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Office of the President

TO THE MEMBERS OF THE COMMITTEE OF FINANCE:

ACTION ITEM

For Meeting of March 19, 2014

AUTHORIZATION TO RETIRE AND REFUND EXISTING TAX-EXEMPT DEBT OBLIGATIONS FOR THE CHILDREN'S HOSPITAL OF OAKLAND BY THE UCSF HEALTH SYSTEM, SAN FRANCISCO CAMPUS

EXECUTIVE SUMMARY

This item recommends to the Regents that UCSF Health System be authorized to retire and refund existing tax-exempt debt obligations issued by the Association of Bay Area Governments (ABAG) Finance Authority for Nonprofit Corporations for the benefit of Children's Hospital and Research Center at Oakland, specifically the bonds designated as Series 2007A. In January 2013, the Regents approved the affiliation of Children's Hospital and Research Center at Oakland, a California nonprofit public benefit corporation (CHRCO) with the UCSF Health System. The affiliation closed in January 2014, and the Regents became the sole member of CHRCO. The strategic alliance between UCSF Health System and CHRCO will serve to strengthen both institutions in terms of scale, financial benefits, and improved market strength. As part of the affiliation, it is recommended to retire and refund existing tax-exempt debt obligations for CHRCO, as detailed in the background information for this item. In connection with such retirement and refunding of this debt by the Regents, it is recommended that the Regents enter into a loan agreement with CHRCO which specifies the terms upon which CHRCO will repay the Regents for such retirement and refinancing.

RECOMMENDATION

The President of the University recommends that the Committee on Finance recommend to the Regents that:

A. The President be authorized to retire and refund the existing Association of Bay Area Governments (ABAG) Finance Authority for Nonprofit Corporations Refunding Revenue Bonds (Children's Hospital and Research Center at Oakland) Series 2007A (the CHRCO Bonds) in an amount not to exceed $55.5 million in outstanding principal, plus additional related financing cost, subject to the following conditions:

    (1) As long as the debt authorized to refinance the CHRCO Bonds is outstanding, UCSF Health System gross revenues shall be maintained in amounts sufficient to

pay the debt service and meet the related requirements of the authorized financing.

(2) The general credit of the Regents shall not be pledged.

B. The President be authorized, after consultation with the General Counsel, to approve and execute a loan agreement between the Regents (on behalf of UCSF Health System) and the Children's Hospital and Research Center at Oakland for repayment of the authorized financing.

C. The President be authorized, after consultation with the General Counsel, to approve and execute any documents necessary in connection with the above, and any amendments or modifications, provided such amendments or modifications do not materially increase the obligations of the Regents.

BACKGROUND

In January 2013, the Regents approved the affiliation of Children's Hospital and Research Center at Oakland, a California nonprofit public benefit corporation (CHRCO), with the UCSF Health System. The affiliation closed in January 2014, at which time the Regents became the sole member of CHRCO. The strategic alliance between UCSF Health System and CHRCO will serve to strengthen both institutions in terms of scale, financial benefits and improved market strength. Under this affiliation, CHRCO remains a separate corporation and its hospital remains separately licensed with its own medical staff.

CHRCO currently has $55.5 million of outstanding bonds with an obligated group structure (CHRCO and its related Foundation) and restrictive covenants that can be eliminated via a refinancing into the University's Medical Center Pooled credit. The CHRCO Bonds are payable solely from CHRCO's revenues and are secured by an obligation issued by an obligated group comprised of CHRCO and its related charitable foundation (the Foundation).

There is the potential for pre-existing compliance issues with respect to the tax-exempt status of the CHRCO Bonds which would be eliminated with the refunding. In addition, the CHRCO Bonds include much more restrictive covenants than are included in the University's Medical Center Pooled Financings, including a limitation on short-term indebtedness, a requirement to maintain liquid unencumbered assets, financial and operational reporting requirements, and a prohibition on removing the Foundation from the CHRCO obligated group. These covenants create potentially significant limitations to UCSF's flexibility to manage the affiliation between UCSF Medical Center and CHRCO over time and impose additional reporting burdens.

The University's plan is to refinance the CHRCO Bonds by a loan from the Regents (on behalf of UCSF Health System) to CHRCO, financed by either the University's commercial paper program or other short-term line of credit. The transaction will, based on current market assumptions (as of mid-February 2014), have a slight present-value benefit to the combined UCSF Health System of approximately $2.4 million and will result in annual debt service savings of a nominal amount of approximately $30,000 annually. At the planning rate of six percent, the transaction would be at a present-value cost of approximately $6 million. The transaction is recommended in order to achieve the following important benefits:

- Eliminates the potential for any pre-existing compliance issues with respect to the tax-exempt status of the CHRCO Bonds

- Eliminates restrictive financial and operating covenants such as:
  - Limitations on additional indebtedness,
  - Restrictions on sale, lease or other disposition of property,
  - Restrictions on consolidation, merger, or acquisition,
  - Liquidity covenant: Maintain liquid unencumbered assets of at least 75 days operating expenses.

- Eliminates CHRCO obligated group structure, which includes the Foundation, and releases the guarantee by the Foundation, providing more flexibility to UCSF Health System.

The Regents and CHRCO will enter into a loan agreement, which will specify the terms under which CHRCO will repay the loan from the Regents to refinance CHRCO's existing bonds. CHRCO's sources of repayment under such loan agreement will come from sources described further below.

UCSF Health System has evaluated the financial feasibility of assuming CHRCO's existing debt obligations under the combined entity through refinancing. Furthermore, in 2016, UCSF Health System plans to request approval from the Regents of an additional $50 million in external financing in order for the Regents (on behalf of UCSF Health System) to make an additional loan to CHRCO for capital improvements. The additional borrowing has been incorporated into the financial feasibility projections in this item.

The key elements of this financial feasibility assessment are summarized in the following table.

Table I
UCSF / CHRCO Combined Financial Summary and Key Credit Statistics

	Forecast	Projected									
($ in 000's)	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Average Daily Census	*627*	*631*	*638*	*645*	*652*	*657*	*663*	*669*	*674*	*679*	*685*
Financial Summary											
Revenue	$2,744,339	$2,878,412	$3,038,915	$3,128,612	$3,249,056	$3,367,060	$3,480,100	$3,611,587	$3,744,208	$3,886,400	$4,037,492
EBIDA	$286,525	$243,979	$251,802	$274,437	$298,794	$321,536	$333,338	$367,019	$380,613	$404,281	$412,649
Net Income	$141,048	$54,401	($28,061)	($10,363)	$11,871	$32,680	$42,776	$76,733	$107,851	$145,500	$147,522
Cash, unrestricted	$520,635	$478,089	$497,341	$519,635	$569,869	$620,014	$664,128	$704,476	$753,392	$826,877	$900,151
Net Assets	$1,970,646	$2,094,273	$2,092,233	$2,106,579	$2,113,839	$2,144,800	$2,167,403	$2,200,160	$2,262,403	$2,358,174	$2,454,809
Key Credit Statistics											
Days Cash on Hand	76	65	63	64	68	72	75	77	80	85	88
Debt Service Coverage	4.1	4.3	4.2	4.3	4.4	4.5	4.6	4.2	4.4	4.8	4.8
Debt to Capital	55%	61%	61%	59%	56%	54%	52%	51%	49%	46%	44%

Financial projections for UCSF/CHRCO Combined Health System are included in the table above. These projections assume the proposed refunding of the CHRCO Bonds. They are based upon the following key assumptions:

- Modest increases in inpatient growth coupled with increases in outpatient growth,
- Government reimbursements continue to be pressured by legislative actions,
- Aligned goals with affiliated medical groups resulting in growth and efficiency,
- Investments in clinical IT and associated infrastructure with related operating ongoing expense increases,
- Reducing staffing levels to meet targeted benchmarks,
- Synergy between the affiliated children's hospitals' operations resulting in increased efficiency and positive financial impact.

These assumptions are consistent with local experience for both UCSF and CHRCO and are based upon:

- Recent service mix and financial performance,
- Recent occupancy and outpatient volume experience,
- Estimated effect of the Affordable Care Act resulting in reduced reimbursement,
- Estimated effect of aging population resulting in shifts from private insurance to Medicare coverage.

Average inpatient daily census is projected to increase from 627 in 2014 to 685 in 2024 due to a combination of adding more beds in the Mission Bay expansion and a shift in projected patient services. Outpatient visits are projected to increase two to four percent per year due to population growth, new programs and shift of existing services.

Revenue is estimated at $2.7 billion in 2014 to over $4 billion in 2024. Significant components of revenue include net patient revenue, and other operating revenue and philanthropy. Net patient revenue is projected to increase due to the Mission Bay expansion and related backfill of existing beds, outpatient volume growth, and inflation rates. Based on local experience, the revenue projection includes modest inpatient revenue increases (one percent) projected to maintain market share and outpatient revenue increases (two to five percent) driven by increasing volume and intensity of services. CHRCO is expected to receive additional revenue due to a change in Medi-Cal reimbursement methodology and expansion of its Federally Qualified Health Center. The Hospital Quality Assurance (Provider) fee revenue is projected to increase from 2014 to 2016, and then decrease to prior levels. CHRCO philanthropy is expected to increase three to eight percent per year due to enhanced synergy between the affiliated children's hospitals.

Earnings before interest, depreciation, and amortization (EBIDA) increase from $286 million in 2014 to $413 million in 2024, driven by revenue increases combined with cost reductions. These cost reductions include economies of scale due to the children's hospital affiliation and the successful implementation of cost reduction initiatives. A reduction in the cost per case will be achieved by improving and standardizing processes, tightening fixed cost structure and effective utilization of the Lean principles and other management tools. Other cost reduction initiatives include staff streamlining and integration efficiencies. The cost reduction initiatives are required to offset increased operating costs due to labor and non-labor inflationary increases of three to five percent, increased operating costs due to the opening of the Mission Bay hospital, and the transition costs of the CHRCO affiliation.

Net income is projected to range from $141 million in 2014, decreasing to a net loss of $28 million in 2016, and increasing to $148 million net income in 2024. This volatility is due primarily to anticipated depreciation, a non-cash expense, and interest expense related to the Mission Bay hospital opening in 2015. In 2017 and later years, net income shows an improving trend due to operational growth and cost efficiency, combined with expected increased philanthropy.

Net assets show a modest increase from $2 billion in 2014 to $2.5 billion in 2024, an average yearly increase of two percent.

Unrestricted cash has been adjusted for the anticipated refunding of the CHRCO Bonds. The unrestricted cash balance is estimated at $521 million in 2014 and grows to $900 million in 2024. Operational results, adjusted for depreciation, contribute an average of $250 million of positive cash flow per year. Philanthropy is projected to range from $154 million in 2014 to $58 million in 2021, depending on the timing of the fundraising campaigns. Investment income cash flow is estimated to range from $12 million in 2015 to $23 million in 2024. These sources are used to fund capital investment, including the Mission Bay hospital, CHRCO seismic upgrades, and ongoing capital requirements including planned IT infrastructure.

With the refunding of the CHRCO Bonds, the combined entity is forecasted to have 76 days cash on hand, 4.1x debt service coverage and 55 percent debt to capital ratio in 2014. Between 2015 and 2017, days cash and debt to capital ratio are expected to slightly deteriorate as UCSF opens Mission Bay and CHRCO continues with its seismic upgrade project. By 2024, the UCSF Health System is projected to have 88 days cash on hand, 4.8x debt service coverage and 44 percent debt to capital ratio. Overall the credit metrics for the combined entity are expected to remain strong over the ten year projection period.

SUMMARY FINANCIAL FEASIBILITY ANALYSIS

Project Title: **CHRCO Bond Retirement and Refunding**

Proposed Sources of Funding:

Total Borrowing[1] $ 58,000,000

Projected Financing Terms:
Interest Rate 6.0% Planning Rate and Current Market Rates (as of mid-February 2014)

Estimated Annual Debt Service: $6.1 million at Planning Rate
$3.8 million at Current Market Rates
(as of mid-February 2014)

Estimated UCSF Health System Long-term Debt June 30, 2014:	
UCSF Medical Center	$ 848,437,000
CHRCO	$ 53,829,000
Total	$ 902,266,000

Estimated UCSF Health System Long-term Debt June 30, 2019:	
UCSF Medical Center [2]	$ 852,903,000
CHRCO [3]	$ 97,620,000
Total	$ 950,523,000

[1] At financial feasibility planning rate

[2] Includes additional interim financing for Mission Bay expansion as UCSF Medical Center continues to collect on its pledges receivable

[3] Includes additional $50,000,000 planned borrowings for CHRCO capital investment