

## FEATURE STORY

Laca Wong-Hammond  
Lorie Damon



## financing strategic plans for not-for-profits

Developing a plan for capital access to support key initiatives can help not-for-profit health systems better position themselves in a challenging economic environment.

The mechanisms not-for-profit health systems use to finance their strategic plans have shifted dramatically in the past five years as their asset mix has changed.

### AT A GLANCE

To succeed in today's complex economic environment, a not-for-profit health system requires an effective strategic capital planning process that harmonizes three elements:

- > The organization's long-term business plan and mission
- > Existing financial resources and finance options available to support the organization's business plan
- > Financial risk and return on equity to the organization's stakeholders (within acceptable parameters for business risk)

Historically, not-for-profits' strategic capital plans were heavily oriented toward tangible physical assets (e.g., real estate, property, plant, and equipment, diagnostic/clinical equipment). Today, facing a more complex operating environment, these health systems are more heavily focused on physician acquisition, clinical IT investments, and reengineering their ambulatory strategies to transform care delivery models.

Regardless of their tax status, hospitals and health systems face operating environments today that are challenged by a variety of stresses, including declining volumes and demand for inpatient services and limited near-term revenue growth. Moreover, hospital operating margins are further stressed by the shift away from hospital-based care toward care provided in outpatient settings. Health systems also are coping with costs related to healthcare reform and are bracing for changes to payment models and payer mix.

In response to these changes, a number of not-for-profit health systems have deferred both routine maintenance and intensive capital expenditures for aging facilities. However, these activities cannot be delayed indefinitely. Not-for-profit health systems should develop strategic capital plans that align funding sources with mission-driven, operational, and growth initiatives. Having such a plan will help to ensure a health system's access to capital is sustained and available through multiple channels, enabling more seamless execution of initiatives to meet long-term organizational needs and goals.

### Investing in a Strategic Capital Plan

Strategic capital planning is a vital up-front process that supports a health system's ability to achieve long-term mission and stakeholder objectives. Rather than being treated as a one-time event, strategic capital planning is best conceptualized as an ongoing practice of measuring results against the strategic plan and making midcourse corrections to achieve long-term objectives.

In essence, an effective strategic capital planning process harmonizes three essential elements:

- > The organization's long-term business plan and mission

- > Existing financial resources and finance options available to support the organization's business plan
- > Financial risk and return on equity to the organization's stakeholders (within acceptable parameters for business risk)

An effective strategic capital planning process can help health system leaders and boards make prudent choices when ideal business and shareholder objectives cannot be attained due to lack of resources. It is therefore a useful exercise for both not-for-profit and for-profit organizations. This process can illuminate potential modifications to either the business plan or the capital

#### PRIMARY COMPONENTS OF A STRATEGIC CAPITAL PLANNING PROCESS



strategy that could help an organization better meet its goals. Such modifications might include:

- > Accessing external debt or equity capital
- > Resetting, reprioritizing, or downsizing business plans, targets, and objectives
- > Evaluating buy-versus-build strategies or options
- > Purposely assuming higher business or financial risk

The process could even point to once-unthinkable options, such as a merger, sale, divestiture, or partnership.

Health systems typically face capital demands for three areas of investment:

- > Acquisitions/affiliations with physicians and other service providers
- > Clinical technology
- > Ambulatory strategy to address shifting modalities of care

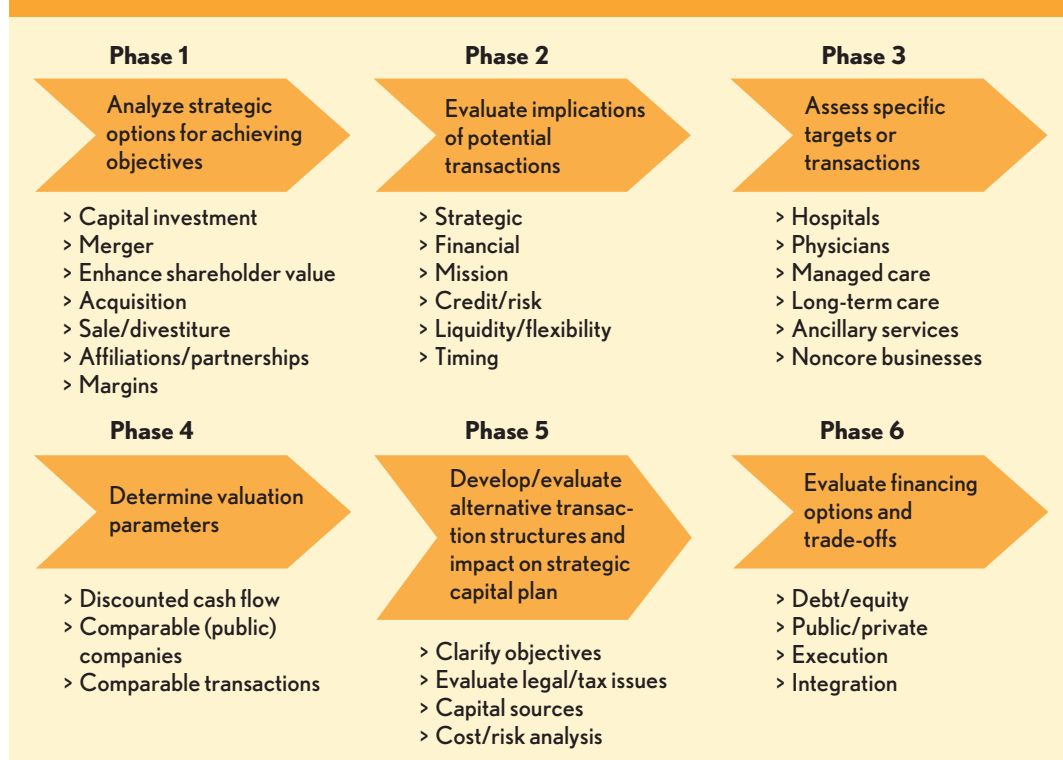
Each of these investment areas requires substantial capital over protracted periods of time. Capital-

constrained health systems may find that they must make difficult choices with respect to their strategic planning to facilitate—to the extent possible—desired strategic initiatives.

For instance, an increasing number of not-for-profit health systems are actively acquiring or affiliating with physicians and other service providers to move toward more integrated care that addresses the requirements of healthcare reform, improves outcomes, and reduces costs. Such initiatives often require substantial capital, as the acquisition targets are often larger practices, and the acquisition costs can include ancillary expenses such as owned or leased real estate. Ancillary expenses, such as real estate assumption, can double or triple the cost of a practice acquisition.

Likewise, clinical technology investments are often essential to health systems' strategic plans, as they can help to secure and maintain market share among covered patients; aid in physician recruiting and retention; and help to ensure

#### SIX PHASES OF THE STRATEGIC OPTIONS ASSESSMENT PROCESS



strong clinical outcomes by providing the best options for treatments. But these investments also have stretched the finances of not-for-profits: Electronic health records (EHRs) in particular have cost not-for-profit systems millions of dollars. In addition to the costs of the technology itself, there are expenses related to training staff to use EHRs as well as housing and operating these systems.

Ambulatory strategy initiatives also require substantial financial commitments because they can potentially encompass clinical technology investments, real estate (owned or leased) and, staffing investments, as well as marketing/branding costs to ensure that all facilities help to reinforce or expand the system's market position and patient base.

Considering these investments through a strategic options assessment process can help to clarify and prioritize investments and identify a variety of potential sources for funding them. The exhibit on page 72 outlines the six phases of an effective strategic options assessment process, with each phase's primary objectives and key areas to be considered.

### Evaluating Financing Methods and Options

Sourcing external capital (debt and/or equity) is one of the chief mechanisms for financing not-for-profit strategic initiatives. In considering potential options for external debt, four vehicles should be considered:

- > Tax-exempt bonds
- > Taxable debt
- > Project-level debt, such as mortgages
- > External equity (i.e., third-party equity or joint-venture funding)

**Tax-exempt bonds.** A traditional mechanism for debt financing, tax-exempt bonds present a viable choice as interest rates remain low for strongly rated systems. Some risk may arise as systems consider fixed- versus variable-rate issues. In the past two to three years, for example, a large, Midwestern not-for-profit health system has reversed its fixed-to-variable debt mix, shifting

from approximately 30/70 fixed-to-variable to 70 percent fixed-rate debt.

**Taxable debt.** Under current capital market conditions, high-grade systems can take advantage of taxable financing sources as their interest rates now compete with tax-exempt funds, while these taxable sources impose fewer constraints on the use of funds. In some instances, interest rates on taxable debt, particularly for systems with strong credit ratings, may be only a few basis points higher than those for tax-exempt debt.

An investment-grade health system recently deployed this strategy as part of its strategic capital planning process. In the spring of 2012, the system issued \$200 million in new 30-year tax-exempt bonds at 4.25 percent for the long maturity. In early 2013, the same Aa2/AA-rated not-for-profit system elected to take advantage of historically low taxable rates and issued \$300 million in 30-year taxable bonds in the public market, achieving a rate of 4.0 percent for the long maturity. At the same time, tax-exempt rates would have been greater than 4 percent.

As not-for-profit systems consider taxable debt options, they should consider carefully how rating agencies treat leases. In Moody's *NFP Healthcare Ratings Methodology*, published in March 2012, the rating agency states: "[A]nalysis of the balance sheet considers both direct debt [debt that is capitalized on the balance sheet] and comprehensive debt, which includes the unfunded pension liability and a capitalization of operating leases. The ratios in the scorecard are calculated using direct debt, but cash to debt is also recalculated using comprehensive debt ..." Thus, long-term leases are considered "on-credit," but their implications to an organization's overall leverage and creditworthiness warrant further discussion with credit analysts and are evaluated on a case-by-case basis.

**Project-level debt.** Mortgages and other types of project-level debt remain a viable financing option for healthcare systems. Although construction financing remains difficult and expen-

sive to secure, systems with strong credit ratings can source attractive rates on project-level debt under current market conditions.

**External equity options.** Systems also can consider external capital sources, including philanthropy and joint ventures (particularly public/private partnerships). Philanthropic contributions are generally classified under two categories: recurring and nonrecurring. Both mechanisms may provide capital sources for specific projects or for general needs, but in many cases, philanthropic sources include restrictions on how donations can be used.

Public/private partnerships can serve as another source of equity capital. Several such partnerships have made headlines recently, as well-known for-profit health systems have partnered with not-for-profits in a variety of arrangements designed to yield benefits to both parties. Examples include for-profit Vanguard Health Systems' partnership with Detroit Medical Center and Tufts Medical Center and for-profit LifePoint Hospitals' partnership with Duke University Health System, the latter arrangement being focused on acquiring and sharing ownership and governance of community hospitals. Such arrangements allow not-for-profit health systems to raise additional capital that is often used to fund strategic initiatives, such as expanding referral networks, and to maintain independence.

### **Financing Alternatives Beyond Debt and Equity**

Beyond raising capital through traditional debt and equity vehicles, healthcare systems can also consider a range of other alternatives, including:

- > Evaluating strategies to buy, lease, or build
- > Exploring outsourcing options
- > Considering merger, sale, divestiture, or partnering options
- > Assuming higher business or financial risk
- > Resetting or reprioritizing business plans, targets, and objectives

**Strategies to buy, lease, or build.** This type of analysis can be particularly productive as systems evaluate options for physician practice acquisition, purchase

of clinical technologies, and ambulatory strategy investments.

When it comes to clinical technology investments, buy-versus-lease evaluations are common. Similar assessments can occur with real estate and other technology costs associated with practice acquisitions and ambulatory strategy investments. For many capital-constrained health systems, the costs of developing new ambulatory care facilities are simply prohibitive. Instead, several health systems have taken advantage of high vacancy rates and/or low rental rates in nonhealthcare properties, such as general office buildings or retail environments, to advance their ambulatory strategies.

A number of health systems—Crozer Keystone, Dignity Health, Mercy Health Services (Baltimore), and Genesis HealthCare System—have adapted retail sites, including locations in grocery-anchored retail centers, into clinics or even ambulatory surgery centers. Such adaptations have proven more cost-effective than developing and building new facilities and have helped these systems capture market share, extend their brands in critical markets with strong patient demographics, and provide patients with more accessible care in more affordable settings.

**Outsourcing options.** Health systems also may consider outsourcing various operating functions to third-party providers to improve operational efficiencies. One not-for-profit owner-operator of skilled nursing facilities in the Northeast recently outsourced its rehabilitation functions to a for-profit operator specializing in rehabilitation services and has since made that function—once a loss leader—profitable. Other functions such as labs and dialysis also can be candidates for outsourcing, with positive financial and operational results.

**Mergers, sale, divestiture, or partnering.** These options can take many forms and sizes, ranging from business-unit levels to enterprise-level activities. Merger and acquisition activity can afford health systems opportunities to enhance

their investments in clinical technologies, ambulatory strategies, or physician practices. These opportunities are not without execution or integration risk, so these factors also should be considered thoroughly when assessing options to join forces. Mergers and acquisitions can increase cash flow for an acquired entity, although these transactions often require longer time horizons to be executed, particularly if the proposed structure must undergo regulatory review.

Divestiture of noncore assets or operating entities may serve as a faster and perhaps more efficient means of generating capital that can be redeployed to achieve alternative strategic goals. Although reprioritization for healthcare reform has caused monetization activity to stall among health systems recently, current market conditions are especially attractive for divestiture of particular types of noncore assets, including medical office and other noncore real estate, senior care housing, and other ancillary services. For example, investor demand for medical office and other noncore real estate is high, and many have capital ready to deploy for high-quality portfolios, while growing interest from both operators and real estate investors in senior care housing is generating attractive multiples for both the real estate and operations of these assets.

Behavioral health, imaging, labs, pharmacy and other hospital acute care support services also are attracting much investor interest. For example, market demand for high-quality labs is strong and growing, as publicly traded lab corporations have been active strategic acquirers.

All of these types of transactions can be structured to afford the selling health system some mechanisms for control. For instance, one common transaction structure involves selling the underlying real estate to an investor, but retaining operational control of the clinical enterprise. This strategy not only affords health systems a means to address patient needs across the continuum of care and ensure high-quality clinical outcomes, but also generates significant liquid-

ity, which can be deployed for core, clinical purposes. Other transaction structures, such as ground leases, also can afford systems vital controls over real estate assets that are located on their hospital campuses or on hospital-owned land.

Partnerships also can offer an effective means of achieving economies of scale and/or increased access to capital while allowing the partners to maintain some measure of independence and separate brand identity. Partnerships can take many forms—from entity-level arrangements to collaborations among various providers to commingled locations—and can be formed among health systems, physician practices, insurance providers, and the like. Partnerships can afford members opportunities to capitalize on one another's strengths, share resources and expenses, and enable members collectively to become greater than the sum of their parts.

Like mergers, acquisitions, or divestitures, these types of arrangements are not without risks. Compromise or failure of one party can taint the other; governance and decision-making can be a challenge; and reconciling two different cultures can present difficulties that must be mitigated via the partnership agreement. Other types of arrangements include alignment, collaboration, and consultative relationships.

**Business or financial risk.** The strategic financial planning process may lead some health systems to determine that they must assume higher business or financial risk to achieve their strategic plans. For instance, some systems may elect to use taxable third-party capital to develop a new ambulatory facility rather than issuing tax-exempt debt. Or a system may decide to buy a competitor hospital or health system, even though such an action may result in a short-term credit rating downgrade or negative outlook. Such decisions may complicate future capital positions or access to capital, but they may be appropriate in some instances, seeding critical components of a strategic plan.

**Business plans, targets, and objectives.** Another potential outcome of the strategic financial planning process may be a reprioritizing of business plans, targets, and objectives based on consideration of the health system's financial position and ability to access capital. Although trimming business plans, targets, and objectives is never easy, it may be prudent, particularly when those plans may require substantial investments whose returns are difficult to calculate. As with other capital expenditures, some investments can be deferred or delayed—so long as the implications of a course of action are understood. For example, before delaying investment in clinical technologies, a health system should consider the impact of such a decision on strategic concerns such as physician recruiting and retention, market share, recalibration of services, expansion of ambulatory strategy, and competitive threats and opportunities.

### A Framework for Meeting the Challenges Ahead

Conceiving of strategic financial planning as a process rather than as a finite exercise promotes more fluid discussions and decisions, creating a structured approach that is routine and that contributes meaningfully to the overall strategic planning process. For health systems (both for-profit and not-for-profit), hospitals, and private operators, engaging in strategic financial planning can provide a thoughtful means to align the organization's mission and long-range business objectives with its financial resources by providing a thorough framework in which to assess and establish priorities among a wide variety of competing goals and needs.

As not-for-profit health systems, in particular, grapple with the significant capital-intensive needs that are critical to meeting the demands of healthcare reform, they must engage in thorough strategic capital planning if they are to identify options and opportunities for various capital sources, including partnership opportunities that they might not have considered previously.

Given the dynamism in the current capital environment and within the competitive and regulatory environments in which most healthcare providers operate, hospitals and health systems also should revisit their strategic financial plans at regular intervals and make adjustments as internal and external circumstances demand. This practice will allow for leveraging of opportunities in the capital, real estate, and other markets amid the competitive and regulatory pressures. ●

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#### About the authors



**Laca Wong-Hammond**

is senior vice president and head of healthcare real estate, healthcare finance division, Raymond James, New York, and a member of HFMA's Metropolitan New York Chapter (Laca.WongHammond@raymondjames.com).



**Lorie Damon**

is an independent consultant (loriedamon@gmail.com).