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FHA 242 program debt is in demand

INNOVATIVE CAPITAL GETS HOSPITAL DEALS DONE WITH UNIQUE BUSINESS MODEL

By John Mugford

At the start of this decade, as Alan P. Richman was delving into the idea of starting a company that would, among other services, secure Federal Housing Administration (FHA) Section 242 mortgage insurance for rural community hospitals, there were certainly some obstacles to overcome.

COMPANY PROFILE

"I was starting the company at a time when (there weren't many banking firms) that wanted to finance FHA deals for rural community hospitals," he says today. It was a company that would probably entail a three-year pipeline to land a substantial number of projects, and it would be working with smaller hospitals that were, in many instances, not very profitable.

But Mr. Richman forged ahead with his company, in part because he thought the business model could be financially viable and in part because he saw a chance to provide a valuable service to smaller hospitals, many in rather remote areas.

In some cases, he would be able to help out hospitals having trouble getting financing for capital projects. In yet other cases, he could assist hospitals that had already gotten into troublesome financial deals and loans.

In order for the company to be successful, Mr. Richman realized he needed to properly brand InnoVative Capital LLC.

For one thing, the former bond analyst started spreading the word about the FHA Section 242 Hospital Mortgage Insurance Program, often referred to simply as FHA 242. The FHA is part of the U.S. Department of Housing and Urban Development (HUD).

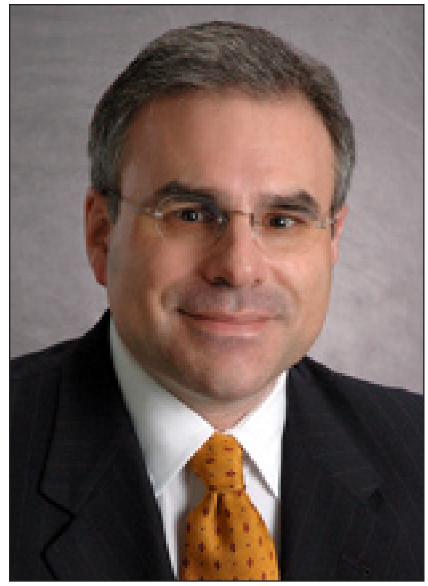
"I spoke at conferences, met with lots of people and went around the country talking about FHA 242 financings, which is a securitization mechanism used either for tax-exempt bonds, Build America Bonds or direct Ginnie Mae loans," he says.

(The Government National Mortgage Association, GNMA, commonly known as Ginnie Mae, provides guarantees on mortgaged-back securities. It is a federally owned corporation that operates within HUD. Build America Bonds are taxable municipal bonds that carry special tax credits and federal subsidies for either the bond issuer or the bondholder. They were created as part of the American Recovery and Reinvestment Act)

These days, Mr. Richman's sales pitch sounds almost like a crusade to protect the country's small, rural hospitals from bad financing deals for capital projects.

Among the clients he's worked for are Critical Access Hospitals (CAHs), community hospitals in smaller markets, municipally owned hospitals in small cities and counties, and other, non-urban hospitals. Most are not-for-profit hospitals, but some are for-profit systems.

And while he's still ready to make his sales pitch and tout the benefits



Alan P. Richman

of the services his company provides at almost any time, he's also getting more and more calls directly from hospitals, many of whom are either in bad financing deals or finding it hard to locate the right financing deal for a crucial project.

Currently, InnoVative Capital is benefiting from an economy that is still in rough shape, as well as the fact that FHA 242 loans backed by the federal government have become much more desirable and acceptable by hospitals and investors.

"The product that we've been pitching for the last nine years is definitely in more demand than ever," he says. "But I want to make sure that people know the FHA 242 Program isn't a government handout; it's not a federal loan. It's loan guarantee of the federal government."

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In demand indeed.

Since it was founded in 2001, InnoVative Capital has lined up more than $250 million in funding through the FHA 242 Program for new hospital projects in Georgia, Texas, Idaho, Montana, Alabama and Colorado. In recent months the company has been working on FHA 242 deals with projected financing exceeding $300 million. Those projects are in Tennessee, Georgia, Alaska, Mississippi, California, Pennsylvania and West Virginia.

Referrals, in fact, are providing Mr. Richman and his company with a steady diet of frequent flier miles. In many cases, he visits with hospital executives, checks up on the hospital's financial statements and strengths, and determines whether the facility can afford to expand or build new.

"There are a lot of banking firms out there telling hospitals they can be their lender, be their banker," he says. "We tell them we'll do all that we can for them but first we want to truly assess what the hospital can afford. We analyze their debt capacity, sources and uses, we look at alternative funding sources, and whether there can be tax support. A lot of our hospitals are municipal hospitals and they have the ability to get the tax support from the local community. We've had tax ballots go in front of communities and the measures have passed to subsidize some of the hospital's operations."

Mr. Richman says that he not only wants his firm to help hospitals, but to be known as a "straight shooter" concerning their finances.

"I think that's one of the big reasons why we are getting referrals, we do not start financing engagements prematurely," he says. "We go to some of the hospitals and tell them, 'We have reviewed your financials and considered all of the options, and you would be better off waiting to pursue your project when your operating performance has improved. You are simply not ready at this time to undertake your project.' "

He often works with the hospital on a course of action to bolster its finances in order to ready itself for the future project.

In many cases, the hospitals heed Mr. Richman's advice. Some, however, tell him they know of a banking firm that can provide them with the financing they need for a capital project.

"Those are the hospitals I worry about – I have seen some of them end up in default."

The approach

Mr. Richman says InnoVative Capital typically provides a three-pronged approach: financial advisory services, merchant banking and mortgage lending. For example, when officials with the Matagorda County (Texas) Hospital District were looking for ways to finance the construction of a new replacement hospital in Bay City, Texas, they looked at many options, according to Bryan Prochnow, the CFO.

Mr. Richman says the hospital was well-run by the administration and well-managed by Brentwood, Tenn.-based Quorum Health Resources (QHR) LLC, the country's largest hospital management firm. However, like a lot of hospitals in smaller towns, Matagorda had a debt-to-cash ratio that institutional investors did not look favorably upon. If lenders would have provided a loan, it would likely have been of a low-credit quality – something the district could not afford.

So, hospital administrators contacted InnoVative Capital after hearing about the company from officials with QHR. Mr. Richman worked with the hospital, looked at its situation and determined it to be a perfect fit for the FHA 242 program. As things turned out, InnoVative ended up structuring, underwriting and securing FHA Section 242 Hospital Mortgage Insurance from HUD on behalf of the hospital district to finance a $46 million bond issue. AAA-rated bonds were sold with an interest rate of 4.74 percent.

"We did financing that combined HUD and tax-exempt bonds – because we can do it with tax-exempt bonds as well as direct Ginnie Mae loans – for the hospital district," he says.

The district's new 66-bed replacement hospital opened in Bay City in July.

Mr. Prochnow notes that without the FHA Section 242 mortgage insurance the hospital probably would not have been able to secure financing it could afford.

"I would say we saved anywhere from 60 to 95 basis points on the financing," he says. "I don't think we would have gotten a deal done. Without the FHA mortgage insurance, I don't think there would have been buyers for the debt."

As noted earlier, Mr. Richman and his firm have also stepped in to rectify financial deals gone bad. An example is in Phenix City, Ala., where the community hospital had closed in 2002. Local leaders then brought in Nashville, Tenn.-based Ameris Health Systems to finance, develop and manage a new 70-bed hospital.

Ameris did its homework, according to Mr. Richman, and had decided to use the FHA 242 mortgage insurance program because it would give it the ability to borrow 90 percent of the project cost. Also, it requires no personal debt guarantees.

However, Mr. Richman says the deal was on the verge of disaster because the consultants hired to do the financing did not understand all of the rules and regulations of the FHA 242 process.

InnoVative Capital came in and rectified the problems and resubmitted the paperwork. The result was that HUD issued a $33 million mortgage insurance policy in 2005. The new hospital opened in 2006.

The idea

While private industry often takes jabs at the federal government for excessive red tape and moving at a snail's pace, Mr. Richman has nothing but good things to say about HUD and its use of the FHA Section 242 Hospital Mortgage Insurance program.

Mr. Richman's background in the world of finance is quite extensive. Included are stints as the director of municipal research for The Vanguard Group Inc., as a senior hospital analyst for T. Rowe Price Group Inc. (Nasdaq: TROW), and as senior investment banker and bond analyst in Manhattan.

"As an institutional buyer at Vanguard and T. Rowe Price our portfolio managers had been buying FHA 242 insured municipal bonds for years," he says, "almost exclusively for urban facilities." The borrowers were not bad hospitals, but many had financial issues for any number of reasons.

For example, in New York hospitals that were not AA-rated had a hard time accessing tax-exempt bonds due to regulatory impediments. Thus, even though many sat on valuable real estate, they were strapped for capital.

As Mr. Richman worked as a bond analyst, he observed a growing trend of mounting challenges for smaller hospitals trying to access capital funding. He notes: "While I was at Vanguard the size of each one of these funds was getting bigger – not just the fund complex itself, but the individual funds. "

He says he realized that as the funds grew in size, smaller bond financings, such as those for community hospitals, would become less and less desirable to mutual fund investors.

"As more and more of these rural hospitals said they wanted to modernize, and then the federal government started the Critical Access Hospital program back in the late 1990s with almost no applicants, I realized these hospitals were going to want to borrow money and that they were not going seek large loans … but major mutual funds were not going to be interested in buying their small debt issues."

As he brainstormed how those smaller hospitals, in some cases CAHs, were going to finance projects, he turned to the idea of using securitization through the guarantee offered by the FHA 242 mortgage insurance program.

"I wanted to securitize these small hospital loans, to make the bonds more palatable for inclusion in different investment portfolios, and also take advantage of the favorable reimbursement changes being offered to rural hospitals," he says. "I thought if I could marry the FHA 242 Program with CAHs I would have a good business that could help a lot of hospitals."

There were some obstacles to overcome. For example, previously the FHA 242 program required that the financing be done only in Certificate of Need (CON) states – which accounted for half of the states in the country.

Also, even though the CAH program gave smaller community hospitals a chance to make a profit – which was difficult for them to do in the past – there were only about 65 CAHs in the country in 1999. Mr. Richman had a strong hunch that those numbers would rise, and they certainly have. Today there are more than 1,200 CAHs in the United States.

While Mr. Richman thought he had a good idea entailing the use of FHA 242, he knew would need some help from the folks at HUD to make it viable.

HUD tweaks program

"I approached the professionals at HUD's Office of Insured Healthcare Facilities in (Washington), D.C., and told them what I was thinking about doing," he says. "I laid it all out for them and asked if they would have an appetite for something like this. They said they thought it could work."

Over time, HUD adapted the FHA 242 program to meet the specific credit needs of smaller hospitals, including CAHs.

He also lined up Quorum to be ready to step in for hospitals needing management help. With Quorum lined up and HUD on board, Mr. Richman raised equity and started the company in Manhattan in 2001. By 2003, he moved the firm near to Springfield, Pa., which was near his home in the Philadelphia suburbs.

Since then, business, in large part because of its use of FHA 242 mortgage insurance, has been growing steadily, he says.

Soon after Mr. Richman founded InnoVative Capital and soon after he started working with HUD under its newly modified, CAH user-friendly FHA 242 program, the company started putting together the first FHA 242 deal involving a CAH.

In 2003, InnoVative Capital secured $19 million through the use of FHA 242 for a replacement hospital for Shoshone Medical Center in Kellogg, Idaho. After that, the company secured financing for a replacement CAH in Whitefish, Montana. From there, more deals were in the works.

Even so, the company faced several more obstacles once HUD was on board. First of all, many regional banking firms and commercial banks didn't want any part of HUD deals; nor did architects and construction managers, according to Mr. Richman.

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"The investment bankers wanted to close simple transactions where they would sell the securities and place the securities with a local bank," he recalls. "And the architectural firms and construction managers thought it was too difficult to work with HUD."

These days, however, with the recession still looming, the housing market still hurting, and the capital markets still restrained, these banking firms and architects have changed their tunes and become FHA 242 converts. In some cases, this isn't the best scenario for certain hospitals, Mr. Richman says.

"What I'm finding is that a lot of hospitals have entered into financial agreements that are problematic for them," he says. "

Hospital finance is complicated, and there are banks out there executing financing engagements, without informing the hospital that they are novices when it comes to the intricacies of hospital financing, and that they really are in over their heads. Or they know what they're doing but they don't level with the hospital that the financing they are pitching isn't really best for them."

This is due to the fact that, according to Mr. Richman, that the hospital cannot afford the financing and is assuming too much risk should something go wrong.

Due diligence

On the other hand, the FHA 242 program can be a good fit for many small, financially constrained hospitals because the federal government does plenty of due diligence before issuing its mortgage insurance commitment, Mr. Richman says.

"Believe me, if you're in partnership with the federal government, you'll know that you will not take on a loan that you can't afford, and that's because HUD works to avoid guaranteeing any loans that are excessive," he adds. "HUD spends a lot of time up front because they go under the proposition that they want to finance creditworthy hospitals and do not want to have problematic loans in their portfolio, which could require HUD's involvement in the hospital's future operations. This is something that HUD looks to avoid at all costs."

He adds that the HUD deals are for 25 years and include construction and permanent financing.

"So there could be 25-year amortization plus construction, and they are at fixed rates, not variable rates, you don't need swaps, you don't need caps, and they (can be financed) with municipal bonds and Build America Bonds, as well as direct loans we can place that are wrapped with AAA Ginnie Mae securities," Mr. Richman says. For those reasons, he calls the FHA mortgage insurance is a very flexible credit enhancement vehicle.

"Currently municipal bond-financed construction projects pose a problem, where lump-sum, upfront funding of the project creates a fully funded construction account that earns basically no interest until it's used," he says. "When you're borrowing at, say 6 percent, substantial negative arbitrage is created and that costs a lot of money.

"So, on our FHA 242 direct loans, where we use Ginnie Mae securities as collateral, we essentially fund the loan through a private placement, which mirrors a stepped construction loan structure as the money is disbursed as needed. Therefore, you don't have that negative cost of carry and negative arbitrage… Well, there's no way really to do one of those deals, unless you have credit enhancement. And the only credit enhancement vehicle for a hospital to do one of these direct loan deals, these Ginnie Mae deals, is HUD."

Mr. Richman says that in addition to wanting to run a successful business, he is concerned about setting up the proper financing deals for hospitals.

"This is my company, my legacy, and I completely understand the notion that what goes around comes around," he says. "We realize that by helping hospitals out, by making sure they get into the proper financing deals, we are providing long-term value and this ultimately helps us, as a company, as well." ❑

InnoVative CAPITAL®

Springfield, Pennsylvania

STATS
- **Licensed: HUD-approved FHA Mortgage Lender**
- **Founded: 2000**
- **Financial services provided: FHA Section 242 Mortgage Banking, debt-related financial advisory, hospital consulting, senior living, healthcare real estate development and merchant banking**
- **Clients: rural, community, tertiary and critical access hospitals; assisted living and skilled nursing providers; municipalities and proprietary healthcare companies**

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