Hospital Capital Financing:

A Historical Overview

Assessing Not-For Profit Credit Worthiness

Joseph A. Spiak, President

AMS Health Care Mortgage Corporation

November 22, 2013

AMS Health Care Mortgage Corporation

Financing Tomorrow's Hospitals Today

AMS Health Care Mortgage Corporation

Mortgage bankers to the healthcare industry

Specializing in FHA Insured Mortgage financing

- Four professionals:
  - Joe Spiak
  - Jim Cooper
  - Lorraine McLaren
  - Maura Davalos
- Full range of mortgage banking services:
  - Preliminary assessment
  - Pre-application
  - Application and funding
  - 2008-2013 volume: $2,058,709,600

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Topics

- The origins of capital finance for US not-for-profit hospitals
- The growth Years: from the simple to the sublimely complex
- The Rating Game: assessing hospital credits
- Jacksonville Market: microcosm of America
- Final Word / reflection

The Origin of Capital Finance for US not-for-profit Hospitals

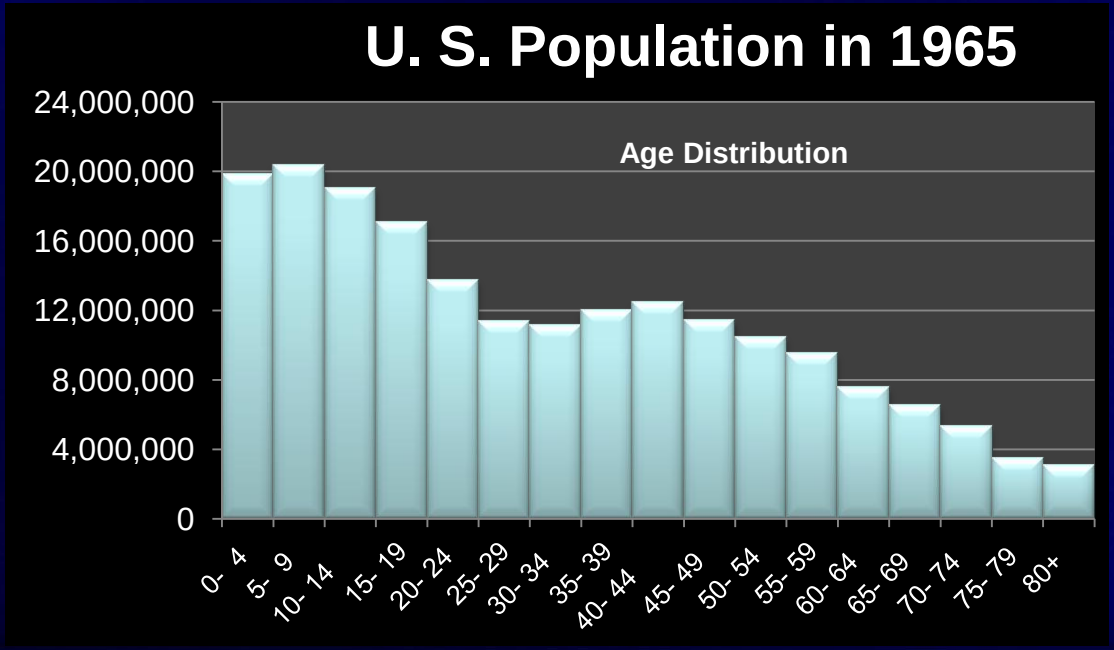
The Origin of Capital Finance for US not-for-profit Hospitals: “Tin Cup Capitalization”

John Gordon Freymann, MD, The American Health Care System

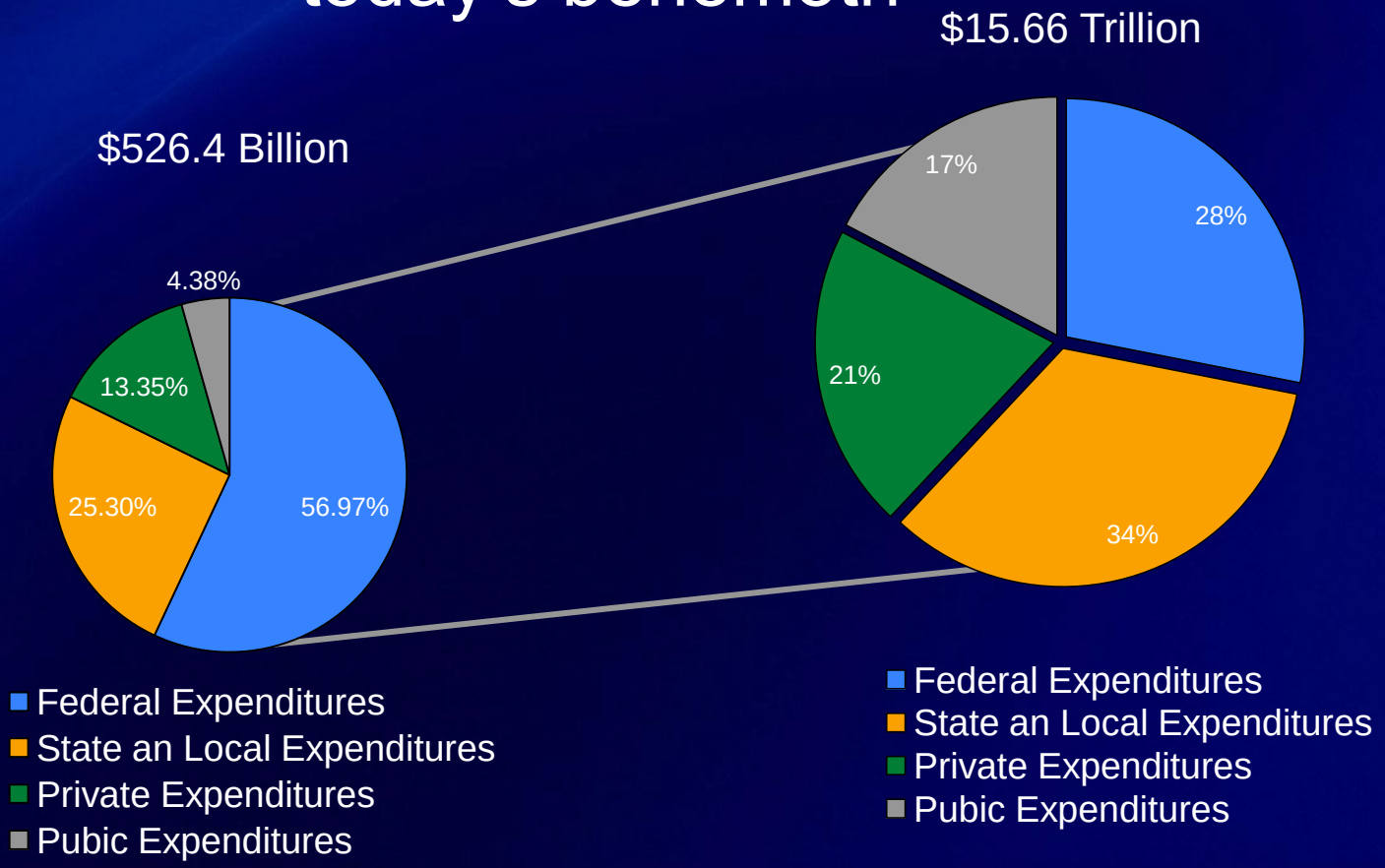
- Prior to Medicare hospitals did not:
  - Consider depreciation in accounting
  - No fund were put aside to replace plant and equipment
  - Reimbursement covered operating expense
  - In keeping with the tradition of charity, hospitals were not expected to borrow
- Connecticut Blue Cross did not reimburse for interest payments until 1965

US population and life expectancy 1965

- Population 65 and older was 9.1 %
- Life expectancy for men 65 was 2.7 years
- Life expectancy for women 65 was 8.2 years



The 1960 US economy was a fraction of today's behemoth



A look at the game changer

President Johnson Regarding Medicare:

“Thirty years ago, the American people made a basic decision that the later years of life should not be years of despondency and drift. The result was enactment of our Social Security program.

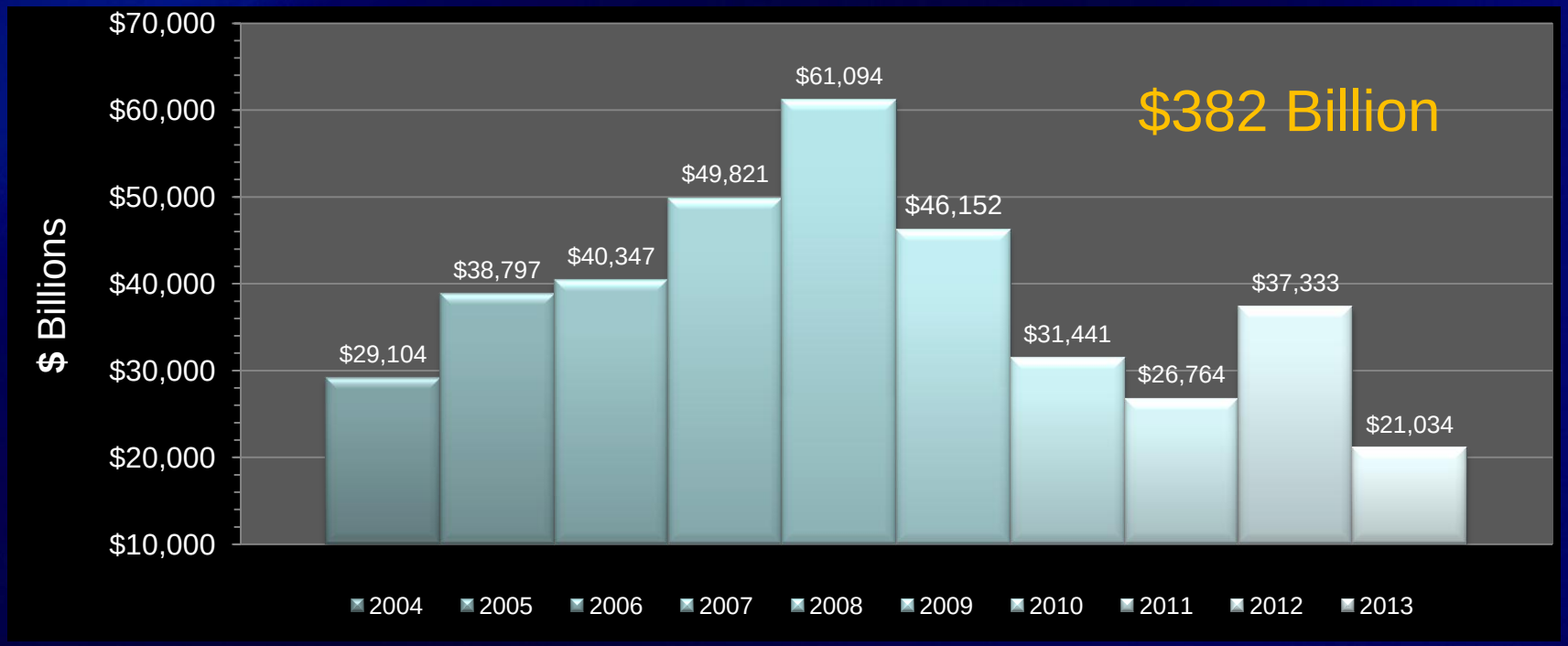
. . . . Since World War II, there has been increasing awareness of the fact that the full value of Social Security would not be realized unless provision were made to deal with the problem of costs of illnesses among our older citizens.

Compassion and reason dictate that this logical extension of our proven Social Security system will supply the prudent, feasible, and dignified way to free the aged from the fear of financial hardship in the event of illness." – *January 7, 1965*

With Medicare came access to long –term tax-exempt debt, sold to the public

- The Connecticut Health & Education Facilities Authority was formed in the late 1960's to provide tax-exempt funding for colleges, universities, and not-for-profit hospitals
- In 1968 CHEFA sold three tax-exempt issues to fund projects:
  - Mount Sinai Hospital, $11,450,000
  - New Britain General, $5,540,000
  - Rockville General, $3,400,000

Medicare and Medicaid gave not-for-profit hospitals unprecedented access to capital financing



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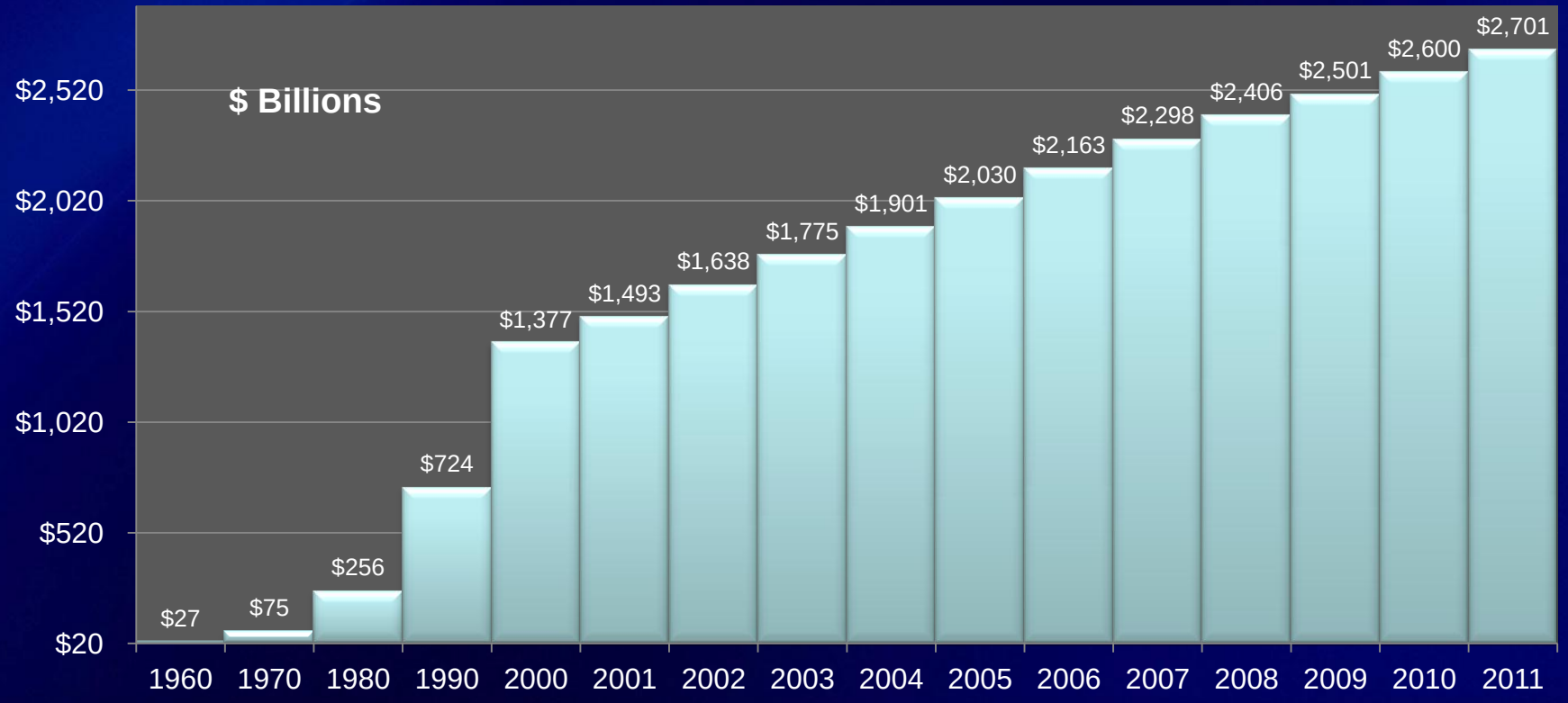
The Growth Years: from the simple to the sublimely complex

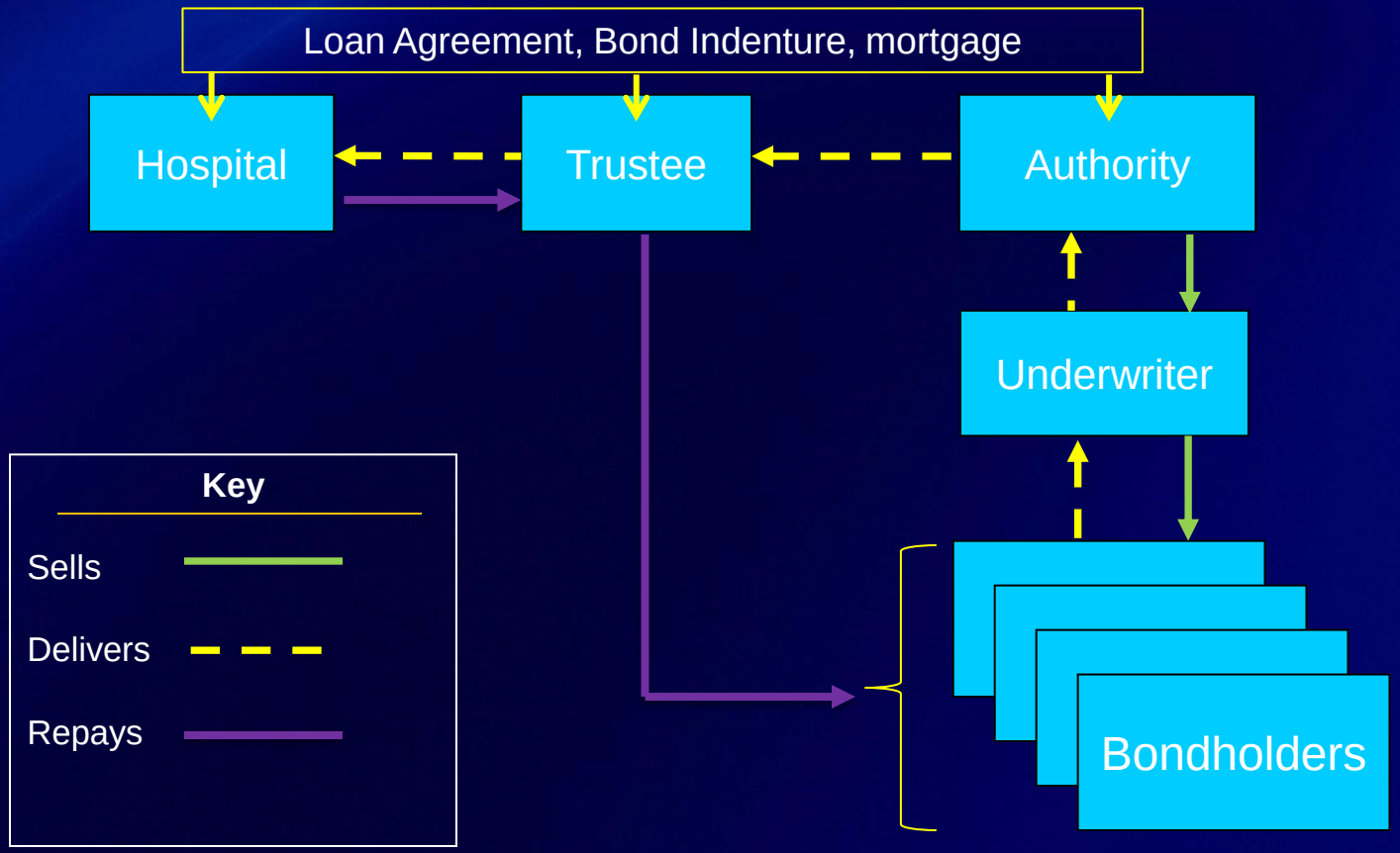
Total US health care expense 1960 -2011



1965 to 1980 fixed Rate Bond Structure

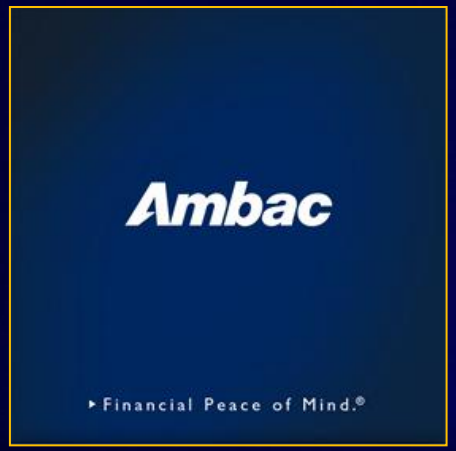
- Hospital tax-exempt bonds were issued through local government “conduit issuers” as revenue obligations and in some cases as mortgage revenue bonds
- The interest rate was fixed to maturity
- Most deals were level debt service, some however were level principal, which results in declining debt service
- Bonds generally matured in 30 years and had both serial, that is annual maturities and term bonds, or periodic maturities
- Security for the debt was a “gross” or first dollar pledge of revenues
- Bonds were generally not callable for the first 10 years and then a premium of 2 to 3%

1965 : Fixed Rate Bond Structure



1971: The rise of the mono-line bond insurers

- American Municipal Bond Assurance Corporation (Ambac) is formed in Milwaukee as a subsidiary of MGIC Investment Corporation
- Ambac's purpose is to offer an unconditional, irrevocable guarantee to bondholders that principal and interest payments would be received in full and on time



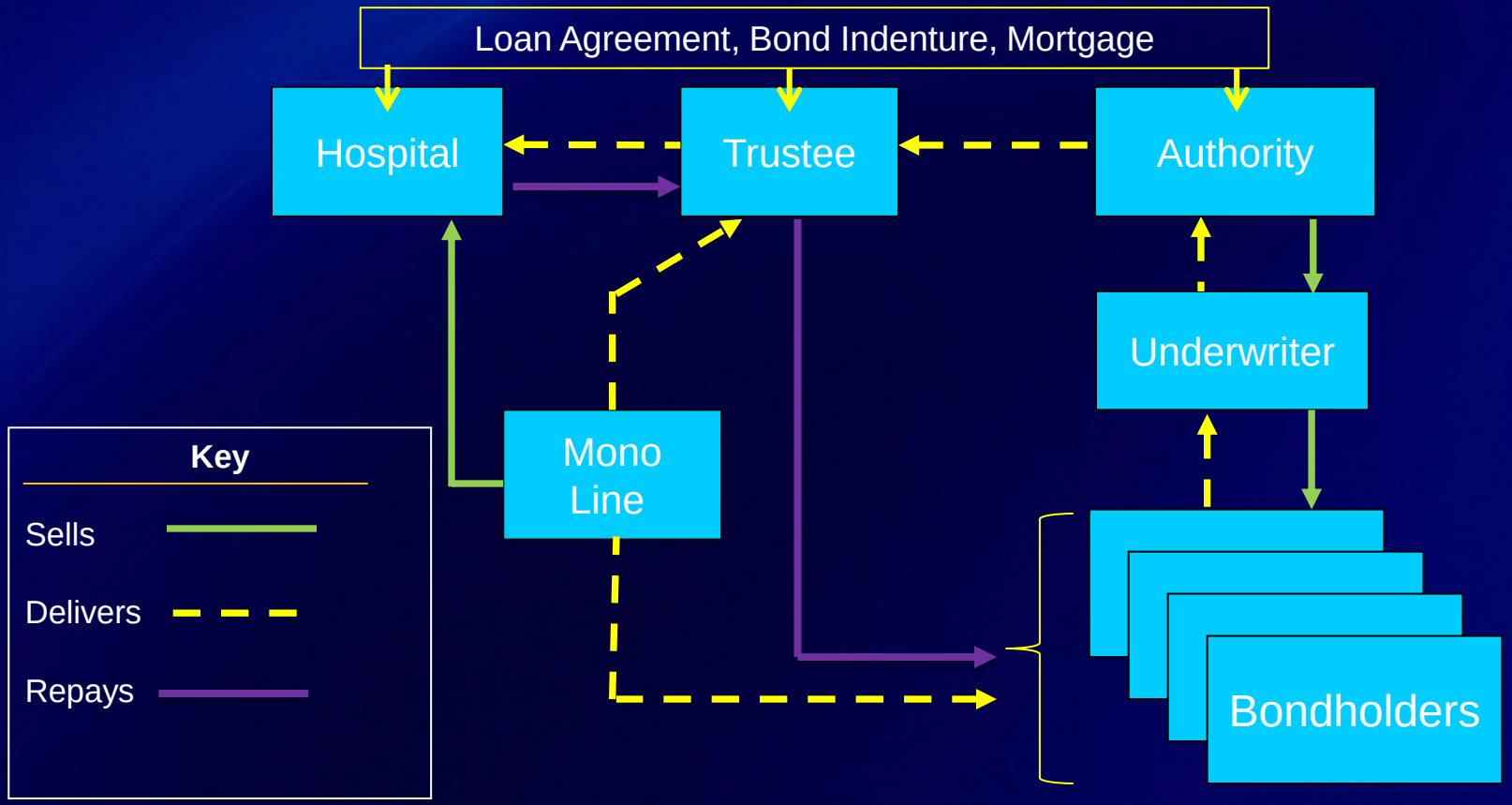
Rise of the Mono line Bond Insurers

Insurer	Rating
Ambac	Aaa / AAA/ AAA
FGIC	Aaa /AAA/ AAA
MBIA	Aaa /AAA/ AAA
CIFG	NR / AAA
FSA	Aaa /AAA/ AAA
Assured Guaranty	Aa-1 / AAA
RADIAN	Aa3/AA/AA
FHA Health Care Facilities	Aaa / AAA / AAA

1971: Mono-line bond insured bond structure

- Hospital select conduit issuing authority
- Commercial mono-line insurance company provides an unconditional, irrevocable financial guarantee policy as additional security for the bonds
- The interest rate is fixed and the bonds trade at the rating level of the insurer, usually “AA” or “AAA”
- The mono-line insurer is obligated to pay on presentment by the trustee should the hospital fail to pay interest or principal when due
- The mono-line insurer usually adds additional business covenants to assure hospital future financial performance

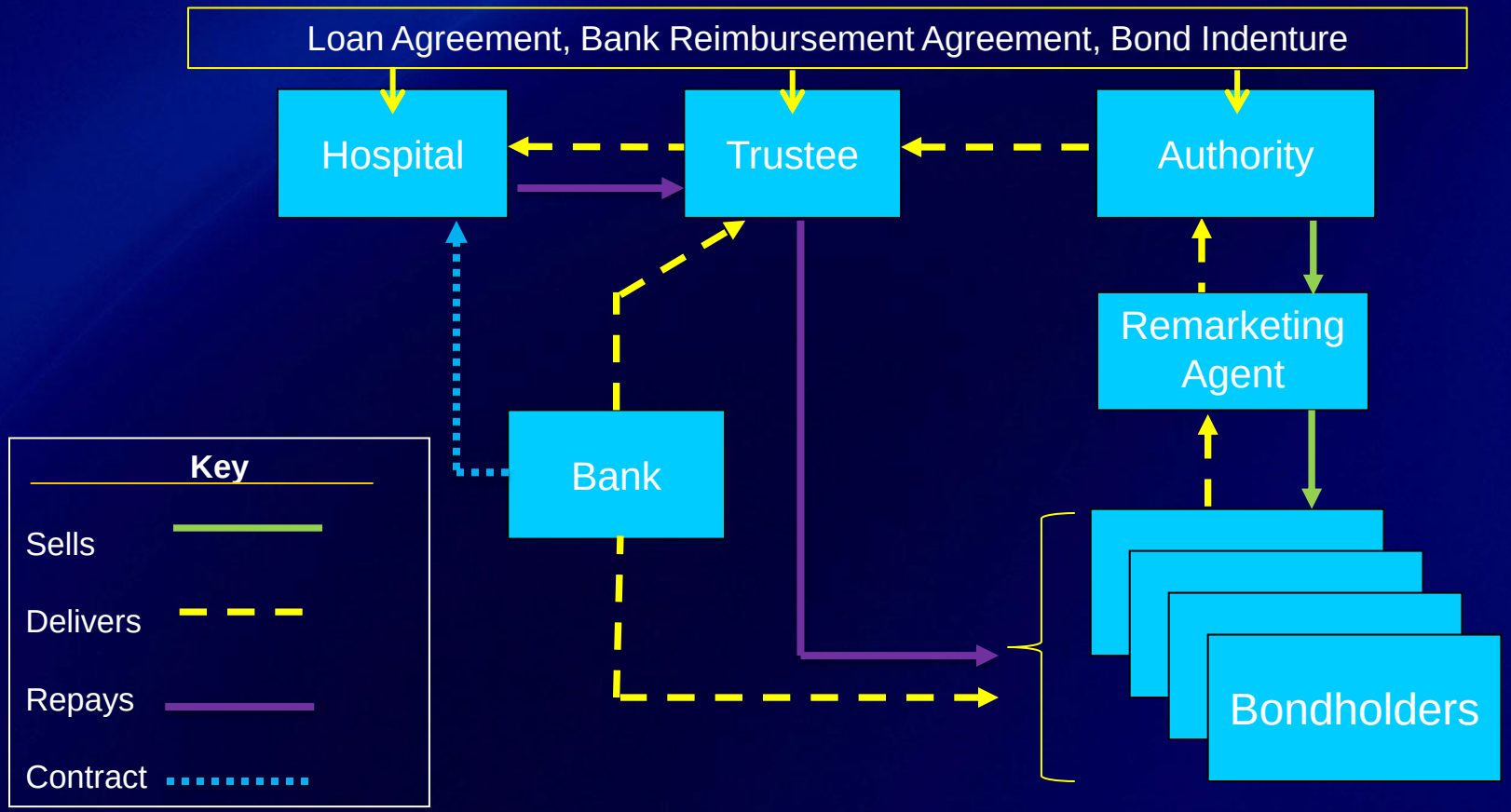
1971 Insured Fixed Rate Bond Structure



1980 Variable Rate Bond Structure

- Hospital select conduit issuing authority
- Commercial bank provides a direct-pay letter of credit as liquidity and security for the bonds
- The interest rate is reset daily, every 7, 30, 90, 180 or 365 days
- Principal purchasers are 2A7 mutual funds, commonly known as money market funds
- Hospital and bank enter into a bank reimbursement agreement managing the relationship between the bank and hospital
- Term of the bank direct pay letter of credit is 3 to 5 years

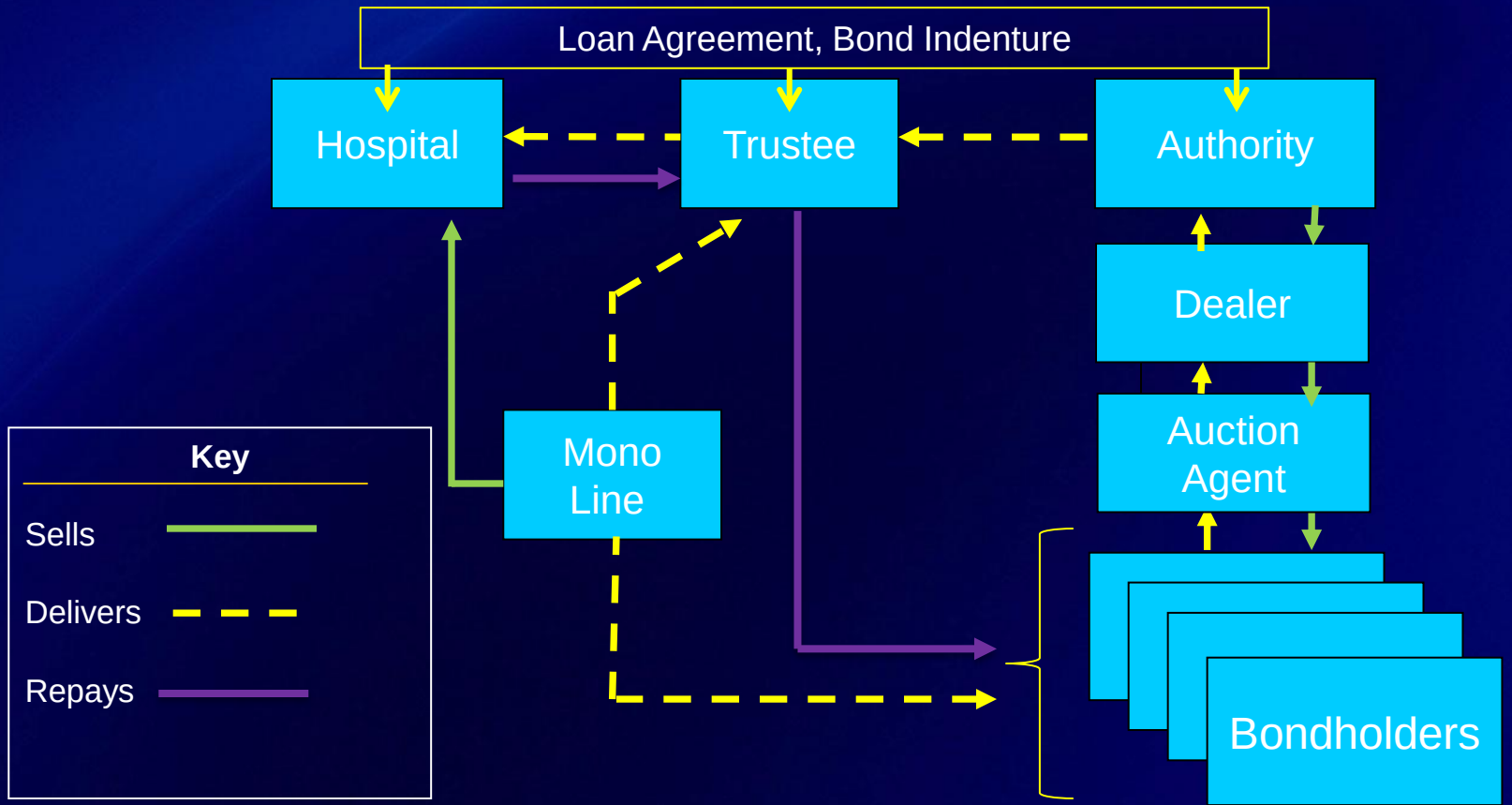
1980 Variable Rate Bonds Structure



1990's: Auction Rate Securities (ARS)

- ARS are bonds that pay a variable mode of interest
- ARS bonds are sold to the public through a "Dutch auction" similar to the way US Treasury securities are sold
- ARS bonds are generally insured and rated "AA" or "AAA"
- Investors can sell their bond at the next auction, however, if there is no buyer, they must wait until the next auction
- ARS are sold in daily, weekly, 28 day, and 35 day interest periods

1990's: Auction Rate Securities (ARS)



1985: The Derivative Revolution

- Derivatives are non-debt contracts that effect the mode, fixed or variable by which a hospital pays or accounts for its interest expense
- Derivatives are not debt
- There is no payment of principal
- Derivatives are interest rate related contracts between two counterparties
- Derivatives can be from one year to 40 years

Basic Swaps: Fixed Payor / Fixed Receiver

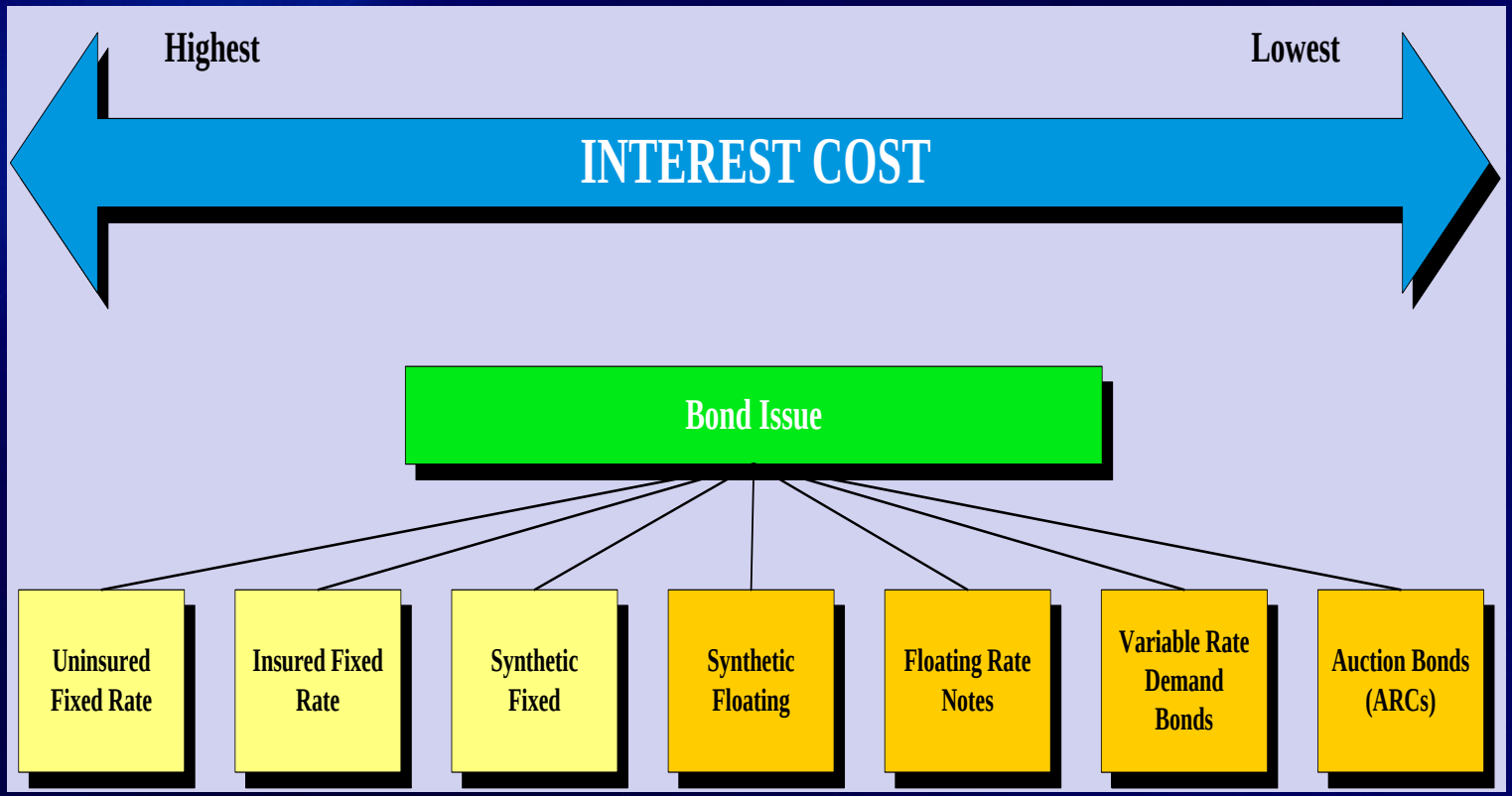
- Fixed Receiver / Floating Rate Swap: Hospital pays fixed interest to its bondholders. Coverts fixed interest cash flow by contracting with a Counterparty to pay Variable and receive Fixed cash flow.

- Fixed Payor / Fixed Rate Swap: Hospital pays floating rate interest to its bondholders. Coverts floating interest cash flow by contracting with a Counterparty to pay Fixed and receive Variable cash flow.

Post 2008 Commentary

"Derivatives are financial weapons of mass destruction"

Fast forward to the 2000's: Financing Options abound



Comparison of Interest Rate Modes: 1960 - 2007

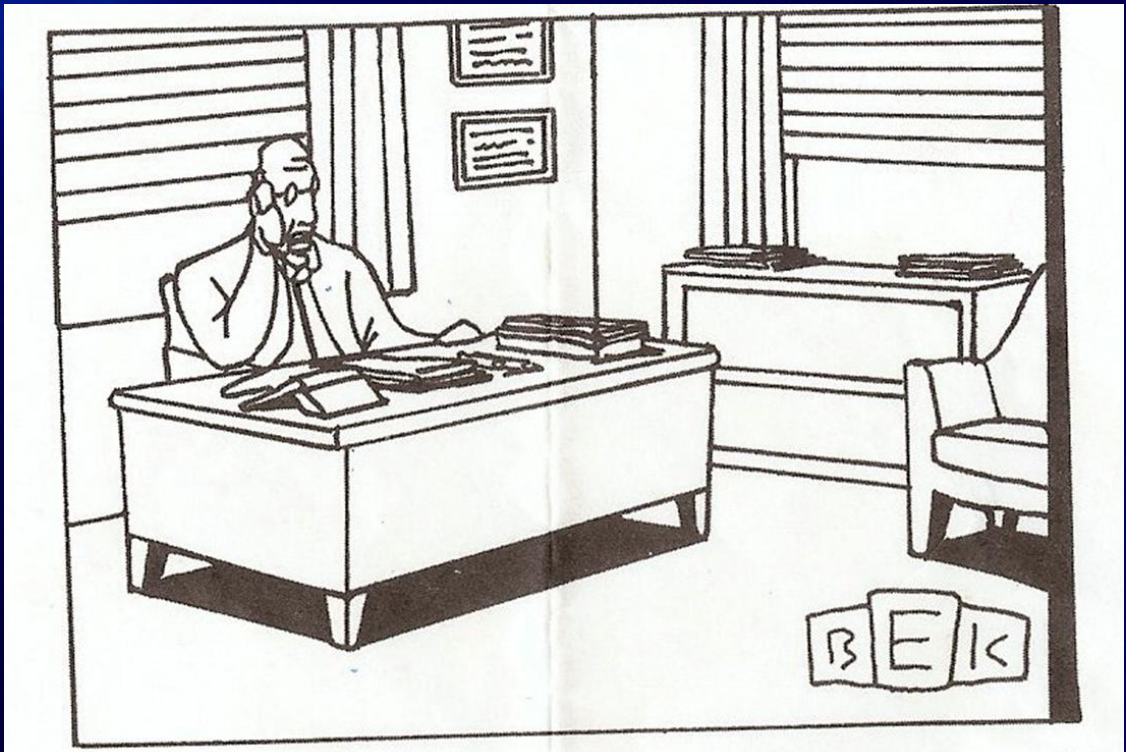
1960

- Fixed rate

2007

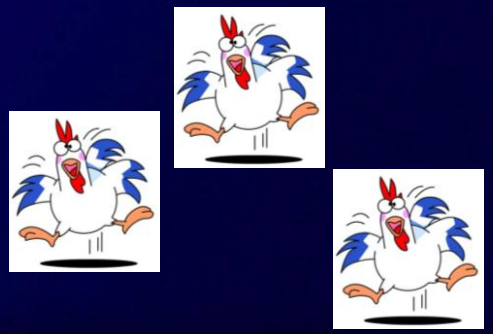
- Fixed Rate
- Variable Rate
- Auction Rate (ARS)
- Term Rate
- Commercial Paper
- Indexed Put Bond (IPB)
- Floating Rate Notes (FRN)
- Synthetic

A word to the wise…….



"We structured the deal so it won't make any sense to you."

The Financial Meltdown

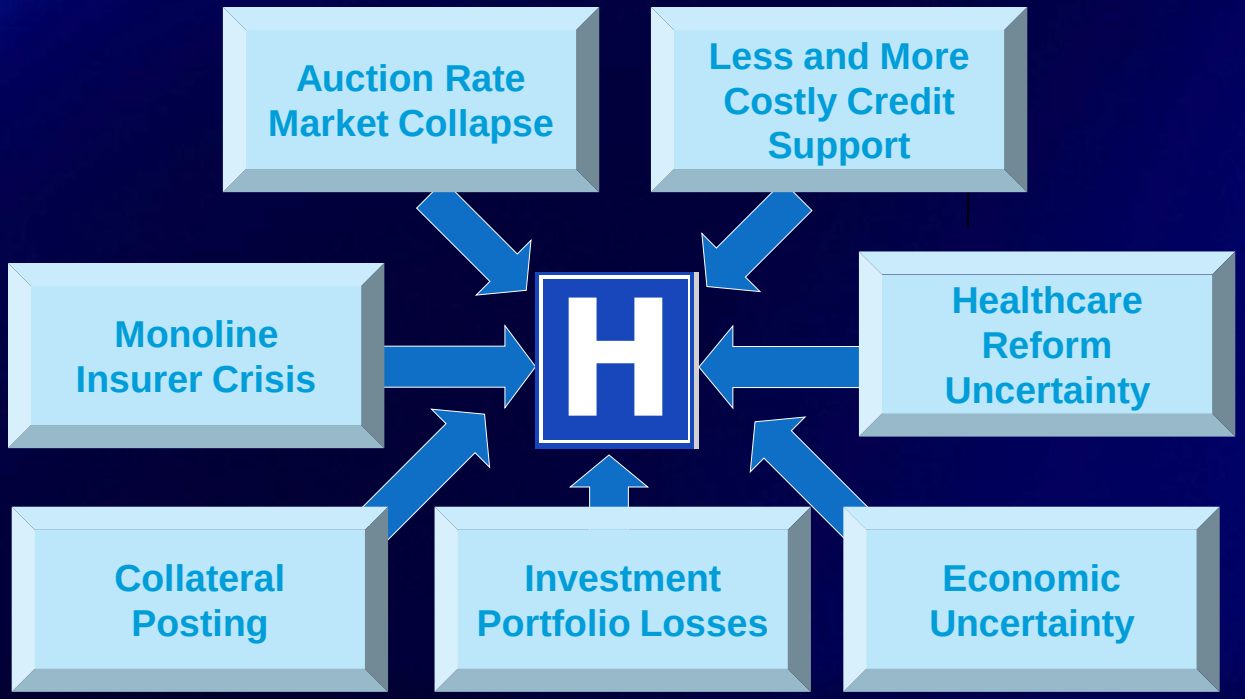


By the fourth quarter, the credit crisis, coupled with tumbling home and stock prices had produced a paralyzing fear that engulfed the country…..
By yearend, investors of all stripes were bloodied and confused, much as if they were small birds that had strayed into a badminton game.

Is there an alternative?

Back to basics

Market disruption and economic events of the recent past have caused providers to re-evaluate capital plans and structures



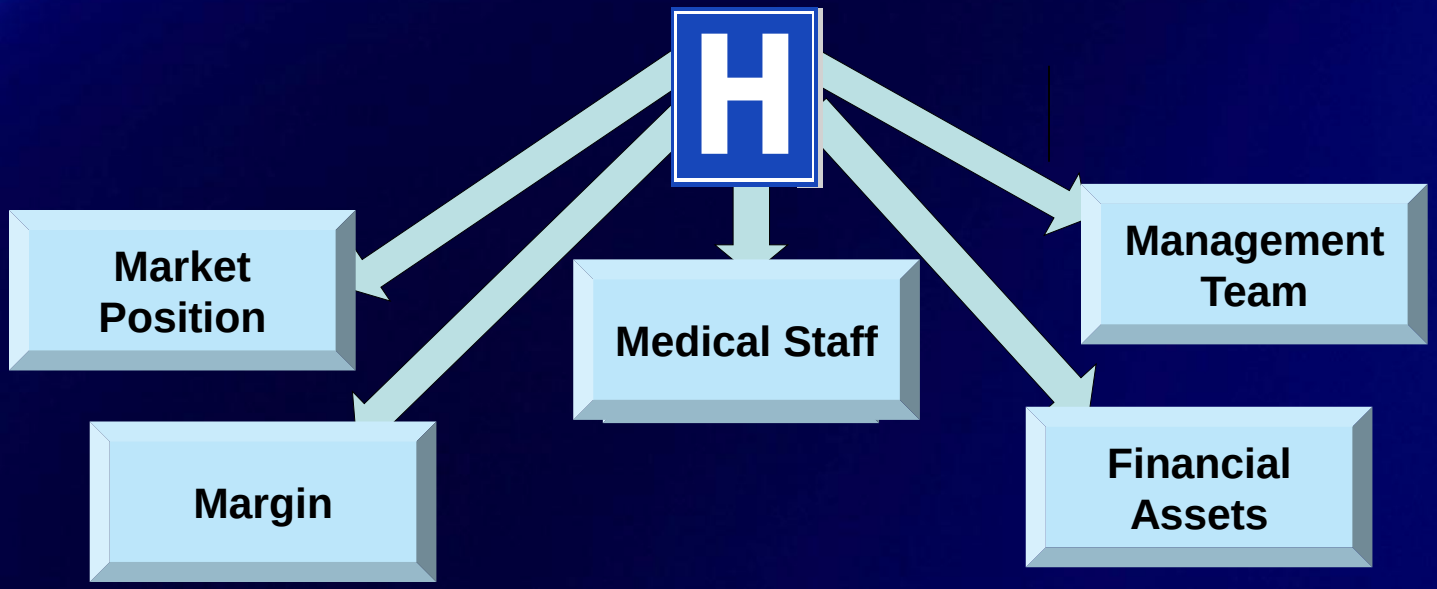
The Rating Game: assessing hospital credits

The “Bond Rating” is an “opinion of likely repayment”

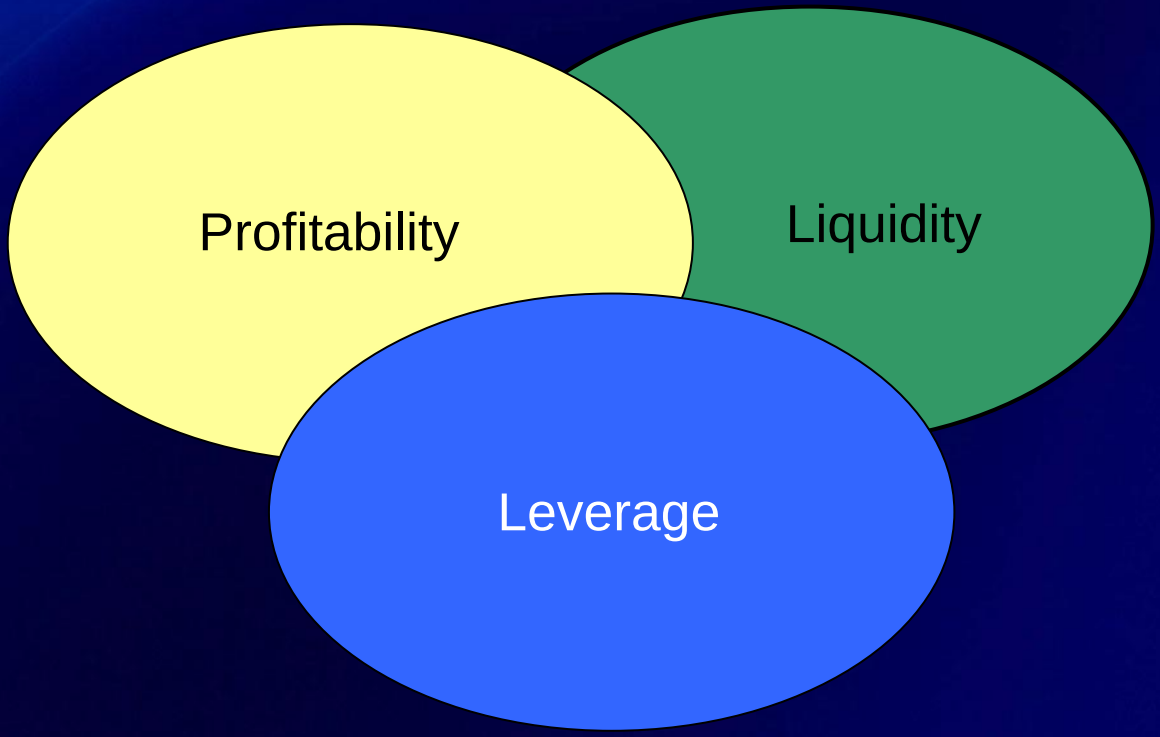
- ***The agencies***: Moody’s, Fitch, Standard & Poor’s
- ***The focus***: overall assessment of the enterprise & the Board of Trustees
- ***The key components***: *Management; Market; Medical Staff; Money*
- ***Management***: seasoned leadership; problem solving/problem avoidance; skill in adversity
- ***Medical Staff:*** diversity of practice models solo; group; multi-specialty group; employed; Physician Loyalty
- ***Market position***: leader; recognized in the community; negotiating position with third party payors; reputation; stature
- ***Money:*** strong balance sheet; clear asset management program; knowledgeable treasury operations; positive cash flow; operating margin

Back to basics:

- Market Position, strength and loyalty of the Medical Staff, Financial Results, and Asset Management are more important than ever



Key financial performance indicators



The three credit rating agencies use letters to indicate their credit opinions

Investment Grade

Moody's / S& P / Fitch

Aaa/AAA/AAA	Highest Quality
Aa1/AA+/AA+ Aa2/AA/AA Aa3/AA-/AA-	Very Strong Capacity
A1/A+/A+ A2/A/A A3/A-/A-	Strong Capacity
Baa1/BBB+/BBB+ Baa2/BBB/BBB Baa3/BBB-/BBB-	Adequate

Non-Investment Grade

Moody's / S& P / Fitch

Ba1/BB+/BB+ Ba2/BB/BB Ba3/BB-/BB-	Non Investment Grade Speculative
B1/B+/B+ B2/B/B B3/B-/B-	Highly Speculative
Caa/CCC+/CCC -/CCC/- -/CCC-/-	Substantial Risk
-/-/DDD -/-/DD -/D/D	Default

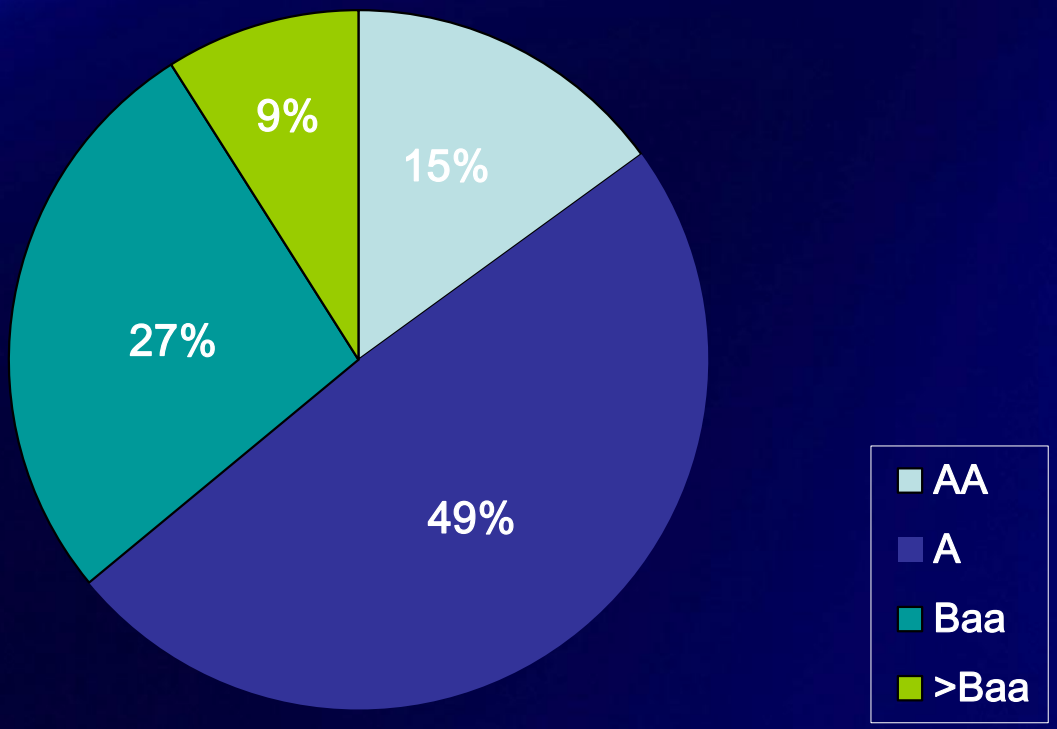
Key national median ratios

Ratio	Aa	A	Baa	Below Baa
Operating Margin	3.7%	2.9%	1.2%	-1.8%
Excess Margin	7.7%	5.9%	3.5%	-0.2%
Days-Cash on Hand	264.5	204.5	140.1	80.1
Debt Service Coverage	6.2X	4.6X	3.2X	1.7X
Leverage	30.7%	37.4%	47.8%	57.8%
Days-in Accounts Receivable	51.0	50.0	48.2	49.0

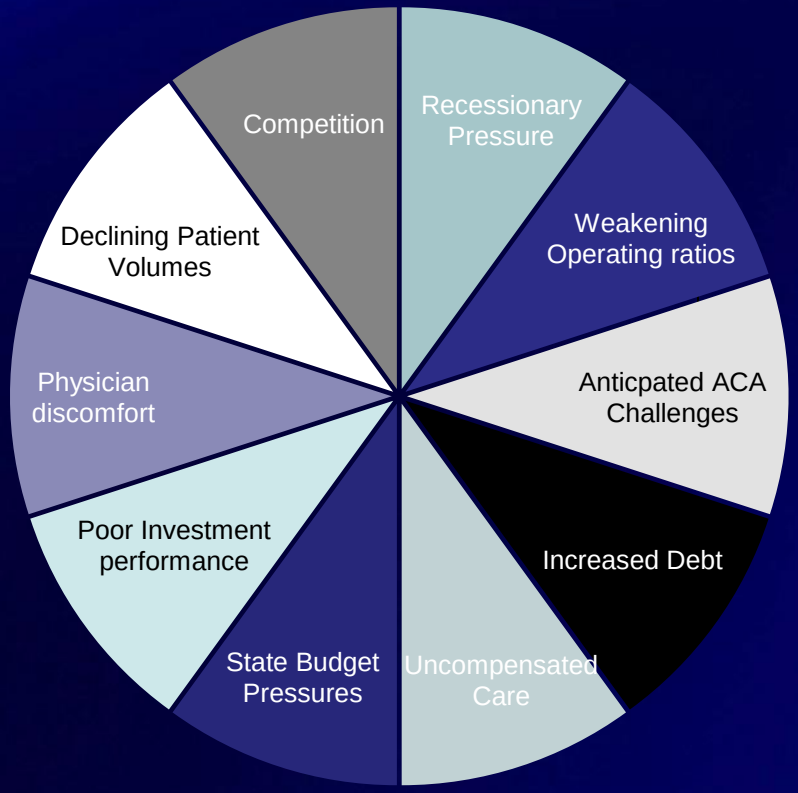
Moody's Investors Service 2013

Rating Distribution among US Hospitals

Moody's distribution of hospital ratings 2012



The new reality of credit assessment and risk avoidance



Jacksonville Market: microcosm of America

Three Jacksonville health care market participants

Baptist Health
Changing Health Care for Good.

- Multi-hospital system
- Regional provider core-nonteaching services
- Private, not-for-profit
- No Tax support

MAYO CLINIC

- Member of a multi-hospital, integrated system
- National & International referral center
- All employed medical staff
- Multiple organ transplant services
- Private, not-for-profit
- Teaching, research, clinical care

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- Affiliate of Shands Gainesville
- Teaching, clinical care, safety net provider
- Regional Trauma Center
- Tax-supported

Baptist Health
Changing Health Care for Good.

Rating Indicator	Assessment
Management	Hugh Greene, President & Chief Executive Officer Michael Lukaszewski, Chief Financial Officer Diane Raines, Senior Vice President & Chief Nursing Officer Edward Sims, President, Physician Integration Audrey Moran, Senior Vice President Social Responsibility & Community Advocacy
Market Position	Hospitals: Baptist Hospital Jacksonville Baptist Medical Center South Baptist Medical Center Beaches Baptist Medical Center Nassau Wolfson Children's Hospital Beds: 1,032 Hospital Admission: 50,321 Patient Days: 238,831 Outpatient visits: 242,026

Baptist Health
Changing Health Care for Good.

Rating Indicator	Assessment
Medical Staff	Voluntary Medical Staff: 200 / 800 Employed physicians: majority voluntary Clinic sites: multiple Medical Students & Residents: limited
Money: Financial Indicators	Net Patient Service Revenues:$1.241 billion Total Unrestricted Revenues: $1.295 billion Cash & Investments: $982.2 million Long Term Debt: $570 million
Financial Ratios	Operating Margin:7.1%: $83.8 million; 15.4%: $199.0 million Days cash-on-hand:327 Debt Service Coverage Ratio:5.9 times Leverage :34.6% Days in Accounts Receivable:54.5 days

Rating Indicator	Assessment
Management	John H. Noseworthy, MD, President & Chief Executive Officer, Mayo Clinic, Rochester, MN William C. Rupp, MD, Vice President Mayo Clinic & Chief Executive Officer, Mayo Clinic Jacksonville Robert Brigham, Chief Administrative Officer Jacksonville Jeffery W. Bolton, Chief Financial Officer, Mayo Clinic Mary Hoffman, Chief Financial Officer
Market Position	Hospital: Mayo Clinic Jacksonville Outpatient Centers: Jacksonville Beach; St. Augustine Controlled Affiliate: Satilla Health Services, Inc. 231 beds; Waycross, GA Hospital Admissions: 12,547 / 130,650 Patient Days: 65,244 / 625,626 Outpatient visits:48,508/ 2,450,095 Surgical Patients: / 81,694 Core Patients: /3,762,393 Enrolled Patients: 1,165,000

MAYO CLINIC

Rating Indicator	Assessment
Medical Staff	Voluntary Medical Staff: 0 Employed physicians: 419 / 4,100 Clinic sites: Rochester, MN, Scottsdale, AZ, Jacksonville, FL Medical Students & Residents: 3,450
Money: Financial Indicators	Total Revenues: $8.843 billion Net Medical Service Revenue: $7,485 billion Cash & Investments: $5.719 billion Long Term Debt: $2.102 billion
Financial Ratios	Operating Margin:4.68% Days cash-on-hand: 224 days Debt Service Coverage Ratio: 8.31 times / 5.75 times Leverage :31% Days in Accounts Receivable:57.35 days

Rating Indicator	Assessment
Management	David S. Guzick, MD, Senior Vice President, Health Affairs, UF; President, UF Health Russell E. Armistead Chief Executive Officer David J. Vukich, MD, Senior Vice President & Chief Medical Officer Michael E. Gleason, Chief Financial Officer Patrice Jones, Vice President & Chief Nursing Officer Eric B. Stewart, MD, Vice President & Director Community Clinics Penny Thompson, Vice President of Government Affairs
Market Position	Hospital: Shands Jacksonville Medical Center, Inc. Beds:620 Hospital Admissions: 24,001 Patient Days:108,004 Outpatient visits: 365,249

Rating Indicator	Assessment
Medical Staff	Voluntary Medical Staff: Employed physicians: 391 Clinic sites: Main hospital and consolidated clinics Medical Students & Residents: 365
Money: Financial Indicators	Total Revenues: $522.876 million Net Patient Service Income:$487.436 million Cash & Investments: $89.350 million Long Term Debt: $139.9 million: $39.9 million to Shands Medical School Support: $22.301 million
Financial Ratios	Operating Margin: 3.24% /(1.14%) Days cash-on-hand: 64.14 days Debt Service Coverage Ratio: 6.89 times / 3.39 times Leverage : 45.34% Days in Accounts Receivable: 59.7 days

Rating sweepstakes

Baptist Health
Changing Health Care for Good.

AA - (Stable)

MAYO CLINIC

AA (Negative)

AA -2 (Stable)

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Baa-1
(Negative)

Final word / reflection

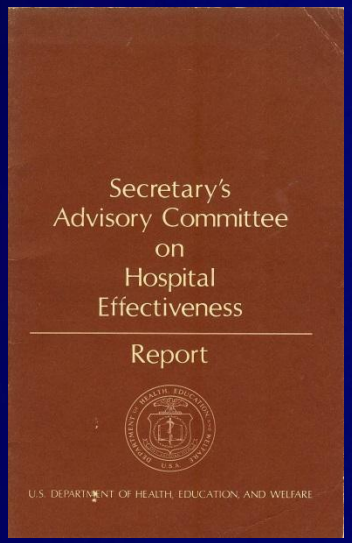
The last words……..

The Secretary asked us to think hard about what more effective systems of healthcare should look like. This called for us to scrutinize the basic structure of the health care industry (hospitals, physicians, and others), including the nature of industry output and the degree to which it effectively meets public need. I suggest that the industry's purpose is wrongly conceived; the industry should develop the capability of delivering comprehensive health care for the *people* rather than merely providing episodic treatment for *patients*. In a pluralistic society there will be various organizational approaches: the :systems" to which the Secretary referred. Physicians exercise primary authority over how health care resources are used; comprehensive, integrated systems in which they will participate with economically responsibility hold most promise. But by whatever means, it is important that physicians and hospitals join in developing economically self-sufficient modes of functioning before public impatience with irrationalities in the health care industry forces a "political solution" as the "least worse" alternative.

The last words……..

Government effort should be concentrated on eliminating legal and other restrictions which inhibit the development of diverse methods of organizing health care and on fostering development of effective incentives for systems within the industry to assume responsibility for comprehensive health care for their constituencies – an approach which can introduce significant competition among health care systems.

Mr. Scott Fleming, Kaiser Foundation Health Plan
Secretary's Advisory Committee on Hospital Effectiveness, 1968



The last words……..

90 % of the game is half mental….

Hospital information sources

- DAC Bond: 15c2-12 compliance depository:
  - www.dacbond.com
- Electronic Municipal Market Access (EMMA):
  - www.emma.msrb.org
- Guide star: IRS form 990 depository:
  - www.guidestar.org
- American Hospital Association:
  - www.aha.org