Planning For & Financing Major Capital Projects in a World of Risk & Uncertainty

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LarsonAllen LLP
CPAs, Consultants & Advisors

Learning Objectives

At the end of this session, you will be able to:

- Identify recent trends in capital markets
- Have alternative strategies for building capital and debt capacity

Overview

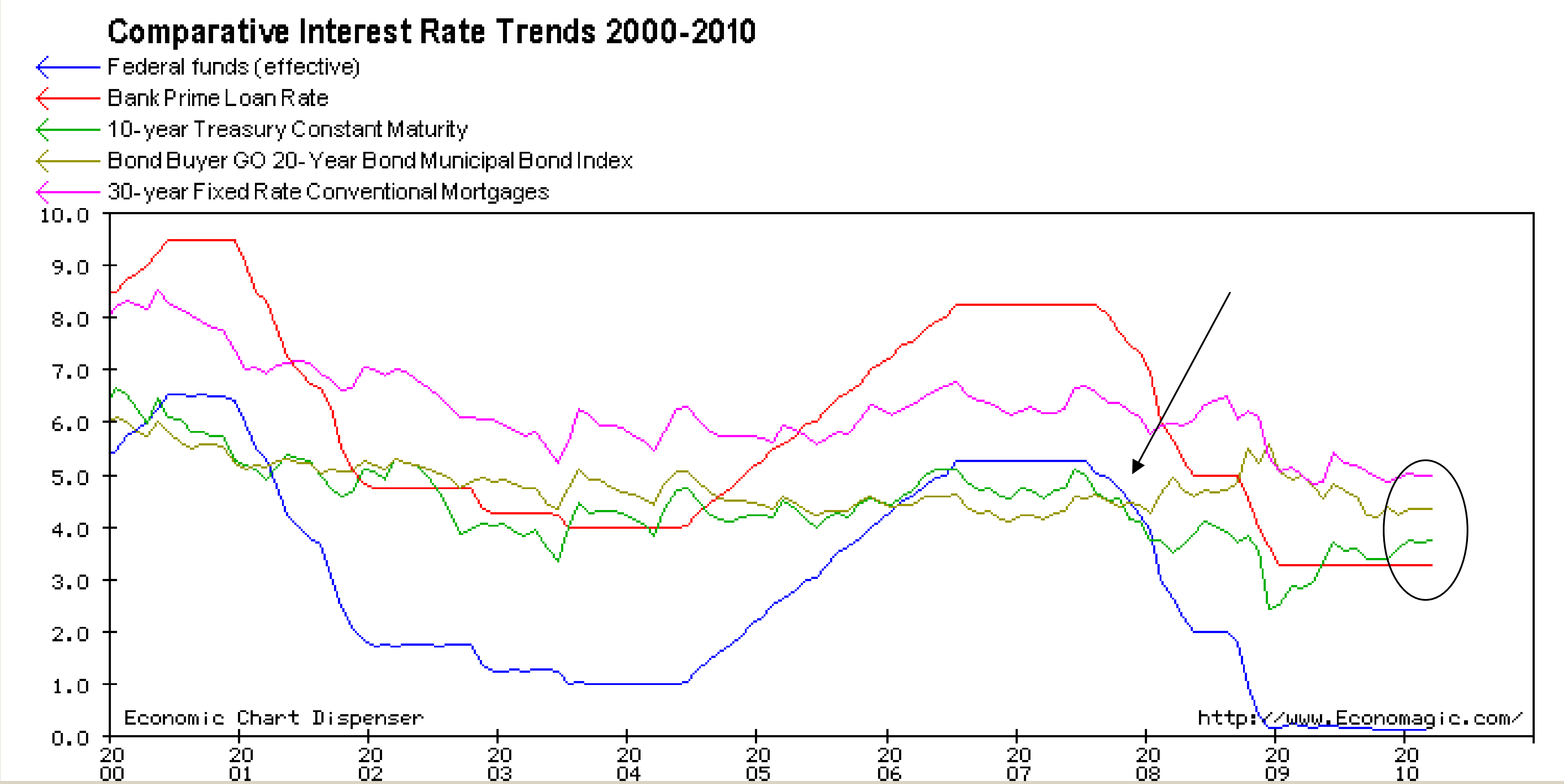
- Historical Perspective: Back from the Edge
- Understanding Risk: Developing a Credit Story
- Finance Fundamentals
- Pre-Project Planning
- Developing a Plan of Finance
- Financing Team Resources

A Few Lessons Learned 2008-2010

- Markets are connected and inter-dependent
- Question more!
- Governance role: understand financing risk to the organization
- Bubbles will pop
- Don’t overreact!
- Prepare for multiple scenarios
- If it sounds to good to be true, it likely is too good to be true (understand your risk!)

Historical Interest Rate Trends

- Tax-exempt trending back to pre-2008 levels
- Treasuries rates reflect “flight to quality”



NOTICEABLY **DIFFERENT**

Funds Flow Impacts Capital Access

- Investors are getting tired of 0% return in money markets and have been moving funds back into BOND FUNDS; how long will they accept lower yields as stock market continues to stabilize?

- Key trend to watch: interest rates and risk tolerance!

Estimated Net Flows $Mil	March 2010	Q1 2010	2009
U.S. Stock	1,316	1,600	(25,748)
International Stock	6,642	19,725	25,532
Balanced	1,372	6,153	(3,290)
Taxable Bond	31,731	74,540	284,465
Municipal Bond	3,905	14,002	72,123
Alternative	1,485	6,120	14,103
Commodities	1,080	3,091	10,224
All Long Term	**47,530**	**125,230**	**377,409**
Money Market	(148,182)	(324,362)	(378,362)

Source: Morningstar Direct Fund Flows

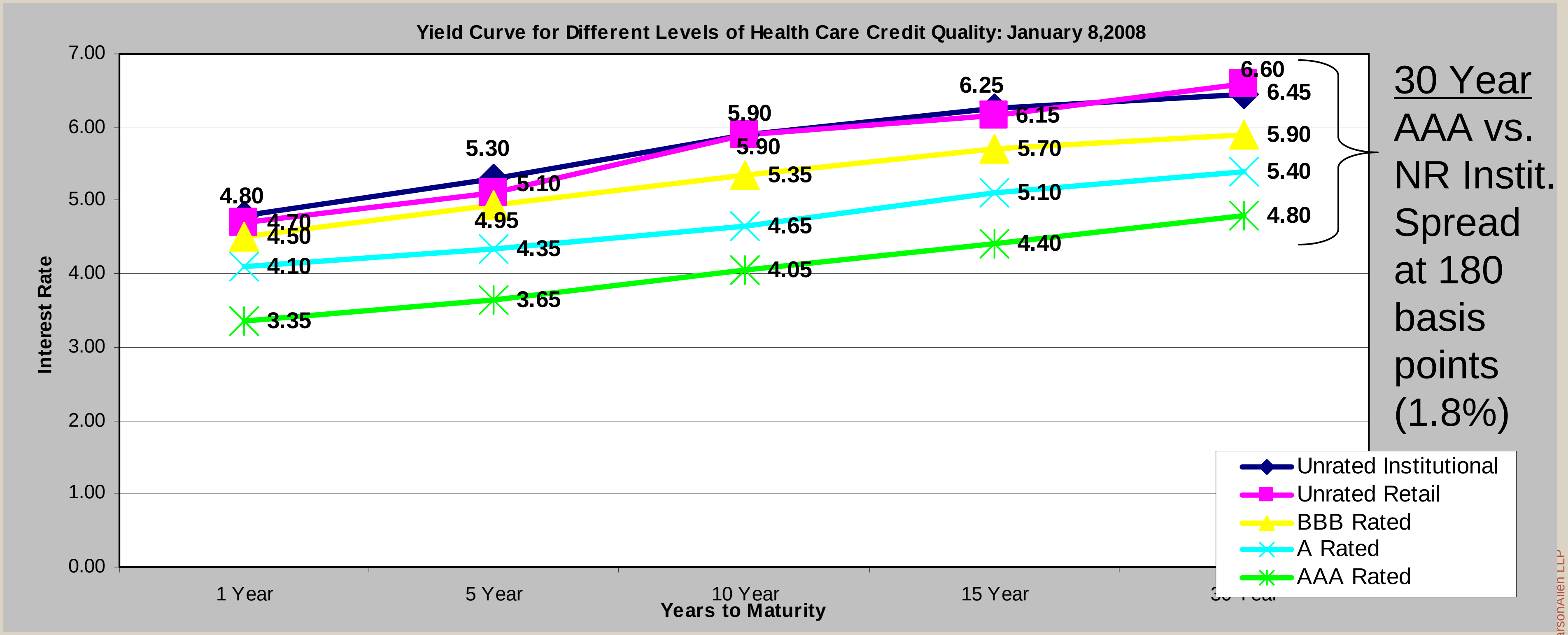
Significant outflows from money markets!

NOTICEABLY **DIFFERENT**

1/08 Rate Snapshot: "Early Signs of Trouble"

Sub-Prime Fallout: Fourth Quarter 2007 bond investor "Flight to Quality"

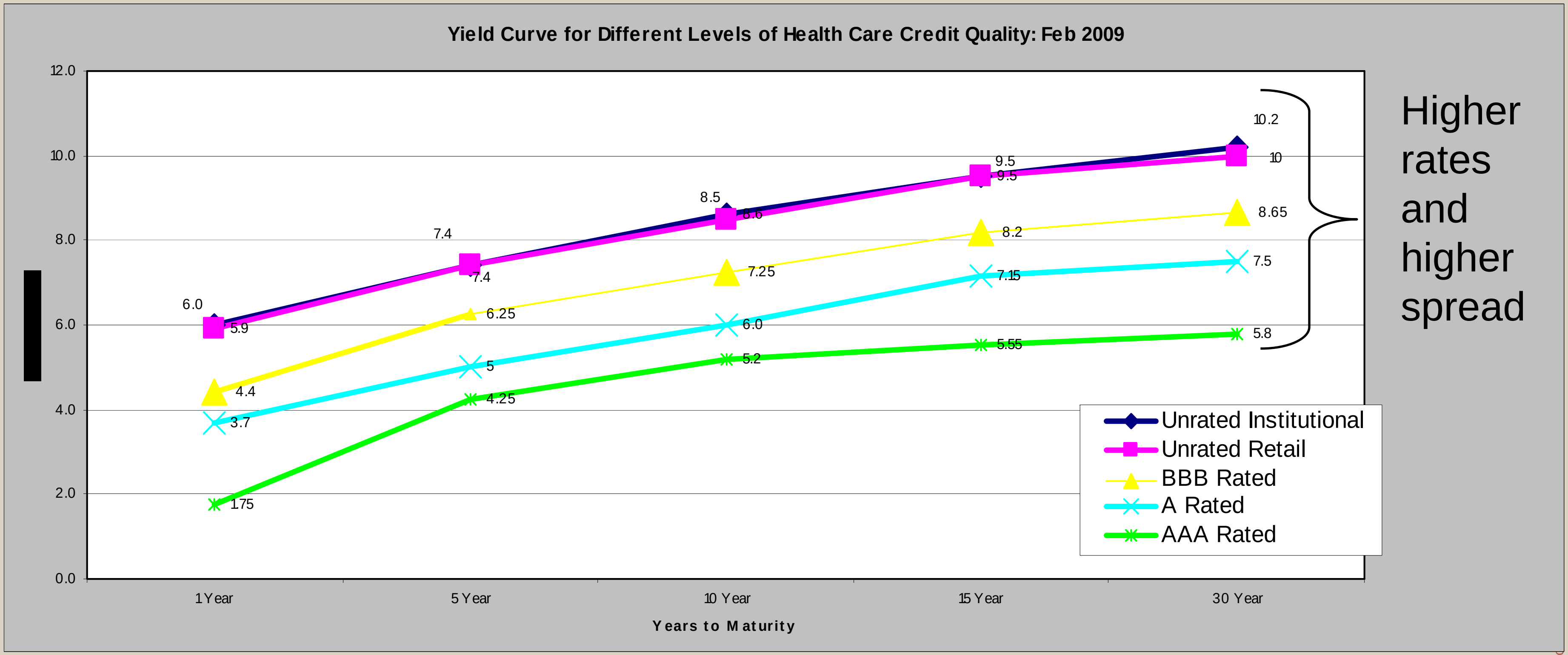
- Spread on 30 year AAA vs Unrated has widened to 1.8% versus .84% spread in May 2007



Source: Ziegler Securities: Weekly Interest Rate Pricings January 8, 2008

Interest Rate Comparison: February 2009

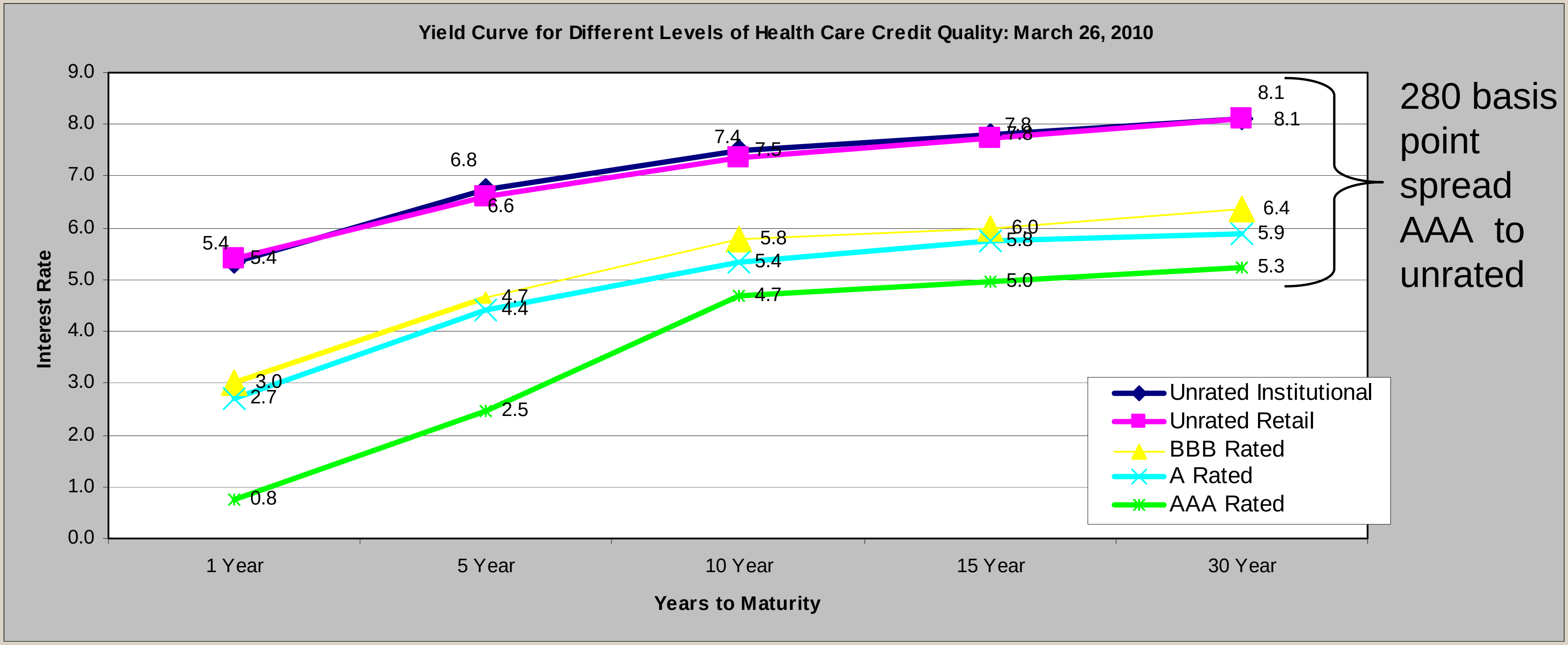
- Growing concern regarding access to capital for lower quality credits
- Spread between short term and long term rates widened
- Financing projects economically un-obtainable for unrated credits



Source: Ziegler Securities: Weekly Interest Rate Pricings

Moving Back: Narrowing Spread & Risk Premium

Economic recovery pace, future inflation fears, and bond fund outflows likely to impact future interest rates



Source: Ziegler Securities: Weekly Interest Rate Pricings

Yield Curve Impacts Affordable Rates

As the spread between short and long term rates increased in 2009, more borrowers moved to structure shorter term resets or maturities to access capital at affordable levels

Spread Comparison: 5 vs. 30 Year Tax Exempt Rates

	Jan-08	Feb-09	Mar-10
Credit Level			
Unrated	1.5	2.6	1.5
A	1.05	2.5	1.5
AAA	1.15	1.6	2.8

Source: Ziegler Securities: Weekly Interest Rate Pricings

Risk Tolerance

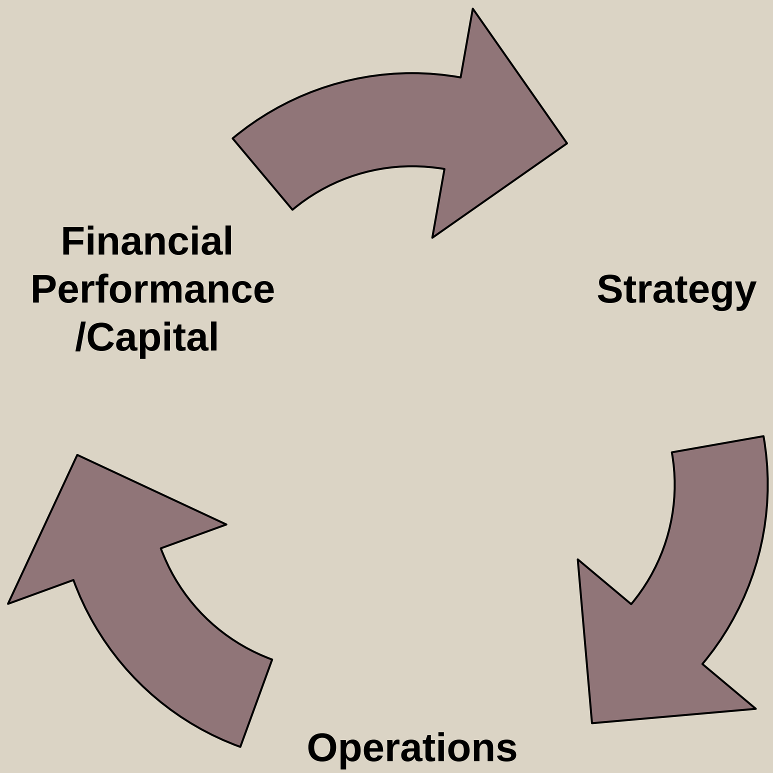
- Various dimensions of risk to assess and evaluate:
  - Macro economic factors
  - Industry
  - Market
  - Governance
  - Leadership
  - Access to capital

Important: Lender/investor perspectives may be highly variable based on current perceptions and regulatory environment

- Strategic planning that links capital and performance is a critical component to fueling future growth and increasing capital capacity!

Planning Cycle: Focus and Align Resources

Payor Mix
Service Line
Mix
Profitability
Strategic Invest.
Routine Capital
Cost of Capital
Debt
Partners
Investment Inc
Philanthropy



Market
Payors
Clinical Services
Work force
Partners
Competitors

Care Models
Facility Distribution
Productivity
Workforce Development
Per Unit Cost
Clinical /Service Quality

- Strategies tied to Plan goals and objectives…
- Require implementation success at the operating level…
- To generate capital to support ongoing and future strategic investment

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Major Components of Credit Story

Health Care Example:

- Market
- Competitors
- Medical Staff
- Volume Trends
- Financial Performance
- Management
- Governance
- Valuation (depends on security)

Emphasize both historical trends and future projections as a way to demonstrate organization's ability to implement its plans

Recommended sources for additional background:

- Rating agency credit criteria reports and special credit reports (Moody's, Standard and Poor's, Fitch Investors Service)

Set Financial Targets to Define Debt Affordability

- Typically weighting Income Statement and Balance Sheet metrics to assess comprehensive view of performance
- Key Metrics:
  - ✓ Debt Service Coverage (Annual EBIDA/Max. Annual Debt Service)
  - ✓ Annual Debt Service % of Operating Revenues
  - ✓ Cash to Debt (Cash and unrestricted investments/LTD)
  - ✓ Debt to Capitalization (LTD/(LTD plus Unrestricted Net Assets)
- Alternative Scenarios to Test Range of Comfort:
  - ✓ Historical (last one or average two years)
  - ✓ Current Year actual or budget
  - ✓ Plan impacts (one year after completion of construction)
- Credible and realistic planning assumptions are key element to telling your credit story!!

Performance: Building Blocks

- Base Year Performance

  (Audited FYE or BYE)

  PLUS
- Environmental Assumptions

  PLUS
- Strategy Impact (Management Action)
  - Market Strategies: (new services, payor mix)
  - Growth (population)
  - Margin on Growth
  - Improvements on Core Operations

  PLUS
- Current Capital Commitments
- Additional Strategic Investments
  - Capital, Programmatic

Five Year Strategic Financial Plan

Assumptions Drive Expectations

"Typical" Assumption Range by Planners

No Growth

History Repeats Itself

Initiatives Driving Volume

New Initiatives Market will Respond

It's all ours for the taking

Never Consider

Marginal Growth

Market Speaks for Itself

New Initiatives to Drive New Volume

New Initiatives / New Markets

← Conservative →

← Moderate →

← Aggressive →

Doomsday Scenarios

Tangible Negative; Ability to Impact

Clearly Achievable Plan

Plan in place, Variables in Control

New Territory

Tangible Negative; inability to impact

Demonstrated Success Underway

Plan in Place, Success

Plan in Place; Limited Control

Wishful Thinking

Appropriate Assumption Range for Financing

Capital Financing Sources

- Operating and Non-Operating Income
- Debt
- Equity
  - Partnerships
  - Joint Ventures
  - Philanthropy
- Capital Partners: Developers, REITS, Strategic Partner, etc..

Financing Fundamentals: Debt

- Direct Loans
  - Banks (Typically Asset Focus on Credit Review)
  - Finance Cos. (Asset Focus)
  - Mortgage Brokers
  - State Loan Funds
  - Loan Programs (USDA Community Facilities)
- Grants/ Programs
  - Rural Development Programs
  - Rural Electric Co-ops

Financing Fundamentals

- **Tax Exempt Bonds/Leases:** issued by municipality (state, city, county, hospital district); subject to federal and state tax law
  - General Obligation: taxing power secures payment, municipality
  - Revenue: secured by revenues of project, mortgage may be required, use municipal conduit for issuance
  - Dbl Barrel Bonds: combination of both
  - Bank Qualified: borrower issues < $30 M per year (sunset 2010)

- **Taxable Bonds/Leases:** Build America Bonds, bank loans

Financing Fundamentals

- **Type of Bond Sale**
  - Negotiated vs. Competitively Bid
    - ◊ Timing of underwriter selection
    - ◊ Pricing the bonds (pricing and interest rates)
    - ◊ Fees
  - Public Offering vs. Institutional Sale (Private Placement)
    - ◊ Broad market exposure vs. selected group views capital request
    - ◊ Disclosure implications
    - ◊ Credit requirements and loan terms and conditions may differ
- **Type of Credit: enhanced or own credit**

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Plan of Finance

Fixed Rate Bonds

Advantages	Disadvantages
No Interest Rate Risk	• Higher Interest Expense
Budget Certainty	• Longer Time to Call Bonds
No Liquidity Facility	• Lack of Flexibility
Lower Financing Costs	

Variable Rate Bonds

Advantages	Disadvantages
• Financial Flexibility	• Interest Rate Risk
• Lower Cost of Capital	• Budgeting Uncertainty
• Pricing Efficiency	• Future Credit Risk
• Ability to Convert to Fixed Rates	• Higher Financing Costs
	• LOC Renewal Risk*

* Variable Rate Demand Bonds (VRDB) require highly rated credit

Scenario: Fixed vs Variable Rate

Bank: 4.75% seven years, reset cap 1.5%
Amortization 25 years
Loan to Value 80%

Bond: 7.75%
Amortization 28 years
Reserve Fund
Capitalized Interest Higher

	Bank	Bond
MADS	$2.2M,$2.5,$2.7,$2.8	$3.6M
Initial Equity	$6.0M	$3.0M
All In Yield	5.9%	8.0%

Developing a Plan of Finance

1. Define project affordability based on specific target financial metrics and current capital markets parameters
2. Use strategic capital plan to drive project scope and establish parameters for design team
3. Develop project timeline to incorporate approvals, construction, regulatory requirements, financing process
4. Clarify board risk tolerance for fixed and variable rate alternatives
5. Within 8-12 months of construction start date, contact lending sources to evaluate credit perspective; develop alternatives for Plan of Finance for review and approval
6. Define (estimates or term sheet) credit terms including rate, rate adjustment provisions, payment terms, security features, covenants, default terms
7. Execute the plan to coincide with construction start

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Developing a Plan of Finance

Alternative Security Features: mortgage, pledge of gross or net revenues, pledge of foundation assets, Obligated Group pledge

Covenants: Rate, additional debt, transfer of assets, merger, insurance, liquidity, debt to capitalization

Default Provisions: management consultant report required, requirement to correct the problem, lender's rights if not a payment default

Interest rate: fixed or variable, reset timing, index, spread to index, cap on reset

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Financing Team Resources

- Financial Advisor:
  - ✓ Independent advisor to the process & key support to CEO / CFO
- Accountant:
  - ✓ Independent advisor and support for disclosure materials
- ✓ Regional / Local Banker:
  - ✓ Often historic relationship/typically expects additional business from lending relationship
- Placement Agent:
  - ✓ Acts as agent to the borrower / solicits multiple lenders
- Mortgage Banker:
  - ✓ Access to HUD programs
- Underwriter:
  - ✓ Access to banks, capital markets for debt sale/ may take underwriting risk to complete transaction

Recommendations

1. Incorporate future risk and volatility in cost of capital by adopting conservative assumptions related to future plans and projections

   “Plan to outperform the Plan”

2. Anticipate future capital sources and uses with enough time to establish and achieve performance levels on critical benchmarks before adding new debt

3. Build the financial literacy of senior management team and board; understanding capital options and impacts is not a topic that should be limited to the CFO or finance committee

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