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Three Steps to Effective Long-Term Capital Planning for Small/Rural Hospitals

By Tanya K. Hahn

Examining capital needs and sources and establishing policies can help small hospitals get a handle on capital management.

Many small and rural community hospitals wrestle with capital planning. In the current uncertain economic environment, it is simply a challenge to keep on top of construction needs, changing service line requirements, fierce competition, and other demands on capital.

Hospital leaders can overcome those challenges and develop a long-term capital plan with three important steps: create a plan that prioritizes needs, determine the available sources of capital, and establish a capital policy.

Create the Capital Improvement Plan and Prioritize Needs

The first step is to create a capital improvement plan that assesses every long-term fixed asset on the organization's balance sheet. This should include a walk-through with the facilities team and a review of fixed asset schedules to determine the status of key items.

Every item on the plan should have a specific target date and cost estimate for replacement. Here are some typical examples:

> 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 user needs for improved technology

Assets often overlooked include parking lots, landscaping, interior streets, signage, bathroom facilities, and internal decorations (for example, art in lobbies).

Leaders should then 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.

Many of the hospitals we work with find it helpful to use a decision grid (see the exhibit below) to annually score each project based on criteria important to their organizations.

Another way to assess projects is to group them into two grids: one containing new proposals and the other containing maintenance or routine capital items. The funding for each of these may come

A Decision Grid Helps Many Hospitals Decide Which Projects to Fund

	ED Renovation	Roofs	HVAC	Phone System	Radiology Equipment
Estimated cost	$10 million	$3 million	$2.5 million	$500,000	$3 million
Safety/regulatory	0	2	2	0	0
Mission	1	0	0	0	1
Energy/cost savings	0	1	2	1	1
Patient care	2	0	1	0	1
Revenue generating	2	0	0	0	1
Market share retention/growth	1	0	0	0	1
Failure/damage costs	0	1	1	1	1
Total score	**6**	**4**	**6**	**2**	**6**

Source: Robert W. Baird & Co. Used with permission.

A numerical ranking can be applied to each need, such as 0 (not important), 1 (important), and 2 (critical or revenue-generating), with the idea that the highest point projects will be funded first. In this example, hospital staff identified an emergency department renovation, HVAC replacement, and new radiology equipment as their top three priorities.

from different sources. If a hospital has not been funding routine maintenance items every year, the analysis may include catch-up expenditures for deferred maintenance.

Determine Available Capital

Capital comes from multiple sources, including annual excess operating cash, funded reserves, capital campaign dollars, contributions, leases, asset sales, and debt issuance. On the other side of the balance (see the exhibit below), capital is used for maintenance, infrastructure, renovation, and other demands. Rarely is the scale balanced.

However, at a minimum, hospital leaders should set the annual depreciation expense as a funding level for capital expenditures. This way, the hospital is at least reinvesting and keeping up with depreciation, a noncash expense, every year.

The 2013 rating agency median for annual capital expenditures in relation to depreciation expense is about 100 percent for BBB/Baa-rated credits. A-rated hospitals spend between 120 percent and 128 percent annually. These are good guidelines to use even if your hospital is not currently rated. They are viewed as positives by lenders or bond investors.

Establish a Debt and Capital Funding Policy

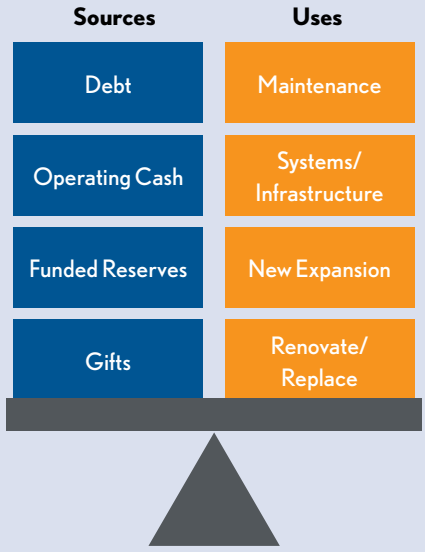
Hospitals should create a debt and capital funding policy that helps leaders make decisions in a number of areas, including how to identify which projects are funded from which sources, how much earmarked cash must be on-hand before a project commences, and how to set the time period for funding a project.

The source of revenue for a given project depends on the type of project. If the project is generating new revenue, the estimated net cash flow from that new project may be sufficient to repay the debt. If the debt is related to a project that might not produce cash flow but lends itself to charitable gifts, contributions might be used to repay the debt. Operating cash may be the debt repayment source for projects that enhance the appearance of the hospital or positively affect operations and create incremental cash flow over time.

Ideally routine capital expenditures are paid for with cash reserves set aside in an account such as funded depreciation. Many smaller hospitals do not use their depreciation expense to pay for such routine items, but it is a good practice.

The policy should also specify the percentage of a project's capital that must be on-hand before the project begins. This is important because donations to fundraising campaigns are usually paid over time, not all at once. The policy also

The Sources of Capital and the Demands on Capital Rarely Balance



Source: Robert W. Baird & Co. Used with permission.

Capital funding and expenditures rarely balance out. However, at a minimum, hospital leaders should set the annual depreciation expense as a funding level for capital expenditures.

Creating a Debt Policy

An hospital's debt policy should address 10 elements, including the maximum debt outstanding and definitions of key terms.

Any hospital contemplating debt should have a debt policy to guide decision making. Having this in place also keeps leverage in check as board members and key administrative personnel change over time and as credit markets evolve.

We have observed many smaller hospitals taking on debt without fully understanding the structure and risks of the debt, financial covenants required, flexibility to add more debt, or their ability to refinance or pay off the debt. And too often, the CFO is delegated the task of taking on debt, even if he is inexperienced in debt management or does not have the guidance of experienced outside advisors who understand the not-for-profit hospital setting and tax-exempt debt markets. Managing debt using a debt policy helps ameliorate such shortcomings and boosts the organization's financial standing, likely providing more access to capital.

- The debt policy should address the elements below and be reviewed at least annually at the board level and/or when the capital structure of the hospital changes due to additional debt, a large cash infusion, debt payoff, or change in strategic plans:
- Projects to be financed, including information about debt and equity contributions required for each project.
- Amount of maximum debt outstanding at any time and key financial ratios, such as debt to capital, cash to debt, and pro forma debt service coverage ratios.
- Allocation of fixed and floating rate debt tied to the organization's risk profile and investment mix or balance sheet strength.
- Approvals necessary for new debt based on dollar amount, including the passage of reimbursement resolutions at the board level.
- Definitions of key terms so that all parties understand the nuances. For example, it is important to define "variable rate debt" and explain what index drives the rate change and how often it changes.
- Continuing disclosure compliance procedures.
- Rating agency, investor, and lender reporting compliance procedures and checklists.
- Triggers for evaluating refinancing of existing debt, such as minimum present value savings percentages or minimum cash savings each year.
- Policies regarding the use of derivatives (swaps, caps, collars) in connection with any debt or investment instrument.
- Procedures for monitoring and compliance of any counterparty risk, such as bank and insurance company credit ratings tied to your lender or derivative provider.

Like personal financing options for a home mortgage, there are a number of debt options available to hospitals and each has its pros and cons. Implementing a comprehensive debt policy will identify the most sensible options for each hospital.

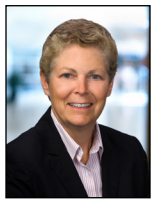
should specify that sources of future operating expenses related to a project need to be specified in advance, which ensures the burden on the hospital's operating revenue will not be unmanageable.

Another timing issue that the policy should address relates to the role of operating cash in project funding. For example, if a project is just one year in duration, one year's worth of available operating cash should be considered in the funding calculation. If the project will last more than one year, multiply the annual contribution to the project from operating cash times the number of years. For example, in this scenario, a hospital might look at the following sums of capital to determine the net needed from debt over a three-year spending cycle:

Operating cash	$3 million ($1 million per year)
Contributions in cash	$1 million
Cash from reserves	$1 million
Total available	$5 million
Project costs	$15 million
Difference = debt	$10 million

Secure a Solid Position

In closing, if all of the above items are considered when planning capital expenditures, small and rural hospitals can be confident they have been thorough in making capital funding decisions and securing a solid capital position. This diligence will ensure a more financially solvent organization for the long term, regardless of what external factors impact the hospital's operations.



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