

IT for the Little Guy

Community hospitals face funding challenges as they try to compete with larger systems in the IT world.

HealthLeaders Media recently held an online Webinar entitled “IT Funding: Making Technology Affordable for Community Hospitals.” Participants gained insight about how to make smart technology investments despite the limited means of most community hospitals. Moderated by Philip Betbeze, finance editor at *HealthLeaders* magazine, speakers included Ronald Park, chief financial officer at Somerset (Pa.) Hospital; Janet Marchibroda, chief executive officer of the E-Health Initiative in Washington, DC; and Neil Sutliff, director of sales and marketing at McKesson Capital LLC, in Alpharetta, Ga., the Webinar sponsor.

PHILIP BETBEZE (FINANCE EDITOR, HEALTHLEADERS): *Let's get to the crux of the matter here as we get started. How are smaller, standalone community hospitals supposed to compete in the IT realm against bigger, better-financed competitors. Aren't they falling ever farther behind?*

JANET MARCHIBRODA (CHIEF EXECUTIVE OFFICER, E-HEALTH INITIATIVE): Well, it seems like every day a large hospital system announces an IT initiative that costs quite a bit, and they are doing it for a wide range of reasons. One of the most prevalent is the promise of greater efficiencies. What's interesting to watch is how large payors and purchasers are

beginning to think more about what they call value-based purchasing programs or pay for performance. So community hospitals often feel that they may be left behind. They don't have the same resources as their larger counterparts. But with careful planning and the integration of several new creative financing options, community hospitals can get wired and enjoy some of the benefits of IT that larger, better-financed hospitals do.

BETBEZE: *We want our participants to discover the funding options that are available and, depending on your budgetary constraints, the ones that are appropriate for you and your hospital or physician practice. Right now, let's talk about Somerset Hospital's IT financing and the implementation. Ron, how*

"WHAT WE TRY TO DO IS SEPARATE THE FINANCING DECISION FROM THE INVESTMENT DECISION."

did you prioritize your project in context with other spending priorities that are competing for your attention?

RONALD PARK (CHIEF FINANCIAL OFFICER, SOMERSET HOSPITAL): First, the link between a hospital's strategic plan and the financial plan needs to be tight. One of the core focuses that we have at Somerset is to try to link those two functions as closely as we can. We do maintain a three-year rolling plan, both strategic and financial, and when we begin to implement the specific aspects of the operational budget and our capital

budget, again, we go through a rigorous process where anything that's requested over \$250,000 is run through a balanced scorecard, a large portion of which is financial, about 75 percent driven from a net present value determination. The remaining 25 percent is driven from some additional intangible items such as patient relationships, physician relationships, strategic alliances and so forth. One of the points that I want to make is that over the last several years up until our most recent process, the IT plan that we adopted here did not make the cut. We were not able to put together a plan that made sense from our perspective.

NEIL SUTLIFF (DIRECTOR OF SALES AND MARKETING, MCKESSON CAPITAL LLC):

These kinds of projects can span 12, 24 and maybe even 36 months, and during the implementation, many times vendors are expecting to be paid a down payment or other fees for services and hardware. Other kinds of payment options could be varied, could be interest-only. You may even begin with a rent holiday so that you actually don't have any outflows until you're online. Then other things can be constructed, whether they're quarterly or step-up payments or even variables depending on if people have seasonality issues. Beyond that, we're seeing usage- or rental-type

agreements. Janet can speak about grant funding options.

MARCHIBRODA: Some states are putting out fairly large grants, and philanthropies can be one source of funding for your projects. But they do come with expectations, and they're usually programmatic in nature. We've seen more funding options emerge from agencies like the Department of Health and Human Services, as well as foundations like the

help you put together your solution and are they going to allow for the transaction to be altered at some point down the line.

Some of the funding sources may put the deal together up front and sell it off the same way your mortgage may be sold.

BETBEZE: *What should borrowers watch out for?*

SUTLIFF: Make sure what you saw in your proposal is what ends up in your

lenges you faced when making decisions about your \$3 million IT project.

PARK: We're about five months into that decision. Somerset is a rural community facility. We're about 65 miles east of Pittsburgh. Our net revenue is about \$55 million, and our operating margin in 2005 was slightly more than 3 percent, which for our region is very good. We have some fairly high leverage. We just completed a major building project about two years

"AS YOU'RE LOOKING AT YOUR FUNDING SOURCE, THINK ABOUT WHETHER THEY REALLY UNDERSTAND THE TECHNOLOGY AS THEY HELP YOU PUT TOGETHER YOUR SOLUTION AND ARE THEY GOING TO ALLOW FOR THE TRANSACTION TO BE ALTERED AT SOME POINT DOWN THE LINE."

Robert Wood Johnson Foundation. Most are focused less on implementation within one institution and more on aspects related to connectivity and interoperability or connecting and exchanging health data between your institution and others. We will see some grants emerge from the federal government—not an enormous amount—given the climate.

BETBEZE: *Neil, what about some of the issues to consider when you're talking about funding these projects?*

SUTLIFF: If you're dealing with high debt levels or perhaps you're approaching some of your bond [restriction] covenants, the non-debt solutions may be appropriate, whether that's an operating lease, usage agreement or some of these grants or potential philanthropic donations. As you're looking at your funding source, think about whether they really understand the technology as they

actual final document. Sometimes fees arise. Make sure they are all legitimate fees. Watch for things like interim rent. We talked about lenders providing for that funding need during implementation, and if they're paying your bills on their behalf, it certainly is fair for them to earn some return in the same way, you know, you'd expect on your credit card. They're going to have an interest cost also associated with it, but it shouldn't be credit card rates. Look at the end of your deal about automatic renewals or evergreen clauses where the lease continues on and on and on moving forward, and as you look at that, also remember there are notification time periods, many times that say you must notify the funding source two, three or four months in advance.

BETBEZE: *Taking a more detailed look at our IT case study brings us back to Ron. Tell our audience about Somerset and the chal-*

ago, and at this point, as we entered this discussion on the IT project, we did not have any significant incremental debt capacity. Our IT project covered a core replacement for our entire hospital information system. We're moving away from a system that we've had in place for more than 11 years.

BETBEZE: *What was your biggest hurdle?*

PARK: The biggest hurdle was how to finance it. We were in a position where we did not really want to use our hospital cash position to fund this project, and we began discussions with McKesson Capital. I entered into this whole process feeling skeptical that we could structure an off-balance-sheet transaction for an IT investment, a large part of which includes software investment and implementation services. But we were able to create essentially a 54-month lease, 10 months of which would be considered to be a rent

holiday or a payment holiday. During the implementation period, which we're going through now, we don't have to extend any capital during that process. Starting with the implementation date, we will pay a monthly lease amount over the next 44 months. We're out of paying any costs associated with implementation. We're out of paying any costs for software or hardware. The funding source took all of that responsibility.

BETBEZE: *Any advice on due diligence?*

PARK: Involve your auditors early in the process. My background is on the auditing side, and there have been numerous instances where clients had developed a lease arrangement that they felt was off balance sheet that ended up not being. Our auditors gave us an opinion in writing that this lease did meet operating lease criteria and enabled our board to make the decision that we were going to move ahead.

BETBEZE: *What about grant funding options, Janet?*

MARCHIBRODA: Many first-time grant writers are able to get much of the grant written with just a little bit of guidance from books, publications, maybe some consulting support. But if you're going for something that's a little bit of a larger proposal, you'll definitely need support if this is your first time. There are consultants out there who can help you. Costs for grant writers run anywhere from \$70 to \$125 an hour. This could take anywhere from 40 to 100 hours.

BETBEZE: *One of our participants wonders*

whether an IT project can safely be structured off balance sheet, and I think that probably comes from some of the negative news stories we've heard about with Enron and off-balance-sheet transactions and things like that. Ron, let's get your perspective. Any qualms about going off balance sheet with this?

PARK: As I indicated, I was skeptical that we would be able to structure an off-balance-sheet transaction. What allowed us to pull this together was a good partnership between McKesson Capital, the funding source we selected, and the linkage with our auditors just to make sure that we were dotting all the i's and crossing all t's. At the end of the day, our auditors were able to give us a three-page written opinion that we safely met all of the criteria necessary to qualify it as an operating lease.

BETBEZE: *With a third-party lease, the hospital loses a lot of leverage because funding to*

"IN ALMOST EVERY CASE, YOU CAN STRUCTURE IT SO THAT THE HOSPITAL RETAINS THE AUTHORITY ON WHETHER TO APPROVE ANY INVOICE THAT'S DUE."

the vendor often occurs before the implementation of the system. Neil, is this something that can be negotiated?

SUTLIFF: In almost every case, you can structure it so that the hospital retains the authority on whether to approve any invoice that's due. That way you still know you've got a vendor who's got a stake in the solution going live. There's a lot of technology that seems

to not come in on time or just not be there. I would have to get one heck of a good price to have a vendor not have any stake in it.

PARK: What you mentioned, Neil, is what we experienced here. Before the funding source makes the payment to the vendor, we review those payments to make sure that it's in accordance with the contract that was negotiated. So the funding source and the hospital had a good understanding of that up front.

BETBEZE: *Janet, another question for you: What are the most active foundations that give grants in this area beyond Robert Wood Johnson?*

MARCHIBRODA: There are a couple of other foundations that are thinking about it, and we're certainly trying to push this, as well. We're beginning to

see some interest from some of the large corporation foundations. I think you're going to be less likely to see a foundation come forward and just fund an IT implementation within an institution, but if you're working on a community-based project, whether to improve patient safety or to exchange data, to support quality improvement goals or public health goals, I think you'll have a better time at it. And

hopefully we're going to see additional funding in the budget on the federal government side as well.

BETBEZE: *I guess that's where pay for performance sometimes comes in, as well, right?*

MARCHIBRODA: I think that's where we'll see the real change; you know, the \$100 million here or \$200 million there won't get us very far when you think about the price tag on wiring Americans' healthcare. We're going to need significant changes or payment reform to get there, and I see it coming. Unique forces are at work right now.

BETBEZE: *One of our listeners wants to know how you protect yourself from escalation on soft costs like external consultants and internal full-time employee costs that are not budgeted.*

PARK: We did not include those types of expenses in the transaction that we did, but we did take a strong look at what external and internal resources were going to be necessary to implement the systems. Up to this point we have been about 90 percent accurate in making those assessments. There are a couple of instances that we did not properly consider when we were going through our decision time frame, but we generally budgeted for an increment in human resource costs internally as well as a portion for program and implementation management that we're buying from an outside source.

BETBEZE: *When you're trying to sell this off-balance-sheet transaction, one of the key constituencies that you're going to have to sell it*

to is your board, and probably no one is more aware of that than you are. How do you deal with their skepticism?

PARK: We went through a multi-phased approach where we actually presented this to our board in segments. The first segment dealt with the strategy side of the investment—going through the use issues associated with how we envisioned improving things within the hospital. The next session in the following month was when we actually went for approval. We brought the numbers to the table and looked at return on investment, the financing stream that we were looking at, the off-balance sheet, the criteria, including our auditor's opinion, and some of the core terms. The board recognized, because we had already shared our financial plan with them, that we were not going to be able to finance this acquisition absent doing an off-balance-sheet transaction, and so that was obviously a strong imperative from their standpoint.

BETBEZE: *Another question for Ron: How did the off-balance-sheet method change your ROI on this project?*

PARK: What we try to do is separate the financing decision from the investment decision. We go through a core ROI determination based on the acquisition price and then we upload the financing piece attached to it. We did look at some alternatives, but just given the fact that we were in a position of having to do this off-balance sheet, it did impact our ROI somewhat—but not materially enough to change the nature of the transaction.

BETBEZE: *One of our listeners wants to know if Neil has worked with any critical access hospitals.*

SUTLIFF: Yes. And I think the neat thing about critical access is to find funding sources that appreciate your position. Some don't like that kind of risk. And there are others who have taken the time to really kind of understand those markets. I've seen some folks who—I won't say they have a preference for that—but they have an appetite for that.

BETBEZE: *One of our listeners is concerned about the short shelf life of some parts of IT.*

SUTLIFF: The first thing that comes to my mind is that I've seen some hospitals combine IT financing with bricks and mortar. You know, somebody combines this technology and wraps it all into one big package and maybe throws it out there on a 15- or 20-year amortization. But are you living up to your fiduciary responsibilities to have technology that you know is going to need to be replaced in a short time on a 20-year amortization? But you know, folks do it. It may work out just fine. But before you make that decision, maybe investigate some of these alternatives.

BETBEZE: *Ron, did you have anything to add to that?*

PARK: Just a little bit. The issue for us is we're essentially looking at a 44-month term from the point of first use, and from our experience, even with the technological explosion that's out there, we feel confident that during the term of the financing that we have created, that this system will retain its useful life. ☐