

FEATURE STORY

Jim Ambrose
Andrew Harris

tax-exempt private placements a new opportunity for not-for-profit providers

With the window narrowing for traditional financing options for some hospitals, many not-for-profit hospitals are turning to the private markets to seek tax-exempt loans.

Although for-profit hospital systems have long relied on a wide variety of financing alternatives, many not-for-profits have only recently begun seeking a broader range of financing options. The rising popularity of tax-exempt private placements is being driven by benefits such as greater flexibility, lower fees, less paperwork, fewer players, and much shorter time to complete than public bond issues.

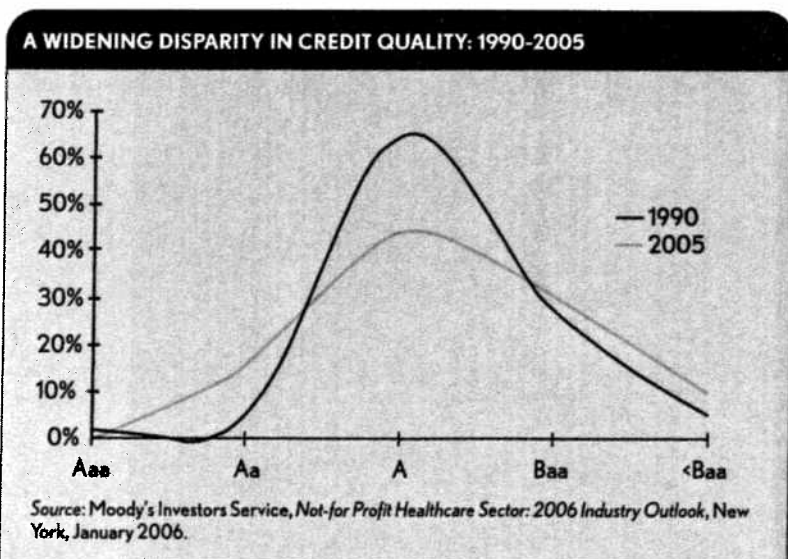
AT A GLANCE

Tax-exempt private placements offer an attractive financing alternative for not-for-profit healthcare providers for which the public debt market is no longer a viable option. They offer the following advantages:

- > Greater flexibility
- > Lower fees
- > Less paperwork
- > Fewer players
- > Shorter time to complete

Tax-exempt private placements hold increasing appeal for hospitals that are struggling financially as well as those in good financial shape. Not-for-profits have traditionally obtained investment capital from four sources: philanthropy, investment income, operating income, and the debt market. But some of those sources have become less reliable for many not-for-profits, with investment returns and philanthropy now considerably less dependable than in the 1990s. Moreover, a high percentage of not-for-profit providers are losing money or are only marginally profitable.

A high percentage of not-for-profit hospitals are losing money or are only marginally profitable. For some of these hospitals, the public debt market is no longer an option.



Some of these institutions also have reached a point where the public debt market is no longer a viable option. In *Financing the Future Report 4: The Future of Capital Access* (2004), led by HFMA in partnership with GE Healthcare Financial Services and with research conducted by HFMA and PricewaterhouseCoopers, 24 percent of CFOs said their hospitals had reached their debt capacity. And only better-performing organizations—those that least need the money and have more capital sources because of their strong financial situation—can acquire bond insurance, which is required to receive the highest ratings for a bond issue.

Yet many hospitals that are lower investment grade, or even non-investment grade, can arrange a tax-exempt private placement. And for hospitals that can readily tap the public markets, private placements offer a way to

bolster their already solid financial position. With possible cuts in government reimbursements looming, some not-for-profits are getting ahead of the curve by setting up financing alternatives now.

How Private Placements Work

The nuts and bolts of a tax-exempt private placement are relatively straightforward. A tax-exempt private placement is a loan between a not-for-

profit or municipal borrower and a single lender or a small syndicate of lending institutions. The loan terms are negotiated privately between the two entities.

A tax-exempt private placement also can be structured as a capital lease or an operating lease. Tax-exempt capital leases are categorized as debt, like any other loan. As payments are made on this debt (usually monthly), they are booked as repayments of principal and payments of interest. Tax-exempt operating leases differ from capital leases because they are not categorized as debt and are not carried on the hospital's balance sheet. Tax-exempt operating leases require

With tax-exempt private placements, hospitals can set the length of financing to correspond with the term of the project so they aren't paying for equipment years past its useful life.

approval of both the hospital's bond counsel (to qualify as tax-exempt) and its auditors.

Repayments of this type of financing are categorized as rental payments. The items financed do not become assets on the hospital's balance sheet, nor does the amount financed become a liability; instead, the amount financed is reflected in the audit notes under "leases."

Because items acquired through tax-exempt financing are not subject to property taxes in most states, neither tax-exempt capital leases nor tax-exempt operating leases require the hospital to pay property taxes.

Tax-exempt private placements typically exceed \$1 million and generally require no

USING PRIVATE PLACEMENTS FOR MORE FLEXIBLE TERMS

As Honolulu-based Hawaii Pacific Health set out to become the first healthcare organization in the state to implement an electronic health record system, it also ventured into new financing ground by paying for the system with its first tax-exempt private placement. Like many not-for-profit hospital systems, Hawaii Pacific had traditionally relied on cash flow or the public bond market to finance large capital investments. But the more flexible terms of the private placement, designed to coincide with the expected useful life of the technology, won it over. So Hawaii Pacific arranged a five-year, \$26.8 million private placement that financed all hardware, software, licensing fees, and implementation costs for its first-generation electronic health record system.

USING PRIVATE PLACEMENTS TO TAILOR FINANCING TO NEEDS

Mountain States Health Alliance, Johnson City, Tenn., first opted for a tax-exempt private placement five years ago when its debt level precluded it from issuing public bonds to finance new clinical equipment for a half dozen recently acquired hospitals. Even after its financial situation improved, the 10-hospital system has opted for more private placements to obtain more than \$30 million in equipment. "Tax-exempt private placements allow us to tailor our financing to our needs, helping us more effectively manage our balance sheet," says Kerry Vermillion, vice president/CFO, Washington County Operations.

USING PRIVATE PLACEMENTS TO MAINTAIN MARKET POSITION

Using a tax-exempt private placement, Saint Vincent Health System, Erie, Pa., purchased \$8.5 million in equipment, including upgrades to its catheterization laboratories and other cardiovascular imaging and image archiving technology. The system considered these investments to be critical for maintaining its position as northwest Pennsylvania's leading provider of cardiovascular services.

financial covenants, credit enhancement, debt service reserve funds, bond rating, official statement or other public disclosure. They require updated financial statements on an annual basis. For collateral, most lenders hold a secured lien on the assets financed.

When to Use Private Placements

Traditionally, public bond issues have been considered the best option for longer-lived projects of 25 or 30 years, especially for investment grade borrowers. Publicly issued bonds have historically been priced at lower rates than private issues, which more than offset their higher costs of issuance. The higher up-front costs to issue a public bond were spread over a long enough time period, minimizing the impact on the borrower's all-in cost of capital.

Today, many hospitals are finding that the private placement market is offering competitively priced capital for both long-term and short-term projects. Some hospitals looking to refinance their debt at today's low rates are also considering using private placements to allow quicker and easier execution with greater flexibility. Private placements also require less disclosure at time of issuance and are not subject to continuing

disclosure requirements. Hospitals with "story bonds" benefit from being able to tell their story directly to the buyers of their debt rather than to the broad public market. Private placements in the \$100 million range traditionally were rare, but are becoming more common in today's market.

Hospitals also are facing many shorter-term capital needs, including upgrading expensive clinical equipment, replacing boilers, buying new helicopters, and investing in healthcare IT systems such as electronic health records. With tax-exempt private placements, hospitals can set the length of financing to correspond with the term of the project so they aren't paying for equipment years past its useful life.

Advantages of Private Placements over Public Bonds

Tax-exempt private placements share some important similarities with public bond issues. The financing must be targeted for a tax-exempt purpose. The borrower must hold a public hearing in accordance with the Tax Equity and Fiscal Responsibility Act. Also, not-for-profits must work through a government financing authority that serves as the issuing agent for the tax-exempt debt. Authorities and their jurisdictions vary from state to state, county to county, and even city to city. As government entities themselves, municipal hospitals don't need a separate issuing authority to complete a tax-exempt private placement.

On the other hand, tax-exempt private placements offer several important advantages over publicly issued bonds. Although public issues traditionally have been viewed as being more cost-efficient for large transactions, they involve numerous parties, including underwriters, rating agencies, trustees, credit enhancers, and bond counsels. The complexity of many moving pieces can slow down the process and significantly increase the costs of issuance. Bond offerings also require exhaustive public disclosure, including significant events that happen after the bonds are issued.

FEATURE STORY

Tax-exempt private placements offer a much faster and more private way to raise capital. Because there are only two main parties to the transaction, the process is streamlined and transaction fees are reduced. In addition, because the lenders are knowledgeable institutional investors holding the loans for their own account, the borrower is not required to publicly disclose financial and other information that would ordinarily be required for a public deal.

An Attractive Alternative

As demand for private placements increases, more financing companies and banks are entering the market and providing competitive interest rates. Beyond price, hospitals might want to consider such issues as access to capital as well as the lender's understanding of the healthcare industry and its track record of providing financing to healthcare institutions during both flush and lean times. With the wealth of available

financing sources in today's market, hospitals that have not considered private placements in the past may be surprised to find that they are an attractive and economical alternative to paying cash or issuing public bonds. ●

About the authors



Jim Ambrose

is general manager, global equipment finance, GE Commercial Finance, Healthcare Financial Services, Chicago (jim.ambrose@ge.com).



Andrew Harris

is managing director, GE Healthcare Financial Services, Tampa, Fla., and a member of HFMA's Florida Chapter.

The Healthcare Experts



Commerce provides healthcare financing to New York Metro acute care hospitals, long-term care and assisted living facilities, nursing homes and physicians' groups.

Put Commerce Bank's team of experienced healthcare professionals to work for you.
Call Greg Braca at **1-888-751-9000**.

Commerce
Bank *America's Most Convenient Bank®*
commerceonline.com

Member FDIC

400+ convenient locations throughout Metro New York, Metro Philadelphia, Metro Washington, DC and Southeast Florida

