BYPASSING BOND INSURERS PAYS OFF

A small Texas hospital builds a new facility and stays independent through HUD 242-backed financing.

Bond insurers started imploding last summer when the economywide credit crisis hit. Used as a tool to buy higher credit ratings for borrowers, most bond insurers had overextended themselves by placing gilt-edged ratings on bonds that deserved nothing of the sort. When it became clear that bond insurers might actually have to pay out on some of these bonds, many bond insurers stopped taking on further risk, leaving hospitals in need of financing in a quandary: Bond insurance wasn't available for any price.

Many hospitals shelved their expansion or replacement projects in light of the trouble. But not 66-staffed-bed Matagorda County District Hospital, a Level III trauma center with a six-bed ICU. Instead, the hospital's leadership undertook the seldom-used but growing FHA-242 mortgage insurance program made available by the Federal Housing Administration to allow nonprofits a vehicle to obtain federally backed bond insurance.

Like many small independent hospitals, Matagorda was caught in a difficult situation. Located about 70 miles southeast of Houston, the hospital sits in a county with one of the highest unemployment rates in the state and boasts a financially unenviable elderly service mix. Further, Matagorda's inpatient payment mix—70% Medicare, 10% Medicaid, 13% commercial, and 7% self-pay—would make most chief financial officers turn the other way, says Matagorda CFO Bryan Prochnow, who, along with CEO Daryle Voss, are employees of hospital management firm QHR, which manages Matagorda under contract. The problem: The hospital was woefully outdated—the original facility was built in the 1940s and was updated in the '60s and '80s—and faced severe competition from a big city to the northwest littered with world-class academic medical centers. Something had to give.

"We had no preconceived ideas," says Voss. "We thought we would tear down the building built in the '40s and hoped we could pull off a $10 million tower in its footprint. But as we brought in some engineers, that was a big wakeup call. We needed to spend that much just to fix the pipes in the rest of the hospital."

THE DEAL

Building and associated: $36.7 million

Equipment: $4.6 million

Debt refinanced: $3.3 million

Other collateral contributed by hospital: $8 million through taxing authority

Total cost: $54 million

After the hospital's leadership team completed a master facility plan, pressure grew. Some local officials said the hospital, which has local taxing power, should be sold to a for-profit operator that promised a new hospital in the deal and elimination of the local tax.

"It was tough," says Voss. Estimates for a five-year refit of the existing facility were $35 million, while building an entirely new hospital on a greenfield site was $36 million. That was all well and good, but was more than a hospital that makes little operating margin could swallow under normal conditions.

"When any hospital has minimal amount of debt and marginal profitability and then incurs a large debt financing, debt service can be a major challenge to the credit rating," says Alan P. Richman, president and CEO of InnoVative Capital, a Pennsylvania-based banking and financial advisory firm retained by the hospital to help it get the best possible financing deal on the new hospital. "Ratios go out of whack when looking at financing through that prism. It is hard to see any investment-grade credit rating." The hospital had a relatively good cash and leverage position, but it doesn't make much money through operations. Given the credit crisis bond insurers found themselves in, buying traditional insurance wasn't an option. And board members, despite the local pressure, were resolute that the hospital should remain independent.

InnoVative, acting as the mortgage banker and originating mortgagee, structured, underwrote, and secured Section 242 mortgage insurance from the U.S. Department of Housing and Urban Development for a $46 million tax-exempt bond issue to build the new Matagorda General Hospital. At the time bonds were sold, Matagorda had a AAA rating because the bonds were guaranteed by HUD. Further, because of the guarantees, the bonds were oversubscribed by buyers searching for super-safe investments amid the bond market meltdown, allowing the hospital to achieve a low 4.74% interest rate over the life of the bonds. Further, contrary to some who shun 242 financing because of the perceived bureaucratic hurdles that must be cleared, financing was obtained in nine weeks from the time Matagorda filed its application with HUD.

Construction for the 118,000-square-foot hospital started in August 2007, and it will open for business in September 2009.

"When the bond market was going to hell in a hand basket, there was a flight to quality among potential bond buyers," says Richman. "We went to market with a pristine AAA bond rating."

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