

# Strategies in Capital Finance

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## FINANCING AND DEBT RESTRUCTURING SOLUTIONS FOR THE SENIOR LIVING INDUSTRY FINANCIAL CRISIS

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CAIN BROTHERS

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INVESTMENT BANKERS & CAPITAL ADVISORS TO THE HEALTH CARE INDUSTRY

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## INTRODUCTION

In our recent *Strategies in Capital Finance* white paper, “The Financial Crisis Hits the Senior Living Industry: Operational and Debt Restructuring Considerations for Trustees and Executives,”<sup>1</sup> we described the factors in the current financial crisis that have radically altered the financial results of many senior living facilities. The affordability of senior housing projects has declined materially in many parts of the country, and income statements and balance sheets of senior living providers have been severely and negatively impacted. The senior living industry is dependent on the state of the housing and real estate markets, the stock market, and debt market for its financial health. Unfortunately, all of these sectors have experienced dramatic and negative changes during the past year.

That white paper also identified the obligation of nonprofit trustees and managers to pay attention to the needs of creditors, in addition to their usual focus on their duty to the organization’s mission, when an organization enters the “zone of insolvency.”<sup>2</sup> Many senior living providers are facing this kind of financial challenge. In these cases, we recommend engaging appropriate financial advisors early, so aggressive proactive action can be taken and the organization can survive to meet the needs of its residents. In doing so, investors and creditors need to be assured that the organization is making every effort to seek operational improvement and debt restructuring strategies that make it as financially sound as possible. Creditors also need to know that advisors representing the senior living organization will not favor one class of creditors over another based on historic investor relationships or current and ongoing self interests.

Objective outside advisors with experience in senior living financing and debt restructuring that can rapidly assess the situation on the strategic level and that can help develop an action plan, should be engaged to confirm or enhance the organization’s internal plans. Since the current challenges include greatly depressed housing and stock markets that may well continue into the future, the organization’s plans need to include strategies to address both operations and capital structure. This *Strategies in Capital Finance* white paper continues our focus on the challenges facing senior living organizations in the current financial climate by focusing on refinancing alternatives and debt restructuring strategies.

Overall debt market trends have significant negative implications for senior living borrowing. Fixed rate borrowing costs for most tax exempt senior living providers are currently out of the range of feasibility, and most investors are avoiding nonrated credits and lower rated senior living projects altogether. Nonrated and lower rated projects represent the majority of senior living borrowers. The volume of senior living sector tax exempt bond issuance declined significantly in 2008 compared to previous periods, and, so far through the first quarter of 2009, there is little improvement. Bank letters of credit (LOCs) that are part of the typical capital structure of many nonprofit senior living providers are much less available and more expensive when they can be obtained. Campus valuations are also under pressure due to increasing capitalization rates. Some borrowers now have greater debt levels than the current value of their campuses even as their bottom lines may have stayed constant, and that makes any refinancing extremely challenging.

These and other issues have created capital structure challenges for many senior living organizations. In some organizations, refinancing solutions may be available simply by thinking more creatively about how a community’s credit requests are packaged. In

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<sup>1</sup> Volume 59 is available on the web at [www.cainbrothers.com](http://www.cainbrothers.com).

<sup>2</sup> The “zone of insolvency” arises when an organization cannot fully pay its debts or when its liabilities are greater than the market value of its assets.

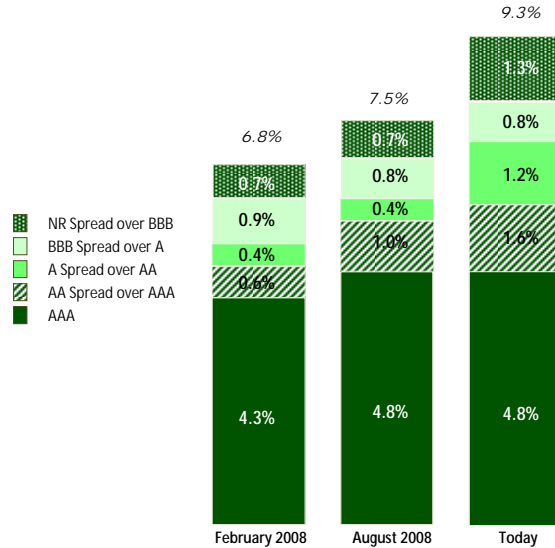


CASH AVAILABLE TODAY, BUT FUTURE REFINANCING NECESSARY

CHALLENGES

Figure 2 illustrates the recent significant increases in tax exempt senior health and housing long term interest rates. Current borrowing costs for nonprofit senior living facilities, which are primarily a function of rates available and investor appetite in the nonrated tax exempt bond market, have created a situation where many proposed projects are not feasible.

FIGURE 2. Rates for 30 Year Tax Exempt Health Care Lending to Nonrated Organizations Have Increased in the Current Market and All But the Highest Rated Borrowers Are Under Pressure



Source: Cain Brothers Analysis as of 4/1/09. Nonrated rates are illustrated along with incremental credit spreads across rating categories. Numbers do not total due to rounding.

SOLUTIONS

While interest rates and investor willingness to invest are significant challenges for organizations needing to borrow today, the market also provides a potential opportunity for some organizations because the market values of bonds trading in the secondary market have declined. Thirty year fixed rate bonds that a senior living organization may have issued in the past at 6%, for example, may now be valued at a 25-40% discount in the secondary market. If an organization has excess cash, this situation presents a buyback opportunity to the organization. It could purchase its own bonds in the secondary market at a discount. It could then either hold and later resell them for a gain, if interest rates decline and the trading value increases, or retire the debt, which will improve balance sheet and income statement ratios.

As interesting as this potential opportunity may be, most organizations will be reluctant to permanently commit too much cash to repurchase bonds because cash ratios need to remain strong to support future necessary borrowing. Most senior living organizations facing credit access challenges will, therefore, have to be cautious in how they take advantage of the lower current market value of their already issued debt.

In some situations, however, a permanent debt refinancing planned within a one to two year period could include a secondary market debt repurchase component that replenishes the organization's cash. The organization would either have to wait until the refinancing was committed or be able to raise cash on an interim basis (through bridge loans or donations, for example). It could use those funds to buy its own

discounted bonds, planning to hold them for a limited and defined period of time. If after a determined hold period the bonds increased in value, the organization would have the option of either realizing gains by reselling the bonds in the secondary market or refinancing those bonds with new debt. When the debt is refinanced, the repurchased discount from par is locked in. If the organization is able to successfully put in place a permanent refinancing transaction at a similar rate to the bonds being purchased, for example, it will be able to lower both its leverage and annual debt service payments.

Leverage is lowered in direct proportion to the price paid for the bonds and amount of bonds repurchased. Savings possible in annual debt service payments depend on the amount of bonds repurchased, the bond's purchase price, the cost of funds used to repurchase the bonds, and the interest rates paid on the new permanent refinancing. A hypothetical example is shown in Figure 3.

**FIGURE 3. Discounted Bond Repurchase Can Be Beneficial If a Refinancing Is Contemplated**

ASSUMING THAT CURRENTLY OUTSTANDING BONDS CAN BE PURCHASED AT AN 85% DISCOUNT	CURRENT	AFTER BOND REPURCHASE AND REFINANCING
Total Interest Costs	5.5%	5.5% <sup>1</sup>
Debt	\$31 million	\$26 million
Annual Debt Service Payments	\$2.8 million	\$1.9 million
Tendered Bonds Term	20.9 years	20.9 years
Total Gross Savings		\$10 million
Total Principal Savings		\$5 million
Total Interest Savings		\$5 million

<sup>1</sup> Refinancing rate assumes an issue of VRDBs secured by a bank LOC with a fee of 2.5% and 10 year fixed payer swap rate of 2.75% plus other annual fees of .25%

Source: Cain Brothers Analysis.

If some of the original bonds remain outstanding, organizations will also need to put in place a refinancing transaction that considers the requirements of the existing non-purchased debt structure that will remain in place.

Because cash is such a crucial component of a borrower's credit profile, any buyback of bonds should be considered as part of a larger capital strategy, and, in most cases, as an element of upcoming refinancing, to be accomplished in a relatively short period. Since the organization in most cases will not want to reduce liquidity, we suggest a limited use of this approach to organizations that can reasonably predict an ability to obtain refinancing at favorable rates at a future time. The process is summarized in Figure 4.

FIGURE 4. The Mechanics: Bond Repurchase

Based on a comprehensive capital plan, investment banker and borrower determine amount of funds available for repurchasing bonds and which term of bonds should be targeted for repurchase. Should carefully consider borrower's short and mid term liquidity needs and debt covenants before cash is committed.

Borrower decides if it would like to execute a market order or establish an ongoing repurchase program.<sup>1</sup>

Based on knowledge of the institutional buyers and current market, investment banker pinpoints bonds with the highest likelihood of repurchase.

Trading desk communicates with bondholder(s). If a mutually agreeable price is achieved, transaction is executed.

The purchase transaction can be settled in as little as three to five days.

<sup>1</sup> Organizations should work with experienced investment bankers and bond counsel to purchase individual bonds on a negotiated basis, and be careful to avoid inadvertently creating a formal tender offer or repurchasing program. Formal tender offers or repurchasing programs may sometimes be appropriate as well.

In addition to incorporating this possible solution as part of a comprehensive capital strategy that involves analysis of cash and investments, as well as debt, an organization must carefully review its specific bond covenants, as there may be provisions that facilitate or limit an organization's ability to execute the solution.

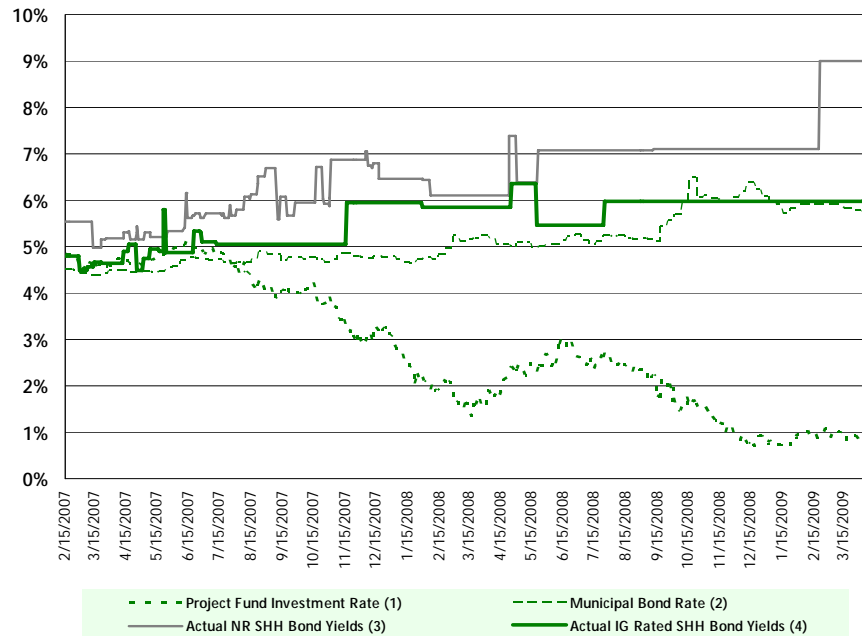
## MAJOR EXPANSION NEEDS FINANCING

### CHALLENGES

Prior to 2004, most CCRC expansions and start ups were financed with a mixture of long term fixed rate and short term bank LOC backed debt. That pattern shifted about five years ago when a number of CCRC start ups were financed primarily with lower cost bank LOC based structures. More recently, however, banks have been tightening start up and expansion LOC underwriting criteria. Because of the current financial crisis, 100% LOC financing for start ups or large scale expansions is much less available today. The high yield/high risk institutional funds that invested in the long term fixed rate portions of CCRC projects prior to 2004 do not have investment dollars to support new senior living projects today. Instead, lately, these institutional funds have gravitated toward larger, higher rated health care issues and other more traditional sectors of the municipal bond market, such as public works and higher education borrowings.

Even when available, fixed rate debt would be too expensive for most expansion projects due to the level of interest rates required for nonrated or lower investment grade borrowers, coupled with significant increases in the amount of interest required to be funded during construction. Figure 5 shows that the interest rates of tax exempt long term fixed rate bonds have gone up since 2007, while investment rates have decreased significantly. The interest rates required for nonrated free standing (non obligated group guaranteed) borrowers are currently about 9% or higher, much higher than the available Treasury interest rates shown below. Even if investment rates are higher than the current Treasury rates shown below, a 5 to 7% negative carry on reinvestment of bond proceeds pending construction expenditure makes many projects infeasible.

FIGURE 5. Increasing Interest Rates AND Decreasing Investment Rates



- (1) Two year Treasury.
- (2) Bond Buyer Revenue Bond Index.
- (3) Tax exempt new issue interest rates (long bond maturity) for actual nonrated, senior living transactions, par greater than \$10 million.
- (4) Tax exempt new issue interest rates (long bond maturity) for actual investment grade rated, senior living transactions, par greater than \$10 million.

Source: Bloomberg as of April 6, 2009; Cain Brothers Analysis and Estimates.

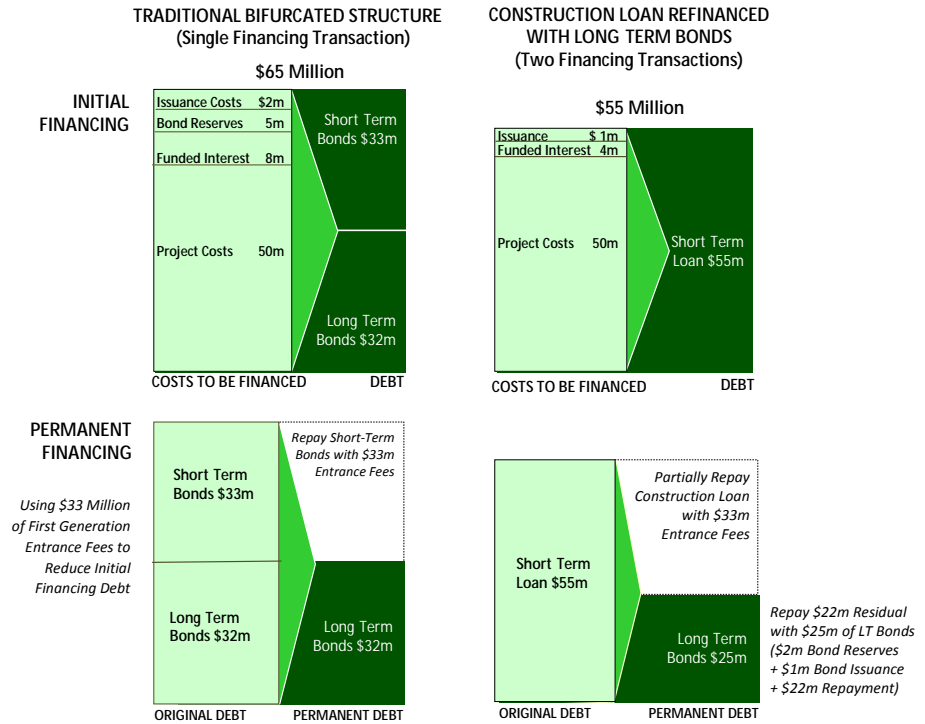
**SOLUTIONS**

► **Use Conventional Construction Loan with Tax-Exempt Bond Take out**

Projects with strong fundamentals may be able to attract conventional bank construction lending where the bank’s exit strategy is through permanent financing using tax exempt bonds. Using a construction loan can allow the borrower to avoid the significant negative interest carry inherent in today’s bond structures during construction and possibly through the rent up period. After the completion of construction, tax exempt bonds can be used to permanently refinance any residual construction loan, hopefully at a time when such financing rates have returned to more traditional tax exempt interest rate levels. Additionally, deferring the issuance of permanent debt until after construction is completed eliminates that risk and should translate into lower, more favorable cost of capital. When construction financing is used to build entrance fee units the collected entrance fees upon occupancy could be used to partially retire construction debt, leaving less outstanding debt for the ultimate tax exempt bond issue. This approach also segregates the project’s risk between construction or development lending, on the one hand, and commercial business lending, on the other. Since individual banks or banking divisions are often more comfortable with a focused risk that they have the expertise to evaluate and monitor, bank financing may be easier to obtain than with one transaction covering construction and permanent financing.

Figure 6 compares a hypothetical start up CCRC with \$50 million of project costs to finance and \$33 million of first generation entrance fees expected to have been collected after the move in phase is complete.

**FIGURE 6. Splitting Construction Financing from Permanent Financing Can Be Advantageous in Today's Market**



Source: Cain Brothers Analysis.

The first column shows that, if the organization uses a traditional bifurcated bond structure for financing, it will have to issue a total of \$65 million in bonds: \$33 million of short term variable rate bonds (VRDBs) it expects to repay with first generation entrance fees and \$32 million in long term bonds it expects to keep as permanent financing. This level of debt includes \$8 million of net interest to be funded during construction, due in part to the negative reinvestment results described above. If the same CCRC project uses a bank construction loan to fund all development and construction costs, its initial financing will be significantly lower at \$55 million. For this debt plan, once the project is complete, first generation entrance fees of \$33 million are used to partially repay the construction loan. The residual construction loan of \$22 million is repaid with \$25 million of long term fixed rate bonds. Funded interest is less than in the traditional bifurcated bond structure, because the construction loan amounts are drawn down as needed and interest expense on the construction loan is calculated based on the cumulative balance of the amounts drawn.

The level of permanent debt to be serviced under the second, construction loan financing plan is \$25 million; \$7 million lower than by using the traditional bifurcated structure. The construction loan option is more efficient in the current market, in part, due to low investment rates, relatively high tax exempt fixed rates, and limited LOC capacity.

Banks that have historically done more traditional real estate deals will understand such take out strategies and may be attracted to senior living deals when they can understand the project fundamentals in terms they are familiar with. Stronger fundamentals may involve equity contributions from sponsoring organizations resulting in more robust debt service coverage and leverage ratios. There should be

enough cash reserves or equity to achieve 75% to 80% loan to value upon stabilization. Unfortunately, many bank construction loans will require partial or full construction guarantees from stronger parent or related foundation entities. Such guarantees may reflect better usage of parental balance sheets than full guarantees more typical of obligated group financings. In some limited cases, greater appreciated land or long term land leases donated to the project or reimbursed at below current value could be used to help reach the bank's required loan to value ratios. Finally, in the case of entrance fee projects, the banks may allow the early pay down of some construction debt to count in helping borrowers meet their loan to value ratios.

► ***The Use of Third Party Developers and Emerging Underwriting Standards***

Those responsible for project development also need to respond to the realities of the marketplace. A high percentage of troubled properties reflect third party, fully turnkey development efforts undertaken by development groups for nonprofit organizations.

Historically, requiring a minimum of 70% presales has provided a market test of a project's feasibility and a condition for construction funding. Developers of many of these turnkey projects wanted a rapid return of their seed capital and, therefore, emphasized phased projects with few independent apartments in the first phase so as to minimize the number of presales needed to meet the 70% presale requirements and to accelerate the presale period and start of construction. This often had the effect of diminishing or removing the historic market test that requiring presales provided. This, in turn, has meant that many campuses were built in shallow markets and have failed to complete a second phase. Many of the resulting phase one campuses have experienced severe financial distress as they had too few independent living units to help carry the cost of fully developed common areas and higher shelter levels of care, all financed in the first phase in anticipation of a second, and even a third, residential phase. It has been Cain Brothers' experience that few campus projects with less than 120 independent living apartments thrive when built and financed alongside a full continuum of campus care.

Both nonprofit and for profit turnkey developers will increasingly be required by lenders to have "skin in the game" by holding seed capital rates of return to capital market norms, deferring development fee pay outs to meaningful occupancy milestones, and demonstrating appropriate unit fee pricing and knowledge of local real estate markets. Prudent lenders will seek to segregate the source of seed capital from development team members that stand to profit from accelerated project starts. Finally, lenders will often expect nonprofits to make equity investments of at least 20% of required seed capital.

In the 1990s, most presale efforts required the future resident depositors to have a financial stake in their deposits should they seek withdrawal prior to occupancy for reasons other than serious health reasons. Over the last few years, many developers moved away from any presale withdrawal penalties. Banks and bond funds will increasingly seek to define a qualified presale as one where a depositor faces a financial penalty or forfeiture of any interest earnings on the deposit in cases of depositor withdrawal. State regulatory rules may also apply.

Average entrance fee pricing will also be expected to reflect the local real estate based pricing realities, putting a brake on over leveraged projects not financially sustainable over time. Entrance fees at no greater than 100% of the upper 50% of median area home sales may be a good starting point for home ownership underwriting levels,

since this relates to the bulk of middle to upper middle income residents. Market affordability tests are still emerging and will need to be revisited as the most recent decline in the housing market likely separates the historic links between regional home values and entrance fees.

As bank lending starts to increase, some strong projects and financially fit sponsors will be able to take advantage of current real estate opportunities, such as lower land prices. The purchase and conversion of large scale condominium projects that can be converted into CCRC style campuses at dramatic savings to the cost of new construction may also provide opportunities. Large scale luxury oriented residential condominium or rental multi family projects have the potential for especially good CCRC conversion opportunities as their adjacent surface parking lots can often be downsized and used as future assisted living (AL) and skilled nursing facility (SNF) construction sites. Older residents tend to need fewer parking spaces than do younger family occupants. We believe that the senior health and housing development market has shifted in fundamental ways, however. Project designs will need to reflect the new, more economically conservative market realities as they adjust to a banking industry that may no longer accept the 100% loan to value ratios often used to finance amenity rich communities in the past.

For the very near term, banks will likely avoid major start up efforts, in general, and constrain their lending to routine refinancing or to mid sized expansions where there is a solid history of strong occupancy, operating characteristics, and demographic trends. Where major expansions are proposed, such efforts should be oriented to adding more revenue producing units. Necessary upgrades for deferred capital replacement costs or forgone modernization will likely need to rely more on improved profitability and fund raising than what incremental unit growth can provide.

Senior living organizations will also have to consider that banks will likely want ancillary banking business and strong collateral coverage as part of the price for providing credit. In cases of significant construction, banks will also want secondary construction completion guarantees by the borrower and any related foundation or sponsoring organization.

In cases involving major expansions of existing projects, senior living organizations can also consider whether federal program guarantees could finance a part of an existing campus, allowing the remainder of any major expansion to more easily qualify for the reduced levels of bank financing available today.

► **Government Agency Financing**

Debt secured by the Federal Housing Administration Section 232 insured loan program can be utilized to finance up to approximately 93% of assisted living, dementia care or skilled nursing project costs. The FHA 232 insured mortgage program has over a 35 year history and is the largest provider of credit enhancement for skilled, assisted living, and dementia care facilities in the nation. Section 232 mortgages can be funded on either a taxable or a tax exempt basis, depending upon market conditions, and can fund new construction, acquisition or refinancing/renovation efforts.<sup>3</sup>

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<sup>3</sup> When contemplating the use of FHA insured conventional debt to refinance tax exempt bond financing, bond counsel should be consulted regarding IRS regulations to ensure that the borrower retains future rights to return to tax exempt bond financing in the future.

New issue interest rates for taxable and tax exempt FHA insured loans are quite close today with conventional taxable issues being funded at approximately 6.25% and tax exempt rates at 6.00%. Both estimated rates include an annual insurance premium of 0.50% and a monthly servicing fee of approximately 0.25%. (In some recent periods, taxable rates have been lower than tax exempt rates.) Both rates are slightly greater than most “all in” LOC backed VRDB financings, but they are significantly less than nonrated fixed rates and, because they are trading at rates that are greater than historic averages, FHA insured loans should be carefully monitored going forward for possible interest rate reductions. At the now typical 2.5% bank LOC fee rate, underlying tax exempt variable rates would need to return to the 20 year historic average of approximately 3.3% from the current less than 1% historic low to be financially comparable. However, in today’s market, achieving the absolute lowest cost of capital may not be the highest priority. Long term interest rates of 6.25% still represent a reasonable cost of capital, and funding with FHA insurance is very predictable.

While cheaper bank credit enhancement for new projects is difficult to find, FHA debt is plentiful, always available, and increasingly user friendly, as the government attempts to inject financing into the long term care industry as part of its overall economic stimulus efforts.

Leverage is also much greater under the FHA program than can be obtained by either of the other two funding alternatives, because most banks are capping their lending at 65% to 75% loan to value ratios. Tax exempt FHA rates are starting to fall as bond investors once again realize that FHA’s government credit support is more dependable than private bond insurance. Bond insurer’s credit ratings tumbled in 2008 due to their involvement in the sub prime mortgage markets. An outline of the advantages and disadvantages of the program is included in Figure 7.

**FIGURE 7. FHA 232 Program: AAA Rated Insurance That Can Be Used In Connection With Either Nonprofit or For Profit Projects Use for Dementia Unit/SNF/AL Stand-Alone Facilities or as a Component of a CCRC**

ADVANTAGES	DISADVANTAGES
Can be used for refinancing, acquisitions or new construction.	Borrowers must be single asset entities, so CCRCs must be subdivided between health care and housing components. These property distinctions are for lending purposes only and don’t impact operations as the parent CCRC enters into lease arrangements that control the newly subdivided space.
Once issued, borrower’s exposure is not influenced by market collapse/ change.	Similar to other fixed rate issues, has a minimum eight year call penalty provision for early payoff.
Underwriting driven by cash flow, not balance sheet, so allows excess cash >1.17x debt service coverage to be up streamed to parent.	Because not balance sheet driven can be used as a “take out” source in combination with the “bond buyback” strategy mentioned earlier. In the case of new construction, construction contractors must pay labor based on prevailing wage scale, which may add construction cost outside of major metropolitan areas without unionized labor forces – not a factor when refinancing existing debt.
100% non recourse.	Can only insure fixed rate debt. Not for residential facilities.
0.75% credit enhancement is highly cost competitive.	Deferred capital improvements must be funded based on physical needs assessment study.
Credit enhancement is “pay as you go.”	No entrance fees.

Source: Cain Brothers Analysis.

A recent positive development in the FHA 232 Program is the advent of LEAN processing. Under LEAN, the Department of Housing and Urban Development (HUD) has taken a large step in making the underwriting and processing of the insurance commitments more streamlined and more controlled by the mortgage banking firm doing the FHA underwriting. FHA has committed to process "complete" applications within 60 days. Early indications and experience with the new system has been good.

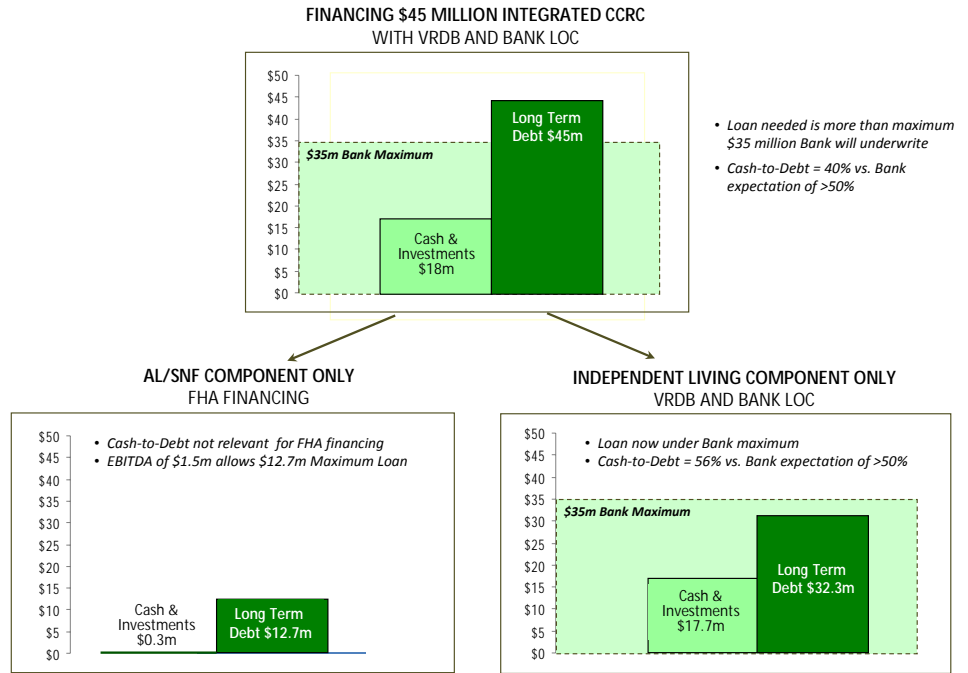
An advantage of using the FHA Section 232 program for the AL/SNF financing is that FHA's insurance underwriting is based on appraisals that utilize market oriented cash flow experience, not actual expenses, which are higher in many nonprofits. The borrower does have to demonstrate the ability to produce and monitor a separate cost center accounting for the portion of its campus that will be FHA insured.

The FHA underwriting process also gives credit for economies of scale, which helps to increase service line values. For example, SNF dietary costs for a facility adjacent to a larger retirement community campus where all residents obtain daily meals would likely generate economies of scale that reduce meal costs to an amount lower than a single facility SNF could achieve. This same credit is granted for facilities that want to expand their Section 232 eligible service lines. For example, an existing SNF provider that wanted to add assisted living units should be able to justify the fact that any new service could make significant use of the SNF's existing mid management supervisory staff and key supportive service departments to achieve operational cost savings.

Balance sheet strength is not a significant factor in the underwriting process. FHA instead evaluates and underwrites projects based on demonstrated cash flow and the funding of working capital and renewal for replacement escrows at closing. FHA's mark to market appraisal of cash flows often increases the values attributed to the facilities financed under the program, which allows the borrower's balance sheet to be more fully committed to other, primarily residential, components of its campus, thus strengthening the financial results of the other components. Resulting cash to debt ratios for operations that are not part of the FHA transaction may then be used to meet the bank's tougher underwriting standards.

Figure 8 illustrates a planned integrated CCRC expansion projected at \$45 million with \$18 million of cash equity available. If the LOC bank is only willing to underwrite a maximum of \$35 million and requires cash to debt ratios of greater than 50%, the planned facility cannot meet the bank's standards. Alternatively, the organization could seek FHA financing under Section 232 of the program for the AL and SNF components of a CCRC, and finance the housing portion (independent living) of the facility with variable rate debt backed by a bank LOC. One advantage of this approach is that by obtaining financing for a component of the facility from another source, the total loan value supported by a given LOC amount can be reduced and better fit into the bank's lower current credit limits of greater than 50% cash to equity.

FIGURE 8. Example of FHA Financing for a CCRC



Source: Cain Brothers Analysis.

Fannie Mae/ Freddie Mac are applicable for independent/congregate housing communities, mostly limited to rental projects that have little SNF, AL, and dementia supportive care. Fannie Mae and Freddie Mac credit enhancement are described in Figure 9. These programs have been utilized frequently in the multi family housing markets and for the financing of single level, rental senior housing projects, but somewhat less in the multi level senior health and housing arena.

FIGURE 9. Fannie Mae and Freddie Mac: AAA Rated Guarantees of the Federal Government Use for Independent and Congregate Housing Credit Enhancement

ADVANTAGES	DISADVANTAGES	CURRENT PROCESS
Can be used for refinancing, acquisitions or new construction.	With some exceptions, is limited to rental projects—very modest entrance fee levels only.	First mortgage lien on property, no financial covenants.
Once issued, borrower's exposure is not influenced by market collapse/change. – Low interest rates – Can be fixed or variable rate debt	Very limited acceptance of SNF (<10% of total campus bed/units), so often combined with FHA for multi level campuses.	Market appraisal by third party determines maximum insurable mortgage of 80% loan to value (with 85% allowed for exceptional nonprofit properties when tax exempt bond debt is used).
100% non recourse.	10 year term reset.	Allowance of mark to market appraising of cash flow often increases appraised values.
Underwriting driven by cash flow, not balance sheet so allows excess cash >1.35 1.4x debt service coverage to be up streamed to parent.	Applicant needs to own at least five facilities to qualify.	Market oriented expense to revenue ratios of 85% (SNF), 65 68% (AL), and 70% (dementia) are allowed compared to 90% actual ratios in many nonprofits.
Credit enhancement is "pay as you go."		
Can be used in combination with FHA to free balance sheet cash for acquisitions or to provide bank support.		Requires separate and distinct lot subdivisions for each mortgage.

Source: Cain Brothers Analysis.

## BANK LOCs ARE HARDER TO OBTAIN AND RENEW

### CHALLENGES

Many senior living facilities financed replacement or expansion projects using VRDBs backed by bank LOCs. Organizations seeking to renew those LOCs are finding that in some cases renewals are not forthcoming. In virtually all cases, renewals, when available, are obtained at significantly higher prices, shorter renewal periods, and with more onerous covenants. A very high percentage of banks are renewing LOCs for only one year and using higher pricing to create disincentives for the borrower to remain with the bank.

Those banks that are willing to renew LOCs will often not do them on the same terms as in the original agreement. While an organization might have obtained a LOC with a 40% cash to debt ratio in the past, banks are now often looking for as much as 50+% cash to debt before issuing the LOC. Banks are also often limiting any renewals with lower total credit thresholds than in the past. An organization that previously obtained a LOC for \$40-\$50 million may be limited to \$35 million today due to blanket bank limitations. Declining campus valuations can also create credit threshold problems. For example, a lower campus valuation may increase loan to value levels from the previous 65%-75% level to as high as 85%-90%, a full 10%-15% over most bank's limits. Senior living organizations that cannot qualify for a bank LOC under these more conservative credit standards need new financing structures.

### SOLUTIONS

#### ► *Federal Home Loan Bank Wraps*

Even though bank LOC renewals are difficult to obtain in the current market, when available, overall debt costs using a variable rate structure are still low. With variable rate debt at historic lows, all in costs for senior living debt issuers using this structure can be as low as 5%, even including the cost of interest rate management tools such as swaps, caps, or collars, and considering that the price of LOCs has risen from previous rates of 1-1.5% to 2-3% today. Financing options that reposition the balance sheet with higher cash to debt and a smaller loan amount requiring a LOC can permit the organization to take advantage of this low cost financing for part of its capital structure.

Refinancing using VRDBs secured by a bank LOC and fixing the interest rate with a fixed payer swap has the advantage of creating low cost fixed rate financing, when it can be done. However, organizations should be aware that typical LOC maturity terms have declined from 5-7 years to 1-3 years, so renewal risk is now greater in this structure and exposes the swap to termination risk should no substitute letter of credit provider be found.

With national bank LOC providers hard to find, some senior living organizations may have solid banking relationships with local community banks that are willing to write a LOC but which may not be rated or have the minimum credit ratings that tax exempt money market funds require in order to invest in the underlying VRDBs. In 2008, the IRS gave the Federal Home Loan Bank (FHLB) expanded powers to "wrap" or guarantee the underlying LOCs of their member banks used to enhance tax exempt VRDBs. These wrap fees are quite affordable at 0.1%-0.2%, and the wraps allow the rating of the VRDBs to meet the requirements of the tax exempt money market funds for investment. Despite the FHLB wrap, first dollar risk remains with the local community bank, so local bank participants will undertake extensive due diligence before committing to the program. Activity in these wraps has been increasing, with most FHLB deals remaining under \$20 million due to the risk concentration assumed by the local bank. Local banks will expect

commercial business in exchange for assuming the risk, so this option may be somewhat limited because the preponderance of commercial business may have been given to the primary bank LOC writer. However, because of the local nature of secondary banking relationships, local banks may be satisfied with receiving priority exposure to campus residents and/or feel that providing such secondary LOC commitments helps them gain favor with wealthy or otherwise influential individuals on the nonprofit's board of trustees.

► ***FHA Mortgage Insurance***

The use of FHA mortgage insurance (described in the previous section) to reduce the LOCs required in the overall refinancing may also be possible. Through the use of a new or affiliated LLC or fully controlled nonprofit corporation, a single asset financing entity may be set up in order to acquire and hold the SNF and AL portions of the project. The acquisition would be financed via the FHA 232 program.

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## DEBT LEVELS ARE NOT AFFORDABLE

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### CHALLENGES

Trustees of senior living organizations facing financial stress must make decisions that are in the best financial interest of all parties. In some cases, that requires the trustees to approach lenders for debt relief and/or restructuring. This process is a negotiation. Banks, bond holders, and other creditors will not generally agree to restructure any debt unless they believe it is in their best interests to do so and that all opportunities for bottom line profitability enhancement have been exhausted.

The needs and perspectives of investors in the organization's debt should be considered when outside advisors are engaged. Institutional investors, for example, will be concerned about potential historic conflicts of interest with other debt holders on the part of outside advisors and will want to be comfortable about an advisor's objectivity. Different kinds of creditors, which can include banks, bond funds, institutional investors, retail investors, interest rate swap counterparties, and vendors all have different interests and motivations. Investors and creditors need to be assured that the advisor representing the senior living organization will not favor one class of creditor over another based on historic relationships and current and ongoing self interests.

When financing and/or occupancy covenants have been violated, the organization may be required to bring in operational consultants. The most important aspect of that engagement is that all of the original assumptions for operations and marketing need to be put on the table for discussion. While the natural instinct may be to engage the original feasibility consultants for this operational review, time and effort can be wasted if those original feasibility consultants try to justify why their original five year projections were not achieved.

Hiring expert operational consultants is a critical and necessary self examination activity. A thorough and exhaustive review of all operating and marketing assumptions is a vital first step for any organization contemplating asking lenders for any debt restructuring relief. The borrower must be able to demonstrate that it has maximized all sources of revenue and reduced all operating expenses to minimum levels to ensure maximum EBITDA. Most troubled organizations will benefit by hiring an experienced outside advisor to help management prepare for those challenging outside operational assessments. The organization will benefit if it can spot in advance its likely operational

vulnerabilities. An advisor can then work with management to obtain third party validation of new corrective operational approaches identified as part of its self assessment. The expert and the debtor may then be able to package a corrective plan that remedies lender covenant violations.

Such self examination cannot be limited to only those profit opportunities that fit within a borrower's comfort zone. Examples could include the outsourcing of support services areas that had a history of inefficient operations. A traditional CCRC with an attractive SNF, but with a long stay convalescent care orientation might have to consider the outsourcing of the management of its SNF to an experienced short stay rehabilitative care operator in order for the campus to generate greater profitability out of that space. Of course, in that example the organization would need to retain sufficient longer stay beds to honor its CCRC commitments.

In cases of extreme duress, the executive director might need to replace administrative staff with management company support if the resulting product produced quality care and service at a lower operational price point. Extraordinary one time rate increases, program diversification and even management or marketing department outsourcing all need to be on the table for serious consideration in order to convince a lender of the seriousness of the borrower's motivations and debt restructuring needs.

One element that cannot be compromised is the need for the campus to fully fund capital replacement costs going forward prior to debt service. A campus with a deteriorating appearance will have trouble attracting residents, which only makes all debt service financing that much harder to achieve. Facilities suffering from declining profitability should have a third party undertake a long term capital replacement study so as to establish an objective baseline for capital replacement funding for cash flow protection and negotiations with their lenders.

## SOLUTIONS

When organizations cannot meet the debt service for VRDBs and LOC terms, restructuring options include reducing swap rates by lowering interest rates and extending terms and reducing LOC fees. Changes to loan amortization can include suspending amortization of the debt through interest only payments for a short period (1-3 years) as a temporary cash flow strategy and extending the amortization term of the loan. Finally, restructuring can include actual debt reduction and/or forgiveness.

For fixed rate debt, options can include interest rate reduction, debt reduction, principal deferral, or re-amortizing the debt back to its original 30 year term or even further to a full 35 to 40 year period. Obviously, any such amortization extension must be contemplated in close cooperation with bond counsel to make sure it complies with all IRS regulations.

Most creditors will resist debt reduction/restructuring requests and only consider such options as last resorts, so borrowers must be persistent and establish a formal record of seeking such relief. Creditors will want to see that the organization has first restructured operations, doing the hard things to optimize revenues and right size expenses. Key debt restructuring negotiating principles include:

- Any solution must allow for sufficient annual capital replacement funds to keep the campus marketable.
- Transparency and honesty should guide all operational improvement suggestions and evaluations. The organization must offer to pay what it can afford, even if it

might mean outsourcing certain operational functions to achieve lower cost service delivery and/or aggressive program diversification to raise new revenues.

- In cases where more than 10% of debt is held in retail hands, the original underwriter tends to have conflicts, so it is good to consider an independent advisor to serve as the project's new underwriter/debt restructuring agent.
- Having take out strategies such as FHA/Fannie Mae or even bank LOC commitments incentivizes existing debt holders to reach agreement as bondholders have learned that many "halfway" negotiated restructurings tend to return a few years later. There are times when debt levels are simply too great, and donors can be found to help reduce a campus' overall debt levels. With donor commitments in hand, it may be possible to bring even today's reluctant LOC banks to the table to help restructure and refinance a troubled credit. However, typically donors don't want to provide grants unless they are part of an overall debt restructuring plan where debt levels are brought down to manageable levels.
- Keep regulators and the state's Attorney General (AG) informed. An AG will not want to first learn of financial troubles at a community in the newspaper, and an AG may advocate on behalf of the organization's residents. Some state CCRC regulators may actually intervene in creditor/debtor negotiations as advocates for the residents, forcing all parties to take the tough decisions required to protect the resident's entry fee investments.

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## LOW INTEREST RATES LEAD TO MANY SWAP CONTRACTS BEING SIGNIFICANTLY "UNDER WATER"

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### CHALLENGES

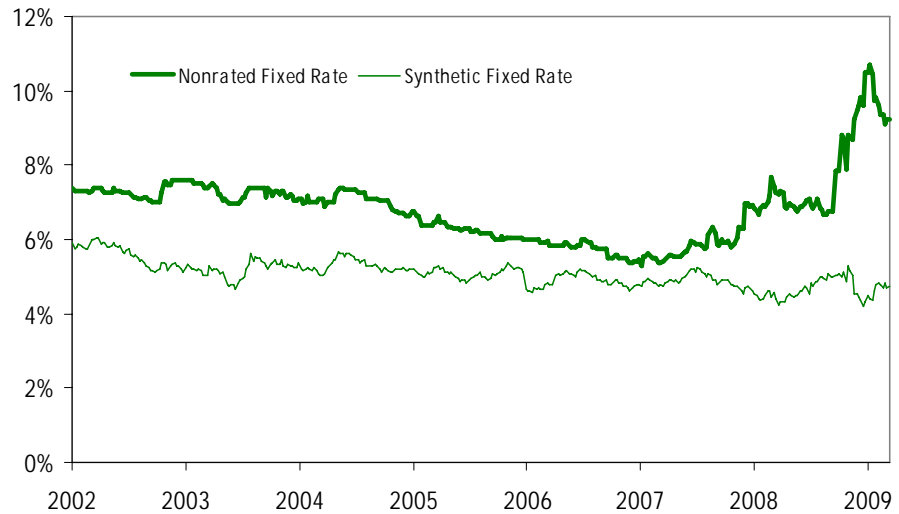
During the past decade, synthetic debt, which typically involves utilization of interest rate swaps to "synthetically" turn a variable rate borrowing into a fixed rate borrowing, became an important part of the capital structure of many senior living organizations. While an alternative financing option for many of these organizations in the past may have been to issue tax exempt fixed rate bonds, the cost of debt service for lower rated or nonrated bonds of this type often made project feasibility difficult or impossible. As a result, many senior living organizations instead issued VRDBs backed by bank LOCs. The LOCs increased the credit quality of the bonds and enabled the borrower to access low cost variable rate debt. However, since neither the banks issuing the LOCs nor the organizations issuing the debt wanted to be subject to the risk of the variable rate rising to unacceptable levels over time, an interest rate risk management tool was added to the capital structure to mitigate that risk.

Most senior living organizations used fixed pay interest rate swaps to manage the interest rate risk. They negotiated with a counterparty to pay a fixed interest rate and in exchange receive a variable rate, usually indexed to SIFMA or a percentage of a LIBOR.<sup>4</sup> As illustrated in Figure 10, the result of this structure was to create a synthetic fixed rate borrowing with an overall cost of capital as much as 2% lower than was often available with natural fixed rate debt. Many organizations were able to proceed with otherwise infeasible capital expansion or replacement because they chose the synthetic debt capital structure.

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<sup>4</sup> The Securities Industry and Financial Markets Association Municipal Swap Index (SIFMA) is a short term index that reflects tax exempt interest rates in the VRDB market. The London Interbank Offered Rate (LIBOR) is a short term index that reflects the interest rates at which banks borrow unsecured funds from banks in the London wholesale money market and reflects rates in the variable rate taxable market. Both SFMA and LIBOR serve as benchmarks on which the floating rate components of swap contracts are based. The floating rate portion of a swap contract is typically based on SIFMA (an average of short term tax exempt rates) or a percentage of LIBOR.

FIGURE 10. Synthetic Fixed Rate Debt Historically Cheaper Than Nonrated Fixed Rate Debt



Source: Cain Brothers Analysis. Nonrated fixed rates are for tax exempt 20 year issues that include hospitals. Swap rates assume 67% of LIBOR, a spread and LOC charge.

Fixed pay interest rate swap contracts where the borrower pays fixed and receives variable have a market value that fluctuates as interest rates move up or down. In the current environment the market value of these interest rate swaps has fallen significantly, as long term swap rates have decreased significantly from when the swaps were written. Short term interest rates are at all time lows, which reduces the swap payments received and, therefore, increases the cash payments that the borrower has to make. However, this cash flow effect is offset by lower interest paid on the actual variable rate bonds.

The terms of some swap contracts require the borrower to post collateral for the benefit of the swap counterparty, when the swap's market value falls below a certain threshold or the credit rating of the counterparty is downgraded. Posting collateral eliminates the borrower's ability to use the posted assets for other purposes and deducts the posted amount from liquidity covenant calculations, such as days cash on hand.

The periodic changes in market value of the interest rate swap also has to flow through the income statement of the borrower, although hedge accounting may allow the organization to move the loss recognition to a more acceptable place within the statement of changes in net assets. Lower swap market value will decrease net assets on the balance sheet, and this will sometimes trigger credit worthiness deterioration termination provisions in bond or swap contracts.

Many organizations that competitively bid their swaps, however, were able to exclude specific credit deterioration triggers and collateral posting requirements. Even when they are under water, therefore, these swaps can continue to serve their original hedging purpose against the variable rate debt and, if the organization can keep them in place for the life of the swap, they will eventually mature with a zero market value.

In addition to the market value related problems of swaps, underwater fixed pay interest rate swaps have become problematic for many senior living organizations that otherwise are in financially solid shape, because the organization needs to make a

change to the underlying variable rate debt structure the swap was originally designed to hedge against. As described on page 13 of this white paper, this is often because renewing LOCs is difficult today. Organizations that might consider switching to direct fixed rate financing will have to deal with either terminating the no longer needed swap contract at a significant loss or leave the swap outstanding with a negative monthly carry cost as high as 3% in the current market.

## SOLUTIONS

Solutions to interest rate swap challenges will be driven by the circumstances of the senior living borrower, the particular terms of the swap contract, the interests of the existing and/or new swap counterparties, and the overall interest rate environment. We recommend the engagement of an independent financial advisor with both derivatives and senior living experience to evaluate the current situation and identify potential solutions.

A fixed rate term out that converts the underwater position in the swap to long term debt can be a powerful solution for borrowers that can access the fixed rate market and where the interest rate swap was integrated for tax purposes into the original financing structure. If the swap was integrated into the original structure when the debt was issued, the cost of terminating the swap is a qualifying cost for refunding purposes. In that case, any termination payment can be financed in a new tax exempt issue, and the borrower will not have to use other scarce cash assets to terminate the swap

For “orphaned swaps,” (i.e., swaps that remain outstanding but are no longer serving hedge purposes) there are a number of potential structural solutions available to mitigate the borrower’s negative cash flow position. Every potential solution will be circumstance driven, but among possibilities worth investigating are the following:

- Eliminate the fixed rate leg of the swap by converting to a basis swap. An example would be to pay SIFMA and receive a percentage of LIBOR that keeps the market value of the swap the same. The result is a swap with two variable legs and a cash flow position that is better than leaving the fixed rate leg outstanding.
- Leave the original swap in place with its negative carrying costs and
  - Sell an option to the counterparty to cancel the swap for a period of time (say, for example, for two years). Use the proceeds of the option to reduce the negative carrying costs on the orphan swap. Counterparties do not normally have the right to cancel a swap contract, so they will pay for the option. Meanwhile, the borrower hopes that interest rates will rise to the point where the counterparty will want to exercise its new right to cancel the swap. The offsetting consideration is that if interest rates do indeed rise, the borrower will have sold the swap’s potential upside market value.
  - Delay the effective date of the swap and create temporary cash flow relief by pursuing one or a combination of the following:
    - Extending the swap maturity and/or
    - Increasing the fixed pay rate.
  - Pay cash to buy out (terminate) part of the swap.

An experienced, independent advisor will be able to help borrowers consider alternatives that fit the borrower’s circumstances.

**EXTERNAL PRESSURES LEAD SPONSORS/OPERATORS TO CONSIDER SELLING OR JOINT VENTURING FACILITIES**

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**CHALLENGES**

Hospital based health systems around the U.S. are postponing capital expenditures, initiating layoffs, and evaluating overall capital and operating priorities in response to the current financial crisis. The senior care component of a hospital or health system may not be performing up to expectations, and the system may want to make a change due to the negative impact that the senior care component has on the system's obligated group's balance sheet and overall financial performance. Required subsidies from the system that have been tolerated in the past may now be brought into question. Independent operators of senior living facilities that are facing financial pressure and/or debt refinancing challenges may not have attractive debt restructuring options for one or more of their troubled facilities. Organizations in these kinds of situations have begun to consider whether the mission of the overall organization could best be served by a merger, off balance sheet financing, or sale of these facilities.

**SOLUTIONS**

Nonprofit hospital systems considering sale or merger of their underperforming senior living component will find some limitations on potential nonprofit acquirers. Most strong nonprofit senior living providers seeking merger and acquisition candidates tend to limit their acquisition pricing to what they can afford assuming 95% to 100% loan to value financing. This is in marked contrast to the for profit sector where acquirers assume they will invest as much as 20% to 25% equity or mezzanine debt into a deal. For profit acquirers are therefore often able to out bid their nonprofit competitors. This is the reason that most troubled nonprofit senior living organizations have found themselves acquired by for profit firms when forced into bankruptcy.

While local or regional market dynamics may create particular opportunities for some organizations, a merger or acquisition that simply transfers the ownership of an unprofitable facility rarely makes sense. On the other hand, a merger or acquisition involving a financially stressed project can make sense in the context of all parties working to modify the debt so that the project can support it. Most acquisitions, therefore, need to be structured as part of a "take out" strategy as a condition of the merger. In this approach, current creditors agree to either reduce debt levels or restructure debt to more attractive and affordable levels and the acquiring entity agrees to take on the new debt obligations.

If the merger or acquisition results in a stronger borrower as the owner, creditors may be more willing to restructure debt costs in the belief that the new borrower will be less likely to return to the table for future debt relief. Because of the stronger balance sheet an acquirer might bring to such a transaction, it may be able to give comfort to existing lenders that the restructuring is a one time reduction or to reach out to cheaper "take out" financing sources through the provision of secondary debt guarantees.

A potential acquirer of a troubled senior living organization will attempt to calculate a debt level that can be sustained with either available replacement financing or through restructuring debt. Acquisitions of this type are complicated because they combine elements of both debt structuring with creditors and a merger/acquisition. This type of transaction may be accepted by creditors because they believe that the nonprofit acquirer will be able to reduce upper and middle management operating costs. Examples from other health care areas suggest such savings are best realized when identified and agreed upon by the parties prior to the mergers.

## CONCLUSION

Trustees and executives of many senior living organizations today are rightly focusing on the significant challenges caused by the simultaneous material declines in the housing and stock markets and the liquidity crisis in the debt market. These challenges include the current high cost of tax exempt fixed rate debt, increased operating costs, more stringent credit criteria for obtaining bank LOCs, low levels of investment earnings leading to unaffordable levels of funded interest during construction, underwater swap contracts, and financial pressures on hospital based health systems that impact financial expectations about any senior care operations. Daunting as these challenges may seem, organizations that act swiftly and thoughtfully to make proactive changes in recognition of their changed circumstances will be in the best position to survive and continue to meet the needs of their residents over the long term. The earlier an organization can identify the causes of its financial stress and begin to take appropriate action, the more options it will have to implement operating and capital structure changes that are consistent with the organization's mission.

## CAIN BROTHERS 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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