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Alan P. Richman

financing the future of independent community hospitals

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CASE STUDY

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Staying viable as an independent community hospital is not easy in today's environment, where selling to out-of-town purchasers is often the only alternative to closure. But the experiences of one hospital demonstrate that it can be done.

AT A GLANCE

- > Effingham Hospital, a critical access hospital, undertook a modernization initiative to expand the limited scope of its inpatient services to improve financial performance and ability to build liquidity reserves.
- > FHA Section 242 mortgage insurance was the only means for Effingham to credit enhance its debt and obtain a low-interest rate loan.
- > Effingham needed to convince residents and county commissioners to pledge 27 years of additional tax support to offset its annual uncompensated care.
- > The hospital won support from the community and the commissioners, in part because of the educational outreach of the CEO, CFO, and board in articulating the imperative for maintaining local hospital care and the present and future economic benefits for Effingham County.

Several years ago, hospital leaders at Effingham Hospital, a critical access hospital (CAH) in Springfield, Ga., faced a dilemma common to many small hospitals: Develop new sources of revenue or eventually close. Built in 1969, the hospital had anemic admissions, outdated surgical facilities, a small emergency department (ED), and inadequate primary and specialty care. Historically, the hospital's market share for inpatient services in the local community was less than 6 percent, because most patients traveled 40 miles south to hospitals in Savannah. The limited scope of inpatient services undermined the hospital's financial performance and ability to build liquidity reserves.

Even so, Effingham Hospital had at least four good reasons to be optimistic that the time was right for decisive action. First, its reservoir of potential patients was growing. Springfield, the seat of Effingham County, had seen a 40 percent increase in population, from nearly 38,000 in 2000 to 52,000 in 2010, making it one of the nation's fastest growing counties, according to the U.S. Census Bureau. Second, unlike the campuses of many older community hospitals, Effingham Hospital's existing campus was in a desirable location, with street visibility and easy accessibility from main highways. The campus also was home to a medical office building and nursing home and had room to grow. Third, the hospital anticipated major revenue growth following its recruitment of a general surgeon and three primary care physicians and the addition of ancillary services, such as off-site imaging centers. Fourth, even though several areas of the hospital were operationally inadequate and obsolete, the overall facility was well maintained, and some parts, such as patient rooms, remained in good condition. Any capital project, therefore, could be limited to a cost-effective hospital renovation-expansion project, rather than a full-scale replacement.

The bottom line: The timing appeared right for Effingham Hospital to pursue a certificate of need for a modernization project.

An Up-Front Assessment

Buoyed with optimism and an obligation to preserve the mission of providing health care for the community, the hospital's strategic committee—led by Rick Rafter, chairman of the Effingham Hospital Authority, the hospital's appointed governing body; Norma Jean Morgan, president and CEO of Effingham Hospital; and Ed Brown, the hospital's CFO—embarked upon an ambitious journey that, if successful, would secure the hospital's future.

Working with a financial transaction team, the committee determined key metrics that would guide the financing process and project development. To start, internal-use financial advisory analyses—including debt capacity, project budgets, sources and uses statements, and financing options matrices—were generated for the hospital authority and senior management.

The project faced two obstacles. First, at a time when independent CAHs were facing few affordable financing options, Effingham Hospital could pursue only credit-enhanced debt financing, which could deliver a low-interest rate consistent with the credit profile of a much stronger hospital. Second, since the hospital's opening, Effingham County residents and their elected commissioners had been authorizing annual tax support to reimburse the hospital for the cost of providing indigent care and to help cover operating expenses, including debt service. To generate the revenue sufficient to produce a financial forecast that could cover its debt service payments and produce a positive bottom line, the hospital needed to convince residents and county commissioners to pledge 27 years of continuing tax support as an offset to its annual uncompensated care. The renewal of the expiring annual tax support of approximately \$3.6 million, which represented about 15 percent of expenses, was going to be a tough sell in a recession.

“We had to level with the community, there was no alternative,” says Brown. “Whether we went forward with the project or not, if we didn't have that support, the hospital would be in the red consistently and would have to close.”

Commissioners, however, didn't view the modernization project as a requirement to staying in business and saw the ever-increasing levels of taxes as a real threat.

“At the time [in 2009], the economy was starting to crash, so commissioners were under a lot of pressure to spend county money wisely and not raise taxes,” Rafter says. “They were trying to make sure that what we were planning wasn't going to put the county in a position where it had to keep bailing out the hospital.”

County and other community leaders needed to be convinced, in unambiguous terms, that without new services and physicians, both of which would be dependent upon a modernized facility, the hospital would die a gradual death.

Developing the Project

Rather than risking future budget woes on unnecessary expenditures and missteps during actual implementation, the hospital obtained a clear understanding of how much it could afford, its array of financing options, and the project parameters that were financially practical.

The financial transaction team directed an independent feasibility consultant to prepare a forecast, which became the basis for the project budget.

Factored into the forecast was a revenue estimate based upon reasonable assumptions regarding the anticipated growth in clinical services resulting from the project. The forecast also included estimated revenue growth from the new surgeon, plus the benefits of cost-based reimbursement of a CAH. For expenses, a conservative interest rate was used.

The forecast demonstrated the hospital's debt capacity of \$31 million, which would allow the

hospital to finance the entire cost of the proposed project, while requiring it to use its own cash to retire the \$2.3 million of outstanding debt.

With the assistance of an architect and construction manager, a master plan for a modernization project was developed that fit within the \$31 million budget. The new hospital would be designed to accommodate the scope of services and patient throughput required to generate the revenue to cover the forecasted bond debt services payments and produce a positive bottom line. The goal was getting the maximum value for the minimum cost.

Securing the Financing

At the beginning of the financing process in early 2010, wide credit spreads between high-grade (money-fund caliber) AAA general obligation backed municipal debt and low investment-grade hospitals remained a serious impediment to a community hospital debt issuance. Nonrated hospital bond financings had become rare, and in fact, only recently had small hospitals experienced modest success in pursuing commercial bank loans. However, although commercial bank loans and debt placement, as well as direct bank loans, offered some CAHs capital funding, these hospitals generally had loan terms limited to intermediate durations, restrictive covenants, and provisions requiring that they maintain cash and investment accounts with the commercial banks issuing the loans. Further complicating matters was the turbulent state of Georgia's banks, which were experiencing unprecedented bankruptcies in 2009 and 2010.

It was decided that, to finance the project, Effingham Hospital had to insulate itself from the reluctance of investors to purchase debt of lower-tier hospital credits. To attract prospective investors, the hospital needed to turn its bond borrowing from nonrated into AAA. To do so, the hospital and its finance team turned to federally guaranteed mortgage products. With a double layer of federal backing, the hospital debt obligations could be rated AAA.

First, the U.S. Department of Housing and Urban Development (HUD) would provide credit

enhancement of the hospital's mortgage loan through its Federal Housing Administration (FHA) Section 242 Mortgage Insurance Program, which guarantees the repayment of mortgage loans for approved hospital applicants.

Second, AAA Ginnie Mae securities would collateralize the bonds used to fund the loan. The bond buyers would "look through" the hospital's finances and instead focus on the financial wherewithal provided by the AAA credit enhancement.

An FHA 242 mortgage insured loan offered several advantages:

- > Ready capital market access and low interest rates from debt investors eager to purchase high-grade government securities at a time when nonrated new-issue hospital debt issues were virtually unmarketable except with punitive interest rates and financial covenants.
- > The certainty of lower interest rates, which provided greater confidence in forecast budgeting—a major plus when spending finite cash reserves developing the project prior to the receipt of a HUD commitment.
- > A fixed-rate 25-year mortgage loan amortization period, commencing after project completion, with a mortgage insurance commitment extending for the duration of the loan, without any renewal risk.

The hospital was also eligible for stimulus money through the federal Build America Bonds (BABs) program, which reimburses 35 percent of the annual interest expense on loans for governmental entities.

The financing package meant the modernization project was not only possible, but also affordable. Yet several challenges remained. First, there was the expiring tax support, which was included in the financing plan's revenue forecast. The hospital, therefore, needed the Effingham County Commission to approve reauthorization of the annual 2 mill levy for the term of the proposed loan. Second, HUD had to become comfortable with a revenue forecast that projected significant surgical and inpatient growth as the result of the rapidly maturing practice of the newly hired surgeon.

To top it off, financing had to be completed before the BABs program expired for new issuance—on Dec. 31, 2010.

Convincing the County Commissioners

Perhaps the greatest challenge was gaining the county's confidence. Because the hospital required tax support to supplement its operating revenue and produce a positive bottom line, county commissioners were concerned that perhaps the hospital was being operated inefficiently.

"What commissioners didn't realize was that, despite running our operations within industry benchmarks, reimbursement was simply insufficient to cover the cost of uncompensated care," says Brown. Effingham's expense for uncompensated care had amounted to \$4 million in 2008 and \$4.5 million in 2009 and 2010. "Even with the annual mill levy receipts of approximately \$3.6 million, there was still a shortfall covering uncompensated care, which the hospital had to pay," he says.

Brown adds that securing the hospital's future necessitated growth in services and revenue to make up an increasing imbalance between tax support and costs of indigent care. "Reauthorizing the current mill levy would provide nonoperating tax support, but would not grow our own revenue and services," he says. "The only impetus for hospital revenue growth would be the completion of the modernization project."

With a modernized facility, the hospital could recruit new physicians, grow services, and drive greater patient demand. The financial analyses demonstrated that all that was needed was the same amount of tax support the county had been supplying just to keep the existing facility open.

The message to commissioners was clear: "We can build a better, newer facility with the same tax support. We're not asking for anything more, but we've got to keep what we've got."

Gaining Community Support

It very soon became clear that persuading the county commissioners depended on gaining the

community's support. To win this support, Effingham Hospital had to spell out for the public the financial benefits of the project and the economic consequences of maintaining status quo. The public needed assurance on two issues.

First, the community needed the assurance that the tax levy would be capped at 2 mills and would not constitute an open-ended liability for residents. The hospital needed to demonstrate that its forecasted operating performance coupled with a finite tax assist would comfortably pay for the bond debt service and generate operating profits.

Second, the hospital project needed to demonstrate a positive rate of return to the local economy. This point was proved in an independently commissioned report on the economic impact, which projected that the modernization would create 276 jobs, boost the local economy by \$28.7 million during construction, and thereafter generate a positive annual return of \$23 million beginning in 2015. The result would be 282 new permanent local jobs in industrial and service sectors, such as manufacturing, health care, legal, accounting, finance, banking, and real estate.

The hospital initiated a public relations campaign to get the message out. Senior management, authority members, physicians, and the project financing team met with county commissioners, state representatives, and the general public in "lunch and learn" sessions to explain the benefits of the project and address concerns. Reports and analyses were presented detailing why a mill levy was required to fund indigent care and how the hospital project would grow revenue and utilization.

"We just ran the gamut of getting our community informed as to what we were trying to do," says Morgan.

Rafter, Morgan, and Brown concur that what ultimately swayed the county commissioners was the community's overwhelming enthusiasm for the project. Once community members fully understood the benefits of modernization, says

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Morgan, they let county commissioners know that they value their independent hospital, along with its nursing home, medical offices, and clinic, and that they would support an investment to ensure its future and develop the community's own healthcare system.

HUD Says, "Show Me the Numbers"

Convincing HUD's underwriting committee represented yet another challenge. The concern was that the hospital's financial forecast was too heavily dependent upon the successful retention and start-up of a general surgeon. Previously, Effingham Hospital had no full-time surgeon on staff. Although the FHA 242 application required HUD-specific financial analytics and a feasibility study produced by a HUD-approved CPA firm, these were no substitute for actual results.

Fortunately, the new surgeon actually began work during the application process. Even more fortunate was the surgeon's remarkably strong performance from day one. After the general surgeon started in July 2010, several months before the hospital received approval on its HUD application, surgeries skyrocketed. In June, five surgeries were performed at the hospital. In July, 100 surgeries were performed. Likewise, from FY10, which ended June 30, through FY11, the hospital saw its net revenue grow from \$25 million to \$29 million, while gross revenue increased from \$41 million and \$55 million.

Such tangible results served to validate the feasibility report's forecasted hospital volume and revenue growth. Brown calculated that by capturing just 30 to 40 percent of the healthcare market in the county, and continuing to get the tax support, the hospital would demonstrate its credit strength and ability to pay off the debt.

"Upon our receipt of the county's agreement to pledge its mill levy for the term of a prospective FHA 242 mortgage insured loan, we were confident that we had allayed HUD's credit concerns and were on track to receive an FHA 242 mortgage insurance commitment," he says.

A Better Interest Rate—and Hospital

One month before the expiration of the BABs program, in early December 2010, Effingham Hospital was approved for FHA mortgage insurance. At the direction of its transaction team, the hospital successfully applied for the balance of Georgia's unused allotment of a specialty type of bond—Recovery Zone Economic Development Bonds (RZEDBs). These bonds, offered an even greater interest subsidy of 45 percent to qualifying areas in need of an economic boost.

As a result, the hospital's net loan rate was reduced to 3.63 percent. When compared with interest rates available to any hospital, regardless of size or credit rating, this borrowing rate was exceptionally low.

Effingham Hospital broke ground on the renovation and expansion project in January 2011; completion is expected in February 2012. Plans include a 58,000-square-foot addition with new surgical areas, a radiology center, a laboratory, a larger ED, a cardiac and physical rehabilitation unit, and a dedicated Alzheimer's unit.

It's a solid financial deal, but more important, Effingham Hospital will be able to help its local economy, while retaining its independence and fulfilling its mission as a source of local health care.

Morgan sums it up this way: "So many folks believe that if you're small, you won't be successful. But that is not true. If you believe in yourself, and if you put the right team together, and if you have vision, you can be a successful small hospital. We are a viable, necessary hospital in Effingham County and for the state of Georgia." ●

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