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Dear Clients and Friends:

Over the past nearly seven years, First River Advisory clients have benefitted from my insight, independence, thoroughness and ability to distinguish between the you-know-what and the shinola. A case study was presented in a newsletter recently published by a leading investment banking firm that just didn't pass the smell test, even after two readings (and plenty of chuckling over a certain diction error). I couldn't resist investigating further to confirm or disprove the information presented.

THE "PLAIN VANILLA" APPROACH

In this case study, the investment banker's client, a non-profit health care organization, was considering alternative capital financing strategies for a significant expansion and renovation project. The most straightforward course of action under consideration was a plain-vanilla issue of long-term, fixed-rate bonds. Because of the credit quality of the organization and the ambitiousness of the project, it was determined that bond insurance would not be available, nor would there be much chance of obtaining an investment-grade rating. Thus, these non-rated bonds were expected to yield approximately seven percent. More or less the conventional wisdom, so far.

The banker observed that during the eighteen-month development period for the project, the reinvestment rate for those bond proceeds awaiting application toward project costs (and capitalized interest) would be approximately 2¼ percent due to the short-term nature of the investment (an average life of only nine months) and the relative steepness of the yield curve. The borrower would also experience "negative arbitrage" with respect to the debt service reserve fund (DSRF), although to a lesser degree because of the longer-term nature of the DSRF investment. These shortfalls would have to be alleviated by issuing more bonds than would be the case if the reinvestment rates were closer to the bond yield. With debt capacity already an issue, the banker and his client were rightfully sensitive to the impact of issuing more bonds.

AN ALTERNATIVE STRATEGY

The banker then presented an alternative that would substantially resolve the negative arbitrage issue – the issuance of weekly-mode variable-rate demand obligations (VRDOs), the familiar "low floaters." In this instance, the VRDOs, backed by a bank letter of credit (LOC), would be used as interim financing, designed to be refunded by a long-term, fixed-rate bond issue in approximately two years. The banker contended that the health care organization would be able to

save \$3½ million minus the cost of issuing the refunding bonds, a significant amount when measured against a \$29 million construction project. This \$3½ million reflected the difference in principal amounts between the two alternatives. Of this amount, however, \$1½ million (43 percent) represents the difference in amounts deposited into the DSRFs, which would eventually be returned to the borrower, thereby calling into question the validity of this comparison.

FIRST RIVER ADVISORY'S RESPONSE

To achieve a valid comparison, the more appropriate analysis is not as simplistic as that which the banker presented. The two cases to be compared should be:

1. Issue long-term, fixed-rate bonds now; versus
2. Issue VRDOs now, and issue a series of long-term, fixed-rate bonds at the end of the eighteen-month development period to refund the VRDOs which would then represent the permanent financing.

Let's assume that the securities are issued on July 1, 2002, so that the development period would end on January 1, 2004. In both Cases, because interest would be capitalized during the entire development period, there would be no cash flow impact on the borrower before 2004. In Case #1, the borrower would be obligated to pay interest from its operations beginning on January 1, 2004. The bonds would commence amortization on January 1, 2005, according to a level debt service schedule until their final maturity in 2034. In Case #2, all of the VRDOs issued on July 1, 2002 would still be outstanding on January 1, 2004, but would be refunded at that time. The long-term, fixed-rate bonds issued on that date would have the same characteristics thereafter as the bonds issued in Case #1. Despite some simplifying assumptions (but without invalidating the analysis), I was able to replicate the banker's figures to a reasonable degree:

Sources and Uses of Funds			
	Case 1	Case 2	Comments
Sources of Funds:			
Bond Proceeds	35,245,000	33,345,000	
Liquidation of DSRF re VRDOs	0	1,623,500	Not typically required for VRDOs, but it was assumed by the banker
TOTAL	35,245,000	34,968,500	
Uses of Funds:			
Refunding of VRDOs	0	31,775,000	The VRDOs funded all project costs, the DSRF, capitalized interest and costs of issuance
Deposit to DSRF	2,842,200	2,689,300	Maximum Annual Debt Service; invested at 5.75% and used to offset capitalized interest
Deposit to Project Fund	29,000,000	0	Gross funded; invested at 2.25% and used to offset capitalized interest
Deposit to Capitalized Interest Fund	2,871,567	0	Net funded; invested at 2.25% with earnings retained in this fund
Costs of Issuance	528,675	500,175	1½%; costs of issuing the VRDOs (at 1¼%) had already been funded by the VRDOs
Rounding Amount	2,558	4,025	
TOTAL	35,245,000	34,968,500	

The difference in principal amounts between the long-term, fixed-rate bonds issued now and the VRDOs is \$3,470,000, almost precisely the difference calculated by the banker. Unlike the banker's analysis, however, the amounts deposited into the respective DSRFs would be less than \$153,000 apart.

What's more meaningful, though, is the difference between the principal amount of the long-term, fixed-rate bonds issued now and that of the long-term, fixed-rate bonds to be issued to refund the VRDOs eighteen months from now. That difference is only \$1.9 million. But the interest on that differential must be taken into account, as computed in the table below.

Debt Service Requirements			
	Case 1	Case 2	Difference
Principal	35,245,000	33,345,000	1,900,000
Interest (excluding amount capitalized)	49,962,500	47,262,600	2,699,900
Total Debt Service	85,207,500	80,607,600	4,599,900

Because the time frames are alike, there is no need to calculate present values. Also, because the amounts on deposit in the DSRFs relating to the two Cases differ by only slightly, the earnings differential can be disregarded.

Electing the course of action recommended by the banker would save the borrower nearly \$4.6 million. Sounds like a great deal (though it would take thirty years to accrue all such savings, a fact not clearly stated by the banker in connection with his \$3½ million estimate). But, one normally doesn't get something for nothing without taking on risk.

NO FREE LUNCH

One risk that the banker rightfully identified is that the VRDOs may not remain at their current low levels (remember what the "V" in VRDO stands for). It would be reasonable to assume that for a below-investment-grade borrower, the three percent "all-in" rate assumed by the banker could be divided into 1¾ percent for the VRDOs themselves, plus 1¼ percent for the annual LOC fee (ignoring the annual remarketing and other ongoing fees). Consider that the long-run average of VRDO rates is approximately 3¾ percent. That average rate, plus the LOC fee, would result in an "all-in" rate of five percent. Suppose we split the difference, and assume an "all-in" rate of four percent in order to estimate the sensitivity of the model to interest rate changes. The principal amount of the bond issue that would refund the VRDOs would increase to \$33,895,000, and total debt service would increase to \$81,937,400. This change in assumption would put a \$1.33 million dent in the \$4.6 million savings figure calculated above, diminishing such savings by nearly 29 percent.

One significant risk that the banker does not point out is that the yield on the long-term, fixed-rate bonds to be issued later to refund the VRDOs is not likely to be seven percent. True, it could be lower, providing the borrower with a "win-win" scenario. But, as I frequently illustrate to clients, the "best-ever" borrowing rate for a below-investment-grade hospital is in the upper 5's; "worst-ever" is sixteen percent. Given that information, seven percent sounds attractive to most decision-makers, with more downside (adverse) potential than upside potential. If the yield on the long-term, fixed-rate bonds issued in the future were even 0.25 percentage point greater (7¼ percent), total debt service savings would decrease by nearly one-half, to \$2,386,363. An increase to 7½ percent would evaporate the savings altogether. Worse yet, the borrower could encounter adverse interest rate changes with respect to both the VRDOs and the long-term, fixed-rate bonds, thereby compounding their individual effects. Governing board members of non-profit organizations who are entrusted with the stewardship of the public's assets may face some rather challenging questions about their decision-making in 2002 if the interest rate environment were to change adversely as the time to implement the long-term, fixed-rate refunding bond issue approaches. I know of two hospitals in particular which, in those unprecedentedly favorable pre-AHERF days in 1998, utilized bank loans having five-year terms to finance major building projects. Their alternative at the time would have been the issuance of long-term, fixed-rate bonds, probably at yields under six percent. We'll see what the interest rate environment has in store for them in 2003.

One additional factor that the banker discusses is the limitation on future flexibility imposed by the bank which issues the LOC. Remember, though, that the borrower's plan to refund the VRDOs in (my assumption) eighteen months would enable the LOC to be cancelled and the relationship with the bank discontinued. I don't believe that the covenants that would be imposed by a bank during the development of an ambitious project by a below-investment-grade borrower would be materially different from those imposed by high-yield bond investors or any other lender. Thus, I believe that the banker overestimates this risk. He cites a potential limitation on additional indebtedness. However, it would seem to me that an organization which had not yet spent the \$32 million that it just borrowed would be foolish to consider incurring even more debt, unless, of course, a genuinely remarkable "can't miss" opportunity were to present itself. The banker suggests that the borrower may become comfortable with the VRDOs' interest rate risk, and may prefer to keep them outstanding for the long run. If the borrower were to elect that course of action, other bank covenants and limitations would, naturally, become more meaningful.

There is no mention by the banker of other events which could transpire over the period between the two financings. For one, the organization's credit quality could deteriorate. Because it is already a below-investment-grade credit, any material deterioration could cause the organization to find itself unable to gain access to the capital markets entirely. Then, the organization would be faced with having to use what had been originally intended as interim financing as permanent financing. I would predict some difficult negotiating sessions with the bank that provided the LOC, for its expectations regarding the interim nature of its LOC were similar.

EXPECT BETTER

Health care organizations, especially smaller ones which are infrequent participants in the capital markets, must have confidence that their capital finance consultants, be they investment bankers or financial advisors, are conducting insightful, unbiased and thorough analyses. In this case study, faulty logic and the lack of thoroughness resulted in:

- the wrong figures being compared, calling into question the savings figure presented;
- the inclusion of a significant portion of the purported savings that should not have been counted;
- no mention of the time frame over which savings would accrue; and
- fewer than all the risks being identified, much less quantified.

Without much effort, I was able to produce an analysis that rectified these shortcomings. Moreover, my quantitative analysis revealed that even relatively minor changes in key assumptions produce material changes in expected outcomes. Maybe the case study presented appeared superficial due

to publishing space limitations, and that the analyses actually presented to the client were more accurate and complete. I can only hope that the client was better served than this case study would seem to indicate.

First River Advisory clients who have completed financings will recognize that the logic and thought processes that formed the foundation for these comments are consistent with those which I applied to their particular situations. For those of you with whom I have not yet collaborated, let these comments provide an example of how my expertise and approach can benefit your organization. If you are planning a project that may require financing, or if your organization's balance sheet could use some improvement, please contact me. For more information on First River Advisory's capabilities and accomplishments, please visit us on the Internet at www.firstriver.com.

Best regards,

A handwritten signature in black ink, reading "Shelley J. Cronin". The signature is written in a cursive style with a long, sweeping flourish extending from the end of the name.