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prioritizing capital projects when cash is scarce

Today's economic conditions have exacerbated the liquidity problems faced by many healthcare organizations, whether they wish to access outside capital or make use of internally generated funds.

In both good times and not so good times, three strategic factors influence capital allocation decisions by managers of all organizations, not only healthcare companies: organizational mission, availability of funds, and cost of funds.

Organizational Mission

Defining the organization's mission is paramount to any organization's success. Times of tumult, like the present, challenge an organization to refine and refocus its mission. Refining the mission requires an assessment of the needs of the community or population served to determine whether the healthcare system provides the most critical and pervasive services. Refocusing allows the system to define areas of expertise on which to focus, thus creating a competitive advantage.

This refocus serves to eliminate counterproductive strategies such as attempts to be all things to all people, growth of self-serving "fiefdoms" in the organization, and duplicative programs and services within the system.

Prioritizing capital projects is more of a straightforward process when the organization's mission is clearly defined.

Availability of Funds

One of the key drivers of a capital budget is the available cash for required expenditures. The determination of capital allocation begins upon management's completion of the organization's financial projections, including its cash position.

When reviewing the financial budget and allocating cash for capital projects, managers charged with the capital budgeting process should reevaluate the organization's ability to meet its financial projections and examine what external or internal constraints may limit available funding for capital projects. Four issues influence these considerations.

Projections. Financial budgeting will provide the first insights into expected cash flows and capital funds availability.

Liquidity events. Anticipated debt issues, restructurings, and/or fund drives—as well as any upcoming sales of assets—should be considered as a part of this planning process. In addition, the analysis may include any upcoming sales of assets.

Risks. The managers should objectively assess the organization's ability to achieve its operating budgets, including volumes, case and payer mixes, staffing, and costs. Results may need to be adjusted for risk to determine a likely level of performance and capital for allocation.

Constraints. The managers should identify and adjust their analysis to account for spending constraints, such as bond covenants and debt service requirements. Appropriate planning is essential if a significant portion of existing debt is maturing and if refinancing and/or restructuring is required because the doldrums of the current capital markets may have caused transactions to take longer to close.

After managers have reviewed their organization's mission and determined the available cash level for capital projects, only then can they evaluate, prioritize, and select projects. The initial phase of the project evaluation process should include the

classification of projects into several categories such as the following:

- > Replacement and maintenance projects
- > Mandatory projects (legislatively or statutorily necessary)
- > Core mission investments
- > New business and market expansion projects

Cost of Funds

Although painful for any organization, economic uncertainty provides an excellent opportunity to inject objective procedures into the capital planning process. Unfortunately, many organizations continue to budget via an antiquated three-step process:

1. Determine total available capital spend dollars.
2. Ask department managers to prioritize projects by A, B, and C levels.
3. Approve projects in priority level order until the funds are exhausted.

This approach does prioritize spending, but it does not necessarily achieve the desired objectives of support of the strategic mission of the facility or system, efficient use of limited resources, support of the financial goals of the organization, and recognition of the cost of funds.

Senior management can use this opportunity to implement accepted and mainstream tools such as ROI calculations using discounted cash flow analysis. This may be unfamiliar ground to clinical managers, but proper training with these tools will help ensure the financial viability of individual projects, which is critical to the success of any capital budgeting cycle.

All operating managers with budget responsibility should be familiar with the basic concepts of cost of capital. It is imperative that managers understand that all funding has a cost, which is dependent on the source of the funds and the associated risks of the project. Equally important is that all decision makers understand the time value of money, which is critical for discounted cash flow, internal rate of return, and net present value analysis. With these tools in the proverbial toolbox, managers at all levels in an organization

can streamline capital planning, thereby securing a more efficient and successful process.

A key element in the capital allocation review is taking into account the incremental after-tax cash flows associated with an individual project. When setting priorities among projects, it is necessary first to analyze the contributions of each project. Three steps should be part of this process:

- > Review the timing of cash flows, and project all expected cash flows over the life of the project/asset.
- > Include all relevant costs (initial costs to start project, opportunity costs, cannibalization, and depreciation) and exclude sunk costs.
- > Assign an appropriate discount rate for each project by analyzing the organization's overall risk, and just as critical, the project risk and the required return necessary to meet the organization's cost of capital.

Regardless of funds availability, most organizations cannot undertake all projects at once and must allocate capital based on which combination of projects yields the best outcome for that particular period.

A New Imperative

With access to liquidity under pressure from a variety of external and internal sources, it becomes more important than ever that health-care managers be astute in presenting and pursuing capital projects. And when financial decision makers contemplate capital project requests, they should focus on the mission, analyzing the organization's current funds available, and assessing the cost of funds for the project. Regardless of the organization's financial condition or the size of the capital project being considered, an analytical process should be implemented for each project under review. The improved decision-making will differentiate between profitable low-risk projects and unprofitable high-risk projects while furthering the organization's mission. ●

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