CALIFORNIA HEALTH FACILITIES FINANCING AUTHORITY

Cedillo-Alarcón Community Clinic Investment Act of 2000

Allocation of Grant Interest Earnings

March 25, 2004

Background: Effective January 1, 2001, the California Health Facilities Financing Authority was authorized to administer the Cedillo-Alarcón Community Clinic Investment Act of 2000 (Act). The Act provided $50 million in available grant funds to community clinics for purposes of capital projects. In total, $51,152,395 has been allocated to 301 community clinics throughout the state with at least partial funding for every eligible applicant under the program. Although more than $50 million in grants have been disbursed, there is an approximate fund balance of $3 million remaining because of interest earnings from the initial appropriation.

The Authority's enabling legislation permits it to use any net earnings beyond that necessary to implement a particular program to fulfill another authorized purpose of the Authority or to disburse the funds to the general fund. Staff recommends allocating the interest earnings from the initial $50 million grant allocation to the HELP II program.

HELP II Program Expansion Proposal: The HELP II Loan Program (HELP II) has assisted small and rural health facilities obtain adequate financing for their capital needs. Since the HELP II inception in May 1995 through December 31, 2003, the Authority has lent $37,182,770 to 104 facilities, with no defaults. Although demand for HELP II funds remains strong, staff proposes combining the interest earnings from the Cedillo-Alarcón grant program with the HELP II fund balance and modify program requirements and eligibility standards in a continuing effort to provide low-cost capital to health facilities within the state so that they may pass the savings onto their patients.

- ***Expand Maximum Loan Limit from $400,000 to $500,000***

The maximum loan amount under the HELP II has been adjusted several times since the launch of the program. When the program began in 1995, the maximum loan amount was $300,000, but was increased to $500,000 in 1997 given initial slow loan originations. In June 1999, when funding for the program was low, the maximum loan amount was reduced to $300,000, but was increased in December of 1999 to $400,000 when a $10 million cash infusion was made to the program. Since 1999, the maximum loan amount under HELP II has remained at $400,000.

From January 2003 through February 2004, 18 of the 24 loans funded during this period were $400,000 loans. Most of these borrowers were financing construction or property purchases and used a combination of their own cash, grant funding, and/or other loans to complete the financing. Since 1999, annual double-digit real estate appreciation in many regions of the state has not been uncommon. Increasing the maximum HELP II loan will assist eligible borrowers with maintaining their existing facilities or acquiring new facilities to better serve their patients.

- ***Expand Term Length from 10 Years to 15 Years for all Real Estate Secured Transactions***

The loan term under HELP II has been adjusted once since the inception of the program. When the program began, the maximum term was 10 years but was changed to 15 years in March 1997 in response to slow initial originations. Currently, the maximum term is 15 years, but is ten years for all loans less than $300,000.

Since the HELP II assists borrowers who would otherwise have difficulty securing conventional bank loans, approving borrower loan requests of $300,000 or less with 15-year loan terms, in lieu of 10-year terms currently imposed, will improve current cash flows of many HELP II target borrowers. At the $300,000 threshold, a 15-year amortization results in an annual payment of $24,700 while a 10-year amortization results in an annual payment of $34,400. Many small clinics operating on thin margins can easily benefit from the extended term and pass savings onto their patients. Since January 2002, ten real estate secured HELP II loans were approved with 10-year terms based on loan amounts of $300,000 or less. These borrowers may have benefited from an extended term.

- ***Expand Refinancing Opportunities***

In 1999, when the HELP II fund balance was low, the Authority limited refinancings to cases where there are significant savings (generally loans with interest rates above 10%) or for loans with balloon payments due within twelve months. On a case-by-case basis, the Authority has approved refinance requests of loans with interest rates less than 10%, as long as the borrower would realize a significant interest rate savings.

Since the interest rate environment over the past five years has been at near historically low levels, refinancing requests pertaining to existing loans with rates less than 10% are becoming more common. Although the interest rate difference between a loan to be refinanced and a 3% HELP II loan may be small, the cash flow improvement to a borrower may be great. For example, a borrower may have a $400,000 commercial loan at 6% and request a HELP II loan to refinance it. A new HELP II loan would result in an annual cash savings of $8,000, which help many borrowers operating on thin margins pass these savings onto their patients.

- ***Expand Eligibility Requirements***

Although district hospitals are eligible for HELP II funding, the program's general requirement that specifies gross revenues cannot exceed $20 million causes these facilities to become ineligible for financing. Presently, district hospitals are having difficulty in accessing capital and could benefit from a low-cost financing program like HELP II. Based on data retrieved from the Office of Statewide Health Planning and Development (OSHPD) website, there are 45 district hospitals within the state (the majority have gross revenues exceeding $20 million), of which 33 had marginal operating results in calendar year 2002. These hospitals will benefit from low-cost financing offered through HELP II, especially as many embark on seismic retrofits, as required by law. Staff proposes waiving the HELP II gross revenue restriction for district hospitals only. All other potential borrowers will need to exhibit gross revenues less than $20 million.

- ***Consider High Risk Borrowers***

Since there have been no defaults under the current HELP II program, staff proposes expanding the program to allow certain higher risk borrowers. Staff will monitor all loans considered high risk more closely than lower risk borrowers (i.e. those who do not fall in the two categories outlined below) in an effort to further diversify the existing HELP II loan portfolio. Ultimately, these higher risk borrowers provide health care services needed in the state and will benefit from the low-cost financing available through HELP II.

Borrowers with Low Debt Service Coverage Ratio

As many health facilities are facing negative revenue pressures as capitation and reimbursement rates are declining, on-going state-funded grants are questionable and investment portfolio returns are negative, some health facilities are unable to meet the minimum debt service coverage ratio of the HELP II. Currently, the HELP II is limited to borrowers with debt service coverage ratios of at least 1.25x, although on rare occasions staff has recommended borrowers to the CHFFA Board with slightly less coverage due to strong compensating factors. Staff proposes considering borrowers with debt service coverage of at least 1.10x, based on the most recent audited fiscal year financial performance, for the HELP II program. All parameters of the program, such as the maximum loan amount, term, and interest rate, will remain the same for these borrowers as any other borrower meeting the 1.25x debt service coverage ratio.

Borrowers Starting a New Eligible Health Facility (Start-up Facilities)

Currently, the HELP II is limited to organizations that have been in existence for at least three years performing the same types(s) of services and have three year audited financial statements. Although there has been minimal interest in the HELP II by start-up facilities (i.e., those facilities with no operating history) since the inception of the HELP II loan program, staff proposes expanding the eligibility requirements of the program to allow these entities. Since start-up facilities generally represent the most risky of borrowers, staff proposes the Authority mitigate some risk by considering only those start-ups with at least a $100,000 loan commitment from a commercial lending institution, a completed feasibility study with realistic profitability expectations, state and federal tax exemption letters, and a completed application to the Department of Health Services for any applicable licensing. Furthermore, staff proposes limiting HELP II loans to start-up facilities to $200,000, with the standard interest rate of 3%.

Cumulative Impact of Proposals to HELP II:

During the past two calendar years, the Authority has approved on average 1.8 HELP II loans per month for an average of $7.4 million per year. Activity in 2004 includes four closed loans and ten loans pending closure for a total amount of $4.6 million. Year to date activity is atypical since many of the loans pending closure are a result of the STARTS program refinance. The net HELP II fund balance, after excluding all loans pending closure, is approximately $8.5 million and would be approximately $11.5 million if the proposed allocation of grant interest earnings to the HELP II program is approved.

At the current lending pace and with the proposed program enhancements, staff estimates the HELP II fund balance will be exhausted between late 2004 and early 2005. Once funds are exhausted, the loan payments received from current borrowers will fund up to $5 million per year in HELP II loans.

Should these proposals result in volume not consistent with targeted annual lending, staff will return to the Authority with additional proposals to appropriately manage the volume.

Marketing Proposed HELP II Enhancements: If the proposed changes are approved, staff will market the HELP II enhancements in trade newsletters, conduct a bulk mailing to eligible facilities, and highlight changes on the CHFFA website.

Staff Recommendation: Staff recommends the Authority allocate the interest earnings from the Cedillo-Alarcón Community Clinic Investment Act of 2000 grant program to the HELP II program and approve the HELP II enhancements, as proposed.