FEATURE STORY

James W. Blake
Eric A. Jordahl

managing risk through a global capital strategy

Risk is ever-present in the capital markets. Rather than avoiding risk, hospitals need an effective strategy to manage it.

U.S. healthcare organizations are still recovering from the financial tsunami that swept the world in 2007 and 2008. They have been highly focused on clearing the debris, plugging the remaining leaks in their capital structure, and getting on with life in a very different world. For executives with finance responsibilities in the nation's hospitals and health systems, the recovery process has demanded an intense focus on capital access and cost issues, liquidity, investment losses, damaged debt programs, and other balance sheet problems resulting from the financial crisis.

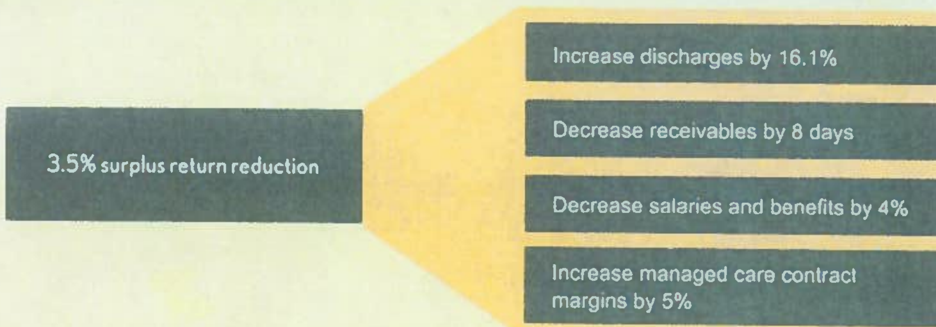
Although the capital markets stabilized during 2009, finance executives have had little time to pause for a deep breath. Now, with the passage of the Patient Protection and Affordable Care Act in March 2010, they must shift their focus toward positioning their organizations to respond to the new business conditions emerging with the legislation and the rapidly evolving marketplace.

The capital structures built by hospitals and health systems during the past decade can positively or negatively impact organizational success in the new business environment. Such structures, defined as the combination of debt and equity that funds an organization's strategic plan, are much more complex than they were in previous decades. Current risks related to debt and stock market volatility, the relationship of interest-rate indexes, new and emerging financial products, and changing credit markets can be sizeable for providers.

Risk Aversion Versus Enterprise Risk Management

Given the current situation, finance executives may face some challenging questions from their hospital boards: Why don't we liquidate our investments and pay off our debt so that we can focus on improving operational performance without worrying that the capital markets will "burn us" again? Why don't we move all our debt to fixed-rate products so that we don't have to worry about the fluctuating interest rates?

These questions reflect a natural reaction to past financial damage and future business uncertainties, namely the desire to eliminate capital structure risks. Unfortunately, paying off all debt or moving all debt to fixed-rate products simultaneously jettisons the opportunities attached to appropriately managed risk positions. Hospital executives should always be seeking the "right" balance between operating the organization as aggressively as possible in competitive markets and maintaining a conservative approach to fiscal management that recognizes financial realities and responsibilities. A balanced approach means taking risk that is appropriate to the hospital's financial, operating, and competitive position and actively managing such risk.



Source: Kaufman, Hall & Associates, Inc.

Note: Based on an average of four systems with revenues ranging from approximately $400 million to $3 billion and ratings ranging from "A3/A–" to "Aa2/AA."

During the past decade, a significant proportion of the bottom line of many not-for-profit hospitals and health systems has come from managing capital structures to create surplus return. Defined as the difference between the cost of debt capital and the return rate on investments, surplus return has yielded as much as 30 to 50 percent of organizational earnings.

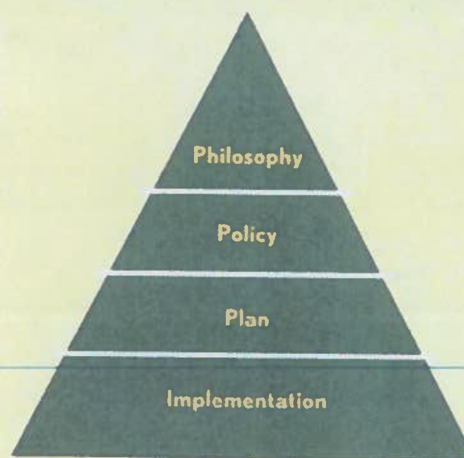
Managing balance sheet risk and continuing to generate surplus return are likely to remain extremely important to overall financial performance. Few hospitals can afford to significantly reduce surplus return at this point in history. The exhibit above identifies the representative operational improvements that a provider might need to achieve on various fronts to offset the "loss" of 350 basis points of surplus return.

A well-developed and implemented enterprise risk management approach to treasury practices can mitigate balance sheet stress in the future. Because hospitals and health systems have different operational and financial characteristics with different credit profiles and tolerance for risk, no one "perfect system" fits all. However, a single approach that will work for all organizations is a *global capital strategy*, which is characterized by a solid framework that covers both debt and asset sides of the balance sheet and includes a philosophy, a policy, a plan, and an implementation process.

A Philosophy

The treasury *philosophy* reflects an organization's big-picture reasons—the purposes and objectives—for having investments and debt, and the relationship of these elements to the organization's operations. Almost all not-for-profit healthcare systems have mission statements that document the operating philosophy, but on the nonoperating or treasury side, many organizations have not developed or documented a philosophy. A well-conceived philosophy addresses three key considerations: cash and debt.

THE FRAMEWORK FOR GLOBAL CAPITAL STRATEGY



Source: Kaufman, Hall & Associates, Inc.

AT A GLANCE

A global capital strategy should be the product of a philosophy, a policy, a plan, and a clear process for implementation:

- A well-conceived philosophy addresses cash and debt, approach to cash balances and investments, and approach to risk.
- A good policy defines scope, sets authority, focuses on risk management, offers boundaries, and prescribes actions.
- An effective plan defines and documents treasury goals and specific tactics for achieving them.
- Effective implementation requires a four-stage process in which three preliminary stages—evaluate, develop, and monitor—precede the actual implementation stage.

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Cash and debt. Why would an organization maintain a significant number of days cash on hand while also having significant debt? Although for-profit healthcare systems typically maintain under 20 days cash on hand, most not-for-profit organizations retain significant cash balances to help create a credit profile that supports favorable access to external capital.

Approach to cash balances and investments. What might an organization choose to do with cash balances and investments? Some organizations use cash balances to structure investments and debt, pursuing surplus return to help meet bottom-line operational targets. Others look at investments as long-term endowments whose earnings should continue to add to the endowment principal.

Approach to risk. How should the organization manage its risk? The philosophy can identify perspectives on capital-structure risk and, particularly, the priority level of this risk relative to operating risk, market risk, or other types of organizational risk.

There are no right or wrong answers to these questions, but having answers, as articulated through a documented philosophy, is important. This is particularly true in times of financial stress, when leaders require a firm understanding of the organization's overall objectives, without which they could incur additional risk as a result of suboptimal response strategies.

A Policy

A healthcare system also needs an appropriate capital structure policy or policies. Healthcare systems may have investment, debt, and swap

Philosophy Example: Adventist Health System—Sunbelt

About 10 years ago, for a variety of reasons (including the Balanced Budget Act), Adventist Health System—Sunbelt experienced both pressure on earnings and investment volatility. These combined stresses and other factors contributed to the organization's debt-rating downgrade to the "BBB" category.

As part of its total response strategy, Adventist reevaluated its treasury philosophy and developed an approach with the expectation that its treasury department should contribute just like any other operating division. Relative returns from investments and surplus return over a multiyear period (even as limited as five years) were no longer the objective; instead, the department was expected to contribute a defined surplus return each year to support the health system's overall operations and bottom line.

To meet the annual contribution expectation at a high statistical confidence level, the treasury department's staff must actively manage the volatility associated with debt and/or investments. "Although the planning horizon is five years, the treasury department has a one-year horizon for producing specific, absolute returns and is allocated a very specific amount of risk that we get to 'spend' each year in order to achieve such returns," says Gary C. Skilton, vice president of treasury operations.[a]

The treasury department's task is to determine the mix of asset classes that will yield the expected return at the required confidence level. "On the asset side, every day, we measure how we are performing relative to the return and risk targets using several methodologies commonly used by banks and investment firms including 'value at risk,'" notes Skilton.

On the debt side, the goal is to reduce Adventist's cost of debt capital through diversification of the debt portfolio with an acceptable mix of fixed-rate, floating-rate, and derivative vehicles at the appropriate level of risk, as defined.

The structured approach to assets and liabilities, which reflects the organization's overall treasury philosophy, has played an important role in helping Adventist to improve its profitability and strengthen its credit rating from the "BBB" category in 2000 to its current level of "AA−/Aa3/AA−," while funding significant investment and growth across the system.

a. "Managing the Balance Sheet: An Interview with C. Talbott Heppenstall, Jr., and Gary C. Skilton," Kaufman Hall Report, Spring 2007, www.kaufmanhall.com.

policies, but their policies may not be up to the challenge of managing risk and helping to produce the highest level of surplus return within an acceptable risk limit.

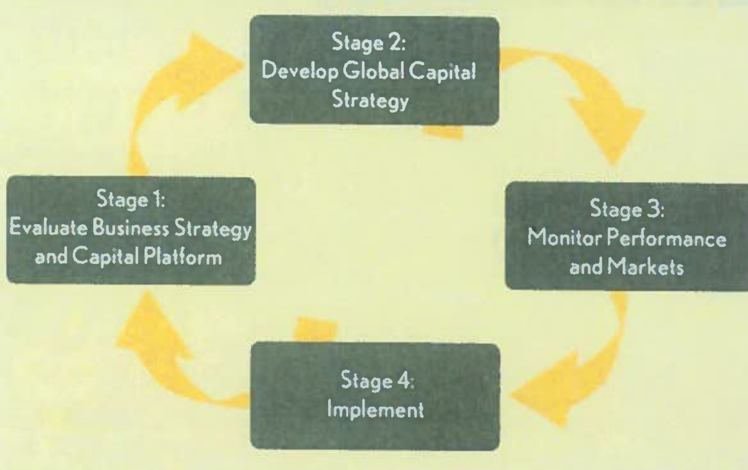
Investment policies often have clear structure, a greater emphasis on risk management, and better requirements for performance and risk monitoring and reporting. On the liability side, many organizations would benefit from a comparable framework to proactively manage liability portfolio risk. Perhaps most important, consideration should be given to integrating investment and liability policies and related functions.

What differentiates good policies from bad policies? Good policies define scope, set authority, focus on risk management, offer boundaries, and prescribe actions. Key actions include setting risk parameters on individual risk indexes or indicators, monitoring and reporting performance and risk, and developing and maintaining a capital structure plan.

A Plan

Developing a global capital strategy requires a plan that documents the organization's treasury goals and strategies, articulating specific tactics the organization would use to achieve those strategies. It includes the many "rules of thumb" and concepts that, if left undocumented, would reside only in the CFO's, treasurer's, financial adviser's, or banker's heads. The discipline of talking about and documenting goals and strategies forces the leadership team to think about corporate finance theory, peer comparisons, and best practices.

Documentation also provides clarity regarding the organization's capabilities and priorities, and can be used internally, at different management or governance levels, and externally. It also enhances communication between the organization's financial executives and the finance committee and facilitates proactive execution of approved strategies within the treasury and finance operations. Essentially, the global capital strategic plan becomes the road map for understanding and



Source: Kaufman, Hall & Associates, Inc.

discussing treasury activities and how they relate to the rest of the organization.

The global capital strategy planning process is continuous, involving evaluation of the existing plan against dynamic credit markets as well as the impact of specific transactions. Through use of this approach, a hospital's board and management team can:

- Document strategies and provide a framework for making capital structure decisions
- Better link capital strategy to capital funding and business strategy
- Better understand, evaluate, and manage risk, including interest rate, tax, product, volatility, and event risk
- Facilitate communication among management and between management and the board
- Reinforce development of best practices
- Understand the impact of individual transactions on the organization's overall capital structure, including the incremental impact of surplus margin, organizational cash flow and liquidity, and financial risk position
- Respond proactively to organizational and/or market change

In short, like the comprehensive integrated strategic financial plan developed on the operational side to enhance decision making related to the organization's strategic direction, the global

capital strategy plan applies careful study and analytics to ensure an optimal capital structure that supports the integrated strategic financial plan. This end is accomplished through a four-stage process: evaluate, develop, monitor, and implement.

Stage 1: Evaluate

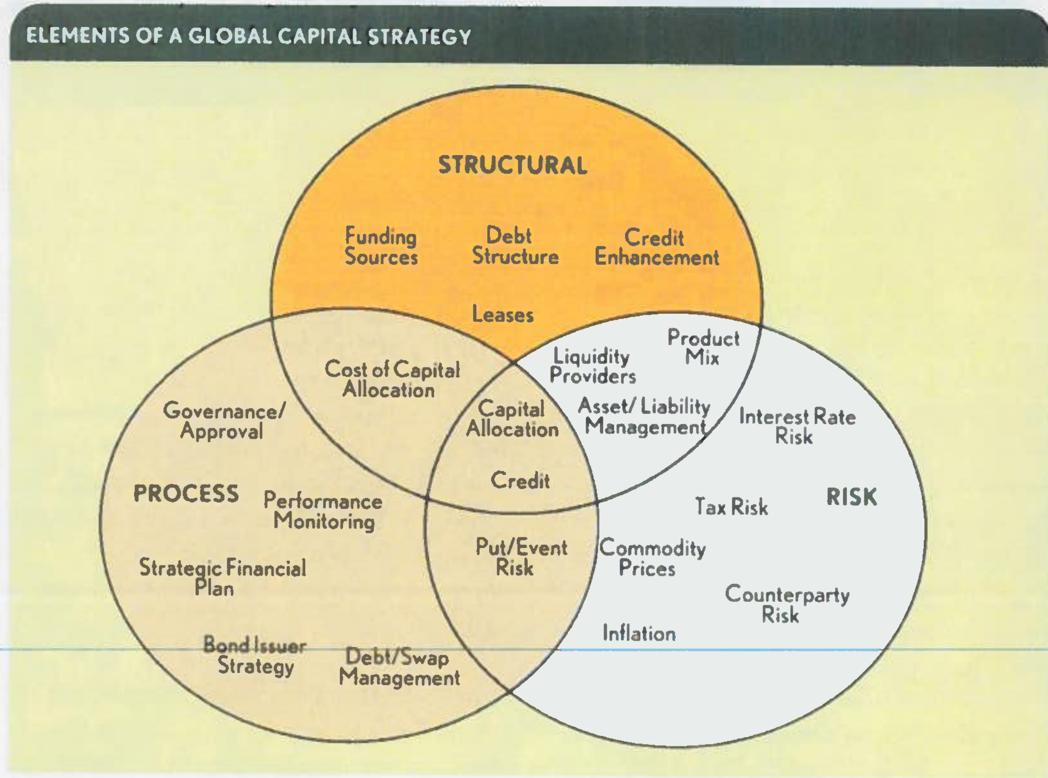
The first step in building a global capital strategy is to evaluate the organization's current business strategy and capital platform, looking closely at its capital needs, existing debt and swap structure, bond covenants, current liquidity, profitability and leverage, and projected debt capacity. The findings will help the organization to identify the opportunities that come with developing an appropriate and viable capital structure strategy and to recognize the particular constraints imposed by such a strategy. As an example, a strong liquidity position combined with low forward capital needs might suggest the opportunity to carry relatively more floating-rate debt and related interest rate swaps. Or a deteriorating market and credit position might suggest that it is more important to reduce capital structure risks than it is to pursue reduced cash flow costs.

Stage 2: Develop

With an understanding of its existing capital structure and strategies, the organization can begin to develop, or update, its global capital strategy. Moving from a mostly undocumented and transaction-oriented approach to a fully documented and strategic and risk management process represents a huge shift for most organizations. Typically, this transition requires the largest effort during the first time through the cycle.

In the *develop* stage, the organization's capital structure should be separated into "granular" components within three categories: structure, risk, and process. This granular look is similar in many ways to how asset classes are categorized on the investment side. There is significant value to identifying and correctly categorizing elements on the liability side, as well. Health systems may focus more on some elements than on others, or

ELEMENTS OF A GLOBAL CAPITAL STRATEGY



Source: Kaufman, Hall & Associates, Inc.

they may add new categories depending on the circumstances.

The focus at a granular level enables organizations to:

> Understand where key points of exposure reside and the urgency of mitigation
> Assess and respond to the impact of any single transaction
> Focus at the strategic and risk management level
> Develop best-practice comparisons with other providers, and perhaps with organizations or companies in other industries.

Such a thorough capital structure assessment also can help organizations identify priority areas in which they can lower the cost of capital or shift an out-of-balance risk position. The following are examples.

Extending the average life of debt. Extending debt service as far into the future as possible allows organizations to reduce debt service costs and retain more cash. For many organizations, the review of current capital structure might identify the benefits of restructuring debt to move toward a "low, long, and level" structure.

Enhancing monitoring and management of leases. Joint ventures and partnerships related to hospitals, physicians, and ambulatory surgery centers over a many-year period can result in a wide range and volume of operating and capital leases. Because leases often have shorter amortizations and relatively higher costs than do traditional tax-exempt debt, and because lease accounting and rating treatment are changing, organizations should carefully reassess their lease position relative to other funding alternatives.

Setting risk parameters. Historically, many healthcare systems have bundled risks and managed the overall risk at this bundled level without fully appreciating the impact of individual risks within the bundles. Or, in some instances, organizations have set variable-rate mix targets, considering only interest-rate risk, and not fully measuring or appreciating the underlying event, tax, bank, bank renewal, product, remarketing, basis, and other risks. Setting risk parameters at the individual risk-metric level across the whole system, independent of any single financial transaction, can reduce the downside of risk.

Clearly, not every area of exploration will produce a major issue to consider. However, examining individual components identifies specific value-added adjustments and provides a profile of the range, number, and magnitude of potential opportunities and concerns.

As an example, Baylor Health Care System (BHCS), a system with 26 owned, leased, or affiliated hospitals in Texas, is using its global capital strategy to meet identified capital structure goals. Goals include protecting its bond rating, funding strategic capital and growth, creating debt capacity, lowering cost of debt, monitoring and managing risk, maintaining effective investor relations, and monitoring and managing financial assets and liabilities.

"In the past, the system has approached its debt structure in what could be described as a more transactional basis," says Frederick Savelsbergh, Baylor's CFO. "We now want to assure that the debt side has the same rigor and discipline of risk parameters that exists on the investment side."

A component-level analysis indicated that BHCS could reduce its maximum annual debt service by extending the average life of its debt and that close monitoring and management of leases through a comprehensive lease management program could lower cost of capital.

Stage 3: Monitor

The next stage involves monitoring risks, market performance, and credit dynamics. On the investment side, the finance committees of hospitals and health systems typically expect regular (quarterly, monthly, or even more frequent) monitoring and reporting of at least investment performance, and often also of risk, correlation of risk to overall investment allocation, and

detailed information of exceptional occurrences, either negative or positive. This information provides ongoing education about the organization's investments and, consequently, a context for understanding what is occurring with the investment portfolio.

The debt and derivatives portfolio should be similarly monitored and reported. Cost of capital, debt in each risk bucket, exposure by type of risk (interest rate, put/event, tax, counterparty, credit, bank, and more) and overall shape of debt structure, and many other elements should be tracked, comparatively evaluated, and documented for the board and management team. Also beneficial is tracking performance against expectations, both on a component basis (i.e., synthetic fixed-rate bucket) and on a portfolio basis.

Effective monitoring and reporting offers many important benefits, including the following.

Establishes a base level of performance. Executives and trustees often have no context for judging how well or poorly their treasury strategies are performing unless they have a base level of performance against which to compare current performance. Information and analysis provided through the monitoring process facilitate comparative analysis, communication, and the appropriate adjustment of strategies.

Provides a longer-term perspective and context. As on the investment side, continuous monitoring of portfolio changes provides a bigger picture of overall performance and improves the framework for tactical decision making.

Consider, for example, a situation in which information provided to a hospital board indicates that the cost of capital is now 300 basis points higher overall than in previous months or years. Yet because the trustees understand the organization's overall debt-mix strategy and the portfolio's performance over time, they know that the organization has, in fact, saved $20 million during the past 10 years by achieving the targeted mix of variable-rate and fixed-rate debt. They have a different context for viewing the cost-of-capital increase and a better understanding that a particular debt-mix strategy has achieved positive (or negative) results.

Sounds an early warning. A solid monitoring system tracks the incremental impact of individual transactions on the organization's overall capital structure, including cash flow, liquidity, and financial risk position. Again, as on the investment side, continuous monitoring of indicators related to market, credit, and debt and derivative performance provides an early warning of performance that might warrant, for example, some adjustment of treasury strategy to take risk on or off the table.

Enhances organizational ability to seize opportunities. This benefit completes the cycle. A well-articulated and well-understood treasury philosophy, accompanied by a debt and swap policy that supports that philosophy and that requires authorization, a written strategy, and monitoring of that strategy, allows organizations to be more proactive in the management of their assets and liabilities. Organizations can identify and pursue emerging opportunities, rather than miss them.

Consider, for example, that long-dated tax-exempt debt currently is cheap compared with treasuries (tax-exempt rates are relatively high). However, every several years, there are periods when long tax-exempt rates are "rich" (i.e., rates are relatively low) compared with treasuries, as was the case during the last half of 2006. Hospitals that were monitoring their performance and risk parameters at that time were more likely to have had a better context with which to understand the opportunity then presented to convert variable-rate demand bonds into fixed-rate debt and then swap to variable. They could convert back to variable rates that were similar to traditional variable-rate debt, but without incurring any bank renewal risk, event risk, or put risk. They assumed certain swap mark-to-market risk but, overall, could significantly reduce their risk profile in numerous risk buckets. Floating-rate

notes in 2007, which were long-term debt with a floating index, are a similar example with even lower risk.

Opportunities to reduce capital structure risk at the same or slightly higher cost are especially important to evaluate. By taking certain risks off the table, an organization might gain capacity to assume different or additional risk in other areas, thereby gaining the potential of further lowering costs, enhancing flexibility, and increasing overall organizational capital capacity.

Leadership teams that take a more strategic approach to risk management, including thorough monitoring of performance and risk, are better positioned to act. The same is not likely to be true for teams that are more focused on one transaction at a time and that are, therefore, unlikely to want to pursue strategic-oriented transactions that cost a bit more, but create a better balanced risk position.

Specific risks and risk premiums become tighter or wider as markets change. An effective monitoring system improves an organization's ability to gauge the cost-benefit of the risk reduction, making it less likely the organization will miss an opportunity because it is solely perceived to increase capital cost.

Stage 4: Implement

An organization that effectively completed the first three stages of this process should be able to seamlessly implement transactions in accordance with its capital structure philosophy, policy, and plan. If approached correctly, in a disciplined fashion, implementation should be routine. With key decisions already set, finance executives have the freedom to tackle other issues, while their team arranges execution.

All of the elements of global capital strategy and its planning process should be revisited on a regular basis, as defined by the organization's board and management team. Regular review and management of global capital strategy as a cyclical process ensures that appropriate adjustments are made for competitive and market conditions, organizational goals and performance, and the many other factors described previously.

A Bulwark

The past 24 months have been exceedingly challenging for healthcare leaders. The consequences of the financial tsunami have made many market participants averse to risk, and often, by default, to risk management as well. In many hospitals and health systems nationwide, current debt methodologies have been inadequate to handle the complexities and risks associated with debt.

A global capital strategy for managing capital structure risk offers hospital executives and trustees an effective means to meet this challenge. With such an approach, transactions become the means or tools to execute the overall strategy, not the focus. As a result, hospital and health system management teams can effectively manage risk, develop and implement an optimal capital structure, measure the impact of transactions, and respond proactively to organizational and market change. ●

About the authors

James W. Blake is a partner, Kaufman, Hall & Associates, Inc., Skokie, Ill., and a member of HFMA's First Illinois Chapter (jblake@kaufmanhall.com).

Eric A. Jordahl is a partner, Kaufman, Hall & Associates, Inc., Skokie, Ill., and a member of HFMA's First Illinois Chapter (ejordahl@kaufmanhall.com).