

Where have the healthcare restructurings gone?

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Why healthcare companies fail

Demand for healthcare is highly inelastic; thus the industry does not fluctuate with the overall business cycle. Healthcare has its own cycle based on technological advancements and political factors. For sure, some healthcare companies fail for the same reasons that companies in other industries fail: principally, failure of management to anticipate and respond to changes in the competitive landscape, weak corporate governance, and fraud. However, there are a few notable risk factors that are unique to healthcare firms.

Reimbursement. Chief among the unique risk factors in healthcare is abrupt and dramatic shifts in government reimbursement, usually focused across an entire sector within the industry. Although companies which have in the past experienced dramatic reimbursement cuts may claim to be unwitting victims, most industry experts believe that long-range shifts in reimbursement are relatively predictable. One only has to review the last two decades of Medicare reimbursement reform to understand how reimbursement policy evolves. Predictably, sectors that involve large government payments which also demonstrate high profit margins or unusual revenue growth over a sustained period inevitably grab the attention of the Washington bureaucrats that monitor healthcare policy. Just consider the circumstances that lead to implementation of radical reimbursement reform in hospitals, skilled nursing facilities, home healthcare and freestanding diagnostic imaging centres. It is important to understand that Medicare / Medicaid administrators view growing and profitable healthcare providers not as a good investment, but rather as fertile ground for reimbursement reform.

Regulatory. Few industries are as complex or heavily regulated as healthcare. Not surprisingly, many distressed healthcare companies can trace their problems back to serious regulatory missteps. Although some providers unintentionally run afoul due to the overly complex arcane system of rules and regulations, many simply have been caught 'gaming' the system for unfair advantage. Since the inception of government reimbursement programs, certain sectors have been notorious for widespread fraud and abuse, including home medical equipment and workers compensation. To understand the cost of running afoul of the government, consider that HCA's regulatory issues cost shareholders well in excess of \$1bn. Tenet Healthcare is currently facing similar costs.

Flawed business models. When looking at the service provider side of healthcare, only a fraction of economic activity on the healthcare services sectors is provided by sizeable, investor-owned, for profit companies. This results in the private sector often 'stretching' to develop creative business models for investors to participate in, and profit from, more sectors. The best example of this dynamic is the rise and fall of the physician practice management companies (PPMCs) in the 1990s. In this experiment, companies purchased individual physician practices in transactions whereby physicians pocketed large sums and became essentially employees, thereby weakening the entrepreneurial drive necessary to make the model successful. Ultimately, most of these arrangements were unwound; usually by selling the practice assets back to the doctors for a fraction of the original purchase price. Other times, pursuit of creative business models to deal with the frustrating complexities of the business have resulted in executives saying "Well, we thought it was a good idea at

the time". A recent example of this problem is the complex capitation arrangements assumed by providers with inadequate ability to manage and control utilisation. The rise and fall of capitation as a widespread utilisation management tool played out over roughly a decade.

Beware of the high-flyer syndrome.

Investors and lenders should be intimately aware of the 'high flyer syndrome', which includes: (i) firms that consistently and substantially outperform their peers within the sector without a clear, understandable and sustainable competitive reason; and (ii) entire sectors within healthcare that demonstrate a high level of spending growth and/or profitability.

Examples of the first include Oxford Health Plans, Phycor, Tenet, AHERF and HealthSouth. Such performance is usually not sustainable, even in the intermediate term. Operating models in healthcare are usually transparent and available to all competitors. This results in only short-term competitive advantage when new, creative models are developed. Stakeholders should be wary when a company in a competitive sector reports performance well above peer level for an extended period of time.

Examples of the second include skilled nursing and home health in the early/mid 1990s (BBA 1997), freestanding outpatient diagnostic imaging (DRA 2005) and home respiratory therapy / home equipment over the last decade. These sectors predictably came under the government's reimbursement knife after analysts noticed high rates of revenue growth and profitability.

Healthcare restructuring opportunities

Over the long-term (or at least until meaningful reform is passed), healthcare will consistently present many restructuring ►►

opportunities in a cyclical, rotating sector basis. Consider the following facts. Spending on healthcare goods and services accounts for more than 15 percent of GDP. Over the past decade, the healthcare CPI has grown at 2x-3x the general rate of inflation in the economy with no signs of abating. As the Baby Boom generation enters the ranks of 'the elderly', the demand for healthcare services will continue to accelerate. According to the latest government statistics, there are 46.6 million Americans without some form of health insurance coverage. Although the number of Americans without health insurance is growing, the number of Americans insured through government entitlement programs is growing (yes, this means the number of Americans covered under employer-sponsored plans is declining even more).

Based on these trends, industry analysts agree that the demand for healthcare services will dramatically outstrip our ability to pay for such services. What does all of this mean for a few of the larger sectors?

Physicians. Due to their sheer size and visibility in the overall healthcare delivery system, physicians and hospitals are under constant pressure on all fronts. In particular, decreasing reimbursement is driving doctors to compete with hospitals for a greater share of the 'technical component' of each healthcare dollar. Exacerbating this trend is the meteoric rise in the cost of (or outright unavailability of) malpractice insurance. While doctors face many intra-sector competitive disadvantages, namely severe fragmentation and poor access to capital, they control at least one critical element: patient referrals. Historically, many physician ventures failed due to a lack of business and management sophistication. However, doctors today are becoming business savvy in finding creative ways to compete with traditional providers of technical services.

Hospitals. It's clear that hospitals are facing greater competitive pressure from competing ventures (both physician and non-physician). The relentless march of technology will continue to result in the migration of high-reimbursement services from the inpatient setting to alternative sites; notably

for-profit, physician-owned outpatient ventures. As a result of this competitive encroachment, hospitals will face tremendous pressure to invest in the newest, most costly technology in order to attract and retain physicians and patient volume. This will put more stress on already weak hospitals and will continue the nationwide trend of hospital closures. Inevitably, some hospitals will not be able to compete.

Long-term care. There is no doubt that the demand for long-term care and senior housing will continue rising as the Baby Boom generation ages. Generally, the long-term care and senior housing sectors are doing well at the current time. However, the unresolved question remains finding a reliable, politically acceptable funding solution for these important services. Currently, there are no (or very limited) government entitlement programs which cover the growing need for senior housing and low-intensity long-term care (e.g., assisted living). Entitlement programs which cover skilled nursing services are under constant budgetary strains at the Federal and state levels. Making matters worse, the public is concerned about perceived gaps in nursing home quality of care. Moreover, providers are in a genuine bind in balancing the quality expectations of consumers with inadequate reimbursement levels.

When pressed to make tough decisions, politicians inevitably opt to squeeze providers (e.g., cut reimbursement rates) rather than ration services or limit eligibility. This, along with structural features of government reimbursement programs, will result in periodic, cyclical and fairly predictable declines in reimbursement that can cause widespread distress in an entire sub-sector (discussed above). Highly leveraged and capital intensive firms cannot easily adjust to material fluctuations in reimbursement rates. Reimbursement fluctuations, rapidly advancing technology and constantly changing market dynamics will undoubtedly result in a robust restructuring market for the foreseeable future.

Thoughts on the next round

Near term. Cuts in payments to physicians and the continual shift from inpatient to

outpatient services will continue to adversely impact the hospital sector by driving doctors into competitive ventures. Over the next 5-10 years, physicians will become more effective competitors in the quest for a larger share of the technical fee. As has been the case over the last 3-5 years, small community hospitals with weak market positions and limited access to capital (predominantly not-for-profit) will continue to face severe financial pressure. Each year for the next 5-7 years, we should continue to see a small number of these hospitals either close or undergo restructuring. In the for-profit hospital sector, all eyes are on Tenet Healthcare. The issue is whether Tenet can fix its operations, balance sheet and government problems while also avoiding bankruptcy. The Deficit Reduction Act of 2005 is expected to cause significant distress in the freestanding diagnostic imaging sector. A complete strategic and market re-engineering is very difficult, but will be required in this sector. Reimbursement pressures will continue to cause distress in the home medical equipment sector.

Longer term. Valuations in the senior care sector are at, or near, all-time highs. M&A has been robust for a few years now and leverage has been liberally applied. While consumer demand in these markets isn't a problem, operators may find it increasingly difficult to achieve the levels of rate increases necessary to maintain current growth rates. Furthermore, skilled nursing facility operators will find it very difficult to lobby congress for reimbursement increases on par with the rise in operating costs. Eventually, a more permanent long-term care funding solution must be adopted. If history repeats itself (and it usually does) this will likely result in a significant shake-up in this capital intensive, fixed-cost laden industry.

Finding and implementing a permanent healthcare funding solution may take a generation or more. Until that time, it is my opinion, and that of many others, that healthcare will continue to be fertile ground for restructuring professionals. ■

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