Grant Thornton

Health care financing in challenging times

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Introduction

With the uncertainty surrounding health care reform, the effects of a slow-to-recover economy, and the constraints of tight credit markets, it is undoubtedly a challenging time for the health care industry. These factors, combined with rising costs, lower reimbursement rates, and higher levels of charitable care and bad debt, are limiting — sometimes severely — financing options that have been readily available in the industry for years, and putting a growing strain on health care systems.

Prior to the financial sector meltdown, the provision of health care services was thought to be recession-proof. National, regional and local banks, along with finance companies, were a ready source of financing for health care providers, and the availability and relatively low cost of capital encouraged health care systems to borrow and spend freely. However, last year saw a dramatic reduction in the number of banks and finance companies in the health care lending business. Now, all of the traditional financing options — including bonds, banks, finance companies, private equity, venture capital, REITs, private philanthropy and grants — have experienced restrictions that are limiting access to capital.

Adding to the difficulty, not-for-profit health care providers have encountered an unprecedented reduction in charitable contributions and grants due to the overall economy, and mixed returns on investment portfolios. In particular, endowed institutions have suffered severe portfolio write-downs and have significantly less investment income to fund health care organizations. While there has been some recovery in 2009 and 2010, remember that it takes a 100 percent recovery in investment value to offset a 50 percent decline. Moreover, many health care providers suffered similar losses in their own portfolios and are no longer able to count on subsidizing negative operating cash flow simply with investment income from contributed funds.

Yet the United States health care industry continues to demand substantial financing, including investment in new facilities and technologies, in order to maintain its competitiveness. At the same time, the timing of reimbursement — long after services are provided — creates an ongoing demand for working-capital financing for even the most profitable providers. Consequently, many health care providers are scrambling to line up alternative financing as their previous lenders have exited the market. Even the remaining lending institutions have tightened their underwriting standards and are commanding restrictive covenants in comparison with the past.

In these challenging times, Grant Thornton LLP offers a number of suggestions to health care organizations for restoring rigor and discipline throughout their businesses. We advise taking proactive steps to prepare for what we believe could be a slow economic recovery, with financing options difficult to access for all but the most creditworthy.

Instilling rigor: Where should you focus?

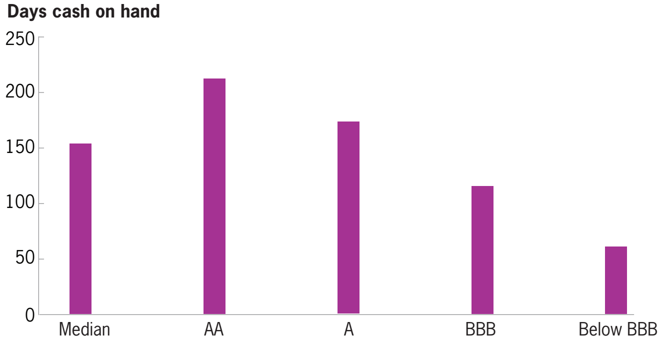
Cash is king

In recent months, many health care organizations have found out the hard way that cash matters more than earnings. Lenders, investors and financial advisory professionals are very focused on the cash flow statement and cash flow projections. Red flags are raised when earnings grow faster than cash is collected. This has been a problem for many health care providers that have reported revenues not supported by historical cash collections.

A slower economy puts additional pressure on cash flow because payers are likely to pay more slowly, third-party reimbursement rates are reduced, revenues and profitability diminish, and banks are less inclined to lend against insufficient or aging collateral. If not monitored closely, liquidity can become constrained very quickly and without warning.

The axiom "what cannot be measured cannot be managed" is applicable to cash management. Establishing a cash flow projection and then closely monitoring adherence to that projection is essential for health care organizations. This will give advance warning of points at which cash may not be sufficient to maintain existing operating levels or maintain compliance with loan covenants involving cash balances. It will also give you the ability to aggressively manage cash as necessary under the circumstances. If you do not have the capabilities to produce a cash flow projection that accomplishes this, consider consulting with outside professionals specializing in cash flow forecasting during difficult times.

Days cash on hand for nonprofit hospital and healthcare system - 2009



Source: FitchRatings

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Optimize cost structure and improve margins

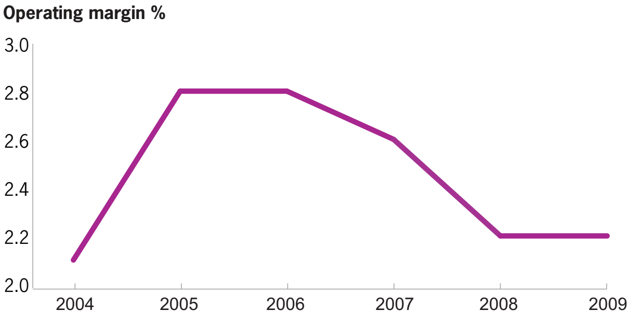
Many providers have been successful at cutting costs and trimming the fat in recent years. Knowing where to cut expenses is key to maintaining efficient and stable operations. However, while these efforts have made a difference, profit margins for most health care systems have continued to decline year after year. Typically, the biggest cost savings are captured early, and after that, additional savings are smaller and increasingly difficult to realize and sustain.

Focus on expenses with the greatest impact. Labor and medical supplies are generally the two largest cost centers of health care organizations' operating expenses. Analyze these categories of spending thoroughly to get the highest potential savings impact. The current economy has allowed hospital employers to significantly reduce their cost structures, particularly labor costs, without creating organized labor unrest.

Sharpen your pencil and look at all of your administrative expenses, such as use of consultants, temporary staff and managerial salaries, including inefficient distribution of support staff positions. Continually examine your entire indirect cost structure to ensure that it links directly with patient and quality care.

How else can you improve and maintain margins? In times like these, it is critical to have financial systems that generate service line profitability. Take this opportunity to implement metrics and benchmarking to evaluate service lines that either need to be fixed or dropped.

Operating margins for nonprofit hospital and healthcare system



Source: FitchRatings

Increase the efficiency of patient processes, allowing more patients to be treated. This leverages existing beds and allocates fixed expenses more efficiently, thus generating higher operating margins. You might also consider critical process improvement reviews, such as Six Sigma, in order to align the efficient use of resources with high-quality patient care. Managing patient flow more effectively will result in better revenue capture, as well as reduced expenses. The integration of information systems and processes will allow for the highest level of efficiency, while minimizing costs generated by redundancy of efforts and out-of-pocket expenses.

Minimize collection risk and maximize revenues

The already staggeringly high rates of unpaid bills are growing quickly as more patients lose employment, insurance and their ability to pay for care. To minimize the impact of collection risk to your bottom line, strengthen your registration and admissions process, verify data inputs, and maintain accurate and complete medical record files. This will allow you to avoid costly payment deferrals and denials.

Analyze clinical documentation to ensure all reimbursable complications or co-morbidities are captured in order to maximize revenue. Stay ahead of third-party contract renewals, and realign incentives when possible. Recent hospital failures have been attributed to the inability to capture and bill for all the charges that are being incurred.

In order to have less exposure to receivables that are outstanding for a long period of time, it is also a good idea to speed up the collection process. Create an atmosphere of zero tolerance for significant delays to collect. After patient care, managing the revenue cycle is the most complex process in provider management. Seamless operational integration and flawless execution are essential to maximize net revenue realization. Taken as a whole, these steps not only minimize collection risk, but also improve provider satisfaction and the patient experience.

Examine and strengthen key relationships

In challenging times, it is more important than ever to take a critical look at all of your key relationships. This includes the most important relationship of all, your referral sources — physicians and the medical community at large. The competition is eyeing your referral sources, so work to align the interests of your referral sources with your own. Other important relationships include your internal staff and your community. Since it is common for hospitals to be the largest employer in an area, maintaining open communication with staff and the surrounding community will serve to maintain and strengthen your position as the market and employment conditions continue to improve.

Take a critical look at those relationships that are most effective for your organization, and seek ways to strengthen them. Consider establishing strategic partnerships with other providers in your marketplace that will enable you to better meet the community's health care needs. It may also be time to end or at least scale back those relationships that are chronically unprofitable.

Manage the use of capital effectively

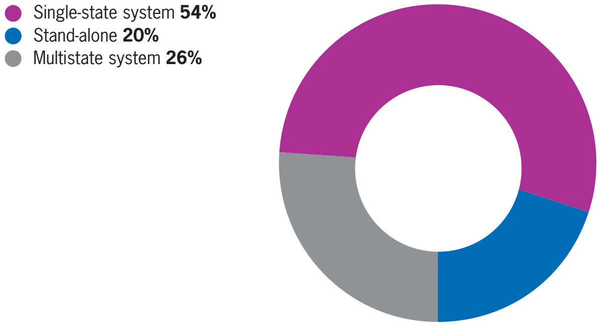
Examine any approved strategic plans to assess whether they are on budget and on schedule. Push for proper return on investment (ROI) analyses for any proposed capital projects, large equipment purchases or acquisitions, and judiciously protect capital.

Another area of concern is inventory control. Reexamine optimal order size in light of increased carrying costs. Consolidate SKUs where possible, and ensure that your operating personnel and inventory management teams are not maintaining excess inventory. To the extent that you have excess inventory, liquidate it. Now also is an ideal time to negotiate with suppliers for consignment opportunities, extended terms and larger, early-pay discounts.

If your health care system has multiple facilities, consider opportunities to consolidate its buying power into a centralized purchasing department in order to purchase more for less. You may even want to join or form a new purchasing organization. Put aside competitiveness, and work with other health care systems for opportunities to pool purchasing power, aggregate demand and wield more clout with suppliers.

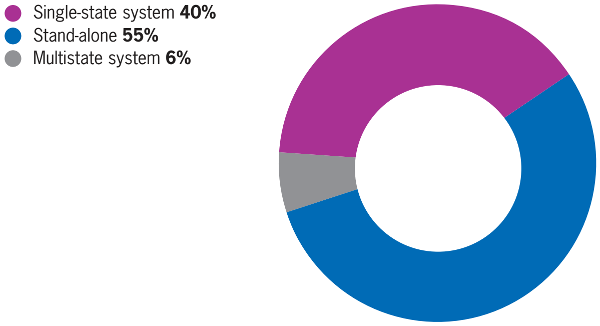
During times of illiquidity and earnings pressure, it is a natural inclination to curtail virtually all capital spending. However, be aware that future projections may be dependent upon certain key capital expenditures that drive growth in service lines. Continue to make those key capital expenditures a priority to give your organization the opportunity to achieve its goals.

AA rating category Median revenue size $1.6 billion



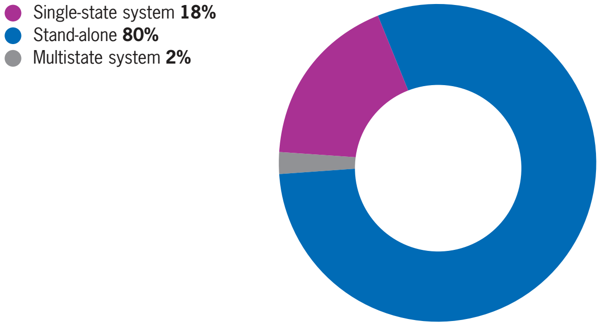
Source: FitchRatings

A rating category Median revenue size $484 million



Source: FitchRatings

BBB rating category Median revenue size $265 million



Source: FitchRatings

Seek out consolidation opportunities to emerge stronger after the downturn

Consolidation in the health care industry is taking place at a record pace. Larger systems that have increased market share dramatically for many years are now strategically evaluating the markets that they want to be in and divesting from those that they do not. In addition, struggling smaller systems are seeing that their very survival may be dependent on merging with or being acquired by another system. This is creating an environment where consolidation can be an opportunity for health care systems, large and small, to be better positioned to deliver cost-effective care.

Consolidated systems also tend to have higher bond ratings than stand-alone systems. Evidenced by the current bond ratings, the majority of systems that are creeping toward distress tend to be stand-alone systems.

Considering your financing options

If you are having issues with your lender, either due to your problems or theirs, the result can be a severe restriction in your borrowing capacity, or worse, elimination of your existing financing facilities altogether. And given the financing environment, it's not as easy as it once was to secure an alternate source of capital.

Make sure you understand all your options for funding your business. Start with your incumbent lender, and consider alternative ways of structuring your credit facility. Understand default provisions in your current borrowing agreements. Be aware that in this environment, many existing lenders are willing to work out loans in order to keep them from being in technical default. Based on your size and location, understand who the alternative local, regional and national senior lenders might be for your business. Also consider other types of secured financing sources like leasing, asset-based lenders and factoring companies. In some locations, state and local government-supported financing programs may be available.

Other types of outside financing include subordinated debt, private equity and venture capital. These funding sources are generally longer in duration and often take more time to arrange. If you have enough time and flexibility, these sources can help improve your capital structure over a longer period of time.

Finally, don't forget about creative ways of accessing cash that might be tied up in the business. As discussed earlier, shortening your working capital cycle should be your first priority. Look at negotiating payments on long-overdue accounts receivable, or obtain financing through your trade vendors. Consider the sale of noncore assets or subsidiary businesses. Consider sale leasebacks on real estate to generate cash.

Do not automatically assume that your current lending relationships are going to stay in place. Avoid being in the position of not understanding your alternatives if you are forced to end your relationship with your bank, lender or other investors. Court other sources of capital, just in case. Don't be left without a contingency plan.

Recognizing the signs of financial distress

In evaluating whether your system may be in financial distress, consider the following questions:

Financial	Yes	No
1. Is a "going-concern" opinion at issue?	□	□
2. Has patient revenue decreased by more than five percent during the last 12 months?	□	□
3. Has gross margin decreased during the last 12 months?	□	□
4. Do cash flow projections for the next 12 months reflect a shortfall in funding operations, capital expenditures or debt service?	□	□
5. Have the company's accounts receivable days outstanding increased in the past 12 months?	□	□
6. Have days cash on hand decreased by more than 20 percent in the last 12 months?	□	□
7. Have existing lenders expressed their intent not to renew existing loan agreements at their maturity date?	□	□
8. Did utilization on revolving credit exceed 85 percent of availability in the last 12 months?	□	□
9. Has the company violated the terms of its borrowing agreements or breached debt covenants in the last 12 months?	□	□
10. Is the company highly leveraged relative to industry competitors?	□	□
11. Has the company's debt credit rating been downgraded, or has its debt traded at a discount over the last 12 months?	□	□
12. Does the company expect to have difficulty meeting scheduled principal or interest payments?	□	□

Management/Organizational	Yes	No
13. Has there been significant turnover among the senior management team?	□	□
14. Is the institution's approach to problem-solving more reactive than proactive?	□	□
15. Has the company failed to produce a monthly financial plan (including projected income statement, balance sheet and cash flow statement) in the last 12 months?	□	□
16. Has the company failed to prepare a strategic business plan in the last 12 months?	□	□

Operations	Yes	No
17. Is there over-capacity in the community and the market you serve?	□	□
18. Has the organization lost market share to competitors in the last 12 months?	□	□
19. Is the company's technology lagging behind local competitors?	□	□
20. Have physicians, employees and patients cited a rise in problems with quality in the last 12 months?	□	□
21. Has the managed care/employer insurance payer class declined as a percentage of total revenue?	□	□

If you've answered yes to more than one or two of these questions, this may indicate that your company is experiencing financial and/or operational distress. We strongly recommend that you develop a proactive improvement plan — either on your own or with the help of an outside adviser.

Planning for the worst-case scenario: What now?

You've taken a hard look at your business and stress-tested patient revenue assumptions, but your fixed costs are such that even break-even cash flows are based on levels of revenue that may be hard to achieve. Your balance sheet is highly leveraged, and you are approaching the "zone of insolvency." Your short-term cash flow forecasts are negative, and you see a serious liquidity crisis looming in the near term. A payment is due on bank or bond debt, lenders are becoming increasingly concerned, and a default is imminent.

Don't panic. The credit crisis and economic downturn are impacting businesses across almost every industry and the entire credit spectrum, so you are not alone. Carefully consider strategic alternatives. Is raising equity an option? Are the state or local government units willing to provide emergency funding to make sure that needed health care is provided to your community? Are there potential buyers or merger partners? What are the advantages and disadvantages of restructuring a business through a bankruptcy? How do you determine the value of your business?

Look at your hospital or health system without its existing debt, and determine its debt capacity based on your most current realistic financial projections. There are two fundamental approaches to determining debt capacity: leverage multiples and coverage ratios. Both are highly dependent on market conditions. Lenders and debt investors also look at alternative exit strategies, including the liquidation value of collateral and tertiary sources of recovery such as personal guarantees.

Understand your bargaining position and your view on value. Consider your fiduciary responsibility. If you are operating in the zone of insolvency, consider your responsibilities.

Do not wait until you are nearly out of cash. Build cash reserves, and hire professionals who can help you assess your options. Don't assume the problem will go away over time. In most cases, doing nothing will cause value to erode rapidly. If possible, defer conversations with banks and bondholders until a full game plan is developed. Do not agree to provide additional collateral or a personal guarantee in exchange for covenant waivers until you have fully assessed your options.

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Looking ahead

The forces competing for quality patient care, patient access and affordability — combined with the uncertainties surrounding health care reform and a challenging economic environment — exert a tremendous amount of pressure on the health care industry. This pressure demands a back-to-basics approach that embraces sound business practices, which may have been ignored during earlier periods of growth and liquidity. Health care executives will want to be proactive in order to address issues and respond swiftly to warning signs. This means considering a range of strategic options and seeking help as needed from outside advisers, preferably before hospitals or health systems experience significant distress. Organizations that do so effectively will not only have a greater number of options and alternatives available to them, but also will be better positioned to capitalize on opportunities in the future.

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