



Smart Moves: How Hospitals Manage Risk When Borrowing

In an uncertain world, managing financial risk is essential for any business.

This is especially true today for health care organizations. Hospital leaders have to deal with managing a multitude of risks, such as clinical outcomes, reimbursement cuts, regulatory requirements, competing hospitals and more.

While the importance of managing clinical risks is well understood, the 2008 financial collapse and recession demonstrated to many health care executives the significance of how the structure of capital debt can contribute to a hospital's overall risk as well. (For example, the credit crunch made it extremely difficult and expensive to obtain or renew letters of credit, leaving hospitals with fewer options to enhance variable rate debt.) To address this, hospital leadership must identify and mitigate risks associated with their hospital's debt, investments and balance sheet. While these are interconnected with total financial risk, and should be considered as part of an organization's total debt management policy, let us focus on how a hospital can manage its risk exposure by choosing the appropriate debt structure to finance capital projects or refinance existing debt.

Mitigating Debt Risks

When considering the options, a hospital's top priority is to balance both the upfront and ongoing capital costs with the nonfinancial terms and covenants of a debt structure. This balance is key to managing its current exposure to risks associated with short and/or long term debt. The debt structure used to achieve this balance will depend on a variety of factors for a hospital, including credit worthiness, geographic location, current capital structure, financial capacity to take on risk and the capital market's "appetite" for health care transactions.

A hospital's financing team must assess all of the above as well as take into consideration the project (renovation, replacement, acquisition) and objectives when evaluating structured debt products. The best option will be the one that fits the hospital's needs while achieving the lowest possible cost of capital within acceptable risk parameters.

Let's take a look at how three hospitals, using different debt structures, obtained the capital they needed and managed their debt risks.

WHATEVER IT TAKES

Kennedy Health System—Voorhees, N.J.

Public Offering of Tax-Exempt, Fixed-Rate Revenue Bonds

Kennedy Health System operates three campuses in New Jersey: Cherry Hill, Stratford and Washington Township. In recent years, Kennedy had funded its strategic capital projects through operating cash instead of debt. Although this approach allowed the health system to minimize debt, it compromised its overall financial profile by reducing its liquidity position. As a result, Moody's lowered the health system's A2 rating to A3 in November of 2011.

In the meantime, Kennedy Health System had plans to make significant capital improvements at all three campuses and decided to refinance its existing debt and finance future capital projects to leverage its balance sheet. Kennedy's leadership chose to proceed with a public offering of tax-exempt, fixed-rate bonds to fund about \$20 million in new projects and refinance about \$46 million in existing indebtedness. The health system was able to take advantage of the strong, resurging health care market for rated credits to issue tax-exempt, fixed-rate bonds in order to refund Series 1997 A and Series 2001 bonds and finance its new capital projects. As a result, the health system was able to generate more than 15% in debt service savings, which equates to \$8.8 million in net present-value savings. In addition to the low cost of capital, the bonds were sold without a mortgage or debt-service-reserve fund required, thus ensuring maximum flexibility for the organization going forward.

By choosing tax-exempt, fixed-rate bonds, Kennedy eliminated interest rate and remarketing risks. Additionally, the structure avoided renewal risk or bank risk. Amenable covenants and the lack of a mortgage or debt service reserve fund requirement also increased organizational flexibility for future strategic considerations.

Cameron Memorial Community Hospital—Angola, Ind.

USDA Community Facilities Program Direct and Guaranteed Loans, Bond Anticipation Notes, Bank Construction Loan and Equity

The leadership team of Cameron Memorial Community Hospital, a 25-bed critical access hospital in Angola, Ind., decided to modernize its aging facility in order to provide the efficient delivery of medical care necessary to remain competitive. After thoroughly reviewing an array of financing options, Cameron was able to obtain a commitment from the USDA Community Facilities Program for a \$37 million direct loan at a fixed-interest rate as well as a commitment for \$10 million of guaranteed loan funds.

While the USDA commitments squared away the permanent financing, the hospital still needed to secure the construction financing. The relatively large project cost and associated construction risk proved problematic for several banks, despite the promise of the USDA takeout. Therefore, Cameron's leadership committed to an innovative funding solution: the sale of \$37 million of tax-exempt bond anticipation notes (BANs) for a three-year term. The BANs were secured by the anticipated proceeds of the permanent USDA direct loan and received a "MIG 2" rating by Moody's Investor Services (the second highest short-term debt rating available), resulting in a cost of capital near 2%. The rest of the \$53 million project financing came from \$6 million in hospital equity and a \$10 million construction loan from the community bank that was serving as the USDA Community Facilities guaranteed lender. The bank's construction loan will be paid off by the USDA Community Facilities guaranteed loan after construction is completed. The guaranteed loan will have a market-based interest rate and a 25-year term and amortization. In total, Cameron obtained funding at a low cost of capital, with a blended interest rate below 3% for the construction period and below 4% for the 40-year life of the post-construction, permanent debt.



In reviewing the hospital's overall capital structure risk, let's examine the debt offering's component parts. For the \$37-million USDA direct loan, there was no interest rate risk since it was fixed rate, no refinance or renewal risk as the term equals the amortization and no bank risk. For the guaranteed \$10-million loan, \$9 million was guaranteed and \$1 million was not guaranteed, so there are different risks to take into consideration. For the \$9-million piece, the hospital has the option to fix the interest rate at any time—essentially nullifying interest rate risk. The \$1-million piece is variable rate, so there is interest rate risk involved. There was no refinance risk as the term equals the amortization and no bank risk because the loan is provided directly by the bank (no bank credit enhancement). All in all, while Cameron's debt structure is relatively complex, the only capital structure risk to the hospital is minimal interest rate risk (on only \$1 million of a \$47 million offering), which hospital leadership deemed acceptable.

Fulton County Health Center—Wauseon, Ohio ***Privately Placed, Tax-Exempt, Variable-Rate Bonds***

Fulton County Health Center (FCHC) is not your typical critical access hospital. Founded in 1973 in Northwest Ohio, FCHC has grown to include the main 25-bed hospital, which includes several specialty units, such as a cancer center, cardiac catheterization lab and sleep center, several medical clinics and a 71-bed senior living facility.

FCHC, in good financial standing, faced an expiring bank letter of credit (LOC) that enhanced a 2005 bond issue. The hospital had an outstanding swap with a significant negative mark to market value, which was not tied to the LOC-backed bonds.

After reviewing all available options, FCHC selected a multimodal, privately placed sale of \$28.75 million in bonds with a regional bank. This option addressed the upcoming LOC expiration and allowed the swap to stay in place to maintain an effective interest rate hedge.

Additionally, the variable-rate, tax-exempt direct purchase structure removed the bank credit risk and the renewal risk with a five-year term instead of the typical one- to three-year LOC extension period. While the variable rate bonds and the separate swap exposes the hospital to some interest rate risk, it was deemed acceptable in light of the short term and the current low interest rate environment. However, FHCA has the flexibility to refinance the bonds should interest rates rise.

Maintaining Good Financial Health

As you can see, managing risks associated with a hospital's capital structure is essential to the organization's overall financial health. A hospital's choice of debt structure, which should balance the cost of capital with the available terms and covenants, is an important risk management tool. In the process of choosing the best structure, it's important for hospital leaders to know their balance sheet's strengths and weaknesses, understand how rating agencies and investors measure various risk components and determine their organization's tolerance for risk.



The capital strategies highlighted above show the importance of being able to access debt with optimum efficiency with the lowest possible risk exposure. Therefore, it is imperative to assemble a knowledgeable and experienced financial team, consisting of internal and external experts, to navigate the ever-changing capital markets and to determine the best possible debt structure to ensure this priority.

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Types of Risk

Hospital Credit Risk	When a decline in a hospital's credit rating may result in an increase in the bank fees and variable-rate funding cost.
Interest Rate Risk	When interest rates will increase, making the cost of variable rate debt higher in the future.
Bank/Credit Provider Risk	When a decline in the bank's credit rating, might lead to an increase in the variable interest rate on the bonds.
Renewal Risk	When a letter of credit might not be renewed at its scheduled expiration date.
Refinancing Risk	When term is shorter than amortization.
Remarketing/Put Risk	When investors "put" or sell their positions back to the borrower for payment at par.
Mark to Market Risk	When fair market value or mark to market value declines (e.g., if interest rates fall).

