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Finding Financing for Seismic Retrofit Projects

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Whether the California seismic retrofit mandate looms imminently or stands unthreateningly in the future depends on the applicable implementation dates and your facilities' specific needs. But whether the deadline is 2013, 2015, or 2030, project planning can take years, and financing can take from mere months to years depending on the hospital plan's development and the capital markets. And regardless of whether hospitals must meet the seismic standards immediately, they still require periodic capital infusions along the way.

A recent California Hospital Association survey taken during the credit crunch indicated that over two-thirds of California hospital CFOs saw continued deterioration in their ability to access sufficient capital. Complicating matters, several temporary hospital financing options created or modified by the American Recovery and Reinvestment Act expired after 2010, leaving hospitals with yet another shift in the financing landscape that requires re-examination of available financing alternatives.

Where, then, to turn in 2011?

Investigate Internal Resources

Very strong, credit-agency-rated hospitals and systems may be able to issue debt on their own credit strength. The interest rate on these unenhanced bonds depends on the hospital's credit profile if the bonds are revenue-backed, and on the municipality's credit rating if they are backed by a district's general tax obligation. Hospitals that are part of strong systems may be able to rely on a system's guarantee to improve the interest rate on unenhanced debt.

Unenhanced bonds require no third-party enhancement fees, and rates are fixed. But very few unrated, unenhanced health care bonds have been issued in 2011. Investors are heavily scrutinizing the transactions that come to market. Practically, unenhanced bonds are available only to the strongest systems right now.

Look Locally

In 2011, most non-investment-grade hospitals will require credit enhancement to make interest rates affordable. Local banks can be an excellent resource. Their familiarity with the hospital's role in the community and their interest in its well-being may incent them to participate in a financing.

Strongly rated banks can provide letters of credit, which let the hospital borrow using the bank's credit rating. Many local community banks, however, may not have such a rating. Nonetheless, unrated or low-investment-grade banks may be able to provide such enhancement by having the Federal Home Loan Bank of San Francisco back up the bank's letter of credit. The FHLB option can be used only for taxable bonds, but it provides a low-cost enhancement

and AAA-rated debt.

Banks can also purchase bonds directly and may be willing to accept a lower interest rate than the general market. Small banks may not be able to purchase the entire bond amount, but the investment banker may be able to identify multiple banks to each buy a portion of larger debt issuances (generally required for financings over $15 million).

Designating bonds "bank-qualified" can further reduce interest costs. Banks can list the cost of buying and carrying these bonds as a tax deduction. In exchange, banks are generally willing to accept a lower interest rate. Only $10 million of bonds can be so designated by each issuer each calendar year, but hospitals may be able to phase projects over multiple years to take advantage of this structure.

Direct bank placements and bank-qualified bonds have limited public disclosure, flexible terms, and the option of drawing on the bonds in phases to avoid paying interest on the entire amount at once. They allow hospitals to capitalize on local relationships, but success depends on the community banks' strength and willingness to participate.

Go with the Government

Both the Federal Housing Administration and the U.S. Department of Agriculture offer hospital financing. The USDA Community Facilities Program and USDA Business & Industry Program can provide rural hospitals very low interest rates and amortizations of up to 40 years. The Community Facilities Program may be available only through 2011, however, as it is currently not included in the 2012 federal budget proposal.

FHA-insured hospital mortgages have been used in California only a few times recently, but HUD seeks to expand its insured base here. Becoming increasingly popular in the western states, FHA insurance offers some of the lowest fixed interest rates and most appealing terms in the market. The debt is rated AA or AAA, and the enhancement fee is a flat half-percent annually. The debt is also non-recourse to systems or affiliated entities.

In California we have a similar state program, Cal-Mortgage. The upfront premium is based on the hospital's credit strength, and the resultant tax-exempt bonds would carry the state's credit rating, currently A-. Over 500 health care facilities have issued $6 billion in Cal-Mortgage loans since 1972. Like an FHA-insured loan, Cal-Mortgage loans can have long lead times to closing, but they also have favorable fixed rates and up to 30-year amortizations.

Conclusion

Despite the recent market tumult, interest rates in general are still at some of their lowest levels in recent decades. Variable tax-exempt rates remain low, and while some lower-rated hospitals have issued fixed rate tax-exempt bonds at rates exceeding 8% in April, other hospitals have achieved fixed interest rates below 5% in the past 18 months via federal enhancement programs such as FHA and USDA.

While the Office of Statewide Health Planning and Development estimates that about half of California hospitals will benefit from the 2030 deadline associated with HAZUS reclassification, borrowers still facing the 2013 and 2015 retrofit deadlines need to proceed with planning and arranging financing to meet the structural integrity standards of the seismic retrofit mandate and ensure their hospitals can remain operational following an earthquake. In these situations, special consideration should be paid to incorporating flexibility into debt covenants, prepayment terms and penalties and other terms. The borrower may find that paying a higher interest rate is worth the benefit of future flexibility to refinance early.

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