PEARL CREEK
ADVISORS, LLC

Capital Formation for Senior Living - A Primer

Introduction

When pursuing debt financing, your capital formation strategy should focus on four primary objectives, each varying in importance. They include 1) *minimizing structure risk*, 2) *maximizing strategic flexibility*, 3) *minimizing borrowing costs* and 4) *maximizing certainty of execution*.

Non-profit organizations seeking debt financing have several options. Although other options are available, the two most common include **privately placed tax-exempt bank debt** ("Bank Debt') or **publicly issued tax-exempt bonds** ("Bond Debt"). The following outlines each and why most organizations incorporate both in a capital formation strategy.

Overview

Bank Debt - A large number of banks lend to the non-profit senior living space. And the number is increasing. With Bank Debt, the bank provides money directly to the borrower and is usually structured as variable interest rate debt. Interest rate swaps can be used to fix the interest rate. Bank Debt is not considered public securities.

Bond Debt - Although tax-exempt bond transactions can be quite large (over $1 billion), there is a robust market for small tax-exempt bond transactions (as small as $10 million), even for non-investment grade transactions. Issued in $5,000 denominations, Bond Debt, considered public securities, is sold to both retail (individuals) and institutional (tax-exempt mutual funds) investors. Unlike Bank Debt, an Offering Statement or Circular is required.

1) Minimizing Structure Risk

Under Bond Debt, the final maturity or amortization is usually 30 to 35 years with the intertest rate locked in for the entire length of the loan, thereby eliminating most structure risk. However, Bank Debt does introduce structure risk, including **Reset Risk, Interest Rate Risk and Tax Risk.**

Reset Risk - Although banks will allow long amortizations, up to 25 or 27 years, they are not willing to make long commitments. Therefore, Bank Debt must be renegotiated after 7 to 15 years, creating *"Reset Risk"* to the borrower. The date that the loan is renegotiated is known as the "reset date."

Interest Rate Risk - In addition, the interest rate on Bank Debt is usually variable, usually tied to a monthly index, which adds *"interest rate risk"* to the borrower. However, this can be mitigated up to the reset date with a variable-to-fixed interest rate swap, creating a "Synthetic" fixed interest rate. In addition, some banks are willing to offer a "natural" fixed interest rate. Usually, the natural fixed interest rate offered is higher than a synthetic fixed interest rate.

Tax Risk - Bank Debt can create *"Tax"* risk. Many tax-exempt Bank loans incorporate language that increases the interest rate to borrowers if the Corporate Tax Rate is reduced. When Corporate Tax Rates fall, tax-exempt income is less valuable to banks - thus the provision. Many times, this language can be negotiated out of the documents, or, if not, language can be added that benefits the borrower if the corporate tax rate is increased.

Publicly sold, Fixed Rate Bonds

- Sold publicly to investors
- Interest Rates locked in (Fixed) for life of securities (up to 30 or 35 years)
- Construction Escrow funded fully at closing (negative arbitrage)

Privately placed, Bank Debt

- Includes interest rate risk and reset risk
- Attractive for construction projects —"Draw down" reduces negative arbitrage
- Financial Covenants may be more restrictive

2) Maximizing Strategic Flexibility

Because Bank Debt may require a larger financial commitment in the form of equity or guarantees and may have more restrictive covenants in the loan documents, the sponsor may have less financial flexibility to pursue other strategic initiatives. But this depends on the financial strength of the sponsor. For sponsors that have built-up equity, healthy reserves and/or cash flow, this will not be a concern. However, for sponsors with limited resources, Bank Debt could limit strategic flexibility.

Equity and Guarantee Requirements - Because banks are asset lenders, banks focus on the underlying value of the assets as well as cash flow. Therefore, banks require appraisals that show certain loan-to-value ratios, usually no less than 85% loan-to-value and can be as low as 75%. As a result, to incur Bank Debt requires significant equity or subordinated debt from the sponsor, related entity, or another lender *if the new project is being financed is not a part of an existing Obligated Group*.

To avoid contributing equity or utilizing subordinated debt, the sponsor must be willing to provide substantial guarantees or make the new or expansion project a part of the existing entity or borrowing group. This is known as creating an "Obligated Group." If the new project is a stand-alone entity and is not a part of the Obligated Group, transactions completed with Bank Debt will require subordinated debt or significant guarantees from the sponsor.

Although bond investors, like banks, do require mortgages on most senior living loans, they are cash flow lenders and do not require loan-to-value ratios. As a result, there is usually no equity requirement. However, investors of fixed rate bonds will require a limited guarantee from the sponsor/related entity/interested party, usually in the form of a liquidity support agreement ("LSA"), *if the entity if not a part of the Obligated Group*.

Financial Covenants - In addition to requiring less equity or a smaller guarantee from the sponsor, financial covenants associated with Bond Debt are usually more flexible. For example, Bank Debt may require that the borrower obtain approval from the bank before any additional debt can be incurred. With Bond Debt, if the borrower demonstrates sufficient debt capacity through objective metrics that are agreed to upfront, either through historical performance or projected performance, the borrower can incur additional debt as it deems appropriate. So, in general, Bond Debt offers more strategic flexibility than Bank Debt.

3) **Minimizing Borrowing Cost**

Because Bank Debt incorporates more structure risk and may limit strategic flexibility, why would an organization choose Bank Debt over Bond Debt? The answer is that bank debt may provide substantially lower borrowing cost.

Lower Interest Rates - The first advantage is that Bank Debt carries lower interest rates because short-term variable interest rates have historically been lower than long-term fixed interest rates. Even if the interest rate on Bank Debt is fixed, interest rates are usually lower on 10-year Bank Debt than 30-year Bond Debt. It is the reason many homebuyers sometimes choose 7-year adjustable-rate mortgages over 30-year fixed rate mortgages. In addition, if a bank becomes comfortable with a credit, the credit spread is usually less than what bondholders charge, creating a lower interest rate. It is important to remember though that Bank debt has a shorter interest rate period.

Draw Down Feature - Under a Bond transaction, the borrower is required to borrow all the money upfront and pays interest on that debt immediately. Under Bank Debt, the borrower is allowed to draw on the loan as the money is needed. This "draw down feature" allows the bank to defer paying interest on a loan until the money is spent, thus reducing the amount of interest required to be funded during construction, thus substantially reducing the amount of debt incurred.

4) Maximizing Certainty of Execution

When planning and developing any project, the four levers at the sponsor's disposal include 1) Revenues, 2) Expenses, 3) Project Costs and 4) Cost of Capital. To ensure certainty of execution, all four must be considered. So, during the development process, it is important to understand that the funding source and the assumptions associated with that funding source can have huge implications for certainty of execution.

Therefore, if Bank Debt is being pursued to take advantage of lower funding costs, understanding that banks have more restrictive qualitative and quantitative underwriting requirements than Bond Investors means that there is less certainty of execution. So, make sure that there is a back-up plan if Bank Debt is being pursued. Be prepared to offer more financial support from the parent or sponsor to secure said Bank Debt, or make sure that the project is also feasible under a Bond Debt scenario. There is no right or wrong option. The choice will depend on an organization's tolerance for certain risks and an organization's future funding needs.

Disclosure:
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