

HOSPITAL INVESTMENTS IN COMPETITIVENESS: FINANCING OPTIONS

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FINDING CAPITAL FOR THE FUTURE

Despite reimbursement squeeze and credit crunch, hospitals are investing in buildings and equipment to stay competitive

A NOTE ON THE SURVEY RESPONDENTS

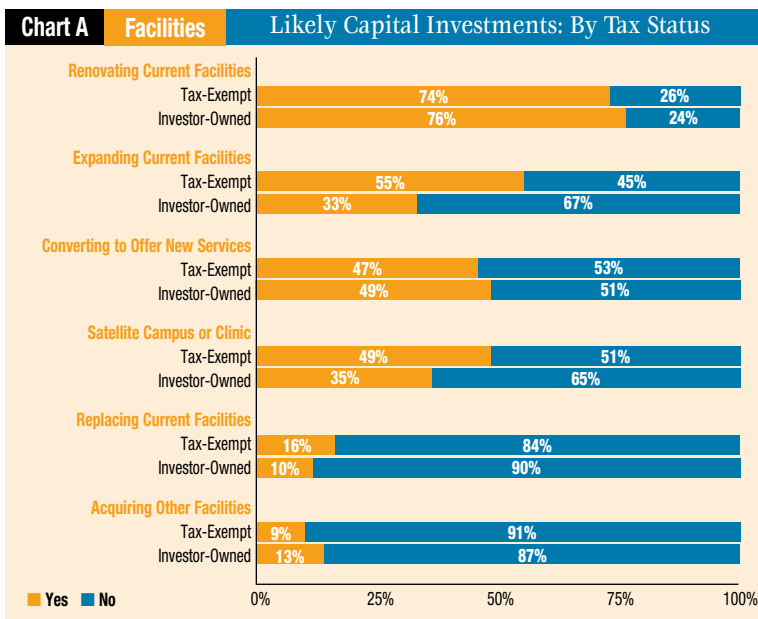
The survey was conducted during the summer of 2007 on behalf of the law firm Waller Lansden Dortch & Davis, LLP and HealthLeaders Media by Prince Market Research of Nashville. It was mailed to 4,085 executives at hospitals and multi-hospital systems, of whom 464 returned completed questionnaires. Of the respondents, 89 percent were CEOs, and the remainder were primarily chief financial officers. Tax-exempt or public facilities represented 86 percent of the respondents; 14 percent worked in investor-owned facilities. About 53 percent of respondents worked in stand-alone hospitals, while 33 percent were in a facility within a multi-hospital system, and 13 percent worked for a multi-hospital system at the corporate level. Three-fifths of the respondents work in rural settings, one-fifth in suburban settings, and one-fifth in urban settings. Regionally, the respondents came predominantly from the Midwest (35 percent) and the Southeast (29 percent), with 18 percent from the Southwest including California and Texas, 10 percent from the Northeast, 7 percent from the Northwest, and 1 percent from Alaska or Hawaii. Selected results and a synopsis of the survey follow. For additional results and analysis, please visit www.wallerlaw.com

Sid Peterson Memorial Hospital, founded back in 1949 in Kerrville, TX, went to the debt market in 2003 for the first time ever. Still in its original location, the 109-bed hospital needed to move to the growing end of town to keep both its community and its finances healthy. The new building was going to cost \$80 million—quite a chunk of change for an institution that up till then had gotten by nicely on revenues and donations.

Like so many tax-exempt hospitals, Sid Peterson Memorial eventually ended up pursuing a bond issue, but putting the deal together was unusually challenging. With no credit history and no parent company to guarantee its proposed debt, the institution wasn't as attractive to the bond market as it might have been, says chief executive Patrick Murray. The hospital explored borrowing from local banks, but it couldn't put together a financing package of that size at an affordable interest rate.

Array of options

"We looked at trying to structure a variety of debt instruments," Murray says. "There's an amazing array of options available. You can peg to any number of indexes. It was just incredible the variety of synthetic instruments there are. If you have sufficient risk tolerance, you can really play with it. We're a healthcare provider first and not an investment bank, so we wanted to keep it simple."



The hospital ended up with a BBB bond rating from Standard & Poor and has issued \$81 million in bonds with various interest rates, ranging from four to five percent. "We had a delightful time telling our story over and over to rating agencies," Murray says. The hospital's healthy cash reserves—200 days worth—were what ultimately sold the market on the hospital's ability to repay its debts.



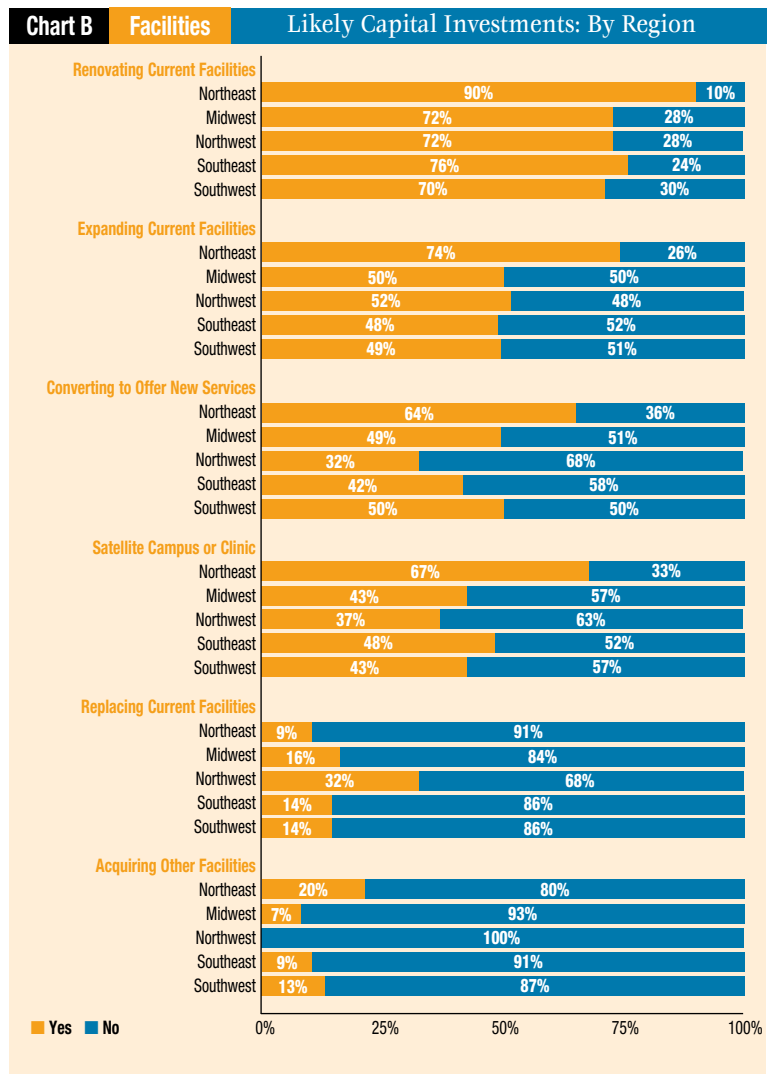
Ralph Davis

Chairman

Waller Lansden Dortch & Davis, LLP

Most of the bond money is going to the building project, although \$13 million will be used for capital equipment purchases. The remaining cost of the project is being funded by a capital drive that's raised almost \$20 million, including a challenge grant from the foundation that originally started the hospital. Murray says it's blessed with many generous donors, including a large com-

munity of retirees from Houston, some 250 miles to the east. More funds will come from the sale



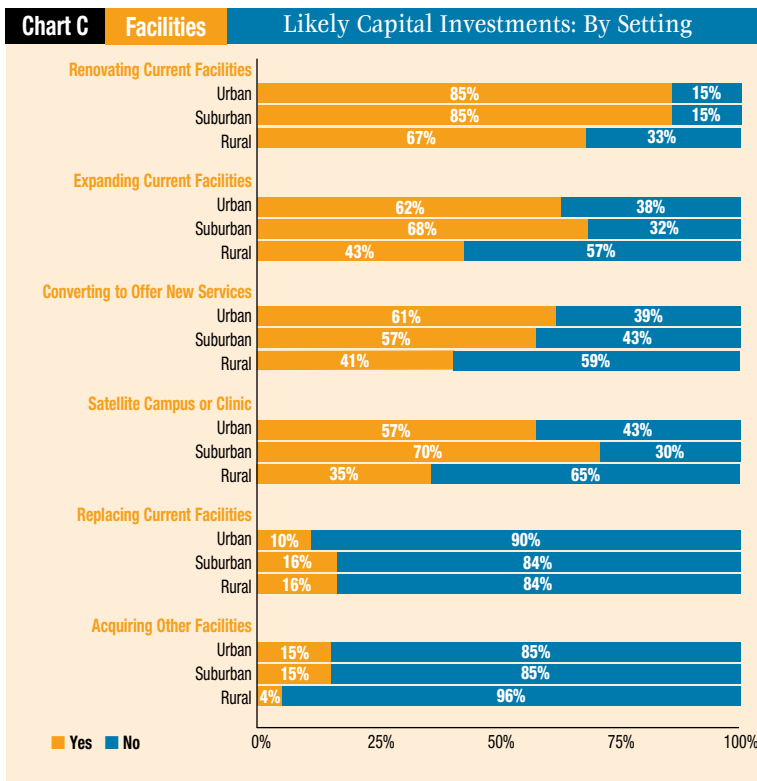
or redevelopment of the original property when the hospital moves to the new building next year.

to issue bonds to pay for capital projects, according to the survey of hospital executives conducted by HealthLeaders Media and the law firm of Waller Lansden Dortch & Davis, LLP, Nashville, which represents many tax-exempt and investor-owned healthcare institutions.

The survey was conducted during the summer of 2007, just before the sub-prime lending crisis shook the U.S. credit market. Out of 4,085 executives asked to participate,

"It's important for us to stay abreast of business trends before they become legal trends."

Despite the bewildering variety of financing options available, most tax-exempt hospitals still opt



Respondents were asked which types of building and major capital equipment expenditures they were planning over the next two years and how they anticipated paying for them. The survey covered replacement facilities, expansions, building reno-



Reggie Hill
Partner

Waller Lansden Dortch & Davis, LLP

464 returned completed questionnaires, for a response rate of about 11 percent. (See sidebar for more on the respondents.)

Waller Lansden sponsors research in areas of interest to the healthcare industry so the firm can have a deeper understanding of its clients'

business to handle client work once it's been handed to you. It's vital to stay in step with the industry."

Access to capital was a key issue for the firm's healthcare clients even before the recent turmoil in the credit markets, Davis says, and it's of even greater inter-

"All hospitals are faced with the competitive pressure of maintaining up to date facilities, technologies and equipment."

concerns, says Ralph Davis, the firm's chairman. "It's important for us to stay abreast of business trends before they become legal trends," Davis says. "It is not enough in our

est now. "Healthcare companies that have large fixed asset requirements have very different financing needs than many other kinds of businesses."

vations, and any capital equipment expenditures exceeding \$500,000 for information systems, new or expanded services or other purposes.

"All hospitals are faced with the competitive pressure of maintaining up-to-date facilities, technologies, and equipment to attract physicians and patients and provide the best quality of care," says Reggie Hill, a partner at Waller Lansden.

The recent credit crunch has not only affected borrowers but also lenders, says Hill. "A number of deals have closed recently with the banks holding onto the debt rather than syndicating it as they had originally planned," he says. "Because of that, there's a backlog of financing to work through."

It's the rare hospital that isn't planning major capital projects in the next few years. Three out of four survey respondents said their organizations are planning to renovate facilities in the next few years, and more than half are planning to

expand. Almost half are planning a satellite campus or clinic.

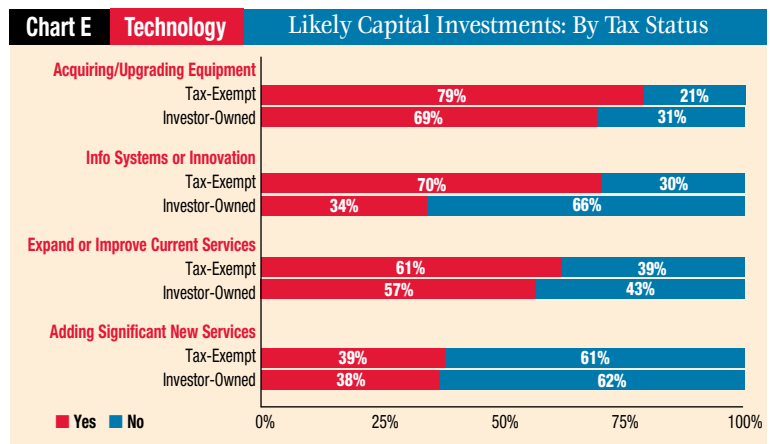
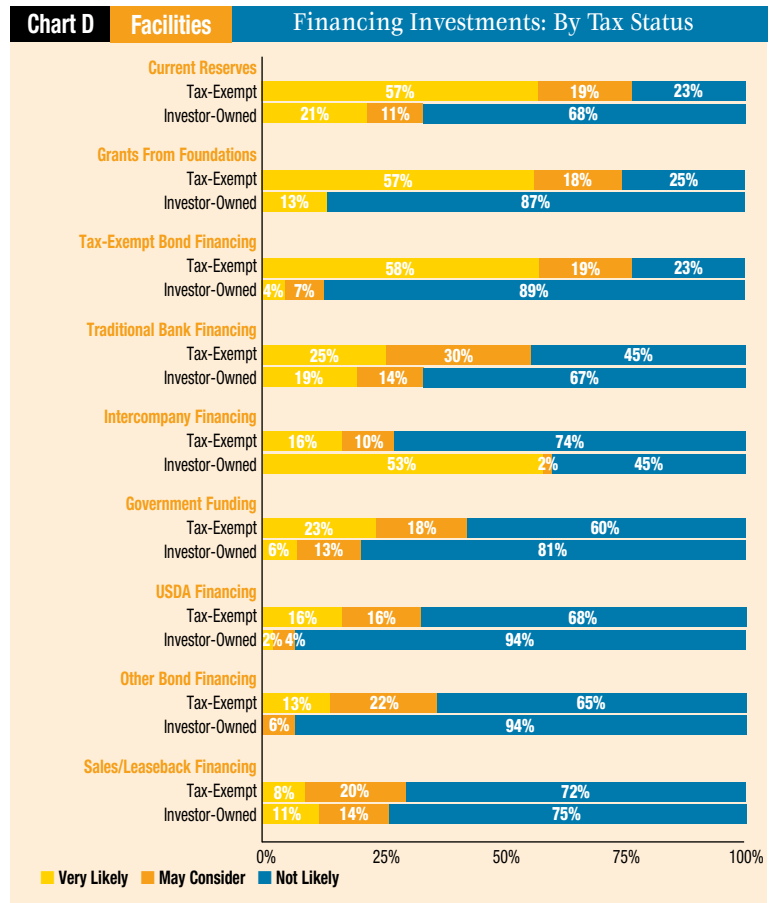
Only 16 percent of respondents were planning to build a complete replacement hospital, though the response varied sharply by region; in the Northwest, one in three respondents reported plans for replacement facilities.

Investing in tech

Almost all hospitals are looking at investing in new technologies or services. Three out of four respondents will acquire or upgrade new equipment worth more than \$500,000 over the next two years, and 65 percent are making major investments in information systems. Four in ten respondents expect to add significant new services. Again, there are noticeable regional differences: 96 percent of hospitals in the Northeast are planning to invest in new technologies, and 89 percent in information systems, while the corresponding figures for the Northwest are 63 percent and 53 percent. (See chart F, p. 6.)

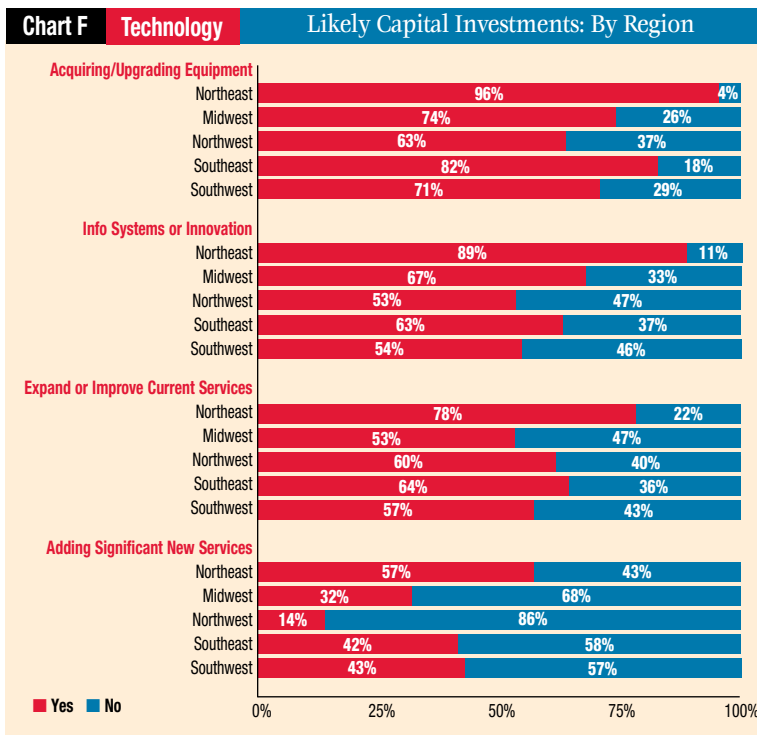
Despite the array of financing options available, most hospitals prefer traditional means of paying for capital projects. For buildings, tax-exempt hospitals rely about equally on tax-exempt bond or debenture financing (58 percent), their current reserves (57 percent), and donations (57 percent). For equipment purchases, they're less likely to seek bond financing (40 percent) and are more likely to opt for using current reserves (56 percent) or leases (51 percent). Almost half are likely to seek grants and donations. (See chart H, p. 8.)

Investor-owned hospitals ordinarily don't have the option of tax-exempt bonds, but they can rely on financ-



ing from their parent companies (53 percent for buildings and 54 percent for equipment). Less popular options

are relying on current reserves (21 percent for buildings and 18 percent for equipment), leasing (35 percent

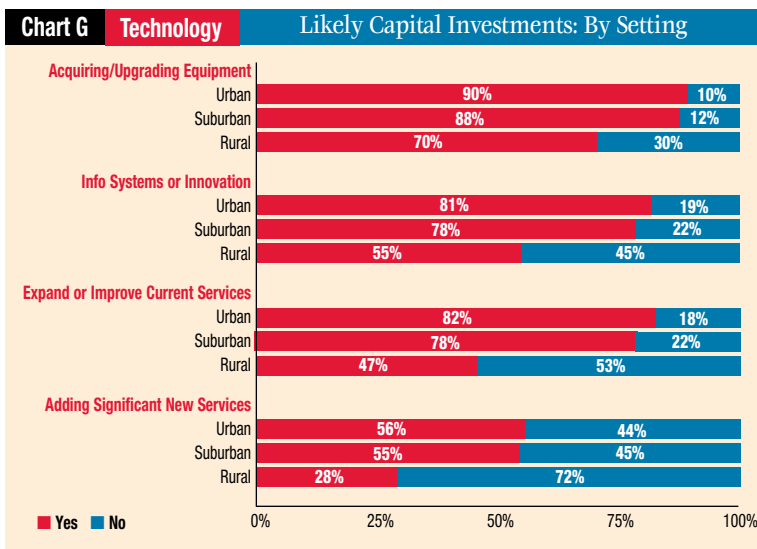


ing, or paying for capital projects by selling facilities or assets. (See charts D & H, pp. 5 and 8. To review charts D & H in their entirety, please see the additional survey analysis at www.wallerlaw.com.)

Trying not to borrow

Charlevoix (MI) Area Hospital is trying its best not to borrow for the next five years, after completing a major building expansion in 2002 that increased its square footage by more than 50 percent. Charlevoix is a 25-bed critical access hospital with a thriving outpatient business. Its location—a resort community on Lake Michigan—isn't as remote as that of most hospitals in its category. A drawbridge separates it from another hospital in a nearby town, however, making it the only available source

“We built it and they're coming, though they haven't all gotten here yet.”



of inpatient beds for miles when boat traffic is moving from Lake Charlevoix to Lake Michigan. The hospital converted to critical access status in 2004, with the backing of its U.S. representative, who had gotten caught in an hours-long traffic jam while the bridge was up.

The 2002 expansion was planned to be big enough to handle growth for several years, says chief executive officer Bill Jackson. “We built it, and they're coming, though they haven't all gotten here yet,” he says. Charlevoix is a popular retirement area for many who historically spent weekends and summers there, which guarantees not only a grow-

for equipment) and traditional bank financing (19 percent for building and 18 percent for equipment).

The many financing options that amazed Patrick Murray of Sid Peterson Memorial aren't drawing

much interest from his colleagues, either. Very few expressed any interest in financing facilities or technology through sale/leaseback financing, REIT mortgage financing, healthcare specialty lending, hedge-fund lend-

GOVERNMENTS OFFER BOND ALTERNATIVES

Because of unique circumstances, some hospitals have attractive alternatives to standard tax-exempt bonds.

Pershing Health System, Brookfield, MO, is in north central Missouri. Due to its critical access status, the hospital has to limit its staffed beds to 25, but its ER outpatient business is booming, so it's spending \$10 million to build a 38,000-square-foot addition for a new emergency department, laboratory, imaging facility and outpatient surgery center.

Pershing has very healthy cash reserves, and probably couldn't turn to the normal debt markets for financing, because Medicare might tag such a move as "unnecessary borrowing" and decline to pay for it under the critical-access reimbursement rules, says chief financial officer Gary Tandy. Despite having to put \$2 million of its cash toward the building project, Pershing still has \$4 million in free cash.

But because of its location, Pershing qualified for a USDA rural development direct loan of \$8 million, to be paid back at 4.25 percent over 25 years. "That's about as cheap as you can get," Tandy says. The hospital received approval for the loan two years ago and is drawing it down as construction proceeds.

Children's Hospital of Central California in Madera has an even better deal thanks to California voters. The eight children's hospitals in the state sponsored a ballot proposition in 2004 to issue \$750 million in state bonds to support specialty children's healthcare, with most of the proceeds allocated specifically to those eight hospitals. That's in the neighborhood of \$75 million each over the next 15 years for capital projects, with no payback obligation. The measure passed with almost 60 percent of the vote and no organized opposition.

Children's Hospital is in the fortunate position of being almost brand-new: The current building went into service in 1999 with 255 beds.

"Because we are such a relatively new facility, we don't have a lot of debt financing anticipated, other than what we're already paying down," says chief

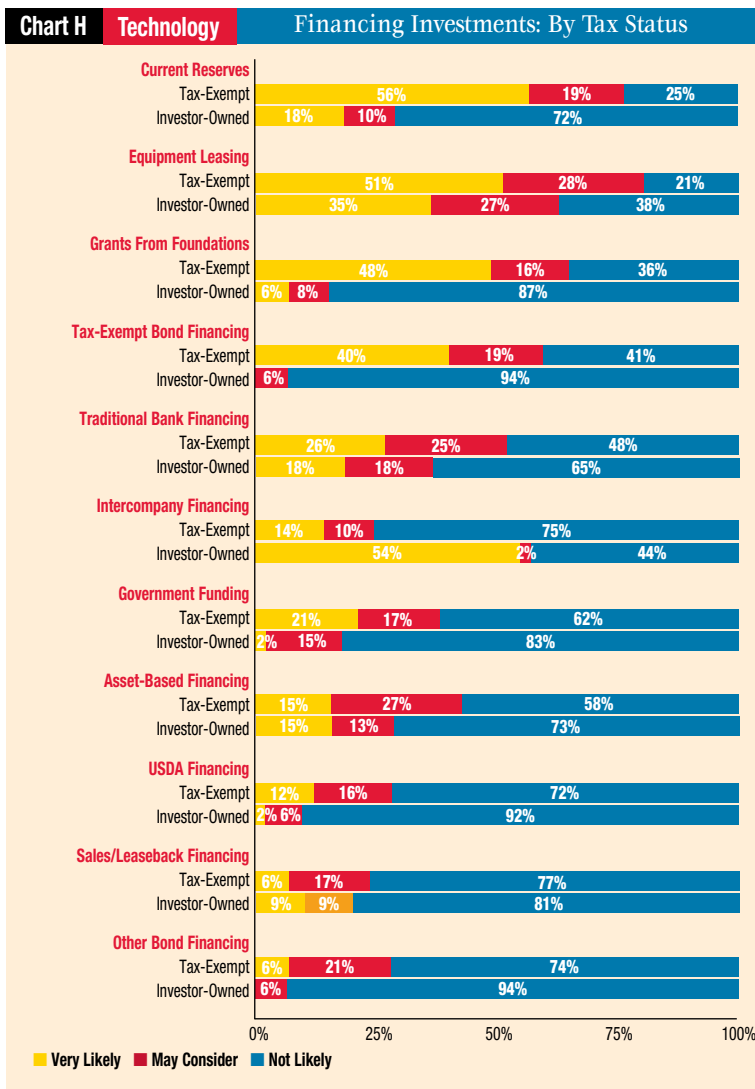
executive William Haug. "Other children's hospitals that are older, or have seismic issues that require a lot of building, are probably looking at a variety of different debt financing alternatives."

But the population around the hospital is growing quickly. Despite projections that it would be able to handle growth for at least a decade and maybe two, the new building was bursting at the seams by 2004. Haug has already expanded to 297 beds and plans to add 43 more by 2010. He'll build out shell space, re-purpose some non-clinical areas, and add an 80,000 to 100,000-square foot expansion. The hospital also plans to double or triple the size of its trauma and emergency center, and add operating rooms and imaging space.

The California children's hospitals may go to voters soon with another ballot proposition similar to the first one. Even if it doesn't pass, however, Haug believes that Children's can swing its capital needs—which he estimates at \$300 million over the next ten years—through a combination of cash reserves, current income, the remaining proceeds from the first ballot proposition, and a bond issue of \$40 million that the hospital completed within the past two years.

Tiny Lanai Community Hospital is the only hospital on the Hawaiian island of Lanai. Its 14 beds serve 3,500 island residents. There are very few privately owned hospitals in Hawaii; the majority are operated and heavily subsidized by the state. Lanai has an annual budget ranging from \$2.5 million to \$4 million, of which half is state-subsidized. (The remainder is about 43 percent private insurance, with Medicare and Medicaid making up most of the rest.)

Capital funds are likewise provided by the state—when it feels like it, says CEO John Schaumburg. "We state facilities hang on by our fingernails and hope for the best," he says. During the most recent legislative session, Lanai was voted \$1.2 million to renovate its emergency department and upgrade its building and equipment, mostly because Schaumburg was able to demonstrate that his average age of plant was 19.5 years—more than seven years older than the state median. Even so, he now has to persuade Governor Linda Lingle to release the funds before the allocation lapses in three years. "I think it's going to take a little bit of lobbying," he says.



Richard Henley, chief executive of Pocono Health System, East Stroudsburg, PA, is looking at a potential expenditure of \$350 million over the next ten years for replacement equipment and renovations, new services such as electrophysiol-

“The cost of capital has gone up dramatically even for tax-exempt organizations.”

ogy and a 64-slice CT scanner, and eventually a major facility expansion to add inpatient capacity to 192-bed Pocono Medical Center.

“The cost of capital has gone up dramatically even for tax-exempt organizations,” Henley says. “Organizations like ours that have good credit ratings can access additional debt on reasonable terms without private insurance. Hospitals that don’t have a good credit rating are beholden to bond insurers and, in the market right now, there’s a lot of concern.” Pocono’s debt rating is currently BBB+.

Nonetheless, the organization already carries quite a bit of debt, and Henley is looking for ways to avoid taking on more. Equipment leasing is playing a major role in his plans, especially in radiology. He also recently replaced all of the organization’s intravenous pumps with leased units. For the rest, the system is paying cash whenever it can, and focusing on projects and services that will yield cash flow that can act as seed capital for future projects. ■

Interviews were conducted by a freelance editor contracted by HealthLeaders Media.

ing stream of new patients, but also a growing pool of potential donors.

Jackson is able to fund many small projects through donations, and when he does have to borrow, he can take advantage of a town-hospital finance authority.

Deaconess Health System in Evansville, IN, a five-hospital system serving southern Indiana and parts of Kentucky and Illinois, built a brand-new hospital, Deaconess Gateway, in 2006, and is remodel-

ing its other facilities and constructing medical office buildings. The system finances its projects with a combination of cash reserves and bonds and treats its A+ bond rating like the crown jewel that it is. “Keep a really good credit rating—that’s our mantra,” says chief executive officer Linda White. “Our board of directors demands that we maintain a five percent operating margin every year, and we always find a way to do it.”