

## Observations From the Front Line

What a difference six months can make! The first quarter of 2009 was one of the gloomiest periods in the United States' economic history, as consumers were increasingly unemployed and in hibernation, equity markets were declining rapidly and credit markets were frozen. Following the meltdown of the banking system the previous fall, the difficulty in determining the extent of core financial damage led to a widespread loss of confidence in the credit of American individuals and corporations.

As the October Healthcare Update goes to press, the fixed rate markets are thawing rapidly as investors are scrambling to invest cash inflows and coupon payments. Retail investors are again reaching for yield in an environment that is punishing savers. Recent successful bond sales using fairly conventional structures are a major reason for optimism regarding the availability of capital to the sector. Interest rates and credit spreads are declining rapidly. Bank financing is still challenging in certain parts of the country. With a rally in the stock market over the summer and the success of the Cash for Clunkers program, there is certainly a sense of optimism that the worst of the financial storm has passed.

As usual, the purpose of this publication is three-fold: (i) provide management insights into the current complexities of managing healthcare businesses; (ii) demonstrate accessible methods of obtaining capital for various business activities; and (iii) demonstrate the industry expertise and financial strength of the BB&T Healthcare businesses. To that end, the following articles are included in these pages.

- 1. Restructuring Opportunities.** Although the credit crisis has been a challenge for a majority of providers, it has also opened up additional financing structures that can help diversify a borrower's capital structure. Some of the additional structures will only be available until the end of 2010 so it is imperative that providers review their current capital structure for restructuring opportunities and review their upcoming capital projects.
- 2. Build America Bond Case Study.** Did you know that BB&T Capital Markets was the first firm in the country to underwrite variable rate Build America Bonds for the Healthcare sector? This case study provides insight into the financing process undertaken for the Catawba Valley Medical Center transaction.
- 3. Recently Introduced Healthcare Bill.** New legislation was introduced in mid-September that could dramatically impact non-profit 501(c)(3) providers by requiring them to perform updated needs assessments every three years and to put in place an action plan to address any unmet needs.
- 4. Clarification of Accounting Treatment of VRDOs.** Have you been concerned about the accounting treatment of your VRDOs? This article will provide an overview of how accounting firms will begin to classify VRDOs going forward.

We hope you too are beginning to feel that the glass is half full again. Please contact any of our team if we can elaborate further on any of the content herein and we look forward to visiting with folks through the fall conference season. ■ - *John R. Franklin – Managing Director*

## A Rapidly Evolving Market Provides Restructuring Opportunities

The credit crisis that unfolded over the past 24 months presented extraordinary challenges to healthcare providers in the form of access to capital. Conversely, a capital markets rebound has occurred over the past three months that is just as extraordinary, presenting a window of opportunity for healthcare providers to restructure debt portfolios at interest rates and with unique products that may have a short shelf life. Both the fixed rate and variable rate markets are participating in this amazing turnaround.

First, the market is seeing some unique variable rate products made available to hospitals – both through Wall Street invention and legislative action. Most variable rate structures, like auction rate securities and variable rate demand bonds, utilize credit enhancement from a bond insurance company or commercial bank to gain a high rating on the bonds and provide liquidity to short-term investors. Unlike fixed rate debt, variable rate debt credit enhancement must continually be maintained or renewed over the 30-year life of the borrowing – opening borrowers up

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During 2009 our teams have utilized some of the most creative financing structures employed by healthcare providers, including the use of our own capital in the form of conventional bank loans, bank qualified tax-exempt loans, letter of credit backed variable rate demand bonds, traditional fixed rate tax-exempt bonds, as well as government agency program financings like Fannie Mae, Freddie Mac and HUD. With the broadest platform in the industry for healthcare organizations to access capital, we can put our industry expertise and financial resources to work for you during these challenging times.

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to the ongoing credit risk of the insurance company or bank in order to sustain the debt structure over the life of the issue. Many borrowers are finding themselves currently unable to access capital at a reasonable cost due to credit downgrades with bond insurers, commercial banks or interest rate swap counterparties. Given these challenges, many borrowers are seeking alternatives to the distressed banking sector and are taking the opportunity to diversify their capital structure. Enter the Federal Government.

**Federal Home Loan Bank Wraps** – In response to the lack of larger financial institutions willing to extend credit, the Housing and Economic Recovery Act of 2008 included a solution that would allow community banks to extend credit enhancement. Community banks were largely excluded from the credit enhancement process because many do not have credit ratings and those that do are not at a level appealing to investors. Legislation passed in July 2008 granted the Federal Home Loan Bank (FHLB) the authority to extend credit enhancement for non-housing bonds in conjunction with credit enhancement extended by community banks. Under this structure, referred to as a “wrap”, the FHLB guarantees payment to investors in the event the member bank(s) fails to perform. The bonds carry a Aaa rating based on the FHLB. Authority for this structure is currently granted through December 2010; however, there is potential for it to be extended. While not the original purpose of the program, the FHLB wrap structure has also been used to enhance the credit rating of many large regional banks that have experienced credit rating downgrades.

**Bank Qualified Loans (BQ)** – The Federal Government also expanded the tax-exempt programs available to providers through The American Recovery and Reinvestment Act of 2009 (ARRA). ARRA modified rules designed to encourage banks to provide financing for qualified issuers of tax-exempt bonds. Previously, the Bank Qualified exception (BQ) (allowing Financial Institutions the ability to deduct that portion of interest expense allocable to carrying tax-exempt obligations), was limited to a maximum of \$10 million per issuer per year. However, the ARRA increased the annual limit to \$30 million per borrower for 2009 and 2010. Thus, each 501(c)(3) non-profit may now issue \$30 million in tax-exempt BQ debt each year, even if the issuer exceeds this limit. In addition to expanding the BQ exception, the ARRA allows bank providers to apply the same tax treatment allowed on BQ transactions to new money issues in 2009 and 2010 so long as these obligations do not exceed 2% of the bank’s average adjusted basis of its assets. The 2% rule effectively allows bank providers to issue tax-exempt BQ debt in excess of the \$30 million per year exception. Banks are still in the process of determining their 2% availability and their appetite to utilize the 2% rule for tax-exempt issues.

Generally, bank qualified financing commitments for healthcare borrowers contain a tax-exempt variable interest rate, which may be converted to a fixed rate via an interest rate swap (executed in

a manner similar to that of a synthetic fixed rate bond structures previously used by providers). In addition, bank qualified financings generally have a put option occurring every five years throughout the commitment. In many cases, bank qualified debt offers a comparable (or lower) cost of funds than a variable rate demand bond (VRDB) structure, while also removing the remarketing and most of the counterparty risk from the transaction; however, bank qualified debt does not remove put risk faced by the borrower. Lastly, the agreement between a bank qualified provider and a borrower, is similar to the agreements used in a commercial loan, and bank covenants are usually more restrictive than those included in a fixed rate financing. This is likely to include more aggressive ratio requirements, limitations on capital expenses, the incurrence of additional debt, disposition of assets, etc.

**More to Come** – While there appear to be alternatives for highly rated borrowers, lower credit quality borrowers are still left struggling for solutions. The House Financial Services Committee is expected to vote on a bill in the fall that would provide a temporary liquidity facility for variable rate demand obligations. If passed, such a facility may prove crucial to the capital structures of many healthcare providers.

**Self Liquidity Structures** – In addition to recent legislative initiatives to improve access to capital, Wall Street has created some new variable rate products that create alternatives to traditional VRDBs. Under these new structures, variable rate bonds are priced based on a fixed spread to the SIFMA Index. The remarketing agent continues to remarket the bonds at the fixed spread to SIFMA until it can no longer do so, at which time a new spread to SIFMA is created. Another variation locks-in the spread for a specified period of time (i.e. 180 days), at the end of which a new spread to the SIFMA Index is set based on the current market. This variation provides borrowers diversification with their put risk. Instead of being subject to put risk on a weekly basis, borrowers determine the specified intervals which could be beneficial to asset/liability management. Additionally, investors receive comfort that the spread to SIFMA will automatically be revisited.

An additional emerging structure for Aa/AA category borrowers allows the borrower to issue variable rate demand bonds under self-liquidity but provides a term-out period. Under this structure, there is a longer remarketing period than traditional structures. If the bonds cannot be remarketed or the rate at which they could be remarketed is undesirable, the borrower has a defined period of time to purchase or restructure the tendered bonds. In the meantime the investor/owner of the bonds is forced to hold the bonds until the end of the defined period. Unlike traditional structures, the interest rate on the bonds would remain at the same spread to SIFMA throughout the term-out period. This is advantageous to borrowers as they are not subject to penalty rates while working through the term-out period. Another anomaly

with this structure requires all of the bonds to be redeemed in the event of a failed remarketing. Under traditional structures, only the bonds that could not be remarketed would need to be liquidated. This structure is attractive to investors as it provides portfolio diversification.

**The Fixed Rate Market** – The fixed rate market has had an amazing run with falling rates over the past two months climaxing several weeks ago with several noteworthy financings in Georgia, Kansas and South Carolina that established strong data points at or below what have been psychological barriers in the past few months.

First, Palmetto Health in Columbia, South Carolina, sold \$127 million of fixed rate bonds rated Baa1/BBB+/BBB+ at a yield of 5.90% in 2039. This was significant to establish this benchmark below 6%.

Secondly, Via Christi in Wichita, Kansas, with ratings of A+/A+, sold \$75 million of fixed rate bonds at a yield of 5% (par bonds) in 2034. This is the first A category financing to touch 5% flat.

Following the Palmetto Health and Via Christi pricings, BB&T Capital Markets was a 50% Co-Senior Manager on an \$81 million Aa3/AA rated fixed rate bond issue for the Medical Center in Macon, Georgia. Breaking through the 5% level at a spread of 85 bps to MMD is a significant psychological data point in the market and is indicative of very strong demand right now for traditional tax-exempt bonds.

There has been plenty of fixed rate issuance lately, but it is somewhat unusual to have three financings on back to back days at each of

these ratings levels. This is a great demonstration of a very strong fixed rate bond market. The combination of the perception of a strengthening economy, less municipal bond supply due to new structures like Build America Bonds, significant inflow of cash to tax-exempt mutual funds and significant retail investor interest is firming the market at a rapid pace. In fact, since those three financings were priced, we have seen the MMD index fall another 20 basis points.

There is quite a bit of activity on the horizon for fixed rate bond issuance in the hospital market, as we are aware of numerous hospitals pondering entrance to the fixed rate markets. With the strengthening capital markets and desirable institutional and retail investor supply/demand balance, getting into the market and pricing into this strength is a very advisable strategy for folks who are already considering access to the fixed rate market.

One of the lessons learned through the credit crisis is the importance of diversification. It is crucial to the overall financial health of an organization to have diversification in investment portfolios capital structures as well as banking relationships. Borrowers who had all of their eggs in one basket have been hit the hardest during this period of financial strife. We will continue to see many changes in the capital markets for the foreseeable future. Borrowers will need to weigh all options and risks in deciding their optimal capital structure. ■

Borrower	State	Ratings	Pricing Date	Final Maturity	Coupon	Yield
Palmetto Health	SC	Baa1/BBB+/BBB+	9/16/09	2039	5.75%	5.90%
Via Christi	KS	A+/A+	9/16/09	2034	5.00%	5.00%
Med. Center of Central GA	GA	Aa3/AA	9/17/09	2035	5.00%	4.90%

## Unique Use of Build America Bond Program

BB&T Capital Markets recently worked with Catawba Valley Medical Center (CVMC) in obtaining financing for several capital projects that will create a tremendous benefit to the Medical Center and the patients it serves. CVMC is a 258-bed general acute care hospital located in Hickory, North Carolina. CVMC is owned by the County of Catawba and its operations are accounted for as an enterprise fund of the County.

In reviewing and developing its strategic plan, CVMC felt it was imperative that the hospital renovate and reconfigure its surgical suite as well as make improvements to an aging central plant. The estimated cost of these projects along with several routine capital expenditures was approximately \$25 million. Once the project size was determined, the finance team set out to develop the most cost effective and efficient financing vehicle to serve the borrowing need.

Unfortunately, the capital markets environment in early 2009 for not-for-profit borrowers had never been more challenged. In a perfect financing world, CVMC would have preferred to issue traditional fixed rate debt. However, the fixed rate market starting in September 2008 through early summer 2009 was basically shut down for "A" rated and below borrowers. Provided this, the finance team was forced to consider alternative financing structures that would result in a lower cost of capital without subjecting CVMC to unreasonable risk.

Historically, the most logical tax-exempt alternative to fixed rate debt is tax-exempt variable rate debt supported by a letter of credit from a financial institution. CVMC was interested in diversifying its capital structure and a variable rate transaction was very attractive given the organization's strong cash position and conservative investment policy (100% invested in high grade fixed

income securities). However, there was a very unusual problem that eliminated CVMC's ability to issue various forms of tax-exempt variable rate bonds.

The first complication involved bank qualified (BQ) debt. The program allows banks to deduct for tax purposes 80% of the interest income it receives from making loans to BQ borrowers. In an attempt to increase lending, the recent stimulus package expanded the BQ program significantly. The major changes were to increase the BQ limit from \$10 million to \$30 million per year and to make the program borrower specific rather than issuer specific. Although the change allowed borrowers to qualify for BQ financing rather than issuing authorities, CVMC was considered a division of the County and therefore, the County and CVMC were determined to be one borrower. Because the County had already planned to issue up to \$30 million of BQ tax-exempt debt, CVMC could not access the tax-exempt market at all because doing so would eliminate the County's ability to issue its own BQ debt.

While contemplating delaying the financing until 2010, another new program surfaced – **Build America Bonds (BABs)**. BABs is another program the government instituted through the stimulus package to increase lending. The theory is qualified borrowers, including states, municipalities, state owned agencies and municipally owned hospitals, would issue taxable bonds and receive a 35% rebate from the federal government. The theory was that selling taxable bonds would open the market to a wider universe of buyers and that the borrower could issue the equivalent of tax-exempt debt in the form of a rebate from the government. Because CVMC is a municipal borrower, CVMC qualified to issue BABs. Because BABs are issued as taxable debt rather than tax-exempt debt, CVMC could issue an unlimited amount of BABs, which would not count against the BQ limit for the County.

By mid 2009, a handful of municipalities had issued BABs, but all had been issued on a fixed rate basis. Because CVMC had a desire to diversify its capital structure and reduce its cost of capital, BB&T explored issuing BABs on a variable rate basis rather than a fixed rate basis. While no variable rate BABs had been closed, the finance team was confident the program allowed this flexibility. CVMC was able to obtain an attractive letter of credit from BB&T that would support the issuance of taxable variable rate bonds. Under the BAB program, CVMC submits an application to the government on a quarterly basis for rebate requesting 35% of the interest paid to bond holders.

As BB&T was working to close the BAB transaction, another government support program found its way into CVMC's capital structure. As further incentive to bolster the economy, the government provided another special funding source to states in the form of **Economic Recovery Zone Bonds**. Economic Recovery

Zone Bonds are very similar to BABs except the rebate for qualified bonds is 45% rather than 35%. Each state is allocated a specific amount of funds that qualify as Economic Recovery Funds. North Carolina was allocated a total of \$418 million of which \$8.5 million was allocated to Catawba County. As previously noted, because Catawba County was utilizing BQ funding for its capital projects, it was supportive in allowing CVMC to use the Recovery Zone Bonds designated for the County.

CVMC started its financing journey with the idea of issuing traditional fixed rate debt only to find itself trying to do so in a very difficult tax-exempt market. CVMC's next option – BQ debt – was closed off because it would destroy the financing structure desired by the County. Little did anyone realize that these two unfortunate and unique circumstances would lead CVMC to an uncharted but a very efficient financing solution! When the dust settled, CVMC had issued \$25 million of taxable variable rate bonds, \$16.4 million of which were classified as Build America Bonds and \$8.6 million of which were classified as Economic Recovery Zone Bonds. On August 12, 2009, CVMC became the first borrower in the country to close both a variable rate BAB and an Economic Recovery Zone financing. CVMC's all-in interest rate for the seven-week period post issuance, after its rebates, has been 1.66%. ■



**Series 2009**

**\$25,000,000**

County of Catawba, North Carolina  
Taxable Variable Rate Demand Hospital Revenue  
Bonds (Build America Bonds)  
(Catawba Valley Medical Center Project)

Moody's: Aa2/VMIG1

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## Recently introduced Health Care Bill to Affect Non-Profit Hospitals

Senate Finance Committee Chairman Max Baucus (D-MT) introduced legislation in mid September that would pose new requirements for non-profit 501(c)(3) and bond financed hospitals. This legislation passed the Senate Finance Committee by a vote of 14-9 on October 13, 2009 and will now head to the Senate floor. Although the new mandates vary in scope and severity, under the new bill called "America's Healthy Future Act", the bill's main objectives would be to require hospitals to conduct routine community health assessments and create financial assistance programs. The impending legislation would be required in order for hospitals to prove and maintain their tax-exempt status.

Should the act become law, each hospital would need to conduct the new needs assessments at least every three years and put into action a specific plan to address any unmet needs found during the assessment. The methodology for the hospital's plan would need to be outlined as an additional section of the facility's IRS form 990 (charitable organizations are currently required to file a form 990 information return). In turn, the IRS would be required to review a hospital's community benefit activities at least once every three years (information that is already being currently provided in schedule H of IRS form 990). This IRS review would be similar

to reviews conducted on companies registered with the Securities Exchange Commission.

In addition to the community health assessment portion of the bill, facilities would be required to formulate a financial assistance policy and properly inform the public about the availability of said policy. Important mandates under the newly crafted financial assistance policy for each hospital would be as follows: (a) the facility could not charge patients who qualify for financial assistance any more than they would charge insured patients; (b) the facility would not be allowed to enact collection proceedings on a patient prior to notifying them of the financial assistance option(s); and (c) eligibility qualifications and billing for charges under the policy must be easily decipherable by the public.

The Joint Tax Committee believes that the proposed legislation will have little impact on revenue for non-profit hospitals. Baucus' bill is likely to cause fewer headaches for non-profit hospitals than other ideas for healthcare reform that have been posed earlier in 2009. Participants in the municipal market are certainly keeping abreast of this bill and other congressional proceedings as broader healthcare reform remains a key topic on Capitol Hill. ■

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## Clarification of Emergent Issues Task Force (EITF) 78 – Treatment of VRDOs and other Debt callable by Creditors

Recently, there has been some confusion as to how variable tax-exempt debt supported by a liquidity facility or letter of credit should be treated; specifically, whether the debt should be treated as a long-term liability or a current liability on the balance sheet. Our understanding is that as long as the credit facility has longer than one year remaining and the borrower is not in violation of any of the covenants in the credit facility agreement, the underlying debt will be treated as a long term liability.

If the credit facility expires in less than a year, all or a portion of the underlying debt will be treated as a current liability. The amount of the debt to be treated as a current liability will depend on the "term out" provision. For example, if the term out provision requires that all of the debt is due on demand if the credit facility is not renewed, then all of the debt is treated as current. If the term out provision allows the debt to be paid over a five-year period, then one-fifth of the debt will be treated as current.

However, VRDOs backed by credit facilities that have a "best efforts" remarketing agreement are treated differently. Because of recent failed remarketings on these types of transactions and subsequent draws on the credit facilities, a distinction is being made. Under a failed remarketing, the bonds would be tendered and there would be a draw on the letter of credit, at which time, the payback provisions defined in the agreements would be put into effect. Usually these then convert to a term loan or some

other mechanism for repayment of the draw on the letter of credit. The criteria noted in the EITF indicates that in these types of arrangements, REGARDLESS OF WHETHER THERE IS AN ACTUAL DRAW, so long as the ability exists for the debt to be "put" as a result of the potential of a failed remarketing, the debt would need to be classified as current. As in the prior example, only the debt that is required to be paid in the first year of the term out is classified as current.

One recommendation to avoid this classification is to ensure that under the provisions of a "failed remarketing," that the first principal payment does not occur earlier than a year and one day. This would then ensure that the "put" that may occur relating to the failed remarketing does not preemptively require classifying the debt as current as the EITF would require, even though there has been no failed remarketing.

As a result, it is very important for hospitals to negotiate credit facility agreements with this in mind and to monitor renewal dates to determine the treatment of the underlying debt. Such treatment could have significant ramification on related covenants and the audit opinion itself. ■

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