maryland
health services
cost review commission

MEMO

TO: Wynee Hawk, Director, Facilities Planning & Development, MHCC
Jeanne-Marie Gawel, Acting Chief, CON, MHCC

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

DATE: November 1, 2023

RE: Luminis Health Doctors Community Medical Center (LHDCMC)
Obstetric Service & Facility Expansion & Renovation
Docket No. 23-16-2466

This memo is in response to your request dated May 19, 2023, regarding our review of the financial projections as provided in the Certificate of Need (CON) application dated April 7, 2023, and our opinion on the initial feasibility and ongoing viability of the proposed project. In addition, you have requested that we comment on the status of discussions with the applicant regarding their seeking an increase in their Global Budget Revenue (GBR) for a capital award to cover the incremental depreciation and interest to be expensed following the construction and commencement of operations of the proposed project.

BACKGROUND:

LHDCMC is a non-profit hospital located on a 40-acre campus in Lanham, Prince George's County, Maryland, with 200 licensed acute care Medical Surgical Gynecological Addictions (MSGA) beds. The hospital was founded in 1975, and it was recently CON approved for an additional 16 psychiatric beds scheduled to be operational by 2027. In 2019, LHDCMC became an affiliate of Luminis Health, Inc., which also manages Luminis Health Anne Arundel Medical Center (LHAAMC), and J. Kent McNew Family Medical Center.

THE PROJECT:

LHDCMC proposed to establish a new obstetric program, construct a new acute care pavilion adjacent to the existing hospital building, and renovate hospital infrastructure and surgical services facilities to improve hospital functions. The new 4-story pavilion is expected to span 167,000 square feet, and to house administrative functions on the 1st floor, general purpose operating rooms on the 2nd floor, and the new obstetrics program on the 3rd and 4th floors. As per the CON, the cost of the project is approximately \$286.6 million. The lower three floors of the pavilion will align with and connect to the existing hospital, while the 4th floor will not connect back to the existing hospital. The renovations to existing facilities include laboratory, imaging, morgue, loading dock, supply, kitchen, dining, laundry, and environmental services. The project is to be executed via three separate contracts, one for each of three phases: Phase One includes the loading dock relocation (18 months); Phase Two includes constructing the new 4-story pavilion (24 months, and Phase Three includes the renovation of existing spaces (24 months). The anticipated timeline includes relocating the loading dock by 2024, obtaining financing and beginning pavilion construction activities by January 2025, opening the pavilion, and beginning renovations by January 2027, and concluding renovations by January 2029. LHDCMC plans to request a GBR capital award to be effective beginning in FY 2027.

The initial CON project budget reflects uses of funds of capital cost of $254.4 million, inflation allowance of $29.1 million, and bond issue fees of $3.1 million. The sources of funds include cash of $33.7 million, philanthropy of $5 million, bonds proceeds of $152.9 million, and state grants of $95 million.

MHCC has stated that the utilization projections included in the CON are reasonable, and that HSCRC staff may assume that the hospital will achieve its projected utilization volumes.

<u>HSCRC STAFF REVIEW, DISCUSSION AND OPINION:</u>

HSCRC staff (Staff) reviewed the following materials: the LHDCMC CON application dated April 7, 2023; the LHDCMC Responses dated May 17, 2023 to MHCC Request for Completeness Information dated April 25, 2023; the LHDCMC Responses dated June 23, 2023 to MHCC Completeness Questions dated June 2, 2023; the LHDCMC Responses dated July 7, 2023 to MHCC Request for Table's Assumptions dated June 30, 2023; and the Audit Reports for fiscal years ended June 30, 2022 and June 30, 2021 for Luminis Health, Inc. and Subsidiaries. In addition, Staff requested and reviewed the internally prepared (unaudited) financial statements for the fiscal year ended June 30, 2023, which were received October 3, 2023.

The most recently Revised Tables were submitted July 7, 2023, with the LHDCMC responses. The revised Table E Project Budget reflects an increase of $12.4 million to project uses for capitalized interest during the construction period, and an increase of $12.4 million to financing sources from cash. The total project budget now reflects $299.0 million. As per the applicant, the obligated group for any borrowings to finance this project is Luminis Health, Inc., LHAAMC, LHDCMC, and Luminis Health Imaging. Staff noted that the estimated useful life of assets acquired ($296 million) was assumed by the applicant to be 36 years. Upon review of the Revised Table E Project Budget, Staff noted that the fixed equipment component of the new construction was grouped together with building and not segregated. Such equipment may likely be material in value and likely carry a 15-year useful life. As per Staff's review of recent CON applications, the average useful life of acquired assets in construction projects was 25 years, and as per review of the Luminis audit report, the average useful life of Luminis' assets is 25.5 years. Given that this project represents an entire hospital building, Staff believes that the 36-year average useful life assumption may be miscalculated and likely overstated. Staff notes that the effect of applying overly optimistic lives to assets may lower reported accrual based annual depreciation expense thereby inflating operating margin, but such has no impact upon cash flow from operations. Staff prepared an amortization schedule for a $152.9 million bond at 5.5% interest assuming the borrowing and pavilion construction begin January 2025 and the pavilion opens January 2027. Staff computed approximately $16.7 million of capitalized interest over 24 months, while the applicant computed approximately $12.4 million in capitalized interest during construction. Additionally, Staff computed approximately $50.6 million in expensed interest over the periods projected, while the applicant computed approximately $49.1 million in expensed interest. Staff notes that the potential understatement of interest to be expensed may overstate projected net operating margin.

Revised Table G (P&L Uninflated, Entire Facility & Services) and Table H (P&L Inflated, Entire Facility & Services) reflect changes to top-line Revenues for existing IP and OP services to reflect annual price inflation (2.8%), Contra-Revenues to reflect a consistent 17.1% annual reduction, Interest Expense on Current Debt to reflect a falling balance on debt, Interest Expense on Project Debt to strip off price inflation, and Depreciation Expense on Project's Assets to strip off price inflation, as compared to the initially submitted respective Tables. Staff notes the values presented ($4,161,451 in current 2023 dollars or $4,647,477 in future 2027 dollars) for a capital award to GBR for the proposed project's incremental cost of interest and depreciation, as well as open questions on the project's interest on borrowings (both capitalized and expensed) and project's depreciation expense given a relatively long average useful life of acquired assets. The Revised Table H (P&L Inflated, Entire Facility & Services) for fiscal 2033 which represents the second full year after all changes due to the newly proposed service reflects top line revenues of $469.2 million, net operating revenues of $391.5 million, and an operating margin of $25.6 million profit (or 6.5%).

The revised projections are also subject to the realizability of budgeted proceeds from philanthropy ($5.0 million) and state grants ($95.0 million). As of this date, none of the philanthropy is reported as collected, and $6 million of the grant was appropriated for FY 2024, with an additional $10 million pre-authorized for FY 2025. That leaves $84 million yet to be realized. Although Luminis is confident in the realizability of gifted/granted funding, to the extent that such planned sources go unrealized, Luminis plans to increase draws against operating cash, liquidated investments, and bond financing. This would put additional stress on the financial feasibility of the project by reducing the Days of Cash on Hand and Debt Service Coverage Ratio.

Revised Tables J (P&L Uninflated, New Facility & Services) and Table K (P&L Inflated, New Facility & Services) also reflect changes to Contra-Revenues, Interest Expense on Project Debt, and Depreciation Expense on Project's Assets, as compared to the initially submitted respective Tables. The most recently submitted Table K for fiscal 2033, which represents the second full year after all changes due to the newly proposed service, reflects top line revenues of $57.5 million, net operating revenues of $47.7 million, and an operating margin $5.8 million profit (or 12.2%).

Staff prepared pro forma projections for Tables H and K. Such pro forma presentations reflect Staff's judgement on likely operating performance after consideration of gathered information. Relative to patient service revenues, the pro forma projections provide for one-time reduction to GBR for the All-Payer Rate Reduction for TCOC Performance for Medicare Compliance of $288,672 split between 2023 and 2024; and such also provide for the assumed 2.8% annual update factor, and a flat 17.1% contra revenue for each fiscal year. Relative to operating expenses, the pro forma projections provide for expensed interest as per the debt amortization test, and depreciation expense consistent with the 25.5-year average useful life of acquired depreciating assets consistent with the audit report. Staff reviewed for reasonableness the projected revenues per obstetric (OB) case and per OB patient day, as well as the reasonableness of the annual update factor of 2.8%, and the volume growth assumptions for OB cases over time due to proposed market-shift and demographic changes. These assumptions were judged to be reasonable on their face; however, specifics by year were not within the scope of our review. Staff computed an approximate capital award for incremental interest and depreciation on this project consistent with the policy model of $6.52 million, to become effective when operations commence mid-year fiscal 2027, and to grow at an annual rate of 2.8%. The Pro Forma Table K (P&L Inflated, New Facility & Services) yielded average operating results on OB Services for the 3 years ended 2033 as follows: annual operating income of $3 million or 6.2% of operating revenues, and annual cash flow operating margin of $14.5 million. The Pro Forma Table H (P&L Inflated, Entire Facility & Services) yielded average operating results on Hospital Services for the 3 years ended 2033 as follows: annual operating income of $20 million or 5.2% of operating revenues, and cash flow operating margin of $43.5 million.

Staff requested but did not receive projected balance sheets. Staff reviewed Days Cash on Hand and Debt Service Coverage Ratio (DSCR) for the Luminis Obligated Group as of the most recent audited balance sheet date (June 30, 2022), and determined 169.6 Days of Cash on Hand, and a Debt Service Coverage Ratio (DSCR) of 0.97:1 on June 30, 2022 (that is Operating EBITDA $28.735,000 / Debt Service $29,543,000). This project's budget of $299.0 million represents 120.9 days of FY 2022 cash operating expenses, which if on a pro forma basis had been transacted with no other financing sources, would have left the Luminis Obligated group with just 48.7 days cash on hand as of July 1, 2022. Alternatively, if the sources of financing were as budgeted and applied to the same balance sheet date, then the Days Cash on Hand would have been 212.8 days (due to debt proceeds and cash used) and DSCR would have been 0.83:1 on July 1, 2022. A DSCR of 1.2:1 or higher is barely sufficient, while a DSCR below 1.0:1 indicates a potential failure of a Bond Covenant. Staff notes the DSCR of the Obligated Group as measured June 30, 2022 (0.97:1), and the pro forma measure assuming the project budget was afforded on July 1, 2022 (0.83:1).

Staff requested and did receive the internally prepared (unaudited) financial statements for Luminis Obligated Group as of June 30, 2023. Staff reviewed such statements and determined 175.8 Days Cash on Hand, and a DSCR of 0.98:1 on June 30, 2023 (that is Operating EBITDA $28,219,000 / Debt Service $28,963,000). The project's budget of $299.0 million represents 124.4 days of FY 2023 operating expenses, which if on a pro forma basis had been transacted with no other financing resources, would have left the Luminis Obligated Group with just 51.4 days of cash on hand as of July 1, 2023. Alternatively, if the sources of financing were as budgeted and applied to the same balance sheet date, then the Days Cash on Hand would have been 220.2 days (due to debt proceeds and cash used) and DSCR would have been 0.94:1 on July 1, 2023. Staff notes the DSCR of the Obligated Group as measured June 30, 2023 (0.98:1), and the pro forma measure assuming the project budget was afforded on July 1, 2023 (0.94:1).

Staff believes that the above measured DSCRs for June 30, 2022, and June 30, 2023, are indicative of operating performance measures for the obligated group that are insufficient to service the burden of its present debt and its planned additional project debt.

Staff spoke with MHHEFA, the Luminis finance management team, and executive management with another large healthcare system in Maryland, regarding the computation of DSCR used in evaluating debt covenants. Staff was able to confirm that the DSCR covenant for hospitals is computed inclusive of realized investment income (interest, dividends and net realized gains) and certain other realized non-operating income items, and that such computation is consistent with MHHEFA bond covenant requirements. The DSCR inclusive of realized "below the line" income as computed by Luminis and shared with the rating agencies and MHHEFA is 1.84:1 for 2022 and 1.57:1 for 2023. By comparison, the Moody's Healthcare September 2023 report reflects a median DSCR of 3.6:1 for 2022, and the S&P's Healthcare August 2023 report reflects a median DSCR of 3.2:1 for 2022.

Staff notes that for any hospital, their investment portfolio is subject to market risks that lay beyond the control of the hospital, and the degree of reliance upon non-operating "below the line" income items to service its debt is reflective of additional risk that such income may or may not be both consistently present and of material positive value in future fiscal periods. The reliance and associated risk may grow as the Operating EBITDA may fall. Such a risk may lead to increases in the cost of debt financing which in turn may further erode the DSCR.

Staff notes that in a report dated October 25, 2023, S&P Global Ratings lowered its long-term rating on the MHHEFA hospital revenue bonds, issued for Luminis Health to 'A-' from 'A', with a stable outlook. To quote the credit analyst mentioned in the report, "The downgrade reflects consistently negative operating performance and modest cash flow, generating weak maximum annual debt service coverage." The report continued to state that the downgrade further reflects Luminis Health's weakened balance sheet metrics, with already light Days Cash on Hand and unrestricted reserves-to-long-term debt no longer commensurate with the 'A' rating. This downgrade from an 'A' to 'A-' rating may well result in an additional twenty-five basis point increase in its cost of capital.

In conclusion, assuming the volumes projected for the proposed obstetrics program are realized, and based upon Staff's review of the applicant's likely liquidity and projected operating margin, and subject to the realizability of philanthropic gifts and governmental grants, and based upon review of all the information, Staff believes that all of these issues combined call into question the financial feasibility of this project. The project could possibly be feasible if all these issues are resolved in a positive manner. However, the macro financial investment markets may be unpredictable and the applicant's reliance upon non-operating performance to service its debt may prove to be risky, and, therefore, the project's longer term financial viability may be questionable. Staff has estimated that the applicant may be eligible to receive an incremental capital adjustment of approximately $6.52 million to its GBR upon completion and full operation of the proposed addition to facility and service. This adjustment could help to improve the feasibility of the project.