

Critical Access Hospitals: 8 Steps for a Successful Renovation or Replacement Project

RED CAPITAL GROUP® Small & Rural Hospital Finance White Paper

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Introduction

Rural hospital leaders are often faced with outdated, inefficient facilities that were not designed to accommodate advanced diagnostic technology and the modern array of outpatient services. Prior to the Balanced Budget Act (BBA) of 1997 many small and rural hospitals financially struggled to achieve break even financial performance, much less build the balance sheet flexibility necessary to consider extensive facility projects. The passage of the BBA reintroduced cost-based reimbursement to a special class of hospitals designated Critical Access Hospitals (CAHs), which began receiving cost-based payments from the Center for Medicare and Medicaid Services (CMS). Hundreds of small and rural hospitals have now received cost based reimbursement for up to 10 years under the CAH program, which has enhanced their ability to finance facility improvements. The improved profitability of many CAHs, under cost-based reimbursement, means that renovation or facility replacement is now a realistic consideration.

The Challenge for Senior Management

Significant renovation and facility replacement projects for CAHs come with a set of planning challenges that are unique in the healthcare industry. Under CMS's cost-based reimbursement system, CAHs are reimbursed for the cost of providing services to Medicare patients, of which depreciation and interest are allowable costs. With capital costs allocated to revenue producing departments based on square footage, future Medicare reimbursement for CAHs is dependent upon both project design and anticipated volume. The fact that Medicare is typically the largest third-party payer for CAHs heightens the importance of understanding these relationships. The dependency of CAH projects on effective design and expected volume to facilitate financial performance, underscores the importance of carefully planning facility projects.

Hospital management must also coordinate myriad relationships with professional service providers such as feasibility consultants, architects, bankers, owners' representatives and construction managers throughout the project development process. This internal resource constraint is compounded by the proliferation of project design and delivery methods as well as financing alternatives. In most project situations, hospital management is responsible for the mastery of numerous functional skill sets including design planning, investment banking, accounting, legal, and construction management. Project success is often dependent upon the successful integration of services and ideas provided by numerous vendors early in the planning and development process.

Eight Steps for a Successful Renovation or Replacement Project

Coordinating analysis early in the CAH project process is crucial to achieve the synthesis needed to ensure long-term financial viability of the hospital. When describing his approach to projects, renowned architect Frank Lloyd Wright was quoted as saying "Get the habit of analysis - analysis will, in time, enable synthesis to become your habit of mind." The most effective CAH renovation and facility replacement projects consider market conditions, facility needs, reimbursement implications, financing costs, and balance sheet impacts to create synthesis in the long range financial and strategic planning process. Appropriate analysis and synthesis will not only save CAHs time and money in the short term, but will enable the facility to be successful for many years to come. To avoid project rework, CAH senior managers are advised to seek out vendors who support an integrated approach to providing preliminary planning services and to use the following guidelines in the beginning stages of significant facility projects.

1. Use Proforma Debt Capacity as a Preliminary Guideline for Project Scope

Prior to commencing with market planning, design and financial forecasts, CAH hospital senior managers are well served to create a frame of reference for what they can afford to build. Working with a financial advisor or investment bank, develop a proforma debt capacity analysis to create an affordability guideline based on past performance plus expected future cost-based reimbursement. Developing an affordability guideline will assist administrators later in the process when faced with difficult decisions on service line selection and project scope.

2. Define Your Market and Services Before Designing the Facility

Hospitals should evaluate their strategic plans and their market needs in tandem to accurately determine their best facility scenarios prior to commencing facility need assessments and space planning. In lieu of qualified internal resources, demand planning firms or integrated planning and architect firms typically offer market definition and forecasting as a service. Service area definition and affirmation is the foundation to determine the future medical needs of the community. Historical admission and visit trends typically serve as the basis for this definition unless specifically targeted medical staff expansion is a part of the strategic plan. With a firm service area definition, analysis of demographic trends and utilization trends can lead to initial demand forecasting by service line. Service line volume forecasts and market share opportunity analysis can, in turn, lead to medical staff planning and service line selection for the project.

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Future Medicare reimbursement for CAHs is dependent upon both project design and anticipated volume.

3. Use Block Plans to Consider Space and Project Cost Scenarios

Given the cost tradeoffs between renovating versus replacement, consideration should be given to space planning and rough cost estimation based on future market needs. Architect and planning firms offer needs assessments, block space planning, and cost estimation services. Senior management should work with their professional service provider to understand:

- needs of the existing building and facility and the required mechanical, plumbing, electrical and structural system upgrades to meet code;
- plans for at least 2 renovation scenarios of the current facility and at least 1 green field scenario that accommodate various service lines deemed necessary in the marketing analysis;
- costs of site development, utilities, and land acquisition for any off-campus locations under consideration.

Expensive renderings of the facility should be avoided until the cost and benefit tradeoffs of the various renovation or replacement scenarios have been addressed. Later in the process, the selection of project scope and cost will become an input into the allocation of depreciation and interest used in estimating cost-based reimbursement for Medicare.

4. Understand Financing Alternatives and Prioritize Financing Needs

With context for project cost scenarios, hospitals should understand the available financing alternatives in the market and the impact these options will have on capital structure, liquidity, and interest costs. Investment banks are the appropriate resource for this service as their access to trading and pricing information will help in accurately forecasting debt cash flows. Senior management and the board should prioritize financing needs and associated risks of financing alternatives. The relative importance of the cost of capital, rate structure, maturity, security, and impact on liquidity reserves should be assessed and ranked. Interest rate, maturity, and reserve requirements should be modeled for the financing alternatives available to the hospital based on project cost estimates developed earlier in the process. When considering financing alternatives, hospitals should understand how much cash they can comfortably commit to the project and what, if any, additional funding sources such as donations or tax levies are available. The balance sheet impact of the preferred financing execution, including equity contributions and additional funding sources, should be assessed and analyzed. This task should result in agreement upon a preferred financing method based on funding the desired project scenarios with a clear understanding of the long-term balance sheet impact to the hospital.

5. Forecast Future Revenues and Expenses with the Project

After exploring market-driven construction scenarios and capital market availability, senior management should focus on understanding the future cost structure and reimbursement impacts of the project. Management should forecast future revenue based on included service lines, expected price trends, physician staffing, and service area demand and market capture. To the extent that service mix is not expected to change with the project, this analysis may be conducted at a high level to save time and cost. At this point, management should minimally understand the gross revenue forecast and anticipated expense structure associated with project scenarios under consideration.

Hospitals should compare financial projections with various project scopes and service offerings, using a preferred financing methodology, to understand the financial limitations and risks associated with these choices.

6. Understand Medicare Reimbursement Impacts of the Project to Prioritize Services

In nearly all cases, CAH management should take the time to fully understand the Medicare reimbursement implications of the project. Typically, Medicare proforma cost reports should be developed for each design scenario under consideration. As mentioned earlier, future Medicare reimbursement for CAHs is dependent upon both the project design and anticipated volume. For CAHs, indirect costs, such as depreciation and interest related to the project, are allocated to allowable revenue producing cost centers to determine cost-based reimbursement. For departments not reimbursed on a cost basis, indirect cost will be mapped to these revenue centers and taken away from allowable cost-based revenue centers. Once costs are allocated to the revenue department level, Medicare reimbursement is determined by the proportion of departmental care that is provided to Medicare beneficiaries times the allowable cost. Thus the size of departments and the estimated future Medicare activity at the department level have a significant impact on future Medicare reimbursement. The lack of profitability for non-cost reimbursed departments can adversely impact hospitals' ability to afford proposed projects and should be carefully considered in selecting future services. Guided by reimbursement estimates for various project scenarios, senior management can make financially informed decisions regarding hospital service mix and project scope.

7. Use Third Party Reimbursement and Expense Opportunities to Close the Financial Gap

While comparing financial projections, senior managers should keep in mind that profitability is driven by non-Medicare volumes, non-Medicare payment rates, and cost structure. In the event that project cost creates a projected profitability shortfall, management should explore the appropriateness of pricing, cost levels and third-party contract terms, relative to its competition, to search for additional improvement opportunities. Accounting and consulting firms offer the appropriate reimbursement, cost

benchmarking, and financial forecasting resources to help senior management understand the financial impact of project related decisions. Management should decide which analyses are useful and beneficial to understanding forward looking risks and financial performance. In some instances, pricing, reimbursement, and cost benchmarking analyses are the proper decision, while in other cases only one or more of these tasks may be prudent.

8. Use Integrated Financial Forecasts to Finalize Project Scope

At this point in the process, senior management should compare financial projections with various project scopes and service offerings, using a preferred financing methodology, to understand the financial limitations and risks associated with these choices. In some instances, it may be necessary for CAHs to fund a smaller construction project to support departments that are not reimbursed on a cost basis. It is the intent of planning synthesis to bring these difficult decisions and conversations to light. In weighing quantitative financial projections against community needs, management should move towards selecting the optimal scope and project cost for the project.

Conclusion

Coordinating analysis early in the project process is crucial to achieving viable CAH facility projects. The sooner management can begin synthesizing design decisions, capital markets options, and reimbursement consequences the better they can manage board expectations and facilitate discussions to ensure the future financial success of the hospital. With a properly oriented board communicating about difficult project, financing, and service tradeoffs, management can move towards project design and financing knowing they understand the financial implications of their project choices.

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The RED hospital team includes Red Mortgage Capital, Inc., an FHA and USDA approved lender and servicer with expertise in financing hospitals and senior care facilities; and Red Capital Markets, Inc. (MEMBER FINRA/SIPC) a registered broker-dealer of taxable and tax-exempt securities.