

Strategies in Healthcare

Fall 1997

The Ultimate Healthcare Issue: Capital

*How Do You Ensure You Have
Enough?*

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Introduction

Capital strength has been and continues to be a defining issue in a competitive and volatile healthcare services industry. The sustaining lifeblood of any organization is capital – particularly during times of significant change. Capital provides for growth, expansion, replacement; capital provides a financial cushion for business realignment in a sudden financial downturn (e.g., upon unexpected price and/or utilization declines); capital provides resources for strategic reorientation; capital influences an organization’s relative attractiveness or leverage in consolidation discussions. It is little surprise then, that capital is one of the top concerns of healthcare executives and directors/trustees.

What is surprising is that large sectors of the healthcare industry engage in little overt capital planning. Many organizations continue to rely on principles of annual “budgeting to cashflow” or on management or board intuitive conservatism to control capital usage and allocation.

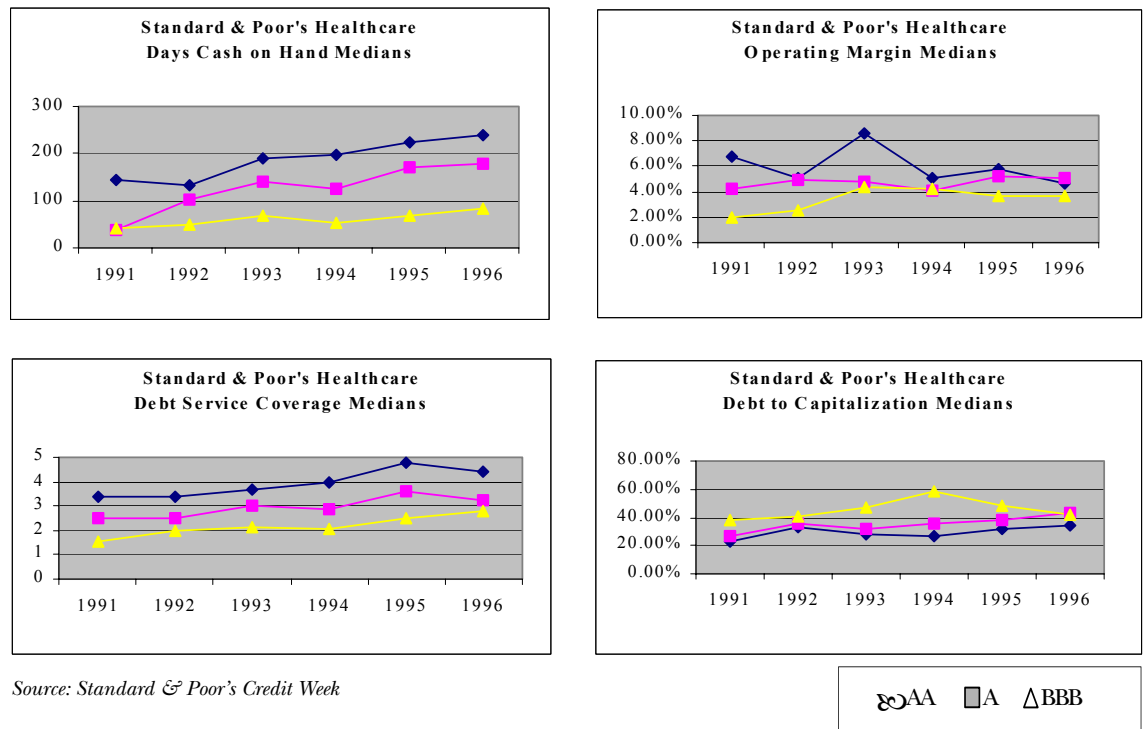
This publication presents Shattuck Hammond’s conceptual and analytical multi-year approach to understanding and controlling capital at the organizational level. In presenting this approach, we address the following questions:

- How can an organization define and estimate its future available capital or “capital capacity”?
- How can an organization ration and prioritize capital spending?
- How can an organization measure its cost of capital?
- How does capital capacity analysis dovetail with financing strategy issues?
- Should an organization periodically redeploy capital as the result of its assessment of the operating performance and strategic necessity of certain business assets?

Hospital Industry Capital Trends

Below we have compiled several historical Standard & Poor's median financial ratios for different rating categories. Although the sample sizes utilized for these ratios are not statistically significant, these ratios provide an interesting proxy for industry trends.

Figure 1. Capital Trends



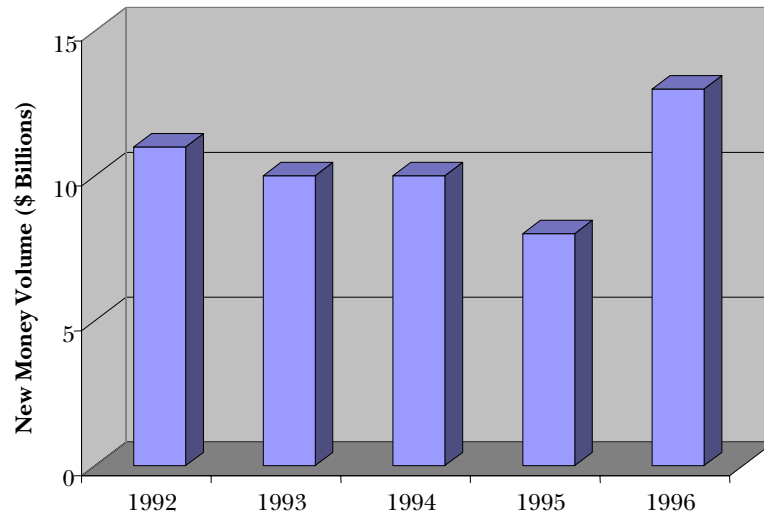
Source: Standard & Poor's Credit Week

From a review of these graphs, the hospital industry appears to be building substantial cash reserves during a period of generally improving operating margins. Although leverage appears to be rising modestly, debt service coverage is showing a positive trend.

Given the increasing competition among hospital, physician and payer sectors for total healthcare profits, these observations raise the question of whether the hospital sector is investing sufficiently to reposition itself in the future.

Tax-exempt “new money” bond issuance for not-for-profit healthcare organizations has followed the trends illustrated below by the historical volume chart. New money issuance generally declined from 1992 to 1995 but began to increase in 1996.

Figure 2. Healthcare Tax-Exempt Bond Issuance



Source: Securities Data Co.

Consolidation’s Impact on Capital

The pace of hospital consolidations accelerated from 1993 to 1996. According to data compiled by Irving Lewin Associates, hospital consolidation transactions increased from 100 in 1994 to 144 in 1995 and to 150 for the first nine months of 1996.

One of the often cited goals of consolidation is greater access to capital. In many markets, organizations with substantial access to capital (for example, Columbia/HCA) are perceived as a significant threat in part because of their capital strength. These competitors often have stimulated reactive or defensive consolidations in which other competitors merge in an effort to create greater market and capital strength parity.

In a consolidation of hospitals or hospital systems, the potential for enhanced capital strength is derived from two fundamental sources. The first of these sources is the improved cashflow resulting from cost and operating synergies and, potentially, enhanced contracting leverage resulting from stronger market share. This potential improved cashflow creates more internal cash and increased access to external capital in the form of debt. The second source of improved capital access results from lowering risk either by creating

a stronger market position in a single market or by creating risk diversification through establishing a presence in multiple independent geographic markets. Reduced risk theoretically translates into lower borrowing costs and greater access to debt capital. Of course, achieving this lower risk benefit requires the creation of a consolidated system credit structure.

Changing Uses of Capital

Although some hospital organizations are facing major replacement capital expenditures, an informal survey indicates that the majority of hospital capital expenditures are focused on “strategic” expenditures in the following areas:

- Information systems;
- Physician management company acquisition and/or capitalization;
- Renovation of current facilities or construction of new facilities to accommodate the shift to outpatient-based services; and
- Capitalization of risk-contracting entities.

The focus on the above capital uses is consistent with general trends toward decreasing inpatient utilization. In this “no growth” or “low growth” environment, capital expenditures are largely directed to the strategic repositioning of the hospital organization in the managed care era.

Capital Trends Summary

Although recent statistics indicate that the financial performance and capital availability of the hospital industry is improving, the industry remains challenged to maintain its current capital intensive asset base and at the same time invest in a major strategic reorientation of the hospital organization’s role in the healthcare environment. These capital challenges present many risks that can be better quantified and understood through diligent and thorough capital planning.

Defining and Estimating Capital Capacity

An organization's capital capacity is the sum of all "available" sources of capital over a given time horizon. These sources can be understood by separating them into external and internal source groupings.

Internal Capital Sources	External Capital Sources
Operating Cashflow	Debt-Borrowing
Non-Operating Cashflow	Philanthropy
Liquid Investment Reserves	Equity (applicable only to for-profit business ventures)
Divestiture of "Marginal" Business Assets	

The extent to which certain capital sources are "available" for use – for example, incurrence of debt and use of liquid reserves – is a function of the credit or risk profile that an organization seeks. Therefore, the first major assumption that must be established in analyzing capital capacity is the target credit or risk profile that an organization desires to achieve. Such a risk profile – in the form of maximum external debt capacity and minimum internal liquid reserves – can be established by proxy using rating agency financial data. Different risk profiles or credit ratings establish varying levels of available funds from internal and external sources. In general, the more risky lower-rated credit profile will possess lower levels of liquid reserves and higher levels of debt. Future capital availability will then depend partly on the relationship between the organization's current financial position and its future target credit profile.

The table below illustrates the significant variance in potential target credit profiles (all investment grade) by using Standard & Poor's 1996 hospital median ratios for a range of rating categories. A lower debt service coverage target generally translates into a higher amount of external debt capital. "Days cash on hand" measures liquid investments in terms of days of operating expense.

Organizational Risk	Rating	Days Cash on Hand	Debt Service Coverage
lower risk	AA	239	4.4x
medium risk	A	180	3.3x
higher risk	BBB	83	2.8x

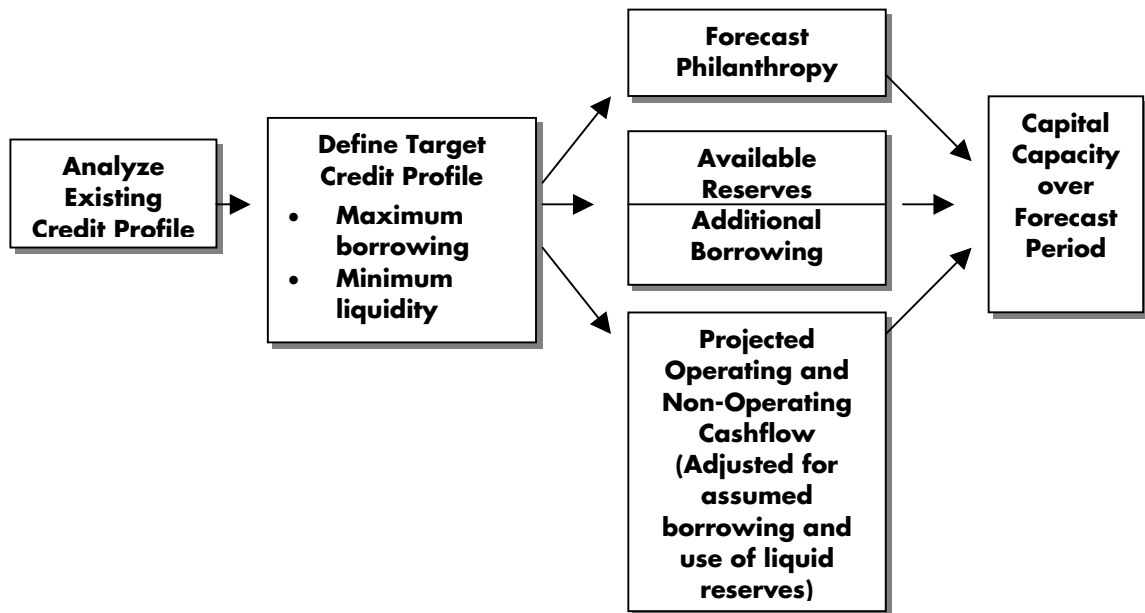
As the table above illustrates, selection of a target credit profile can have a significant impact on capital available for spending over a forecast period by requiring minimum liquidity levels and setting a maximum debt limit.

Capital capacity also depends heavily on the future expected ability of an organization to generate operating cashflow. For example, in markets with

heavier levels of managed care penetration, the ability to maintain or improve operating cashflow is not taken for granted. Therefore, we suggest a sensitivity approach to forecasting operating cashflow. This approach enables our clients to understand the credit and capital capacity impact of varying operating cashflow performance relative to baseline historical performance.

Shattuck Hammond has incorporated the preceding analyses and approaches in a proprietary financial model which combines a sensitivity approach to both credit profile and forecasted operating cashflow over a four or five year period. Conceptually, the model is structured as illustrated below.

Figure 3. Capital Capacity Model



The end result of the above analysis is a multi-year planning tool that can be used by management to understand available capital capacity constraints under various assumptions.

Rationing and Prioritizing Capital Spending

Defining an organization's multi-year capital capacity budget is inextricably linked to the capital spending decision. Together, these decisions heavily influence an organization's long term financial destiny.

Developing an optimal approach to rationing and prioritizing capital spending will depend on each organization's unique circumstances. For example, some organizations may be facing significant facilities renovation or replacement needs; others may be focused largely on strategic investment.

The common elements of developing a rationing and prioritization approach are as follows:

- *Triage.* Potential capital uses must be “triaged” into groupings each of which can be evaluated against a common relevant set of criteria or measurements.
- *Criteria.* Evaluation criteria, both financial and non-financial, should be developed for each expenditure grouping. On an ongoing basis, these criteria allow an organization to develop different controls and procedures for various expenditure groupings.
- *Evaluation and Prioritization.* Expenditures should first be evaluated and prioritized within groupings. Prioritization among groupings will be a direct function of an organization's business strategy. This matrix of prioritization then will create a process in which the “wish list” can be reduced to meet the multi-year capital capacity budget.

There are a myriad of ways to develop relevant groupings for potential capital expenditures. These groupings may include the following:

- *Routine Capital.* Most organizations maintain a relatively constant level of recurring annual “routine” capital expenditures. These routine expenditures are generally comprised of small items, but in total may involve a significant percentage of annual capital outlays.
- *Facilities Renovation and Replacement.* As a group, these spending needs are often motivated by code requirements and/or operational issues and may entail some cost savings, but are unlikely to generate incremental revenue.
- *Strategic Investments.* These capital expenditures can entail expenditures to grow current business lines or to expand horizontally or vertically. Sub-groupings may be appropriate for the “strategic” category of capital investments.
- *Mission Investments.* Many mission investments are accounted for as an operating expense. However, these investments as a group may also comprise a significant “capital” budget expense particularly when ongoing losses are funded for mission purposes.

What becomes immediately apparent to any organization which engages in a deliberate capital planning process is the competition and tension among groupings of potential expenditures. All healthy organizations have a capital wish list that exceeds capacity. The goal of the capital planning process is to provide an analytical framework for an important dialogue of what combination of capital expenditures is most essential to an organization. Further, the process focuses an organization on eliminating unnecessary or wasteful expenditures that would otherwise displace more essential capital uses.

Measuring Cost of Capital

Understanding an organization's risk-adjusted cost of capital is important for a very fundamental reason – if an organization is not earning a return at least equal to its cost of capital, it is dissipating its value. To ensure that an organization's value is maintained or enhanced, the current asset base, in combination with additional capital expenditures, should be generating a return in excess of risk-adjusted capital cost. Extending this concept further, an organization's cost of capital should provide a useful discount rate or benchmark rate of return for analyzing and prioritizing some types of capital investments, particularly strategic investments.

Theoretically speaking, an organization's Weighted Average Cost of Capital ("WACC") can be calculated using the following equation:

$$\text{Weighted Average Cost of Capital} = K_e \left(\frac{E}{D + E} \right) + K_d \left(\frac{D}{D + E} \right)$$

K_e = cost of equity capital

D = long term debt

K_d = cost of debt capital

E = equity position or fund balance

Although this equation can be readily applied to public or private for-profit companies, its application to not-for-profit organizations is less straightforward. Specifically, the issue is determining an appropriate cost of equity capital for not-for-profit organizations. Below we describe several potential alternative approaches to estimating cost of equity capital and weighted average cost of capital.

The first approach is to use the organization's opportunity cost of investment as a proxy for cost of equity capital. Mechanically, to employ this approach requires decisions regarding proxy investment profiles and time horizons. Theoretically, one should use a sufficiently long time horizon (approximately 10 years) and an investment profile that approximates the risk of the organization's asset portfolio. This proxy equity cost of capital would be incorporated into the WACC formula to estimate cost of capital.

A second approach may be more applicable to organizations that have a significant percentage of their assets in marketable securities. This approach would require perhaps different weighting and different returns for

investment assets versus operating assets. The objective is to create a proxy cost of equity capital that mirrors the risk-return composition of the organization's asset portfolio.

Using this approach we would estimate cost of equity capital for the operating portion of equity using public company data for companies in similar industries (for example, public for-profit hospital companies). From this data, it is possible to derive industry specific cost of equity capital using either the Capital Asset Pricing Model or the Gordon Growth Model. The drawback of this approach is the potential lack of comparability between not-for-profits and for-profits in terms of risk profile and business composition.

Under the second approach the WACC formula would be modified as follows:

$$WACC = K_D \left(\frac{D}{D + E} \right) + K_E \left(\frac{E_O}{D + E} \right) + K_I \left(\frac{E_I}{D + E} \right)$$

D	=	long term debt
E	=	equity = E _O + E _I
E _O	=	portion of equity in operating assets
E _I	=	portion of equity in investment assets
K _D	=	cost of debt
K _E	=	cost of equity
K _I	=	cost of investment assets (opportunity costs)

Capital Capacity and Financing Strategy

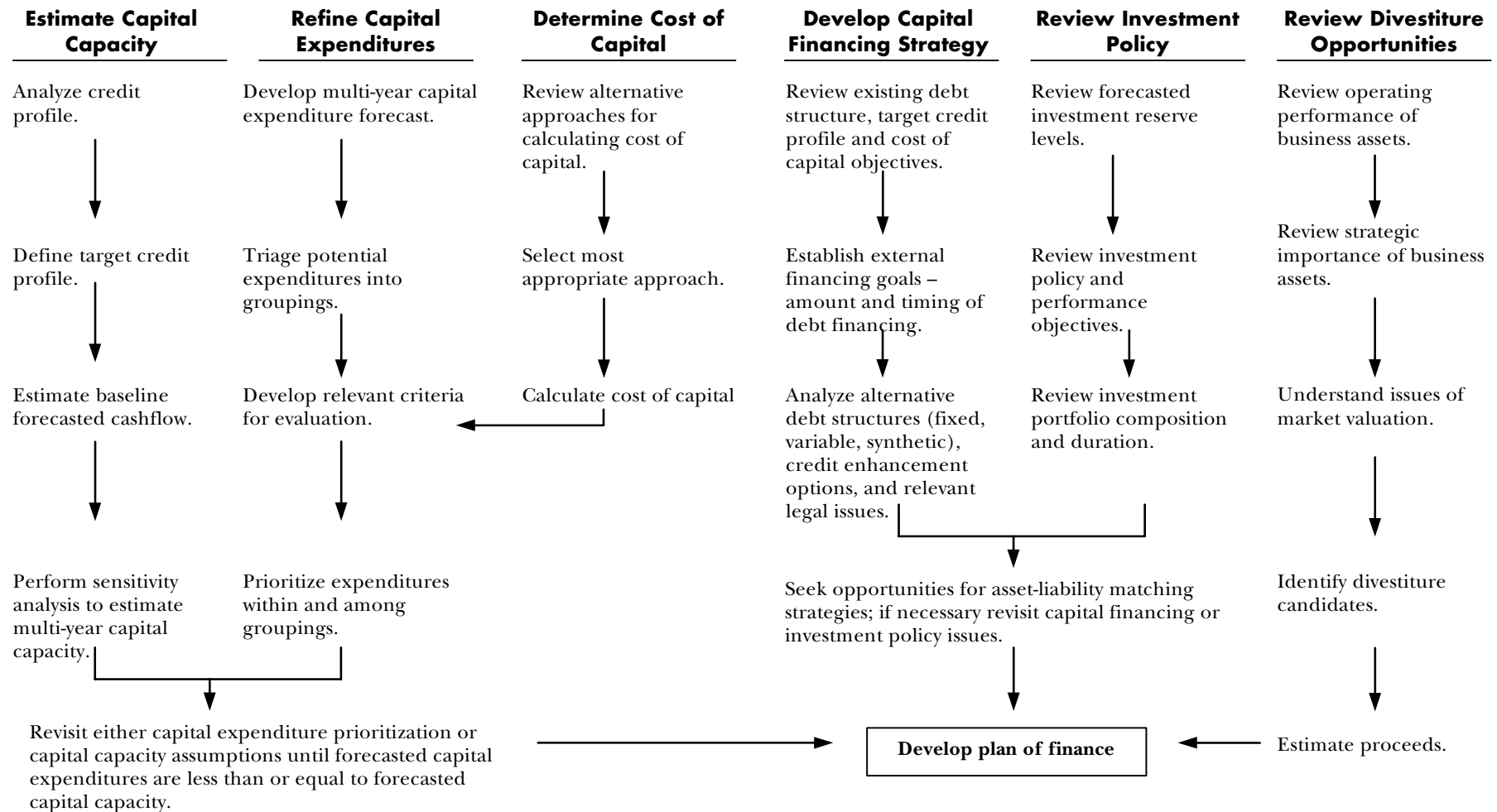
The evaluation of capital capacity and the prioritization of capital spending necessarily dovetail with the formation of the capital financing strategy. In fact, both the capital capacity analysis and the cost of capital analysis make overt assumptions regarding the amount of equity (internal) versus debt financing and the costs associated with these financing sources. Furthermore, a global view of financing strategy in the context of overall capital planning provides opportunities for re-evaluating investment policy (in light of liquidity objectives) and for seeking asset-liability matching strategies (between financing and investment strategies) that may lower risk and increase return.

The chart on the next page illustrates the inter-relationships among the various analytical components of the overall capital planning process.

Assessment or Re-Assessment of Asset Deployment

As the market environment and related business strategy of an organization change, certain business assets or service lines can and will become of marginal value to an organization. Recognizing the limited nature of capital resources, it is thus important for an organization periodically to re-assess its asset deployment and, as necessary, divest of business assets to more effectively deploy its capital resources.

Capital Planning Process Overview



About Shattuck Hammond Partners

Shattuck Hammond Partners Inc. is an investment banking firm specializing in healthcare services with particular focus on managed care, hospital, physician practice and long-term care sectors. Through offices in New York, San Francisco and Atlanta, Shattuck Hammond provides municipal and corporate finance services to healthcare providers and payers throughout the country. Our professional staff of 32 investment bankers makes the firm one of Wall Street's largest firms serving the healthcare services industry.

Shattuck Hammond provides the full range of services and capabilities necessary to assist a hospital organization in confronting the challenges and engaging in the process generally described in this brochure. We have provided these services for the following organizations:

BJC Health System (St. Louis, MO)
Citrus Valley Health Partners (Covina, CA)
Franciscan Missionaries of Our Lady Health System (Baton Rouge, LA)
Good Samaritan Health System (San Jose, CA)
MultiCare Health System (Tacoma, WA)
St. Mary's HealthCare Corporation (Reno, NV)
Sharp HealthCare (San Diego, CA)

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