

# Debate Ensues Over Watsonville Hospital Leaders Plan to Purchase Manufacturing Plant for Site of New Hospital

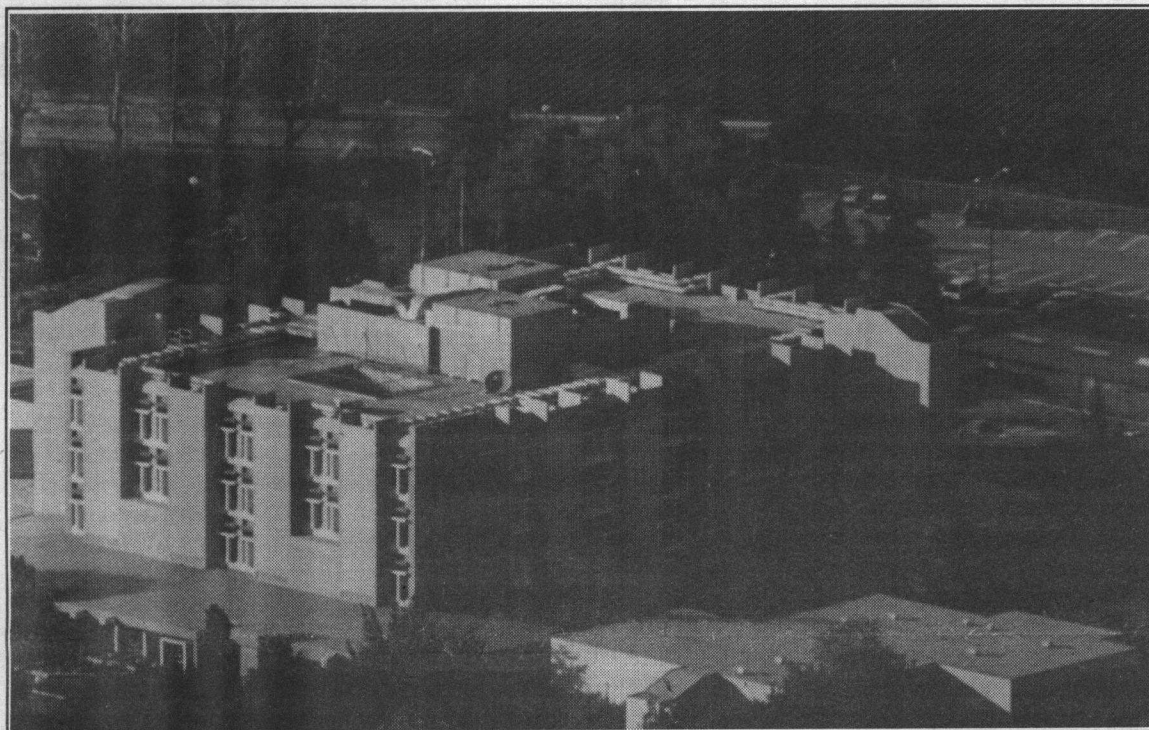
## Veteran Community Activists Challenge Hospital Board Members to Take Another Look at the Numbers

by Mary Bryant

After nearly four years of on-going debating with federal and state regulators over disaster relief funding, Watsonville Community Hospital directors have encountered more questions about their intentions to purchase Seagate's manufacturing plant near the freeway in Watsonville for \$19.6 million and build an approximately 200,000 square foot medical campus on 14 acres of the 27-acre parcel.

In a letter to area newspapers and the current members of the hospital's Board of Directors, local residents requested that hospital leaders continue deliberations and reconsider their decision to purchase one of the few remaining developed industrial properties in the City of Watsonville. Among the men and women signing the short statement that summarized their concerns about the fiscal risks inherent in the expansion project were former city council, school board and hospital officials.

The letter to the hospital board



Aerial view of existing Watsonville Hospital.

members arrived at a time when hospital officials are in the midst of finalizing negotiations with the Federal Emergency Management

Agency (FEMA) regulators. Until final negotiations are settled, hospital leaders will not know the total of the disaster relief assistance available from the federal government. What hospital leaders do know is that state regulators have limited the state's contribution to the project to \$5 million, an amount that has already been paid the hospital.

"I couldn't even begin to give you an estimate of what it's going to come out to," said Christopher Doyle, of FEMA's Infrastructure Support Division in Washington, D.C. Doyle is responsible for preparing one of the final grant proposals. The final grant for equipment costs remains on appeal at FEMA's regional office in San Francisco, according to Doyle. Doyle said the hospital directors and FEMA staff were still apart on the actual construction unit (square foot) cost, but that a final estimate for the construction phase should be ready by the end of March.

"I've got one from FEMA and one from Watsonville Hospital, neither of which I'm prepared to disclose," said Doyle referring to the construction cost units.

With current project costs estimated at \$67.4 million, including the

purchase of land for nearly \$20 million, hospital leaders are counting on FEMA contributing a total of \$43 million, an amount Watsonville

Hospital's president said he is sure he can secure. Hospital directors are expecting to finance about \$20 million of the project costs through short- and long-term loans.

### Community Response

While the hospital directors have attempted to involve the community in discussions about the planning of a new hospital to replace the current facility that was damaged in the Loma Prieta Earthquake, not everyone is evidently in agreement about the proposed location of the new acute care hospital.

After reviewing parcels available on the market, hospital directors selected the Seagate property because of the site's existing sewer and electrical capacities, the proximity of the location to the freeway and the ability to expand facilities in the future. But the price of a developed piece of land came high.

The original agreement the hospital signed to purchase the land last summer had a price tag of \$22 mil-

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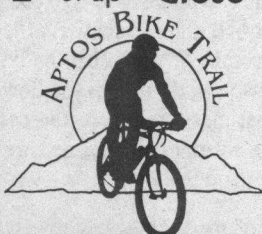
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lion, a figure that was negotiated downwards to \$19.6 million a few months later. Directors believed that the price of \$19.6 million was ultimately less expensive than the costs of securing permits for and running sewer and utility lines to the 17 acre parcel the hospital owns immediately adjacent to the existing facility. The board directors also believed that a new hospital could be opened about two years ahead of the time that it might take to build on existing property.

However, hospital leaders were apparently unable to convince some members of the community that they had fully considered the alternatives.

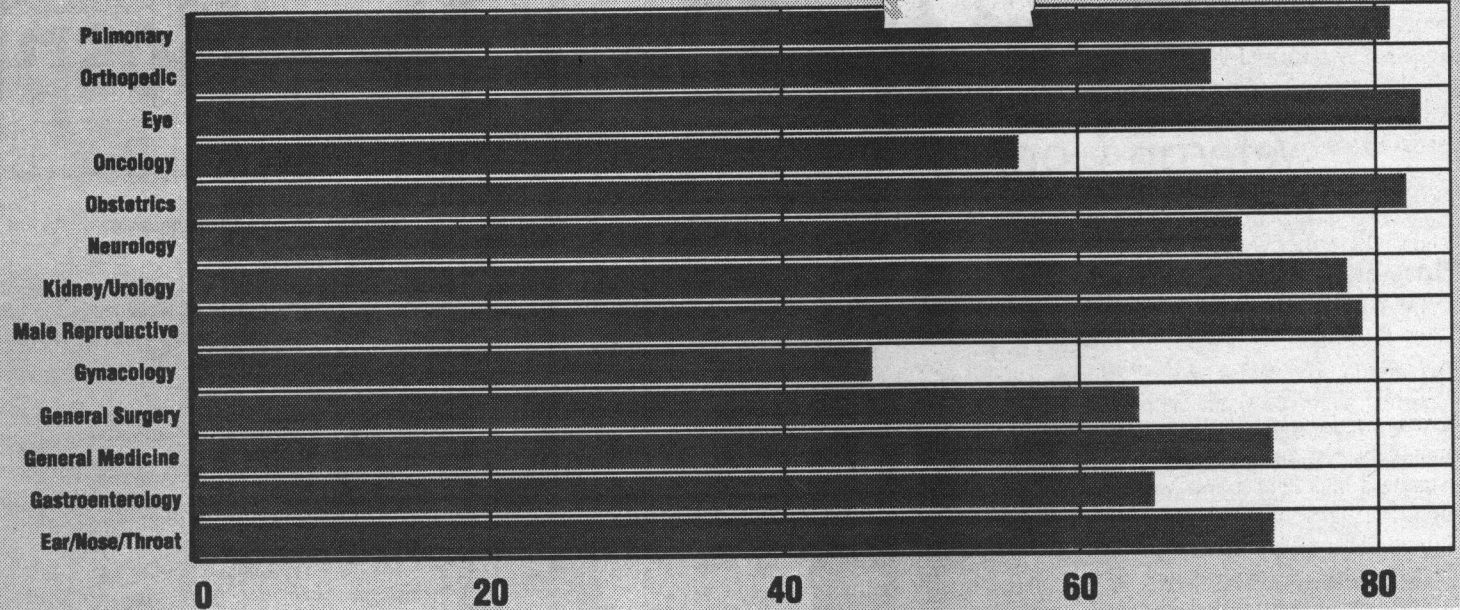
"We have reviewed the financial data of the proposed relocation of the Watsonville Community Hospital which you as directors own. As members of the public, and also donors [to the hospital], we are concerned... It appears that you, as directors of the Watsonville Community Hospital, are placing the hospital in jeopardy if this relocation is achieved," read the letter.

Men and women signing the letter included Dr. Eihler Eiskamp, a founding pioneer in the South County physician community. Another woman signing the letter was Betty Murphy. Murphy is a former hospital board member and former mayor of the City of Watsonville.

"I think people are concerned, but because they're so anxious about a hospital, a lot of people don't want to express their view point," said Murphy in an interview with The Post. "I don't think I'm the only one running around concerned. I have additional concerns other than the

## GAINING MARKET SHARE Watsonville Hospital Captured Different Percentages of Service Markets in South County in 1992

South County is defined as Freedom Boulevard to North Monterey County.



Hospitals are considered very successful if the institution can retain about 85 percent of the market in the service area. However, it should be remembered that doctors admit patients to hospitals, and the number of physicians in practice in a community will significantly impact hospital admissions.

money."

Murphy is also worried about the loss of developed industrial land in the City of Watsonville and the subsequent forfeiture of future job growth in the area that she envisions. Murphy suggested that the hospital directors might again consider the property already owned by the hospital for development. Murphy is not alone in her contention that the hospital might find suitable land closer to the existing site to build a new hospital.

Watsonville Hospital directors have also been unable to convince

FEMA officials of their need to purchase land. As a result, hospital leaders have asked FEMA to allow them to spend the proceeds of the final approved settlement towards an "improved" project.

More simply put, FEMA officials will decide what they would have spent to replace the existing facility and will provide up to that amount on the construction of a new facility. Any costs above the amount contributed by FEMA will be paid for by the hospital.

"That's really what triggered this

as an improved project. The fact that we still believe that they could be building on that site [next to the hospital]. But it's their option, as it is any applicant's option when it comes to receiving federal capacity assistance," said Doyle. "They will go ahead and take what our contribution would have been had they replaced [the hospital with] an identical facility, and go ahead and add square footage onto the building or whatever."

The existing hospital structure is 146,000 square feet. The hospital design for the new facility includes the construction of a new 110,000 square foot facility next to the existing 200,000 square manufacturing /warehouse facility on the site. In the initial phase, about half of the existing structure will be retrofitted and refurbished to house hospital non-acute ancillary and administrative services, leaving about 100,000 square feet in unused space for future expansion and physician offices.

### Paying for a New Hospital

"Anytime you get into a project this size that we're getting into, there's need to be concerned. That's the job of the Board of Directors and myself, and we've been over this thing from a variety of angles," said John Friel, Watsonville Hospital's president and chief executive officer. "We're confident that it can be done and that we can do it. Our job now is to get that message out to the community in a variety of ways and we're planning to do that."

Part of the message is that with recent increases in excess revenues over expenses or profits, that the hospital is heading towards a time when

it can expand debt load.

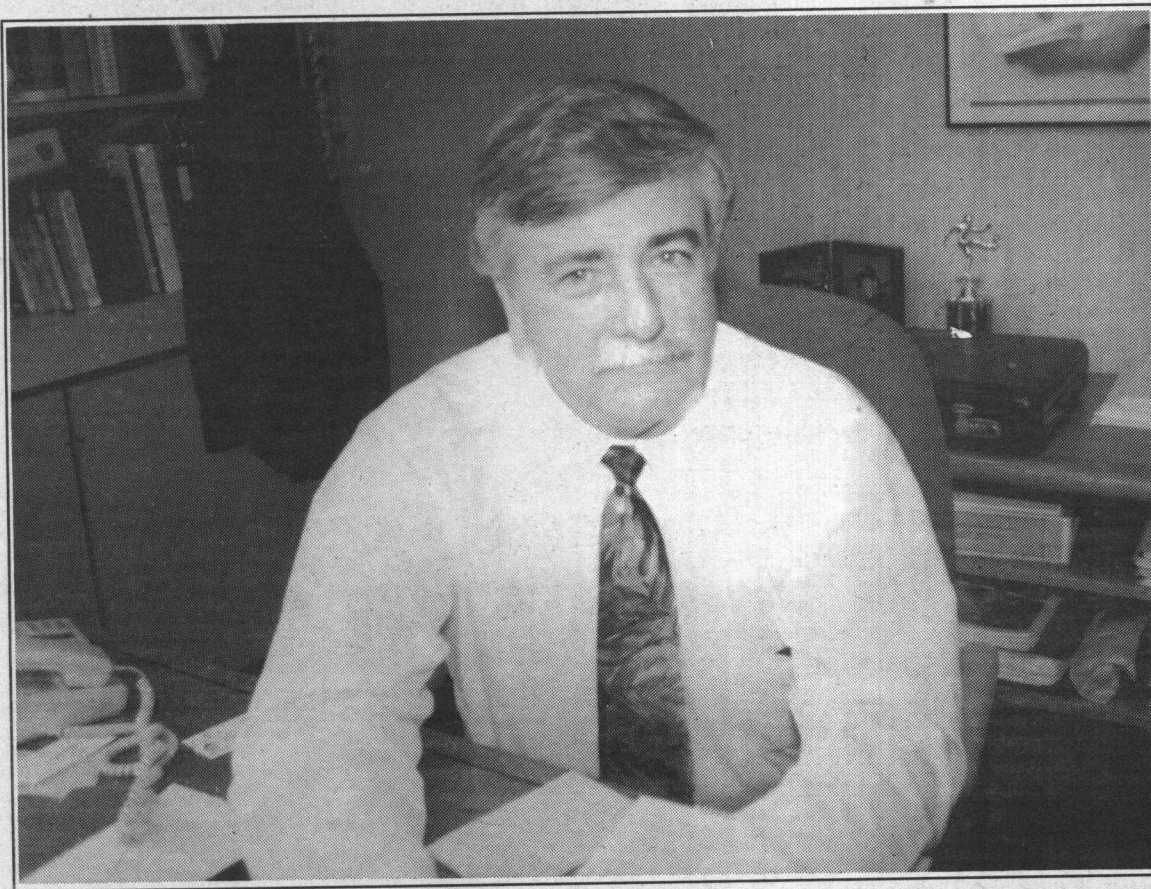
Currently hospital directors plan to bridge the gap in project costs of \$20 million with three loans.

The first loan is \$8.6 million from Seagate on the purchase of the land, with an extended payback period. The second loan or credit line of \$9.3 million is from FEMA, a loan which must be repaid in five years from the date a new hospital is licensed. However until the final amount of the FEMA grant is calculated the total amount of the available loan dollars for the second loan cannot be confirmed. The third loan of \$2.1 million is also from FEMA and is a loan against the current value of the existing hospital site. The third loan will be repaid within two years or upon the sale of the existing site.

"We're looking at another way of getting that \$9.3 [million] without having to go through FEMA because it does have a short payback period. We are investigating opportunities with the Cal- Mortgage program, that presently holds those notes on the \$18 million," said Friel referring to the hospital's existing bond debt of more than \$18 million.

In order to qualify for additional bond debt, the hospital will have to show historic profits appropriate to cover the debt load. The calculation commonly used to establish the debt coverage ratio takes into account existing interest and principal payments and depreciation, along with annual debt service minimums. The debt service minimum is like a minimum credit card payment, except that it includes the yearly principal pay down amount.

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President of the Watsonville Community Hospital, John Friel



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Using the hospital's current 1993 reports, the hospital could not currently meet the insurance or bond rating requirements for additional bond debt, ratings that are reviewed each year.

In 1990, when the hospital did not show a year end profit, the hospital's bond insurer (Cal- Mortgage), required the hospital demonstrate a response to incurred losses. One of the hospitals' responses to demonstrate fiscal viability was to lay-off about 60 workers to reduce operating expenses.

In order to qualify for a total of about \$18 million more in bond debt to consolidate the Seagate and FEMA loans, the hospital would have to increase earnings to about \$3.3 million per year to establish as debt service coverage ratio of 2.5, an average ratio that falls between the minimum performance levels set by Standard and Poor's and Moody's bond rating minimums for BBB+ bonds. This calculation does not include increased depreciation on a new plant nor does it allow for increased principal payments due on existing bonds. Or, more to the point, it is an conservative estimate.

It is also a valid estimate should hospital leaders only attempt to finance the FEMA loan on the bond market, since interest and principal

payments paid Seagate would remain part of the rating process.

However, gaining insurance for bonds in today's markets will be different than it was in 1988 when the last bonds were issued by the hospital.

When California's Triad Healthcare hospital system defaulted on \$167 million in state-guaranteed loans last year, the popular Cal-Mortgage (California Health Facility Construction Loan Insurance Program) was suspended. While this program will likely be available in future, state program directors have publicly said that the emphasis of the project will now be on insuring bonds for small community clinic facilities offering primary and preventative care services to the poor or state-insured patients and those facilities that provide care for the underserved. It is this last category Watsonville Hospital might fit. It should also be remembered that state programs remain active in response to funding from state legislators.

Nonetheless, qualifying for bond sales will only be part of the equation. The hospital will also have to increase profits on existing volumes or increase total volumes to pay off new debt.

"Our effort is not to penetrate the Santa Cruz [market] and bring people from Santa Cruz here," said Friel. "Our effort is to recapture people from

our catchment area to get care here."

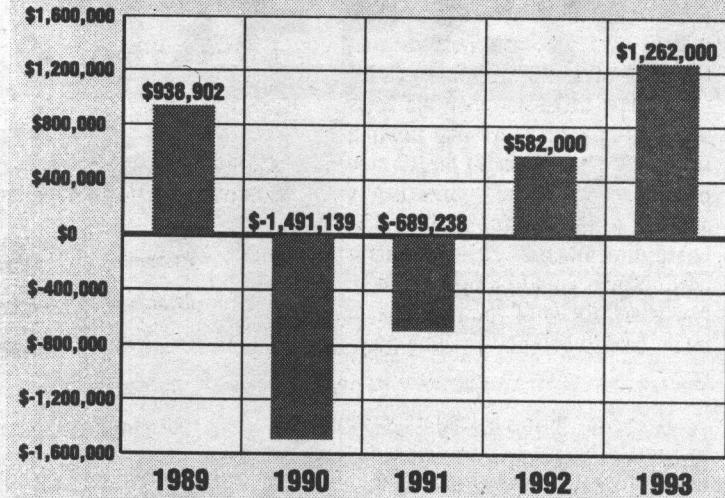
Friel is referring to people who travel out of South County to be admitted to a hospital (see chart this issue). While it is generally considered that a hospital cannot capture more than 85 percent of a market or service area, it should also be noted that there are entire service areas Watsonville Hospital does not attempt to compete. For instance, there is not a neurosurgery market in Watsonville because the hospital is not equipped to allow doctors to perform neurosurgery, nor are there any practicing neurosurgeons in the South County area.

However, even within established service markets, building a hospital is not the same as building a physician community.

The South County area is presently underserved by physicians in many service areas, and patients travel outside the area to see a doctor and subsequently wind up admitted to the hospital near the doctor's practice. In service areas where there are sufficient physicians available in the South County region, like obstetrics, the hospital retains a very good base of in-patient admissions.

"If you were to look at the numbers and see where patients are going that could stay here, it's primarily to Dominican because of the physician

## WATSONVILLE HOSPITAL SHOWS STEADY GAINS To Meet Bonding Standards to Cover Expanded Debt Load Hospital Officials Will Need to Earn about \$3.3 million/year



SOURCE: Watsonville  
Community Hospital Audited  
Financial Statements

NET PROFIT/LOSS (Year End 6/30)

relationships. Our effort is to provide access to physicians at the hospital that need it," Friel said.

The other area that Watsonville Hospital excels is out-patient surgeries, retaining a very substantial portion of this type of admission, Friel confirmed. With this in mind, the proposed facility will be constructed to better accommodate out-patient surgeries, Friel said.

While there is little competition for the existing hospital in the out-patient surgery market, the expanded and more modern facility will help

ward off any future competition.

However, should the hospital find it difficult to significantly increase patient volumes, then hospital leaders will have to look to increasing profits. To increase net profits to \$3.3 million, hospital leaders would need to see the profit margin grow to more than 7 percent on current net revenues. Friel said that the hospital is expecting net profits to be \$2 million by the end of this year, and that the new hospital at the Seagate facility will be open by 1997. □