MAXIMIZING VALUE AMID UNCERTAINTY IN THE HEALTHCARE INDUSTRY

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Managing through uncertainty is a constant for healthcare operators. For years, healthcare companies have faced disruption related to reimbursement rate cuts or new market entrants. However, the impact of COVID-19 is creating a new kind of stress across various sectors in the healthcare industry. Healthcare operators need to address key pressure points and review strategic options to best position themselves for a successful future.

With elective surgeries put on hold, hospitals and physician practices have seen a significant decrease in revenues, leading many of them to cut staff or stop capital spending plans. Critical cash shortages faced by medical groups led them to deplete their cash reserves, all while incurring more costs as they procure more protective equipment at higher costs or turn to agency staffing to help meet COVID-19 patient demand.

Additionally, there is increasing uncertainty over the extent of reimbursement for COVID-19 treatment, and the timing is questionable for when elective surgery volumes will return to pre-crisis levels. Hospitals should also expect to see an increase in uninsured and Medicaid patients as unemployment increases and there is shift away from commercial insurance coverage. This shift in payor mix will negatively impact operating margins and further pressure free cash flow generation.

The loss of revenue is especially critical for rural hospitals that generate most of their revenue from outpatient services. Even before the COVID-19 crisis, rural hospitals were especially vulnerable to closures due to limited sources of capital, lower patient volumes, and an unfavorable payor mix. A significant number of rural hospitals across the country are now vulnerable to closing, and rural hospital restructurings tend to be liquidations through a Chapter 7 process.

Nursing home operators are also experiencing severe distress as occupancy levels are pressured and the payor mix has shifted to lower margin reimbursements. Skilled nursing home operators depend on post-surgical rehabilitation patients, often a profitable payor type. Rehab reimbursement is typically through private pay, private insurance, or Medicare. Patients, however, are deferring elective surgeries that require post-surgical rehabilitation, and the lower volumes are negatively impacting nursing home operators' revenue and, more importantly, their operating margins.

Continued declines in revenues and payor mix could devastate operators. Nursing home operators typically borrow against their receivables, which include government payors (Medicare and Medicaid), private insurance, and private pay residents to help improve liquidity. In the current environment, operators will likely see constrained borrowing base capacity due to lower revenues and an increase in bad debts from uninsured patients.

The impact of COVID-19 will impact state budgets as tax revenues decrease due to businesses closing and unemployment costs increasing, leading to potential cuts to Medicaid programs. States have looked to increase tax revenues by asserting bed taxes on hospitals or nursing homes in recent years. These bed taxes are asserted on either total available beds and/or occupied beds and negatively impact a company's operating margin.

Other healthcare sectors are also not immune from the impact caused by COVID-19. Many pharmaceutical companies have seen a decrease in sales related to drugs administered by physicians as well as delays in clinical trials for non-COVID-related drugs, leading to cuts to research and development (R&D) projects to preserve cash. By deferring or halting R&D projects, many pharmaceutical companies could see delays in bringing new drugs to market, thus limiting new revenue sources and negatively impacting near-term and long-term cash flows.

Continued pressure on revenues, coupled with a largely fixed cost structure, will require healthcare companies to review their strategic options and quickly implement a transformation plan. Acting quickly to manage liquidity will give them time to implement a comprehensive and cost-effective turnaround plan.

Initiatives Operators Should Undertake

In periods of distress, companies need to instill a "cash is king" mentality

continued on page 8

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continued from page 7

to help enhance liquidity both in the near term and long term. Companies need to depart from solely forecasting cash based on traditional accrual accounting (indirect cash flow method) and focus on developing a direct cash flow forecast. A weekly cash forecast will provide management with greater insight into collection trends and give them more control over essential payments while reducing nonessential spending. The cash forecast should align with the company's business plan to ensure savings initiatives are captured and are sustainable.

The following key liquidity management initiatives will help companies stabilize their business while positioning them for future growth.

Short-Term Cash Initiatives. Developing a weekly cash forecast is a great tool to enhance a cash culture within an organization. A 13-week cash forecast enables management to understand troughs that may not have been visible when assessing cash flows on a monthly or quarterly basis. With greater visibility into weekly cash collection cycles and vendor disbursements, management can be proactive and avoid surprises.

When developing a weekly cash forecast, management needs to analyze the cash conversion of its receivables by customer or service offering. Specifically, in healthcare, a gross sale does not always translate into a fully recognized receipt. Chargebacks and rebates are a significant part of how operators generate revenues. For example, pharmaceutical manufacturers typically have chargeback and rebate terms outlined in their contracts with their wholesale customers.

As a pharmaceutical manufacturer sells its product through the wholesale channel, these customers can offset their payments with the accrued chargebacks or rebates earned. The timing of these chargebacks or rebates may not align with the collection of the related sales, so timing and tracking of these accruals is important to understanding the full sales-to-collection cycle. Healthcare operators also have rebate programs with their Medicaid and Medicare payors which can be set off against receipts. This concept of setoff or recoupment is a key issue when healthcare companies need to restructure in a Chapter 11 bankruptcy.

Healthcare operators facing liquidity issues can also improve their cash position by closely managing their vendor trade payments. Examples of short-term cash generating initiatives related to trade payables include:

- Introducing standard payment terms
- Using full terms offered by suppliers, such as stopping early payments and taking all applicable discounts offered
- Reducing the number of payment runs

By simplifying the payment runs, management will have more control over what payments are made and when. If companies properly communicate their payment standards to their vendors, companies will be able to take advantage of grace periods. For distressed companies, adding a couple of days to their days' payables can be a lifeline.

Long-Term Cash Initiatives. After a company has been able to stabilize its near-term cash flow needs, it should focus on initiatives that will help improve cash flow generation in the long term, such as alternative funding or asset disposals.

Many healthcare companies look to finance their receivables either through a securitization facility or an asset-based lending (ABL) credit facility. Funding through an accounts receivable securitization facility involves selling the accounts receivable to a special purpose vehicle (SPV), which uses the receivables as collateral to raise capital at a percentage of the gross accounts receivable value. The issuing company receives capital upfront from the SPV with the balance paid as receivables are collected.

Under an ABL credit facility, the company can borrow funds against the net value of the receivables or other collateral. A lender will typically discount the collateral based on aging and collectability as well as include reserves, which reduce the amount available for the company to borrow against. The collateral included in the ABL facility is typically refreshed each month, but many lenders may require the borrowing base to be updated weekly or daily if the borrower is distressed and the lender is concerned about recovering on its collateral.

Companies can also look to sell non-core assets to raise capital. Disposing of non-core assets can help improve liquidity and realign the business. Operators need to be realistic about timing to execute on an asset sale and the collection of proceeds, given that the industry is highly regulated and transactions require regulatory approval. In the pharmaceutical industry, branded drugs require U.S. Food and Drug Administration approval to move product licenses, while in the nursing home industry, the respective state(s) and the Centers for Medicare & Medicaid Services (CMS) must approve the transfer of operating licenses and provider agreements.

Operators should sensitize their business plans for any asset carve-outs and test the remaining company's cash flows against financial covenants. The company's cost structure should be evaluated and realigned to reduce stranded overheads costs. It is important to note that proceeds from asset sales may require repayment of outstanding debt obligations, which would reduce the net proceeds available to the company.

Many nursing home operators have turned to private equity or real estate investment trusts (REITs) to generate cash through a sale-leaseback of their real estate. While these operators were able to effectuate a one-time cash infusion, these lease agreements include annual rent increases which can lead to liquidity issues as nursing home operators face continued pressure with reimbursement rates.

Any type of transaction needs to be properly vetted, and operators need to run sensitivities not only on their cash forecasts but also on their business plans.

Business Plan Development and Assessment. A comprehensive three-to five-year business plan is important for identifying key strategic initiatives that will drive the business in the future. While it may be tempting to make quick fixes to improve short-term liquidity, a business plan will outline the long-term impact of short-term decisions, particularly in regard to R&D projects, supply chain optimization, and portfolio diversification.

The business plan also serves as a tool to assess whether capital investments, new product development initiatives, or R&D projects are still appropriate investments for the organization. Capital investments in the healthcare industry are often material components of a business plan, including modernization or expansion of facilities and enhancing equipment and technological capabilities. Specifically, for pharmaceutical companies, investments in new drug pipelines, including R&D and marketing spend, will greatly impact the company's growth profile.

A year ago, a multiyear payoff period may have been prudent, but given the level of uncertainty now, operators must weigh the costs and benefits of capital investments. Disruption often requires deeper focus and investment in core products and services, especially as

continued on page 10

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continued from page 9

demand decreases. This is particularly relevant for pharmaceutical companies that need to quickly pivot from growth and expansion to maintaining the core product portfolio and competing against new market entrants.

Cash flow must be top of mind. If initiatives are tying up cash, is there enough cash flow to maintain operations and stabilize the core business? If maintaining capital investments means taking on uneconomical financing arrangements, the previously contemplated economic benefits of such investments may be significantly reduced. Furthermore, assumptions previously utilized to evaluate profitability of investments may require significant change. The effects of COVID-19 on the healthcare industry illustrate the need to continuously reevaluate assumptions on long-term investments given fundamental shifts in patient volume and payor mix.

Business plans need to align with cash forecasts, with specific assumptions on revenues and expenses showing a direct effect on the cash forecast model. Business plans should account for various scenarios, including volume and price changes impacting revenue and key cost drivers. Often, business plans are developed at too high of a level and opportunities for identifying cost savings or increasing revenues are missed, impacting EBITDA levels over the three- to five-year period.

Business plans developed by business unit or product can be quickly amended if companies need to carve out certain assets to generate incremental cash flow. A company can assess the direct costs of the business unit or product and identify what indirect or shared costs need to be reduced to better align with the prospective business.

Business plans are also essential in evaluating whether a company's current capital structure is sustainable at lower cash flow levels. Companies that are proactive in developing new cash flow forecasts and preparing fully vetted business plans will be more successful in negotiating with their lenders. By going through this process, companies can understand key sensitivities of the business, so they can identify risks in advance and proactively plan to avoid any potential defaults.

Key Issues in Healthcare Restructurings

When assessing strategic options, healthcare companies need to understand key financial and legal issues that are unique to this industry. Addressing these key issues in advance of an in-court or out-of-court restructuring will allow companies to better position themselves for negotiations with their creditors and avoid unnecessary problems.

Cash Collateral and Control Agreements. Government receipts, either Medicaid or Medicare receivables, are required to be deposited in government-controlled accounts, which prohibit any third party from having a secured interest on the account. Government receivables are only paid to the entity which holds the provider agreement and license. The company will sweep the government receipts into a lender-controlled account that will be commingled with non-government receipts, such as insurance or private pay receipts. The setup of a government receipt account, a non-government receipt account, and a lockbox concentration account is referred to as a "three-tiered lockbox" structure.

A lender will not have a customary UCC "control agreement" on the government account, which limits a lender's recourse until funds are swept into the lender-controlled concentration account. While a secured lender may have a security interest in the Medicare receivables, the federal Anti-Assignment Act limits the ability of a secured lender to take action against receipts held in a government-controlled account until the funds are deposited into the lender-controlled account. As a result, lenders may reduce borrowing availability until funds are swept into their controlled accounts, causing a potential delay in accessing cash or new availability on the borrowing base.

Medicare Provider Agreements & Cost Reports. To participate in the Medicare reimbursement program, operators must enter into provider agreements with CMS. In exchange, operators must comply with the Medicare provisions and charge a reasonable cost for services provided. Each year, operators must file a cost report with CMS which contains utilization data, Medicare settlements, and other financial information. These cost reports are used to determine if any overpayment or underpayment true-up is needed.

Medicare may take years to audit the annual cost reports submitted by nursing home or hospital operators, which could result in significant liabilities if CMS determines it overpaid over a substantial period of time. CMS has the right of setoff and can apply overpayment claims against receivables for new services provided, which will negatively impact a company's liquidity forecast.

Right of Setoff or Recoupment. CMS has the right of setoff or recoupment, which allows it to recover claims against recent receivables. The right of setoff is an equitable right of a creditor to deduct a claim it has against the debtor arising out of a separate transaction. Recoupment is slightly different in that the netting of a credit and debit must arise out of the same transaction. Both setoff and recoupment require that mutual obligations be between the same parties.

There is court precedent that the U.S. is one party for mutuality purposes, and claims held by one government agency can be recovered through a setoff or recoupment from a different agency. The IRS, for instance, can recover on its claims through a setoff against receivables owed to CMS. The right of setoff is important for both the company and its lenders to understand, as it can negatively impact cash flows while potentially reducing recoveries for other creditors.

Regulatory & Licensing Issues. The healthcare industry is highly regulated both by local jurisdictions and federal agencies. Companies across the healthcare industry, from pharmaceutical companies to hospitals to nursing homes, require some type of license or provider agreement to operate, especially if products or services are offered to Medicaid or Medicare patients.

These licenses are difficult to obtain and have intrinsic value, as they act as a barrier to entry. The ability to transfer a license in an asset sale could be an impediment to closing a deal quickly and realizing the cash proceeds in a timely manner. Sellers need to factor in the time needed to obtain the appropriate approvals when developing their cash forecast and business plan related to an asset carve-out sale.

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Conclusion

Healthcare operators that are experiencing unforeseen stress on their business need to be proactive and quickly assess different strategic options. Developing a weekly cash forecast is an extremely important tool to help identify potential troughs in liquidity, allowing management time to implement initiatives to improve near-term liquidity and maximize the runway for improving performance.

However, initiatives that might help with near-term liquidity need to be closely analyzed so as not to impair the company's future growth. Companies that are proactive in revaluating their business are able to confront potential issues before they arise, allowing them to be in a better negotiating position with their creditors. Taking steps now will allow healthcare companies to maximize value in the future.

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