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Valuing the Troubled Hospital

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This is the second article in a series that Juniper is publishing with The Governance Institute during 2018. Each quarter, we are analyzing a specific topic related to healthcare merger and acquisition (M&A) transactions. For each subject, we define the issue, describe how it was handled in similar transactions (as well as in comparable industries), and provide context within the current hospital industry environment. As we will explore, large-scale changes in health policy from Washington, D.C. present new risks and opportunities for non-profit hospitals participating in business combination transactions.

In December 2017, we suggested that the majority of health systems appear to be considering strategic alternatives (i.e., arrangements that result in some change of ownership and/or control).[1] We also noted that the pace, and nature, of transformation will likely accelerate. Further, M&A strategies, whether via growth or divestiture, at non-profit companies are becoming more offensive, rather than defensive, and occupy a larger role within overall corporate finance decision making. Unlike previous decades, the majority of acquisitions are now being led by non-profit systems.

Key Board Takeaways

- *Don't allow value to erode.* A hospital's value, in the eyes of a partner, is mostly a function of: a) the market it serves (demographics, payer mix), b) its share of that market, and c) the trend of those metrics relative to competitors. Unlike a manufacturing or industrial company, near-term financial performance is secondary as suitors believe they can "fix a hospital, but can't fix a market." Very often, boards wait until these indicators are in dire straits before initiating a search for a strategic partner.
- *"Value" is not just money.* Financial value is rarely among the leading objectives sought by the board of a hospital seeking a partner. To maximize the overall transaction outcome (to patients, the community, and employees), great attention should be paid to the number, type, and identity of partners participating in the process. It is for this reason—to maximize decision-making flexibility—that initiating a thorough controlled competitive process before nearing the zone of insolvency is so critical. Waiting too long, when value is depleted, is generally the main reason a hospital must consider bankruptcy, or worse yet, closure.
- *Remember that healthcare is different than other industries.* Bankruptcy for non-profit hospitals differ from their corporate counterparts. Court-led restructuring is often less necessary and advantageous given the makeup and orientation of capital providers. Board members should, therefore, be leery of using "the code" as the magical fix. Most often a strategic partner in the M&A market offers equal or greater potential for operational improvement.

Enterprise Value: *Techniques Not All That Different; Quality of Information and Timing Are the Booby Traps*

Transactions involving financially troubled hospitals present unique challenges and opportunities. The basic valuation techniques used in the distressed market are similar to those used in ordinary circumstances—i.e., precedent transaction analysis (multiples), discounted cash flows, public company comparables, and the like. The main difference, and challenge, resides in the *quality* and *accuracy* of

[1] Rex Burgdorfer, "A Year of Change for Community Hospitals," *Hospital Focus*, The Governance Institute, December 2017.

information. Data is often startlingly incomplete. This represents both a challenge and an opportunity. The challenge is associated with building a set of reliable assumptions upon which to base forecasts. The opportunity is achieved by those who can roll up their sleeves during diligence to truly understanding the business. That is, there is a premium available to those who can understand the company better than its management does.[2]

Determining the "enterprise value"[3] of a company nearing insolvency is generally a two-step process:
1. Review the company's assets.
2. Ascribe a value to its liabilities.

Very often, these deviate widely from the book value shown in the financial statements. If the value of the liabilities exceed the assets, corporate restructuring or bankruptcy is often considered.

Bankruptcy: *A Slippery Slope into the Jaws of a Hungry Sub-sector*

Unfortunately, even a whiff of bankruptcy often sets off downhill momentum toward court-led restructuring. Bankruptcy professionals are much like wedding planners or divorce lawyers—they are very good at inserting themselves into a leading (and costly) role in the process. In our observation, only a small percentage of hospitals that utilize the bankruptcy code truly need to do so. A volunteer board and management team that has never participated in a restructuring can easily fall to the snowballing momentum of professionally led restructuring.[4] **Table 1** shows the classic application of the bankruptcy code.

Table 1: Most Common Application of the Bankruptcy Code

The utility of the bankruptcy code is highly dependent on the type of industry and characteristics of the financial sponsor. The table below illustrates the pros (+) and cons (-) of court-led restructuring in the non-profit hospital sector versus other corporate borrowers.

11 U.S.C. § 363	Airlines/ Autos/etc.	Non-Profit Hospitals
Number of creditors ➢ Claimants are usually identifiable upfront and finite in number (assuming debt is not publicly traded municipal bonds)	+	-
Alternative uses for assets ➢ Planes can be leased to others, factories retooled, labor reallocated	+	-
Creditors likely to grant concessions ➢ Private lenders (banks) are likely to accept repayment below par (say $.70 –.90) versus liquidation value	-	+
Bankruptcy effectiveness	+	-

Transaction Flow of Funds: *Proceeds Analysis*

Regardless of transaction structure, satisfying liabilities has become an important part of completing M&A transactions for both buyers and sellers.[5] Alterations to payment protocols, sometimes attributable to IT system or revenue cycle changes, have caused working capital deficits to grow. Receivables, many times from state or federal agencies, have multiplied. Payables can only be delayed for so long—sometimes inverting working capital.

[2] Thomas J. Barry, Donaldson Lufkin & Jenrette, "Valuing the Troubled Company," in *The Mergers and Acquisitions Handbook*, Second Edition, eds. Milton L. Rock, Robert H. Rock, Martin Sikora, 1987.
[3] "Enterprise value" is defined as "the sum of a company's market value of equity and debt, less excess cash," Michael Mauboussin, *Thoughts on Valuation*, Credit Suisse First Boston Corporation, 1997.
[4] Emily Glazer and Jennifer Smith, "Bankruptcy Costs Attacked," *The Wall Street Journal*, May 12, 2013.
[5] Rex Burgdorfer, "Hospital Merger and Acquisition Transactions: A Focus on Retiring Liabilities," *BoardRoom Press*, The Governance Institute, October 2013.

Major, long-term obligations that must be satisfied in a change-of-control generally include:
1. Retiring funded debt
2. Unwinding interest rate swaps
3. Satisfying defined benefit pension plans[6]
4. Covering post-closing risks (e.g., acquiring tail insurance)

Today's difficult operating environment combined with historically low interest rates have narrowed the math of what a seller can hope to extract from a transaction.

Retiring Funded Debt

The municipal bond market is the most common form of external capital utilized by non-profit hospitals and health systems. This $3.7 trillion market, unique in the developed world, allowing government entities, schools, utilities, and hospitals to finance their operations and capital expenditures. Investors in these tax-exempt debt instruments are attracted to their strong credit and tax-advantage characteristics.

Historically, retail clients were the primary investor base for municipal bonds. However, the proliferation of mutual funds and exchange-traded products has increased the role of institutional buyers. Most underwriters believe this trend will instill more selection discipline and require larger offerings. In turn, this could stimulate the formation of larger, vertically integrated healthcare companies.

While complex in execution, there are conceptually only two broad ways that funded debt (whether municipal bonds, directly placed bank notes, or private placements with institutions) can be handled in a merger or acquisition. The transaction structure determines the approach.

Purchase of Stock

In a transaction structured as a purchase of stock (as opposed to assets, see below), the target's legal entity remains intact and the buyer "steps into the shoes" of the seller to become liable for its financial obligations, including its funded debt.[7] Liabilities of the new subsidiary either remain in place by being *assumed* or *guaranteed* by the new parent company (as part of the obligated group), or are *retired* via refinancing or defeasance.

This form of merger, in which both legal entities survive, usually occurs between two non-profit systems. These are referred to as "membership" or "sponsor" substitutions since there are no clear equity holders in community non-profits. Note, this is not the case with for-profit, religious-sponsored, or publicly owned hospitals that have clearly defined shareholders. Procter & Gamble's acquisition of Gillette represents a corporate analogy to these member substitutions. Procter & Gamble, as the new owner, became explicitly liable for the debt obligations of Gillette upon acquiring all of Gillette's shares. The same principal is true in the hospital industry.

Purchase of Assets

In a transaction where the acquirer purchases the assets of the target, the buyer is obtaining ownership of select assets and requires that the seller delivers the business "free and clear of encumbrances" at the closing. Asset sale transactions typically occur between non-profit hospital sellers and for-profit buyers and are referred to as "conversions" by regulators because their tax status is changing. This differs from the merger structure described above in that the acquiring company is the only legal entity to survive.

In these situations, the seller collects a purchase price from the buyer, retains cash and other financial assets, and utilizes the economic outcome of the transaction (the "gross proceeds") to *call, defease*, or *tender* for the bonds. The IRS requires the retirement of tax-exempt debt in a conversion because for-profit companies cannot hold tax-exempt debt:

- *Calling* bonds from investors (usually at par) is straightforward and follows a prescribed formula laid out in the bond indenture and described in the official statement.

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[6] University of Pennsylvania Wharton School, "Is the Latest Corporate Bankruptcy Strategy a Death Knell for Pensions?" October 2004.
[7] Rex Burgdorfer, "Membership Substitution Transactions," *The Bond Buyer*, February 2017.

- *Defeasing* the bonds is more complicated and is necessitated when the bonds are in the "no-call period," typically six to 10 years following issuance. Defeasance involves purchasing a laddered portfolio of U.S. Treasury securities that will generate a yield sufficient to pay the bonds' principal and interest payments until the no-call period has elapsed and the bonds can be retired. Defeasance has become more costly recently due to the low interest rate environment. This results in sellers having to purchase a larger number of securities to service the defeased bonds.
- *Tendering* for the bonds is rare and involves negotiating with institutional holders to accept a price less than par. In our experience, this is achievable only during major economic disruptions or in response to the threat of bankruptcy proceedings.

From these two examples, it is easy to see that selling the stock of a business has certain advantages to sellers related to simplifying the handling of funded debt in a transaction. A stock transaction is attractive for sellers as the cost to retire the debt might simply be unachievable. Conversely, buyers prefer to acquire assets as it limits future legal obligations. This is particularly true when the seller is in distressed financial condition.

Conclusion

Some basic arithmetic illustrates how the four issues described in this article have caused problems for independent hospitals determining whether they can afford to sell. Consider a $150 million revenue stand-alone 501(c)(3) hospital with $50 million in cash and equivalents. Due to changing industry demands inherent in healthcare reform, this hospital implemented a competitive process to find a partner. The hospital received competing proposals and, for sound fiduciary reasons, has decided to sell to a for-profit company. The for-profit partner is willing to pay the hospital $100 million in cash at closing for the equity of the business. Combined with its $50 million of retained financial assets, the hospital now has $150 million to work with to address these four liability issues:

1. The cost to defease the bonds is $80 million
2. Interest rate swaps require $10 million
3. Fully funding and freezing the pension with the Pension Benefit Guaranty Corporation will require $50 million
4. Tail insurance is $5 million

This totals $145 million. So $150 million of gross proceeds less $145 million in expenses (before any transaction costs) narrowly nets a $5 million foundation. Many sellers are now in this type of predicament where the strategic logic of a transaction is enormous, but the ability to sell and margin for error is extremely thin.

Boards of non-profit hospitals that wait to find a partner until they near the zone of insolvency are presented with a number of challenges.[8] First they should explore whether their principal creditors would grant any sort of extension or concession on financing arrangements. As shown here, modifications outside of court proceedings usually increase the number of strategic transaction alternatives.

The Governance Institute thanks Rex Burgdorfer, Vice President at Juniper Advisory, for contributing this article. He can be reached at rburgdorfer@juniperadvisory.com.

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[8] Michael Peregrine, "Zone of Insolvency," American Bankruptcy Institute, 2002.