

Tight Capital Market's Impact on Hospitals

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Over the past 24 months, world economies have been stressed by a surge of economic challenges which originated in the United States. The result has been historic gyrations in the credit markets, with nearly every type of nonfinancial industry experiencing difficulty obtaining capital to fund their businesses. The hospital and health care sectors, while often viewed as anti-cyclical businesses, have not been immune to the operational and financial realities of the present economic environment.

In recent years, many nonprofit (tax-exempt) hospitals tailored their capital structures to include a mix of debt obligations, including fixed and variable rate debt. Fixed rate debt is much like a home mortgage in that the terms and cost of the debt over the entire payback (usually 30 years) is locked in at closing. Variable rate obligations, however, while also long-term borrowings of up to 30 years, are structured to have the rate reset on a regular basis (usually daily or weekly)—thus enabling the hospital to borrow long-term money with short-term interest rates.

Most variable rate structures, like auction rate securities and variable rate demand bonds, utilize credit enhancement from a bond insurance company or commercial bank to gain a high rating on the bonds and provide liquidity to short-term investors. Unlike fixed rate debt, variable rate debt credit enhancement must continually be maintained or renewed over the 30-year life of the borrowing—opening borrowers up to the ongoing credit risk. The financial management of a hospital capital structure has been made very difficult lately because many hospitals are finding themselves unable to access capital at a reasonable cost while at the same time their existing variable rate capital structures are impaired due to credit downgrades with bond insurers, commercial banks, or interest rate swap counterparties.

Due to a lack of liquidity in the fixed rate tax-exempt market in late 2008 and early 2009, hospitals were unable to borrow. Although the market is now thawing so that an "A" rated hospital can borrow at a 7% interest rate for a 30-year loan (compared to less than 5% two years ago), it remains to be seen how thoroughly the markets will thaw for

lower-rated hospital credit. In addition, the fees that banks are charging for letters-of-credit associated with variable rate debt structures have doubled or even tripled in cost.

The takeaway from this is that the increased cost of capital has caused some hospitals to delay capital improvement plans due to the expense. Hospitals that made major improvements to their facility prior to the credit market disruptions will have a competitive advantage over hospitals that will have to raise capital in the current market environment. In addition, hospitals with stronger credit profiles will have easier access to capital than hospitals with weaker credit profiles. Weaker hospitals are therefore seeking nontraditional sources of capital including HUD 242 Loans, Federal Home Loan Bank Loans, and Bank Qualified Loans, which became more available as a result of the recent stimulus package passed by Congress.

At present all three major rating agencies (Moody's, Fitch, and Standard & Poor's) have negative outlooks for the hospital industry. In fact, 81% of all credit rating downgrades by Moody's Investors Service in 2008 were for hospitals rated Baa1 or lower, a category that generally includes stand-alone community hospitals and rural hospitals. Interestingly, 74% of all Moody's credit rating upgrades were for hospitals rated A or Aa or better, which typically includes dominant-market leading community hospitals and tertiary hospital systems.

The credit gap is widening between strong and weak hospital credits, and the cost differential of capital between the two is causing the gap to widen further. The pivotal event that causes smaller hospitals to seek a partner is a lack of access to capital. Therefore the current capital squeeze will accelerate consolidation in the industry through mergers, acquisitions, and closures. Just like the rest of the United States, North Carolina will see a significant increase in system affiliation.

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Stock market declines translate directly into loss of reserves. Our reduced amount of reserves has the compounding effect of making us a less attractive borrower and limits our future capacity to invest in ourselves.

The UNC HCS's debt has remained remarkably stable for several reasons. First, we hold types of debt that have not had increased interest rates. Second, because we came into the recession with financial strength, we are still not seen as a high risk. Third, we are not yet seeking new debt.

Many other institutions have been less fortunate. Bond rating agencies have downgraded the debt held by many

hospitals and health systems. Lenders simply offer loans at the most attractive rates to the most reliable borrowers. With these downgrades, the cost of borrowing and existing variable rate debt is more expensive. The analogies to the housing mortgage market are striking. Hospitals are now paying more interest, are less able to borrow, and more will face challenges meeting their repayment obligations.

Our future capital spending is a much gloomier picture. Our equity losses and the heightened operating challenges we face inevitably mean that we will invest less in our facilities and future expansion than would be ideal. In round numbers,