Financing New Hospital Projects with FHA Section 242 Mortgage Insurance

Presented by:
Alan P. Richman
President & CEO
Innovative Capital, LLC

March 5, 2010
California Hospital Association
The 25th Annual Rural Health Symposium
Sacramento, California

Outline

• Capital Planning
  o Due Diligence Discovery
  o Capital Budget Determination
  o Project Definition
  o Debt Capacity Analysis
  o Picking Your Financing Structure

• FHA Section 242 Mortgage Insurance
• Exciting Developments and Applications for FHA Section 242 Mortgage Insurance

Capital Planning
Due Diligence Discovery - A Self Examination

• What do we need?
• What can we afford?
• Location?
• Politics?
Capital Planning
Due Diligence Discovery - Action Plan
- Selecting the Team
- Feasibility Assessment and Debt Capacity
- Master Planning and Project Development
- Milestone Planning
- Community Acceptance
- Media Relations
- Economic Impact Analysis

Capital Planning
Expect the Unexpected
- Legal Structure
- Wetlands, Endangered Species, Historic Preservation
- Environmental
- Planes, Trains and Automobiles

Capital Planning
Financial Feasibility 5-Step Determination of Debt Capacity

| STEP ONE | Preparation of market analysis & financial forecast by CPA firm |
| STEP TWO | Select a financing strategy based on borrower’s credit profile and a capital markets assessment |
| STEP THREE | Use conservative borrowing assumptions for debt sizing |
| STEP FOUR | Sensitivity modeling of project budgets and loan sizing |
| STEP FIVE | Calculate maximum debt capacity and project budget optimization |
Capital Planning

Picking Your Financing Structure

<table>
<thead>
<tr>
<th>Credit Structure</th>
<th>Applicant Requirement</th>
<th>Debt Rating</th>
<th>Borrowing Parameters</th>
<th>Capital for Most Community Hospitals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond Insurance</td>
<td>AAA - A</td>
<td>fixed rate</td>
<td>$5m - $15m</td>
<td>Generally not practical due to project size.</td>
</tr>
<tr>
<td></td>
<td>BBB+</td>
<td>variable</td>
<td>$5m to $15m</td>
<td>Rarely qualify due to credit profile.</td>
</tr>
<tr>
<td></td>
<td>BBB</td>
<td>variable</td>
<td>None</td>
<td>None. Only 2 active insurers, offers little chance of bond insurance due to credit profile.</td>
</tr>
<tr>
<td></td>
<td>EIR</td>
<td>variable</td>
<td>None</td>
<td>None. Non-rated.</td>
</tr>
<tr>
<td></td>
<td>FHA</td>
<td>variable</td>
<td>None</td>
<td>None. Multiple funding sources provides maximum flexibility.</td>
</tr>
</tbody>
</table>

Capital Planning

Borrowing Rates for CAHs

The Value of FHA Section 242 Mortgage Insurance is Evident

<table>
<thead>
<tr>
<th>Borrower Credit Quality</th>
<th>Approximate Market Interest Rates (as of 2/8/10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA Municipalities</td>
<td>4.14%</td>
</tr>
<tr>
<td>Single A Retail</td>
<td>4.75%</td>
</tr>
<tr>
<td>General Revenue Borrowers</td>
<td>5.88%</td>
</tr>
<tr>
<td>BBB-  Retail Hospitals</td>
<td>6.25% - 6.45%</td>
</tr>
<tr>
<td>Non-Rated Hospitals</td>
<td>8.00% - 8.50% - unmarketable.</td>
</tr>
<tr>
<td>FHA 242 GNMA Insured Direct Loan</td>
<td>6.50% + 50 bp FHA MIP</td>
</tr>
<tr>
<td>FHA 242 GNMA BAB’s</td>
<td>5.50% + 50 bp FHA MIP - non interest cost with federal 35% subsidy</td>
</tr>
</tbody>
</table>

FHA Section 242 Mortgage Insurance

Overview

• The Program
• Hospital Applicants
• Attractive Terms and Conditions
• Why Use FHA Section 242
• Loan Uses
• The Project Team
• The HUD Process and Timeline
• Miscellaneous Program Tidbits
• The Financing
The FHA Section 242 Program and the Office of Insured Health Care Facilities

- Since 1968, 370 FHA 242 commitments > $15 billion loans
- Current portfolio > 90 loans
- HUD processing timeline - 3 months
- Centralized Washington underwriting
- Engineering headquartered in N.Y.C.
- Regional office project support
- Extremely low loan default rate
- Loans range from $10m to $900m
- Hospitals range from 15 beds to > 1,000 beds

Centralized Washington underwriting
- Engineering headquartered in N.Y.C.
- Regional office project support
- Extremely low loan default rate
- Loans range from $10m to $900m
- Hospitals range from 15 beds to > 1,000 beds

Hospital Applicants
- Acute care hospitals
- Rural and critical access hospitals
- Urban teaching hospitals
- University hospitals
- Nonprofit and municipal hospitals
- For-profit hospitals
- Start-up hospitals
- Health systems

Attractive Terms and Conditions
- No maximum loan amount
- Loan-to-value 90%
- Potential for 100% financing
- Loan term up to 25 years
- Fixed annual premium of 50 bp
- One time fees of 80 bp
- All-in-one construction/permanent loan
- Fixed rate loans
- Multiple funding options including BAB’s
- Can also be used to refinance existing debt
FHA Section 242 Mortgage Insurance

Reasons Why CAHs Use FHA Section 242 Mortgage Insurance

- Hospitals are ineligible for commercial credit enhancement
- Eliminate the need for construction loan and refinancing risks
- Fixed rate FHA 242 loans are marketable to investors.
- Hospitals want to lower their borrowing costs by enhancing their credit ratings.
- Off-balance sheet financing for hospital systems

FHA Section 242 Mortgage Insurance

Loan Uses

- Construction
- Replacement
- Expansion
- Modernization
- Equipment
- Remodeling
- Refinancing

FHA Section 242 Mortgage Insurance

Program Eligibility Requirements

A hospital candidate must have:
- An average operating margin of at least 0.0% over the last three years
- An average debt service coverage ratio for three years of >1.25x
- On a pro-forma basis, positive operating income
- On a pro-forma basis, a debt service coverage ratio of >1.4x
- An ability to pledge a mortgage of fee simple title or leasehold interest
- A project that is urgently-needed and be an essential provider of services
- A project that has not commenced construction

Please note: Exceptions to the above criteria may apply.
**FHA Section 242 Mortgage Insurance**

**The Project Team**

- Hospital Management
- Owner’s Representative
- Architect/Engineer
- Construction Manager
- HUD Account Executive
- HUD Division of Architecture & Engineering (DAE)
- Project Manager

**The Ceremonial Handing Off of the Check!**

**The Process and Timeline**

<table>
<thead>
<tr>
<th>STEP I.</th>
<th>PRE-APPLICATION PREPARATION &amp; SUBMISSION - Months 1-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>STEP II.</td>
<td>PRE-APPLICATION MEETING IN WASHINGTON, D.C. - Month 2</td>
</tr>
<tr>
<td>STEP III.</td>
<td>PREPARE AND SUBMIT HUD APPLICATION - Months 3-5</td>
</tr>
<tr>
<td>STEP IV.</td>
<td>COMPLETION OF PROJECT DEVELOPMENT &amp; DESIGN - Months 4-5</td>
</tr>
<tr>
<td>STEP V.</td>
<td>ISSUANCE OF HUD COMMITMENT (requires GMP) - Month 6-7</td>
</tr>
<tr>
<td>STEP VI.</td>
<td>PRICE AND CLOSE THE LOAN - Month 6 (CAH), Month 7 (non-CAH)</td>
</tr>
<tr>
<td>STEP VII.</td>
<td>START PROJECT CONSTRUCTION - Months 6-7</td>
</tr>
</tbody>
</table>

**Miscellaneous Program Tidbits**

- Davis Bacon wage rates are required
- Design-Build projects are eligible with size limitations (<$60m of construction cost)
- Medical office buildings and nursing homes can be financed with hospital projects
- Maintenance/Utility Buildings that support health facilities can be financed
- HUD makes monthly site visits during construction and opening phase
- HUD approves monthly loan disbursements made by FHA mortgage banker
- Pre-Commitment work is subject to receipt of prior approval of HUD
**Exciting Developments and Applications for FHA 242 Mortgage Insurance**

**What are Build America Bonds?**
A Unique Opportunity for your Hospital Clients Ending 12/31/2010**

- They are taxable municipal bonds issued on behalf of municipal borrowers.
- All governmental hospitals are eligible, but not 501(c)(3) entities.
- The Federal Government provides a BABs interest rate subsidy of 35%.
- The bonds can have a term up to the average useful life of financed assets.
- The bonds are rated based on the creditworthiness of the borrower.
- BABs are ineligible for refinancing purposes, but can be supplemented with traditional bonds.

**Discussions are currently underway to extend the deadline with possible modifications**

---

**Exciting Developments and Applications for FHA 242 Mortgage Insurance**

Build America Bonds and FHA 242 Mortgage Insurance
A Unique Opportunity for your Hospital Clients Ending 12/31/2010

- FHA 242 Mortgage Insurance combined with a Ginnie Mae (AAA) security can credit enhance a BAB’s and increase the credit rating to AAA.
- The representative long-term interest rate for a BABs is approximately 6.5%.
- With the BAB’s 35% subsidy, the net interest cost to the hospital would be 4.22%!

**Discussions are currently underway to extend the deadline with possible modifications**

---

**Exciting Developments and Applications for FHA 242 Mortgage Insurance**

FHA Section 242 Pursuant to 223 (f) – Refinancing Program Highlights

- Refinancing primarily for debt retirement and issuance costs
- No more than 20% of loan can be for capital improvements
- Refinancing must reduce monthly debt service
- For past 3 years, hospitals must have both:
  - Total operating margin > 0.06%
  - Average debt service coverage > 1.4x
- Hospital’s interest rate must have increased >= 1% since 1/1/08, or demonstrate that increase is imminent
- HUD may use its estimate of a projected interest rate in calculating financial ratios for prior periods
- FHA Section 242 may be a better choice for refinancing candidates!

**Per Proposed New Regulations.**
FHA Section 242 Mortgage Insurance Program
Why FHA Section 242 is Important for CAHs

- It provides a financing vehicle that is widely accepted in the marketplace.
- Allows hospital to have confidence the project they start will receive financing on a timely basis.
- This confidence allows hospitals to begin spending money on project design/development with less fear of a failed loan closing.
- The FHA 242 process is manageable with the right professional team, without excessive time delays or increased costs.

FHA Section 242 Mortgage Insurance Program
Why FHA Section 242 is Important for CAHs (cont.)

- Reduced FHA 242 borrowing rates turn unaffordable projects into financially viable ones.
- The lower interest rate increases hospital debt capacity and enhances the project budget and scope.
- HUD rewards a strong project and financing team with substantial HUD personnel support.
- FHA Section 242 Mortgage Insurance is the best, if not the only credit enhancement vehicle available to the overwhelming majority of community hospitals and CAH's!

FHA Section 242 Mortgage Insurance Program
Questions?

Alan P. Richman
President & CEO
Tel: 610-543-2490, Ext. 101
arichman@innovativecapital.com

InnoVative Capital, LLC
1489 Baltimore Pike, Building 400, Springfield, PA 19064
Tel: 610-543-2490 | Fax: 610-543-2491 | www.innovativecapital.com
Capital Planning
Financial Feasibility 5-Step Determination of Debt Capacity

**STEP ONE** - Preparation of market analysis & financial forecast by C.P.A. firm

**STEP TWO** - Select a financing strategy based on borrower’s credit profile and a capital markets assessment

**STEP THREE** - Use conservative borrowing assumptions for debt sizing

**STEP FOUR** - Sensitivity modeling of project budgets and loan sizing

**STEP FIVE** - Calculate maximum debt capacity and project budget optimization
# Capital Planning

## Picking Your Financing Structure

<table>
<thead>
<tr>
<th>Credit Structure</th>
<th>Applicant Requirement Debt Ratings</th>
<th>Borrowing Amount Parameters</th>
<th>Outlook for Most Community Hospitals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond Insurance</td>
<td>AAA-A fixed rate tax-exempt bonds.</td>
<td>None.</td>
<td>Only 2 active insurers, offers little chance of bond insurance due to credit profile.</td>
</tr>
<tr>
<td></td>
<td>Health System or major tertiary hospital (BBB+), all others (A).</td>
<td>$5m - $15m</td>
<td>Generally not practical due to project size.</td>
</tr>
<tr>
<td>Bank Letters of Credit</td>
<td>BBB or higher.</td>
<td>None.</td>
<td>Rarely qualify due to credit profile.</td>
</tr>
<tr>
<td>FHLB Letters of Credit</td>
<td>Low investment grade rating equivalent</td>
<td>$5m - $30m</td>
<td>Limited investors and loan size and term restrictions are daunting.</td>
</tr>
<tr>
<td>Non-Rated Bonds</td>
<td>BB- to BB+ caliber hospitals</td>
<td>None.</td>
<td>Few investors. High interest rate limits project size.</td>
</tr>
<tr>
<td>Bank Qualified Bonds</td>
<td>Low investment grade rating equivalent</td>
<td>Estimated at $25 million (usually $10m-$18m).</td>
<td>Most project &gt; in size than USDA range. Construction loan refinancing requirement adds unacceptable risk.</td>
</tr>
</tbody>
</table>

**USDA Loans (Direct and Guaranteed) with independent construction loan.** B- and higher. **Estimated at $25 million (usually $10m-$18m).** Most project > in size than USDA range. Construction loan refinancing requirement adds unacceptable risk.

**HUD/FHA Section 242 Mortgage Insurance (Ginnie Mae loan, BAB’s, T-E bonds).** B- and higher. None. Multiple funding sources provides maximum flexibility.
# Capital Planning

## Borrowing Rates for CAHs

The Value of FHA Section 242 Mortgage Insurance is Evident

<table>
<thead>
<tr>
<th>Borrower Credit Quality</th>
<th>Approximate Market Interest Rates (as of 2/8/10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA Municipalities</td>
<td>4.14%</td>
</tr>
<tr>
<td>Single A Rated General Revenue Borrowers</td>
<td>4.75%</td>
</tr>
<tr>
<td>Single A Rated Hospitals</td>
<td>5.85%</td>
</tr>
<tr>
<td>BBB- Rated Hospitals (the lowest investment grade level)</td>
<td>6.25% - 6.45%</td>
</tr>
<tr>
<td>Non-Rated Hospitals</td>
<td>8.00% - 8.50% - unmarketable.</td>
</tr>
<tr>
<td>FHA 242 GNMA Insured Direct Loan</td>
<td>6.50% + 50 bp FHA MIP</td>
</tr>
<tr>
<td>FHA 242 GNMA BAB’s</td>
<td>3.9% + 50 bp MIP - net interest cost with federal 35% subsidy</td>
</tr>
</tbody>
</table>
# FHA Section 242 Mortgage Insurance
## The Process and Timeline

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Timeline</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Step I.</strong></td>
<td>Pre-Application Preparation &amp; Submission</td>
<td>Months 1-2</td>
</tr>
<tr>
<td><strong>Step II.</strong></td>
<td>Pre-Application Meeting in Washington, D.C.</td>
<td>Month 2</td>
</tr>
<tr>
<td><strong>Step III.</strong></td>
<td>Prepare and Submit HUD Application</td>
<td>Months 3-5</td>
</tr>
<tr>
<td><strong>Step IV.</strong></td>
<td>Completion of Project Development &amp; Design</td>
<td>Months 4-5</td>
</tr>
<tr>
<td><strong>Step V.</strong></td>
<td>Issuance of HUD Commitment (requires GMP)</td>
<td>Month 6-7</td>
</tr>
<tr>
<td><strong>Step VI.</strong></td>
<td>Price and Close the Loan</td>
<td>Month 6 (CAH), Month 7 (non-CAH)</td>
</tr>
<tr>
<td><strong>Step VII.</strong></td>
<td>Start Project Construction</td>
<td>Months 6-7</td>
</tr>
</tbody>
</table>