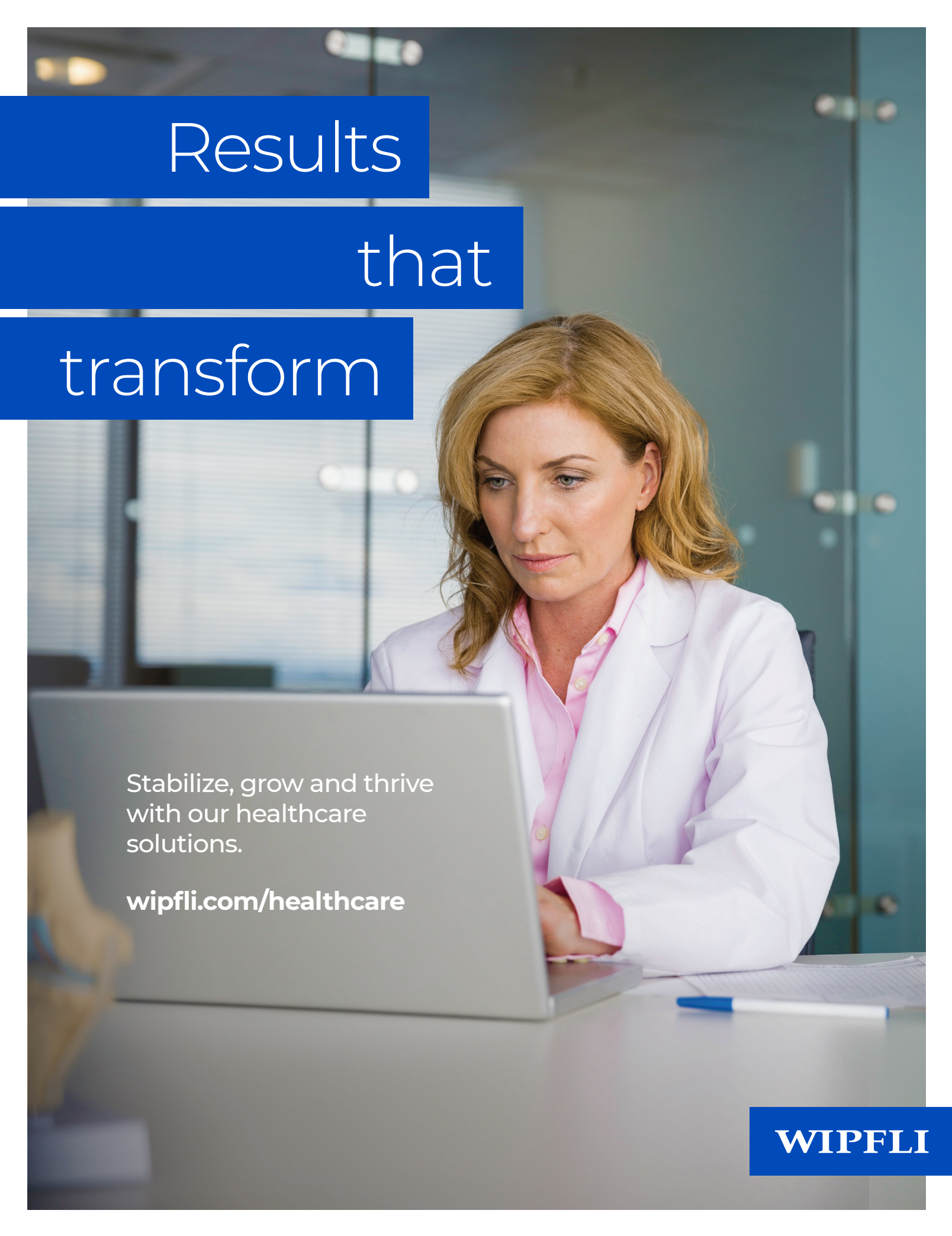


2020 Health Care Financial Management

Resource Guide



A woman with blonde hair, wearing a white lab coat over a pink shirt, is sitting at a desk in a modern office. She is looking at a laptop screen. The background shows office windows and glass partitions.

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Capital Financing During Uncertainty: How Due Diligence Helps Streamline the Process and Improve the Outcome

Kelly Arduino, *Principal, Healthcare Industry Leader* | Wipfli LLP
karduino@wipfli.com

When a healthcare client wants to discuss their growing capital needs, it may be due to changing priorities or concern about how they will access capital. This article will dive into why strategic capital planning is the right path to take and address other considerations, such as factors that are driving the need for capital, barriers to accessing capital, what strategic capital planning involves, today's financing options, and other key questions that should be considered.

Why Do Healthcare Organizations Need Access to Capital Right Now?

For many years, one of the biggest trends that healthcare facilities have been a part of is decreasing their number of inpatient beds and investing more in outpatient care. Now that the COVID-19 pandemic has created the need to isolate or distance patients, many hospitals are planning for capacity issues and are rethinking their facility investments and master facility plan. They are asking some critical questions, such as what does our campus look like, and where do we need more space? Do we need a free-standing ICU? How do we adjust the flow of waiting rooms? Do we need to upgrade the air circulation systems? How can we accommodate drive-by testing, imaging, and prescription pickup? How do all of these necessary changes impact our commitment to team-based care? These questions merely scratch the surface of issues that must be addressed when considering facility investments into the future.

The COVID-19 pandemic immensely accelerated the use of telehealth and telemedicine services.¹ Many healthcare organizations² did the best they could to quickly ramp up their telemedicine services out of urgency and sheer necessity, but not necessarily in a thoughtfully planned manner given the speed at which COVID-19 was spreading and continues to spread. Now that some time has passed since the first coronavirus case in the U.S. was confirmed, healthcare organizations are even more motivated to better understand the investments they need to make in the people, processes, and infrastructure necessary to offer telemedicine services in a more efficient and effective manner.

Pre-COVID-19, telemedicine struggled to launch or gain traction mainly due to commercial and governmental payers' reluctance to reimburse providers; however, the recognition of its safety in terms of being able to provide care while socially distanced and its ability to increase access to patients during a public health crisis has temporar-

ily changed those reimbursement rules. Increasing use of telehealth and telemedicine is also helping to solve longstanding issues related to physician shortages and lack of healthcare access in rural areas. Although there has been some discussion of "rolling back" reimbursement for telemedicine services, such discussions have not diminished the desire of healthcare organizations to invest in telehealth and telemedicine.

What Are the Barriers to Accessing Capital?

These are economically uncertain times for consumers of healthcare and healthcare organizations, which have suffered significant losses through shutdowns and varying degrees of compensation for the care of COVID-19 patients. The availability and cost of capital has also become increasingly uncertain, especially for the near term. Investors, wary of the volatility within healthcare, are looking to see which organizations have weathered the storm and whether the volumes will return and stabilize. This volatility is challenging for investors to assess because the answers will likely not be apparent in recent financials, CARES Act monies will have a skewing effect on investors' assessment, and the perspective on recovery is not yet evident.

Investors want to know, has the healthcare organization lost revenue because it could not perform elective surgeries for a period of time? Did it receive funds from the U.S. Department of Health & Human Services or the CARES Act? If the healthcare organization laid off employees, how quickly can it ramp back up if needed? How has the organization operated differently because of the pandemic, and did it operate effectively?

Because of the unknowns involved in healthcare, the historically low interest rates recently experienced do not necessarily translate into lower borrowing costs for healthcare organizations; other factors can determine future viability, such as geographic differences in market impacts and the size and scope of services offered by a healthcare organization. That said, there is still activity in the tax-exempt bond market, as well as a desire for solid credit from commercial banks that are lending to healthcare organizations, but the recent lack in volume has been concerning for lending institutions.

If in the coming months we have more clarity on how the pandemic has impacted revenue, these institutions may loosen up a bit. Thus far, however, it has been a confusing year for both healthcare

organizations and investors looking to evaluate their credit worthiness and wondering if there will be another round of government funding. In addition, many healthcare organizations are concerned about whether they are correctly following often vague government guidance on how funds can be used and how those funds need to be recorded.

The Importance of Strategic Capital Planning

The importance of strategic capital planning and due diligence is highlighted in the midst of healthcare organizations trying to determine their volumes and their full financial picture. Every organization can prepare itself for capital investment by using the process of strategic capital planning, which allows the healthcare organization to calculate how much total money it will need in order to achieve its strategic objectives, taking into account projected financial performance. It estimates credit strength under different scenarios so that a healthcare organization can prioritize its capital investments. When complete, the organization will have made an accurate determination of its capital requirements and when funds will be needed so that it can evaluate its current funds, debt capacity, and financing options. This will enable the organization to start prioritizing its objectives.

Performing Strategic Capital Planning

Strategic capital planning can be conducted internally, assuming the team has both the time and skill set, but even so, the process can be time-consuming and take away from other essential analysis and planning initiatives. Using a third-party resource can not only streamline the process but also bring a high level of experience and objectivity to the table. When a healthcare organization is simultaneously trying to prioritize its needs, stay financially healthy, and weather current and future threats of service disruption, it could be worthwhile to lean on experts who can create a plan that will provide guidance and direction to everyone involved.

Part of the strategic capital planning process involves creating a pro forma of five to ten years that documents assumptions about the future and looks at various “what if” scenarios. Listed below are seven important factors to keep in mind during the development of an organization’s pro forma:

1. **Equipment:** Create a list that estimates the cost and average life of the equipment needed to achieve the targeted projects.
2. **People:** Identify whether the organization will need to add employees and when. Create a list identifying costs around salary, benefits, and other labor concerns.
3. **Processes:** Will any of the projects result in improvements around efficiency (e.g., consolidating services and saving on utility bills with a higher-efficiency HVAC system).
4. **New costs:** On the flip side, the time and effort it takes to implement new projects can often result in a temporary loss of productivity in other areas.
5. **Existing funds:** Evaluating a project’s feasibility and how it will impact the organization’s credit profile requires identifying existing unrestricted funds, grants, debt capacity, and other existing funds.
6. **Financing options:** Calculate conservative assumptions on the cost of capital and financing. Changes in these assumptions and the effect on the credit profile can help evaluate future debt amounts.
7. **Assumptions:** Create a list of external environmental changes that could impact financial performance, both positively and negatively. Examples include changes in reimbursement, decreased volume as a function of the insurer environment and manifest in gross revenues, contract labor increases or inability to recruit, and self-insurance claims for a particular year.

Taken all together, a healthcare organization can make decisions on quantifiable evidence rather than subjective opinions. The “what if” scenarios help clarify the most important levers that will affect outcomes and help build those risks into the planning process.

Looking at Today’s Financing Options

As a healthcare organization explores financing options (and there are many), it is important to weigh the benefits, challenges, and limitations of each option in order to pursue the most prudent choice for the future. Below are several potential financing options.

Banks

We are currently in a historically low rate environment, and as a result, local, regional, and national banks are currently providing very attractive loan rates and terms. However, the challenge in working with banks is making sure they understand the healthcare organization’s specific business model. Banks also often manage risk by requiring a significant equity contribution and by providing loans with interest rate resets. Furthermore, there is significant variation in banks’ understanding of key covenants and ensuring that the financial covenants associated with a loan are relevant.

Both cash for equity and the ability to “weather” interest rate increases can be difficult for a healthcare organization that is subject to reimbursement changes (and cuts) and has a relatively stable revenue stream that cannot increase as fast as the interest rate on the debt.

With interest rates at historically low levels, it may be a time to lock in a longer-term rate.

Tax-exempt Bonds

Tax-exempt bonds are a way in which nonprofit and municipally owned healthcare organizations can access long-term fixed rate debt at a record low rate. Today, investors are attracted to certainty of return, and bonds supply that in a volatile market. Risk, and therefore return, is assessed by the rating on a series of bonds (i.e., a published credit rating from Moody’s, Fitch, or Standard & Poors) that are considered to be investment grade and ranked in order of highest to lowest from AAA through BBB-.

The market for non-rated bonds (i.e., a borrower that does not have a published credit rating) is often referred to as “story credits” and is largely untested given the pause in capital access resulting from the pandemic. These story credits are often smaller free-standing hospitals or senior living organizations that, because of size and lack of peers, are difficult to categorize in terms of a rating, but which are attractive to investors because they provide a better rate of return than many other options (i.e., higher risk). That said, the communications of the business model, market and financial viability of non-rated bonds is paramount to securing the lowest cost for these entities.

Savvy investors will carefully scrutinize the risks of a healthcare organization’s project. They will take into account planning and assumptions of future performance when evaluating financings, which are economic conditions outside the control of healthcare organizations. Almost always, a financial feasibility study prepared by a third party is required as part of the offering statement in these financings. Such a report would detail assumptions and model the potential effects of key success factors, such as uncertainty about the future of Medicare and Medicaid, diminished value of retirement assets, a weak housing market (in the case of senior living), ability to secure providers/healthcare workers, rising construction costs, and/or investment returns on cash reserves.

Government Programs

Government lending programs can be cost-effective alternatives to raising and securing capital. The most active government agencies that offer such lending programs are the Office of Housing and Urban Development (HUD) and the U.S. Department of Agriculture (USDA), depending on the location and type of healthcare entity. Despite the application process being relatively slow, time-consuming, and involving a lot of paperwork, securing such a loan can be well worth it as these options offer low interest rates that are also fixed long term. Factors can include for profit versus nonprofit or municipal and rural versus urban.

HUD 232 Mortgage Insurance

The HUD 232 mortgage insurance program allows both for-profit and nonprofit senior living organizations to access low interest rate loans. Essentially, the HUD 232 offers “credit enhancement” by offering mortgage insurance on the underlying debt, such that the applicant can receive a rate that would only be available to an AA-rated entity (i.e., a published credit rating from Moody’s, Fitch, or Standard & Poors). Applications are taken on a rolling basis.

In years past, HUD has been referred to as the “lender of last resort.” The process to apply and secure monies has generally been regarded as slow; however, the HUD 232 program has streamlined its application process. The new “lean” approach has resulted in reduced processing time and has been further improved by hiring staff with relevant industry expertise.

HUD 242 Mortgage Insurance

The HUD 242 mortgage insurance program is the equivalent program for hospitals and is available to both for-profit and nonprofit hospital organizations. Varying programs address whether the monies will be

used for construction or refinancing, but the process is generally the same. An examined financial forecast is required and has very specific requirements in terms of content. The HUD website provides a list of approved consultants who can perform these studies.

USDA Financing Options

In order for a nonprofit to qualify for a USDA loan, the project must be in a rural area or town with a population up to 20,000. In addition to a grant program—which has been shrinking in terms of availability and offers modest sums on average of \$15,000—there are several types of USDA financing available.

Those most relevant to a nonprofit healthcare organization are the Rural Rental Program and the Community Facilities Loan Program, discussed in more detail below. The latter gives the option for a “Direct Loan” (USDA-administered and paid directly to the borrower) or a “Guaranteed Loan,” which is essentially insurance or a guarantee on a bank loan or bond issue.

USDA loans are awarded by the state USDA office and are competitive among all eligible projects. If a large amount is requested (e.g., over \$5 million), the loan must be approved and be competitive at the federal level (national office). An examined financial forecast prepared by a CPA firm is required as part of the application.

USDA Community Facilities Loan

Historically, the amount of community facilities loan funds available has been limited, but recent allocations to this program have significantly increased over the past decade and are currently approximately \$3 billion annually.

Larger projects can be funded only if they use the Direct Loan in combination with another funding source, a requirement known as P3 or the Public Private Partnership. In addition to the Direct Loan, other financing can come from General Obligation Bonds, a USDA Guaranteed Loan, or other vehicle as long as the Direct Loan and “private” debt are on parity. There is no mandate for the split between the Direct Loan and other loan, but a general rule of thumb is a minimum of 20% should be from private funding.

The Guaranteed Loan program provides a 90% guarantee on the interest and principal on an approved loan made by a bank. Banks are interested in making USDA-guaranteed loans because the guaranteed portion does not count against the bank’s “capital risk ratio,” which is a measure of the bank’s financial strength based on the ratio of assets and capital reserves to loans. In short, a bank can make a guaranteed loan with only the 10% that is unguaranteed counting toward its “risk” or exposure to loss.

Some benefits to the USDA Community Facilities Loan include the following:

- » The loans are fixed for up to 40 years.
- » Once an application is reviewed and approved, the rate is locked in and the recipient of the loan has up to five years to utilize it.
- » The loan documents for the Direct Loan and some parts of the Guaranteed Loan are standard.

Limitations on both USDA loan types include the following:

- » Uncertainty of availability and timing of funds.
- » Potential environmental restrictions (e.g., wetlands, habitat for endangered plant or animal species, toxic waste area, etc.) could affect where an organization can or cannot build/expand, which could increase application processing time.

Today's economic environment, coupled with increased regulation of bank assets, has made government-sponsored borrowing an attractive option. By first understanding the features of each option—as well as their pros, cons, and corresponding fees—a healthcare organization can more carefully consider the impacts of each.

Key Questions to Consider in Today's Financing Environment

Once a healthcare organization understands its options, how does it move forward? There is always more to know when it comes to making effective decisions.

Considering current interest rates and capital accessibility, it is a good time to borrow, but healthcare organizations should incorporate updated expectations of financing rates and options for capital providers into their project planning. The risks, costs, and limitations of the different financing options should be carefully considered within the context of the organization's specific situation. Some important questions to consider are the following:

- » Is the project financially feasible, and does it incorporate new interest rate assumptions into planning?
- » What financing options, other than the capital markets, should be seriously considered?
- » What are the risks associated with each of the financing options?
- » How will a particular financing option affect the healthcare organization's ability to borrow in the future?
- » How much of the financing costs are associated with a particular financing option, and are those costs reasonable?

Lenders are not the only ones proceeding with caution; borrowers are showing increased diligence as well. Even where there is a long-term banking relationship, many organizations are conducting a competitive RFP process and asking detailed questions about terms and risks associated with the debt.

With that in mind, we debunk a couple common beliefs on how best to evaluate debt options and conduct effective diligence.

Common Belief: We should decide on a financier/lender as soon as possible in the capital planning process.

False. It is common for the size and scope of a project to change, and the amount of borrowing can influence the best type of lender for the project.

For example, a hospital that started with the intention to build a replacement facility at an estimated cost of \$40 million realized that its debt capacity would not support that amount of debt. Instead, the hospital decided to build an outpatient surgery center for \$5 million.

In the case of the replacement facility, a HUD 242 loan would have been an appropriate choice, but in the final decision, the local bank provided a cost-effective option. If the hospital had chosen a HUD lender from the onset, they would likely have been tied to that lender. That lender might not have offered the full array of financing products and/or have been as competitive on a smaller financing plan, and it would not be unusual for the hospital to have to pay some type of termination fee.

Common Belief: The Costs of Issuance (COI) should be compared and can differentiate one firm from another.

False. COI includes a number of items that have nothing to do with the financing firm. Examples include title recording, appraisal, and legal counsel. In addition, COIs vary significantly between the types of financing vehicles, with HUD generally having the most costs and bank loans having the least.

That said, commercial bank loans often bury COI in the interest rate, so the best comparison of the costs of financing options is the all-in cost, which is the equivalent calculation of an APR for a mortgage.

Some lenders will also specify the True Interest Cost (TIC) calculation, which includes only the underwriting/origination fees plus the interest rate. The TIC is a better comparison of the costs of using a particular lender than the overall cost of the financing.

The Most Important Determinants

There are a number of considerations a healthcare organization should take into account when evaluating options, especially in today's market where there have been significant changes in covenants and reporting requirements.

In general, lenders are less lenient about allowing organizations to borrow more debt, as evidenced by limits on and/or approval for additional borrowing. Other covenants, such as the debt service coverage ratio (DSCR) (which measures an organization's ability to cover current year interest and principal payment), and days cash on hand (DCOH) (which gauges liquidity by measuring the number of days of cash operating expenses the organization could support if its revenue stream were to be reduced or eliminated), are used by lenders to monitor financial performance and evaluate the likelihood that the debt will be repaid. If an organization falls below this number, then the lender often has the right to call in a consultant or, in extreme cases, declare a default.

Lenders have higher standards for maintaining minimum DSCR and DCOH so that if there is financial trouble, they can intervene earlier. From the perspective of the healthcare organization, this can mean less money to spend on working capital or other special projects since funds must be set aside to meet the debt covenants. More frequent reporting, specifically quarterly and, in some cases, monthly financials and utilization are required to be submitted to the lender, which can be time-consuming. In short, the flexibility of operating the business and the amount of time spent satisfying lender reporting requirements should be an important consideration, in addition to the interest rate.

Performing Strategic Capital Planning Internally versus Externally

Attorneys often work on different aspects of financing, such as reviewing loan documents. Knowing experts who are adept at conducting strategic capital planning can make the attorney's financing work easier.

Hiring an external consultant to facilitate the strategic capital planning process is valuable because there is no question of objectivity. Internal resources can be biased because certain things have always been done a certain way, or they have a strong vision that has not taken everything into account. It helps to have an objective facilitator guide the healthcare organization through generating ideas and holding discussions around key strategies for the future.

Certainly, many organizations can do their own financial forecasting. There are templates and automated tools available for purchase that enable financial projections, and some can interface with a healthcare organization's EMR. However, the organization must make sure that any purchase: (1) is cost effective, (2) will free up time and resources, and (3) is appropriately customizable in a way that allows for modeling the idiosyncrasies of the organization's reimbursement structure.

On occasion, a strategic capital plan is best done by consultants specializing in this area using their own tools and processes, especially in situations where the healthcare organization has a specific question to answer (e.g., start-up of a new service line or location).

Often, a lender will require that a third-party firm perform a financial feasibility study. It may be advisable therefore to have a third-party firm conduct the study first, as opposed to having the healthcare organization internally conduct an initial study, only to then have a third-party firm conduct the study again. Starting off with the third-party results in a more integrated and objective plan also will give the healthcare organization more credibility with lenders.

If the healthcare organization decides to move forward with leveraging a consultant, it should make sure it has a clear understanding of the deliverable. Important questions to ask include:

- » Is a copy of the model included in the engagement pricing?
- » Can the healthcare organization negotiate an annual update fee for the next few years?
- » What level of detail will accompany the report?
- » What level of involvement is needed from the healthcare organization's employees?
- » What type of information has to be prepared by the organization vs. the consultant?

Depending on the nature of the capital project and the credit worthiness of the organization, the intensity of a strategic capital plan will vary, but it will generally encompass market share and financial forecasts.

If, however, the organization chooses the internal study option first, that will still be helpful in terms of providing direction on how much money to spend on which projects, and the results of the internal study can provide a level of comfort to the board when approving funding for the next steps in architectural planning and mechanical/engineering projects. An internal study will also provide the ability to

understand the "what ifs" of a planned project if conditions change, as well as the impact on the affordability of various priorities, which is valuable information during a time when many external drivers are in flux.

This higher level of internal planning also can be used to inform the more detailed feasibility study performed by an independent consultant and required by lenders and/or the capital markets, thereby streamlining what can be an onerous process. In the end, knowing the "what ifs" empowers the organization through objective, reasonable financial expectations.

How Long Does This Take and What Happens Next?

The most commonly asked questions regarding the strategic capital planning process are how long does it take and what happens next?

In terms of timing, the pace is essentially set by the healthcare organization. The process can be as fast or as slow as the organization wants or needs it to be. Strategic capital planning is a very interactive and iterative process because the plan belongs to the organization—the organization is just having someone else, i.e., the third-party expert/consultant, help them develop the plan and model the financial impacts of the plan.

However, the planning process should not be so lengthy that an actual plan never comes to fruition. We often recommend to healthcare organizations a planning timetable of three months, which generally gives them time to get constituents on board, provide feedback, collect data, and perform analysis.

As for next steps, in the best of all worlds, a strategic plan is refreshed annually—or at least the financials are. Healthcare organizations should revisit initiatives to see if they are still relevant, how they were completed, and how they did or did not turn out.

Conclusion

When advising clients, it is important to understand the lay of the land for the capital market and the availability of dollars. Knowing how to advise a client on how to spend their funds appropriately is going to be very valuable as the COVID-19 pandemic continues to impact the healthcare industry. Strategic capital planning is one of the best, most accurate ways that healthcare organizations can determine what capital they need, when they need it, and how to go about getting it.

Endnotes

- 1 The American Academy of Family Physicians uses the word telehealth to refer "broadly to electronic and telecommunications technologies and services used to provide care and services at-a-distance," and telemedicine "as practice of medicine using technology to deliver care at a distance. A physician in one location uses a telecommunications infrastructure to deliver care to a patient at a distant site."
- 2 The author is using the term "healthcare organization" to refer to a wide range of organizations, including physician practices, hospitals, and businesses that serve the healthcare industry, such as telehealth equipment manufacturers.

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1099 14th Street, Suite 925, Washington, DC 20005

www.americanhealthlaw.org

info@americanhealthlaw.org

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