

Equipment Financing: What You Need to Know to Get the Best Deal for You

BY MARK SEDLMEIER



Healthcare institutions are spending more capital than ever before on equipment: in fact, they're allocating approximately 51 percent of their capital for fixed assets to this line item, according to a recent *Financing the Future* report published by the Healthcare Financial Management Association. Driving these trends are the day-to-day demands of operating a hospital, such as keeping up with health and safety code requirements; ensuring the high-quality practice of medicine; maintaining efficient operations; and driving strategic business expansion.

Advancements in medical technologies are also driving the increase in equipment spending. Most

medical equipment, such as CT scanners, is experiencing a contracting lifecycle and new concepts, such as paperless medical recordkeeping, are no longer a want but rather a need. Add in patients' desire to get more involved in their medical treatment, and it's easy to see why more physicians, executives, and administrators are exploring new ways to fund healthcare equipment spending.

Fortunately, because health care is one of the few growth industries these days, plenty of lenders are eager to arrange financing for high-technology medical equipment such as linear accelerators and CT scanners. But before leaping at the first offer, it pays to understand the ins and outs

of capital equipment financing. Some critical considerations:

- Should we utilize a lease or loan?
- What are the tax and depreciation implications?
- How will it affect the balance sheet?
- What do lenders/lessors look for?
- And which lenders would be best for administrators and physicians to work with?

The Options

In equipment financing, there are two primary choices: leases and loans. Leases generally run three to seven years and have lower monthly payments. In essence, borrowers/lessees are paying for the use of the equipment rather than the ownership. With less money diverted to payments, medical professionals can improve their cash flow, matching revenues with expenses. Moreover, most leases don't appear on the balance sheet as debt. Thus, they don't adversely affect ratio analyses such as debt-to-capitalization, which can be critical for hospitals interested in issuing bonds.

Leasing offers greater flexibility and can be written to wrap in upgrades and services, such as maintenance. Leases also help guard against equipment obsolescence. At the end of the lease, the borrower can opt to purchase, renew or return the

equipment, providing borrowers the opportunity to maintain state-of-the-art equipment cost-effectively.

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On the Other Hand . . .

If cash flow and equipment obsolescence aren't an issue, leasing may not be your best financing alternative, especially at the end of the lease term. That's because the borrower doesn't own the equipment at end of the term and must decide whether to purchase or renew the equipment at a fair market value or return the equipment. If the lessee desires to purchase or renew, they must negotiate a fair market value with the lessor. However, it is possible to mitigate the fair market value uncertainty by negotiating a fair-market value cap or early buyout option at the inception of the lease term.

Another potential disadvantage is that the lessor, not the lessee, keeps the income tax benefits, including the right to depreciate the equipment's cost—although most lessors indirectly pass these tax benefits back to the lessee in their pricing. Most medical equipment is a five-year depreciable asset, so the cost of a \$1 million CT scanner is completely recovered over six years. That's approximately \$167,000 per year that could be used to shelter taxable income.

With loans, borrowers keep the tax benefits, including deducting the interest expense and depreciation. Loans also offer a predictable, though higher, payment schedule, often ranging between three years for information technology equipment to seven years for linear accelerators.

In addition, borrowers that are planning to go public might favor loans. Depreciation and interest for loans fall below the EBITDA—expenses before interest, deprecia-

tion, taxes and amortization—line. Using a multiple of EBITDA is a common valuation methodology for businesses.

What Do Lenders Want?

For both medical centers and group practices, lenders will evaluate:

- Cash flow
- Working capital
- Profitable growth for three or more years
- Collateral coverage throughout the finance term

Lenders place greater emphasis on financial statement analysis for hospitals because they retain their annual income and tend to be seeking financing for replacement equipment. For new projects or medical groups, which distribute the majority of their income, financiers will also examine:

- How long the group has been in business
- The stability of the doctors within the group
- Historical and pro forma distributions to partners
- Reimbursement and payer mix
- Viability based on a minimum of three years of pro forma numbers
- Growth assumptions/projections for three years, such as
 - Number and origins of new patients
 - Expenses
 - Revenues
 - Net cash flow

Choosing a Lender/Lessor

When seeking healthcare equipment financing, one place to start is the manufacturer. Most of the major manufacturers offer financing, and

many will provide favorable pricing and financing. While most vendor financing groups only finance their own equipment, there are a few specialty lenders that have the healthcare financing acumen to finance other medical vendor's equipment.

Independent lenders offer both equipment loans and leases. Some may specialize in a market, such as healthcare, or a geographic region. Industry expertise gives lenders greater insight into specific issues affecting healthcare customers. This knowledge also allows the lender to specialize in valuation and remarketing of medical equipment. Based on this industry expertise, they frequently offer better terms and flexibility.

Banks are another source of financing, specializing in providing loans. They are generally located in the geographic area and provide very competitive debt rates.

Ideally, a lender would have industry expertise, offer a wide range of financing packages, and be committed to the healthcare industry long term.

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