ASC Financing:

The Current Outlook

by Kris Ellis

Money is Still Up for Grabs for Those Who Mean Business

The ASC industry emerged from the year 2003 somewhat bruised. The Medicare freeze coupled with continuing fallout from the DVI and HealthSouth incidents prompted many to enter 2004 a bit more warily with an eye toward the increasingly uncertain future. As the year begins to wind down, however, an assessment of the current trends and conditions shows financing for ASC start-up and expansion remains readily available to the right projects.

"The start-up ASC market has never experienced a time where it has been so active," according to Jeff Fox, vice president and national sales manager for the Outpatient Finance Group at CitiCapital. "We're seeing a lot of start-ups, and there are monies available."

"The money is still out there," says Terry Gill, vice president of sales for GE Healthcare Financial Services. "I think lenders are still bullish on the market, particularly the healthcare lenders — the ones that focus on that marketplace."

The experience and specialized knowledge of healthcare lenders put them in a unique position to gauge and evaluate the market.

"Globally, there are fewer people currently lending money in healthcare who have the expertise to lend in healthcare," says John Medina, senior vice president of CIT Healthcare Financing. "That doesn't mean that healthcare in general is not a desirable market; it is a desirable market but it requires an expertise to risk evaluate that not a lot of people have currently. Specifically as it pertains to ASCs, it requires a certain evaluation of the success factors of an ASC, which requires experience."

While the money is there for the borrowing, the terms by which it can be had have changed a bit. It is generally acknowledged that the days of plentiful non-recourse deals are over.

"With the DVI debacle, everybody is re-evaluating their portfolio, their go-to-market strategy," says Gill. "What was readily available in the past, which was non-recourse financing, is no longer readily available."

The expertise available from healthcare finance specialists can be valuable in a number of ways, including terms that are potentially more favorable compared to institutions that may not possess a similar breadth of knowledge and experience in the field.

"The local bank, if they can provide financing for the start-up ... it would be a potentially low interest rate but the offsets are: the owners will have to provide significant personal guarantees on the financing and there will be very tight financial covenants on the entity," says Ken Seip, vice president of sales and marketing for MarCap Corporation. Seip adds that it is not uncommon for banks to rule out start-up financing entirely.

"We're a bank, but we behave differently," says Fox. "In our arena, we'll finance 100 percent of the costs whereas a bank will not. A bank will probably do 80. That's a big deal because that 20 percent delta, we want

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the physicians to use that money to run their business."

The traditional thinking has advocated retaining enough money in the bank to operate for 90 days, but Fox recommends five months as a safeguard against unforeseen complications, such as a delay in Medicare inspection.

"From our standpoint, we like to see a pretty sizeable equity contribution from the doctors, which they basically give to themselves," Fox continues. "It goes into their bank account, not my bank account. If they don't use it all, it becomes a distribution back to them."

For those looking to procure ASC funding of any kind, interest rates must be considered. As the national economy begins to show increasing signs of life, interest rates have begun to creep up in many arenas, including healthcare financing.

"Historically, rates have been generally flat over the last five to 10 years, relatively speaking," says Seip. "Just recently with the spike in rates, customers are subject to the rate movement upward." Seip adds that customers have shown recent interest in purchasing protection from rate increases.

Interest rates are also affected by other factors such as risk level of the project. "Interest rates, in part, compensate risk," says Medina. "Let's say a greenfield project has an affiliation with a very substantial developer and that developer retains an interest in the project thereafter, and the project itself is composed of surgeon-members who are in highly reimbursable disciplines. That project carries with it a very favorable interest rate."

Fox points out that fixed rates are not the only option. "The other great alternative for customers to consider is floating rates," he says. One advantage of this approach is avoiding pre-payment penalties. "When you get pre-payment penalties in our industry, it's very painful," he continues.

Assessing Potential

Financiers see a great number of business plans, feasibility analyses, proformas, metrics and the like when they evaluate potential projects. While these elements may contain an array of vital information, lenders zero in on hard practical evidence that the project will succeed. Realistic case volume and revenue forecasts are usually a large part of this.

"If there is not a correlation between the membership and the surgeries being forecasted, no matter how you cut it and how many pieces of paper you give us, then it's very difficult to substantiate the project," says Medina.

"This single biggest issue that we look at is this: does that business plan tell me how they are going to get paid for those cases and does it explain how many cases and why," says Fox. "For every surgery center we have ever had get in trouble, there's a simple reason and it's that they either ran out of working capital before they got Medicare certified, or they got terrible contracts."

Seip explains there are specific areas of a projected plan that tell the story. "When you cut through the business plan, we look at first, the strength of the management team that's going to manage the development, the build-out and the ongoing management of the site itself," he says. "The second is really what I call prove-up. Can the lender reasonably project the case volume and therefore the revenue will be there to support the site? It's also deeper than that; it includes contracts and insurance. The third element is liquidity. Any start-up entity, whether it's a restaurant or a manufacturer or a surgery center, needs a certain amount of working capital to get it through its start-up period," he continues.

Gill also stresses the importance of solid management and equity contributions. "You want to make sure they (doctors) are capitalized, they have proper management and the proper mix of doctors. If you've got that starting out, you probably have a model that can get a deal done," he says.

Gill explains that a sensible and manageable blend of specialties can make things easier for financiers. "For example, if you had fifteen doctors and they're all plastic surgeons, you have a cash-based business that's hard to monitor," he says. "You'd like a multi-specialty focus if you can."

The philosophy and decision making processes vary from one financial institution to another when it comes to healthcare lending. The concept of a set of best practices for seeking funding might include a number of guiding principles such as:

- Set up a detailed timeline for the project
- Choose an experienced developer
- Make contact with a lender early in the development process
- Ensure specialties are highly reimbursable
- Research potential payors
- Contribute equity to the project

The local market and existing hospitals are factors that warrant evaluation as well in terms of potential conflict. "When we do our due diligence on a facility, we look very hard at the local market and you always anticipate a hospital challenging an ASC," says Gill. "You have to factor that into your credit decision."

Scip points out that borrowers should be prepared to answer any questions the lender sees fit to ask, even if they are unexpected. "In most cases the questions that come from the lender are going to seem pretty rational; sometimes they may not," he says.

Looking Ahead

In examining some of the projects that are being considered, financed and built, financiers keep an eye out for trends as the industry moves forward.

"A major trend that we're experiencing is joint ventures between big health systems or not-for-profits and doctors, and it's about time," says Fox. "That's really re-kindled a whole new round of (development)."

Gill also sees hospital-physician joint ventures as a growing phenomenon based on hospitals' desire to be a part of the ASC market.

"That does not always make a deal, though," he says. "One could argue that a poorly run hospital would equate to a poorly run ASC."

Scip notes that emerging specialty trends exist as well. "We've done a couple neuro projects this year and we've never done that before, so I see a trend on the neuro side," he says.

Another emerging trend involves the real estate component of an ASC. "We're starting to see doctors wanting to do more on the real estate side more often," says Gill. "Instead of just renovating a facility and renting space from a landlord, now the doctors want to be the landlords."

Medina points out the real estate piece can be part of a turnkey solution that may be available from experienced healthcare lenders. "Turnkey means we sell the improvement financing, equipment financing, land and building, and then a component for working capital," he says.

The future appears to hold continuing promise for ASC development and financing. Generally speaking, lenders are optimistic. Although further legislative involvement is always a potential threat, most people are not losing sleep over it. However, it is still an issue that warrants consideration.

"I think the biggest government regulation we are concerned about, if anything, is Medicare reimbursement," says Gill. "There is talk about moratoriums and regulation on the ASC space, but we really don't see that ever happening."

"I think we sometimes believe we're in an industry that's purely capitalistic in nature and when things like the moratorium come up, or certain states say they're thinking of precluding doctors from owning, it sends little waves through the business," says Fox. That being said, his outlook is still positive. "Based on what I see today, we're going to be building centers for a while to come."

"We're banking on surgery centers being fairly safe for some period of time," says Scip. "Generally speaking, we think surgery centers are relatively safe on the legislative side, and we say relatively safe on a federal level, from the Stark perspective. What we are watching more closely is on a state level."

An abundance of strong and viable potential projects will also have a positive impact on financing conditions going forward. "I would say the outlook is that there is enough money to go around the projects and it is getting stronger," says Medina. "Because the projects are getting stronger there is going to be a more favorable interest rate environment." ❑