

# MAKING THE DECISION TO FINANCE

## A Primer on the Borrowing Ability of Nonprofit Organizations

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## Making the Decision to Finance

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# Making the Decision to Finance: *A Primer on the Borrowing Ability of Nonprofit Organizations*

Gerald M. Swiacki

The world of finance can be quite intimidating for many people. However, as with most things, getting acquainted with certain concepts and practices can lead to better understanding. This paper was written for executives and board members of nonprofit organizations who have little or no experience in banking. However, it may also prove to be a good refresher for those more familiar with the enterprise.

This article will reveal some of the nuances, as they relate to financing, inherent to nonprofits. First, we will identify what makes these organizations unique, especially as it relates to capital formation. Next, we will explain why organizations choose to finance rather than spend their internal funds on capital expenditure projects. Finally, we will provide an overview of tax-exempt bonds, which have one of the lowest costs of capital available to a nonprofit entity.

We have created appendices to supplement the information provided within this article. Readers are encouraged to use them as reference for a more comprehensive understanding of the material presented. We start with *Appendix A: "Terms Used in Financing."*

Our goal is not to make you financial experts, but to assist you in becoming more knowledgeable and facilitate your ability to identify those opportunities that will most benefit your organization. Well-informed individuals make better decisions. We hope you will find this a useful tool in **Making the Decision to Finance**.

**PART I:  
WHY NONPROFIT ENTITIES ARE UNIQUE**

**The Nonprofit Difference: Planning for Perpetuity**

Not-for-profit organizations are an important part of the service economy in the United States. The resources and benefits they provide for the good of society are valued and, thus, are rewarded by the government with certain tax breaks and other financial advantages as compared to for-profit organizations. This difference creates myriad other distinctions within the governance structure, accounting practices and operating standards for nonprofit organizations.

Nonprofit organizations are primarily motivated by a desire to fulfill a mission — not to satisfy shareholders. Thus, there is never a need to sacrifice quality for profit or to devise an exit strategy for the single purpose of achieving a targeted return on investment. In fact, the goal of a nonprofit organization should be existence into perpetuity so long as it is still fulfilling its mission. Leaders in nonprofit organizations must constantly be thinking long term and preparing for the future — both fiscally and organizationally. In contrast, financial officers, executives and board members of for-profit companies can make decisions based upon short-term gains, bottom-line profit and shareholder return.

The tax-exempt status of nonprofit organizations has obvious implications as to the exclusion from income and property tax levies and even freedom from paying sales tax. The government grants an additional benefit to nonprofits by allowing them to borrow money through the issuance of debt for certain specific purposes and pay interest to investors that is free from taxation. This form of financing is referred to as tax-exempt bonds and results in a less-expensive cost of capital relative to other debt options, including conventional bank loans.

**PART II:  
WHY BORROW?**

**Financing Growth and Maintenance of Existing Capital Assets**

Growth is an important component to furthering the mission of any nonprofit organization. It can be achieved in many ways, but most often is accomplished through the expansion of services or facilities that provide a particular service. Organizations that rely heavily on fixed assets for delivery of their service platform must also continuously reinvest in these assets to accommodate changing technology, methods of service delivery and consumer demands.

Upkeep and maintenance of physical assets tend to accelerate in the latter half of their useful life, further exacerbating capital expenditure needs. The manner in which a nonprofit chooses to finance growth and upkeep of its existing physical assets will make a significant impact on the capital structure and financial strength of the organization. Sources of capital are limited to cash generated through operations, contributions from benefactors, investment income and debt.

The most immediate source for covering project costs is to pay from internal funds. This, of course, is not an option for organizations that lack readily accessible cash and liquid investments. The alternative is to fund a project with debt, raise cash or gifts through a capital campaign, or have some combination of both. If the entity is creditworthy, incurring debt will be much more expeditious than soliciting contributions. Additionally, the amount of debt raised is known, as opposed to the vagaries and uncertainties associated with collecting pledges.

For organizations with sufficient internal funds, the analysis is more complex and requires a comparison of using cash and investments to finance the project versus continuing to invest those assets. Initially, avoiding debt may appear to be a prudent answer, but on further inspection, the more appropriate decision may be to maintain investments if the expectation is that investment returns will exceed the overall



cost of borrowing. This spread (returns less costs) is commonly referred to as arbitrage and is a concept embraced by many nonprofit organizations. See *Appendix B: “Arbitrage for the Nonprofit”* to learn about arbitrage strategies.

While the opportunity for arbitrage is enticing, incurring debt may require an organization to overcome its own historical tendencies. The nonprofit sector has long associated affordability with spending only from savings. In fact, many organizations take pride in being debt-free and consider it to be conservative financial management. However, depleting current assets to fund project costs reduces liquidity and may have the unintended consequence of compromising an organization’s credit strength. This phenomenon is commonly referred to as “saving yourself into poverty.”

The risk of failure increases as credit quality deteriorates. Financial ratios, which include measurements of capital structure and liquidity, are an important component of determining that risk. Assessing the impact of actions by monitoring these financial ratios will help determine whether credit strength is improved or impaired.

The way to optimize the capital structure is to maximize the relative credit characteristics to achieve the highest possible credit quality. This “optimal capital structure” varies from organization to organization. However, in most instances, prudent leverage of the balance sheet – adding some debt to the overall capital structure – is recommended as a means of maintaining or improving access to capital.

The best advice is to avoid debt and equity extremes and have a bias toward more liquidity. Executives and board members should focus on peculiar characteristics that make their organization unique and complete a more thorough analysis of “affordability” as it relates to the ability to pay and to repay. Creating options and maintaining financial flexibility are very useful in achieving long-term operational goals.

In the end, most organizations will realize the many benefits of maintaining investments to realize investment returns in excess of borrowing costs. Nevertheless, it is extremely important to obtain expert information and make informed decisions. Do not presuppose one option to be better than another. Seek the expertise of trusted advisors to assist in evaluating the opportunity.

### PART III: USING TAX-EXEMPT DEBT

#### Types of Debt

The goal of any borrower is to obtain financing at a fair price with reasonable terms in an acceptable period of time. A side-by-side analysis of funding options allows for the comparison of cost (interest expense and related fees), terms (constraints on the borrower and limitations of the lender) and the amount of time necessary to complete a transaction. The first step in the process is identifying debt market alternatives.

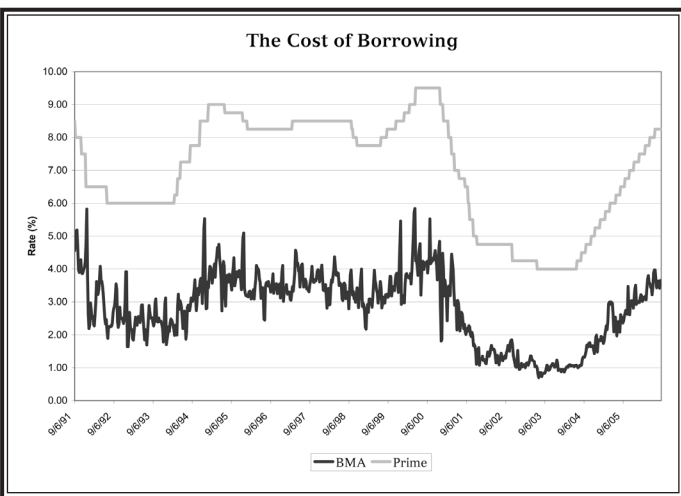
An obvious source of borrowed funds comes from a traditional commercial bank in the form of a line of credit or term loan. These products are readily available from local and national banks across the country and are quite common. The challenge, however, is determining whether another type of financing is a better option.

A tax-exempt bond issuance is a widely accepted alternative for projects with a long useful life. These offerings can be tailored to the individual needs of an organization and have a significant range in the amount of capital that can be raised. Although no project is too big or too small to be considered for this type of funding, cost-efficiency is usually achieved for projects in excess of \$1.5 million.

The inefficiency is directly attributable to the costs associated with issuing tax-exempt debt. The table on the following page compares up-front costs for a term loan and letter-of-credit-enhanced, variable-rate bond issue and illustrates the investment necessary to access the lower cost of capital available in the tax-exempt marketplace.

Principal = \$8,000,000		
Issuance Cost Estimates	Bond	Term Loan
Underwriter's Discount (1.0%)	\$ 80,000	\$ -
Administrative Fees (DTC, CUSIP, etc.)	\$ 5,000	\$ -
Bond Counsel	\$ 25,000	\$ -
Bank Counsel	\$ 15,000	\$ 10,000
Underwriter's Counsel	\$ 10,000	\$ -
Trustee Acceptance Fee	\$ 2,000	\$ -
Rating Agency Fees	\$ 15,000	\$ -
Issuing Authority Fee (0.125%)	\$ 10,000	\$ -
Bank Commitment Fee (0.50%)	\$ 40,000	\$ 40,000
	<b>\$202,000</b>	<b>\$ 50,000</b>

One's first impression of the table is that the term loan is more attractive to a borrower than the bond. However, the annual savings, in the form of lower interest expense on tax-exempt debt, is the compelling feature of bond financing. Commercial loans are generally set at the prime rate or above. The prime rate is a floating rate and since 1991 has averaged 6.97%. Variable-rate, tax-exempt bonds, on the other hand, trade with significant correlation to the BMA (Bond Market Association) Index and have an average coupon of approximately 2.82% during the period presented. The graph below shows the difference in these rates.



Issuers of tax-exempt debt do not always realize the full difference between these rates because credit enhancement is usually required to obtain the lowest possible rates. However, if credit enhancement is less expensive than the difference between Prime and BMA Index, the borrower realizes a direct savings. For example, a letter of credit fee and other associated costs that total 1.50% would reduce interest expense by approximately 2.65% annually (6.97% - [2.82% + 1.50%] = 2.65%). In the example, the borrower in need of \$8 million would realize savings of about \$216,000 in the first year easily surpassing the initial "extra" cost (\$202,000 - \$50,000 = \$172,000) of issuing bonds. The interest expense savings each subsequent year only adds to the benefit.

Borrowers utilizing variable-rate, tax-exempt debt enhanced with a letter of credit have historically realized an effective rate equal to or below 70% of the prime rate. This is a very attractive cost of capital, but the analysis should not stop here. An organization must also consider its tolerance for interest rate risk. If fixed-rate financing is preferred, the same cost analysis can be performed and should include some consideration of the difference in interest expense and impact to operations by locking in at higher rates. Once again, the suggestion is to consider all alternatives with respect to savings, flexibility and timeliness.

A list of the costs associated with issuing tax-exempt debt can be found in *Appendix C: "Typical Costs of a Bond Issuance."*

**Tax-Exempt Bonds**

Bonds represent an obligation of the borrower to pay interest to the investor in return for the lending of money over a given period of time. The rate of interest is determined by conditions in the capital markets and is influenced significantly by the credit characteristics of the borrower, security provisions provided to bondholders and the structure of the financing.

Typically, interest paid to investors on bonds is taxable by federal, state and local governments. However, by issuing bonds through a governmental or municipal entity, it is possible



for an investor to receive interest income not subject to taxation. Thus, the bondholder will charge a lower rate to realize the same after-tax return they would otherwise achieve on a similar taxable investment. This benefit is passed along to the borrower in the form of reduced cost of capital. See *Appendix D: “Basics of a Tax-Exempt Bond Issuance”* for a diagram of a bond transaction.

It is important to know that not all the capital needs of a nonprofit organization can be funded through the issuance of tax-exempt bonds. In fact, places of worship are specifically excluded. Generally, the proceeds can only be used to acquire, construct or renovate depreciable assets and purchase land. Certain costs related to the issuance of the bonds can also be included as an eligible use of proceeds.

A good rule of thumb for determining eligibility is assessing the project’s ability to fulfill a public purpose with no emphasis on religion. Any further guidance is really outside the scope of this paper due to the complex nature of the eligibility rules. We suggest seeking—as early as possible because there are timing restrictions as well—the advice of competent counsel or an expert in the business of coordinating such financings.

Although the restrictions for issuing tax-exempt debt are numerous, the potential savings are considerable. Additionally, it should be noted that anything deemed ineligible to be financed with tax-exempt bond proceeds can be funded with other forms of debt, including a term loan, line of credit, taxable notes or cash. For a more complete understanding of what type of bonds can be issued and for what purposes, please see *Appendix E: “Private Entities and Projects Qualifying for Tax-Exempt Financing.”*

### Selecting the Investment Banker

After a borrower has decided to issue tax-exempt bonds, the first step is to select a professional to act in an advisory capacity to structure the debt and raise the capital. Some borrowers choose to hire both a financial advisor to structure the debt and an underwriter to raise the capital. However, most investment banking

firms effectively provide both services creating a seamless and singular process that saves the organization time and money.

Selection of the investment banker is an extremely important component of the financing process. The organization should retain the professional who is best able to obtain the lowest cost of capital along with the most flexible terms. The most obvious criterion for selection is experience because it will serve the organization in all phases of the transaction. Expertise must include knowledge of industry trends and conditions in the capital markets. Additionally, the advisor needs to be aware of specific issues affecting the borrower’s operations.

A good advisor will continuously educate the client throughout the transaction to ensure well-informed decisions are made on behalf of the organization. It is important to select a firm with a record of success to represent you in such an endeavor. Other parties central to the transaction can be found in *Appendix F: “Key Players in Tax-Exempt Financing.”*

### Assessing the Credit Profile

A nonprofit organization’s credit strength or financial health is the single most important factor in determining its cost of capital. Organizations with strong financial health have more ability to repay debt, and so tend to be more appealing and less risky to investors and lenders who buy bonds and make loans. Investors and lenders balance their risk with interest rates. The better the credit profile, the lower the interest rate on the financing, and the less capital costs over time.

Investors and credit enhancement providers will review both quantitative and qualitative factors to measure an organization’s credit strength. Quantitative factors define an organization’s ability to repay the debt, and they place it within a broad credit range. Qualitative factors determine long-term financial viability and refine the organization’s position within that credit range.

Ratios that demonstrate financial performance are used in quantitative analyses. These ratios can be generally grouped into three categories: liquidity, profitability and capital structure. *Appendix G: Definition of Ratios* provides a complete list with definitions. The following ratios are relied upon most frequently when assessing creditworthiness:

- Debt Service Coverage
- Days Cash on Hand
- Operating Margin
- Debt to Capitalization

A credit assessment that considers only quantitative financial ratios, however, is inadequate. Credit analysis is both science and art and goes well beyond the basics of assets, liabilities and profitability. Generally, investors will consider qualitative factors such as the state of the economy and the type of industry—along with any peculiarities within it—the borrower serves. Particular attention will be given to board members' competence and independence as well as management's experience and ability to execute. It is also important that borrowers clearly define a strategy that includes both long-term and short-term goals. *Appendix H: "Credit Analysis"* discusses in greater detail the qualitative factors involved in assessing a prospective borrower's credit profile.

After completing the credit profile, a nonprofit organization can work with its financial professional to determine the best way to leverage its strengths and/or use strategic enhancements to improve its position on the credit continuum to achieve lower interest rates and less expensive capital.

### **Structuring the Financing**

When borrowing, nonprofit organizations and their advisers balance long- and short-term goals with creating an optimal capital structure that will improve or maintain the credit profile. Some borrowers, for example, prefer to make larger equity (cash) contributions to reduce the amount of debt necessary to fund a project. While reducing the amount of borrowed capital may initially seem desirable, such actions often

have an offsetting negative impact on liquidity, resulting in a less desirable credit profile. Overreliance on debt, on the other hand, also can strain an organization's resources. The ultimate goal is to develop a finance strategy that maximizes access to the capital markets and minimizes the cost of such capital.

It is important to recognize that the process of creating an optimal capital structure is fluid and requires thorough analysis. Reliance should be placed on a professional with a comprehensive understanding of the impact of financial decisions on asset management, liabilities and cash flow.

### **Accessing the Capital Markets**

In order to achieve the lowest cost of capital, borrowers must issue debt attractive to investors. This generally requires bonds to be of investment-grade quality. Please refer to *Appendix I: "Rated Bonds"* for a discussion of debt ratings.

The investment-grade rating can be attained in many different ways. Some organizations have such an outstanding credit profile (significant investments or endowment, positive operations, appropriate amount of long-term debt) that they can directly access the public market. Other borrowers—even those who are extremely successful but do not have the necessary financial stature—need some form of credit enhancement to access the same marketplace at acceptable interest rates.

Bond ratings suggest to investors the amount of risk involved in purchasing a particular bond. Unrated or low-rated bonds sold without credit enhancement are referred to as "speculative grade," "high yield" or "junk bonds" and carry substantially higher interest rates due to their perceived higher risk to the investor. Credit enhancement acts as a shield for bondholders to protect them against the borrower experiencing financial difficulties. Enhancements can be provided either by commercial institutions, such as banks and bond insurers, or a public entity such as the federal government. Bondholders expect the credit enhancer to repay them if the borrower is unable to do so. If bonds have been



credit enhanced by a rated credit enhancer, the bonds will generally carry the same rating as the credit enhancer.

By purchasing a credit enhancement, a borrower pays another organization to guaranty its obligations. The intended result is a higher rating on the borrowing. This enables the organization to borrow at a lower all-in interest cost, which includes the guaranty fee, than if it were borrowing based solely on its own credit.

Credit enhancement comes in three main forms: bond insurance, letter of credit and mortgage insurance. A more complete discussion on bond structures and forms of credit enhancement can be found in *Appendix J: "Typical Bond Structures."* In each instance, the organization providing the enhancement has a superior financial rating to the borrower, guarantees repayment to the bondholders and accepts the credit risk of the borrower. Essentially, investors purchase the bonds based on the creditworthiness of the guarantor, not the borrower.

It is important to note providers of credit enhancement do not accept the risk of every borrower seeking its product. Borrowers must be able to demonstrate the ability to repay the debt. The guarantee by the credit enhancement provider is insurance, not an assignment of liability. Borrowers must be financially viable with a solid credit profile. In some instances, the borrower will also have to offer collateral to the credit enhancer in the form of a mortgage on real estate, security interest on personal property and a negative pledge of assets. *Appendix K: "Security and Covenants"* provides an in-depth discussion of the reason for, and types of, security and covenants.

The final step in accessing the capital markets, and one that is undertaken only after credit enhancement – if required – has been secured, is the document preparation. A working group will be assembled, led by the investment banker, to finalize the financing structure (refine principal amount, set amortization, gauge rate environment), issue tax opinions, obtain a rating

of the debt and solicit investors. *Appendix L: "The Process for Issuing Tax-Exempt Debt Using Letter of Credit Enhancement"* specifies the steps and time associated with closing a letter of credit-enhanced financing.

### CONCLUSION

Nonprofit executives and board members are encouraged to adopt a more expansive approach for planning and decision making to ensure the long-term viability of their organizations. Entities should develop and revise policies regarding spending, asset allocation and investments. All are crucial in allowing the organization to continue its mission for perpetuity. Additionally, a higher level of sophistication may be appropriate in those instances when debt funding is necessary for capital expansion projects. Nonprofits borrow at some of the lowest available rates in the capital markets. Tax-exempt financing provides a unique opportunity to further the mission of an organization without depleting its cash resources, which might cause financial distress, and improve the overall cash flow of the organization



# Appendices

**Appendix A:**  
**TERMS USED IN FINANCING**

**All-in Interest Cost:** Representation of the true cost of the financing including all interest rates and fees paid.

**Arbitrage:** Generally, transactions where the same security is bought and sold in different markets at the same time for the sake of the profit arising from a price difference in the two markets. Arbitrage, with respect to the issuance of tax-exempt debt, usually refers to the difference between the interest paid by the borrower and the investment income earned by acquiring higher-yielding securities.

**Asset:** Any valuable item that is owned by an organization that is available to generate income or cash.

**Balance Sheet:** Often referred to as the “Statement of Financial Position,” it is a snapshot in time and shows the accumulated values in dollars of assets and liabilities as of a given date. It is important because of its ability to track the balance of assets, liabilities and net assets (equity). The strengths and weaknesses of an organization are easily ascertained from this financial statement.

**Basis Point:** Short reference to 1/100 of 1 percent. For example, the difference between 5.25% and 5.50% is 25 basis points.

**Bond Buyer Reserve (BBR):** A 30-year, high-grade market index composed of tax-exempt, fixed-rate debt obligations. The index serves as a benchmark that is accepted industry wide. The index allows for an efficient way to regularly monitor the short-term tax-exempt market.

**Bond Market Association (BMA):** A seven-day, high-grade market index composed of tax-exempt, variable-rate debt obligations. The index serves as a benchmark that is accepted industry wide. The index allows for an efficient way to regularly monitor the short-term tax-exempt market.

**Bond:** Proof of an issuer’s obligation to repay a specified principal amount and interest—at a predetermined rate or in accordance with a formula—on certain dates. Bonds do not represent ownership but are a type of loan and, thus, considered senior securities. Interest on a tax-exempt bond is exempt from federal income taxation and may be exempt from state or local taxation in the jurisdiction where issued.

**Bond Counsel:** An attorney retained by an issuer to provide a legal opinion that the issuer is authorized to issue the proposed securities, has met all legal requirements necessary for issuance and that interest on the proposed securities will be exempt from taxation. Bond counsel also prepares many legal documents related to the proposed issuance and will advise the issuer regarding authorizing resolutions, the trust indenture, official statements, validation proceedings and litigation.

**Bond Purchase Agreement:** A legal document between the borrower, underwriter and issuing authority that obligates the underwriter to purchase the bonds at an agreed-upon interest rate(s) and with specific terms.

**Bond Transcript:** All legal documents associated with the offering of a new issue or financing transaction.

**Callable Bond:** A bond that the issuer is permitted or required to redeem before the stated maturity date at a specific price, usually at or above par, by giving notice of redemption in accordance with the terms in the trust indenture.

**Cap:** The highest interest rate that can be paid on a floating rate bond over a specified period of time.

**Capitalized Interest:** A portion of the proceeds of an issue that is set aside to pay interest on the loan during the construction period. Capitalization refers to the treatment of the interest cost because it is added to the basis of the asset.



**Closing:** The meeting of concerned parties involved in a new issue during which the requisite legal documents are executed and proceeds are delivered for use of the borrower.

**Collar:** An upper and lower limit on the interest rate that can be paid on a floating rate bond over a specified period of time.

**Conduit Financing:** Bonds, usually tax-exempt, issued by a governmental unit to finance a project to be used primarily by a third party engaged in private enterprise. The taxing authority of the governmental unit does not secure the bonds. The bonds do not constitute an obligation of the governmental unit. Reliance for repayment is placed on revenues generated from the project.

**Corpus:** A term used to describe an income-producing asset, usually stocks or bonds, as contrasted to the income—such as interest—derived from it.

**Cost of Capital:** The financial expenditure required to borrow money. This includes, but is not limited to, issuance costs, attorney fees, credit enhancement as applicable and interest payments.

**Costs of Issuance:** The expenses associated with the sale of a new issue, including such items as printing, legal fees, rating agency fees and underwriter's discount.

**Coupon:** The interest rate on a fixed-income security, determined upon issuance and expressed as an annual percentage of the principal amount.

**Credit Enhancement:** An additional source of security for a bond or loan that comes in the form of a letter of credit from a commercial bank, private bond insurance, and government mortgage insurance and loan guarantees.

**Debt Service:** The series of payments of interest and principal required on a debt over a given period of time.

**Debt Service Coverage:** Expressed as a percentage, the amount of annual available cash flow divided by the annual debt service requirement. Debt service coverage is a primary indication of the safety or credit quality of an issue, or a borrower's ability to repay its debt.

**Debt Service Reserve Fund:** A fund created to cover a portion (usually one year) of debt payments on behalf of an organization should it not be able to pay out of regular revenues. This account is usually funded at closing from bond or loan proceeds to provide added security for the investor. Additional deposits may be required depending on the loan structure.

**Defeasance:** Termination of the rights and interests of bondholders, which usually occurs in connection with the refunding, refinancing or payoff of an outstanding issue.

**Derivative:** A financial instrument purchased or sold to manage the interest rate risk associated with an underlying security to protect against fluctuations in value. Borrowers utilize these instruments in the form of caps, collars and swaps.

**Discount:** The amount by which a bond's par amount exceeds its market price.

**Endowment:** A permanent fund bestowed upon or created by an institution, made up of cash, securities and other investments to be used for a specific purpose. It is considered an asset of the organization and income from investments is used to build the corpus and/or supplement operating expenses.

**Exempt Facility Bonds:** These bonds can be used by for-profit or nonprofit organizations for the development or acquisition of "rental residential housing" when income targeting requirements are met. As distinguished from qualified 501(c)(3) bonds, exempt facility bonds are subject to volume cap requirements.

**Feasibility Study:** A report of the financial practicality of a proposed project and its financing, which should include estimates of revenues to be generated and expenses to be incurred and a review of the physical, operating, economic or engineering aspects of the proposed project.

**Fixed Rate:** A rate of interest that does not change during the entire term the debt is outstanding.

**Floating (or Variable) Rate:** A method of determining the interest to be paid on a bond by reference to an index, or according to a formula or some other standard of measurement, at stated intervals.

**Interest Expense:** Money a borrower pays a lender or investor for use of the loan or bond proceeds.

**Investment-grade:** A term used to define those bonds with a relatively high level of credit quality. Bonds rated “Baa” or higher by Moody’s or “BBB” or higher by Standard & Poor’s and Fitch are considered investment-grade bonds.

**Issuer or Issuing Authority:** Empowered under federal law to issue conduit tax-exempt bonds. The proceeds from the sale of these bonds can be used to provide low-interest loans to 501(c)(3) nonprofit organizations and other qualified borrowers/activities as allowed under the Internal Revenue Code.

**Liability:** A financial obligation, debt, claim or potential loss.

**Liquidity:** The ability of an asset to be converted into cash quickly and without any price discount.

**Official Statement:** The document prepared for or by the issuer that discloses to prospective investors material information on the security being offered for sale, including the purpose of the issue, how the debt will be repaid and the borrower’s financial information.

**Par Bond:** A bond selling at its face value or maturity value.

**Premium:** The amount by which a bond’s par amount is less than its market price.

**Prime Rate:** The interest rate that commercial banks charge their most creditworthy borrowers.

**Put (or Tender Option) Bonds:** Obligations that grant the bondholder/investor the right to require the issuer/borrower or a designated third party to purchase bonds, usually at par, either periodically, at certain times prior to maturity, or upon the occurrence of specified events or conditions.

**Qualified 501(c)(3) Bonds:** Tax-exempt bonds can be issued for certain “qualified organizations.” The most common qualified organization is a nonprofit entity that has been established for charitable purposes. If a project furthers the mission of such an organization, it generally qualifies for tax-exempt financing.

**Ratings:** Evaluations of the credit quality of securities and/or borrowers usually made by independent agencies. Ratings are initially made prior to issuance and are periodically reviewed for confirmation or amendment if the borrower’s credit position has changed.

**Ratio:** A formula used to compare different measures of an organization’s performance. The three main types are profitability, liquidity and capital structure. Benchmark ratios are specific ratios that are constantly used to measure performance of one organization against another.

**Refunding:** A procedure whereby an issuer refinances an outstanding bond (refunded bond) by issuing new bonds (refunding bond). There are generally two reasons for doing this: to reduce interest costs or to remove burdensome or restrictive covenants imposed by the terms of the bonds being refinanced. There are two types of refundings: current and advance. A current refunding refers to the ability to retire the refunded bonds within 90 days of closing the new issue. An advance refunding requires



proceeds of the new issue to be used to purchase other obligations that are then deposited in escrow. These escrowed obligations mature in sufficient amounts and at appropriate times to provide funds to pay interest and principal of the prior issue when due or callable.

**Reimbursement Agreement:** Agreement between the borrower and letter of credit bank describing the reimbursement obligation of the borrower for draws on the letter of credit. Also contains other credit terms typically found in loan agreements.

**Reimbursement Resolution:** An official statement enacted by the directors of an organization that allows the organization to reimburse capital expenditures between the resolution date and the issuance of tax-exempt bonds. The earlier this is done the more reimbursements may be made out of the tax-exempt debt financing.

**Remarketing:** A formal re-underwriting/re-selling of a bond issue that has been “put” by an investor. The remarketing agent typically is responsible for periodically resetting the interest rate on floating/variable-rate transactions.

**Revenue Bond:** A type of bond in which the issuer pledges to repay the bondholders with revenues generated by the operations of the project financed.

**Serial Bonds:** A series of bonds with individual maturities and individual interest rates. Usually these bonds mature in the first 10 to 12 years of a financing.

**Sinking Fund:** A structured plan to accumulate cash for the purpose of redeeming a fixed portion of bonds. This may comprise a portion of or the entire issue and is in accordance with a fixed schedule detailed in the trust indenture or reimbursement agreement. This helps an organization create level debt service over time rather than having to pay it all off at the maturity.

**Swap:** An exchange of streams of payments over time according to specified terms. The most common type is an interest rate swap, in which one party agrees to pay a fixed interest rate in return for receiving an adjustable rate from another party.

**Term Bond:** A bond with a single final maturity date and single interest rate. All or a large part of an issue of bonds may be sold as one or more term bonds. Term bonds usually have mandatory annual payments called sinking fund payments.

**Trust Indenture:** A contract between the issuer and the bond trustee that sets forth the obligations of the issuer to the bondholders. Such contract includes specific repayment, collateral, default and bond fund provisions.

**Yield Curve:** A graph plotting market yields on bonds of equivalent quality but different maturities at a given point in time. The structure of interest rates as reflected by the yield curve will vary according to market conditions. A *normal* or *positive* yield curve results when short-term securities have a lower interest rate than long-term securities. An *inverted* or *negative* yield curve results when short-term rates exceed long-term rates. A *flat* yield curve exists when short- and long-term rates are approximately the same.

**Appendix B:**  
**ARBITRAGE FOR THE NONPROFIT**

The primary reason for issuing bonds is to provide funding for capital expansion projects. Additional benefits include the possibility of increased cash flow to the organization and the ability to structure long-term capital objectives through comprehensive asset/liability management planning. Borrowing on a tax-exempt basis allows an organization to invest cash that would have otherwise been used for the project and obtain a return to offset, and in some instances exceed, its cost of capital. This is referred to as arbitrage.

Tax-exempt financing is beneficial to organizations without extensive assets because it makes borrowing money for expansion and rehabilitation more affordable by offering low interest rates. Organizations with very strong balance sheets or large endowments also find it advantageous because of the possibility to realize returns in excess of the interest expense and arrange rate structures to hedge investment risk.

The general population is encouraged to avoid incurring debt and paying unnecessary interest expense. Nonprofit organizations are different because they can counter the interest payment costs with returns earned through investments. Borrowing at tax-exempt rates and investing at taxable rates is usually an opportunity to realize a positive spread. There are some stipulations and regulations governing these transactions, but this is a legal way to help offset the cost of capital.

Variable-rate debt having a maturity of less than one year is priced at the shortest end of the yield curve and resets regularly throughout the life of a loan. This means that rates and associated debt service payments will change as the market fluctuates. On the other hand, fixed-rate debt is set at the date of issuance for the entire term and is based on rates further out on the yield curve. This locks in debt service and eliminates the risk of interest rates rising.

Fixing rates may on the surface appear to be the more prudent approach, but it is not always

the most cost-effective option. Typically, the correct decision for a nonprofit organization requires analysis of assets and liabilities to create a management plan and adopt an appropriate debt policy. The goal is to develop a method of matching investment income with debt service so that a change in rates will not have a negative impact on the operating budget.

The percentage of debt and assets which pay or earn interest at fixed and floating rates is usually established after assessing risk tolerance and investment return goals. The following are two fundamental arbitrage strategies:

1. Utilize fixed rates for both debt and assets. Invest the assets in maturity-matched, taxable, U.S. Government fixed-rate investments. The net cash flow to the organization is the interest earned on the taxable bonds less the cost of the borrowing.
2. Utilize floating rates for both debt and assets. Invest the assets in taxable, U.S. Government investments with similar rate terms as the debt. While there may be temporary fluctuations, the net cash flow to the organization is the interest earned on the taxable bonds less the cost of borrowing.

When interest rates (both long- and short-term) are relatively low, there is very little difference between the economic values of these two options. Neither will create enough spread to generate significant additional revenue. However, when rates rise, the spread expands, and the result can be considerable additional investment income for the organization using floating rates for both debt and assets.

Historically as rates rise, the taxable rate rises much faster than the tax-exempt rate. This is shown in the diagram on the following page.

The strategy is to fix both debt and assets at a point during the market cycle that allows the organization to realize an acceptable spread and create riskless arbitrage. The result is positive

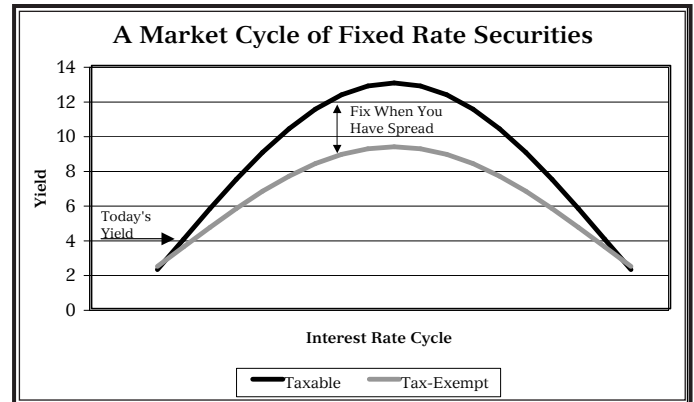


investment returns that translate into additional cash flow to the organization for the remaining life of the debt.

The takeaway from all this: individuals and for-profit entities generally benefit from fixed-rate financing, but nonprofits are different. Nonprofits must overcome the initial impulse to fix rates, establish a certain debt service and eliminate exposure to a rising rate environment. This does not consider the entire situation and focuses too myopically on the liability side of the equation. Nor does this view consider the perpetual income earning nature of most nonprofits.

Nonprofit organizations can borrow at some of the lowest costs in the capital markets. Additionally, most of these entities have positive financial assets available for investment. This combination (low cost and tax-free return) allows for the possibility of arbitrage.

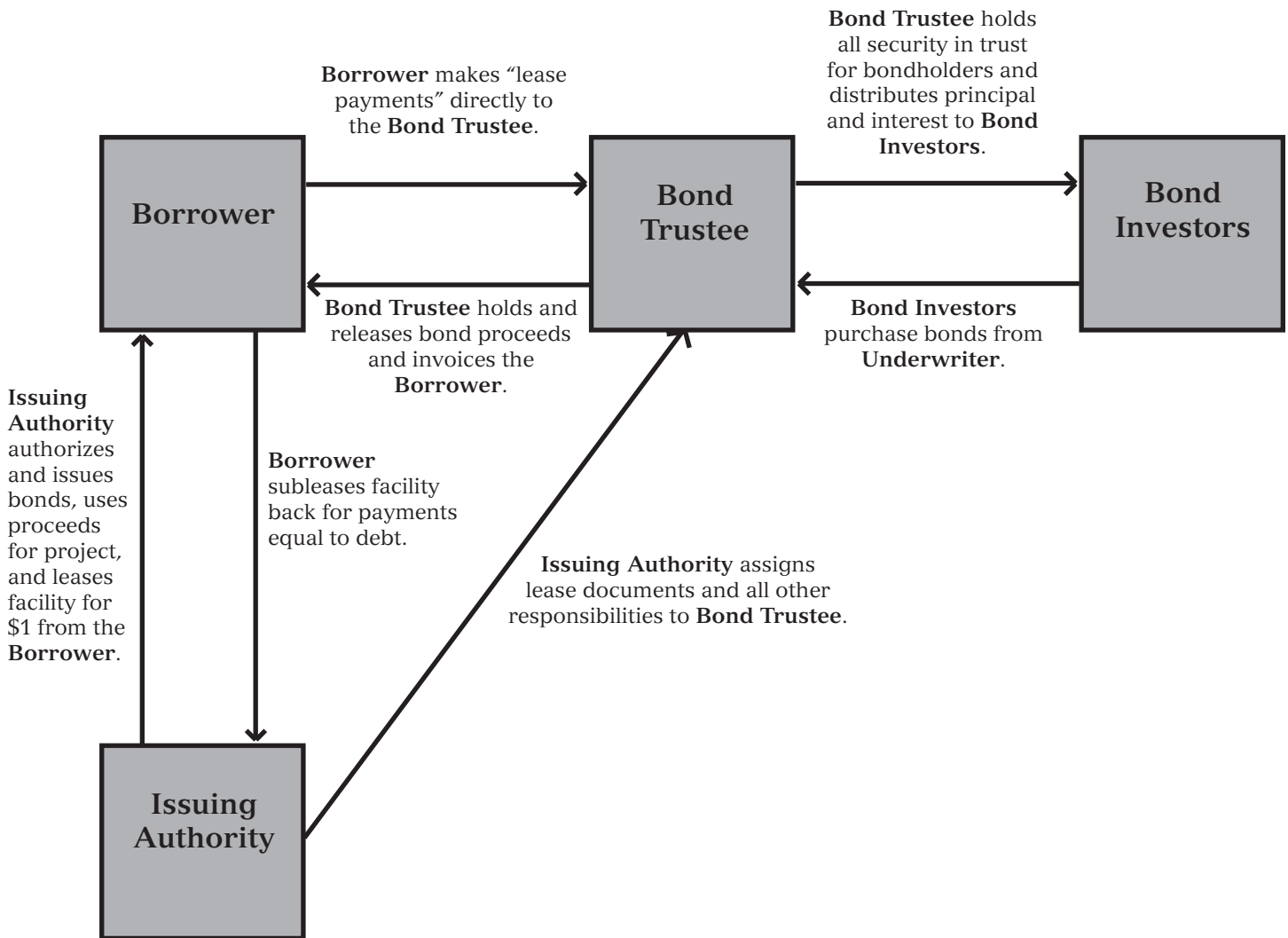
A more complete analysis of the situation, which includes both sides of the balance sheet (assets and liabilities), can result in the development of new policies yielding long-term financial benefits to the nonprofit organization.



**Appendix C:  
TYPICAL COSTS IN A BOND ISSUANCE**

Time of Costs	Type of Cost/Description
<p><b>Up-Front Issuance/Closing Costs</b></p>	<p><b>Attorney Expense:</b></p> <ul style="list-style-type: none"> <li>■ Bond Counsel</li> <li>■ Borrower’s Counsel</li> <li>■ Underwriter’s Counsel</li> <li>■ Credit Enhancement Counsel</li> </ul> <p><b>Up-Front Fees:</b></p> <ul style="list-style-type: none"> <li>■ Underwriter’s Discount</li> <li>■ Printing Costs for Disclosure Documents and Bonds</li> <li>■ Trustee Acceptance Fee (if applicable)</li> <li>■ Issuer’s Fee (if applicable)</li> <li>■ Credit Enhancement Origination Fee (if applicable)</li> <li>■ Bond Rating Fee (if applicable)</li> </ul>
<p><b>Periodic Costs</b></p>	<ul style="list-style-type: none"> <li>■ Annual Trustee Fee</li> <li>■ Annual Credit Enhancement Fee (if applicable)</li> <li>■ Annual Remarketing Fee (if variable-rate debt)</li> <li>■ Rating Fees (if applicable)</li> <li>■ Annual Issuer Fees (if applicable)</li> </ul>

**Appendix D:  
BASICS OF A TAX-EXEMPT BOND ISSUANCE**





**Appendix E:  
PRIVATE ENTITIES AND PROJECTS  
QUALIFYING FOR TAX-EXEMPT FINANCING**

Bonds qualifying for federal income tax exemption must satisfy the requirements of the Internal Revenue Code.

Type of Bond	Description
<b>501(c)(3) Bonds</b>	<ul style="list-style-type: none"> <li>■ Involve nonprofit organizations that are exempt from tax under Sec. 501(c)(3) of the Internal Revenue Code.</li> <li>■ Project must further the mission of the nonprofit organization.</li> </ul>
<b>Housing Bonds</b>	<ul style="list-style-type: none"> <li>■ Involve for-profit and nonprofit owners.</li> <li>■ For low- and moderate-income multifamily or elderly residential facilities.</li> </ul>
<b>Refunding Bonds</b>	<ul style="list-style-type: none"> <li>■ Issued to refinance projects originally financed with 501(c)(3) or Housing Bonds.</li> </ul>

Some of the more notable requirements for each bond type are as follows:

Requirement	Details of Requirement
<b>95% Test</b>	At least 95% of the bond proceeds must be used for land costs and depreciable property.
<b>3-Year Spend-Down</b>	Bond proceeds must be substantially spent within three years of issuing the bonds.
<b>Maximum Allowable Weighted Average Maturity</b>	Maximum allowable weighted average maturity. The weighted average maturity of the bond issue may not exceed 120% of the reasonably expected weighted average economic life of the assets financed.

Requirement	Details of Requirement
2% Maximum for Issuance Costs	No more than 2% of bond proceeds may be used to pay bond issuance costs.
25% Maximum to Acquire Land	Except for 501(c)(3) bonds, no more than 25% of the bond proceeds may be used to acquire land.
Required Inducement Legislation	<p><b>Housing Bonds</b> – Prior to commencing acquisition or construction of a project to be financed with housing bonds, the borrower must obtain from the issuing authority a preliminary resolution indicating its willingness to issue bonds for the project.</p> <p><b>501(c)(3) Bonds</b> – A similar, but less stringent, requirement applies to 501(c)(3) bonds. In fact, nonprofit organizations may adopt their own internal resolution (referred to as a reimbursement resolution) to preserve the eligibility of incurred expenditures prior to receiving a formal inducement resolution.</p>
Annual Dollar Limits by State and Accessing Allocation from State Volume Cap	<p><b>Housing Bonds</b> – The Internal Revenue Code limits the amount of housing bonds that can be issued in any year within each state. Accordingly, each borrower must obtain an allocation from the state volume cap for each bond issue.</p> <p><b>501(c)(3) and Refunding Bonds</b> – Allocation is generally not required for these bonds.</p>
Required Public Hearing	<p>Except for certain refunding bonds, there must be a public hearing on a proposed financing before the bonds can be issued.</p> <p><b>14-Day Notice</b> – Generally, notice of the public hearing must be published in a local newspaper at least 14 days prior to the hearing.</p>

There are other requirements specific to Housing Bonds. These projects must meet either the “20 - 50” test or the “40 - 60” test for the length of time the bonds are outstanding.

Under this Test:	These Points Apply:
“20-50” Test	At least 20% of the project units must be occupied by individuals whose gross income is 50% or less than federally determined “area median gross income.”
“40-60” Test	At least 40% of the project units must be occupied by individuals whose gross income is 60% or less than federally determined “area median gross income.”

**Appendix F:  
KEY PLAYERS IN TAX-EXEMPT  
FINANCINGS**

**Asset Manager:** This position is sometimes referred to as an “Investment Manager” or “Money Manager” and is responsible for assisting an organization in properly investing financial resources to gain the greatest return. The long-term opportunity is for a nonprofit organization to invest any endowment or excess cash reserves to capitalize on the arbitrage opportunity available when issuing tax-exempt debt.

**Bond Counsel:** An attorney retained by an issuer to provide a legal opinion that the issuer is authorized to issue the proposed securities, has met all legal requirements necessary for issuance, and that interest on the proposed securities will be exempt from taxation. Bond Counsel also prepares many legal documents related to the proposed issuance and will advise the issuer regarding authorizing resolutions, the trust indenture, official statements, validation proceedings and litigation.

**Bond Insurer:** Provides bond insurance to assure the full and timely payment of all interest and principal over the life of the bonds. These organizations typically are paid an up-front fee that is calculated on total interest and principal over the life of the bonds.

**Bond Trustee:** Usually a bank trust department that acts on behalf of the bondholders. The trustee controls specific funds created for the bond issue, controls disbursement of bond proceeds, and is responsible for enforcing remedies and taking actions on behalf of bondholders in the event of default. The trustee also receives debt service payments from the borrower and acts as paying agent. The trust indenture outlines the trustee’s fiduciary responsibilities and bondholders’ rights.

**Borrower’s Counsel:** Represents the borrower in the transaction, frequently drafts necessary disclosure statements about the borrower

and issues opinions on behalf of the borrower and on the legality of its actions regarding the bond issue. Additionally, borrower’s counsel ensures that the appropriate documentation of board approval is obtained and that properly authorized individuals are executing the necessary documents. Finally, borrower’s counsel issues the opinion regarding the borrower’s compliance with any outstanding regulations and/or laws.

**Commercial Banker:** Also referred to as a commercial lender or relationship manager, this person works for the letter of credit bank offering a number of commercial banking products (checking and saving accounts, cash management services, payroll services, lines of credit, etc.) may suggest term loans as an alternative to tax-exempt bond financing.

**Credit Enhancer:** Institutions willing to use their credit and financial strength to enhance the financial strength of a bond issue or mortgage loan. The typical credit enhancer is a letter of credit bank (most common), bond issuer, or governmental agency.

**Financial Adviser:** May be retained by either the borrower or issuing authority to assist in developing a plan of finance and to evaluate the pricing and final structure of the bond issue. A financial adviser can become involved in a financing at any point in the process. In most instances, the investment banker will generally act in this capacity.

**Investment Banker or Underwriter:** Responsible for structuring and managing the financing and selling the bonds or mortgage loan. The underwriter buys the bonds from the issuer or issuing authority and sells the bonds to investors. Although these terms frequently are used interchangeably, a distinction should be made between investment banker and underwriter – investment bankers structure the financing while underwriters distribute the securities to the investing public.



**Issuer or Conduit Authority:** This entity is specific to municipal or tax-exempt bond financings. Usually a governmental division, or at least a quasi-governmental agency, it issues the tax-exempt bonds for a project. These bonds are exempt from certain taxes depending upon where they are issued, who issues them, and the tax status and residence of the bondholder. The issuer can either be a special government entity created solely to issue tax-exempt bonds or be the city, county, or state in which the project resides.

**Issuer's Counsel:** Represents the issuer (issuing authority). Bond counsel frequently acts as issuer's counsel.

**Letter of Credit Bank:** Provides a letter of credit (usually a "direct pay letter of credit") that is drawn on by the trustee to make principal and interest payments to bondholders.

**Letter of Credit Bank Counsel:** Represents the letter of credit bank by preparing and reviewing all documents involving the letter of credit bank and the reimbursement agreement between the borrower and the bank.

**Mortgage Banker:** A mortgage banker originates, sells and services mortgages in the mortgage market. This person is necessary when utilizing some of the government enhancement programs.

**Purchaser's Counsel:** Represents institutional investors or purchasers on certain unenhanced and unrated issues that are considered riskier by the investor community. Counsel reviews all documents and may occasionally negotiate terms, covenants and other items on behalf of the investor.

**Rating Agency:** Makes an independent determination as to the likelihood the bond will be repaid in accordance with its terms. The most well-known rating agencies are

Moody's Investor Services, Standard & Poor's and Fitch IBCA. Ratings established by the agencies allow investors to quickly assess a borrower's financial strength without having to personally study financial statements.

**Trustee's Counsel:** Represents the bond trustee and often is the Bond Counsel in a transaction.

**Underwriter's Counsel:** Represents the underwriter and prepares the official statement. Drafts the bond purchase agreement.



**Appendix G:  
DEFINITION OF RATIOS**

**Liquidity Ratios**

**Days Cash on Hand:**

Unrestricted Cash and Investments / Daily Cash Operating Expenses

**Cushion Ratio:**

Unrestricted Cash and Investments / Maximum Annual Debt Service (MADS)

**Cash to Debt:**

Unrestricted Cash and Investments / (Long-term Debt - Current Liabilities)

**Current Ratio:**

Current Assets / Current Liabilities

**Profitability and Operational Ratios**

**Operating Margin:**

(Total Operating Revenues – Total Operating Expenses) / Total Operating Revenues

**Excess Margin:**

(Total Operating Revenues – Total Operating Expenses + Non-operating Revenues) / (Total Operating Revenues + Non-operating Revenues)

**Cash Flow (EBIDA) Margin:**

(Total Operating Revenues – Total Operating Expenses + Interest Expense + Depreciation + Amortization) / (Total Operating Revenues + Non-operating Revenues)

**Capital Structure and Cash Flow Ratios**

**Debt Service Coverage\*:**

(Total Operating Revenues – Total Operating Expenses + Non-operating Revenues + Interest Expense + Depreciation + Amortization) / MADS

**Debt to Capitalization:**

(Long-term Debt - Current Liabilities) / (Long-term Debt – Current Liabilities + Unrestricted Net Assets)

**MADS as % of Total Revenue:**

MADS / Total Revenue

*\* The most widely used ratio in the capital markets, this measures the ability to make debt payments from ongoing operations. The denominator is always the maximum annual debt service, but the numerator can be known by several different terms, including “net operating income,” “net income available for debt service” or simply “net available.”*

**Appendix H:  
CREDIT ANALYSIS**

The best plan of finance is based on a thorough evaluation of the credit strength of the borrower. It is very important to identify and communicate the strengths of the borrower during this process. The following are some important considerations.

**Financial Operating History:** The borrower’s recent financial performance is a strong indicator of credit strength. Generally, three to five years of audited financial statements are necessary for an accurate credit evaluation.

**Financial Position:** Herein the due diligence process assesses the current financial position by breaking down the balance sheet. Particular attention is given to liquidity and capital structure. Highly leveraged organizations will be perceived as being a higher credit risk. So, too, will prospective borrowers with little or no liquidity even if they have minimal long-term debt.

**Financial Feasibility:** Financial projections for the project are important in assessing whether the project is expected to increase revenues or reduce expenses.

**Organization Background/Management/Board:** How long has the organization operated? What kind of experience does it have? Are operations self-managed or does the borrower require the involvement of a management company? If the project is a new endeavor, does the organization have the ability to properly manage it? Attention should also be paid to board members. Their experience, length of service and commitment to the project are all important factors.

**Quality of Services:** What is the perception of the product being offered? How is service delivered? Is it improving? Who are key staff members? What is their experience? What are the staffing levels? How much monetary and human resources will be committed to the project?

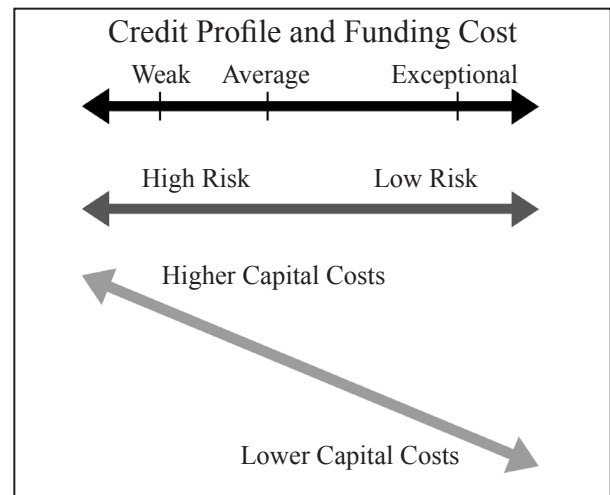
**Utilization and Revenue Mix:** What is the projected utilization of the project? How much can be generated from the project? What is the revenue mix? Are there government payors? Are there private payors? Are there other sources?

**Physical Plant and Location:** Is it new construction or a renovation? What are the construction and utilization risks? How old is the facility? What is the effect on existing operations? Where is the project located? What are the strengths and/or risks of the location? Is there existing competition?

**Litigation History:** What is the history of claims against the organization? Are there any pending lawsuits or claims?

**Collateral:** What is available for collateral to the bondholder in the form of cash and securities, personal property and real estate? What else can be offered to enhance creditworthiness/reduced perceived risk?

The diagram below illustrates the effect a poor credit profile has on borrowing costs.





**Appendix I:  
RATED BONDS**

Ratings on bonds can be achieved in several ways. Bonds can be rated based on the strength of the borrower, or they can be rated because they are backed by another organization that has a published credit rating. The most common example of a backing by another organization is a letter of credit. If a rated bank agrees to stand behind a hospital's bonds, the bonds will receive the same rating as the bank.

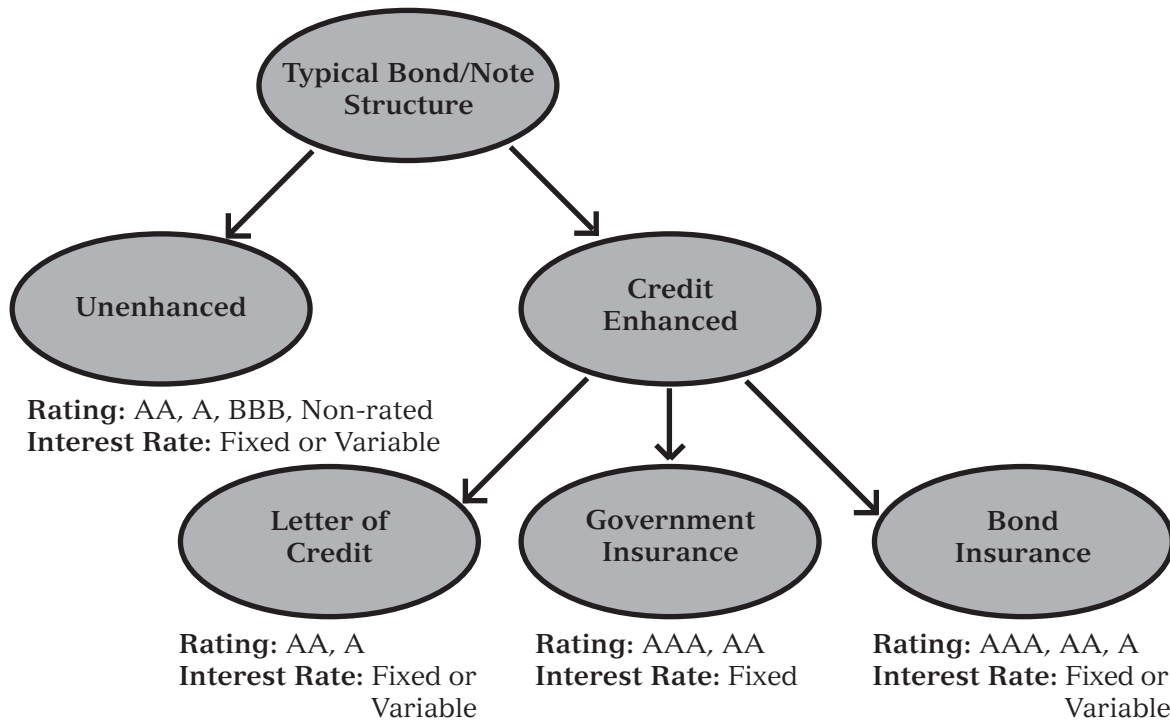
Ratings fall into two general categories: investment-grade and non-investment-grade.

These groupings are significant because many institutional investors can purchase only investment-grade securities. Thus, there is a broader market for distribution of a bond that has an investment-grade rating. This results in a lower interest rate for the borrower.

Issues rated in the four highest categories, "AAA," "AA," "A" and "BBB," generally are recognized as investment-grade. Debt rated "BB" or below generally is referred to as "high yield," "speculative-grade" or "junk bonds." The following chart identifies the relative credit strength of each possible rating category.

	Explanation	S&P	Moody's	Fitch
Investment-grade	Highest rating, capacity to repay extremely strong, highest quality	AAA	Aaa	AAA
	Strong capacity to repay, differs slightly from AAA, high quality	AA	Aa	AA
	Strong capacity to repay/more susceptible to change in circumstance/economic conditions, upper medium grade	A	A	A
	Adequate capacity to repay, adverse economic conditions may lead to weakened capacity to repay, medium grade	BBB	Baa	BBB
NON-Investment-grade	Speculative characteristics, less near-term vulnerability to default	BB	Ba	BB
	Capacity to meet payments, greater vulnerability to default, speculative, low grade	B	B	B
	Current identifiable vulnerability to default, poor to default	CCC	Caa	CCC
	Highest speculation	CC	Ca	CC
	Lowest quality	C	C	C
	Payment in default, default	D		DDD
	In arrears			DD
	Questionable value			D

**Appendix J:  
TYPICAL BOND STRUCTURES**



Each bond structure provides certain inherent advantages, yet there is no one single structure that can generally be deemed “most favorable.” The most appropriate structure for an organization can be determined only after close interaction with management to ascertain objectives, review of the current and anticipated financial condition of the obligor entity, assessment of industry trends and overall market conditions.

Generally bonds can be sold either (1) without any additional enhancement and marketed based on the strength of the obligated entity or (2) credit-enhanced using a variety of vehicles including bond insurance, mortgage insurance and letters of credit.

**UNENHANCED BONDS**

Unenhanced (rated or unrated) bonds sold on the credit profile of the borrowing entity have become widely accepted by investors. These bonds will tend to trade at varying rate premiums depending on the market’s perception of risk at the time of the sale. Bondholders are typically

provided, as security, a first mortgage and lien on property assets, a pledge of gross revenues of the organization, an assignment of resident agreements and trustee-held reserves, including a debt service reserve fund.

The bonds are typically grouped as fixed-rate serial and term bonds bearing a final maturity of 30 years from the date of issuance and defined mandatory principal redemption, and will normally be locked-out to prepayment for a period of 10 years. Since bond investors are relying primarily on the credit strength of the borrowing entity to assess repayment ability, considerable due diligence must be conducted by finance team members and disclosure provided to investors in the official statement. This typically includes a market and financial feasibility study conducted by an accounting firm experienced in assessing similar projects.

This structuring option may be more or less appealing depending on the size of the bond offering, the borrower’s prospective rating, and the perceived credit risk that could result in a premium to reflect the credit spread.



## CREDIT-ENHANCED BONDS

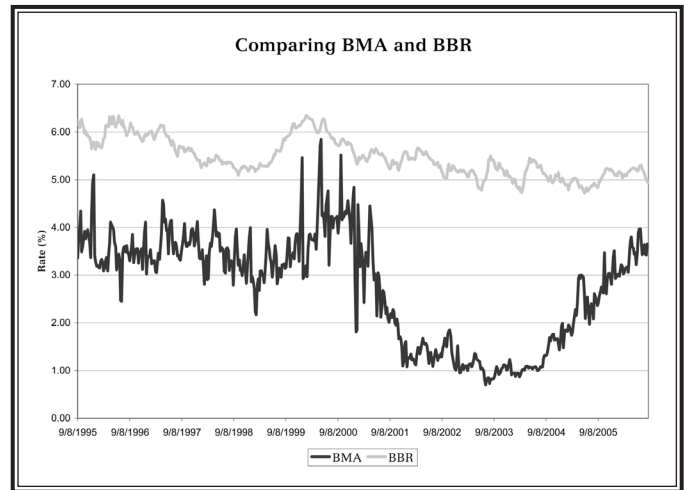
The key to successful credit-enhanced funding is obtaining low-cost credit enhancement with terms that are favorable to the obligor entity and closely align with the short- and long-term financial goals of the organization. Tax-exempt structures are largely sold to institutional accounts with the largest buyers comprising approximately 120 tax-free money market mutual funds. Securities laws and internal credit policies restrict these funds to investing in only the largest and strongest issuers of debt. For these reasons, most tax-exempt issues require that third-party credit support be obtained from large, rated corporate organizations that will effectively guarantee the principal and accrued interest on the debt. The primary forms of credit support, or credit enhancement, utilized in today's market are letters of credit issued by large commercial banking organizations, bond insurance issued principally by one of four primary bond insurers, and government mortgage insurance issued by the U.S. Department of Housing and Urban Development or Department of Agriculture.

### Letter of Credit (LOC)

Letter of credit enhancement from a commercial bank is one of the most effective ways to provide credit support for the issuance of tax-free bonds because the bonds assume the credit rating of the institution issuing the letter of credit. Letters of credit are usually issued for three- to five-year terms and can be renewed or substituted. The cost of a letter of credit is typically calculated on the basis of a one-time fee along with an annual service charge.

The primary benefit of this approach is a lower cost of issuance and annual debt service when compared to other structures. This structure provides more flexibility than any other option and allows the borrower to avoid "locking in the existing credit profile" if it is experiencing a period of vulnerability at the time of the financing. However, the project and the borrower's credit profile must fit into the credit underwriting requirements of commercial banks.

The graph below shows that variable-rate (BMA) structures have historically provided the absolute lowest capital cost to organizations with access to tax-exempt debt as compared to fixed-rate (BBR) structures. Derivative products could be used to substantially mitigate perceived variable interest rate risk.



### Bond Insurance

Bond insurance, like a letter of credit, is a credit enhancement which guarantees that investors will be paid even if the borrower cannot make its scheduled payments. This generally allows the borrower to access capital at much lower interest rates than it could have without enhancement.

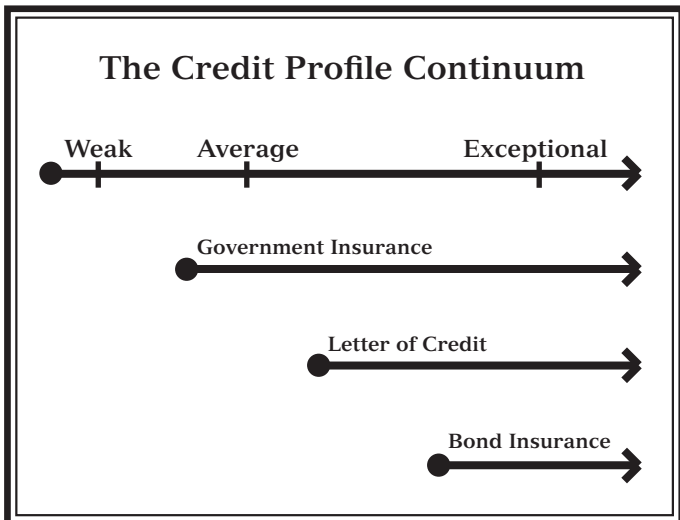
Bond insurance is generally available to a facility that independently can achieve an investment-grade rating of "BBB" or better and can be used for both fixed-rate and variable-rate structures. Bond insurance is generally less expensive on an annual basis than the letter of credit option. The cost, however, must be paid up front, which can have a significant impact on the economics and financial attractiveness of such a transaction.

**Mortgage Insurance**

Credit enhancement for certain types of facilities can also be obtained through utilization of government mortgage insurance programs, which are generally available to fund new facilities, acquisitions, renovation and modernization of existing projects or to refinance existing debt. Mortgage-insured loans provide minimal risk to the bondholder, resulting in lower interest rates and longer amortization terms than are generally available with conventional financing. The lower rates and longer amortization also can enhance the feasibility and affordability of a proposed project, especially for the low- to moderate-income housing market.

Insured mortgages are non-recourse to the borrower and are backed solely by the real estate and other assets of the borrower corporation. This structure also provides minimal risk to the borrower because the organization is only liable for the financial performance of the individual facility being financed. Borrowers taking advantage of this type of credit enhancement must work with approved mortgage lenders to complete the process.

Below is a graphical representation of the credit profile continuum showing the availability of each form of credit enhancement as it relates to the borrower’s creditworthiness.



**Appendix K:  
SECURITY AND COVENANTS**

Bondholders almost always expect some security for their investment. This means that the payment of interest and principal is based on more than a promise to pay by the borrower and is supported or secured by additional items. The underlying credit of the borrower will be the primary determinant of the types of security that will be required for a financing. An investment banker’s skill, reputation in the financial community, and the ability to negotiate on behalf of the borrower can affect those requirements. Security normally includes a first mortgage and security agreement, a pledge of gross revenues, a debt service reserve fund and additional loan covenants.

**SECURITY**

**First Mortgage and Security Agreement:** Bondholders generally expect a first mortgage on the project being financed with tax-exempt bonds. The mortgage is similar to a home mortgage and provides the bondholder certain rights, including foreclosure in the event of default. The lien is documented through a first mortgage and security agreement filed in the county in which the property is physically located. On some higher-rated transactions, a first mortgage may not be required. In this case, a negative lien (where the borrower agrees not to encumber the facility with other liens) will be given as security.

**Pledge of Gross Revenues:** The borrower must pledge all of its gross revenues for payment of debt service on the bonds. This pledge is considered an important part of the security package. Most tax-exempt bond issues are called revenue bonds rather than mortgage bonds because the revenues of the project being financed are the primary source of bond repayment.

**Debt Service Reserve Fund:** It is customary for a bond issue without credit enhancement to include the funding of a debt service reserve



fund that can be used for principal and interest payments to the bondholders if the borrower is unable to pay. It normally equals the maximum annual debt service of principal and interest to be paid in any year during the life of the bonds.

### ADDITIONAL COVENANTS

The legal documents associated with a bond issue include an agreement (“covenant”) by the borrower to pay all interest and principal due on the bonds. In addition to this fundamental repayment requirement, other business terms provide added security for the bonds. Covenants, like other components of an issue, are negotiable. It is important to balance the interests of the parties involved so as to give the bondholder some degree of control and allow the borrower enough flexibility to operate.

**Ratio or Financial Covenants:** These covenants refer primarily to the financial performance of the borrower and some of the more common are listed in *Appendix G: “Definition of Ratios.”* These usually are set at minimum standards and generally are the easiest way to provide early warning of financial trouble. Covenants related to liquidity ensure that the borrower always has cash available for operations and debt service in the event of a revenue shortfall or cash flow shortage. Debt service coverage ratio is probably the most widely used ratio covenant because it measures the ability to make debt payments from ongoing operations.

**Additional Indebtedness:** Bondholders do not want borrowers to incur additional debt indiscriminately and thereby weaken their ability to pay debt service on the bonds. Therefore, borrowers usually must agree to covenants restricting their actions in this area. Guidelines or formulas can be negotiated in the covenant to allow the borrower to incur some additional indebtedness without the bondholders’ permission.

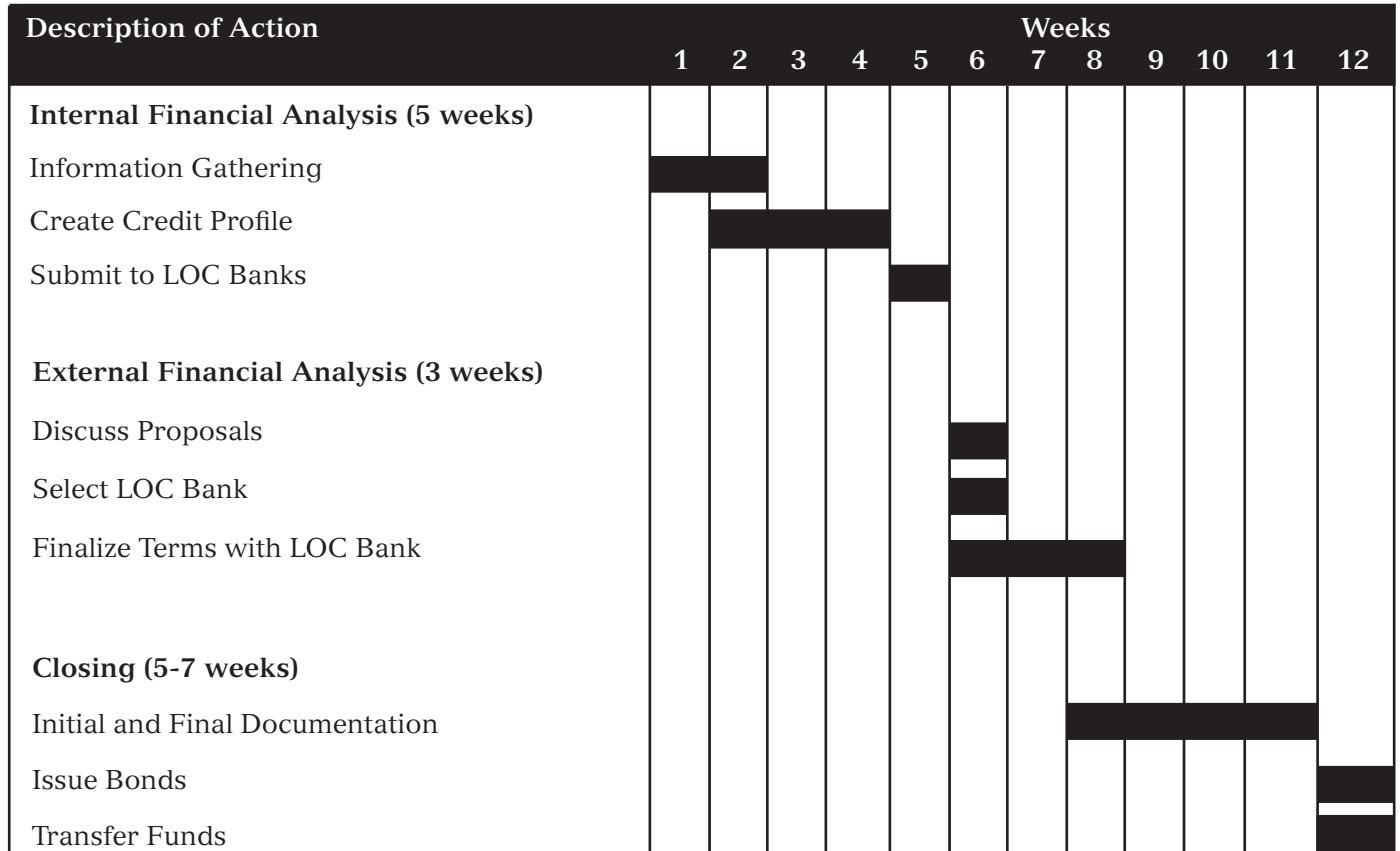
**Insurance Covenants:** These covenants will require that minimum standards for insurance be maintained on assets on which the investor

is holding a security interest and/or are relied upon by the borrower to generate revenue. This enables the borrower to rebuild/replace damaged assets, make available sufficient funds to service debt, and ensure that the bondholder is protected with respect to its reliance on the value of the collateral.

**Maintenance Covenant:** A maintenance covenant refers to the continuous upkeep of a facility or property to help maintain the value. Again, this is important during a bond issue when the investor is holding a first mortgage on the property as a guarantee for the loan.

**Financial Statements:** There always will be a need to review the borrower’s audited financial information to ensure compliance with ratio covenants.

**Appendix L:  
THE PROCESS FOR ISSUING TAX-EXEMPT DEBT  
USING LETTER OF CREDIT ENHANCEMENT**





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