



CAPITAL FINANCE UPDATE

**Hospital Finance Workshop
Wisconsin Office of Rural Health
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BACKGROUND

- Disruption in the Credit Markets- from Wall Street to Main Street
- Increased Scrutiny by Bank Lenders - Credit quality, real estate valuation, healthcare reform





BACKGROUND (cont.)

- Healthcare Capital Needs Continue-
 - Replace and upgrade medical equipment
 - Renovation and conversion of existing space
 - Acquisition of physician practices and assets
 - Replacement hospital facility
- How Can a Rural Hospital Effectively Meet its Capital Financing Needs?



TAXABLE vs. TAX-EXEMPT DEBT

- Tax-exempt debt - a benefit available to 501(c)3 organizations, similar to schools and towns.
- Interest income to the lender/investor exempt from federal income tax and in some cases, from Wisconsin income tax, resulting in a lower interest rate available to the hospital.
- Closing costs on tax-exempt debt are higher than for conventional debt, therefore the borrower must compare the interest rate savings over the life of the loan to the increased closing costs associated with tax-exempt debt.



TAXABLE vs. TAX-EXEMPT DEBT (cont.)

- Tax-exempt debt is only available through a "conduit" issuer. Example: the Wisconsin Health and Educational Facilities Authority (WHEFA) or a municipality. The conduit issuer does not extend credit or guaranty the debt, serving only as an intermediary to satisfy the conditions of the IRS.
- WHEFA is an advocate for healthcare borrowers, to facilitate the tax-exempt financing process.



TAXABLE vs. TAX-EXEMPT DEBT (cont.)

- Restrictions on "Private Use" - subject to certain exceptions, the IRS only allows the 501(c)3 borrower, its employees and the public to use the facilities financed with exempt bonds. Therefore, a MOB Clinic for independent physicians could not be financed with exempt bonds, but could be financed for employed physicians. Facilities may be divided into tax-exempt financed portions and taxable financed portions.



TAXABLE vs. TAX-EXEMPT DEBT (cont.)

- Ongoing Reporting - the IRS requires the hospital to keep track of any private use of facilities financed with exempt bonds and report that tracking on its annual Form 990, for the duration of the exempt debt.
- More IRS Restrictions - the IRS has timelines for the expenditure of exempt proceeds, limits on investment of proceeds and ongoing measurement of any arbitrage earned in connection with the financing.



TAXABLE vs. TAX-EXEMPT DEBT (cont.)

- Ongoing Audit Activity – the IRS has a separate audit program to focus on appropriate use of tax-exempt financing and compliance with applicable IRS Regulations.





SOURCES OF FINANCING - Leasing

- Often used for equipment, occasionally for medical office buildings and clinics.
- Equipment vendor and bank leasing programs use form documents completed in a few days.
- A lease can be tax-exempt (through a conduit) or conventional, taxable. The closing costs make a tax-exempt leasing a realistic option only for larger, longer term leases.



SOURCES OF FINANCING - Leasing

- FASB proposal to eliminate operating lease ("off balance sheet") treatment under GAAP. Under the proposal the asset and liability will appear on the hospital's balance sheet regardless of the terms of the lease.
- **Example:** 44 month lease of a mobile telemedicine unit, including the van, onboard medical equipment and antenna, leased as a single unit through Bank of America Leasing. At the end of the lease term the hospital has the option to surrender the unit, purchase it or extend the lease.



SOURCES OF FINANCING – Local Bank

- A bank can lend to the hospital on a taxable or tax-exempt basis. If tax-exempt, the loan must flow through a conduit issuer (noted above).
- Stimulus Act allows 501(c)(3) borrowers to issue up to \$30 million in "bank-qualified" obligations in any single calendar year. "Bank-Qualified" or "BQ" obligations are more attractive to banks than traditional tax-exempt bonds, though many banks will also purchase traditional tax-exempt bonds.



SOURCES OF FINANCING – Local Bank (cont.)

- NOTE: the BQ treatment for 501(c)3 organizations has a scheduled sunset at December 31, 2010. The provision has been popular and widely used. Lobbying efforts are under way to extend this BQ treatment, but as of August, 2010, it is not certain if it will be extended. To meet the December 31, 2010 deadline, borrowers simply need to "issue" the obligations, they need not spend all the proceeds by the deadline.



SOURCES OF FINANCING – Local Bank (cont.)

- **Example:** A consortium of five local banks made Bank-Qualified loans totaling \$12,000,000 to a 25-bed CAH to replace its existing acute care bed wing. The interest rate is fixed for 5 years, then re-sets at a pre-determined formula tied to the banks' cost of funds.



SOURCES OF FINANCING – Local Bank + Federal Home Loan Bank "Wrap"

- Bonds are sold to mutual funds based on the strength of a Federal Home Loan Bank letter of credit. A local bank does the credit underwriting and requests the FHLB to issue the letter of credit supporting the bonds. The benefit is a local bank credit decision combined with a low interest rate on the bonds, because of the strong "AA" rating of the FHLB. The FHLB support of the underlying hospital credit is sometimes referred to as a "wrap."



SOURCES OF FINANCING – Local Bank + Federal Home Loan Bank "Wrap" (cont.)

- Part of the "cost" of this structure is that the local bank must usually post securities collateral with the FHLB.
- As with BQ obligations, the FHLB option is temporarily available for hospitals, with a scheduled sunset at December 31, 2010. Lobbying efforts are underway to extend.



SOURCES OF FINANCING – Local Bank + Federal Home Loan Bank "Wrap" (cont.)

- **Example:** When a CAH could not reach agreement with a large regional bank to renew its letter of credit on \$4,400,000 of outstanding variable rate bonds, the hospital went to its local bank, who in turn secured a FHLB letter of credit to support the bonds.



SOURCES OF FINANCING – USDA Community Facilities Program

- Eligible Borrowers- nonprofit healthcare providers in communities of less than 20,000.
- Lender of Last Resort - the borrower must show that it cannot secure financing from commercial sources at reasonable rates and on reasonable terms.
- Loan may be direct from USDA or carry a USDA guaranty- there is typically more "availability" for the guaranty program.



SOURCES OF FINANCING – USDA Community Facilities Program (cont.)

- USDA programs generally for new construction, but in certain cases may be used for refinancing, in connection with new construction.
- USDA-guaranteed loans are not tax exempt, but rates are relatively low, given the backing of USDA.





SOURCES OF FINANCING – USDA Community Facilities Program (cont.)

- **Example:** A CAH combined a USDA direct loan and a USDA guaranteed loan, to borrow a total of \$24.5 million to construct a 10 bed replacement hospital facility. The amortization on the combined loans was in excess of 30 years.



SOURCES OF FINANCING – FHA Mortgage Insurance

- The Federal Housing Administration Section 242 Program - available to hospitals of all sizes, and is available to finance new construction, acquisition and in some cases for refinancing outstanding debt.
- FHA mortgage insurance provides a very low interest rate on the loan.



SOURCES OF FINANCING – FHA Mortgage Insurance (cont.)

- CAHs - special underwriting treatment that streamlines the application process and increases the likelihood of approval.
- FHA's eligibility requirements can be challenging and the underwriting process takes time.
- In general, FHA insured loans are taxable. It is possible to structure with tax-exempt bonds, but the complexities and additional costs make it impractical.



SOURCES OF FINANCING – FHA Mortgage Insurance (cont.)

- **Example:** A CAH borrowed \$25 million to construct a replacement hospital facility. The loan amortizes over 25 years and was at fixed rate equivalent to a AAA- credit. The loan closed at the same time the CAH affiliated with a larger health system. The larger system does not guaranty or otherwise support the loan payments.