Effective Long-Term Capital Planning for Non-Profit Institutions

Many small and rural community hospitals, private colleges and universities, senior living providers and other nonprofit organizations wrestle with how to manage construction and renovation projects that need to be completed to best serve patients, students, residents and constituents. Backlogs of deferred maintenance items – some of which may be unknown – can further complicate planning. The process can feel next to impossible when you consider ongoing discussions about how to add, renovate or replace emergency departments, rehab units, community areas, student centers, residence halls, academic buildings, expanded service buildings and other spaces in the current economic climate where reimbursements are low, demand is high, competition is fierce and capital dollars are stretched.

There are several steps institutions can take to plan appropriately:

- Create a plan that covers all necessary capital items – everything from buildings and technology to ambulances, library and text books, landscaping, road improvements and other moveable and fixed equipment.
- Identify what areas have deferred maintenance, which usually is a much larger amount than most organizations realize.
- Create a policy as to what type of asset gets funded with operating cash, contributions and capital campaign dollars, funded reserves and debt.
- Create an annual process for identifying capital projects, requesting funding, scoring all identified projects and allocating scarce resources to each project to ensure a mix of current and deferred projects are addressed.

Creating the Capital Improvement Plan and Prioritizing Needs

The first step is creating a capital improvement plan that assesses every long-term fixed asset residing on the organization's balance sheet. This should include a walk through with your facilities team and possibly your fixed asset schedules to determine the status of key items. This may be daunting, but is a necessary step. Some organizations can use internal staff to help with this assessment and engage outside engineers, architects or construction management firms to assist with the analysis on the large ticket items.

Every item on the plan should have a specific target date for replacement. For example, carpet and flooring every seven years, windows every 15 years, lighting fixtures every five years (energy-saving technology has improved greatly in recent years), roofs every 20 years, HVAC every 30 years, computers every three to four years depending on the user needs for improved technology, etc. Items that are often overlooked include assets such as parking lots, landscaping, interior streets, signage, bathroom facilities and internal decorations, such as art. The list should also include a cost-estimate for each project.

Once this plan is complete, prioritize needs based on factors such as safety and security, organizational mission support, energy and cost savings, revenue generation, expansion of consumer base or maintenance of market share and asset failure or damage costs.

A grid could be used to score each project on the list based on the criteria important to your organization. A number ranking can be applied to each need, such as 0 (not important), 1 (important) and 2 (critical or revenue-generating). The highest point projects would be funded first based on the available capital. Below is an illustration of a decision grid your organization might consider using on an annual basis to allocate capital. In this illustration, the dorm, HVAC and roofs would be the top three priorities assuming the organization had sufficient capital available.

	Wellness Center	Roofs on 3 buildings	HVAC	Phone system	New Dorm
Estimated cost	$15 million	$3 million	$2.5 million	$500,000	$20 million
Safety	0	2	2	0	1
Mission	1	0	0	0	1
Energy/cost savings	0	1	2	1	0
Revenue generating	1	0	0	0	2
Market share retention/growth	1	0	0	0	2
Failure/damage costs	0	1	1	1	0
Total Score	**3**	**4**	**5**	**2**	**6**

Another way to assess projects may be to group them into different grids based on new versus maintenance or routine capital items with similar or different criteria. This can vary by organization and is dependent on annual capital needs and funding levels.

Determining Available Capital
Capital is generated from annual excess operating cash, funded reserves, capital campaign dollars, contributions, leases, asset sales and the issuance of debt. At a minimum, targeting annual depreciation expense as a funding level for expenditures is a basic guide and implies an institution is at least reinvesting and keeping up with depreciation, a noncash expense, every year.

If a list of deferred expenditures is long, the organization most likely needs to access additional funds. We observe many organizations usually have a longer list than they realize in deferred items, since routine capital expenditures are the first to be delayed when the organization has a rough operating year. It is important for the long term success of the organization to continue to reinvest in the fixed assets to at least retain its viability and value.

Institutions should create a debt and capital funding policy which would identify what projects are funded from operating cash flow, contributions, capital campaigns, leases and debt. In regard to contributions or capital campaigns, funds are easy to raise for projects like academic buildings, pediatric wings, women's health centers, community centers and libraries. However, with these campaigns, donations are usually paid over time, so organizations need to set a percentage of gifts received in cash before starting projects and fund for future operating expenses related to any building project so assets can be self-sustaining in the future and not a burden on the operating revenue of the organization.

Funding projects from operating cash needs to be tied to the time period over which the capital will be funded. If just one year, then look to one year's worth of operating cash and if more than one year, use the sum of the two or three year time period as your base. For example, the organization might look at the following sums of capital to determine the net needed from debt over a three year spending cycle:

Operating cash	$3,000,000
Contributions in cash	$4,000,000
Cash from reserves	$2,000,000
Total available	$9,000,000
Project costs	$15,000,000
Difference = Debt	$6,000,000

Debt-funded projects may be identified as those which are revenue self-supporting such as dorms, dining halls, senior living facilities and hospital expansions or replacements and projects that can be completed in approximately 36 months. Organizations should plan to put some amount of equity into the project even if planning to fund with debt given the current lending environment and particularly if utilizing tax exempt private placement debt. Putting some equity into the project also lowers the amount of leverage the organization incurs.

Debt Policy
The debt policy should prescribe elements such as:

- Projects to be financed with debt and equity contributions required for each project
- Amount of maximum debt outstanding at any time based on key financial ratios such as debt to capital, cash to debt, and pro forma debt service coverage ratios that may or may not be tied to specific rating categories
- Allocation of fixed and floating rate debt tied to the organization's risk profile and investment mix
- Approvals necessary for new debt, including the passage of reimbursement resolutions
- Continuing disclosure compliance procedures
- Rating agency, investor, and lender reporting compliance
- Triggers for evaluating refinancing of existing debt such as minimum present value savings percentages
- Use of derivatives in connection with any debt or investment instrument; and,
- Monitoring and compliance of any counterparty risk such as bank and insurance company credit ratings

If all of the above items are considered when planning capital expenditures, organizations will have a more comprehensive approach to capital funding decisions and overall capital position. Additionally, the use of such policies and guides will create a more financially-solvent organization for the long-term.

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