A Guide to Financing Strategies for Hospitals - With Special Consideration for Smaller Hospitals

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Importance of Debt Financing

• Debt financing essential to nearly all hospitals and health systems
• Health reform and transformation accelerating capital needs
  • Physician employment and integration
  • Care management
  • Information technology
  • Facility modernization and expansion
Importance of Debt Financing (contd.)

• Constrained capital markets since mid-2008 have caused more limited capital access, fewer borrowing options, higher cost of capital, more restrictive terms, less flexibility and higher risks

• Especially difficult for smaller hospitals – rural hospitals, critical access hospitals, stand-alone community hospitals
  • Have almost always experienced more difficulty in accessing capital markets
7 Key Strategies

• Understand your strategic financial strength and maintain credit strength
• Identify and evaluate the full range of financing options
• Consider sources of local and state support
• Consider partnership as a broad strategic capital option
• Evaluate and select the best financing strategy
• Involve the right professionals
• Stay closely connected
Understand Your Strategic Financial Strength and Maintain Credit Strength

• Analyze strategic financial position
  • Market and competitive positions
  • Key market demand/volume trends
  • Programs/service line strengths and weaknesses
  • Facility development needs
  • Financial and capital position
  • Current and likely future debt capacity
Understand Your Strategic Financial Strength and Maintain Credit Strength (contd.)

- Quantify expected impact of health reform and market forces on regular basis – at a minimum:
  - Projected volume of business, including Medicaid expansion and new state insurance exchanges
  - Capacity to accommodate new volume
  - Financial implications of payment rate and payor mix changes
  - Operating impacts and capital requirements of expanded hospital-physician organizations/relationships
  - IT-related capital and operating costs
  - Capital needs for other strategic initiatives and routine operating requirements
Understand Your Strategic Financial Strength and Maintain Credit Strength (contd.)

- Understand advantages of strong credit position
  - Access to both taxable and tax-exempt public debt
  - Expanded pool of potential leaders, driving improved pricing and terms
  - Lower cost of capital
  - Less restrictive bond covenants
  - Ability to be market consolidator
• **Action Items**
  - Accurately assess current strategic and financial position, where it needs to go, and resources to get there
  - Do everything possible to preserve strength of credit position

• **For Smaller Hospitals**
  - Challenge is having scale and financial position to secure public credit rating that is high enough to be helpful to capital formation effort
  - Many capital financing strategies involved use of credit intermediaries, e.g., banks, FHA, which do not necessarily require public credit rating
  - Objective strategic and financial planning, along with ongoing rigor and discipline in financial management critical to success of smaller hospitals
Identify and Evaluate the Full Range of Financing Options

- Financing Options
  - Municipal bonds – fixed- and variable rate
  - Direct bank loans
  - FHA Section 242 Mortgage Insurance Program
  - Leasing
  - USDA Rural Development Community Facilities Program
  - New Market Tax Credit Program
  - Debt restructuring
  - Asset sales
Action Items

- Assess full range of financing options, including nontraditional sources
- Recognize that fixed-rate bonds are least risky, but often most costly form of debt
- Be aware of changing accounting environment for leasing (on balance sheet, like debt)
- Ensure that leasing is not used to finance projects to circumvent hospital’s capital decision-making process
- Scrub existing portfolio of businesses and divest non-core assets
For Smaller Hospitals

- While typically fewer options available, public and private financing alternatives available if smaller hospitals willing to invest needed time to access them
- Access to direct bank lending has opened up, but may require exclusive banking arrangement
- Divestiture of businesses or programs that are not affordable or core to mission is key to survival for small organizations without significant credit strength
Consider Sources of Local and State Support

- Can significantly reduce hospital’s cost of capital
- Options
  - Local units of government pledging financial support
  - Waiving state or local sales tax for construction materials
  - Obtaining city or county agreement to support debt service in case of hospital default
  - Introduce “millage pledge” as ballot initiative – promise by taxpayers to support bonds directly or through underlying guarantee
  - Enterprise or redevelopment zone financing
  - Assistance with FHA financing
  - Philanthropy
Consider Sources of Local and State Support (contd.)

• **Action Items**
  - Explore sources of local and state support
  - Pursue philanthropic support as appropriate

• **For Smaller Hospitals**
  - Explore all local and state capital options
  - Communities with small hospitals typically highly invested in retaining local access to health care and related jobs
  - Some might be able to afford direct or indirect support of the hospital
Consider Partnership as a Broad Strategic Capital Option

- Consider partnering with other organizations (or physicians) that can bring capital to the table
- Can vary in level of integration and control
- Criteria for consideration
  - Synergy of mission
  - Organizational culture
  - Market position
  - Financial and operational positions
Consider Partnership as a Broad Strategic Capital Option (contd.)

- Strategic options available to small hospitals
  - Proceed as independent provider
  - Affiliate with larger not-for-profit health system
  - Merge with a not-for-profit health system
  - Divest assets to a for-profit health system and use sale proceeds to establish health care foundation
Consider Partnership as a Broad Strategic Capital Option (contd.)

**Action Items**

- Consider/pursue partnership options as appropriate
- Ensure use of structured process for making well-informed decisions
Consider Partnership as a Broad Strategic Capital Option (contd.)

• For Smaller Hospitals
  • Emerging new business models and health reform more challenging than in past
  • Many stand-alone hospitals and small health systems recognizing that they do not have strategic/financial resources and competencies to be successful in new era
    • Close integration with physicians
    • IT sophistication
    • Balanced service distribution
    • Strong payor relationships
Evaluate and Select the Best Financing Strategy

• Evaluation criteria
  • All-in borrowing rate
  • Costs of issuance
  • Use of proceeds
  • Credit position
  • Document structure and underlying security requirements
  • Covenants
  • Principal amortization
  • Interest rate risk
  • Average useful life vs. average maturity
  • Disclosure requirements
  • Prepayment penalties and unwind provisions

• Stick to basics – use more complicated financing vehicles only if they would provide known and measurable benefits
Evaluate and Select the Best Financing Strategy

• **Action Items**
  - Use evaluation criteria to evaluate each debt financing vehicle
  - Ensure that selected debt vehicle provides as much flexibility as possible and involves lowest overall cost of and risk level
  - Stick to basics – don’t select debt vehicles that hospital executives and board members don’t understand

• **For Smaller Hospitals**
  - Even with fewer options typically available, need carefully evaluate each
  - Covenants related to liquidity can be particularly problematic
Involve the Right Professionals

- Financing Team
  - Borrower
  - Borrower’s counsel
  - Borrower’s financial advisor
  - Issuer
  - Issuer’s counsel
  - Underwriter (investment banker)
  - Underwriter’s counsel
  - Bond counsel
  - Master trustee and bond trustee
  - Auditor
Involve the Right Professionals

Involve the Right Professionals

**Action Items**

- Use a multidisciplinary team for tax-exempt bond transactions; ensure that team members have both national and local experience
- Understand the role of financing team members who represent the interests of both the borrower and lenders/investors/issuers
- Ensure that the financing team can provide independent financial advice

**For Smaller Hospitals**

- Hospitals without access to tax-exempt market will need to obtain independent, objective advice about and assistance with financing transactions
Stay Closely Connected

- Hospital management team and board must remain actively engaged throughout financing process
- Decisions at each step can have significant, cumulative effects on organization
- Question all advisors and professionals about range of options available
- Ensure that all viable options and approaches are fully identified and explored
Stay Closely Connected

**Action Items**
- Ensure that management team and board remain fully engaged
- Ensure that financial and other advisor explore full range of available capital options

**For Smaller Hospitals**
- Particularly important for management teams to be closely involved with strategies that including funding from state or local governments or philanthropic sources
- Maintaining strong relationships can help maximize success
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