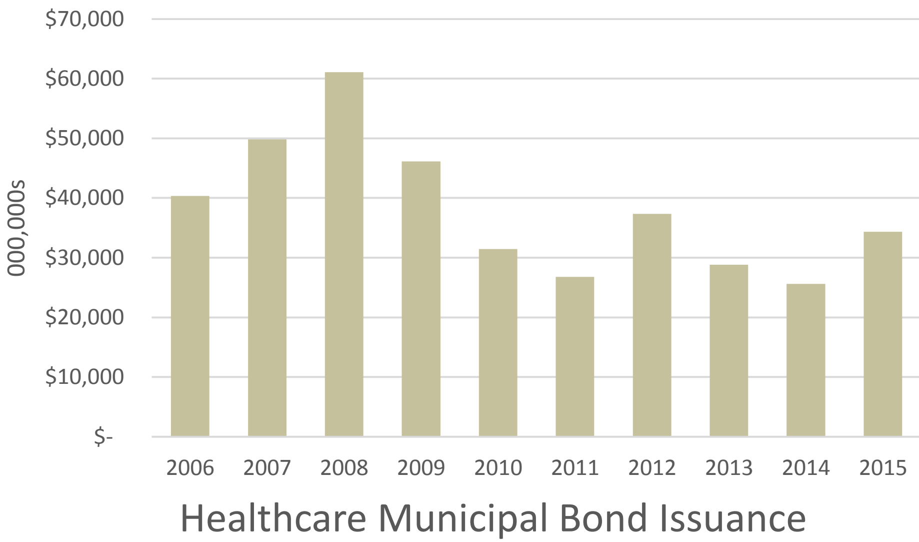
Historical Healthcare Municipal Issuance



- Overall issuance has been down significantly since the peak in 2008
- 2008 spike was due largely in part to the need to refinance existing auction rate securities into a more stable funding mechanism
- 2015 saw a fractured market with renewed activity in the middle part of the year
- Fueled by low borrowing rates, volume in 2015 was highest since 2012 as borrowers restructured existing debt

Source: The Bond Buyer

Rating Agency Commentary

STANDARD & POOR'S RATINGS SERVICES

"Overall, the generally stable to positive financial trends in the bulk of the individual ratings groups dovetail with our rating actions with 14 upgrades since our last rating report compared with eight downgrades.."

MOODY'S INVESTORS SERVICE

"Most not-for-profit hospitals and health systems benefited from revenue growth, strong investment returns and significant gains in the number of individuals with insurance despite growing exposure to government insurance programs.

FitchRatings

"Median operating profitability metrics improved across all categories in 2015 driven by many of the same factors from 2014; namely, the sector's continued focus on improving operating cost efficiencies, expanded coverage from the Affordable Care Act (ACA), and greater focus on revenue cycle improvement and collections."

Trends in Hospital Finance

Emergence of Taxable Debt

- Tax-exempt traditionally offers lower borrowing rates but comes with higher costs of issuance and disclosure requirements
- Taxable (corporate) market is a far larger market than the traditional tax-exempt market
- Today's interest rate correlations make it harder to justify the tax-exemption
  - Short-term: SIFMA (tax-exempt) at 0.64% vs. 1-Month LIBOR (taxable) at 0.51%[1]
  - Long-term: 10-yr. "AAA" MMD (tax-exempt) at 1.49% vs. 10-yr. U.S. Treasury Note at 1.69%[1]
- Also avoids certain IRS use restrictions

[1]As of 9/7/16

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Direct Placements

- Similar to publicly offered bonds in that they can be tax-exempt and utilized for new money or refinancings
- Debt is purchased directly by a bank or consortium of banks
- Interest rate can be fixed or variable
- Eliminates the need for a rating or enhancement
- Less disclosure than a public offering
- Can be utilized in lieu of short-term serial bonds to reduce expenses and lower cost of capital
- Still bears risk of rate reset or a bank put option (not truly committed capital)
- Not just small issues…many large hospitals and systems are using this to diversify their debt profiles

Floating Rate Notes (FRNs)

- FRN market is close to $45 Billion
- A hybrid between a private placement and a letter of credit enhanced public offering
- No need for additional enhancement which eliminates significant capital cost and reliance on other market participants
- Notes reset at a defined period based on a spread to the index
- Mostly reserved for high quality issuers (A or higher)
- Shorter maturities and soft-put features are recent developments that are in the favor of borrowers

FHA Section 242/223(f)

- FHA’s Office of Hospital Facilities is now accepting applications for 100% refinancings
- Eliminates the need for at least 20% “new money” and required feasibility study
- Can provide access to “AAA” like mortgage insurance and 25-year fixed rates approximating 3.75%
- Theoretically provides for a more streamlined application process
- Hospital must meet several criteria to become eligible for the 242/223(f) program
- In some instances, it might be easier to qualify under the traditional Section 242 program and execute an “80/20” transaction with the majority of the proceeds redeeming existing debt

Review of Financing Structures

Traditional Debt Structuring Options

Typical Bond Structure

- **Unenhanced**
  - Rating: A, BBB, N.R.
  - Interest Rate: Fixed
- **Credit-Enhanced**
  - **Letter of Credit**
    - Rating: AA, A
    - Interest Rate: Variable or Fixed
  - **FHA/USDA**
    - Rating: AAA/AA+
    - Interest Rate: Fixed (FHA only) or Variable
  - **Bond Insurance**
    - Rating: AA, A
    - Interest Rate: Variable or Fixed
  - **Tax-Supported**
    - City, County or District Borrowers Only

Access to Capital

Local and Regional Resources

- Direct bank loans
- Direct placement of bonds
  - Bank-qualified bonds
- Letters of Credit
  - Federal Home Loan Bank
  - Regional Banks

Government Resources

- USDA Programs
- FHA-insured HUD mortgages

On Your Own or With Internal Resources

- Unenhanced bonds
- Tax-backed bonds
- Hospital system guarantee

Unenhanced Revenue Bonds

- Interest rate is based on a borrower's credit profile
- May be rated or unrated
- Term: 25 – 35 years
- In today's market, this option is generally available only to rated borrowers or municipalities

Pros

- No enhancement fees
- Fully amortizing structure
- Fixed rate for life of the loan

Cons

- Prepayment limitations
- Locks in current credit profile
- Debt service reserve fund
- Large interest rate gap between investment-grade and non-IG borrowers

Tax Supported Bonds

- Tax can be real estate (ad valorem) or sales based
- Interest rate is based primarily on the income and collection of tax receipts
- Analysis focuses primarily on demographics but will also review borrower operations

Pros

- No enhancement fees
- Fully amortizing structure
- Fixed rate for life of the loan
- Ability for non-core operations to pay debt service

Cons

- Prepayment limitations
- Debt service reserve fund
- Sensitive nature of public vote

Direct Bank Placements

- Tax-Exempt bonds structured and privately placed (sold) with banks as opposed to the Letter of Credit enhanced bond structure
- Can be structured as “multi modal”
- Bank-qualified designation can increase bank interest in buying
- Competitive bidding is recommended

Pros

- Limited public disclosure and administrative paperwork
- Flexible terms
- Draw-down construction bonds can reduce costs

Cons

- Must fit with bank’s needs
- Limited long term fixed-rate options
- Difficult for projects >$35M
- Refinance risk (3-10 Yr. Term)

USDA Programs

Community Facilities Program

- Direct and guaranteed loans, with some limited grants
- Terms up to 40 years
- 90% guaranteed
- Cannot use for 100% refinance
- Fixed or variable rates
- No min/max loan amount
- For populations of <20,000
- One-time 1% guarantee fee
- Loans are taxable

Business & Industry Program

- Guaranteed loans for projects that create or save rural jobs
- $10 million max (up to $25M for special circumstances)
- For areas with populations of <50,000 people
- Fixed rates for up to 30 years
- Up to 80% guarantee
- 3% upfront guarantee fee, plus 0.25% fee annually
- Fixed or variable rates

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FHA Insured Mortgages

- For new construction, renovation and refinance
- For borrowers of all sizes
- Program historically concentrated in northeast and is looking for geographical diversification
- Requires a mortgage
- Provides both construction and permanent financing in one loan

Pros

- AAA or AA interest rates
- Annual MIP is fixed
- Special criteria for CAHs
- Long-term amortization
- No renewal risk
- No financial covenants
- Non-recourse to borrower

Cons

- Longer lead time to close
- Davis-Bacon union wages for construction
- No long-term parity debt

Case Studies

Cameron Memorial Community Hospital (Angola, IN)

- 25 Bed Critical Access Hospital with strong liquidity and DSC ratios
- Seeking to build a $53MM replacement hospital

- Initially approached HUD for financing under Section 242 but project was deemed too large
- Project team was able to secure $37MM in USDA Direct funding and a $10MM USDA Guaranteed loan
- Construction financing was not provided by USDA and was problematic for commercial banks, so Lancaster Pollard underwrote a $37MM Bond Anticipation Note (“BAN”) to provide construction funding
- Obtained a short-term investment grade rating of MIG-2 from Moody’s which resulted in a cost of capital around 2.00% for 3 years

Wallowa Memorial Hospital (Enterprise, OR)

- 25 Bed Critical Access Hospital with taxing authority
- Wanted to replace its aging care center with a state of the art assisted living facility

- Voters approved a 10-year Local Option Tax to fund the construction
- Tax receipts, not hospital operations, were the primary source of debt repayment
- Bonds were structured as 10-year fixed rate bonds and directly placed with a local bank
- Lack of a bond rating and limited disclosure helped keep issuance costs low
- Bank Qualified designation helped to reduce the borrowing cost

Cabinet Peaks Medical Center (Libby, MT)

- 25 Bed Critical Access Hospital seeking to build a $35MM replacement hospital (f/k/a St. John's Lutheran Hospital)

- Multiple financing options were explored during a challenging time in the markets
- Ultimately, FHA mortgage insurance was selected based on the recent drop in borrowing rates and lack of annual volume cap
- Lancaster Pollard provided a $32MM insured mortgage with a 27-Year fixed rate of 3.58%
- The loan provides both construction and permanent financing and is estimated to save the hospital over $17MM in interest costs during the life of the loan as compared to alternative financing options

Wood County Hospital (Bowling Green, OH)

- 196 Bed hospital with strong liquidity and DSC ratios
- Seeking to refinance approximately $43MM of variable rate bonds and provide $10MM for new projects

- Although it enjoyed a good relationship with its commercial bank, the hospital decided not to renew its existing letter of credit enhancement
- During the evaluation period, the fixed rate markets continued to rally which provided an attractive cost of capital
- Lancaster Pollard helped the hospital obtain a first time rating of Baa2 from Moody's
- The public bond offering was oversubscribed 4x which allowed the underwriter to adjust pricing at the last minute to reduce the hospital's borrowing costs

Penn Highlands Healthcare (Du Bois, PA)

- Four (4) hospital system in northwestern Pennsylvania
- Seeking to refinance approximately $52MM of existing debt and provide $42MM for a variety of new projects

- While the system's financial ratios were acceptable, the significant addition of debt would likely have resulted in below investment grade metrics
- Lancaster Pollard put together a detailed offering memorandum that highlighted the system's profitability improvement plan
- The direct placement offering was competitively bid to a variety of commercial banks and specialty finance companies
- The financing was favorably structured with a $80MM term-loan facility (5 yrs.) and a $15MM revolving line of credit (2-yrs.) that provided flexible terms and an attractive cost of capital

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Matthew Lindsay is a Senior Vice President with Lancaster Pollard & Co. as well as one of the firm's regional managers, overseeing investment banking operations in several states throughout the Rocky Mountain and Pacific Northwest regions. Lancaster Pollard is a national investment banking and financial services firm that specializes in providing capital funding to the health care sector. In addition to underwriting tax-exempt bond offerings, Lancaster Pollard provides organizations a complete range of funding options through its Fannie Mae/FHA/GNMA/USDA-approved mortgage lender subsidiary.

Since joining Lancaster Pollard in 2004, Mr. Lindsay has focused his efforts on community healthcare and senior living, structuring a range of bond transactions and mortgage loans for expansion, new construction and refinance projects. He has a thorough understanding of the various financing structures available through conventional financing, HUD programs and the USDA Community Facilities program and has worked on numerous HUD Section 242 transactions. He is a member of the Healthcare Financial Management Association (HFMA) and various state hospital associations.

Mr. Lindsay received a bachelor's degree in finance from Miami University in Oxford, Ohio and earned his Masters of Science in Finance (MSF) degree from the University of Denver. He holds a General Securities Principal license, Series 24, and is a frequent speaker and author on capital funding solutions for health care providers.