Into the Spotlight:

FHA 242 as a Financing Option

What financing options remain for hospitals unable to sustain a top tier credit rating needed to finance a major capital project in these turbulent times?

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A Financing Option

The capital markets are currently all but frozen. Bond insurers have been downgraded and are unable to provide bond holders with the promise of liquidity or obligors with any savings on bond yields. Banks have tightened their credit policies and many are unable, or unwilling, to meet the demand for letters of credit. What financing options remain for hospitals unable to sustain a top tier credit rating needed to finance a major capital project in these turbulent times?

A little used but quite powerful government sponsored credit enhancement program available to hospitals throughout the country might provide an answer for some organizations. The Federal Housing Administration (FHA) 242 program is a self-financing mortgage insurance program specifically targeting acute care hospitals. The program provides "AA" rated credit enhancement for tax-exempt (and taxable) hospital bond issues thereby providing lower quality credits with access to the capital markets.

With very few exceptions[1], the only hospital financings that have been closed since the credit meltdown in October 2008 have been for "AA" rated credits and up. While FHA 242 was viewed previously by some in the hospital industry as an option of last resort, it may currently be the best and often the only financing option for low and medium quality credits or for projects that will require significant leverage that could lead to downgrading an existing high quality credit to a lower rating. Even after the capital markets begin to thaw, it is expected that credit spreads will be much wider than in recent history. Story financings[2] will likely be much more difficult.

Accordingly, FHA 242 merits a closer look. □

[1] A $70M "BBB"-rated deal was closed in early November 2008 at an 8.25% yield.

[2] A story financing refers to situations where the credit worthiness of a project resides, to a significant degree, in the project's potential to transform organizational performance and transcend recent operating results. Hence the imprtance of the story regarding what will happen once the project is completed rather than a reliance on recent historical operating performance.

History of FHA 242

Launched in 1968, the FHA 242 program was embraced primarily by New York hospitals throughout the 1970s and into the 1990s. The regulatory and payer environment in New York State resulted in lean margins and weak balance sheets for the state's hospitals. The FHA 242 program was initiated to provide struggling hospitals, including those in New York, with access to the capital needed for modernization and expansion even when balance sheets were under significant stress.

In the late 1990's, FHA sought to diversify the program's portfolio of loan insurance commitments. This objective has been largely achieved with the percentage of commitments to New York hospitals declining from 89% in 2000 to 55% at present. In 2003, the program was expanded again to include Critical Access Hospital projects. □

How FHA 242 Works

The FHA 242 program has several aspects that make it attractive to organizations seeking access to capital to address key strategic or regulatory concerns, such as seismic upgrades. The program is focused on financing bricks and mortar investments. In return for access to capital at "AA" rates, hospitals agree to provide FHA with a mortgage and annual mortgage insurance premiums of 50 basis points (0.5%) of the mortgage principal outstanding. FHA can insure a bond issue sized as large as 90% of the value of the assets mortgaged (loan to value ≤ 90%). The pledged assets to secure the FHA guarantee can include the value of the facility project being financed, the non-depreciated value of existing facilities and equipment owned by the hospital, the value of equipment purchased for the new facility, and land and other assets owned by the hospital or its affiliates. Hospital reserves and philanthropic contributions can be used to meet some or all of the 10% project equity not funded via the issuance of FHA guaranteed debt.

A finance plan that meets the FHA loan to value requirements should also strive to preserve as much future operating flexibility as possible and maintain cash and assets unencumbered by a mortgage, to the degree possible. □

Getting Started

1. Develop a finance strategy

Stroudwater recommends that a hospital undertaking a major capital project perform preliminary work to document the project need and financial viability. The documentation should include a set of preliminary debt capacity and project cost estimates and financial projections that can be adjusted to reflect different plans of finance for the project. These analytics, combined with assessments of the hospital's existing capital structure, current and future borrowing requirements, risk tolerance, and capital market conditions drive the financing strategy.

These analytics help to ensure the hospital's "story" is accurately and effectively conveyed to key constituencies in the financial community.

2. Select a finance team

The financing strategy is followed by the selection of the finance team. A Request for Proposal (RFP) process to select the finance team provides an opportunity for learning from the respondents, generates potentially significant savings in fees and issuance costs, and provides hospital leadership with the opportunity to assess the qualitative attributes of bankers, including the cultural fit.

n.b. Ensure a seamless cost-effective process

If the development of the finance strategy indicates that FHA 242 is an appropriate option, the finance team is required to include an FHA approved mortgage banker. To avoid duplication of costs, it can be advantageous for the mortgage banker to be the same organization as the bond underwriter. Experience with FHA 242 financings helps to ensure a smooth financing process as the bond trading and sales force are knowledgeable about the FHA 242 program.

Minimum FHA 242 financing criteria

To be eligible for FHA 242 financing, a project cannot be under construction at the time of application (there are few, very limited exceptions to this rule). Additionally, 50% of patient days must be for acute care (critical access hospitals are exempt from this requirement). There are also two simple historical financial guidelines that must be satisfied:

i) average operating margin for the last three years prior to applying should exceed 0.0% and

ii) average debt service coverage for the last three years prior to applying should exceed 1.25x. □

Pro forma FHA 242 financing criteria

FHA 242 has three tiers of *pro forma* feasibility guidelines:

Tier One:

There is some flexibility regarding ramp up following a major capital project, but in general, the proposed project should meet both of the guidelines below throughout the projection period:

- Projected operating margin post project completion of 0.0% or greater, and
- Projected debt service coverage ratio post project completion of 1.40x or greater

Tier Two:

The applicant is required to meet three of the following five metrics:

1. Current ratio ≥ 1.25x
2. Equity financing ratio ≥ 0.20
3. Long-term debt to total capitalization ≤ 0.70
4. Debt service as a percent of operating revenue ≤ 5.5%
5. Working capital as a percent of total assets ≥ 5.0%

Tier Three:

Three metrics without any specific guidance as to how many must be met are:

1. Days cash on hand ≥ 15
2. Days in accounts receivable ≤ 75
3. Average payment period ≤ 75

It bears noting that the ratio thresholds above, and in particular the key ratios of operating margin, debt service coverage, debt to total capitalization and days cash on hand, are significantly more lenient for FHA 242 than even the S&P stand alone hospital medians for non-investment grade credits. The net effect of these FHA 242 criteria is to provide significantly more debt capacity than would be possible at any investment grade rating or the non-investment grade rating based on the major rating agencies median ratios for each category. □

FHA 242 application process

Once the financing strategy has been defined and the finance team - including an FHA approved mortgage banker - is in place, the hospital requests a pre-application meeting with the U.S. Department of Housing and Urban Development (HUD)/FHA staff to outline the project, including:

1. the sources and uses of funds
2. a description of the project and hospital
3. an overview of the service area
4. description of need for the project
5. preliminary financial projections

The pre-application meeting will result in a preliminary review by HUD staff when HUD will determine whether the proposed project meets its eligibility criteria and whether the project, as presented, is viewed favorably. The pre-application meeting provides the hospital with an important indication of HUD's perceptions of its project. A favorable pre-application finding from HUD reduces the risks inherent with proceeding with project design and planning work prior to receiving a mortgage insurance commitment from HUD.

Before the hospital submits its application to HUD, an FHA approved feasibility consultant needs to perform a feasibility study of the project. The feasibility study will reflect well-documented assumptions regarding project costs. As a result, significant planning work must be completed before the feasibility study can be finalized. Additionally, the completed feasibility study has a limited shelf-life and a formal application to HUD must be submitted in a timely fashion or an update to the feasibility study may be required.

Developing facility plans sufficiently detailed to provide the necessary information to obtain well-founded project cost estimates requires significant lead time as does the preparation and completion of the feasibility study. □

Recent Changes at HUD Regarding FHA 242

HUD is significantly enhancing its ability to review and process FHA 242 applications in a timely manner. HUD is in the process of hiring additional experienced healthcare credit analysts and executive staff to provide additional resources for reviewing applications. And, a lean process has been piloted, adopted, and is being implemented to reduce the time from submission of a complete application to a decision to 30 days or less. This investment in resources and improved processes will greatly simplify the applicant experience with the FHA 242 program. □

Closing thoughts

Organizations contemplating FHA 242 as a possible financing vehicle should evaluate the program in light of current capital market conditions (bond yields, credit spreads and investor appetite for bonds from similar projects and credits), other alternative financing vehicles available - if any, and the historical, current and pro forma credit worthiness of the hospital. Specifically, hospital leadership should develop an understanding at the outset of how the capital project will impact the hospital's future cash flow, leverage, and liquidity, and what size project is possible given the key feasibility metrics of alternative financing options and the hospitals recent, budgeted, and projected operating results.

With recent and planned program enhancements, the FHA 242 program may become the credit enhancement of choice for many hospitals. Stroudwater Associates has proven experience guiding leadership through the develpment of a financing strategy and selection of a financing team. If the FHA 242 program is confirmed as a financing option, Stroudwater Associates can assist hospital leadership through the RFP and application processes. □

Contact information

For additional information on the FHA 242 program or crafting a finance strategy for major capital projects, please contact:

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Additional information about Stroudwater Associates, our capabilities, and our consultants is available at:

www.stroudwaterassociates.com

Stroudwater Associates

Stroudwater Associates is a national healthcare advisory firm and a member of the Committee on Healthcare Finance, a policy advisory body that works closely with industry leading legal professionals and mortgage lenders to advise the Department of Housing and Urban Development staff that manages the FHA 242 program for hospitals. Stroudwater is quietly proud of its role in expanding FHA 242 eligibility to include critical access hospitals.

Working with the Federal Office of Rural Health Policy, the Department of Housing and Urban Development and the U.S. Department of Agriculture, Stroudwater has worked to enable rural and non-rural hospitals to access the capital markets.

Our consultants bring a complementary multi-disciplinary, team approach to each engagement. We believe each client is unique and we deliver tailored solutions. □

Recent and Current Engagements which include FHA 242 financing components:

$170M replacement hospital financing, PA
$240M bed tower and seismic upgrade, CA
$300M bed tower and renovation, NY
$230M replacement hospital, New England
$32M replacement hospital financing, MS
$14M ambulatory satellite campus, CO
$23M master facility plan, MT