FREE MONEY

A rural Indiana hospital saves in rate swap refinancing.

Brad Hardcastle occasionally ran the numbers, but it usually wasn't long before he chucked his pencil and calculator and moved on to more pressing responsibilities.

Checking interest rates against Daviess Community Hospital's debt on the off chance the facility might save money with a refinance of the hospital's bonds, Hardcastle usually spent little mental energy on it once he ran a quick calculation of the numbers. Rates would have to drop much further, he thought, to make a difference over the life of the $17.5 million in long-term debt the hospital carried in the form of insured fixed-rate bonds sold in 1998 and 1999.

"I was thinking about a traditional fixed-rate refinancing that wouldn't equate to much savings," says the chief financial officer at the 70-staffed-bed hospital in Washington, IN, a town of roughly 12,000 people in a county of about 30,000.

When interest rates fall more than a single percentage point, smart homeowners often find it beneficial to refinance, often saving thousands of dollars over the life of a traditional 30-year loan. Hospital CFOs periodically do the same essential exercise, but rates have been so stable for municipal debt over the past decade or so that most smaller hospitals don't even try to refinance. But as Hardcastle investigated more sophisticated debt vehicles, he gradually came to believe that a refinance could make a big difference.

Daviess' investment bank and financial adviser were able to construct a refinancing with an underlying interest rate swap that would save as much as $2 million in net present value over the life of the bonds, as well as provide an instant infusion of about $1.5 million in capital the hospital will use to build a new off-campus urgent care pavilion.

"Essentially, it's pretty difficult to get your hands around it," he says, but "once you get a feel for how it works, you feel better."

How it works is what usually puts off small hospital CFOs, says Hardcastle. Such financing strategies are well known at larger hospitals and hospital systems, where even small interest rate moves can make doing such a refinance—known in the industry as a "swap"—enticing, says John Hanley, managing director at Ziegler Capital Markets, which served as the investment banker in Daviess' refinance. Smaller hospitals often find interest rate swaps exotic; indeed, many smaller hospitals without bond insurance don't qualify for such strategies. But Hanley says small hospitals with insured bonds (Daviess' 1998 and 1999 bonds were insured by guarantor Radian) can often save big sums in a rate swap.

In Daviess' case, the hospital essentially performed two transactions on its debt. Through its investment banks and adviser, Daviess issued refunding bonds that are insured with a liquidity facility from another bank. Daviess didn't want to be stuck with variable rate debt, so that facility was sold to another bank, in this case Morgan Stanley, in return for a fixed-rate facility.

"The outstanding debt of this hospital was in the high 5 percent, low 6 percent range and was not on anyone's radar screen for refinancing because its rates were still at reasonable levels," says Alan P. Richman, president and chief executive officer of InnoVative Capital, which served as Daviess' financial adviser on the transaction. "But refinancing using variable rate securities with a fixed rate swap saved them a lot of money."

"It's a little more difficult to do these with smaller hospitals because you have to have the insurance," says Hanley. "Smaller hospitals don't use this structure predominantly because they often can't obtain the insurance."

One of the big attractions for Hardcastle in the refinancing was that it would allow the hospital to roll in $1.5 million to fund a new 5,000-square-foot off-campus urgent-care health pavilion by a new Wal-Mart shopping center in a high-traffic area of town, he says. Basically, the hospital ended up with a $19.2 million Series 2006 municipal bond financing at fixed rates to replace the $17.5 million in long-term debt the hospital had from 1998 and 1999. That allowed Daviess to fully fund the new project and still save $135,000 per year in interest payments over the previous bond terms. Over the life of the new bonds, which will mature in 2029, the hospital will save a little more than $1.8 million in net present value over its previous financing arrangement.

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"The advantage of this was they needed some new money which provided for some clinical projects they wanted to get done to enhance their revenue position," says Hanley. "This allowed them to pay for the majority of the cost of the new capital projects through the refinance."

—PHILIP BETBEZE

Reprint HLR0507-13