

Appendix: Future Sources Matrix

Capital Source	Hospital Position	Industry/Market Position	Outlook	Trends
Cash from Operations	The majority of hospitals say they will use cash to fund future capital needs. 63% of hospitals surveyed said they would rely more on cash from operations over the next five years.	Although the majority want to use cash, having access to it is a different reality. 29% of hospitals have negative total margins, and more than 90% believe that Medicare and Medicaid reimbursement is not adequate.	▶	<p>Access to cash will be divided between the “haves” and the “have-nots.” Although most hospitals want to use cash to fund capital needs, many will not be in a financial position to actualize this.</p> <p>Some analysts also believe hospitals are overspending on infrastructure because the “have-nots” are attempting to compete in the marketplace against high-access systems.</p>
Tax-Exempt Bonds	Half of all hospitals surveyed will seek tax-exempt bond funding over the next five years.	Many hospitals view tax-exempt bonds as a prime capital source; however, a quarter of all hospitals surveyed have reached their debt capacity, and more than 50% of all rated hospitals are rated BBB or below.	▶	<p>Again, capital access in the tax-exempt bond market is largely divided between the “haves” and the “have-nots.” Future access will be available for hospitals that have not reached their debt limit and are rated above a BBB. However, for those hospitals not in the above categories, access will not be possible at any price.</p>
Philanthropy	More hospitals will pursue the charitable dollar. 45% of hospitals surveyed said they will rely more on philanthropy.	Although hospitals say they will increasingly rely on philanthropy to fund capital needs, recent trends in charitable giving indicate a shrinking supply. Between 2001 and 2002, total healthcare giving decreased from \$4.89 billion to \$3.64 billion—a 26% decrease.	▶	<p>Many hospitals have not tapped this resource sufficiently. That will change, but competition for the philanthropic dollar will be fierce. Giving is dependent on donors, and donors’ wealth depends on the economy.</p> <p>For those hospitals wanting to gain “market share” in charitable giving, an investment of time and money will be required. Philanthropy is built on relationships, often resulting in a 3- to 7-year lag time between the effort and return.</p>
Local Taxes	More than a third of the government hospitals surveyed plan to rely more on local taxes as a means to meet capital needs.	Local tax rates are often dependent on the total tax threshold that an area is willing to bear. The competition for additional tax monies from municipalities, counties, school districts, and health districts is intense and heavily dependent on the local tax “tolerance.”	▶	<p>States and local governments are currently cash strapped with a projected combined shortfall of \$75 to \$80 billion in FY 04, which is about 15% of the states’ total budgets.</p> <p>However, local taxes are, in the end, a local issue. Tax-supported hospitals that are located within an area that has not reached tax fatigue and that can put together a persuasive tax campaign will ultimately be successful.</p>

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Capital and Operating Leases	<p>Both “haves” and “have-nots” are using leasing as a way to stretch their capital. 22% of hospital respondents said they plan to use capital leases more over the next five years.</p> <p>Percentage of funding through leases is up from 7% of total in 1997 to 16% of total in 2002.</p>	<p>The lease industry is growing, especially as hospitals look for ways to keep up with ever changing technology.</p> <p>Capital leases offer low issuance costs, generally higher interest rates.</p>	▲	<p>Unlike many of the capital sources, leases are available to a wider range of hospitals—breaking down the division of the “haves” and “have-nots.”</p> <p>The Equipment Leasing Association predicts that the healthcare equipment leasing market will grow from \$6.3 billion in 2003 to \$7.4 billion in 2005.</p>
Investment Income	<p>Following the economic downturn, many hospitals understandably shifted funds away from equity markets into low-risk, low-return fixed investment vehicles.</p>	<p>The Federal Reserve Board is currently optimistic concerning the economic recovery and the potential for gains in the equity markets.</p>	▲	<p>Provided the optimistic view of the economic recovery continues, we are likely to see hospitals again shift funds into the equity markets to realize the associated gains. This trend could thrust us back into the pre-9/11 days when S&P noted that nonoperating revenue generated up to 89% of excess margin.</p>
Bank Loans	<p>Almost 25% of hospitals surveyed plan to increase their reliance on bank loans as a capital access point.</p>	<p>The availability of capital from commercial banks remains strong among the large banking institutions.</p>	▶	<p>The continued consolidation of the banking industry may make it more difficult for hospitals to diversify their debt among a number of banking institutions likely limiting access from this source.</p>
Physician Investment	<p>Only 10% of hospitals surveyed reported that they realized capital from physician investment in the past year. These ventures were primarily a tool used by hospitals to protect market share.</p>	<p>Increased regulation surrounding antikickback issues is likely to dampen physician interest in future joint ventures.</p>	▼	<p>Future capital spurred through physician investment is dependent upon hospitals’ willingness to further dilute management and financial control and increased federal regulation in this area.</p> <p>The 18-month moratorium on physician investment in specialty hospitals means a downturn, at least temporarily, in these investments.</p>
Sale of Assets	<p>Only 15% of hospitals surveyed viewed sale of assets as a likely means for future capital. The majority of hospitals may have already divested most of their non-core assets.</p>	<p>Hospital mergers and acquisitions activity has consistently trended downward since 1996 (an 86% decrease).</p>	▼	<p>The desire to maintain current assets coupled with the slowing of M&A transactions, could limit the cash available to hospitals. However, continued issues in accessing capital may increase the need for hospitals to consider merging or being acquired over the long-term.</p>
Other Lending Sources	<p>Lines of working capital, mezzanine financing, and private placements are tools used often by certain types hospitals and systems, particularly on the for-profit side.</p>	<p>The hospital industry continues to grow faster than the economy in general. Lenders see a strong market for their products in this niche. Private hospital companies will depend on these sources if the IPO market is closed to them.</p>	▲	<p>As long as interest rates remain low, the cost of capital from other lending sources remains historically low as well. Hospitals that have reached debt capacity can tap these other sources and still get a good return on their investment. However, a significant uptick in interest rates could put some of these lending sources beyond the reach of hospitals with limited profit margins.</p>