CREDIT ANALYSIS AND FINANCIAL FEASIBILITY: ASSESSMENT AND EXECUTION

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An organization's credit and financial situation are crucial factors in determining the viability of a new project. While all organizations have some sense of both, many would benefit greatly by applying more rigorous methods to their credit analysis and financial feasibility. Observing best practices in both areas can lead to a smoother transaction in a variety of situations.

Top Ten Credit Analysis Factors

When an organization approaches a credit analysis, it is important to gauge multiple factors without prioritizing any of them. That is, strengths in one area may offset weaknesses in another area, whereas some severe weaknesses may overwhelm all other factors, making the positives moot. As such, the best approach is a holistic one that considers all ten factors below with equal diligence and thoughtfulness.

1. Financial Operating History. Generally, three to five years of audited financial statements are necessary for an accurate credit evaluation, which will include margin, trend and debt service coverage analyses. Stable or growing profitability from operations is desired with minimal reliance on non-operating revenues to meet the ongoing and routine capital needs of the organization. Significant deviations from year-to-year performance or within specific accounts will need to be addressed. Non-operating revenues evidencing community support (either tax-supported or charitable contributions) are viewed favorably.

2. Financial Position. Particular attention is given to liquidity and capital structure. Highly leveraged organizations will be perceived as being a higher credit risk, while organizations with little or no liquidity will be viewed negatively even in the absence of long-term debt. Facilities with balance sheet liquidity will be assessed to determine the scope of investment policies and adherence to them. Investment strategies that produce more consistently stable returns will be preferred. The quality of accounts receivable will be reviewed by aging and payor source, as will the organization's procedures for accounting of contractual allowances, bad debt allowances and write-offs.

3. Financial Feasibility. Financial projections will be important for those projects that may substantially impact revenues or expenses. Underlying feasibility

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assumptions will be reviewed against historical operating metrics, and substantial variances between the two will need to be well supported. Following best practices for financial feasibility studies can be helpful.

4. Organization Background. The organization's history and length of service to the community will be evaluated. Industry experience and tenure of key management personnel will also be considered. Evidence of proactive efforts to address facility challenges or opportunities is a plus. The educational and professional background of board members will also be reviewed, with a diverse make-up and active participation in strategic initiatives viewed positively.

5. Utilization. A three- to five-year historical review of utilization metrics by service line will be conducted with stable or growing trends viewed favorably. Adverse utilization trends will need to be addressed by management with plans to improve market share or implement facility downsizing.

6. Payor Mix. The payor mix will be reviewed over a similar period to identify favorable or negative trends. High percentages of residents using private pay resources are considered most favorable. It will also be important to review the history of support from Medicaid, Medicare and other sources for the program and financial viability going forward.

7. Physical Plant. The age and physical and functional obsolescence of the facility will be considered along with any plans for improvement. Projects involving rehabilitation of existing structures will need to demonstrate a plan to minimize disruption to operations. Construction risk due to potentially rising construction costs and change orders will need to be minimized through contractual arrangements and/or adequate balance sheet reserves.

8. Market Area Characteristics. The site of the existing or proposed facility will be evaluated for ingress/egress, opportunities for expansion, marketing visibility, proximity to ancillary services and profile of the surrounding community. The primary and secondary market demographic and socioeconomic characteristics will be evaluated to determine opportunities for profitable growth. The market share of the organization versus competing area organizations will be determined as well as comparisons by size, physical plant and service lines.

9. Litigation History and Claims Exposure. A review of historical and pending claims as well as management plans to mitigate future claims will be conducted. The types and amounts of liability coverage will be reviewed to determine adequacy to meet pending or potential future claims.

10. Collateral. The type, amount, and quality of security that can be provided to creditors (bond investors or lenders) will be evaluated in light of other credit characteristics. Priority revenue pledges will be preferred, as will first lien mortgage and security interests in real estate and personal property of the facility. Parity security interests with other creditors will be viewed less favorably, although not as poorly as subordinated lien positions.

Best Practices for Financial Feasibility

The basic purpose of a financial feasibility study is to determine if a project will be viable for an organization or business. Finding the best answer will depend on commissioning the appropriate level of analysis for the project. The three types of financial feasibility studies, from lowest to highest complexity, are forecast, compilation and examination. A financial forecast may only include a basic cash flow analysis and can be completed by a consultant or management company. Higher levels, such as a compiled or examined report, will include more detailed reviews of operations and market demographics and are completed by certified public accountants. Keep in mind that the higher degree of analysis, the more costly the study.

Additionally, the type of financial feasibility study may be determined by the preferred debt financing structure. For example, the senior housing mortgage insurance program via the U.S. Department of Housing and Urban Development (HUD) relies on appraisals, which can use information from financial forecasts. Alternatively, the U.S. Department of Agriculture (USDA) offers financing programs that generally rely on examined analysis. Also, tax-exempt bond interest rates may be lowered if a compiled or examined assessment is included with the bond offering documents. For borrowers and their investment bank, a higher-level feasibility study can be cost effective.

Regardless of the level of analysis, a financial feasibility study should act as a business plan and provide clarity and purpose. By pulling the pieces of the project puzzle together, it should allow the steps that follow—financing applications and architecture work—to be undertaken with less wasted investment in unwarranted projects.

The Big Five Best Practices

A hospital is approached by a community task force requesting a new outpatient clinic on the opposite side of town. A nonprofit nursing home recognizes a county's senior population can benefit from an assisted living housing option or perhaps a for-profit operator wants to add memory-care units to existing locations.

These are some common projects under consideration around the nation. As discussed, providers ideally will begin a financial feasibility study to carefully assess risk and opportunity. The following are five best practices for organizations and businesses to pursue:

1. Conduct a Debt Capacity Study.

The first step, before commencing with a financial feasibility study, is to conduct a debt capacity analysis for the organization or business. Much more limited in scope than a full financial feasibility study, a debt capacity analysis will assist management in identifying key financial benchmarks necessary for long-term, sustainable success.

Will an organization's balance sheet provide sufficient liquidity—cash and investment reserves? New projects often require significant working capital, whether to fund initial training or to fund operations during lease-up. These project funding needs generally cannot be financed, and ample alternative sources must be available. A debt capacity analysis will not answer all the necessary project questions but will help establish a framework for more detailed analysis.

2. Identify Key Service Lines.

While a project often represents new opportunities, it is just as important to identify those service lines that an organization may need to discontinue. Service line goals are critical because, whether adding or subtracting, the result will be organizational change. The question for providers is whether patients/residents, staff and the community are prepared for the necessary adjustments.

For example, many community hospitals would like to expand their offerings of surgery and orthopedic services. But are staff prepared for the necessary training and outside assistance to make the goal achievable? Furthermore, is a community prepared to make a necessary trade-off, such as divesting a costly nursing home to provide the cash flow necessary for an emergency room modernization?

Projects are exciting, but managing change can be complicated and time consuming due to the sheer number of people and processes that may be affected. Smart providers recognize this early in the financial feasibility process and make the necessary accommodations in the change management process.

3. Establish a Coordinated Timeline and Stay Connected.

With project parameters and goals determined, an organization should have its financial feasibility advisor, project manager and lender at the table to help outline the timeframes and deadline dates for different steps in the project. The project timeline will involve a number of parallel project tasks, some of which are completely independent and some of which may not begin until a previous task is complete. Therefore, regularly scheduled meetings help keep all parties informed along the way and avoid unnecessary time delays.

Often with new construction, for example, a first step is to identify how long it will take to secure the necessary land. Once that is done, the length of the architectural and construction contract process must be determined, ideally with reasonable expectations for design iterations and, as necessary, value engineering. Overlaying the whole project is securing funding, the timing of which will be determined by the desired financing structure. To avoid delays and additional expense, a financial feasibility study should be pursued in conjunction with the overall project timeline.

4. Build Realistic Revenue Projections.

Successful projects are built around a careful examination of the demographics and utilization information that will support the financial feasibility study's revenue projections. With limited budgets, it is important that providers concentrate on projects with the greatest revenue potential.

Assessing senior housing demand has become fairly formalized over the past several decades. Although there can be local variables to consider, the key is being honest about the number of income-qualified senior households, as well as likely utilization and penetration rates.

Hospital organizations, on the other hand, are facing more moving targets than ever. It is extremely important to understand the demographics of your primary service area, and how those demographics will change over the next five to ten years. Advancements in medical technologies continue to shift more business to the outpatient setting, and the services provided in the inpatient setting are requiring shorter inpatient stays. Understanding demographic and utilization changes helps develop projected volumes, which ultimately leads to more accurate and realistic revenue projections. A financial feasibility study may not be a crystal ball, but it should offer careful analysis of these issues.

5. Recognize Staff as a Key Expense.

Salaries and benefits typically represent almost 50% of an organization's operating expenses. Burnout and turnover are constant employment discussion topics, especially in the health care industry. Organizations often plan to hold to their full-time employee (FTE) level, noting that the project efficiencies will allow them to achieve the desired result; however, they fail to consider that the number of FTEs tend to increase because existing service lines do not immediately change. Additionally, as the health care environment continues to focus on value, newer positions for data analysts, care coordinators, and patient navigators are at a premium. Successful organizations continue to invest in their staff and understand the appropriate departmental benchmarks to make timely project and operational adjustments.

The Pitfall of Delay

The most common pitfall with financial feasibility studies is simply not having your financial advisor or lender involved in the early stages of planning. Unfortunately, it is not unusual to see a capital project that has been through the planning, design or project approval phases that has had either no analysis or the appropriate level of analysis completed on the financial feasibility of the project.

As a result, unreasonable expectations may be set with stakeholders, such as patients/residents, board members, employees and even the community. Whether promising that major organizational changes can be avoided, underestimating the necessary amount of capital or projecting unrealistic timelines, a financial feasibility study should help an organization or business avoid these mistakes that can lead to losing hard-earned support.

Even if support for a project is particularly strong, a late start on a financial feasibility study often leads to rework of the design, delays in construction and organizational issues. While better late than never, all of the delays associated with a tardy study inevitably add project costs and lead to missed market opportunities.

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About Lancaster Pollard

Lancaster Pollard Mortgage Company, a division of ORIX Real Estate Capital (OREC), helps seniors housing and health care providers expand and improve their services by delivering financial advice and financing solutions. Lancaster Pollard, together with its affiliates, offers a full range of investment banking, mortgage banking, private equity, balance sheet financing and M&A advisory services. OREC is a Fannie Mae DUS®, Map- and Lean-Approved FHA, and Freddie Mac OptigoSM Small Balance lender. OREC is headquartered in Columbus, Ohio, and is a wholly owned subsidiary of ORIX Corporation USA. The OREC companies have financed approximately $100 billion in total transaction amount and originate $6 billion annually, with a servicing portfolio over $25 billion. The company has approximately 330 employees in offices nationwide. Securities, investment banking and advisory services provided through OREC Securities, LLC. Member FINRA/SIPC.

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