Healthcare provider operating margins are under pressure. Revenue sources are strained, and expenses for staffing, information technology, pharmaceuticals, and pensions continue to soar. Declining federal and state funding has made the financial situation even worse. But thanks to new Section 242/223(f) rules, provider organizations can now obtain 25-year loans at low, fixed rates. This represents a welcome opportunity for small and mid-sized hospitals — especially those that wish to remain independent.

### CHALLENGES FOR SMALL AND MID-SIZED HOSPITALS

The Affordable Care Act (ACA) is putting tremendous demands on small and mid-sized providers. While all hospitals have to deal with the new ACA regulatory environment, smaller hospitals are unable to spread their compliance costs over a wide base. Meeting regulatory demands can present them with serious financial challenges.

Many banks, if they are lending at all, are providing only short-term financing at variable or high fixed rates. Meanwhile, tax-exempt bond markets have struggled as notable municipal borrowers such as Detroit; Stockton, California; and Jefferson County, Alabama have seen their financial condition deteriorate. Even with attractive crossover spreads, outflows continue to outpace inflows from the tax-exempt bond market. As a result, hospitals have struggled to find good financing options in tax-exempt markets.
Using Mortgage Insurance to Lower Borrowing Costs

A NEW SOLUTION

To help alleviate the financial stress on hospitals and maintain their availability in many communities, in July 2009 the U.S. Department of Housing and Urban Development (HUD) implemented the Federal Housing Administration (FHA) Section 242/223(f) program. This change represented a broadening of the FHA’s old Section 242 program, which insured a hospital’s mortgage — enhancing its credit and providing it with the opportunity to issue bonds with the equivalent of an AA/AAA rating. While Section 242 required that financing had to be for capital projects such as new construction or modernization, Section 242/223(f) enabled hospitals to refinance their existing debt without conditioning the refinancing on new construction or renovation.

Unfortunately, Section 242/223(f) insurance did not generate immediate interest. Rates and spreads in credit markets began to settle down following the worst of the financial crisis, thus relieving some of the pressure on access to financing for hospitals. Acceptance was also adversely impacted by a long and complicated application process.

NEW RULES = NEW OPPORTUNITIES

Today, thanks to a recent rules change, borrowers are showing renewed interest in Section 242/223(f). As of March 7, 2013, new HUD rules governing the FHA Section 242/223(f) Hospital Mortgage Insurance Program are helping hospitals by:

> Allowing a hospital to refinance its existing capital debt without a construction component requirement.

> Permitting Section 242/223(f) insurance to be used for financing to acquire an existing hospital.

> Streamlining the application process and committing HUD to quicker turnaround.

> Providing hospitals with a credit rating of AA/AAA through federal insurance.

In addition to providing support for hospitals in financing acquisitions and refinancing capital debt without requiring substantial construction or rehabilitation, the program offers hospitals the opportunity to eliminate burdensome covenants in existing debt. The result: A stronger financial position for participating hospitals and a strengthened ability to meet the healthcare needs of the communities they serve.
The first step in the Section 242/223(f) process is a preliminary review by HUD to evaluate the hospital against minimum eligibility requirements. The purpose of the preliminary review is to identify deal killers and areas of focus for further analysis if the underwriting proceeds.

In this initial stage, the hospital must:

> Demonstrate that it provides an essential service to the community in which it operates and, based on certain criteria, that its financial health depends upon refinancing.

> Have an average debt service coverage ratio greater than or equal to 1.4, based on the three most recent annual audited financial statements. The hospital may recast interest expense numbers for all years excluding any unusual year.

> Have an aggregate operating margin greater than or equal to zero when based on the three most recent audited financial statements.

In addition, the hospital must meet three of the following seven criteria:

1. The proposed refinancing would reduce the hospital’s operating expenses by at least 0.25%.

2. The interest rate of the proposed refinancing would be at least 0.5 percentage points lower than the rate on the debt to be refinanced.

3. The interest rate on the debt to be refinanced has increased by at least one percentage point at any time since Jan. 1, 2008, or is very likely to increase by at least one percentage point within one year of the date of the HUD application.

4. The hospital’s annual total debt service is in excess of 3.4% of total operating revenues, using the hospital’s most recent audited financial statements.

5. The hospital has experienced a withdrawal or expiration of its credit enhancement facility or the lender providing the credit enhancement facility has been downgraded, or the hospital can demonstrate that one of these two events is imminent.

6. The hospital is party to bond covenants that are substantially more restrictive than the FHA Section 242/223(f) mortgage covenants.

7. There are other circumstances that demonstrate that the hospital’s financial performance would be materially improved by refinancing its existing capital debt.

Source: Office of Hospital Facilities, “2013 Lender Training: FHA Section 242 and 223(f) Refinancing”
After the Initial Review

After HUD ensures that the hospital meets the required criteria, the next step is a pre-application meeting. The purpose of this meeting between HUD and the hospital is to:

> Discuss issues identified during Preliminary Review and any issues that could impact underwriting.
> Review the hospital’s operations and its plans.
> Provide an overview of the HUD process.

The pre-application meeting gives the hospital an opportunity to present its plans, resolve any concerns, and make its case for the borrowing. Once HUD is satisfied with the proposal, the hospital may submit its application. HUD’s standard is to complete the application review within 90 days.

Important Considerations

While HUD is keen to book deals under Section 242/223(f), the program may not work for every hospital. The new standards and guidelines are minimums and do not guarantee acceptance; HUD can still reject applications. A hospital’s application may be turned down for a number of reasons, including a weak capital position or worrisome revenue trends.

Another consideration for a hospital contemplating the Section 242/223(f) insurance program is the security required by HUD. In a Section 242/223(f) insured financing, HUD takes a senior lien on the mortgage of the facility, and thus requires a take-out of all or a substantial amount of outstanding debt before insurance is provided. This may be an important point for entities that have multiple issuances with call dates at differing intervals. A good candidate will have a substantial amount of their outstanding debt that is currently callable. Also, since HUD has a senior lien, hospitals need to obtain HUD’s approval prior to expansion by acquisition.

Hospitals should evaluate the interest cost savings to be gained through Section 242/223(f) against the loss of flexibility when using government insurance. Beginning talks with HUD early on is a key to understanding the program and being ready to move when the time is right for financing or refinancing.
Healthcare Insights

Using Mortgage Insurance to Lower Borrowing Costs

About Key Healthcare

Key Healthcare provides solutions and services to nearly 10,000 hospitals, physician and dental practices, senior housing centers, outpatient facilities, and other healthcare providers. Key is one of the country’s largest healthcare lenders with approximately $7 billion in credit commitments. Further, Key ranked No. 2 nationally in healthcare real estate originations in 2011 and No. 1 in Freddie Mac senior housing lending in 2008-2010 with nearly $1 billion in volume. Key Healthcare delivers the full resources of KeyBank, one of America’s largest financial services companies by providing clients with deep expertise in healthcare finance, revenue cycle management, strategic advisory services, and wealth management. Key Healthcare’s dedicated local teams help clients with optimizing their capital structures, adapting to regulatory changes, enhancing employee benefit packages, ensuring timely reimbursement, and preparing and executing plans for growth or expansion. In addition, Key offers comprehensive planning solutions for growing, protecting, and transitioning wealth along with specialized programs to help ensure the financial health of our clients’ employees. For more than 160 years, Key has been committed to supporting the organizations and individuals that support the health of our communities. Headquartered in Cleveland, Ohio, Key has assets of $89 billion. Learn more at key.com/healthcare.

FHA Section 242/223(f) insurance may provide your hospital with attractive, long-term, fixed-rate funding — and Key Healthcare has the relationships and expertise to help you navigate the HUD approval process. To find out more about this valuable tool for refinancing capital debt or financing acquisitions, contact Walter Olshanski at 917-368-2396 or walter_olshanski@key.com.

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Appendix: An Overview of the Section 242/223(f) Program

Designed to support the refinancing or acquisition funding needs of nonprofit, for-profit, and community-based acute care hospitals, the key features of the FHA 242/223(f) insurance program include the following:

<table>
<thead>
<tr>
<th>Key Program Features</th>
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<tr>
<td><strong>Hospital Eligibility</strong></td>
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<td><strong>Borrowing Purpose</strong></td>
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<td><strong>Funding Vehicle</strong></td>
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| **Processing Time** | Preliminary Review: 10 business days  
Application Completeness Review: 10 business days  
Application Review: 90 business days |
| **Interest Rate** | Fixed rate, fully amortizing; subject to market conditions |
| **Maximum Term** | 25 years |
| **Payments** | Level annual payments |
| **Maximum Loan-to-Value** | 90% |
| **Maximum Loan Amount** | Refinancing  
Maximum mortgage amount not to exceed:  
> The amount required to pay off existing capital debt  
> The estimated hard costs, if any, totaling less than 20% of the mortgage amount  
> Soft costs normally allowed in a Section 242 loan  
Acquisition  
Maximum mortgage amount must not exceed the cost to acquire the hospital based on:  
> Actual purchase price of land and improvements or HUD’s estimate (prior to repairs, renovations, and/or equipment replacement) of the fair market value of land and improvements, whichever is lesser  
> The estimated hard costs, if any, totaling less than 20% of the mortgage amount  
> Soft costs normally allowable in a Section 242 loan |
| **Financing of Swap Termination Fees** | Up to 10% of the loan |
| **Insurance Amount** | FHA insures 90% of the loan amount |
| **FHA Application and Inspection Fees** | FHA application/examination fee: 0.3% of mortgage amount  
FHA inspection fee (refinancing or acquisition only): 0.1%  
FHA inspection fee (for projects with limited rehabilitation): |
| **Hard Cost % of Mortgage Amount** | **Inspection Fee Limit** |
| Less than 5% | 10 basis points |
| 5% to 10% | 20 basis points |
| 10% to 15% | 30 basis points |
| 15% to 20% | 40 basis points |
| 20% or greater | 50 basis points |
| **Mortgage Insurance Premium** | 65 basis points |

Source: Office of Hospital Facilities, “2013 Lender Training: FHA Section 242 and 223(f) Refinancing”