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The Value of Liquidity—the Financial Kind

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Liquidity is to a hospital what altitude is to a parachutist, water depth is to a boater, and gasoline in the tank is to a NASCAR driver. Without liquidity, activity and movement in each of these situations come to a halt, sometimes with catastrophic results. This article helps boards better understand the value of liquidity, the importance of establishing a liquidity safety net, and the risks of not having the appropriate level of reserves.

Defining and Understanding Liquidity

Liquidity is a financial term reflecting the availability of the organization's resources on a short-term basis. According to Investopedia, liquidity represents "how easily assets can be converted into cash. Assets like stocks and bonds are very liquid since they can be converted to cash within days. However, large assets such as property, plant, and equipment are not as easily converted to cash."

A practical way to think about this topic is to ask: How much cash could we raise quickly if we needed to? The most evident—and important—sources of liquidity are the organization's unrestricted (i.e., can be used for any purpose) cash and short-term investments (such as CDs). To understand if these reserves are adequate, some math is required to express the balances in relation to the organization's scale.

Days cash on hand (DCOH) is calculated by expressing the organization's operating costs into an average of the expenses per day and then comparing that result to the total unrestricted operating cash and short-term investment balances. An organization with average daily expenses of $50,000 and a balance of $1,000,000 in the bank account therefore has 20 days cash on hand ($1,000,000/$50,000=20). The higher the DCOH, the more of a "safety net" that exists.

The power of DCOH as a financial metric is that it allows us to compare the amount of assets available to fund operating cash requirements to the "cash burn rate" at

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which the organization would consume those assets if no operating revenue were being generated. Fifty million in cash and investments does not go very far if the organization has annual operating cash needs of $250 million, but that same $50 million in liquid assets tells an entirely different story for an organization that may only have annual operating cash needs of $75 million

Ensuring Adequate Reserves

As a lender with the USDA Guaranteed Loan Program, one of our first tasks is to partner with the borrower in combining an affordable amount of debt with an appropriate equity contribution to fund a long-term capital investment. Since the USDA Community Facilities Program does not have a required equity contribution, we are often asked about how best to determine the amount of equity an organization should contribute toward a project.

There is a tendency to think that, as a lender, our interests are in maximizing the amount of debt the organization can take on; however, the 30-year fixed rate loans that we make represent a long-term relationship with the borrower. As such, a plan of finance that limits equity and increases debt at the expense of the project's viability is a much larger risk than any increased upfront fees or interest payments that may

➜ Key Board Takeaways

- What is the organization's "cash burn rate" or average operating expense per day?
- What is the organization's days cash on hand (DCOH)? Have the board and management agreed upon the target DCOH needed for operations (i.e., the "rainy day" fund)?
- Are there resources above the minimum operating DCOH threshold that are available for reinvestment back into the organization?
- What has DCOH been over the past in the organization?
- Are the organization's *short-term annual* equipment and/or capital investments needs being fully funded?
- Does the organization have a strategic master facilities plan in place for identifying *long-term capital needs* that can be funded with some equity reserves and a sustainable, affordable amount of debt?

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be lost if a borrower elects to increase equity and reduce debt. In other words, it's in the best interest of both the lender and the borrower to find a balance between the amount of debt and the amount of equity that keeps debt future service payments affordable and sustainable while also ensuring adequate reserves and liquidity for the future.

A case study from a past client helps illustrate this balance. The client hospital applied for and was awarded a financing commitment to construct a new medical office building on its existing campus using the USDA Community Facilities Program financing. As background, the USDA financing is for enhancing credit on the permanent loan and the USDA loan guarantee does not take effect until after the project has been completed. This means that borrowers need to utilize a separate, non-guaranteed loan for interim or construction financing to complete the project (at which time the USDA guarantee takes effect).

As the new building was being constructed, the hospital was pursuing its other strategic improvement initiatives, which included an upgrade to its financial systems and electronic medical record (EMR). At the beginning of this project, the hospital had 65 days cash on hand; halfway through the construction project, DCOH had decreased down to 18 days. By the end of the project, the hospital was operating with only eight days of cash on hand, a major threat to its ability to meet operating requirements in a timely basis.

Because the USDA financing is contingent upon no "material change" in the underlying credit of the organization between the time the initial commitment is issued and when the project is completed, this decline in liquidity represented a risk to the total financing package if USDA would have withdrawn its initial commitment. In this case, that outcome was thankfully avoided through staffing changes and an intense effort with the hospital's leadership to correct the system deficiencies that were created from the new EMR and billing platform.

The Challenges and Risks of Poor Liquidity

Rural hospitals tend to operate with tighter operating margins than their urban and suburban counterparts, often resulting in a "pay-as-you-go" or "pay as much as possible" mentality among board members for both strategic and capital investments. While it may appear that this is a more conservative, less-risky approach, it comes with downstream risks that expose the organization in several ways.

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First, the lack of availability of liquidity and the challenges in accumulating enough resources and cash to fund investments—including regular routine capital expenditures—often leads to under-investment in modernizing the facility's infrastructure (buildings and equipment) over time under the "pay-as-you-go" approach. In addition, when an organization invests much of its cash into non-liquid facilities or equipment, the lower "safety net" of liquidity exposes the organization to future operating risks such as disruptions to the hospital's revenue cycle or billing process as described in the case study above. Even without the change of the IT systems responsible for capturing medical information and generating accurate bills, this type of disruption can take place for many other reasons, including:

- Loss of a key staff member in the billing department
- Third-party payers slowing down payments
- The need to refinance or replace debt structures that are not long-term, fixed-rate debt
- The need to pay back Medicare in a cost report settlement (for critical access hospitals)
- Failed contract negotiations that reduce service income

Changes in the healthcare marketplace or local competitive environment are also future risks to the organization with a poor liquidity position. This includes:

- Loss of volumes as a result of a provider group leaving or (even worse) moving to a competitor
- Exclusion from payers' narrow network
- Entry into the market by a new competitor that decreases volumes or requires resources to respond effectively
- A "black swan event"—defined as unforeseen, extremely rare events with severe impacts

The "black swan event" of the COVID-19 pandemic both increased operating costs and reduced revenues simultaneously for healthcare organizations of all sizes. Thankfully, the CARES Act and accompanying Paycheck Protection Program (PPP) funds provided the healthcare system a liquidity lifeline, but not every disruption will provoke such a strong response and assistance from the government; organizations must be prepared to weather the impact of the myriad threats to the organization's future sustainability with adequate liquid resources available.

It's critically important for directors to align with management around the risks specific to their organization and market to establish the organization's appropriate level of reserves for operating needs (aka, the "rainy day" fund). For rural providers,

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this is typically in the 40 to 60 days of cash on hand range at a minimum. Certain higher-risk situations, such as being in a competitive market or depending on a small group of providers, for example, may warrant targeting a liquidity safety net above these minimums to protect against future operating uncertainties. Maintaining liquidity is some of the best insurance your organization can have against the unpredictable and uncertain future.

The Governance Institute thanks Brian Haapala, FACHE, CEO of StroudwaterGCL Rural Healthcare Capital, for contributing this article. He can be reached at bhaapala@stroudwatergcl.com.

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