

Forward-Looking Financing Strategies for Hospitals and Healthcare Systems

By William Roberson

Looking beyond loans to create stability.

Hospitals and healthcare systems are battling to protect their very livelihoods as spending increases and cash flows tighten. A recent report by the Healthcare Financial Management Association demonstrated just how widespread the capital issues have become.¹ The study shows that 72 percent of hospital and healthcare system CFOs project that their capital spending will rise—on average by about 14 percent within the next five years. Nearly half say that they cannot keep up with the current capital needs of their deteriorating plants. And 85 percent of hospital CFOs surveyed say it will become more difficult for their organizations to fund capital expenditures in the future.

A quick look at the healthcare landscape easily explains the shortfalls. Hospitals and healthcare systems are in danger of being swallowed by a growing gap—the gap between what patients want and need and what many cash-strapped health facilities can actually provide. Never in medical history has the disparity between these two ideals been so great.

From a health provider's perspective, spending is about ensuring the viability of day-to-day operations and staying as up-to-date as possible with such needs as replacing aging physical plants and equipment and upgrading technology. If possible, organizations also spend money on strategic future investments—such as building outpatient facilities to reduce the costs associated with acute-care beds—or even toward cleaning up old liabilities or correcting failed operational strategies.

However, expenditures such as the \$1 million an organization can spend on one updated CT scanner aren't being matched by income. For example, in recent years, Medicare payments haven't covered Medicare costs. They've paid for less than 98 percent

of the tab, leaving hospitals and healthcare systems to pick up the rest. It's little wonder, then, that many health organizations spend their scarce dollars just trying to keep up.

But patients—who are paying more out-of-pocket healthcare expenses than ever before—don't want a facility that simply keeps up. Neither do potential employees. These audiences want the latest in technology, top talent, conveniently located outpatient facilities and nontraditional health facilities. Whether they're investing in their health or in a career, patients and employees want to benefit from the advances they read about every day in the newspaper.

And the gap shows no sign of narrowing—not as long as certain factors continue to exist, such as the Medicare situation; huge overheads on malpractice insurance; urban sprawl, which triggers the need for new facilities; and technology that's almost overwhelmingly expensive but at the same time very necessary.

As hospitals and healthcare systems struggle and patients clamor for improvements, many providers have realized that they will have to make tough capital decisions now or risk being driven out of business in the not-so-distant future. However, because of hospitals and healthcare systems' current capital woes, traditional financing solutions—such as a line of credit or a loan—don't work in every situation. More often than not, these solutions only act as a Band-Aid, covering up a larger problem for a short period of time.

William Roberson is Managing Director for GE Commercial Finance Healthcare Financial Services, Miami, Florida. Contact him at william.roberson@ge.com.

Searching for the Solutions

What do these trends mean for financial services companies that cater to hospitals and healthcare systems? In my experience, these issues mean that we can no longer rely on traditional financing solutions to help our clients meet current business demands.

In my mind, to help healthcare system clients compete effectively, financial services companies must not only provide financing but also take a hard look at all client assets to find new ways to generate capital. We must know our clients' businesses from top to bottom; understand their visions, goals and strategies; and examine their customers' wants and needs. While an answer to financing challenges does not present itself immediately, knowing and—more important—really understanding these issues puts the best solutions within our line of sight. That makes doing our job from the financial side much easier.

Working with hospitals and healthcare systems adds another level of challenges in the due-diligence process. By the nature of their industry, it's difficult for these businesses to commit to long-term relationships with outside vendors. Hospitals and healthcare systems are trust and relationship oriented. They need to see from the start that a financial services company can address a capital issue with a deeper understanding of their industry and come up with solutions that do not sacrifice other segments of the business. They want a company with expertise in healthcare so that its team can cast a critical eye on the situation and instinctively know which questions to ask.

Working for a financial services company that specializes strictly in healthcare, I've learned how to "Be the ball," to quote the movie *CADDY SHACK*. That's exactly what our clients want from us—a company that's just as much of an industry insider as they are. To find the best solution for our clients, we must put ourselves in their shoes and learn the unique intricacies of each situation.

Looking Beyond Financing

One way that we address the complex problems of hospital have-nots is to look beyond financing and toward third parties for different kinds of capital solutions. Often, the hospitals with which we work have real estate assets—such as medical office buildings ("MOBs")—that are a financial drain to

the facility because of the intricacies involved in maintaining, managing and upgrading them. For example, MOBs usually come with expensive interior requirements to accommodate medical technology, filtration systems and sound control. Another cost we find is the undervalued nature of hospital-owned real estate not managed by a professional third-party owner. Third-party owners are more likely to seek the higher rents and longer lease maturities that make real estate an acceptable investment and maximize value.

Upon evaluating many situations, we've found that more frequently hospitals or healthcare systems don't need a loan or a line of credit. Rather, they need to take a hard look at their business and determine which real estate is crucial to future success and which is not. More often than not, we've seen that monetizing real estate assets, such as MOBs, for cash to an experienced third-party management company can make a tremendous difference on the balance sheet and plant the seeds for a brighter future.

As a capital provider, GE is involved in these kinds of transactions in two ways. First, if a client has a development need, we will recommend several partners who are well positioned to help that client (because we are not a developer). In these situations, we are essentially a matchmaker who helps make introductions for clients to enable our clients and third parties to move forward. If a situation involves acquisitions, our team will remain involved from start to finish because we are a capital provider. In short, we explore all options to help our clients secure the capital they need. It's part of building the trust that is so important to the healthcare community.

When a third-party solution is a customer's best choice, GE identifies a few real estate companies that we believe bring the track record required to turn around the situation. For example, if a hospital needs a medical office for affiliated physicians or its own outpatient services, and the physicians want to own the real estate, certain developers and owners are better suited to the situation than others. But unlike in traditional financing situations, GE is involved only in the discovery/advisory phase. Our team assesses the challenge, makes recommendations and enables the hospital/health system and third party to conduct their transaction privately.

This approach—one in which GE isn't even extending credit or making loans—has been successful for customers across the country. They appreciate an "outsider's" evaluation of their business and the strategic guidance that will carry them beyond this capital need. In many instances, the third-party solution has paved the way for hospitals and health systems to get their businesses on stable ground because of the capital they've freed and the expenses they've reduced. The third-party solution enabled one customer to create a new physician recruiting and retention program, which has significantly improved its competitive position in its region. Another was able to open a new health and wellness center, which featured equipment and treatments not otherwise available locally. Countless others have been able to upgrade technology, a major issue during a time when medical equipment shelf life continues to dwindle and costs continue to soar.

Another example of alternative sources of capital is a tax-exempt financing to finance not-for-profit-use real estate, such as parking garages and ambulatory care centers. Tax-exempt private placements offer several advantages over publicly issued bonds. While public issues are cost efficient for large transactions, they involve numerous parties (underwriters, rating agencies, trustees, bond counsels, *etc.*), which can slow down the process and significantly increase the costs of issuance.

In contrast, tax-exempt private placements offer a much faster and more private way to raise capital. Because there are only two parties—the hospital or healthcare system and the lender—to the transaction, the process is streamlined and transaction fees are reduced. In addition, since the lenders are knowledgeable institutional investors holding the loans for their own account, the borrower is not required to disclose publicly financial and other information that would ordinarily be required on a public deal.

What's Next

Working with numerous customers has helped GE identify just how important this nontraditional financing trend could become and just how valuable it is to our clients. Because nontraditional financing is making a significantly positive im-

pact on hospitals and healthcare systems, we are constantly looking at new ways to deliver on this concept. Soon, these methods may no longer be considered nontraditional.

In addition to the third-party solutions noted above, several nontraditional financing trends are emerging right now:

- **Sale of noncore assets.** While they may not seem that important in the grand scheme of things, noncore assets—such as parking garages—are certainly key to relationships with target audiences such as patients, physicians and other employees. After all, people are paying more for healthcare than ever before, and competition is intense among hospitals and healthcare systems for talent. Small perks, such as parking garages that make a visit to a health facility more convenient, give an organization a competitive advantage. That's why hospitals and healthcare systems are selling off these noncore assets to experienced third parties. Third parties offer an attractive scenario—the potential to keep the noncore assets open to the health facilities' customers while eliminating the cost associated with maintaining these assets.
- **Debt-service reserve funds.** Paying such contingents as malpractice, liability and workmen's compensation can create tremendous problems for lower-credit-rated hospitals and healthcare systems. In 2004, malpractice payments totaled more than \$4.2 billion, with an average claim of \$265,000, according to the nonprofit organization Public Citizen. To offset these potential costs, health providers are leaning more toward using letters of credit to conserve cash while meeting these unpredictable obligations.
- **Philanthropy.** For a small sector within hospitals and healthcare systems, children's hospitals for example, philanthropy is part of everyday business. These groups approach philanthropy as an ongoing part of their business plans, and it results in a steady flow of cash that those institutions use to meet the increasing cost of being in the healthcare business. Until recently, other healthcare providers viewed philanthropy only as a sporadic boost to the bottom line for special projects. Now we're seeing other hospitals and healthcare systems seriously examine how philanthropy could benefit them if they took a long-term strategic

approach to fund-raising. Ongoing philanthropy could be a common tactic for all hospitals and healthcare systems in a matter of years.

- **Joint ventures.** While we've been seeing joint ventures for a few years now, activity in this area is really picking up as outpatient facilities play a more important role in keeping down the costs of acute-care beds and meeting growing demands of suburban customers. Hospitals and healthcare systems are looking for partners for a "gain-sharing" relationship that will enable them to grow without funding entire projects themselves.
- **Alternative investments.** Hospitals and healthcare systems traditionally have taken a conservative approach to investing. Typically, their investment portfolios are about 60-percent debt and 40-percent bond. Now we're starting to see these institutions become more aggressive in their investments, with an increased involvement in real estate and hedge funds. These forward-looking investments are starting to mean the difference between average

returns and beating the market. Look for more health providers to get into the aggressive investment game within the coming years.

Rethinking Healthcare Funding

Hospital and healthcare systems' capital struggles are unlikely to ease anytime soon, but creative, non-traditional financing solutions can help them reach their goals. As financiers, we need to help our clients change the way they think about funding their organizations so that they can unlock the capital needed to remain competitive in the marketplace.

Endnotes

- ¹ The report, *Financing the Future*, was created in partnership with GE Commercial Finance Healthcare Financial Services and KaufmanHall.

Now Available ... Audit Committees: A Guide for Directors, Management, and Consultants

AUDIT COMMITTEES: A GUIDE FOR DIRECTORS, MANAGEMENT, AND CONSULTANTS presents the history, responsibilities and operation of audit committees. The GUIDE focuses primarily on publicly held companies but also includes a short chapter on audit committees for not-for-profit and public sector entities.

The GUIDE is written in a nontechnical, active-voice, easy-to-read format. The book is useful for directors serving on audit committees, other members of the board of directors, CEOs, CFOs, legal in-house counsels, internal and external auditors, outside legal counsels and other consultants to audit committees. It fills a "gap" in the existing literature in that it blends (1) observations based on real-world experiences from serving on audit committees; (2) expert knowledge of the standards of external and internal auditors; and (3) knowledge of the latest requirements from the New York Stock Exchange, National Association of Securities Dealers/Nasdaq, American Stock Exchange and the SEC, including the Sarbanes-Oxley Act of 2002.

AUDIT COMMITTEES covers subjects rarely discussed, such as the process for terminating an external auditor. This edition is current as of September 1, 2004, and has been revised to reflect the following:

- A new chapter, *The Sarbanes-Oxley Act of 2002*, summarizes all of the requirements, including SEC rules and stock exchange listing requirements, that affect audit committees. In addition, these requirements are discussed throughout the book.
- A revised chapter on *The Audit Committee's Oversight of Internal Control* explains the new requirements for internal control over financial reporting and disclosure controls and procedures.
- Additionally, readers will find sample excerpts from proxy statements and annual reports, as well as new and revised Appendices containing sample checklists and templates.

AUDIT COMMITTEES: A GUIDE FOR DIRECTORS, MANAGEMENT, AND CONSULTANTS is available from CCH INCORPORATED, 4025 W. Peterson Avenue, Chicago, Illinois 60646-6085. To order by phone, call 1-800-248-3248, book #0-6054-400.