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Demystifying the Financing Process: Best Practices in Securing USDA Loan Commitments

As the effects of the COVID-19 pandemic are better understood and the healthcare industry moves toward stability, the need to invest in rural hospital facilities to provide safe spaces for patients and staff alike is increasingly apparent. Rural hospital leaders are recognizing the importance of facility investment and the need to access the capital required to support their longer-term strategy including the ability to recruit and retain staff. Securing capital for investments in new facilities and equipment to enhance services requires the integration of multiple areas of expertise and perspectives that align into a coherent plan.

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Overview

The USDA Community Facilities (CF) program—an initiative under USDA-Rural Development (RD)—offers a tremendous opportunity for rural healthcare providers to take the next step by investing in facilities that reposition them as a provider of choice within their community, particularly for outpatient and ambulatory services. This is accomplished by decreasing outmigration to neighboring, typically larger, health systems and providing an enhanced service program that keeps more local healthcare dollars local.

A new facilities plan backed by USDA must be supported by a quantified need in the marketplace and evidenced by a clear forecast of future performance. Development of this plan requires integrating operational, financial, and strategic perspectives into the bricks and mortar and equipment investments that will be created and deployed. The complexity and expense of these challenges in securing capital to invest in new facilities are some of the primary reasons rural providers have made fewer facility investments than their urban and suburban counterparts.

Rural Hospital Replacement Study Findings

With this level of complexity and the challenge inherent in investing millions of dollars into new infrastructure, many leaders ask if the benefits are worth the risk. Stroudwater Associates asked these same questions beginning in 2005 and then commissioned a series of industry-leading studies of rural hospitals that have replaced their facilities to answer this very question. The study examined the pre- versus post-investment impacts on the hospital's volume, financial performance, and quality comparisons for the now over 170 Critical Access Hospitals (CAHs) that have replaced their facility. Not every CAH needs to be completely replaced, but the study design used a pre- versus post-replacement methodology to examine the specific impacts of modernizing clinical services and spaces to inform planners of the expected changes from capital investments, whether accomplished via renovation, expansion, or replacement.

Highlights of the key findings of this research include:

For Critical Access Hospitals that were replaced in 2011 or later, the overall annual increase in total volume per year for the first three years was 3.8%. These improvements to patient volumes were most consistent for outpatient services.

8% **increase in volumes**

To accommodate the extra volumes, the hospitals increased FTEs by an average 2.1%, but with the increase in staffing lower than the volume increase, the hospitals increased their efficiency overall as a result of the facility project.

2.1% **increase in FTEs**

From a financial perspective, even with the increased capital costs, these improved efficiencies helped ensure hospital performance three years post-replacement was improved with hospitals reporting on average 12.8% EBITDA (earnings before interest taxes depreciation and amortization).

12.8% **EBITDA**

USDA Community Facilities (CF) Program Introduction

Historically, rural healthcare providers have been disadvantaged even further in comparison to their urban counterparts by the lack of a reliable source of capital to fund a project, even when a plan is in place and the need is clear. Over the last decade, this has changed significantly as the USDA CF program has grown tenfold from an annual national allocation of $300 million to over $3 billion. The stated goal of the USDA-Rural Development program is to "invest in essential community infrastructure to help rural areas enjoy the same basic quality of life and services enjoyed by those in urban areas." USDA's recognition of the critical role healthcare plays in rural economic development is shown by the fact that nearly 50% of the entire $10.9 billion USDA loan portfolio is in outstanding healthcare commitments.

While the underwriting criteria to qualify for a USDA loan are relaxed to reflect their commitment to rural communities, the USDA manages the CF program to protect the use of public funds, to help ensure it remains viable, and to be sure the project meets a clearly identified need in the community.

USDA support for rural communities is primarily accomplished via:

Direct Loans
Available for projects with fewer than 20,000 people in the municipality where the project is located.

Loan Guarantees
available for projects with fewer than 50,000 people in the municipality where the project is located.

USDA Application Process and Best Practices

During the application and project development process, an area Specialist typically assists with basic application steps and regulatory requirements. Note: "Specialist" denotes their expertise in the agency rules and regulations across multiple programs. Few area Specialists have significant experience in healthcare finance; therefore, they do not advise applicants in the 'what' or 'how' for the project, but instead stay focused on the agency processes and application requirements. The technical work of translating the community need for the project into designs and a project budget that is based on a sustainable loan amount is provided by the organization's advisors and development team typically including the architects, accountants and bankers working on the project with the organizational leadership.

The application defines the amount of borrowing requested and includes the following due diligence reports from third parties to describe the need for the project, evaluate the sustainability, protect against environmental impacts, and ensure both USDA and the Guaranteed Lender have adequate collateral to secure the proposed loan:

1. **A Phase 1 environmental report, and environmental report or assessment**
2. **An examination-level financial feasibility report completed to AICPA standards**
3. **A Preliminary Architectural Report (PAR)**
4. **An appraisal indicating an 'as stabilized' value completed within Uniform Standards of Professional Appraisal Practice (USPAP) standards**

Successful applications tell the story with the following key elements:

Needs in the community are closely identified and connected to new service opportunities.

There is a clear strategic plan to leverage capital investment into enhanced services.

The facility spaces are designed to be efficient in providing community services.

The project budget is reasonable in size, scope, and design.

The feasibility study demonstrates the project's sustainability.

The costs associated with third-party reports required for application can be included in the loan amount, as can any origination fees charged by the lender; however, any fees paid to loan packagers or brokers are not allowed to be included as part of the loan balance and must be paid out of equity if incurred.

Because these documents are created by different firms with different perspectives, the third-party reporting process must be coordinated. Inconsistencies in these application materials will be revealed through the multiple levels of USDA review, requiring the applicant to go back and make costly and painstaking corrections.

The best practice in the process of developing a successful package of USDA application materials is a mix of technology-supported project management and in-person coordination. The project management function should provide transparency and accountability for individual roles and deadlines. In addition to this, a weekly coordination call is recommended to hold everyone (including the borrower) responsible for moving the project forward. Without this mix of processes, delays from each of the third-party reports can multiply quickly and slow down the application process unnecessarily.

Once completed, the application and supporting materials must first clear the state level through approval from the State Community Facilities Director, and then must pass an independent review and receive approval from regional asset managers that are experts in healthcare lending. This work is then reviewed at the National Office Loan Committee, which includes program leaders in Washington, DC. Given the complexity of the process, it is imperative that the application be properly created, supported, documented, and consistent with USDA's underwriting criteria. Any inconsistencies in the description of the project, the project budget, the financial feasibility study, the appraisal, or the environmental review process will result in the application being denied and the entire process being restarted.

Demonstrating community need and project viability are critical steps in securing USDA financing commitments and are reflected in the following two third-party reports required in the application process:

1. The Preliminary Architectural Report (PAR) completed by the project's architect to demonstrate that the facility is sized in accordance with the need in the market and is projected to be 'reasonable in size and scope' relative to the construction cost estimate.

2. The financial feasibility study completed by the applicant's auditor or a separate feasibility firm expert in USDA's requirements that presents the prior five years of financial history and projects five years into the future to evaluate the financial impacts of the project by taking the market need and translating it into projected volumes and patient care revenues.

Financial viability is assessed by evaluating the organization's past track record and projected future performance as described further below:

Analysis of five years of prior audited financial performance

Applicants may have prior year financial losses and still be eligible for a loan, for example, but if an applicant has had losses within its past five years of audited financial performance, then there is a review process called the "five for five" waiver that must be completed explaining the operational factors associated with that performance and offering evidence for why it is unlikely to happen again.

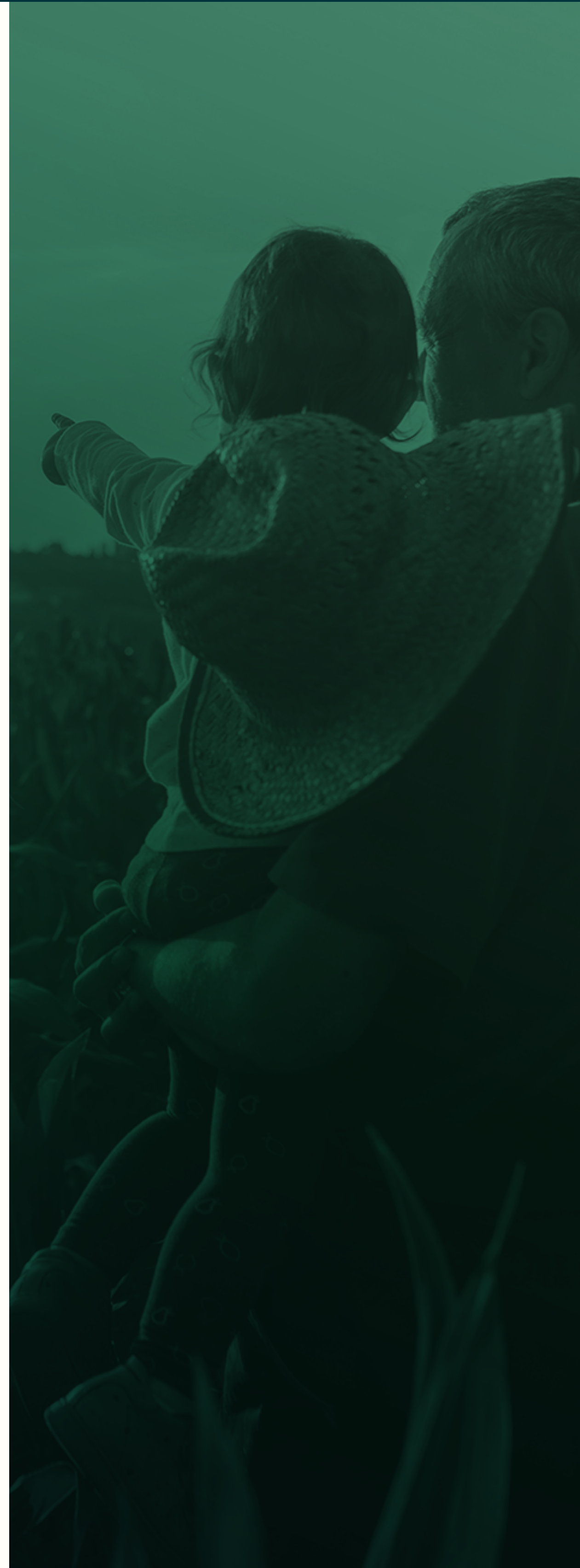
Projected performance for the upcoming five years, including the expected impact of the capital investment

In evaluating the feasibility of the proposed capital investment, the USDA CF program typically has minimal requirements, such as a 1.1 debt service coverage ratio and the funding of a restricted debt service reserve fund that sets aside and accumulates one year of debt service payments over the first 10 years of the loan.

The project's feasibility study and the lender's credit analysis

Must evaluate the underlying assumptions in the project feasibility and represent to the agency that those assumptions are reasonable and consistent with best practices in the industry and are reasonably achievable in the local market with the project investment.

The Community Facilities program enjoys a low default rate because the application process includes the lender's evaluation along with multiple levels of review and checks and balances in the underwriting process.



USDA's Public-Private Partnership and the Plan of Finance

With the growth in demand for USDA financing and the agency's desire to include private lenders in rural investments, these types of facilities projects are no longer funded with 100% allocation of Direct Loan funds. Instead, USDA-RD has sought to create a 'public-private partnership' by requiring funding applications to combine Direct and Guaranteed Loans in the overall financing plan. The typical debt "stack" is 80% Direct and 20% Guaranteed Loans; however, this can vary by applicant need. Requiring some of the project debt as a Guaranteed Loan is also part of the agency's Public-Private Partnership initiative created to leverage public funds and the government's credit rating to generate lender involvement from banks and credit unions. A summary of the different loan terms is below:

80%

The Direct Loan (typically 80% of the total debt) interest rate is fixed at the time of commitment for up to 40 years of repayment. The Direct Loan rate, at 2.25% for the third quarter of 2021, is established at the beginning of each quarter and is in effect for all commitments made within that quarter.

20%

For the remaining 20% of the debt, the Applicant must negotiate the rate specifically with a USDA Guaranteed Lender of the applicant's choosing and the rate may be fixed or variable under program regulations. Guaranteed Loans can be financed for up to 30 years.

In the negotiation of interest rates, some USDA Guaranteed Lenders are hesitant to provide fixed-rate financing for a 30-year period and alternatively will offer a loan that is repaid over 30 years but with an interest rate that "resets" after the first 10 years based on the prevailing rates at that time. This rate reset structure exposes borrowers to the potential for higher interest rate charges in the future, and with low rates in today's market, it is highly advisable for applicants to find a lender offering secure long-term fixed-rate financing to avoid 'playing the market.' Lenders also have different policies about when the loan rate gets locked. Borrowers are advised to review this with their lender and advocate for fixing the rate early in the process to avoid potential rate increases.

The Guaranteed Lender relationship specifically, and the public-private partnership generally, help the agency by ensuring that the private sector has 'skin in the game' in every project. In making loan decisions, the Guaranteed Lender provides the agency with both its underwriting analysis of the project and a commitment to take 'first loss' in the event of default to provide an incentive for making good loans.

USDA Financing Commitments

A successful USDA financing commitment is evidenced by two documents:

1. **A Letter of Conditions indicating the terms and covenants of the Direct Loan,**
2. **A Conditional Commitment for Loan Guarantee indicating the approved terms and covenants for the Guaranteed Loan.**

Of note, neither of these commitments includes financing for construction so borrowers should inquire with their lender regarding the availability of this funding.

The Direct Loan rate included in the Letter of Conditions is fixed for the entire life of the loan, unless the Direct Loan published rate decreases further during the project construction, in which case the applicant will get the better of the two rates when the permanent financing is placed. The Guaranteed Loan rate is negotiated with the lender directly, subject to agency review and concurrence, and the rate may be locked or fixed at any point depending on the lender. The best practice is when lenders fix that rate at the time of commitment. Guaranteed Lenders may also have covenants (requirements to stay in compliance with the loan) that are different, and possibly more restrictive, than for a Direct Loan.

Industry best practice is when Guaranteed Lenders commit to match the USDA Direct Loan covenant requirements.

Examples of covenants:

- Thresholds for maintaining operating days cash on hand
- More than one year's debt service required to be held in a restricted debt service reserve funds
- A debt service coverage ratio in excess of 1.1.

Conclusion

While the USDA Community Facilities program rules are indeed complex, delays in receiving third-party reports and submitting inconsistent application packages are the most common reasons for a long USDA financing commitment process. With a well-designed process resulting in a well-documented and justified application, the process of securing USDA commitments is typically completed within six to eight months. Unfortunately, it is easy for inexperienced advisors in this area to point the finger at bureaucratic programs, agency delays, or other external factors in attempt to displace the "blame" for a longer-than-best-practice timeline. Alternatively, following the best practice approach creates accountability and cuts the red tape to allow things to move forward, and as previously indicated, the research has shown a tremendous upside in the performance and sustainability of rural health leaders who have navigated this process successfully. The USDA Community Facilities program offers rural healthcare providers the chance to take the next step by investing in facilities that reposition them as a provider of choice within their community. The USDA program and many of its affiliated Guaranteed Lenders recognize and support the importance of these investments to enhancing the rural communities, and the low rates they offer through this program provide a tremendous opportunity to ensure the rural health infrastructure is sufficient for generations to come.

For more information, visit stroudwatercapital.us or contact Brian Haapala directly, (207) 221-8264