DAVIS MOORE
HEALTHCARE PRACTICE GROUP

# Financing Strategies for Hospital System Ambulatory Projects: A Comparative Analysis


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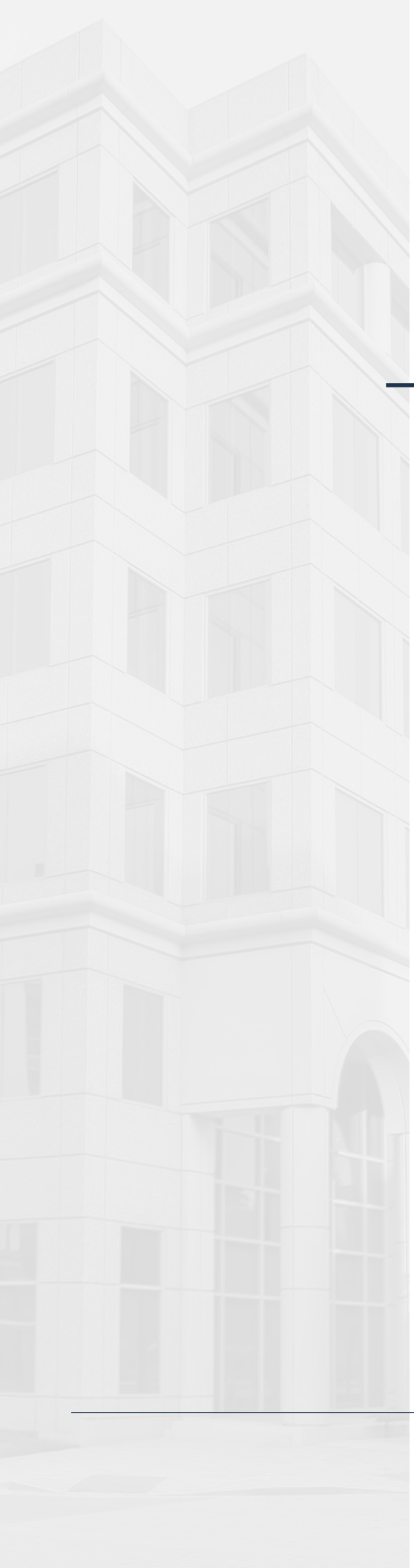


# Outline

# Executive Summary

**Hospital systems face increasing pressure to expand facilities** such as medical office buildings (MOBs) and ambulatory surgery centers (ASCs) to meet growing demand for outpatient services, driven by an aging population and shifts toward value-based care. However, financing these projects requires careful evaluation of options to optimize costs, preserve liquidity, and align with strategic goals. This white paper compares four key financing structures: lease financing, debt financing, structured products financing (Credit Tenant Leases and Synthetic Leases), and using operating cash flows. It provides overviews of each type of financing, a list of pros and cons, incorporates the opportunity cost of internal capital, and offers recommendations for hospital executives.

**Key Findings**

While lease and structured financing products preserve capital and offer flexibility, they often carry higher long-term costs. Debt financing provides ownership benefits but increases risks. Using operating cash avoids external obligations but incurs significant opportunity costs, especially at a weighted average cost of capital (WACC) around 8% for non-profit systems in strong markets. Executives should prioritize total cost analysis, including net present value (NPV), alongside non-financial factors like balance sheet impact and regulatory compliance.

# Introduction

The U.S. healthcare sector is projected to grow at 5-6% annually through 2030, with ambulatory facilities playing a central role in expanding patient care. Constructing or acquiring these assets, however, demands substantial capital – often $5-15 million for mid-sized projects. Non-profit hospital systems, which dominate the sector (comprising about 58% of community hospitals), must balance mission-driven priorities with financial sustainability. Financing decisions impact liquidity, credit ratings, and long-term viability, especially amid rising labor costs, inflationary pressures, and uneven post-pandemic recovery.

This analysis targets hospital leaders navigating these choices. It emphasizes the opportunity cost of internal capital: when using cash reserves, systems forego potential returns from alternative investments (e.g., clinical programs or endowments) which can be quantified via the system's weighted average cost of capital. By comparing financing structures across cost, risk, and strategic fit, this paper equips executives to make informed decisions.

# Overview of Financing Structures

## Lease Financing

Lease financing involves a developer or landlord constructing the MOB, with the hospital system as tenant paying rent over a fixed term (typically 10-to-20-year initial lease terms). The hospital does not own the asset but may have renewal or purchase options.

### Key Features

Rent is determined by the developer's yield requirements which can range from 6.5% to 8% in 2025 based on the location of the project and the tenant's credit profile. Annual lease escalations range from 2.0% to 4.0% with current annual inflation being the driving force. Leases are often structured as triple-net (NNN), where the tenant covers taxes, insurance, and common area maintenance. In a lease from a developer, the developer typically finances the construction through their own debt or equity, then leases the completed MOB to the hospital system. Projects can include a ground leases back to the system if the hospital owns the land.

The developer assumes construction risks, such as delays or cost overruns, and may offer turnkey delivery. Lease terms are customizable, often including options for early termination, expansion rights, or buyout clauses at fair market value. Developers may also offer a speed to market and agile procurement efforts for larger systems that can get bogged down in multiple layers of decision making. The lease structure also avoids adding debt to the balance sheet if classified as an operating lease under ASC 842, preserving borrowing capacity for other needs.

## Debt Financing

Debt financing uses borrowed funds to purchase or build the MOB, with the hospital owning the asset. Repayment occurs either via amortized payments or a balloon payment at the end of the term.

### Key Features

Interest rates around 5.5% for taxable bonds in 2025 and terms typically between 15 and 30 years. This category encompasses several specific instruments:

- **Mortgage Debt:** A secured loan where the building itself serves as collateral. Lenders provide funds based on the property's costs and/or appraised value, typically up to 75-85% loan-to-cost (LTC) or 65% to 80% loan-to-value (LTV). Rates may be slightly higher than bonds (5.75-6.5% in 2025), with terms of 10-25 years and balloon payments of the debt balance expiration. It can be recourse or non-recourse depending on the borrower's credit and includes covenants like debt service coverage ratios. These loan products are Ideal for systems with strong real estate assets but typically require equity for the down payment.

- **Tax-Exempt Bonds:** Available to non-profit hospitals via municipal bond markets or authorities. These offer lower rates (4.0 – 5.0 % in 2025) due to tax-free interest for investors, making them cost-effective for qualifying projects. Issued under IRS Section 501(c)(3) rules, they require the project to support exempt purposes (e.g., healthcare delivery). Terms are long (20-40 years), often variable-rate with swaps for fixed effective rates. Compliance involves use-of-proceeds restrictions and private use tests to avoid taxable reclassification.

- **Taxable Bonds:** Used when tax-exempt status isn't feasible (e.g., for-profit affiliates or non-qualifying uses). Rates are higher (5.5-6.5% in 2025) but provide flexibility without IRS constraints. Issued publicly or privately, they suit larger systems with investment-grade ratings (A- or better from S&P). Both bond types may involve underwriting fees (1-2%) and can be refinanced if rates drop.

## Structured Products Financing

- **Credit Tenant Lease (CTL):** A specialized loan where financing is based on the tenant's (hospital's) credit and lease payments, often in a sale-leaseback. The lender views the lease as collateral.

    ### Key Features

    Rates around 6.0% in 2025, coterminous with the lease, up to 75-100% loan-to-value (LTV) for investment-grade tenants. In a CTL, the hospital may sell the project to an investor or


developer, then lease it back, with the lease payments securing the lender's note. It's essentially a bond-like instrument backed by the tenant's credit rather than the property's value, allowing higher LTVs (up to 100%) for strong credits. Non-recourse to the hospital, with prepayment options via defeasance or yield maintenance. Popular for monetizing existing assets without losing operational control, but requires a long-term, absolute net lease where the tenant assumes all risks.

- **Synthetic Lease:** An off-balance-sheet operating lease where a special-purpose entity (SPE) owns the asset, but the hospital retains tax benefits of ownership (e.g., depreciation). Structured to mimic debt for tax purposes but a lease for accounting.

  **Key Features**

  Rates similar to debt (5.0-6.0%), with a residual value guarantee (e.g., 10% tail risk). Popular for preserving balance sheet flexibility. The SPE, often bank-sponsored, borrows to build or acquire the project, then leases it to the hospital under terms that qualify as operating under ASC 842. The hospital gets tax deductions for interest (via the SPE's debt) and depreciation, while the lease payments cover the SPE's obligations. At term end, the hospital can purchase at a predetermined price, renew, or walk away (with residual risk if the asset's value drops below guarantee). Setup involves legal complexity and fees (1-2% of project cost), and FASB scrutiny may lead to reclassification if it resembles financing.

## Financing with Operating Cash

Using internal reserves or cash flows to fund construction outright, avoiding external obligations.


**Key Features**

No interest or rent payments but ties up capital that could generate returns elsewhere. This approach provides immediate ownership and control, with no ongoing obligations or covenants. However, it requires sufficient unrestricted cash or endowments, which non-profits often accumulate from operations, donations, or investments. Systems must consider liquidity ratios (days cash on hand) to ensure reserves aren't depleted below board-mandated thresholds.

When financing projects with internal capital, systems must not forget that there is a cost associated with these funds that is often higher than the cost of external capital. Opportunity cost represents the foregone benefits when internal capital is allocated to one use over alternatives. For non-profit hospital systems, using operating cash for an ambulatory project means sacrificing potential returns from investing in higher-yield opportunities, such as endowment growth, clinical expansions, or higher interest rate debt reduction. This cost is quantified using the weighted average cost of capital (WACC) which is the blended cost of debt and equity financing. For non-profits in strong markets, WACC averages 7-10% based on 2023-2025 medians from S&P Global Ratings and industry analyses. Ignoring this cost, inflates the appeal of cash financing.

# — Pros & Cons of Each Structure

| Financing Structure | Pros | Cons |
|---|---|---|
| **Leasing Financing** | • Preserves capital for core operations.<br>• Off-balance-sheet treatment is possible under ASC 842 (if operating lease).<br>• Flexibility: No long-term debt; easier exit via non renewal.<br>• Developer handles construction risks.<br>• Lease from developer allows turnkey solutions without in-house expertise. | • Higher long-term costs (rent often exceeds debt service).<br>• No asset ownership or appreciation.<br>• Escalations increase expenses over time.<br>• Potential for landlord disputes or renewal risks.<br>• Developer leases may include markups for their profit margins. |
| **Debt Financing** | • Ownership: Asset appreciation, depreciation benefits (for taxexempt non-profits, limited but useful).<br>• Tax-deductible interest (if applicable).<br>• Fixed payments provide predictability.<br>• Builds equity over time.<br>• Tax-exempt bonds lower effective costs for non-profits; mortgage debt offers propertyspecific security. | • Increases leverage, potentially harming credit ratings.<br>• Interest rate risk (though fixed in bonds).<br>• Requires strong cash flows for debt service.<br>• Balance sheet impact: Adds liabilities.<br>• Tax-exempt bonds involve regulatory hurdles. |

# — Pros & Cons of Each Structure Cont.

| Financing Structure | Pros | Cons |
|---|---|---|
| **Structured Products** | • CTL: High LTV (up to 100%), lower rates due to credit focus; non-recourse options; effective for sale-leasebacks.<br>• Synthetic: Off-balance-sheet for accounting, ownership for tax; custom terms; residual options provide exit strategies.<br>• Both: Transfers some risks to lenders/investors; suitable for sale-leasebacks. | • CTL: Rigid terms; dependent on credit rating; prepayment penalties; lease-backed structure limits modifications.<br>• Synthetic: Complex setup (SPEs); residual guarantees add risk; potential for reclassification.<br>• Both: Higher upfront costs (legal/structuring fees).<br>• Both: Market-dependent rates |
| **Operating Cash** | • No interest, rent, or external obligations.<br>• Full control and ownership.<br>• Avoids financing fees and covenants.<br>• Simplifies balance sheet. | • High opportunity cost: Capital could yield 8%+ elsewhere (e.g., investments or programs).<br>• Depletes reserves, reducing liquidity for emergencies.<br>• Ties up funds in illiquid assets.<br>• No leverage benefits. |

# Recommendations for Evaluating Alternatives

When assessing options, consider the following:

**1. Total Cost Analysis:** Use net present value analysis (NPV) and annual equivalent costs with an appropriate weighted average cost of capital (WACC) to factor opportunity costs. Model scenarios for rate changes or escalations.

**2. Balance Sheet and Liquidity:** Leases/structured products preserve ratios; debt/cash may strain covenants. Monitor S&P medians (days cash on hand ~200 for 'A' ratings).

**3. Risk Profile:** Evaluate interest rate volatility (debt), tenant credit (CTL), or liquidity risks (cash). Non-profits should stress-test for reimbursement cuts.

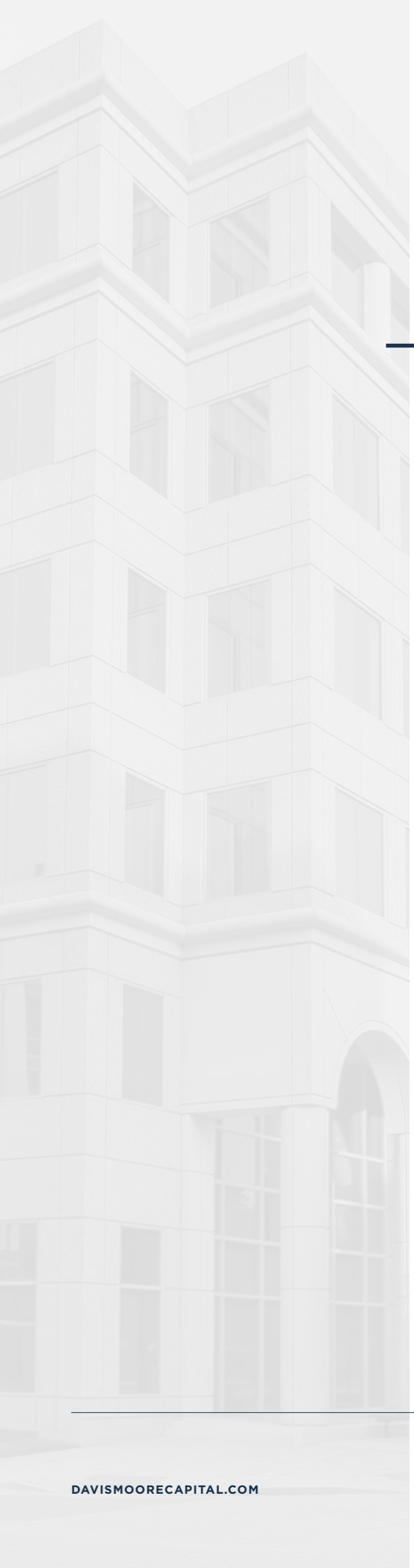
**4. Strategic Fit:** Align with mission by evaluating ownership for long-term control vs. leasing for flexibility in evolving markets.

**5. Regulatory/Accounting:** Ensure ASC 842 compliance; synthetic leases risk reclassification. Consult on tax-exempt bond rules.

**6. Market Conditions:** In 2025, with rates stabilizing (Fed funds 4.25-4.5%), favor fixed-rate debt. Monitor WACC trends which could rise with inflation.

**7. Expert Input:** Engage financial advisors for custom modeling and advice.

By weighing these, executives can optimize financing to support sustainable growth while mitigating risks. For tailored advice, consult your finance team or external experts.



# About Davis Moore

Physician practice groups and health systems turn to Davis Moore to solve their most critical ambulatory real estate needs. Over the past twenty years, Davis Moore principals have participated in more than 1,500 healthcare transactions that total to more than 18 million square feet all from the providers perspective. We understand the issues and opportunities that affect today's healthcare providers, since we only work for providers.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