HOSPITALS

Looking for a Financing Solution: It Pays to Keep Your Options Open

Antelope Valley Healthcare District (AVHD) and Tri-City Healthcare District (TCHD) are similar in many ways.

- Both organizations are a political subdivision of the State of California with elected boards.
- One facility is in northern Los Angeles County and the other is in northern San Diego County.
- Both own and operate medium-sized hospitals with similar revenue bases.
- Both hospitals anticipate future capital needs related to seismic requirements in California.

However, the credit profile and financial needs for the two organizations are very different. Therefore, when the two organizations looked to refinance their existing debt, the solutions were unique.

AVHD's primary asset is a safety-net hospital located in Lancaster, California, with a facility originally built in 1955. The hospital was renovated and expanded several times over the years, and it now has 420 beds. While the hospital has historically performed well financially, other challenges had adversely affected the hospital's credit rating. In addition, the organization was obligor for several different bond issues, which created an administrative burden. Furthermore, the terms of the bond issuances created uneven debt payments including a $55 million bullet maturity due in 2017.

TCHD's primary asset is a 397-bed acute care hospital in Oceanside, California, which originally opened in 1961. TCHD also has an auxiliary campus in Carlsbad, California. TCHD's capital structure was less complicated than AVHD, but TCHD's existing debt was put in place when the district was in a relatively weaker financial position. In the last two years, the hospital's financial position and managerial structure stabilized, and TCHD was in a position to refinance its debt. The primary goal was to find a long-term financial solution with a financial partner that could accommodate future capital needs.

Multi-Tracking for Optimum Capital Solutions

Neither AVHD nor TCHD were considered investment grade organizations by the credit rating agencies, but both districts had credit and market characteristics similar to low investment grade hospitals. Furthermore, a very favorable bond market made public bond issuance a viable option. Considering the financial profiles and goals, the boards and management at both hospitals saw the benefit of a multi-track financing approach. Both hospitals' investment bankers worked to develop a process to pursue tax-exempt bond financing, as well as the Federal Housing Administration (FHA) Sec. 242 program. The benefits of the multi-track approach include:

- The risk of changing capital markets is mitigated. The timing to make a decision regarding a structure and lock in a rate is deferred so that the borrower can take advantage of the best option.
- If FHA approval or the ability to sell bonds becomes questionable, the project team maintains other viable options.
- Having multiple options allows a board to choose a structure that best meets long-term goals, even if price is similar.
- The project team can take advantage of overlap of analytical and legal work. Even though FHA and tax-exempt bonds are very different structures, the credit review and much of the legal due diligence is similar.

When using the multi-track approach, the logical starting point is the longer lead time option, which is usually the government agency program (FHA 242 in this case). Both AVHD and TCHD submitted preliminary review requests to the HUD's Office of Hospital Facilities and received positive feedback. The next step in the FHA 242 process called for a pre-application meeting at The U.S. Department of Housing and Urban Development (HUD) headquarters. While feedback was generally positive, there were certain unique challenges for each district with respect to FHA 242 program requirements. However, the project teams methodically proceeded with the next stage of the FHA process: preparation of the FHA 242 firm application. At this point, the project teams began preliminary work necessary for a tax-exempt bond issue. Fortunately, the firm application is a credit request package that includes much of the same due diligence necessary for a tax-exempt bond issue.

The Roads Diverge

As mentioned above, a primary emphasis for AVHD was cleaning up its capital structure, especially the need to reamortize a Series 2002 Bond issue, which had a $55 million bullet maturity due in 2017. For AVHD, timing and certainty of execution were key considerations. In early 2016, the FHA 242 process stalled because of management changes at the hospital, but the district remained in good financial condition. Fortunately, 2016 was a very favorable time for the tax-exempt bond market, as a strong economy, a lack of supply for tax-exempt securities, and an aggressive fixed income pricing environment presented an attractive pricing opportunity. In early 2016, the hospital's investment banker developed a pricing scale for a proposed approximately $130 million bond issue and simultaneously held discussions with investors that might be interested in securities issued under an FHA insured mortgage scenario.

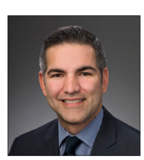
The estimated interest rate for the FHA 242 scenario was 4.85%, while the initial bond pricing scale showed an all-in true interest cost (TIC) of 5.0%. The FHA 242 loan program is limited to 25-year amortization, while the Series 2016 tax-exempt bonds would be limited to final maturity in 2046 (30 years), because of Internal Revenue Service (IRS) rules. Given the similarities in debt service, the remaining question related to covenants. One of the most attractive features of the FHA 242 program is the limited financial covenants, while public bond issuances tend to have covenants dictated by the strength of the market. In 2016, the fixed income environment presented an opportunity to structure bonds without onerous financial covenants. Of course, a fixed income bond offering would have liquidity and debt service coverage requirements, but the market allowed for favorable negotiations of financial measures and limitations.

Given the exceptionally strong fixed income market and uncertainty of the FHA 242, the project team focused on a tax-exempt bond structure, with a goal to refund all prior issuances. Once the decision was made, execution was quick. The process to develop bond documents and go to market took less than three months. Pricing for the bonds was favorable, with a final all-in TIC below 4.90%, which was equivalent to the interest rate under an FHA scenario at the time. In addition, the financial covenants were loosened and unified. Previously, the District's numerous bond issues had separate covenant reporting requirements, and meeting the liquidity covenant was often a challenge because of the vagaries of government health care reimbursement programs. The new structure provides more flexibility.

For TCHD, timing was less of a driving factor, as the existing debt structure was manageable. However, the board and management recognized an opportunity to improve its financial profile and prepare for capital projects in coming years. One attractive feature of the FHA 242 program is a straightforward process for issuing supplemental loans. That is, gaining approval for the initial FHA 242 loan can be a challenge, but established participants in the program often utilize the FHA supplemental loan program (known as 241) to fund projects in stages. By contrast, the ability to issue future tax-exempt debt in the public bond market is less certain. Market forces dictate pricing and covenants, and there is no guarantee that the appetite for non-investment grade fixed income securities will exist when capital is needed. Both AVHD and TCHD will need capital to meet state-mandated seismic requirements by 2030. However, the needs at TCHD are somewhat more extensive. Therefore, the clarity for future debt issuance offered by the FHA 242 program was an important feature. In addition, TCHD's management and board had experienced first-hand the challenges of issuing debt in an unfavorable environment. Years ago, TCHD was forced to refinance its debt at a time when the market was weak and the hospital was experiencing financial challenges. The resulting structure required TCHD to hold $51 million of cash as collateral.

Based on its expected needs and previous experience, TCHD's management and board worked with its investment banker to patiently proceed with the FHA 242 application. The process was delayed by a peculiar legal issue with a local developer, but FHA representatives worked with the hospital to get comfortable with the solution. In the end, the FHA 242/223(f) loan closed with an excellent rate, and the district now has the long-term capital partner that it was seeking.

The AVHD and TCHD examples demonstrate the value in keeping financing options open as long as possible. Two organizations that are quite similar on the surface can have very different needs and the capital funding solution needs to fit. Furthermore, market conditions can change quickly; the solution that seems best today might not be the best in three to six months. Because non-investment grade tax-exempt organizations are particularly vulnerable to market conditions, boards and management should regularly consult a financial advisor when contemplating a capital funding or refinance opportunity.



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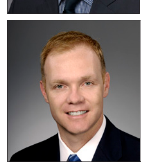

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