

Strategies in Capital Finance

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SENIOR LIVING FINANCE

INNOVATIVE SOLUTIONS PUT INTO PRACTICE IN DIFFICULT MARKETS

This Strategies in Capital Finance paper is a companion to Volume 61, "Financing and Debt Restructuring Solutions for the Senior Living Industry Financial Crisis." It highlights recently completed transactions to illustrate and amplify solutions suggested in Volume 61. Readers may want to review both Strategies Volumes 61 and 63 together.

CAIN BROTHERS

INVESTMENT BANKERS & CAPITAL ADVISORS TO THE HEALTH CARE INDUSTRY

STRATEGIES IN CAPITAL FINANCE
VOL. 63 SENIOR LIVING FINANCE:
INNOVATIVE SOLUTIONS PUT INTO PRACTICE IN DIFFICULT MARKETS

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INTRODUCTION

Last spring, in the wake of the credit crisis that effectively locked virtually all of the nonprofit senior living borrowers out of the tax-exempt debt market, we published our *Strategies in Capital Finance* white paper titled “Financing and Debt Restructuring Solutions for the Senior Living Industry Financial Crisis.” In that *Strategies* paper¹ we discussed solutions for a number of critical financing challenges facing senior living borrowers, including borrowers simply trying to preserve existing financing structures, borrowers with major expansions requiring new capital, and borrowers trying to bring start-up projects to fruition.

There were several critical factors in 2008 and 2009 that negatively impacted many senior living facilities and their ability to borrow new money for start-ups and expansions and refinance or restructure existing loans.

- In the wake of the credit crisis, many traditional senior living bank lenders and letter of credit (LOC) providers exited the market, and banks that continued to participate in the senior living sector dramatically tightened their underwriting and lending criteria.
- Similarly, bond investors that had traditionally focused on the tax-exempt health care debt market fled to other markets, like U.S. Treasuries, that had higher credit quality profiles. While bond investors have begun to return to the senior living sector they require interest rates that are significantly higher than before the crisis started.
- The difference between interest rate levels demanded by long-term investors and a reinvestment rate environment that yields almost zero makes the hurdle of project affordability and long-term project viability much more difficult.

In addition to the challenges presented by lenders, the affordability of senior housing projects declined materially in many parts of the country, because the dramatic fall in home prices and decreased stock market valuations gave seniors much less to spend. Senior living occupancy levels have suffered as a result, and that has hurt borrowers’ operating performance and balance sheet strength, which coupled with declines in investment portfolio values has also reduced debt capacities.

The good news is that there are financing alternatives present in the markets today that will allow senior living facilities to restructure existing borrowings, reallocate debt to generate new sources of credit, and finance expansions and start-ups.

Through case studies of successful recent transactions, this *Strategies in Capital Finance* paper illustrates a number of the solutions that we wrote about in Volume 61. This paper discusses innovative financing solutions put into practice in difficult financing markets.

¹ *Strategies in Capital Finance*, Volume 61, “Financing and Debt Restructuring Solutions for the Senior Living Industry Financial Crisis” is available at www.cainbrothers.com as is the related Volume 59, “The Financial Crisis Hits the Senior Living Industry: Operational and Debt Restructuring Considerations for Trustees and Executives.”

CHALLENGES AND PROSPECTIVE SOLUTIONS

The specific challenges and opportunities that we wrote about in *Strategies* Volume 61 were numerous. The challenges we highlighted primarily involved and still involve senior living facilities obtaining financing at affordable costs and with reasonable terms. Financing challenges facing senior living sponsors include:

- Bank letters of credit that are harder to obtain and renew,
- “Underwater” interest rate swaps, which present significant challenges in most refinancings,
- Debt levels and interest rates that appear to be unaffordable, and
- An inability to obtain financing that is required for an expansion or a start-up project.

But there are solutions, including solutions that have emerged in recent months as a result of federal stimulus legislation. One of the central themes of the solutions discussed in *Strategies* Volume 61 is to take advantage of other institutional credit sources, some common and some not so common. In the current environment, we have found that local and regional banks are often more interested in lending and maintaining relationships than traditional senior living oriented banks that have exited the market; traditional lenders that have suffered from their own credit quality problems; and other larger traditional lenders that are rationing credit through more restrictive loan underwriting requirements, like 75% or better loan-to-value ratios, lower lending limits per borrower, and a new focus primarily on the largest and highest quality health care issuers. And we have found other institutional sources of credit and credit enhancement that make financing structures, particularly those involving local and regional banks, attractive to both institutional and retail purchasers of bonds.

Solutions that Cain Brothers bankers have pursued and we discuss below include:

- A Federal Home Loan Bank (FHLB) wrap to enhance the credit level of a local bank LOC and increase the rating level of the debt offered by a senior living community, and
- Federal Housing Administration (FHA) mortgage insurance to secure a new takeout loan to refinance a loan supported by an expiring bank LOC relating to assisted living and skilled nursing facilities.

Cain Brothers bankers have also successfully pursued additional sources of credit for the benefit of the firm’s clients, including:

- California’s Cal-Mortgage Loan Insurance program for fixed rate loan credit enhancement for a California based senior living community to resolve problems caused by non-renewal of a LOC, and
- Bank qualified loans to take advantage of more aggressive local and regional bank lenders and to expand the lender universe.

We also provide further thoughts on coping with “underwater” interest rate swaps, as they are usually involved in refinancing and restructured transactions; offer related suggestions; and discuss how an independent adviser can be helpful in resolving issues between borrowers, bank LOC providers, and swap counterparties.



FEDERAL HOME LOAN BANK WRAP OF LOCAL BANK LOC – CANTERBURY ON THE LAKE

Senior living borrowers together with their local community lenders can take advantage of the Federal Home Loan Bank System and its triple-A credit rating for credit enhancement. Banks writing letters of credit in support of tax-exempt borrowers normally need to have credit ratings of A+ or better in order to satisfy and attract investors. Many local and community banks, of course, either do not have credit ratings or do not have credit ratings of that level to qualify. However, local banks that are participating members of the FHLB System can have their loans and LOCs “wrapped” by the FHLB, which backstops the primary lender and provides a triple-A credit to investors. Because the primary credit risk remains with the local lender, which may have relatively restricted loan limits, FHLB wrap transactions will tend to be somewhat modest in size.

CHALLENGE

Organized in 1991, Canterbury on-the-Lake is a not-for-profit continuing care retirement center located in Waterford, Michigan, northwest of Detroit. The CCRC has 75 senior living apartments, 39 assisted living apartments, and 140 skilled nursing beds.

In 2005, Cain Brothers successfully negotiated a debt restructuring with fixed rate bondholders that reduced total debt by 20% and then secured a letter of credit from a commercial bank to retire the fixed rate debt and to support the new debt. Canterbury was well managed by a third party manager, Life Care Services, although it historically suffered from weak liquidity due to an excessive debt burden and a rental (versus entrance fee) product type. The restructured debt achieved a borrowing level that was appropriate to the campus and could allow for capital replacement investment and some anticipated plans for future expansion. During the subsequent four years, Canterbury was financially stable, increased the profitability of its skilled nursing operations, and slowly strengthened its balance sheet.

By 2009 operating performance had greatly improved, and Canterbury needed to pursue a new LOC, because the existing LOC bank notified Canterbury that it was leaving the U.S. market. Through a competitive bid process, Cain Brothers was able to secure a well-priced commitment from RBS Citizens Bank for the three-year replacement LOC. However, during the commitment process, RBS Citizens’ short-term credit rating changed from A-1 to A-2, which resulted in the requirement for a confirming letter of credit to complete the transaction.

SOLUTION

Cain Brothers worked with RBS Citizens to secure a FHLB stand-by LOC to “wrap” the RBS Citizens’ LOC for a variable rate bond issue for Canterbury on-the-Lake and underwrote Canterbury’s \$21,295,000 Series 2009 Bonds. The 2009 Bonds were used to refinance the organization’s Series 2005 bonds and pay for certain costs of issuance.

The FHLB’s wrap does not secure the bonds directly, but rather it guarantees continued payments if the primary member bank fails on its LOC requirements. This FHLB wrap was among the first used to enhance the credit rating of a senior living facility, since enabling legislation was passed in July 2008. The legislation was part of the Foreclosure Prevention Act of 2008 and allowed for the FHLB System to issue letters of credit to non-housing related transactions, while also increasing the annual borrowing limit, thus opening the lending universe to senior housing providers. Currently, these provisions are set to expire at the end of 2010, although proponents hope to see the program extended.

The FHLB’s practice is to generally rely on the local member bank and its underwriting and credit approval processes.

The FHLB’s practice is to generally rely on the local member bank and its underwriting and credit approval processes. However, the FHLB’s legal team will review all of the transaction’s documents to determine acceptability from its point of view as well. In this case, the FHLB’s fee to write the stand-by LOC was 30 basis points per annum, which is in the middle of the expected range of 20 to 40 basis points that a FHLB branch will charge, depending on the credit profile of the local initiating bank. (A portion of the premium, of course, will be earned back by virtue of the financing’s triple-A credit rating and lower credit spread.) Cain Brothers also negotiated a consent from RBS Citizens to drop the FHLB wrap at Canterbury’s discretion should the RBS Citizens’ credit rating improve to the point where the wrap no longer provides additional benefit.

The new issue was a variable rate mode borrowing, and coupled with an interest rate swap that will fix the interest rate for 4 ½ years, resulted in an all-in cost of capital of 5.77%. Given the interest rate environment at the time and the fact that the underlying credit was unrated, the cost of capital was quite attractive.



FHA TAKEOUT (MONEY, NOT FOOD) – *OUR LADY OF FATIMA VILLA*

CHALLENGE

Our Lady of Fatima Villa (OLFV) located in Saratoga, California south of San Francisco was founded in 1947 with sponsorship from the Dominican Sisters of Kenosha, Wisconsin (the Sisters). OLFV is a three-acre senior health and housing campus consisting of a 37-bed assisted living facility and an 85-bed skilled nursing facility.

OLFV has a strong community reputation for providing high quality skilled nursing care, and it has maintained high occupancy with significant Medi-Cal utilization. Medi-Cal is California's Medicaid program.

OLFV's assisted living facility was built in 2004 using a conventional construction loan from a commercial bank plus a loan from the Sisters. The construction lender did not want to provide permanent financing after completion of construction. Since the assisted living facility was newly opened and construction over-runs had diminished the facility's financial reserves, securing permanent financing was a significant challenge.

The construction loan was refinanced in 2006 with \$12,305,000 in variable rate demand bonds backed by a three-year LOC from KBC Bank, a Belgian-based bank that had been active in the U.S. senior living market for more than two decades. The Sisters also provided a cash reserve and a continuing support guaranty to KBC to help secure the LOC. In addition, OLFV provided a gross revenue pledge of all assets and a mortgage to KBC. An interest rate cap was put into place to mitigate possible interest rate risks.

In 2009, in the midst of the credit crisis, the LOC was due for renewal. Unfortunately, because KBC Bank had decided to focus its resources on European business opportunities, it was not in a position to extend the LOC on a long-term basis. Instead, KBC Bank granted OLFV a one-year extension on the LOC in order to give OLFV time to find a takeout source of financing.

SOLUTION

Although OLFV's operations were performing well, its total loan to value was approximately 84%. Discussions with more than a dozen bank lenders revealed that none would provide credit to the skilled nursing and assisted living sector unless the borrower had a lower than 70% loan to value. As a result of these and other investigations, Cain Brothers recommended the FHA 232/223(f) mortgage insurance program with its triple-A credit rating as the best refinancing source and worked with a national FHA mortgage banker to assemble OLFV's application to the Department of Housing and Urban Development (HUD), which oversees the FHA programs.

The FHA 232/223(f) mortgage insurance program insures lenders against loss on mortgage defaults. It insures mortgages that cover the construction and rehabilitation of nursing homes and assisted living facilities and allows for long-term, fixed rate financing

for up to 40 years for new and rehabilitated properties and up to 35 years for existing properties. The amount of a refinancing loan is based upon the lesser three tests:

- The maximum loan-to-value ratio for existing projects of 90% for nonprofits (85% for for-profits) and 95% for new construction and substantial rehabilitation (90% for for-profits);
- Minimum annual debt service coverage that is the mathematical inverse of the LTV; for example, if the LTV is 90% the debt service coverage requirement is 1.11 times ($1 \div 90$); and
- The cost of refinancing, including the prior principal balance, accrued interest, costs to bring the facilities up to prevailing standards, funding the initial replacement reserve, and financing costs of up to 3.5% of the allowable loan amount. Any costs above the refinancing loan amount would require additional cash from the borrower at the closing of the loan.

HUD provided a firm commitment to OLFV to insure its loan in December 2009, and the loan was priced in January 2010. The \$13.1 million loan will have a 35-year maturity and an “all in” interest rate cost of 5.1%.

New issue interest rates for taxable and tax-exempt FHA-insured loans are quite close today. Currently, conventional taxable issues are being funded at approximately 5%, “all-in” with credit enhancement, which is lower than prevalent tax-exempt rates at 5.50%-5.75%, an unusual circumstance. In most interest rate environments, tax-exempt rates will be lower than taxable rates. Both estimated rates include an annual insurance premium of 0.50%. (Borrowers that may be contemplating a major expansion or start-up need to be aware that FHA-insured loans come with prevailing union wage construction requirements, which can add a few percentage points of construction cost in some nonurban areas.)

For issuers, the FHA-insured alternative is attractive, because it can remain in place until maturity without worry about the risks of LOC renewal, changes in the credit profile of the LOC provider, or changes in the overall debt markets.

Both taxable and tax-exempt FHA-insured rates are competitive with the “all-in” costs of LOC-backed VRDB financings that have short-term interest rate swaps; and taxable and tax-exempt FHA-insured rates are significantly less than nonrated fixed rate financing transactions for senior living issuers, because investors looking for high quality credits are very happy with FHA’s triple-A credit and interest rates of 5+%. For issuers, the FHA-insured alternative is attractive, because it can remain in place until maturity without worry about the risks of LOC renewal, changes in the credit profile of the LOC provider, or changes in the overall debt markets.

In addition to availability, attractive all-in interest rate cost, and term, the use of FHA mortgage insurance for OLFV’s takeout has additional attractive features:

- The FHA guidelines allow for loan amounts up to 90% of appraised value for existing projects and 95% for new construction, or approximately \$200,000 to \$225,000 per bed/ unit in most sections of the country, subject, of course, to local appraised values,

which can vary dramatically. FHA appraisals are permitted to use demonstrated, market-oriented cash flow experience, not actual expenses, which are higher in many nonprofits. An updated, accurate appraisal, which recognized the value that OLFV had created in its senior living community, allowed OLFV to refinance the outstanding 2006 bonds with almost no additional cash equity required.

- OLFV is only required to pledge the assisted living and skilled nursing properties to support the FHA loan on a non-recourse basis, so OLFV will be free to consider other, future development opportunities on the remainder of its campus. OLFV was also able to transfer several million dollars of balance sheet assets and surplus land over to a newly established affiliated foundation that will use those assets for scholarships or new development efforts.
- The FHA mortgage insurance structure and underwriting focuses on loan-to-value and debt service coverage, so no additional balance sheet support in the form of cash reserves is required of the borrower. That means in OLFV's case that minimal cash will be required to service the loan and operate and maintain the facilities, so surplus cash can be up-streamed to the OLFV Foundation to support other development opportunities or mission-oriented services. Additionally, the Sister's cash reserve and support guaranty was not needed for the FHA mortgage insurance, and those resources can also be redeployed.
- Although not applicable in OLFV's case, FHA mortgage insurance can be combined with other forms of financing on a single campus through a condominium subdivision of facilities. In that manner, FHA mortgage insurance can be applied to one or more of the condominium units, and other financing sources applied to other condominium units. So, for example, FHA mortgage insurance can be applied to skilled nursing and assisted living portions of a senior living campus, and other financing structures, such as a reduction of an existing campus-wide letter of credit, can be used to fund independent living units. This concept was discussed and illustrated in Figure 8 in *Strategies* Volume 61 (pages 11 and 12). Because balance sheet strength is not a significant factor in FHA's underwriting process, a borrower's balance sheet resources (cash) can be committed to a bank LOC provider to meet the bank's tougher credit requirements—and in some cases even allowing the bank to provide a letter of credit in an amount greater than the condominium component's appraised value.



CAL-MORTGAGE LOAN INSURANCE — *CASA DE LAS CAMPANAS*

CHALLENGE

Established in 1989, Casa is located on a 22-acre campus in California's northern San Diego County. With a strong reputation for high quality care with very well kept facilities, the community has 380 independent living apartments, 33 assisted living units, 18 memory care units, and 9 skilled nursing beds.

In 2007, having received an "A-" rating from Fitch, Casa issued \$45,645,000 in variable rate, tax-exempt and taxable bonds that were insured by Radian Asset Assurance and had a standby bond purchase agreement provided by KBC Bank. Proceeds were used to refinance prior fixed rate bonds, reimburse Casa for prior capital expenditures spent on building the memory care units, and to fund future capital expenditures. The taxable bonds were due to convert to tax-exempt bonds in August 2008. All of the bonds were swapped to fixed rate, and a forward starting swap was obtained to cover the bonds converting to tax-exempt status in August 2008. Casa's total tax-exempt synthetic fixed rate cost was approximately 4.5%, assuming the Radian insurance premium would be amortized for at least a 10-year period. This "all in" cost was particularly attractive when compared to natural fixed rates at the time of approximately 5.50% to 5.75%.

In late 2007, as the credit markets began experiencing problems with auction rate and collateralized mortgage securities, bond insurers like Radian saw their underlying credit strength decline and resultant drops in their credit ratings. The uncertainty relating to Radian's continuing credit strength caused the interest rates on Casa's bonds to spike dramatically, although Casa's underlying ability to service its debt remained strong. Because the interest rate spikes were considered to be extraordinary "market disruption" events, the interest rate swaps could not fully protect Casa.

As the market disruption extended over several months, in February 2008 Casa decided to wrap its insured bonds with a one-year irrevocable direct-pay LOC to cover all the outstanding bonds from a strong money center bank. The LOC supplemented Radian's long-term repayment guaranty and substituted for KBC Bank's short-term liquidity, so the KBC standby bond purchase agreement was terminated. With the new LOC in place, the interest rates on Casa's Bonds stabilized.

Later, in the summer of 2008, during the height of the turmoil in the financial markets, the money center bank decided that senior living finance was not a priority business line in the health care sector and informed Casa that the LOC would not be renewed after February 2009. Like other major banks, the money center bank believed doing business with large hospital borrowers would be more profitable and generate more ancillary business income when compared to a single site senior living community, even one with a strong track record like Casa's. Since the LOC was needed for the conversion of the taxable bonds to a tax-exempt status in August 2008, a default occurred on the forward starting swap that would have covered the bonds once the conversion went into effect.

In February 2009, with no replacement LOC, Casa's bonds were all tendered to the money center bank as bank held bonds with the requirement that the bonds be paid off entirely over 20 quarterly payments.

Despite an exhaustive search for a replacement LOC, no lender could be identified. Foreign and domestic banks had become far more selective, and a number of banks with extensive experience in the senior living sector, like KBC Bank, decided to exit the market. Additionally, the potential Casa lenders expressed concerns about what they perceived to be a weak southern California real estate market. After further appeals to both the money center bank and Congressional officials by Cain Brothers, the money center bank agreed to extend the letter of credit for \$28,700,000, or 60%, of the outstanding bonds, and in July 2009 that amount of bonds were remarketed; \$16,945,000 remained with the money center bank and began amortizing. The interest rate swap relating to the \$16,945,000 was also terminated with the termination payment made from Casa's cash reserves.

SOLUTION

Casa's ultimate solution for the challenges caused by the non-renewal of its LOC was to identify and take advantage of the availability of permanent bond insurance through California's Office of Statewide Health Planning. The Cal-Mortgage program, which is unique to California, insures fixed rate bonds and applies to any California nonprofit licensed to provide health care services. Underwriting criteria for the insurance include 90% loan-to-value, 1.35 times debt service coverage, 100-200 days of cash, verified by a feasibility study and appraisal, and a debt maturity that is the lesser of 30 years or 75% of the useful life of the facility.

Although refinancing the existing variable rate bonds with [Cal-Mortgage insured] fixed rate bonds will increase Casa's annual debt costs, it will eliminate Casa's exposure to commercial bank LOC renewal risk.

In October 2009, after complying with the program's underwriting procedures, Casa received a commitment for Cal-Mortgage bond insurance for approximately \$55.1 million. The new Cal-Mortgage insured refunding bonds will replace both the \$28.7 million variable rate bonds and the \$16.9 million bank bonds and the bank bonds' amortization payments. The new refunding bonds include an additional \$4 million to fund future capital expenditures and an amount sufficient to fund the termination payment on the remaining interest rate swap. The refunding bonds are fixed rate, have a maturity of 2027, and California's credit rating of "A-."

Casa's Cal-Mortgage insured bonds were sold in January 2010. Prior to the bonds' issuance, Fitch's review of Casa's rating resulted in a "BBB+" being assigned. The reasons for the downgrade included turnover experienced in 2008 and 2009, lower (although stable) occupancy levels, and a decline in liquidity due to investment portfolio losses. On the positive side, offsetting measures by management included making adjustments to operations to reduce costs, the Cal-Mortgage insured refinancing of outstanding debt to a fixed rate mode, and an expected stabilization in the real estate market, which should help Casa return to historical occupancy and turnover.

Under the Cal-Mortgage program, an issuer's rating impacts the mortgage insurance premium, which is paid in advance for the bond's entire term. Premiums start at 3% for unrated borrowers and decline for borrowers with credit ratings. Casa's premium is 1.85%. The average coupon amount of Casa's new bonds is 5.83%. Although refinancing the existing variable rate bonds with fixed rate bonds will increase Casa's annual debt costs, it will eliminate Casa's exposure to commercial bank LOC renewal risk.

“UNDERWATER” INTEREST RATE SWAPS

CHALLENGE

As highlighted by the Casa de las Campanas case, interest rate swaps put into place in connection with previous financing structures can present difficult current challenges to senior living borrowers. As in Casa's case, many senior living issuers, including most with relatively weak credit profiles, used LOCs to back variable rate bond issues and then used fixed pay interest rate swaps, where the borrower pays a fixed rate and receives a variable rate, to turn the original variable rate borrowing into a synthetic fixed rate borrowing. These kinds of financing structures made (and still make) a great deal of sense, because they achieved interest rate costs substantially below those available from natural fixed rate borrowings.

With today's historically low interest rate environment, fixed pay interest rate swaps put into place in earlier years are “underwater” with negative market values. Today's lower interest rates reduce the payments received by the borrower (although this is offset on a cash flow basis by lower interest paid on the actual variable rate bonds) and increase the net cash payments that the borrower has to make to the swap counterparty.

Depending on the specific terms of the original swap contract, “underwater” interest rate swaps can have negative consequences, such as the need to post collateral for the benefit of the swap counterparty, which eliminates the borrower's ability to use the posted assets for other purposes and deducts the posted amount from liquidity covenant calculations, like days-cash-on-hand. Lower swap market values also decrease the borrower's net assets and can trigger termination provisions tied to measures of credit worthiness.

[With many “underwater” swaps]... the borrower seemingly must choose between terminating the swap contract at a significant cost or leave the swap in place with a significantly negative cost of carry.

Because of the difficulty of renewing LOCs in today's marketplace, many senior living borrowers that otherwise have reasonable or solid financial profiles find themselves having to revise the underlying variable rate financing the swap was originally designed to hedge against. When this happens and particularly when the revised financing structure involves a switch to natural fixed rate financing, the borrower seemingly must choose between terminating the swap contract at a significant cost or leave the swap in place with a significantly negative cost of carry.

SOLUTION

Crafting solutions for interest rate swap challenges like those mentioned above must consider the financial profile of the senior living borrower, the terms of the existing swap contract, the interests of the existing and/or new swap counterparty, the interests of the LOC provider, and the current environment for credit and interest rates.

An independent advisor, like Cain Brothers, can bring valuable perspective to financing and interest rate swap restructuring negotiations. In many cases, the financing team that put the initial financing structure in place may have conflicts of interest. In all cases, a LOC provider or swap counterparty with exposure to the borrower is unlikely to offer ideas or potential solutions that advantage the borrower. An experienced advisor can provide knowledge and expertise that balances the discussion for the borrower. An advisor like Cain Brothers will appreciate the sensitivities of lenders and swap counterparties and understand their potential leverage points. With that kind of perspective, the advisor can perform a forensic examination of the existing contracts and arm the borrower with structural ideas and settlement tactics. Then solutions that clearly recognize the positions of and benefit all parties can be negotiated.

Although hypothetical in nature, the following example illustrates the kinds of structural changes in “underwater” interest rate swaps that can be negotiated and that can result in a more satisfactory outcome for the senior living borrower.

Consider, for example, a \$20 million swap where the borrower pays a fixed rate of 3.50% and receives 67% of one-month LIBOR, a common structure for synthetic fixed rate debt. Such a swap, with a maturity date in 2023, would carry a negative market value of \$1.6 million at current rates. Additionally, the borrower would have a current carry cost of almost 3.35% per annum, or \$56,000 per month. If the underlying debt has been refunded into a fixed rate mode, this additional swap carry can be a huge drain on operating funds, and the borrower may not have the financial wherewithal to terminate the swap and pay the full market value.

However, the LOC bank and swap counterparty have some cause for concern as well. In a default situation, the swap counterparty may be locked out of recovering any of that market value, if the swap obligation is unsecured. Meanwhile, the LOC bank doesn’t want to see that \$56,000 leave the facility every month, and it wants the borrower to pay \$1.6 million to terminate even less. Unfortunately, absent the threat of imminent default, it isn’t possible to reduce negative swap market values. However, one potential solution that could make all parties more comfortable is to enter into an offsetting swap to create a fixed annuity with a lower current cost.

In this circumstance, the swap counterparty would agree to a new swap with the borrower where the borrower pays 67% of one-month LIBOR, and receives a fixed rate, which would be approximately 2.30% at current market rates. This would not help ameliorate the negative market value, but it would reduce the carry cost to 1.20% per annum, or \$20,000 per month, although that cost would now be constant until the

It is important for a borrower to have an advisor that is skilled in the creation, evaluation, and implementation of potential restructuring solutions.

swaps mature. The reduction in monthly outflow can be a big assist to the borrower's efforts towards financial recovery.

This example is only one of several ways to restructure a swap to relieve cash flow pressures created by "orphaned" swaps. Any decision made by a borrower to restructure a swap should be made with full knowledge and understanding of the available options and the benefits and costs that come with each choice. That is why it is so important for a borrower to have an advisor that is skilled in the creation, evaluation, and implementation of potential restructuring solutions.

BANK QUALIFIED BONDS – UNION HOSPITAL



While the following description of the use of "bank qualified" bonds involves an acute care hospital, the bank qualified bond solution is equally and directly applicable to senior living borrowers, and Cain Brothers is actively involved in completing several of these kinds of transactions for senior living communities. In contrast to the commercial banking sector's apparent general reluctance to provide LOCs to senior living borrowers, our experience is that banks are now soliciting for bank qualified loan opportunities and the higher profits they can produce.

CHALLENGE

Union Hospital (UH) is a community hospital located in Dover, Ohio, south of Canton. In 2005 UH completed a restructuring of the remaining \$6,300,000 of its Series 1993A Bonds, which were originally issued as fixed rate bonds. To implement the restructuring, UH executed a total return interest rate swap and a floating-to-fixed interest rate swap with a nationally recognized swap counterparty. The net effect of the restructuring reduced UH's fixed rate capital cost from 6.46% to 4.00%.

As the financial markets began to tighten in the beginning of 2008, the swap counterparty terminated the total return swap with UH. That swap termination settled with no payment due to or from UH. At that same time, the floating-to-fixed interest rate swap had a negative market value and would have cost UH several hundred thousand dollars to terminate, an unattractive alternative for UH. Without any underlying variable rate debt to apply the floating-to-fixed interest rate swap against, UH's cost of capital for the Series 1993A Bonds increased from the original average coupon rate, 6.46%, by the amount equal to the negative cost of carry on the floating-to-fixed interest rate swap, approximately 2.5%, resulting in the total capital cost of the Series 1993A Bonds becoming more than 9%. This capital cost would remain in effect until either the floating-to-fixed interest rate swap was terminated or a variable rate was created that could be aligned with the swap.

While UH's cash position was quite strong, it preferred not to use a sizable amount of cash reserves to make a swap termination payment. Additionally, the fixed interest rate payable by UH on the swap was at a very low level, and UH wanted to keep that low

capital cost in place, if at all possible. Finally, UH was about to undertake several projects that would qualify for tax-exempt financing and would have the opportunity to add a new money component to a refinancing bond issue, if a refinancing bond issue were completed.

The chosen course was to issue variable rate bonds that would refund the Series 1993A Bonds and fund approximately \$6 million of new projects. The new variable rate bonds were to be secured by a bank LOC that was to be provided by an Ohio regional bank. Unfortunately, the Lehman bankruptcy and credit crisis intervened, and like most commercial banks throughout the country the Ohio bank ceased work on all pending transactions. Then, in 2009 after work on the transaction recommenced, the bank suffered a credit rating downgrade. The downgrade resulted in the marketability of the bank's LOC being significantly reduced, which would have increased UH's capital cost to an unacceptable level and increased the uncertainty that investors could be found on a consistent basis for that bank's LOC.

SOLUTION

Cain Brothers and UH concluded that closing the bond issue with that bank's letter of credit was too risky and instead requested that the commercial bank consider the purchase of bank qualified bonds issued by UH as an alternative to providing the LOC.

As part of the federal financial relief program implemented in the aftermath of the financial market collapse, the limitations on a commercial bank's benefit from owning a tax-exempt bond were eased. Previously, tax-exempt bonds whose interest exemption could benefit a commercial bank, known as "bank qualified" bonds, could only be issued in an amount up to \$10 million per municipal issuer (like a state health care financing authority) in any one calendar year. This restriction was modified to allow \$30 million of bank qualified bonds to be issued by each borrower (like UH) in the calendar years of 2009 and 2010, which immediately expanded the availability of bank qualified bonds to many not-for-profit organizations.

Bank qualified bond financings can be attractive for issuers, because several of the risks associated with an LOC and LOC-backed variable rate bonds are either eliminated or reduced...

The Ohio regional bank approved the purchase of UH's debt as bank qualified bonds, and the bonds were structured as variable rate bonds with the interest rate reset weekly priced against a percentage of one-month LIBOR.

At the October 2009 closing, the fixed rate Series 1993A Bonds were replaced by bank qualified variable rate bonds, and the outstanding floating-to-fixed interest rate swap was aligned with the new variable rate bonds. Most importantly, the cost of capital on the bonds was reduced to approximately 5%.

Bank qualified bond financings can be attractive for issuers, because several of the risks associated with a LOC and LOC-backed variable rate bonds are either eliminated or reduced through the bank qualified bond structure:

- Tax-exempt bonds secured by a LOC are priced based upon the credit ratings of the bank providing the letter of credit. As the credit rating is reduced, the coupon rate on the bonds increases. In the case of bank qualified bonds, the bank owns the bonds and no letter of credit is issued, so the bank takes its own credit risk
- Some variable rate tax-exempt bonds secured by an LOC can be sold by the investor back to the remarketing agent for any reason on seven days notice, and a failure to find another investor could result in a termination of the bond issue. In the case of bank qualified bonds, the bank owns the bonds and has no ability to put the bonds back to the issuer prior to the end of the initial ownership term.
- Tax-exempt bonds secured by a LOC are held by investors who usually require the maintenance of certain minimal credit ratings for the bank issuing the LOC. If the LOC bank's credit ratings decline past a certain point, the investors cannot own the bonds, and the bond issue could be terminated. In the case of bank qualified bonds, the bank owns the bonds and no LOC is issued, so the bank takes its own credit risk
- Tax-exempt variable rate bonds are typically priced relative to SIFMA, an index measuring coupon rates for weekly variable rate bonds. UH's floating-to-fixed interest rate swap, like most similar interest rate swaps, was priced with the variable leg set against one-month LIBOR. So with a LOC structure, UH would have paid a tax-exempt based variable rate to its bondholders and received a percentage of a taxable based variable rate from the swap counterparty. The difference between these two cash flows is called basis risk, and this amount varies over time as the relationship between tax-exempt and taxable interest rates change. In this case, UH's variable rate bank qualified bonds bear a coupon rate set as a percentage of one-month LIBOR, the exact same percentage priced into the floating-to-fixed interest rate swap. The basis risk is eliminated.

Each of these structural considerations significantly reduced the capital cost risk and transaction continuity risk for UH; and, therefore, the bank qualified bond structure was much more advantageous than a LOC-backed bond structure and provided much more flexibility to the issuer.

CONCLUSION

In today's very difficult financing market for senior living projects, there are alternatives and solutions that will allow senior living facilities to restructure existing borrowings, reallocate debt to generate new sources of credit, and finance expansions and start-ups. Senior living borrowers are learning to take advantage of non-traditional sources of credit and credit enhancement. Local and regional bank lenders are often far more eager to engage with senior living borrowers than many of the money center bank lenders, and when needed the Federal Home Loan Bank System can wrap the local member bank financing structures to increase a transaction's credit quality to meet bond buyer credit requirements. The FHA offers another source of credit that fits assisted living and skilled nursing assets and secures triple-A credit quality. For California based senior living issuers, the unique Cal-Mortgage loan insurance program can be used to increase a project's credit quality. The recently expanded bank qualified loan program will also fit many senior living projects throughout the country and will remove risks surrounding bank LOC renewals. Finally, there are prudent strategies that can be used to mitigate the costs of "underwater" orphaned interest rate swaps, which are a significant factor in restructuring many earlier financings.

ABOUT CAIN BROTHERS

Cain Brothers is an investment banking firm that focuses exclusively on the health care industry. The firm's clients include providers, payors, medical device and equipment companies, health care information technology companies, and financial sponsors. The firm has one of the largest teams of experienced bankers and capital markets professionals on Wall Street dedicated to the health care industry. Operating out of offices across the country, Cain Brothers creates custom-tailored, market-based capital raising, M&A, real estate, and strategic and financial advisory solutions for its clients.

SENIOR LIVING GROUP

Our senior living bankers generate solutions for the firm's clients in four distinct areas: mergers and acquisitions, tax-exempt bond underwriting, strategic and development advisory services, and capital restructuring assistance.

We are one of the top ranking underwriters nationally in the tax-exempt senior health and housing sector. Our clients are nonprofit entities that range from start-up continuing care retirement communities and small nursing homes to hospitals and large, well-established organizations with multi-state operations.

We also provide strategic and development advisory services to clients seeking to acquire or dispose of land/property, develop new senior living campuses, or modify the use of existing campuses. Our bankers advise clients on project development and feasibility.

Restructuring is a significant activity of the firm. In the current environment, many organizations have been unable to develop successful solutions for overcoming financial challenges and have been forced to restructure their balance sheets through creditor negotiations or, as a last resort, to seek the protection of the bankruptcy courts.

Cain Brothers is often retained by organizations' boards and management teams, or by creditor groups, to coordinate solutions between borrowers and lenders. Our efforts can include leading negotiations, restructuring debt covenants and payment terms, arranging interim and/or long-term financing and equity investment, and selling selected assets or the entire organization. Our objective on each assignment is to reach a consensual solution, sustain the viability of operations, and enhance creditors' recoveries in the event of a sale or liquidation. This needs to be done in a framework that honors the underlying mission of the organization and addresses both state and federal regulatory issues.

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