Highly Leveraged Investments in Health Care:
Growing Concerns and Risks
Health care services and device companies have become a core target for private equity investors. In recent years there has been a binge in the private equity acquisition of health care companies valued between one billion and twenty billion dollars. Private equity funds are eager to seek investments that create value for their investors and are investing where they believe the opportunity for value creation exists. Generally health care companies have assets that can be used as debt collateral and investors see fragmented markets as opportunities for consolidation, operational improvement and cost-cutting.

The health care sector may represent an attractive investment opportunity. It does include significant core risks; these risks include reimbursement fluctuations and increasing pressure on reimbursements, regulatory changes, low admissions growth and a substantial under and uninsured population.

Private equity investors use substantial debt to leverage their equity investment and buy or invest in such companies.

The nursing home industry has played host to a number of highly leveraged investment deals. By 2007, private equity companies had purchased six of the largest chains which represented about 9 percent of the nation’s nursing home beds. Examples of major nursing home transactions include the Carlyle Group’s (“Carlyle”) acquisition of Manor Care Inc., a nursing home operator in December 2007 for $6.3 billion. The transaction was financed through a combination of commercial mortgage-backed securities (“CMBS”), other debt financing and equity provided by Carlyle; the CMBS were backed by 330 nursing and assisted living facilities. Also in 2007, Affiliates of Formation Capital LLC and JER Partners acquired Genesis HealthCare Corporation a nursing home operator. The Genesis deal closed in July and was valued at approximately $1.7 dollars of which $450 million was funded with debt. And in March, 2006, Beverly Enterprises, Inc. announced the completion of the company’s merger with Pearl Senior Care, an affiliate of private equity fund Fillmore Capital Partners.

These acquisitions are attractive because of the asset base of the nursing home target and because of the potential for increased growth or profit. Nursing home companies traditionally owned the real estate underlying the operations; This real estate can be used for example, as collateral to finance a leveraged transaction and can be sold to pay down acquisition debt. The core risks include increased staffing costs, inability to sell the real estate, stagnant admissions, and increased Medicaid pressure on reimbursements. Despite the risks, Ronald E. Silva, president and chief executive of Fillmore Capital Partners is confident that acquiring nursing home chains is a sound investment strategy. Silva was quoted in the New York Times in September 2007, “There’s essentially unlimited consumer demand as the baby boomers age… I’ve never seen a surer bet.”

The benefits of leveraged transactions in health care, if done right, can provide tremendous returns on investment for equity holders. In essence, with small overall increases in enterprise value a fund can double and triple the investor’s returns on investment equity. The challenge to leveraged investing is that if revenues decrease rather than increase, an already constricted cash flow can be overwhelmed by the required debt and interest payments.

I. MECHANICS OF A LEVERAGED HEALTH CARE DEAL

The leverage issue can be exemplified by a typical transaction structure as follows. An equity fund acquires a health care company with approximately seven million dollars in free cash flow. To finance the transaction, they utilize approximately four times the cash flow in debt, in addition to a sponsored amount of equity. Thus, the company borrows approximately twenty eight million dollars. This means that the company is likely to spend approximately two and a half to three million dollars or more a year on interest payments in addition to repayment of the debt principal. These obligations will be paid using the free cash flow. Hence on day one, the company’s free cash flow of seven million dollars that was previously available for expansion is substantially diverted to debt service.

A. What Leverage Ratio is Appropriate?

The leverage ratio must be appropriate for the business; a suitable debt structure for one business could be ruinous for another. I.e. too much debt on a low growth company can be detrimental. Generally, where revenues are constant or improving and the interest and principle payments still leave a healthy cushion of cash flow, then the company is less likely to be overly squeezed by the leverage. However, if reimbursements or admissions decrease, interest rates are too high, or principle payments are too overwhelming, the company may be at risk.
B. How Much Cash is Enough?

Cash flow is important for the company to make investments and grow the business. Additionally, if there is insufficient cash flow, any unanticipated expenses can create loan covenant defaults, and the cushion of expected cash flow to debt payments may not be sufficient to protect the company. Also, with the loss of a small amount of key contracts or small negative changes in reimbursements, the company could be much more likely to reach a point where its cash flow is reduced to a level equal to its interest and principle payments.

II. CHALLENGES: REIMBURSEMENT, HIGH MULTIPLES AND INTEREST RATE INCREASES

A. Reimbursement Challenges

Health care provider chains, such as hospitals, surgery centers, infusion therapy providers, home health agencies, imaging facilities, and others, are increasingly facing decreased revenue due to flat or decreasing reimbursements. Further health care companies are finding that some of their strategic or most profitable profit lines are becoming less profitable. This means that it is not easy to create growth by which to accumulate and add to cash flow.

Rotech Healthcare Inc. (“Rotech”) a provider of home medical equipment and related products and services recently cited their highly leveraged capital structure, Medicare reimbursement reductions and the current capital market conditions as reasons for their financial challenges. Rotech recorded a net loss for the three months ended March 31, 2008 of $13.9 million and is also at risk of being delisted from the Nasdaq Capital Market.

Rotech anticipates that they will continue to face financial and reimbursement challenges in the near and long-term future. The company specifically cites the recent and potential changes in Medicare policies, including freezes and reductions in reimbursement rates for home medical equipment and dispensing fee reductions, competitive bidding requirements, new clinical conditions for reimbursements, accreditation requirements and quality standards.

Rotech derives over two thirds of their patient revenues from federally funded programs including Medicare and Medicaid. The risk for Rotech is that they have experienced a sharp down-turn in operating cash flow, in part because of adverse regulatory changes, and this down-turn could jeopardize their ability to service their debt obligations. In part due to the stress caused by their leverage, Rotech is currently exploring strategic transactions, alternative business and capital structures and potentially bankruptcy protection.

B. High Multiples

Acquisition transactions, taken on at higher multiples to add to a company, often add significant amounts of debt to a balance sheet. As a particular market becomes attractive, higher multiples paid add significant uncertainty as to at what point the transactions become accretive. With acquisitions being priced at 6 to 8 times EBIDTA, and the same fundamental challenges facing the acquisition targets as are facing the existing business, there is an increased chance that transactions will have a negative impact on cash flow rather than a positive impact.

C. Market Slowdown: Interest Rates Increase

Private equity investment activity is slowing in large part because banks have reduced the flow of lower cost credit. Without inexpensive debt, investment opportunities become less appealing because the high interest payments will create a greater continuing burden to the company.

Scott-Macon, Ltd., an investment banking firm, noted that in the first quarter of 2008, M&A activity as measured by total deals and total deal value fell dramatically as compared to the first quarter of 2007. The value of all United States M&A deals dropped 41% from the first quarter of 2007 to $204 billion in the first quarter of 2008. Mason cites as one major reason for the drop-off in activity, the decrease in the number of private equity-led deals due to market conditions related to the credit markets.

For already leveraged deals, the impact of tightening credit markets and higher interest rates can be draconian. The tighter markets can make it impossible or difficult to raise new funds for expansion capital and difficult to refinance existing debt. It can also mean much higher carry costs than planned for when leveraged loans come due and the private equity firm needs to refinance.