An assist from the feds

FHA streamlining its not-so-well-known Section 242 financing program

The Federal Housing Administration's Section 242 mortgage insurance program turns 40 this year, but unlike the hospitals it helps to replace, the program does not seem to be showing signs of age.

FHA 242, as it is commonly known, supports the financing of new hospitals, acquisitions or significant renovation and modernization of existing projects by providing credit enhancement and lower interest rates to borrowers that, in turn, must work with FHA-approved mortgage lenders to complete the process.

One of those approved lenders is Springfield, Pa.-based InnoVative Capital, which worked recently with Matagorda County (Texas) Hospital District to secure financing for Matagorda General Hospital, a 118,000-square-foot replacement facility on an 11-acre medical campus in the town of Bay City. Alan Richman, president and chief executive officer of InnoVative, says not many FHA deals are completed on an annual basis, and that most of the transactions are for larger hospitals in urban settings, unlike Matagorda, a rural facility.

"What makes this deal unique is that we used municipal tax support to supplement the financial performance of the hospital to convince folks at HUD to say, 'community tax support plus money for operations make us comfortable with the loan,' " Richman says.

(The federal Housing and Urban Development Department oversees the FHA.)

Matagorda's beginnings date back to the early part of the 20th century, when services were provided on the upper level of a local inn in Bay City. In 1965, Matagorda General was established through an act in the Texas Legislature that ensured healthcare access for people in the community, regardless of their economic status. In April 1969, the three-story structure opened with a total of 116 beds, according to the hospital. Today it is a sole community hospital that serves about 38,000 residents of Matagorda County and the surrounding region. In a news release announcing the FHA 242 transaction, Daryle Voss, the hospital's CEO, says parts of the facility were built in the '40s, '50s, '60s and '80s, which made building a new hospital a "necessary goal to assure the efficient delivery of healthcare services" in the community.

Richman: Not that many deals are done using FHA 242.

The perfect profile?

As for Matagorda's credit profile, it is "highly leveraged, well-run (and) managed by Quorum Health Resources," Richman says. "But if you look at the ratios of the hospital—debt to cash—institutional investors will say this is a low-credit-quality loan. We looked at it and said, 'What would be the alternative?' So we said this fits the perfect profile of HUD: ability to cover debt and essentiality, or a reason for being."

That's where FHA 242 came in. Acting as the FHA mortgage banker, InnoVative structured, underwrote and secured FHA 242 to finance a $46 million tax-exempt bond issue for construction of the new facility, which will be located in what InnoVative calls a "growth corridor" of the county because it is located on a major highway near commercial development, rather than a residential community. Also, Matagorda General is designated as the emergency-response hospital for the South Texas Project, which operates two nuclear reactors in the county. It has applied to the Nuclear Regulatory Commission for a license to build two additional reactors, according to Richman, but the expansion will be built for the current residents.

"It's not, 'Build it and they shall come,' " Richman says.

Matagorda General is about an hour southwest of Houston, and the new hospital—expected to operate at the same capacity of 58 beds—is scheduled to open in the fourth quarter of 2009. Because the FHA mortgage insurance will guarantee the Matagorda

The Matagorda County (Texas) Hospital Authority used the FHA program to secure financing to build a replacement for Matagorda General.

County Hospital District's loan repayment and requisite bond reserves, the hospital district was able to acquire Standard & Poor's highest credit rating of AAA.

The last point is one reason why FHA 242 can be an attractive option for all types of hospitals, from large systems to critical-access hospitals, says Thomas Green, chairman and CEO of Lancaster Pollard & Co., a Columbus, Ohio-based firm that offers financial advising, mortgage banking and investment banking services.

Not investment-grade

"When you're accessing capital for a critical-access hospital, most of those hospitals do not have the financial characteristics for an investment-grade rating," Green says. "Today, there are only about four investment-grade critical-access hospitals out of about 1,250. Issuing debt without some form of credit enhancement requires that they issue unrated bonds. Every other credit source is going to be priced related to the underlying risk of the hospital, with the exception of FHA 242," he says, adding that the FHA, similar to other federal programs, views it as a "government mission" to help the healthcare system.

Take, for instance, Lancaster Pollard's work with 25-bed Bucyrus (Ohio) Community Hospital, a critical-access facility in the north central part of the state. Lancaster Pollard cited Bucyrus as a case study in its 2006 report, *Financing Options for Nonprofit Rural and Community Hospitals*. The hospital's management developed a long-term plan that included major renovations for the 95-year-old building.

Green: Government programs, despite perceptions, "fare very well."

As the case study noted, the hospital would not have qualified for the traditional FHA 242 program because it did not have positive operating margins. But because FHA has different underwriting provisions for critical-access hospitals—and because Bucyrus was designated as such—Lancaster Pollard was able to recast the facility's financials as if it had been receiving cost-based Medicare reimbursement for the three years prior to applying for the federal mortgage insurance. The hospital has nearly completed 50,000 square feet of renovation and additions, which include a new main entrance, oncology department, and operating and emergency rooms.

The firm also used FHA 242 as a financing option for 48-bed St. Mark's Medical Center in La Grange, Texas. The facility replaced Fayette Memorial Hospital, which was built in 1920 and was relocated in 1967 through the Hill-Burton act, according to Lancaster Pollard. Hill-Burton is a post-World War II federal program intended to improve and modernize hospital facilities. St. Mark's options were limited. It did not have a strong credit profile, which meant the hospital would face higher interest rates when borrowing. And the hospital could not partner with a local for-profit system because the community wanted it to remain independent. St. Mark's eventually worked with Lancaster Pollard on the FHA 242 program and was able to issue $26 million in tax-exempt bonds with the equivalent of an AAA rating.

Lammers: The FHA program doesn't exist "for the hospital that's in deep trouble."

According to the FHA, it has insured 358 hospital mortgages totaling $13.5 billion to providers ranging from small rural facilities to urban teaching hospitals in 42 states and Puerto Rico since the program began in 1968. But even with FHA 242's benefits of lower interest rates, enhanced credit and a loan-to-value rate of about 90%, some hospitals don't even know the program exists. That was the case for William Lammers, health systems adviser in HUD's office of insured healthcare facilities, which oversees the program, who says he was unaware of FHA 242 when he served as the chief financial officer of a 12-hospital system in the Midwest. Another reason is that the process used to be more laborious than it is today.

"In that time period, there were some horror stories where it might have taken a year or more to have an application processed," says Lammers, who added that the office has increased its workforce to help make the process more efficient. In 2007, it took 51 days for HUD to complete an application, compared with 115 days in 2006 and 224 days in 2005, says Steven Hunt, a senior account executive in HUD's Office of Insured Health Care Facilities. And in addition to making the process less cumbersome, the office has boosted its marketing efforts. It has advertised the program and has dropped the "FHA 242" title in favor of "mortgage insurance for hospitals," which might resonate more with providers. The office also has worked to expand the program's reach, especially after a 1996 report from the agency that was then called the General Accounting Office showed that large loan amounts to New York posed a risk for the future stability of the program.

"We felt a need to get the word out that we had a program," Hunt says. "We had a significant part of the portfolio in New York state. A GAO review of our program notified that we should geographically diversify our portfolio."

The changes have produced results. Prior to 2004, there were about two to four applications processed in a year, but additional staff members—who have experience working with hospitals—have helped, Lammers says. There were nine loans totaling $647 million in six states in 2007, and nine loans totaling $943 million in seven states the year before.

"We don't exist for the hospital that's in deep trouble and the very strong hospitals that can access capital on their own," Lammers says. "But there is a whole range of hospitals in the middle that tie into FHA's mission," he says, adding that there is a "tremendous need for capital" for construction and equipment in healthcare today. Also, the FHA provides architects and engineers to work closely with hospitals, given that the FHA must approve the construction projects before it releases the money.

Such efforts to improve the process could help to break down the stereotype about government-run programs that might be keeping hospitals from considering the program. That's a barrier that Green of Lancaster Pollard says is a concern for some healthcare providers.

"I would say the primary reason is that the government in total doesn't have a good reputation with business—whether it's earned or not," Green says. "When in doubt, 'don't get in partnership with the government' is the theme. Sometimes they can be difficult. That's the perception. In the case of many of the programs that we utilize, on balance, when you weigh the positives against the real negatives or perceived negatives, I think the (government) programs fare very well." «