

Appendix: Sources of Capital

Healthcare organizations must find capital to survive. Some organizations are reducing capital needs by delaying building and expansion plans, while other organizations are charting a new course by accessing new or little-used sources of capital. One thing is certain: organizations that wish to thrive must be able to respond to changing conditions quickly. The information that follows is a “nuts and bolts” view of many of the capital sources available to healthcare organizations. Some of these capital sources are traditional, such as bonds, bank loans, and philanthropy. Some of them are less well-known, such as sale of assets, leases, REITS, and partnerships, but may grow to be a regular and primary source of healthcare capital in the future.

The paragraphs below describe each source of capital or credit enhancement. The matrixes that follow provide an at-a-glance view of the uses, access methods, and risks of each.

Capital Sources

Tax-exempt bonds. Revenue bonds are limited liability obligations. The security for revenue bond issues is provided by a pledge of a specific revenue stream—usually derived from the project being funded or the enterprise. There may also be a mortgage on the property financed. Revenue bonds may be supported by a third-party credit enhancement (i.e., bank letter of credit, bond insurance, FHA mortgage insurance).

General acute care hospitals issued 2 percent more bonds in 2002 than in 2001¹, showing an overall tightening of the tax-exempt bond market as investors become more selective and credit enhancement costs continue to increase. Additionally, investors are requiring more financial disclosure and transparency in the reporting process.

As an alternative to the traditional bond market, some healthcare organizations are pursuing creative financing methods that include synthetic floating rate

debt and off-balance sheet monetization. Synthetic floating bonds are the result of a conversion from fixed rate liabilities to floating rate liabilities through an interest rate swap.² In off-balance sheet monetization transactions, hospitals typically sell non-core assets such as medical office buildings, but still retain control of tenants and some fees.

Taxable bonds. Taxable bonds are used by for-profit healthcare companies that do not have access to the tax-exempt or municipal bond markets. They are also used by not-for-profit organizations for hospital-related uses not qualifying for tax-exempt financing, such as medical office buildings.

Currently, historically low taxable interest rates and compressed spreads between taxable and tax-exempt interest rates have increased the attractiveness of the corporate and taxable municipal bond market, resulting in significant taxable bond issuances in recent years.³

Venture capital and public equity offerings. Venture capital funds (VCs) provide early-stage money and operating assistance for companies as they navigate from a business concept to a public company. As a company becomes more mature, it may “go public” through an initial public offering (IPO). To raise additional capital, the company may sell stock through secondary offerings.

Sixteen healthcare companies went public in 2002, and to date, one has gone public in 2003. The majority of healthcare IPOs have been successful, and the companies are trading above their initial offering price. Most of the recent IPOs are small medical device manufacturers.⁴

Sale of assets. One method that some hospitals have used to raise capital is to sell the hospital to another hospital or a healthcare system. Sometimes, this results in a change in tax status for the acquired hospital. This method is typically used by hospitals that perceive a

¹ Center for Medicare and Medicaid Services, “Healthcare Industry Market Update - Acute Care Hospitals,” April 29, 2002.

² Healthcare Finance Forum, “The Future of Not-for-Profit Healthcare Capital Financing,” June 14, 2002.

³ Center for Medicare and Medicaid Services, “Healthcare Industry Market Update - Acute Care Hospitals,” April 29, 2002.

⁴ Jenks Healthcare Business Report, “Health Care IPO Door Opens, But Just a Crack,” July 2003.

lack of access to capital in the markets and may result in conversion of a not-for-profit hospital to a for-profit hospital.

Between 1970 and 1995, 7 percent of non-profit hospitals converted from non-profit to for-profit status.⁵ As institutions continue to look at this option, there is a growing regulatory movement to prohibit the transfer of community assets outside of states, hindering these conversions to large for-profit corporations.

In addition, many hospital systems are selling certain real estate assets, such as medical office buildings and outpatient buildings. Such sales help hospitals deleverage their balance sheets and can help minimize possible regulatory and legal risks that arise when hospitals lease to physicians.

Banks and other financial services companies. Banks and other financial services companies offer a variety of financing options including mortgage loans, credit and/or liquidity enhancement facilities, working capital loans, term loans, revenue and/or tax anticipation notes, equipment loans and leases, and financial derivatives. Banks also may provide letters of credit that enhance a hospital's ability to access capital. Banks typically work with organizations that have healthy balance sheets and strong debt service capabilities, while commercial finance companies will do deals that span a broad spectrum of provider types and financial profiles.

The availability of capital from commercial banks was greatly reduced in the late 1990s, but has shown some growth very recently, even as the consolidation of the banking industry has reduced the number of lenders.

Capital leases. Banks, financial services companies, and equipment manufacturers provide capital lease options that allow healthcare companies to obtain equipment while avoiding the full cost of purchasing.

Currently, an estimated 30 to 50 percent of imaging diagnostic systems are leased.⁶ The estimated size of the healthcare equipment leasing market in 2002 was \$5.8 billion of new volume and is projected to reach \$7.4 billion in volume by 2005.⁷

Joint ventures (JVs) or partnerships. JVs are partnerships formed to share risk and expertise and as a method for one organization to access capital through another organization. Generally, JVs involve physicians who want some management and financial control in a venture, such as an ambulatory surgery center.

The boom in specialty hospitals and ambulatory surgery centers has been financed in large part by physician private company partnerships, although some have been done with physician/hospital partnerships.

Real estate investment trusts (REITS). REITS provide capital through the purchase of healthcare properties and realize their investment return through the subsequent property lease.

The sale of hospital assets to REITS, especially medical office buildings (MOBs), is becoming more advantageous to healthcare organizations. Analysts believe that several trends will increase this market, including rising real estate values, new buyers entering the market, MOB purchasers being more comfortable with healthcare organizations retaining some operational control of the sold properties, and the increased risk of hospitals remaining in a landlord position.⁸

Private philanthropy. Charitable trusts and foundations and individual donors can be a source of capital for hospitals. Recently, healthcare philanthropy has declined. Total cash donations fell from \$4.89 billion in 2001 to \$3.64 billion in 2002,⁹ although the proportion of philanthropy as a source of capital increased between 1997 and 2001.

Public grants. Government grants are often available to health systems that serve a special purpose such as rural or critical access hospitals. Many states are currently using tobacco settlement monies for healthcare grant programs.

With many state legislatures looking to bridge large budget gaps, various cost savings and revenue enhancement methods are being discussed. Tobacco settlement revenue has provided a steady source of healthcare grant money during the last few years and is slated to continue for the next decade under many state settlement terms. One potential risk is that states may attempt to securitize these "annuities" to address budget deficits resulting from the economic downturn.

⁵ Cain Brothers, "What Does the Research Say About Hospital Tax Status Conversions?" *Strategies in Capital Finance*, July 2002, Volume 38.

⁶ R.S. Carmichael & Co. Inc., "Healthcare Equipment Leasing, 2003: U.S. Market Dynamics and Outlook," *Equipment Leasing Association*, January 8, 2003.

⁷ *Ibid*

⁸ Cain Brothers, "From Strategic Assets to Tactical Investments," *Strategies in Capital Finance*, Summer 2003, Volume 41.

⁹ Association for Healthcare Philanthropy, "Report on Giving FY 2002," (draft document).

Credit Enhancement Sources

Letter of credit. Letters of credit are an unconditional and irrevocable guarantee from a bank in the form of a sight draft. Typically, a letter of credit is drawn on to make debt service payments on bonds, and then the bank is reimbursed by the borrower. The letter of credit enables the bonds to obtain the short-term and long-term ratings of the bank providing the letter of credit.

Letter of credit availability decreased significantly in the 1990s due to bank consolidation and perceived decline of the credit quality of the healthcare sector. Recently, availability has increased and pricing has stabilized.

Bond insurance. Bond insurance is an unconditional and irrevocable commitment from a municipal bond insurance company to make scheduled bond debt service payments in the event of non-payment by the underlying borrower. The bonds secured by the municipal bond insurance policy carry the rating of the municipal bond insurer.

The bond insurers AMBAC, FGIC, and MBIA are effectively out of the healthcare market except for very high-quality providers. The bond insurers ACA, Radian Asset Assurance, and FSA are still in market for BBB and better credits.

FHA section 242 mortgage insurance. FHA 242 mortgage insurance provides a credit enhancement to tax exempt or taxable debt. The 242 program does not limit the amount of insurance, but there is a maximum 25-year mortgage term. An FHA-insured mortgage can cover up to 90 percent of the replacement value of the assets pledged as security for the debt.

Until very recently, the 242 program was used primarily in New York and New Jersey. However, because of the program's success, it is now expanding to additional states.¹⁰ More recently, the 242 program is being used for Medicare-designated critical access hospitals—hospitals that receive cost-based rather than formula-based reimbursement from Medicare.

Local taxes. Public tax-supported healthcare organizations often have the ability to increase revenues through local taxing authorities.

As federal and state governments push current budget shortfalls down to local units of government, tax burdens are continuing to increase. Saddled with a soft local economy in many areas, public hospitals may find it harder to make a successful case for further tax increases.

¹⁰ Health Care Finance On-Line, "The Revolution of HUD 242," April 2002.

Capital Sources at a Glance

Capital Source	Best Use	Access Method	Risks
Tax-exempt Bonds	Large infrastructure projects, new buildings, extensive renovations.	Bonds are issued by a government authority on behalf of an institution that is a government-supported or non-profit 501(c)3 health system.	Access is limited by an organization's credit profile and debt capacity. Revenue bond monies are backed by revenue from operations and require the organization to maintain the revenue stream.
Taxable Bonds	Large infrastructure projects, new buildings and extensive renovations, medical office buildings, and any other for-profit activity.	Taxable bonds may be privately placed or underwritten in the corporate or taxable municipal bond market.	Bond debt can lead to increased leverage and credit risk, especially if hospitals do not increase overall cash flow generation.
Venture Capital and Public Equity Offerings	Venture capital funds look for high returns. Healthcare service companies typically are a small percentage of the overall VC market. In general, equity offerings have financed expansions by for-profit hospital chains.	Individual terms are negotiated directly with underwriters and VCs, and many will assist the business through the IPO process.	With venture capital funding and preparation for public offering comes a reduction in management control. The current IPO market is very competitive, as the general downturn in the market has decreased the number of healthcare IPOs substantially. Publicly traded companies also may be subject to takeover, although this has been a rare occurrence in health care.
Sale of Assets	In most cases, capital raised through a conversion of a not-for-profit to a for-profit as a result of a sale is funneled into a foundation that funds local health initiatives. Hospitals may increase their overall access to capital by becoming part of a system that is profitable and therefore has access to capital regardless of any changes in tax status.	The majority of conversions are direct sales to a for-profit corporation. Federal and state laws require that the proceeds from the sale continue to be used for charitable purposes.	Tax status conversion does not ensure future success. Even with greater access to capital, serious operating and debt issues may still remain. It is not uncommon for these converted entities to convert back to a non-profit at a later date. In addition, community leaders may feel a loss of control in the future direction of the local hospital.
Banks and Other Financial Services Companies	Banks and other financial services companies may provide smaller or short-term capital needs (less than \$10 million) or when other capital options are not available. However, commercial finance companies often offer a variety of solutions for transactions of more than \$10 million.	Banks and financial services companies' loan terms are negotiated on a deal-by-deal basis and are influenced by the type of obligation, strength of the borrower, and term of the loan.	Collateral requirements are negotiable but always required. Hospitals may be required to secure loans with gross receipts pledges and mortgages. Covenant violations may result in loss of control of the hospital.

Capital Source	Best Use	Access Method	Risks
Capital Leases	Capital leases are traditionally used for large equipment acquisitions, such as imaging and laboratory diagnostic equipment, and often are accompanied by service contracts. A capital lease may be advantageous to organizations that use equipment with frequently changing technology.	Individual capital lease terms are directly negotiated and typically require a 36- to 84-month lease term.	Non-payment of the capital lease may result in the loss of a major capital asset needed for the core business.
Joint Ventures (JVs)/Partnerships	JVs are best for healthcare organizations that have an innovative solution or product but very little access to capital, and in situations where healthcare providers and physicians want to align incentives.	JV terms are individually negotiated between the two organizations.	Smaller organizations in the JV may lose substantial management power. Owners often do not plan for future management, for example, how to pass on ownership when current physician partners retire.
Real Estate Investment Trusts (REITS)	REITS are best suited for healthcare organizations with large amounts of property and facilities and organizations with underutilized facilities. Hospitals are most likely to sell medical office buildings or outpatient centers to REITs. The sale of property to a REIT typically results in a large cash infusion to the healthcare organization.	REIT terms are individually negotiated between the parties. Some property sales are structured to leave some control with the healthcare organization through retention of the “ground” rights.	REIT investments are highly dependent on real estate market rates. Selling property to a REIT results in a healthcare organization giving up control over a primary asset and forgoing any benefits from the future appreciation of the sold asset. Unless contractually structured, hospitals may lose the ability to determine appropriate tenants for the buildings.
Private Philanthropy	Philanthropy is best used for specific expansion/renovations that are compatible with a naming rights campaign. High-profile services and facilities tend to be most popular, such as cancer centers, pediatric and birthing centers, and research facilities.	Two primary methods of accessing philanthropic funds – a grant process from charitable trusts and foundations and donor solicitation. Large donations are often pursued through a naming recognition campaign for capital projects.	Accessing philanthropy is a highly competitive process, with numerous institutions chasing after the same dollars. Philanthropic funding is heavily dependent on hospital marketing/PR efforts and/or charismatic management/board. Lackluster returns on Wall Street mean that donors have less money to donate. In addition, some regions are more generous givers than others. Salt Lake City is among the most generous, while Hartford, Conn., is among the least. ¹¹
Public Grants	Grant funding is most often used for specific expansions and renovations relating to the institution’s specialized purpose or a service that serves an important public need, such as emergency departments and burn units.	The healthcare grant application process is typically administered through state health departments and local governments.	Grants are won in a competitive process, with many institutions competing for a limited number of funds. Grants should not be relied on for recurring capital improvements and expansion/renovations.

¹¹ Chronicle of Philanthropy

Credit Enhancement Sources at a Glance

Vehicle	Best Use	Access Method	Risks
Letter of Credit	Letters of credit are used to secure a fixed rate or variable rate bond issue (taxable or tax-exempt).	Initially, a credit package is assembled describing the credit picture of the hospital. For higher credit quality health-care providers, letters of credit are typically solicited from a handful of regional banks and a few national banks. For lower credit quality healthcare providers, letters of credit may only be available from the relationship bank or other smaller local banks, if at all.	Letters of credit are typically obtained for a three- to five-year period. As such, the borrower is subject to renewal risk. Often a bank will renew the letter of credit, but if the credit of the borrower has deteriorated, the renewal may have more stringent financial covenants and a higher cost.
Bond Insurance	Bond insurance is used to secure a fixed-rate or variable-rate bond issue (taxable or tax-exempt)	Initially, a credit package is assembled describing the credit picture of the hospital. After the credit package is developed, a request for proposal would be solicited from the bond insurer. However, there are very few bond insurers still active in the healthcare market.	None. The bond insurance policy is in place for the life of the bonds.
FHA Section 242 Mortgage Insurance	The 242 program must be used for new buildings or substantial rehabilitation. A minimum of 15% of the proceeds must be used for new projects and all costs normally associated with a capital improvement project. The balance of the proceeds may be used for refinancing.	The 242 program requires completion of a rigorous HUD application process, including the completion of a feasibility study. In response to recent hospital complaints regarding the complexity of the application process and the lack of state-sponsored feasibility studies in non-CON states, HUD has streamlined the 242 process and expanded its marketing of the program.	No significant risks identified.
Local Taxes	Tax revenue can be used to improve credit profiles or to increase debt capacity for a bond issuance.	Healthcare organization must get local government and/or voter approval for tax increases. This approval process often requires decision-maker/voter education campaigns.	A healthcare organization attempting to raise/implement taxes may not receive decision-maker /voter approval.