



LEASEGUARD

Funding Options for
NHS Trusts and
Foundation Trusts

Introduction

Against a backdrop of a continuing dearth of capital monies to fund major new projects over the next 2-3 years, Leaseguard has undertaken some objective analysis of funding options for NHS Trusts and Foundation Trusts.

About Leaseguard

For more than 20 years, Leaseguard has been a leading provider of lease advisory, procurement and contract management solutions to NHS Trusts, helping them drive down costs, enhance control and improve compliance over a broad range of contracts, including maintenance, leasing, MES, consumables, estates and medical contracts.

To discuss any of the issues raised in this Technical Note please contact Carrie Rudge on 01865 340800. For more information on how we can assist Trusts with the procurement and on-going management of maintenance, leasing or MES contracts, please call Stuart Jefcoate on 01865 340800.

Problem Description

No-one we talk to in the NHS is in any doubt that the coming years will be extremely difficult, and that the days of ready access to capital are likely to be gone for the foreseeable future. In fact four years on, the words of ex NHS Chief Executive, David Nicholson, in his foreword to the 2010/11 Operating Framework, now have even greater resonance:

“We are at a critical juncture in the history of the NHS. After a decade of investment and reform... the NHS, along with other public services, is about to enter perhaps the toughest financial climate it has ever known.”

A variation on this paper was produced by Leaseguard at the request of the Director of Finance of one of Leaseguard’s retained Trusts to help them evaluate and put in place a coherent funding strategy for new projects going forward. Given that this is a generic issue across many Trusts going forward, we have decided to publish a synopsis of our analysis to highlight the major issues.

Primary Funding Options

The options available are:-

- 1. Borrow the capital from a commercial source using “unprotected” assets as security.**
- 2. Borrow from the Independent Trust Finance Facility or take a Capital investment Loan from the DoH via the Trust Development Authority.**
- 3. Borrow from a commercial bank on an unsecured basis.**
- 4. PFI (or equivalent) build of the new facilities.**
- 5. Lease suitable assets and use the funds retained to finance the planned new schemes.**
- 6. Enter some form of Managed Equipment Service to again avoid capital outlay, and use the capital saved to fund the new schemes.**

N.B. Public Dividend Capital (PDC) may occasionally be available for very specific projects but is not a generally available form of finance. As a result, we have not evaluated PDC funds as an option within this report.

Analysis of funding options for NHS Trusts and Foundation Trusts

Below we have assessed the pros and cons of each approach, and we conclude the analysis by subjectively scoring each option against a number of key decision bases.

1. Borrow from a commercial lender using unprotected assets as security

The Trust should clearly identify the assets concerned. In order to take security a commercial source may well require a professional revaluation of land and buildings and a clear delineation between the respective values of both protected and unprotected assets.

Quite often these assets are interconnected, but even assuming they could be separated, we understand that bank lending in the corporate sector is currently usually limited to a repayment term of 5 years at rates of 2%-3% per annum above 3-month LIBOR. It is also often linked to an interest rate management facility to limit the adverse effects of increases in rates in the future. As 3-month LIBOR is currently very low at 0.23% we would anticipate a Trust would currently pay a minimum of 2.23% p.a. There would also be an arrangement fee (typically 1% of the advance), recurring review fees, and a fee for the interest rate management facility. The level of that fee would be determined by the degree of risk taken by the bank. As an example however, a major bank has indicated that a fee of £270,000 would be required to cap base rate rises at 3% p.a. for a £5,000,000 facility repayable over 5 years.

Capping base rate rises above 2% p.a. would command a higher fee, and capping increases in base rate above (say) 5% p.a. would cost less. As it is likely that rates will begin to increase steeply when the economy regains growth and inflation concerns arise it would be prudent to eliminate the uncertainty by buying a base rate cap, but of course it adds to the cost.

2. Loan from the Independent Trust Finance Facility or a Capital Investment Loan from DoH

This is very likely to be the lowest cost option for the Trust, with borrowing rates very low (the 5-year NLF rate is presently 1.62% for example, and the 7-year rate 1.90%). The Trust would also retain the benefits of ownership and control of the assets. However, we believe that the availability of funding may be uncertain in the future, and the facility would impact on the Trust's Capital Servicing Capacity Ratio or EFL. PDC dividend payments are calculated upon average net relevant assets, and therefore a loan as a liability to the Trust will reduce the PDC dividend payable each year by 3.5% of the average principal outstanding.

3. Unsecured loan from a commercial bank

We understand there is presently little appetite amongst banks for unsecured lending, except perhaps for comparatively small sums, and subject to regular review. Even for good quality corporate customers, interest charges would be 4%-6% above 3-month LIBOR with a minimum arrangement fee of 2% of the advance. It is difficult to say whether better rates may or may not be available for Foundation Trusts, given the current high level of government borrowing and increasing monthly deficits, which are bound to result in a very tight squeeze on public expenditure in the future. As with the other borrowing options, this would also impact on the Trust's CSCR/EFL.

4. PFI (including PF2, LIFTschemes etc)

The main benefit of PFI is that more capital projects can be undertaken for a given level of public expenditure and therefore improvements in patient care can be brought on stream earlier. Typically the public sector contribution has been around 10% of total cost. Proponents also argue that there is a transfer of risk to the private sector, which is more commercially aware and better able to manage risk than the NHS.

A planned program of asset replacement, pre-agreed fixed pricing, and potential VAT recovery are also attractions of PFI arrangements. However, far from being a "Pleasurable Financial Indulgence", PFI has also been dubbed a "Public Finance Illusion".

Former Shadow Health Secretary, Dr Liam Fox attested that it does not provide value for money, and The Institute for Public Policy Research in its Final Report of the Commission on Public Private Partnerships, concluded that PFI hospitals had not provided value for money. They came to this conclusion by using data provided by The National Audit Office, who calculated the savings on hospitals built under PFI. However HM Treasury's Managing Public Money (July 2013) identified the following strengths of using private finance to deliver public sector assets and services

- getting projects built to time and to budget
- improving whole-of-life risk allocation and management, creating disciplines and incentives on the private sector to manage risk effectively
- securing a greater focus on due diligence
- securing better integration of design, construction and operational skills
- securing a greater focus on growing market share or value of a joint asset or business

One of the disadvantages of PFI is the length of the contract, which is often around 30 years. It may be unwise to enter into such long-term arrangements as changes in demand and unforeseen events in the future may mean severe restrictions in resources if a Trust is tied in to a long term contract. The underlying assumptions of the project alter with time; personnel change, there is a loss of control, the contract drifts, there is less operational flexibility and, ultimately, higher costs. PFI and MES projects demand considerable ongoing management if they are to deliver the benefits originally promised. In fact, the former Shadow Health Secretary has said "It is perverse that, with hospitals around the country now suffering cutbacks and closures, over 80 NHS organisations are locked into long-term contracts for the building of large hospitals that we have no idea whether the NHS will actually need", and "Every hospital I talk to wants the freedom to structure its borrowing projects as they wish. For all too many, PFI has turned into a straitjacket."

Due to the credit crunch, PFI has become more expensive. Throughout 2008 and 2009, bank lending became scarcer and more expensive. The banks' fundamental view of PFI was that it remained attractive, with safe returns a sharp contrast to plummeting profits in the housing and commercial property markets. However, the problem is that banks are simply reluctant to lend because financial institutions no longer trust each other. Consequently they find it difficult to borrow the money they need to lend in the first place, and even then are reluctant to lend for long periods, because finance has become so volatile.

That poses a particular problem for PFI, because it relies on long-term lending for anything up to 30 years. In good times, long-term lending is a safe bet. In bad times, it becomes far more difficult. Banks don't know whether they are going to be able to borrow money, or how much they are going to have to pay for doing so; they also don't know when they are likely to need to hold back money, for example to make up losses in other parts of their business or to build up reserves.

The cost of borrowing for PFI consortia is made up of two parts: the underlying rate of interest, and the margin the bank charges for lending. Whilst public sector bodies have benefited from the fact that underlying rates of interest have dropped sharply since the credit crunch, bank margins have risen even more dramatically. Before the credit crunch, a typical PFI deal would see banks charging a margin of around 0.25% above Libor. Now, the cost of borrowing is harder to determine, because the market has become more volatile as well as more expensive, but is estimated at more than 3 - 4% over Libor.

5. Lease suitable assets and use the funds saved to finance the planned new schemes

Although the rate inherent in a typical 5 year operating lease is likely to be approaching 7.00 %, the fact that lessors will take residual risk of 17%-25% of the capital cost of the asset results in an effective rate of under 1%. For example, where the lessor takes a residual risk of 20% of cost and an inherent rate of 7.0%, the effective rate is 0.31%.

There would no additional arrangement fees in a lease and the rentals are fixed; they do not vary if interest rates increase. Furthermore, unlike a loan, a lease is not subject to periodic review (which would consume management time and additional fees) and of course the lessor takes the risk that the asset may become obsolete.

Operating leases are off balance sheet and therefore should not affect borrowing limits, or incur PDC dividends, but would impact on EBITDA. To obtain best value from operating leasing the term of the lease should ideally match the duration the Trust expects to retain the asset, and the equipment should be returned on expiry of the lease in good working order. If the lease is extended additional rentals will be payable, and if the assets are not returned in good working order the lessor may claim "condition damages". It is not always possible to match anticipated lifespan to lease term, however the flip side of this is that leasing does provide a measure of flexibility, putting a Trust in a position to make the most effective commercial and clinical decision on whether to extend or replace equipment at the end of the primary lease term. In addition lessors have historically taken far larger residual investments in equipment than their actual potential value has merited, so provided extensions are managed effectively it is possible to achieve extremely good overall deals even when equipment is not returned at lease end – provided the lessor can be encouraged to provide extension pricing based off actual market values rather than their original residual investment.

Leaseguard has an experienced lease management team wholly dedicated to supporting our clients in minimising extension costs.

Leases for standard medical equipment such as analysers, monitors, ultrasound, radiology, and beds, will provide good value for money as lessors are willing to take their highest levels of residual risk in them. Assets which are less suitable or have low value could be batched with better equipment, although as a general rule we would recommend as few assets as possible be included in each lease to ensure that the assets are easy to return on expiry, and to prevent a lessor exploiting a situation where the Trust may wish to return some assets and extend the lease for others.

Leaseguard is able to advise which assets are most suitable for leasing and to provide indicative rates over various lease terms. Where equipment has already been purchased it may be possible to arrange a sale and leaseback transaction to recover the capital outlay.

6. Managed Equipment Service

There are a number of advantages to MES, not least the fact that all issues of qualification and risk associated with the provision of capital are taken on by the private sector provider. Clearly however these need to be balanced against the commercial risks to the Trust inherent within the arrangement- see below. Not only is the requirement for capital for new equipment removed, there is the additional possibility of generating additional funding through the buyout of existing Trust equipment by the provider.

Furthermore, an MES agreement should be structured so as to require continual improvements in service delivery and will include an agreed programme of planned replacement throughout the contract term.

Self-evidently, there are other advantages to the Trust in the sense that risks associated with service-provision are transferred to the provider including, for example, potential staff shortages, escalating external costs etc.

Providing that it is structured appropriately and that the legislative environment remains unchanged, the agreement will remain off balance sheet, will require no capital, will not incur capital charges or depreciation costs and VAT payments will be recoverable.

Against this, careful consideration needs to be given to the principle of giving up effective control over a significant part of the medical asset base and the potential for the associated problems which can arise. These lie primarily in the commerciality of MES arrangements, specifically in three main areas, as detailed in our report 'Managed Equipment Services – A marriage made in heaven OR a divorce in the making?' which is available on request.

Loss of control: How does the Trust ensure that the service and equipment provided within the agreement continues to meet its clinical preferences? In circumstances where technology is constantly moving forward, wording contracts to allow the Trust to benefit from future developments is critical.

Contract Drift: MES agreements tend to be reasonably long term, and once the deal is done the original value proposition and risk analysis tends to be forgotten. Very soon the relationship becomes the status quo, and the original value proposition fades. Inevitably this will not be to the Trust's benefit.

Contract Change: The Trust's requirements will change over time; ensuring that the provision for effecting these changes is reflected in the original agreement is a challenge and it is vital to ensure that the agreement is effectively policed at the points of change if best value is to be achieved.

In consequence the economic cost of Managed Equipment Services should not be evaluated without some acknowledgment of the largely unquantifiable costs and challenges that are likely to arise as time elapses.

7. Options Summary

The following table aims to provide a high level summary of the key areas for consideration in assessing the available options pursuant to the observations made above.

A score has been applied to each of the stated criteria to indicate the relative value, 1 being most negative to 5 most positive. To some extent, due to the number of variables within the current situation these are subjective, but nonetheless reflect the underlying pro's and con's of each approach.

Decision Criteria	Procurement overhead	Effective rate of interest	Loss of control	Impact on key ratios	Total
1 Secured Loan commercial source	3	2	5	1	11
2 Loan from FTFF	5	4	5	1	15
3 Unsecured Loan commercial source	2	1	5	1	9
4 PFI (or equivalent) for new facilities	1	3	1	5	10
5 Lease assets - preserve capital	3	5	4	3	15
6 MES - preserve capital	1	4	2	5	12

Evaluating your options

Whilst we have been able to provide some generic guidance in this report, careful evaluation is required for each Trust to determine the most appropriate funding option for any acquisition. To discuss how we can help call **Stuart Jefcoate**, our Commercial Director, on **01865 340 800**. He will be happy to discuss your specific situation.



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