Capital Markets Update

Offering Financial Advice and Solutions to Health Care, Senior Living, and Housing Providers.

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Lancaster Pollard & Co.
Table of Contents

• Capital Markets Overview

• Financing Strategies and Trends

• Common Financing Structures

• Appendix A: Case Studies
Capital Markets Overview
Capital Markets Update

- Despite continued global pressures, the overall U.S. equity markets performed very well in 2014
- The Federal Reserve has altered its guidance and is hinting that the first interest rate hike in eight years is approaching
- The Fed ended its Quantitative Easing (“QE”) program in October
- Municipal bond volume in 2014 was at its lowest level in decades
- 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 – BBR vs. Healthcare A3

Source: Bloomberg LP
Capital Markets Update – Healthcare Spreads

Rate (%)

Date

A3 30 Yr HC  BBB1 30 Yr HC

Source: Bloomberg LP
BBB+ Rated Healthcare Yield Curve

Source: Bloomberg LP
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
- 2014 saw a fractured market with renewed activity in the latter part of the year
- Despite low borrowing rates, volume in 2014 was near a 30 year low due to continued uncertainty in the new era of healthcare reform

Source: The Bond Buyer
Rating Agency Commentary

“The impact of mergers on ratings has generally been positive although such activity can somewhat mask underlying credit trends.”

“We expect continued financial weakening due to volume declines in a predominately fee-for-service environment, reinforcing our negative outlook on business conditions in the not-for-profit hospital sector.”

“Fitch anticipates further narrowing in operating profitability in fiscal 2014 as expense-reduction efforts may not be sufficient to overcome reimbursement and volume pressures.”
S&P U.S. Not-For-Profit Rating Actions

- **2008**: 70
- **2009**: 60
- **2010**: 40
- **2011**: 50
- **2012**: 40
- **2013**: 40
- **2014**: 40

Legend:
- **Downgrades**
- **Upgrades**

*Financing Progress*
S&P Activity Due to M&A Activity

- 2014: 16 of 39 (41%) of upgrades, 0% of downgrades related to M&A
- 2013: 15 of 37 (41%) of upgrades, 18% of downgrades related to M&A
S&P Ratings Outlook

2013

- Stable: 78%
- Positive: 14%
- Negative: 8%

2014

- Stable: 78%
- Positive: 14%
- Negative: 8%
Industry Headwinds

- Weak revenue growth expected to continue
  - Transition from fee for service model to value based reimbursement
    - Better clinical outcomes resulting in reduced readmission rates
    - Continued advancement in surgical technology and procedures
  - Employer-sponsored insurance is declining
  - Movement into high-deductible health plans by employers
  - Medicare’s two-midnight rule
Industry Headwinds

• Challenges facing hospital CEOs and Boards in 2015:
  • Health insurance exchanges
    • Challenges with lower reimbursement compared to commercial plans, signing up patients for the exchange, and dealing with high-deductible plans
  • Supreme Court to rule in *King vs. Burwell*
  • Uncertainty about continued implementation of ACA
  • Continued movement toward value-based reimbursement levels
  • Heightened competition for patients
  • Increased IT spending
  • Many of the easier cost cutting tactics already deployed
Industry Tailwinds

- Positive credit developments in hospital sector
  - Increased debt service coverage
  - Improving balance sheet and liquidity strength
  - Implementation of new business models
  - Information technology improvements
  - State provider taxes
  - M&A activity
  - Medicaid expansion
Medicaid Expansion

Key:
- Orange: 22 states are not expanding Medicaid
- Green: 23 states (count includes the District of Columbia) are expanding Medicaid
- Blue: 5 states are expanding Medicaid, but using an alternative to traditional expansion
- Light Blue: 1 state with a Medicaid expansion waiver pending approval from CMS
Medicaid Expansion

- **Affirmation**: 386
  - Non-Expansion States: 172
  - Expansion States: 214

- **Upgrade**: 39
  - Non-Expansion States: 19
  - Expansion States: 20

- **Downgrade**: 44
  - Non-Expansion States: 20
  - Expansion States: 24

- 51% of upgrades occurred in expansion states.
- 55% of downgrades occurred in expansion states.
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 0.02% vs. 1-Month LIBOR (taxable) at 0.17%¹
  - Long-term: 10-yr. “AAA” MMD (tax-exempt) at 2.04% vs. 10-yr. U.S. Treasury Note at 1.99%¹
- Also avoids certain IRS use restrictions

¹As of 2/11/15
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
- Rating: AAA/AA+
  - Interest Rate: Fixed (FHA only) or Variable
- Rating: AA, A
  - Interest Rate: Variable or Fixed

Letter of Credit
- Rating: AA, A
- Interest Rate: Variable or Fixed

FHA/USDA

Bond Insurance
- Rating: AA, A
  - Interest Rate: Variable or Fixed

Tax-Supported
- City, County or District Borrowers Only
Access to Capital

<table>
<thead>
<tr>
<th>Local and Regional Resources</th>
<th>Government Resources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct bank loans</td>
<td>USDA Programs</td>
</tr>
<tr>
<td>Direct placement of bonds</td>
<td>FHA-insured HUD mortgages</td>
</tr>
<tr>
<td>▪ Bank-qualified bonds</td>
<td></td>
</tr>
<tr>
<td>Letters of Credit</td>
<td>On Your Own or With Internal Resources</td>
</tr>
<tr>
<td>▪ Federal Home Loan Bank</td>
<td></td>
</tr>
<tr>
<td>▪ Regional Banks</td>
<td>Unenhanced bonds</td>
</tr>
<tr>
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<td>Tax-backed bonds</td>
</tr>
<tr>
<td></td>
<td>Hospital system guarantee</td>
</tr>
</tbody>
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## 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

<table>
<thead>
<tr>
<th>Pros</th>
</tr>
</thead>
<tbody>
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</tr>
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<td>- Fully amortizing structure</td>
</tr>
<tr>
<td>- Fixed rate for life of the loan</td>
</tr>
<tr>
<td>- Ability for non-core operations to pay debt service</td>
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</tbody>
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<table>
<thead>
<tr>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Prepayment limitations</td>
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<tr>
<td>- Debt service reserve fund</td>
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<tr>
<td>- Sensitive nature of public vote</td>
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### 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

## 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
- Loans are taxable

## Financing Progress

- **Direct and guaranteed loans, with some limited grants**
- **Terms up to 40 years**
- **90% guaranteed**
- **Cannot use for 100% refinance**

- **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**

- **Fixed or variable rates**
- **No min/max loan amount**
- **For populations of <20,000**
- **One-time 1% guarantee fee**
- **Loans are taxable**
## 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
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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 Representative license, Series 7, and is a frequent speaker and author on capital funding solutions for health care providers.
<table>
<thead>
<tr>
<th>Investment Banking</th>
<th>Mortgage Banking</th>
<th>Investment Advising</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lancaster Pollard &amp; Co.</td>
<td>Lancaster Pollard Mortgage Company</td>
<td>Lancaster Pollard Investment Advisory Group</td>
</tr>
<tr>
<td>Debt Underwriting</td>
<td>FHA-Insured Mortgage Loans</td>
<td>Arbitrage Assessment</td>
</tr>
<tr>
<td>Financial Consulting</td>
<td>GNMA Issuer/Servicing</td>
<td>Asset-Liability Management</td>
</tr>
<tr>
<td>Financial Derivatives</td>
<td>Mortgage Loan Servicing</td>
<td>Capital Structure Optimization</td>
</tr>
<tr>
<td>Mergers &amp; Acquisitions</td>
<td>USDA-Guaranteed Mortgage Loans</td>
<td>Fiduciary Investment Consulting</td>
</tr>
<tr>
<td>Private Placements</td>
<td>Fannie Mae Multifamily &amp; Affordable &amp; Seniors Housing Lender/Servicer</td>
<td>Project Fund Management</td>
</tr>
<tr>
<td>Remarketing</td>
<td></td>
<td>Risk Management Advising</td>
</tr>
<tr>
<td>Bond Sales &amp; Trading</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mezzanine Debt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Syndicated Loans</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Appendix A: 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
Loma Linda University Medical Center (Loma Linda, CA)

- Three (3) hospital system in southern California with over 1,000 beds
- Needed to update its facilities to meet seismic requirements and market demand
- The system had over $500MM in debt from previous bond issues that needed to be refinanced to facilitate the new developments
- Recently acquired the remaining interests in the third hospital and needed to redeem the outstanding bonds to complete the merger
- Serving as financial advisor, Lancaster Pollard put together a plan of finance that would allow the system to advance refund the existing debt and capitalize its current expansion
- An S&P rating of BBB was achieved which allowed the system to issue $683,305,000 in taxable and tax-exempt fixed rate debt
- The final bonds had a 40 year maturity with a net yield of 4.96%