

Capital Markets Update: The Current State of Healthcare Financing

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Panelist Contact Information

Shane A. Passarelli
Senior Vice President
Healthcare Finance Group, Inc.
333 S. Hope Street, 35th Floor
Los Angeles, CA 90071
O: 213-217-4301
F: 213-217-4310
C: 310-709-8699
spassarelli@hfgusa.com
www.hfgusa.com

Outline

**Part I – The Big Picture:
Industry Trends and Expectations**

Part II – Capital Markets

Part III – Strategic Financial and Capital Planning

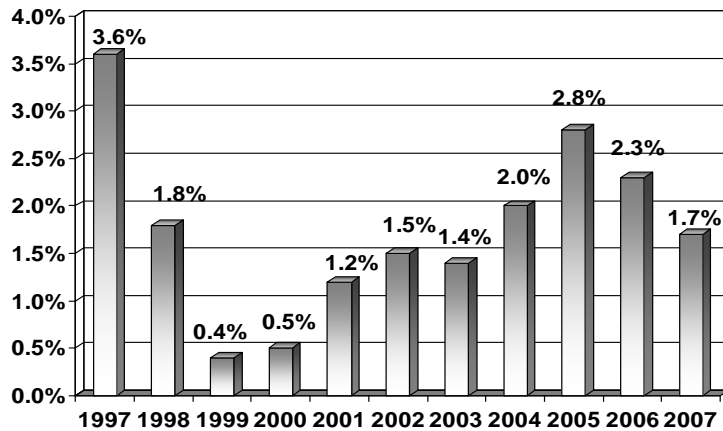
Supplemental Information

Part I:

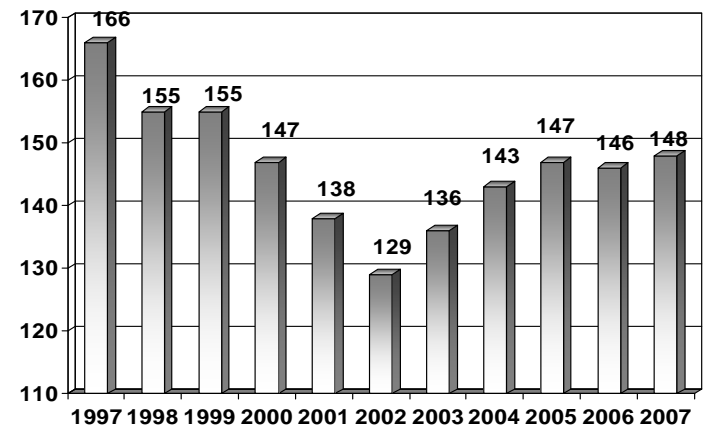
Industry Trends and Expectations

Industry Dashboard: What Industry Lenders See

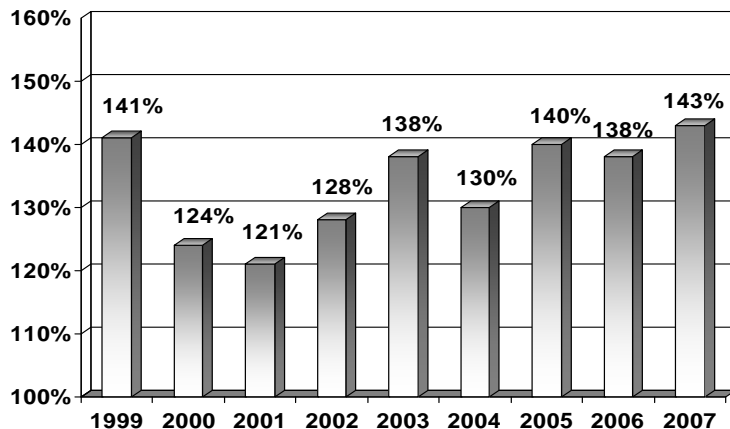
Operating Margin



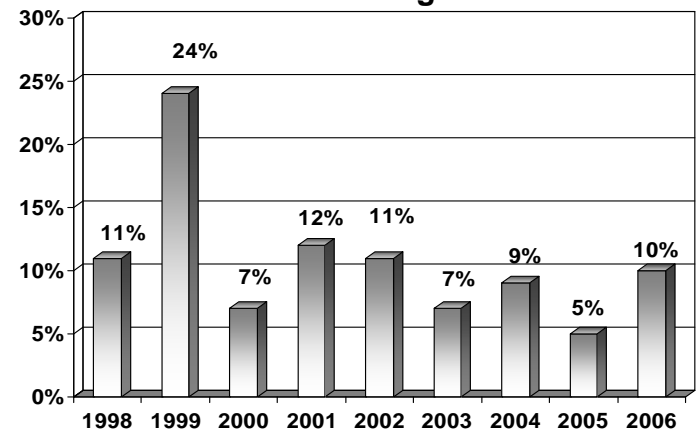
Days Cash on Hand



Median Capital Spending Ratios

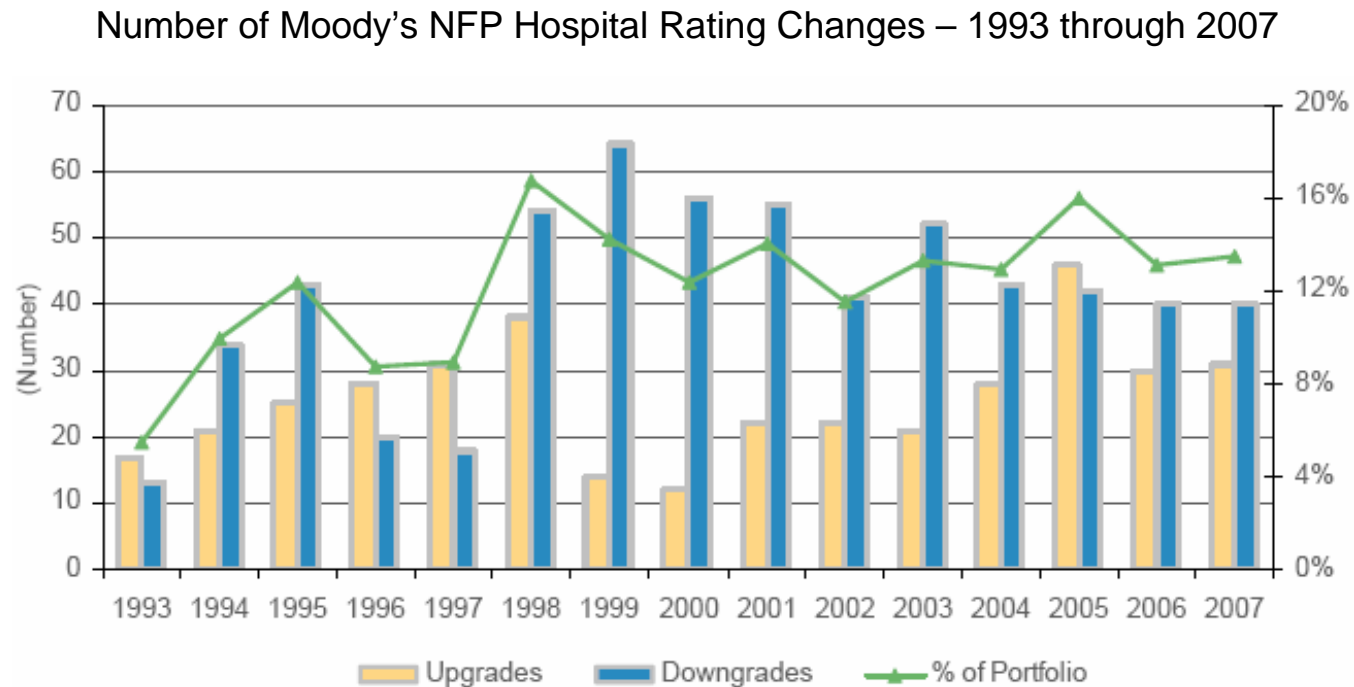


Median L.T. Debt Outstanding Annual Percentage Increases



Source: Moody's Not-for Profit Healthcare Sector: 2008 Industry Outlook

Credit Rating Downgrades Have Significantly Outpaced Upgrades Since 1998



- Moody's downgrades have exceeded upgrades in 11 out of the last 15 years
- 2005 was the first year since 1997 that Moody's upgrades outpaced downgrades; but in 2006 the negative trend resumed

What Keeps Sources of Capital Up at Night

- Primary drivers of insolvency:
 - ✓ Capital structure
 - ✓ Organization and governance
 - ✓ Revenue cycle mis-management
- Quality of earnings vis-à-vis other industries

Drivers of Insolvency: Capital Structure

- Liquidity (e.g., cash reserves, lines of credit, etc)
- Capitalization – balance sheet strength critical...razor thin margins (10%-12% EBITDA) in a capital intensive industry (5-7% CapEx every year)
- Match asset and liability funding – strategic capital planning (e.g., not the best idea to use working capital reserves to pay cash for new equipment)
- Death spiral once CapEx slows down or is shut off, **red alert for board members**

Drivers of Insolvency: Organization and Governance

Poorly Managed Hospitals: “Slow-Motion Train Wreck”

- Lack of performance-based incentives for executives
- Board disengaged due to no incentives
- Lack of singular point of accountability – “too many moving parts”
- Incremental change in isolation v. transparent wholesale change (thousand points of denial)

Strong Performing Hospitals

- CEO who gets paid well to do a tough job
- Clear accountability
- Correct board structures
- No blurred lines of ownership/incentives

Drivers of Insolvency: Revenue Cycle Mis-Management

- Started as improvement of accounts receivable collections rate
- Worked all the way back upstream to patient walking through the door
- Includes everything in between: registration, insurance (finding coverage), coding, billing, collecting
- Systems conversion and integration never go well, just hope that it's not a disaster

Quality of Earnings Issues vis-à-vis Other Industries

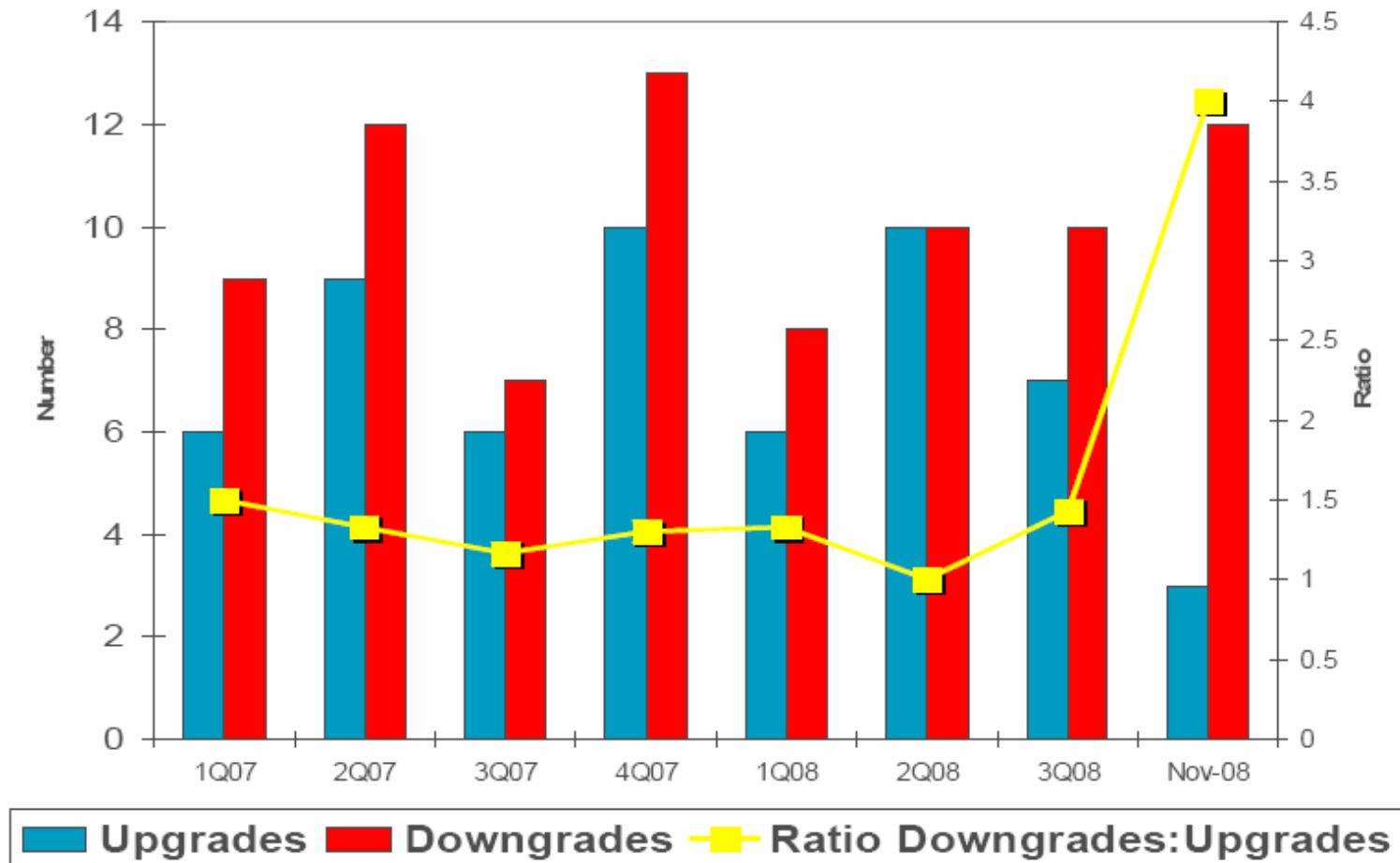
- Slow A/R collection cycle – average of 60-120 days vs. 30-60 days for most industries
- Enforceability of lien issues – in most instances cannot obtain a fully perfected lien on government A/R, only an assignment of the proceeds thereof
- Right of recoupment issues – payors can recoup past liabilities by offsetting future payments (e.g., Medicare cost report settlements)
- Contingent payments that require complex calculations (e.g., disproportionate share or risk pool calculations for capitated payments)

The Result:

Hospitals No Longer Perceived as “Safe Havens”

- Traditionally operated at low or near-zero default rates
- Regarded by investors as a “safe haven”....viewed by investors as an essential community asset and one of the largest employers in town
- Fundamentals of the borrower becoming more important than credit enhancements

4th Quarter 2008 Rating Activity (Through Nov 14th) Heavily Weighted Toward Downgrades



Moody's 2008-2010 Industry Outlook: Revised from Stable to Negative (November 2008)

Moody's last negative outlook on the sector was in 2004; outlook was revised to stable in 2005 where it has been until now.

Mid-year 2008: Stable outlook affirmed with caution

- Economic weakening
- Performance erosion for small to mid sized providers
- Volumes softening
- Access to capital restricting, absence of bond insurers

November 2008: Outlook revised to negative from stable

- Concerns of a deep and protracted recession
- Volumes showing further softening
- Access to capital even more limited

Moody's 2008-2010 Industry Outlook (November 2008)

Factors driving the three-year outlook include the following:

Negative Outlook:

1. Rising charity care and bad debt expense from economic weakening
2. Softening of discretionary patient demand
3. Reductions in Medicaid as state economies struggle
4. Likely reductions in Medicare funding
5. Tougher negotiations w/commercial payors as payor margin erodes

Part II:

Capital Markets

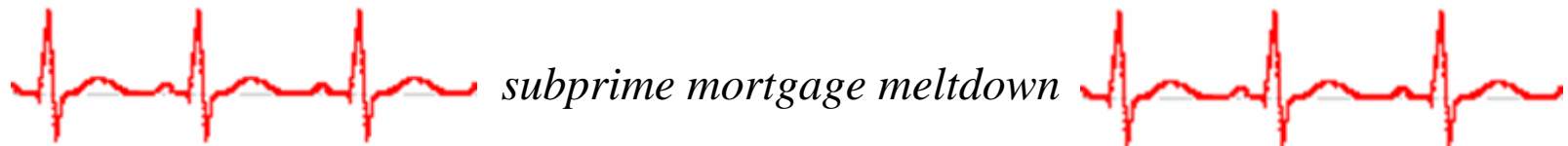
Subprime Mortgage Meltdown

[A]s the rising rate of delinquencies of subprime mortgages threatened to impose losses on holders of even highly rated securities, investors were led to question the reliability of the credit ratings for a range of financial products, including structured credit products and various special-purpose vehicles. As investors lost confidence in their ability to value complex financial products, they became increasingly unwilling to hold such instruments. As a result, flows of credit through these vehicles have contracted significantly.

-Chairman Ben Bernake, "The Economic Outlook," testifying approximately one year ago before the Committee on the Budget, U.S. House of Representatives

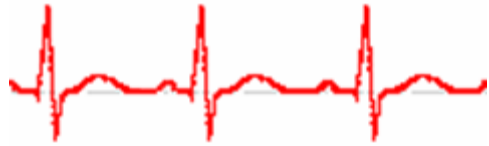
Pre-Credit Crisis

- Capital was abundant...relative demand-supply, lots of money v. few opportunities
- Competition for quality investments fierce among all asset classes
- Unprecedented era of credit stability
- Due to low levels of credit losses, debt sources 'pushed the envelope' relative to historical credit metrics, providing capital to less credit-worthy borrowers
- Hospitals traditionally identified as undervalued due to their complexities
- More dollars began to flow into the healthcare sector from nearly all sources due to lack of investment opportunities in other industries
- **Hospitals traditionally operated at a low or near-zero default rates and were easily insured by financial credit guaranty agencies such as MBIA or AMBAC**
- **Healthcare perceived as a safe haven due to its importance in the community as both a critical service provider and employer**

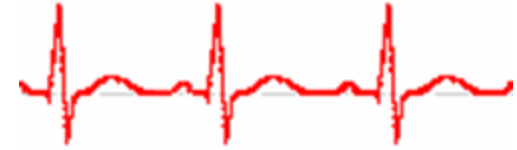


Array of Events Leading to Current Market

- ✓ Subprime mortgage meltdown; banks, bond insurers, investment banks, etc suffer massive losses
- ✓ Bond insurers were downgraded
- ✓ Bank failures rise (25 banks and thrifts failed in 2008 vs. three in 2007 and none in 2006 and 2005 according to the FDIC)
- ✓ Bear Stearns bail out, sold to JP Morgan
- ✓ Fannie Mae and Freddie Mac bailed out
- ✓ Lehman Brothers' bankruptcy
- ✓ AIG is bailed out
- ✓ Wachovia forced to merge with Wells Fargo
- ✓ Reserve Fund Money Market "breaks the buck"
- ✓ \$700 billion federal rescue plan
- ✓ Three automotive companies report several financial difficulties, request portion of federal rescue plan
- ✓ Bank of America and Citibank on the verge of failure



subprime mortgage meltdown

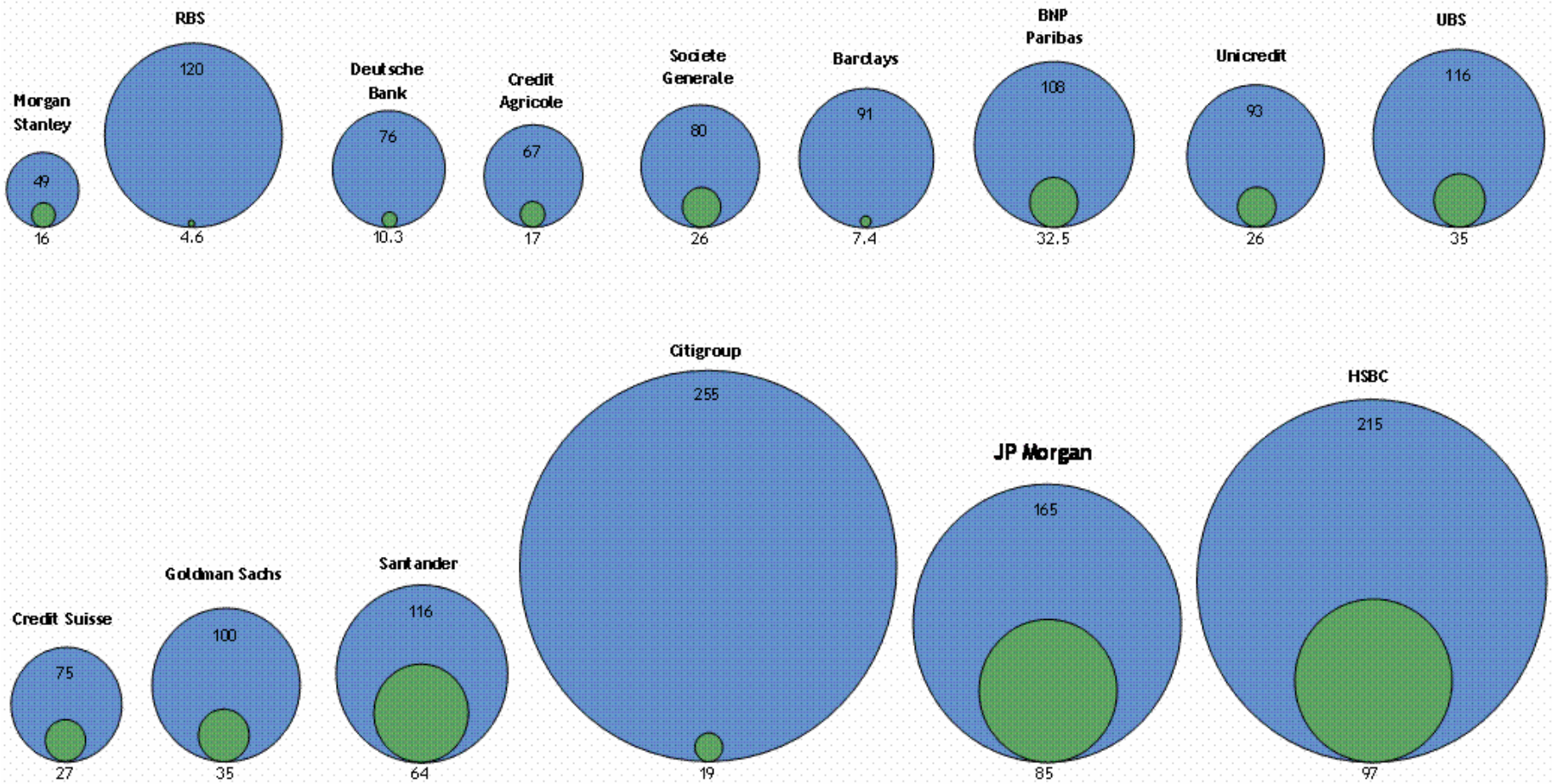


Current Market

- Capital – even from the most reliable sources – has evaporated
- Limited competition , even for quality investments
- Frightening deterioration of credit quality among banks and debt investors
- Bond insurers are facing massive losses due to the subprime mortgage market...compounding the problem for hospitals is an exotic class of securities known as Auction Rate Notes
- The news is much more severe for sub-investment grade and distressed hospitals
 - ✓ Few lenders – commercial banks and private equity firms all but have left the market, only a handful of specialty finance companies are actively lending, fewer REITs
 - ✓ Credit standards have tightened
 - ✓ Spreads have widened (200-500 bps)

Market Capitalization for Major Banks (or lack thereof)

- Market Value as of January 20th 2009, \$Bn
- Market Value as of Q2 2007, \$Bn



Bond Investors

- Limited appetite for non-investment grade and lower "BBB" rated bonds
 - Changing institutional investment policies – eliminating "BBB" and lower healthcare credits from many funds
- Relatively small universe of active institutional buyers (about 50-75 total accounts: only 30-35 most active and even less at the "BBB" or lower range)
- Tighter covenants but not unreasonable
- More security
 - "A" category debt service reserve funding (DSRF)
- Expanded reporting and disclosure requirements
 - Keeping score: Historical quality, accuracy and timeliness create a reputation (good or bad!)
- More frequent and direct institutional investor interactions
 - Investor calls both pre- and post-sale
 - They are also keeping score – better answer that call
- Good news: Still an active market for strong "BBB" and better bonds

Bond Insurers

- Uncertainty surrounding the “AAA” Bond Insurers is a bit of an understatement...Moody’s downgraded AMBAC and MBIA to junk status on 11/7/08
- For borrowers seeking bond insurance, expect:
 - Much higher degree of selectivity
 - Much higher and highly negotiated fees (135-250 bps +)
 - Much more restrictive and highly negotiated covenants
 - ✓ Focus on liquidity (65-90 days cash) and cash flow (1.10-1.35x coverage)
 - ✓ Debt-to-capitalization event of default (55% -70%)
 - ✓ Consultant call-in vs. default triggers
 - ✓ Greater limitations on asset transfers, additional debt, swap incurrence, etc.
 - Stronger security provisions and tighter definitions
 - ✓ Funded or springing DSRFs
 - ✓ Obligated group composition (corporate parent a must)
 - ✓ "Lock boxes"
 - ✓ Tighter cash definition and exclusions

Bank Letters and Lines of Credit

- Retreat by the commercial banks, especially the foreign banks (e.g., Credit Suisse, Dexia, German banks, etc.)
- Letters much more difficult than lines due to credit default exposure
- LOCs not considered a profitable business line by many banks
- Expect:
 - Higher degree of selectivity
 - Shorter LOC renewal terms (1, 3, or 5 years)
 - More restrictive and highly negotiated covenants and security provisions
 - ✓ Similar to bond insurer requirements, but sometimes more or different requirements
 - Explicit tie-in with other banking services (investment management)
- Much less use of LOC-backed VRDN structures
 - Problems noted above
 - "Uncommitted" structure
 - Increasing use of auction rate debt with insurance access

Direct Lenders

- Proliferation of options and high degree of specific engineering
 - Equipment loans and operating leases (e.g., GE) – taxable and tax-exempt
 - Developer funding / ownership projects (e.g., Lillibridge, AMDC, etc.)
 - Real estate investment trusts (e.g., sale-lease back or outright sale)
 - Still some usage of direct bank loans (bank eligible qualifications)
- Most "off-balance" structures are actually "on-credit" – no free lunch
 - Direct guarantees on debt or occupancy (master lease obligation)
 - Financial and perceived moral obligations
 - Know the capitalization rate (might be 10% to 14%+)
- Stay away from transactions you don't understand
 - If it sounds too good to be true . . .
 - Due diligence and full disclosure of all facts and risks are imperative
 - Watch out for very expensive and/or impractical unwind provisions

Implications for Borrowers

- Increased borrowing costs
- More security for debt holders
 - DSRFs, revenue pledges, “lock boxes”, etc.
- Inability to rollover or renew credit, acceleration of debt in instances of default
- Tighter bond covenants
 - Focus on liquidity and cash flow
- Instability in the credit enhancement market; more expensive and less available credit enhancement
 - Dislocation within the once highly rated bond insurers
 - Result: higher costs, more covenants and stronger security, limited supply
- Greater transparency through increased reporting and continuing disclosure requirements
- More frequent interactions with institutional investors, rating agencies, bond insurers, and banks

Part II:

Strategic Financial and Capital Planning

Key Questions Every Hospital Provider Should Be Asking (...and Credit Analysts Want to Know if You Know the Answers)

| | |
|-----------------------|---|
| Strategic Planning | How do we become or maintain the #1 or #2 market position in the primary service area? How much will it cost? |
| Financial Planning | Can we afford the strategic plan within an acceptable credit and risk context? What if we're wrong? Then what? Is it too risky? |
| Capital Allocation | How much should we spend? Are we spending in the right areas? What is the risk adjusted discounted cash flow return? Actual vs. planned project performance? |
| Capital Structure | What is the appropriate amount, mix, structure and cost of debt and equity? |
| Budgeting / Reporting | Do we have the tools and process to deliver a credible budget tied to your strategic financial plan? Is it practically achievable? Are we accountable for delivering results? What happens if we fall short? Then what? |
| Exit Rules / Options | Which services or facilities? Under what conditions? How? |

Why Does an Organization's Credit Position Matter?

❑ **Creditworthy Organizations Have Improved Capital Market Opportunities**

- ✓ Access to commercial banks (e.g., letters/lines of credit)
- ✓ Access to credit enhancement (e.g., bond insurance)
- ✓ Taxable or tax-exempt debt
- ✓ Access to flexible financing options
- ✓ Less restrictive bond document security provisions and operating covenants

❑ **Creditworthy Organizations Have a Lower Cost of Capital**

- ✓ Many institutional bond funds (typically 80%+ of the total investor market) are prohibited by their investment policies from purchasing "BBB" or lower rated debt
- ✓ Creditworthy organization's bonds trade at lower interest rates
- ✓ Lower issuance costs: insurance premium, letter/line of credit, underwriting/remarketing
- ✓ Avoidance of debt service reserve fund

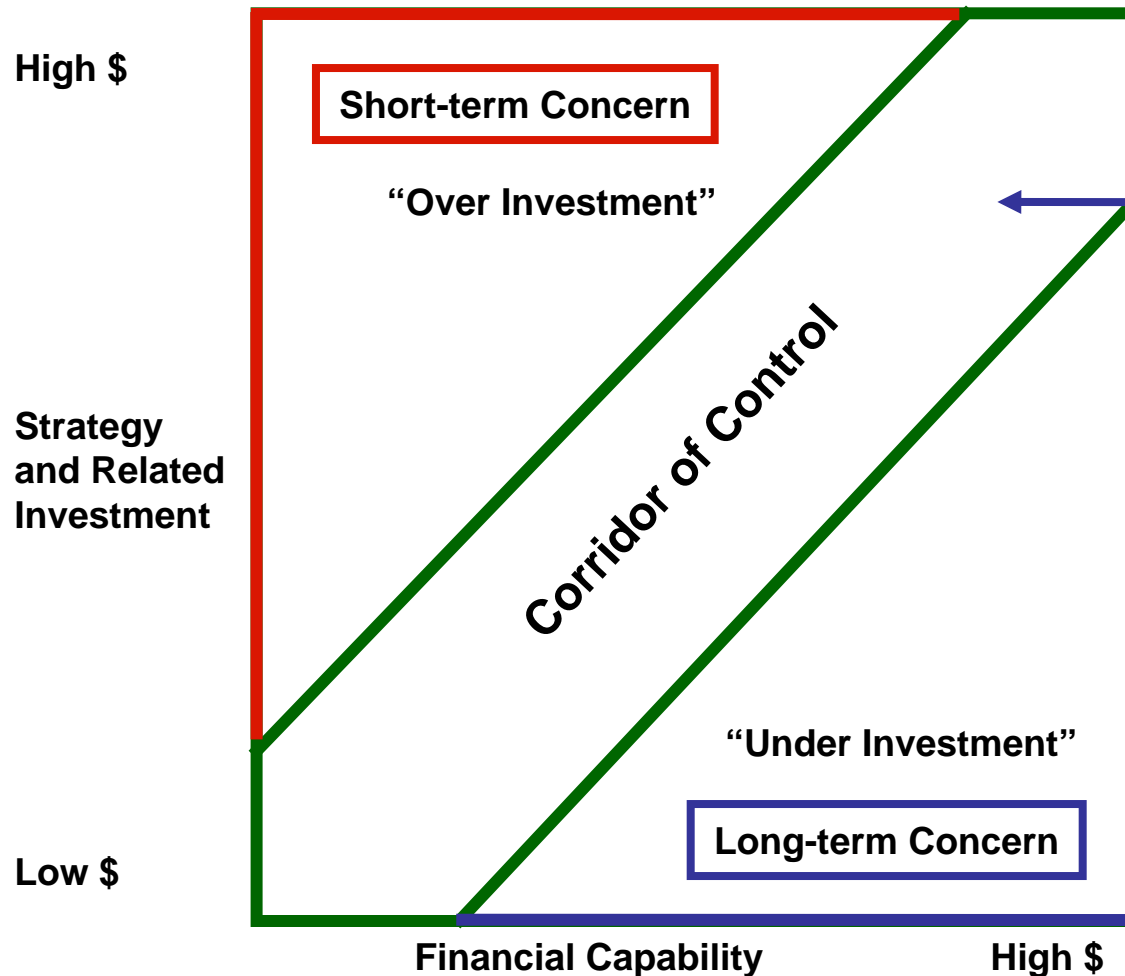
❑ **Creditworthy Organizations Are Market Consolidators**

- ✓ Nation-wide, organizations with the highest credit rating have shown the greatest ability and flexibility to react in the market

The Financial Plan Supports the Strategic Plan by Answering Seven Key Questions

- 1. How much cash (days cash on hand) should the Organization have?**
- 2. How much debt can the Organization afford?**
- 3. What are the Organization's capital requirements?**
- 4. What is the magnitude of the Organization's capital shortfall?**
- 5. What short- and long-term profitability targets are necessary to resolve the capital shortfall?**
- 6. What is the level of expense control or revenue enhancement, if any, required?**
- 7. Where is the capital going to come from in the short-term over the next two years: debt, operations, philanthropy and/or cash reserves and long-term?**

Integrated Planning Focuses on the Balance of Strategic Needs with Financial Capabilities



The corridor of control is the balancing point between two opposing goals:

1. Compete as effectively as you can, which requires aggressive investment of capital and commitment of operating dollars, BUT
2. Respect the fiduciary role of management and the Board to maintain the long-term financial integrity of a community asset.

What Is Capital Structure?

- Combination of debt and equity that funds the organization's strategic plans
- Internal debt vs. external
 - Internal sources include:
 - ✓ Operating cash flow
 - ✓ Existing liquid investments and cash
 - ✓ Non operating cash flow (philanthropy, government subsidies, investment income / earnings) and divestiture of marginal assets
 - External sources include debt instruments

External Capital

Access to external capital is an essential resource for all competitive providers. There is no hospital that can fund its long-term growth strategy solely from reserves or even a combination of reserves and operating cash flow.

Supplemental Information

Definition of Financial Ratios

Profitability / Cash Flow Ratios

$$\text{Operating Margin:} \\ \frac{\text{Operating Income}}{\text{Total Operating Revenue}}$$

$$\text{Excess Margin:} \\ \frac{\text{Operating Income} + \text{Non-operating Revenue}}{\text{Total Operating} + \text{Non-operating Revenue}}$$

$$\text{Operating EBIDA Margin:} \\ \frac{\text{Operating Income} + \text{Depreciation, Amortization and Interest}}{\text{Total Operating Revenue}}$$

Debt Ratios

$$\text{Historic Debt Service Coverage:} \\ \frac{\text{Excess Revenue Over Expenses} + \text{Interest} + \text{Dep} + \text{Amort}}{\text{Annual Debt Service}}$$

$$\text{Capitalization Ratio:} \\ \frac{\text{Long-Term Debt}}{\text{Long-Term Debt} + \text{Fund Balance}}$$

Liquidity Ratios

$$\text{Days Cash on Hand:} \\ \frac{\text{Cash \& Marketable Securities} + \text{Board Design. Funds}}{((\text{Total Operating Expense} - \text{Depreciation}) / 365)}$$

$$\text{Cushion Ratio:} \\ \frac{\text{Unrestricted Cash}}{\text{Maximum Annual Debt Service}}$$

Other Ratios

$$\text{Cash to debt:} \\ \frac{\text{Cash \& Marketable Securities} + \text{Board Design. Funds}}{\text{Long-Term Debt}}$$

$$\text{Average Age of Plant:} \\ \frac{\text{Accumulated Depreciation}}{\text{Annual Depreciation}}$$

Shane Passarelli, Healthcare Finance Group

Shane Passarelli is a Senior Vice President with Healthcare Finance Group, Inc. (“HFG”), a NY-based commercial finance company that provides senior credit facilities exclusively to the healthcare industry. Mr. Passarelli founded HFG’s Los Angeles office and has established a west coast franchise for the company. Prior to HFG, Mr. Passarelli originated and structured senior secured asset-based credit facilities for GE Healthcare Financial Services, providing working capital to middle-market healthcare companies on the west coast. Prior to HFG and GE, Mr. Passarelli executed middle market junior secured lending transactions for Ableco Finance LLC (“Ableco”), a special situations hedge fund affiliated with Cerberus Capital Management, L.P. (“Cerberus”). His primary responsibilities at Ableco were underwriting, structuring, and providing loan monitoring and workout subsequent to closing. Mr. Passarelli has been responsible for the sourcing, structuring, underwriting, or closing of over \$6 billion in senior and subordinated debt transactions in his career. His primary area of expertise remains structuring complex transactions, with situations ranging from leveraged buyouts, recapitalizations, growth capital, transitional capital such as refinancings and bridge loans, Chapter 11 reorganizations including debtor-in-possession and exit financing, out of court debt restructurings, bond defeasances, and turnarounds.