National Association of
Community Health Centers, Inc.

ISSUE BRIEF

Medicare/Medicaid Technical Assistance #30

REAP

Use of Excess Program Income Toward Purchase of a Health Center Building

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INTRODUCTION

Excess Program Income (EPI) is the amount of fees, premiums, and third-party reimbursements, collected by a center, that exceeds the actual costs of an approved project and exceeds the expected amount of fees, premiums and third-party reimbursements. This issue brief provides health centers with basic information on how a center might be able to acquire the building it now occupies by using EPI to fund the cash requirements of the purchase.

DISCUSSION

It might be possible for your health center to purchase the building it now occupies, while saving hundreds of thousands of dollars, if the circumstances are right. The following scenario is drawn from an actual case currently in the final stages of realization. While some of the amounts have been changed in order to protect center confidentiality, the theory is the same, and the cost savings could be even more substantial than in the example. We will walk through the circumstances, thought processes and steps required to accomplish the purchase of the building your Center currently occupies or plans to occupy.

The main element in this process is the use of Excess Program Income (EPI) to leverage the purchase of the building without major additional outlays in any year, but with long term, major cost savings along with ownership of the building.

ASSUMPTIONS

For the purposes of this discussion, let's make the following assumptions regarding your comprehensive community health center. Your center is currently operating in a 20,000 square-foot building and providing the following services: medical, dental, social services, nutrition, podiatry, optometry, limited laboratory and limited radiology. You have elected to be a FQHC for Medicare and Medicaid purposes. You are currently providing 25,000 billable visits with a payor mix of 40% Medicare, 10% Medicaid, 10% other payor and 40% self-pay. The Medicare rate is $68 and the Medicaid rate is $77, with reporting caps of $75 and $89, respectively. There are 18 years remaining on a 20-year lease agreement on a triple net basis; the annual rent is $8 a square foot for the first five years of the lease, $8.50 in years 6-10, $9 in years 11-15 and $9.50 in the final five years. For the 18 years remaining on the lease the total payments will be $3,180,000 plus the real estate taxes. Assume there are no material changes expected to occur in patient volume, payor mix or scope of the project.

PLANNING PROCESS

At this point we must go through a planning process that includes no less than the following:

1. Needs assessment
2. Strategic planning
3. Marketing study and plan
4. Business plan
5. Legal assurances
6. Appraisals
7. Building inspection
8. Public Health Service (PHS) approval of purchase
9. PHS approval of EPI
10. State and local approval
11. Letters of Intent from lending institutions

Needs Assessment

The needs assessment is to ensure that the property will be able to service the present and future needs of the community being served.

Strategic Planning

The strategic planning process will enable you to insure that the property meets the present and future needs and goals of your organization.

Marketing Study and Plan

The market study should measure the Center's service area needs. The marketing plan should project future service requirements including the probable payor mix of patients to be served.

Business Plan

The business plan consists of the following:

A. Project Costs
   1. Hard costs — cost of property
   2. Soft costs
      a. Bank fees
      b. Legal fees
      c. Title insurance
      d. Feasibility and marketing study
      e. Financial planning
   3. Mortgage escrow

B. Project Funding
   1. Available funds
   2. PHS contribution
   3. Program income
   4. Fundraising
   5. Mortgage financing

C. Five-Year Cash Flow Projection

1. Revenues — Utilization projection

    a. Number of visits

    b. Payor mix

    c. Payor rates

    d. Adjustments — contractual and sliding fee

    e. Collection percentage

2. Expenditures

    a. Staffing pattern

    b. Cost trends

    c. Mortgage payments

    d. Lease payments

    e. Real estate taxes

<u>Legal Assurances</u>

1. Contract

2. Closing

3. Title

<u>Appraisals</u> — at least two

1. Establish value for purchase price

2. Establish bank's commitment

Building Inspection

1. Establish condition of building
2. Structural problems
3. System problems

PHS Approval of Purchase

1. Program approval
2. Grants management approval
3. ROFEC approval

PHS Approval of EPI

1. FSR approval
2. Approval to use 100% of EPI on building purchase

State and Local Approval

Some states require Certificates of Need (CON) or other documentation.

Letters of Intent from Lending Institution

1. Preliminary letter expressing intent
2. This is not a commitment letter

FURTHER ASSUMPTIONS

(1) The strategic planning process, marketing study and plan and the needs assessment all show that the property meets all the needs of the Center as well as the community served.

(2) We have met with legal counsel, and everything appears to be in order.

(3) The appraisal of the property establishes its value at $1,850,000.

(4) The building inspection indicates that the building is in excellent condition, with no structural or system deficiencies.

(5) PHS has approved the purchase of the property; however, they stated they would not be willing to increase the funding level for the purchase or the future debt repayment. They also approved the FSR that indicated EPI of $500,000, and approved the use of 100% of the EPI to be used in the purchase of the building.

(6) We received the Certificate of Need approval, a requirement in our state for facility expansion, and received letters of intent from two lending institutions.

BUILDING PURCHASE

The purchase price of the property should be established through hard negotiation with the owner or agent of the property. A couple of real estate appraisals of the property would help establish the Center's position for negotiation. Also, if there are any similar properties for sale in the area, the Center should inquire into the selling price as this might give the Center a good basis for negotiation. Once the price is established, determine the "soft" costs as well as the amount of any escrow deposit the lending institution may require.

Negotiate the mortgage with a lending institution; this could be a bank, mortgage company, CHCCC, private party or others. Be aware of the interest rate (fixed or variable), term (number of years), and type (conventional or balloon). Make sure you negotiate with a few institutions, for the terms of the mortgage play a large part in the overall carrying costs and could make or break the deal. Remember, the interest expense and depreciation of the building are allowable costs for FQHC purposes; accordingly, a percentage of the interest and depreciation will be recovered through an increase in the FQHC rates, if they do not exceed the cap.

<u>THE FACTS</u>

Property value per appraisal	$1,850,000
Purchase price	1,600,000
Excess Program Income (EPI) — 100% approval for purchase	500,000
Mortgage (principal amount)	1,250,000
10 years @10% fixed rate, conventional	
Soft costs — minimal since we are purchasing a building we currently occupy and which was built to our specification	50,000
Escrow requirement (cash balance)	100,000

<u>Funds Required</u>

Purchase Price	$1,600,000
Soft costs	50,000
Escrow requirement (cash balance)	100,000
Total funds required	$1,750,000

Funds Available

Mortgage		$1,250,000
EPI for down payment	$350,000	
EPI for soft costs	50,000	
EPI for escrow	100,000	500,000
		$1,750,000

In preparing the five-year cash flow projection, remember to factor in the following:

1. Visit variance
2. Payor mix variance
3. COL increases
4. Recalculate FQHC rates annually — they change due to cost and visit variance

STATUS

At this time it appears that all is in order, and we are going to move ahead with the business plan. The five-year cash flow projection is an essential part of the business plan, along with a comparison of costs of the lease payments vs. annual mortgage payments (interest and principal). *See Table 1 below.* The lease payments are based on the remaining 18 years of the lease agreement, and include real estate taxes that ran approximately $45,000 in the previous year with a projected increase of 2.5% per year. Once we purchase the property, we expect to receive a real estate tax exemption that is available from our city for certain not-for-profit corporations.

Table 1 below indicates that the annual mortgage payments are less than the lease payments including the real estate tax. For the final eight years of the lease, the mortgage would be fully paid and there would be no debt service payments required. Therefore, there would likely be a sizable savings at the end of the 18-year period even if the mortgage payments were higher than the lease payments for the first 10 years.

TABLE 1

COMPARISON OF ANNUAL LEASE PAYMENT TO MORTGAGE PAYMENT
(Mortgage Payment based on $1,250,000 for 10 Years at 10% per annum)

YEAR	LEASE PAYMENT	REAL ESTATE TAX	TOTAL	MORTGAGE PAYMENT	CUMULATIVE DIFFERENCE
1	160,000	46,125	206,125	198,226	7,899
2	160,000	47,278	207,278	198,226	16,951
3	160,000	48,460	208,460	198,226	27,185
4	170,000	49,672	219,672	198,226	48,631
5	170,000	50,913	220,913	198,226	71,318
6	170,000	52,186	222,186	198,226	95,278
7	170,000	53,491	223,491	198,226	120,543
8	170,000	54,828	224,828	198,226	147,145
9	180,000	56,199	236,199	198,226	185,118
10	180,000	57,604	237,604	198,226	224,496
11	180,000	59,044	239,044	-0-	463,540
12	180,000	60,520	240,520	-0-	704,060
13	180,000	62,033	242,033	-0-	946,093
14	190,000	63,584	253,584	-0-	1,199,677
15	190,000	65,173	255,173	-0-	1,454,850
16	190,000	66,803	256,803	-0-	1,711,653
17	190,000	68,473	258,473	-0-	1,970,126
18	190,000	70,185	260,185	-0-	2,230,311

SUMMARY

You must run the numbers. You cannot assume that if the mortgage payment equals the lease payments, there will be no changes. BHCDA will not bail you out if you incur deficits. The advantage of a purchase may not be recognizable in the short term, but in the long term mortgage payments cease while lease payments do not. See Table I which is based on the current lease in effect and projected mortgage payment (principal and interest) on a $1,250,000 mortgage with a term of ten years @10% per annum. Note that in this example no one-year payment exceeds the lease payments including real estate tax. Note that in year eleven the mortgage payments cease and major savings start accruing, so that, at the end of the lease, the total savings to the organization is $2,230,311. In addition, through a purchase, you will obtain an asset that most likely will appreciate in value and will add to the viability of your organization. Finally, you must go through all the steps: Do not take short cuts. If the evaluation is done properly, you may have a tremendous amount to gain. However, if it is not done properly, you could have a major disaster on your hands that could affect the longevity of your organization.