Recapitalization in the Healthcare Industry: We’ve Only Just Begun

By Wiley P. Kitchell
Managing Director
Moss Adams Capital LLC

The extraordinary impact of the ongoing national economic crisis has profoundly affected most sectors of the healthcare industry. Today one of the major issues confronting mid-size hospitals, and other investor-owned or not-for-profit facilities, is the ability to identify sources of reasonably priced, and structured, debt and equity capital. This financial constraint includes equity and debt for new capital projects or to help strengthen current balance sheets; debt to refinance and extend the maturity of bonds or other outstanding senior debt; and even the level of capital needed to support the continuation of operating lines at their current levels.

As the economic landscape has shifted dramatically, it is increasingly important for senior healthcare professionals to understand as many of the available financing options as possible. In many cases, the choice and availability of financing options is now a leading factor in a healthcare company’s long-term strategic planning process.

The Financing Landscape has Shifted

Prior to the middle of 2007, capital was readily abundant and healthcare facilities of all types were characterized by large investments in buildings and related medical equipment. With ready access to cheap capital, the operators of healthcare facilities were able to easily separate their strategic planning and strategic decisions, from the relatively simple task of raising capital.

Limited Access to Capital Threatens Quality of Care

During the past eighteen months, many healthcare facilities encountered tightening credit and restricted access to capital. Over the short term, most companies were able to survive by tightening their spending, cutting back on capital investments and using up their reserves. Today the recession is lowering patient counts and causing people to defer their care. Eventually quality of care will decline in those facilities that are not able to secure additional capital.

Tough Conditions will Persist

In March, Moody’s Investors Service predicted that investor-owned hospitals will continue to deteriorate financially throughout 2009. Moody’s cites problems with the economy, lower patient volumes and growing bad debt costs. And in July, Moody’s lowered credit ratings for not-for-profit hospitals and health systems for the third consecutive quarter. Factors that contributed to the downgrades include weak operations, dwindling cash reserves and looming maturities of debt.

Most not-for-profit hospitals and facilities rely upon variable-rate bonds that depend upon local banks for underlying guarantees. Now weakened banks either can’t maintain credit ratings, or won’t renew their letters-of-credit. Without the credit support, the healthcare facilities are threatened by rising interest rates.

Know the Alternatives

When facing the decision of refinancing or recapitalizing, it is critical to identify all available alternatives and to then clearly analyze each option. In the shifting land-
scape, non-traditional sources of capital will emerge and, in many cases, may offer strategic advantages to the professionals who are first to embrace the new sources. Some alternatives include:

- **Government funding and support.** There will continue to be government support for debt financing, and this will be an important financing alternative. For example, the federal government is trying to make it easier for not-for-profit hospitals to refinance their tax-exempt debt by relaxing certain HUD requirements. With HUD insurance, a facility may be able to refinance debt as long-term bonds with fixed interest rates.

- **Private debt.** In addition to banks, there are numerous sources that provide both short-term and long-term debt.

Looking beyond the banks and understanding the criteria and attributes of each form of debt is an important step in evaluating alternatives.

- **Private equity.** Healthcare has always been an attractive market for private equity investors. Today some private equity firms are broadening their reach into investor-owned and not-for-profit facilities and healthcare projects. In the future, private equity offers a unique ability to participate in the recapitalization of select healthcare systems.

- **Existing debt presents an M&A opportunity.** When a seller has assumable debt, and a buyer does not need to obtain new financing, there is an opportunity to approach strategic buyers. If the debt is in place and has a known interest rate, a buyer can approach the potential acquisition more aggressively, than if financing is uncertain.

**Plan Ahead. Be Prepared.**

There are huge debt balances supporting thousands of mid-size hospitals and health facilities in the Northwest. Refinancing and recapitalizing these organizations is a significant challenge. The decision is strategic, and business models will adapt to the capital that is available. With such important consequences, adherence to a rigorous corporate finance process is critical to a hospital or health system’s ability to access capital.

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Mr. Kitchell is a Managing Director of Moss Adams Capital LLC. He has more than 20 years of investment banking experience working with privately owned...
companies headquartered in the western United States. He commenced his investment banking career with Goldman Sachs, in New York. Mr. Kitchell received a B.A. degree in Economics and Anthropology from Duke University, and an MBA in Finance from Northwestern University. Contact Mr. Kitchell at wiley.kitchell@mossadams.com.