

ACCESS TO CAPITAL

How community hospitals create a framework to take advantage of favorable market conditions

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Community hospitals face continual challenges to maintain and improve their facilities and equipment. Clearly, a community hospital's failure to achieve this objective could severely impact its viability over the long run. Moreover, community hospitals' perceived lack of access to capital is often cited as a reason to initiate merger or affiliation discussions with larger hospitals.

Despite the continued financial and operational pressures caused by a variety of factors, community hospitals' access to capital has rarely been better. Moreover, many governing board members and executives of hospitals which have successfully accessed the capital markets recently have discovered that they, not lenders or investors, hold the upper hand.

CAPITAL NEEDS

The nature of community hospitals' capital improvement projects has changed remarkably over the years. In recent years, only two cases of Michigan community hospitals having developed complete replacement facilities have been observed: Dickinson County Memorial, in Iron Mountain, and Tolfree Memorial, in West Branch. Nearly as rare are cases where community hospitals have constructed new wings oriented toward inpatient care. Capital improvement projects most commonly undertaken by community hospitals over the past several years may be divided into three categories:

- reconfigurations of organizations' main hospital building to accommodate expanded emergency rooms and more sophisticated outpatient functions;
- acquisitions of equipment, especially information systems and diagnostic imaging units; and
- developments of non-hospital facilities, such as outpatient facilities of various types and senior citizens' residential facilities.

A fourth – acquisitions of physician practices – has become less prevalent as more and more hospitals' financial performances suffer from their operation of physician practices.

CAPITAL FINANCING APPROACHES AND MARKET OVERVIEW

The capital financing approaches most frequently employed by non-profit community hospitals may be divided into three general categories:

- tax-exempt bonds;
- conventional bank loans; and
- a hybrid of the two.

The hybrid approach usually takes the form of either a bank's issuance of a letter of credit to secure tax-exempt bonds, or its direct purchase of tax-exempt bonds.

TAX-EXEMPT BONDS

Most issues of tax-exempt bonds are structured as long-term, fixed-rate securities. The final maturity of a tax-exempt bond issue may be as long as 30 to 35 years. Interest rates are established when the bonds are sold, and do not change for the entire life of the issue. The principal amount of the bond issue is commonly repaid, along with the interest, according to a level debt service schedule, much akin to a home mortgage loan, though variations do occur. There are not usually "balloon payments" associated with tax-exempt bonds. Although tax-exempt bonds cannot normally be prepaid for the first ten years that they are outstanding, techniques are available to enable a hospital to refinance its debt at any time, should interest rates decline.

Tax-exempt bonds may be marketed on the basis of the hospital's own credit quality, as measured by ratings from any of three major debt rating agencies: Moody's, Standard & Poor's (S&P) and Fitch. The nomenclature used by the rating agencies within their investment grade categories is shown in

Investment-Grade Rating Categories	
<u>Moody's</u>	<u>S&P and Fitch</u>
Aaa	AAA
Aa	AA
A	A
Baa	BBB

Table 1. Other rating categories exist, but are considered to be below investment-grade, or speculative in nature. When community hospitals can achieve an investment-grade rating, that rating is

Table 1

usually in the “Baa” or “BBB” category, depending on the rating agency involved. Representative interest rates on long-term bonds in the “BBB” category range between 5½ and 5¾ percent in today’s market. Interest rates on bonds having higher ratings are lower than those on bonds bearing lower ratings.

Hospitals which exhibit superior credit characteristics can often obtain a bond insurance policy from any of several specialized insurance companies. A bond insurance policy provides an added level of protection to investors: in the event that the hospital cannot meet its debt service obligations, the bond insurer guarantees to make such payments on its behalf. Bonds backed by the largest of these insurers earn “AAA” ratings (using the S&P/Fitch system). These enhanced ratings enable the hospital to market its bonds at a lower interest rate than would have been the case if its own rating was used. The hospital pays a premium to the bond insurer, which partially offsets the interest rate savings. Interest rates on long-term insured bonds are currently less than 5 percent.

Bonds that neither bear an investment-grade rating nor are secured by a bond insurance policy can still be sold to investors participating in the “high-yield” market. In today’s unprecedented favorable market environment, long-term “high-yield” bonds frequently yield less than 6 percent.

Beyond the conspicuously lower cost to the hospital attributable to the tax-exempt interest rates, perhaps the greatest advantage of this approach is the opportunity to repay the debt over an extended period that closely matches the useful lives of the assets being financed. The greatest disadvantages are the up-front costs and the degree of effort on the part of hospital management that must be expended to complete a tax-exempt bond financing. Moreover, the cost disadvantage becomes even

assembling an effective and efficient financing team can minimize these disadvantages.

CONVENTIONAL BANK LOANS

While the process of issuing tax-exempt bonds remains mysterious to some, that of obtaining a conventional bank loan is rather straightforward. The relative ease and absence of up-front costs involved in obtaining a conventional loan is offset by the terms of the arrangement. Because the interest income earned by the bank is not exempt from taxation, interest rates are higher than on tax-exempt bonds. Two other characteristics relate to banks’ typical lending practices. First, because banks prefer to be short- or medium-term lenders, terms of conventional loans tend to be limited to the five- to 15-year range. Sometimes, banks will permit hospitals to amortize the loan over a longer period, say twenty years. However, this mismatch results in a potential “balloon payment” which would have to be refinanced or renegotiated at the time. Second, banks prefer to avoid fixed interest rates over the long term. As a result, many conventional loans feature interest rates that are adjusted periodically. This adjustment may occur when the bank changes its prime lending rate, when some other index changes, or at certain predetermined points. It is not uncommon for a conventional loan to feature a 10-year term, a 20-year amortization period and five-year interest rate reset periods. Because of the non-public nature of this market, as well as the diversity of hospitals’ credit quality and lending arrangements, it is difficult to specify representative interest rates on conventional bank loans.

HYBRID APPROACH

The hybrid approach features the issuance of tax-exempt bonds as the funding instrument, but is subject to terms and conditions imposed by the bank involved in the transaction. A bank’s letter of credit (LOC) guarantees the timely payment of principal and interest on the bonds, much like a bond insurance policy. The most widespread application of a LOC is in connection with the issuance of bonds known generically as variable-rate demand obligations (VRDOs). In their most common format, the interest rate on VRDOs is adjusted weekly, and investors may demand repayment on seven days’ notice. Because of the *de facto* short-term nature of these securities, their interest rates are usually the lowest available in the tax-exempt market. A hospital using this technique pays an LOC fee to the bank in addition to the interest rate on the VRDOs. Table 2 portrays a commonly-used index of VRDO interest rates, to which a representative one percent LOC fee has been added. VRDOs may have nominal maturities of thirty years. However, LOC banks usually require that the hospital repay the principal

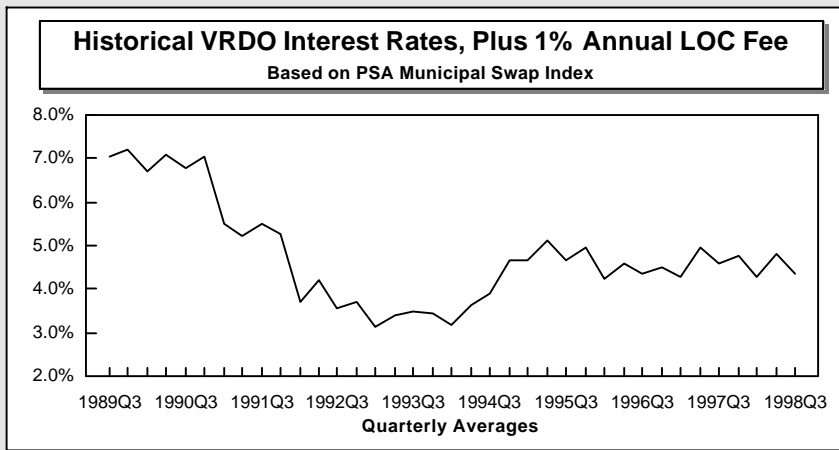


Table 2

more acute as the principal amount of the transaction decreases, a particularly sensitive issue for community hospitals. However,

amount of the VRDOs over a significantly shorter period, often approximating the term of a conventional bank loan. To reinforce this obligation, banks frequently limit the terms of their LOCs to five years, requiring the hospital to negotiate a renewal, arrange for a replacement with another bank, or pay off the balance of the VRDOs at five-year intervals.

The Michigan State Hospital Finance Authority (MSHFA) funds its HELP (Hospital Equipment Loan Program) loans with the proceeds of VRDOs which are secured by a bank LOC. HELP loans are made to hospitals which are approved for participation by the bank, based on the bank's lending criteria. Although the interest rate on the underlying VRDOs fluctuates weekly, MSHFA has maintained the interest rate paid by HELP borrowers at a constant 3.95 percent for over 3½ years. In addition, each HELP borrower pays an LOC fee directly to the bank. HELP loans have been traditionally used to finance the acquisition of equipment, in which case the term of the loan closely matches the useful life of the equipment. Hospitals which have used HELP loans for building improvements have been required by the bank to amortize their loans over a schedule that is much shorter than the useful life of the assets.

A direct purchase of tax-exempt bonds by a bank is very similar to a conventional bank loan with respect to terms, conditions and covenants. The most notable difference is the interest rate. The complexity of the process lies between that of

Current interest rates are even lower. In addition to overall favorable economic conditions, the relative lack of supply of bonds of this nature has also forced down interest rates. Investors have warmly welcomed tax-exempt bonds issued by community hospitals, and have bid aggressively to purchase

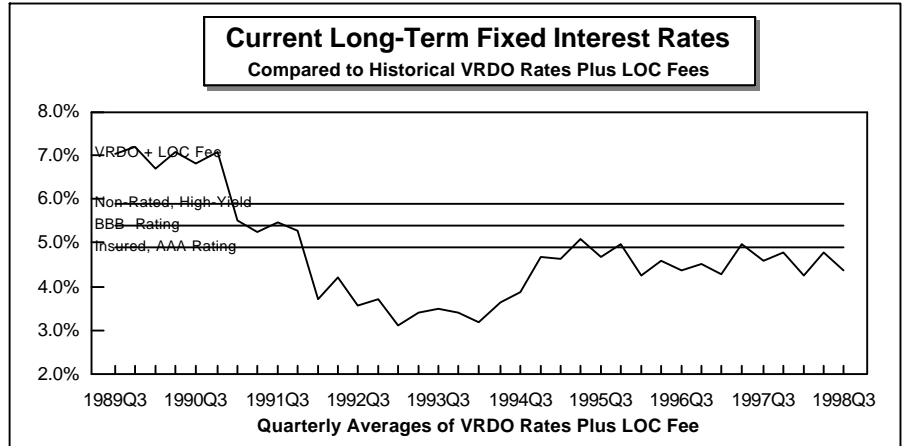


Table 4

them. Consider the accompanying graph (Table 4) of interest rates on long-term, fixed-rate bonds of different credit quality, with the graph of historical VRDO rates (including LOC fees) superimposed.

Notwithstanding the recent stock market downturn, the investment returns on many community hospitals' financial reserves exceed the interest rates on their indebtedness. As a result, opportunities exist for hospitals to preserve their financial reserves by financing capital assets for which, under other circumstances, they would have paid cash. The cash not applied to acquire capital assets may then be invested. The additional debt burden resulting from this strategy has not seemed to have had a negative effect on hospitals' credit quality. In fact, each of the three hospitals cited above was able to finance its entire list of capital projects before exhausting its debt capacity.

CASE STUDY

Prior to this year, Hillsdale Community Health Center (HCHC) had relied on HELP loans to finance its facilities improvement projects. Its governing board and management recognized that unprecedented favorable market conditions presented an opportunity to prepay its HELP loans with the proceeds of its own bond issue. In June, HCHC issued over \$12 million of bonds featuring an investment-grade rating from Standard & Poor's, rare for such a small hospital. The most notable benefits included:

Organization	Ratings			Sale Date (1998)	Final Maturity	NIC
	Moody's	S&P	Fitch			
Garden City Hospital	None	None	None	Feb.19	2017	5.84%
Chelsea Comm. Hospital	None	BBB	BBB	May 28	2019	5.32%
Hillsdale Comm. Health Ctr.	None	BBB-	None	June 17	2026	5.38%

Table 3

a conventional bank loan and an offering of tax-exempt bonds.

CURRENT MARKET CONDITIONS

Interest rates on tax-exempt bonds are near historical lows. Consider the interest rates, as measured by the Net Interest Cost (NIC), on bonds issued by three Michigan community hospitals earlier this year (please see Table 3).

- an amortization schedule longer than that associated with the HELP loans, and which more closely matched the useful lives of the assets financed;
- an interest rate fixed for the life of the bonds at a net interest cost of 5.38 percent, not much higher than the current all-in cost of the floating-rate HELP loans; and
- the elimination of the mortgage and other restrictive covenants required by the bank involved in the HELP loans.

HCHC's capital improvement program consists of the following projects:

Projects that had been completed at the time of the bond issue:

- Lobby, Admitting, Outpatient Registration
- Skilled Nursing Facility
- Critical Care Unit (CCU)
- Labor, Delivery, Recovery, Post-Partum (LDRP) Rooms
- Morgue

Projects that were in progress at the time of the bond issue:

- Emergency Department
- Outpatient Surgery
- Medical Records

Projects that had not yet commenced at the time of the bond issue:

- Third Floor Acute Care Unit
- Administrative Offices
- Routine Capital Budget Items to be acquired through FY2001

The last project listed, the routine capital budget items, was not originally a part of the financing. If not included, HCHC would probably have applied its own cash to acquire these items. The HCHC governing board and management recognized an opportunity to preserve its financial reserves by borrowing funds for this purpose, and leaving its own funds, which would have otherwise been spent, invested. One factor that prompted this decision was the recent report from HCHC's investment managers which revealed a nine percent return for the first calendar quarter of 1998, well in excess of the estimated borrowing cost.

CONCLUSION

Based on the experiences cited above, access to capital does not appear to be an obstacle to the financial viability of community hospitals. Governing boards and executives of community hospitals should consider the benefits of accelerating their long-range capital planning efforts. These deliberations should address the guidelines listed in the box below. The

Capital Planning Guidelines

- ✓ The organization should plan to borrow from positions of financial strength in order to maximize the choices then available and to preserve cash if needed during future periods of weaker financial performance.
- ✓ Target levels of indebtedness to be incurred within a relevant planning horizon should be established. A middle ground should be established between the "pay cash / avoid debt" approach to financing capital assets and a decidedly overleveraged situation.
- ✓ Because of its lower cost, long-term debt should be incurred on a tax-exempt basis whenever possible. Tax-exempt financing should be employed to the greatest extent feasible to preserve cash, philanthropic support and conventional borrowing channels for non-qualifying uses.
- ✓ Whenever tax-exempt debt is to be incurred, the principal amount issued should be maximized to obtain economies of scale.

outcome of this process should be a determination as to whether the current favorable market conditions present opportunities, and, if so, an implementation framework to take advantage of them.

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