MEMO

TO: Wynee Hawk, Director, Facilities Planning & Development, MHCC
Jeanne Marie Gawel, Acting Chief, CON, MHCC
Eric Baker, Program Manager, CON, MHCC

FROM: Jon Kromm, Executive Director, HSCRC
Jerry Schmith, Director, Revenue & Regulation Compliance, HSCRC
Bob Gallion, Associate Director III, Revenue & Regulation Compliance, HSCRC

DATE: September 22, 2023

RE: Hope Health Systems, Inc. (HHS)
Special Psychiatric Hospital – 16-bed Child & Adolescent Facility
Docket No. 23-03-2465

This memo is in response to your request dated March 29, 2023, as updated in your memo to us dated September 21, 2023. This concerns our review of materials submitted by the applicant on March 20, 2023, regarding its amended application for a Certificate of Need (CON), and supplemental materials dated June 9, 2023, and September 8, 2023. Finally, this memo includes consideration of the applicant's responses to completeness questions dated April 4, 2023, and any impact such subsequent review has had on HSCRC staff's (Staff) opinion on the financial feasibility of the project.

BACKGROUND

We have previously responded to similar requests from the MHCC on this same proposed project related to the initial CON application dated October 21, 2020. Our response dated August 9, 2021, concluded that Staff was not in a position to reach an opinion on the financial feasibility of this project. And our response dated September 9, 2021, concluded that Staff was not in a position to reach an opinion on the financial feasibility of the project, so our conclusion remained unchanged.

THE PROJECT

As described in the amended CON, HHS is proposing to establish a 16-bed inpatient psychiatric hospital for children and adolescents, with four single rooms for children and eight single rooms for adolescents. Such hospital is to be established in a yet to be renovated portion of a facility in Woodlawn, Maryland where currently HHS operates an outpatient behavioral health facility for adults, children, and adolescents. The capital cost of the Project is to be split between HHS ($1,365,000 principally for tenant's working capital startup costs) and its affiliate Hope Health Properties (HHP) ($4,612,140 principally for landlord's cost of the renovation of the 15,329 square feet space to be used for the inpatient hospital facility), with additional capital cost to be afforded via lease rental by HHS for medical and IT equipment and furnishings. HHS and HHP share common ownership and management. HHS is proposing to enter into a lease agreement with HHP for the space once finished and renovated. The inpatient hospital is to have a separate entrance for patients and visitors, distinct from the outpatient portion of the facility.

HSCRC STAFF REVIEW, DISCUSSION, and OPINION

Staff reviewed the following materials: the HHS CON application dated March 20, 2023; Responses dated June 9, 2023, to Completeness Questions dated April 4, 2023; Revised Application Tables dated June 9, 2023; the Independent Audit Report dated June 7, 2023, for HHS and HHP Combined for the year ended December 31, 2021; Supplemental Responses dated September 8, 2023, to Completeness Questions dated April 4, 2023; and the Independent Audit Report dated September 9, 2023, for HHS and HHP Combined for the year ended December 31, 2022.

In the previous reviews of this project, Staff had requested audited financial statements with full GAAS footnote disclosures. Included in the materials for this amended CON, the applicant has provided an audit report for fiscal 2021 from a nationally reputable CPA firm, and Staff studied the audit opinion, the statements, and the disclosures. The audit report for fiscal 2021 was dated June 7, 2023, and the opinion was clean with provisions for emphasis-of-matters related to substantial doubt about the company's ability to continue as a going concern. Such brought attention to the fact that as of the date of the statements, the applicant had debt due to the bank with substantial balances beyond the respective maturity dates and subject to immediate repayment. Upon review of the footnote disclosures, it was noted that as of the balance sheet date, the applicant was not in compliance with restrictive covenants; was delinquent in payments to the bank by a material value and was subject to possible foreclosure; and additionally, that the applicant's management did not anticipate contributing more funds to service the debt in 2023. Days-cash-on-hand to service cash basis operating expenses was just 4 days, and the debt service coverage ratio was a -0.5 measure (EBITDA of -$2.1 million over debt service of $3.9 million).

Included in the materials for the Supplemental Responses dated September 8, 2023, to Completeness Questions dated April 4, 2023, the applicant provided an audit report for fiscal 2022 from a local CPA firm (different from the firm engaged in the prior year's audit), and Staff studied the audit opinion, the financial statements, and the footnote disclosures. The audit report was dated September 9, 2023, and the opinion was clean and without mention of any qualification for the company's ability to continue as a going concern. Upon review of the financial statements, it was noted that the balance sheet did not foot; the statement of Retained Earnings did not tie back to the balance sheet; and the statement of Cash Flows did not tie back to the balance sheet. Additionally, it was noted that certain balance sheet values which had been written off by the prior auditor as unrealizable, were written back on to the balance sheet by the most recent auditor. Upon review of the footnote disclosures, it was noted that certain values included in the notes as pertaining to the financial statements did not tie to the financial statements, and certain values included in the notes as pertaining to the 2022 financial statements actually tied to the 2021 financial statements. In addition, the Supplemental Responses made mention of a refinancing transaction that occurred on June 23, 2023; however, such transaction was not noted as a subsequent event in the audit report. Events of a material nature occurring after the balance sheet date but before the end of audit fieldwork (which should coincide with the date of the audit opinion) are to be disclosed in the notes to the financial statements. Staff concluded that the audit report for fiscal 2022 as submitted, is seriously deficient. Given that certain of the CON Tables were represented in the September Supplemental Responses as being modified and resubmitted to be consistent with the 2022 audited financial statements, Staff did not reference those amended Tables.

Staff noted that Tables H (P&L Projected for Entire Facility or Services with Inflation) and K (P&L Projected for New Facility or Service with Inflation) as submitted June 9, 2023, did not foot. Derived profitability was greatly diminished when the projections were made to foot. Additionally, Staff took note that interest expense projected on current existing debt and interest expense projected on project related debt were understated in the projected P&Ls, and that HHS is guarantor of HHP debt. Staff noted that as per Table E (Project Budget), none of the interest on planned project debt is capitalized during construction. Staff notes the applicant's assumption that the payer mix for the proposed inpatient (IP) services is 80% Medicaid and 0% Medicare, and that the payer mix for the entire facility/service is 73.6% Medicaid and 6.4% Medicare. Such high public payer mix suggests that the HSCRC may not regulate their operations nor set their reimbursement rates. Staff is comfortable that the starting position (FY 2023) of IP service rates used in the projections approximates the average reimbursement per patient day for Sheppard Pratt and Brooklane.

Staff prepared pro forma Tables K and H incorporating the information researched during this review; such pro forma Tables were based upon the June submission. The pro forma Table K (P&L Projected for New Facility or Service with Inflation) reflects: annual inflation on the Medicaid portion of the IP psych services of 3.0% as per review of the Maryland Medicaid Administration, Public Behavioral Health System Fee Schedules for IP in-facility psych services for the five years ended fiscal 2024; contra revenues of 14.5% as per review of the RE schedules on file by Sheppard Pratt and Brooklane; and a conservative presentation of interest expense on project debt recognizing that HHS is guarantor of HHP debt, and using the debt financing assumptions included in the CON application (inclusive of the assumption that no interest is capitalized during the construction period). The pro forma Table K projected pre-tax operating margin for the five years ending fiscal 2028 averages profit of $374,000 per year (or 4.4%), and the pre-tax operating margin for fiscal 2028 (the first year at full occupancy measured at 83.3%) is a profit of $966,000 (or 11.0%).

The proforma Table H (P&L Projected for Entire Facility or Services with Inflation) incorporates all the assumptions used in pro forma Table K plus interest on current debt as calculated using the amortization schedules on existing debt as reflected in the 2021 audit report. The pro forma Table H projected pre-tax operating margin for the five years ending fiscal 2028 averages a profit of $513,000 (or 1.9%), and the pre-tax operating margin for fiscal 2028 (the first year at full occupancy) is a profit of $1,502,000 (or 5.5%). Staff notes the applicant's change in implied billing rates per OP visit in its submissions after March; iterations of Tables G and H reflect higher OP revenues while the OP volumes assumed did not change in Table F; and such changes have the effect of driving up projected OP revenues from the initial March projections to the June projections and again higher still to the September projections. The probability that the pro forma results will be achieved five years out is subject to the bank's willingness to forego payment on delinquent balances and extend additional credit. The pro forma operating performance measures are just a piece of the projected financial condition of the applicant, as debt service on delinquent debt positions may draw down available cash for operations to an uncomfortable level.

In the opinion of Staff, the probability that the applicant can achieve and maintain healthy solvency and secure additional financing for this project is less than likely. And it is the opinion of Staff that the servicing of current debt plus the servicing of any additional debt it may incur while also staying current on vendor payables and payroll may greatly erode the already insufficient liquidity of the HHS and put the applicant's financial position at additional risk for insolvency.

You have requested that Staff opine on the financial feasibility of the special psychiatric hospital project proposed by HHS. Staff is not satisfied that the applicant has sufficient working capital to maintain the operation from its inception throughout at least two years after the completion and full occupancy of the project. Staff does not see sufficient resources in place as of the 2021 audited balance sheet date, and Staff is not comfortable with the reported 2022 audited balance sheet. Staff also is concerned that use of its working capital places at risk the financial position of the applicant (as measured by its debt covenants, its balance sheet liquidity, its leverage, and equity ratios). Given the history of related party transactions, and relatively poor liquidity and profitability, Staff is not comfortable that the applicant will avoid detrimental risk. In addition, staff is not comfortable that the applicant can assemble the financial resources necessary to get the project off the ground and can then subsequently service any such financing sources without putting its financial position at a level of unhealthy risk.

Based upon the history reviewed and the materials submitted to date, Staff is less than assured that the applicant can secure the needed additional financing and then service both existing debt plus any new debt without running short of resources. These required levels of comfort go beyond the question of whether the project can achieve a positive operating margin at least two years (or longer as required) after project completion and full occupancy. Staff typically bases its opinion on sufficient competent evidence as submitted by the applicant, recognizing that there are times when the evidence needed to review is beyond that which was included in the initial CON application. At this time, based upon review of all the submitted materials, Staff is not able to reach a positive opinion of the financial feasibility of this project.