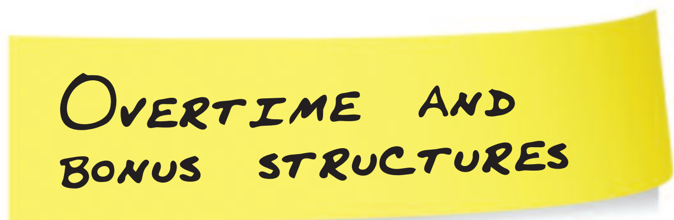

Restructuring the Balance Sheet
By
Jonathan A. Burklund
streamline operations and strengthen the balance sheet to prepare for difficult times



If you are anything like me, you have had a few sleepless nights worrying about the future of the health-services industry. Historically, the industry has been a safe haven for investment due to the fact that it is not directly dependent on economic cycles. That, however, has changed in recent years (Figure 1).

It shows that the health care sector is suffering from weak capital markets and reimbursement pressures. The relatively few bankruptcies from 1998 to 2000 were most probably a result of the reimbursement pressures caused by the Balanced Budget Act of 1997. The recent set, from 2007 through the second quarter of 2009, is a result of a more complex set of factors, including lower reimbursement mandated by the DRA and bloated balance sheets due to the credit bubble, followed by an arid wasteland of a financing market that limited refinancing options. In addition, providers are saying that volumes are down due to economic pressures. Higher copayments and deductibles are causing patients to think twice before seeing a physician.

Most analysts believe that the other shoe will drop in reimbursement, as the majority of the funding for universal health care (if enacted) will come from some forms of reimbursement cuts that require providers to treat/diagnose more patients at a lower revenue point per encounter. Thus, providers will need to streamline their operations and strengthen their balance sheets to prepare for an impending difficult operating environment. In the event the first two actions do not sufficiently improve their financial positions, companies also might need to restructure their debts.

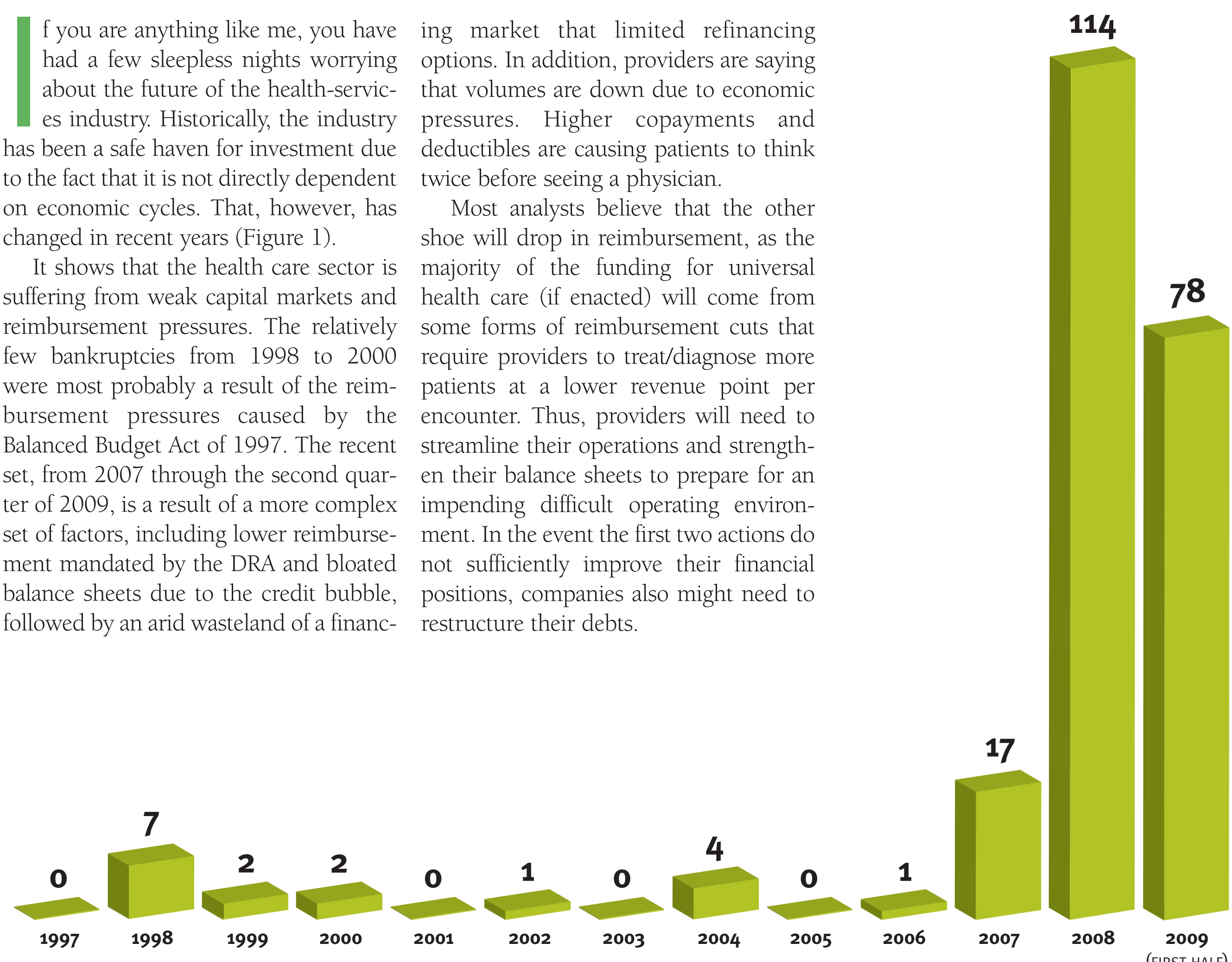


Figure 1. Bankruptcies in the health care sector from 1997 through the second quarter of 2009; data compiled by River Corporate Advisors.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Getting Lean

Most health care providers (and all diagnostic imaging facilities) operate with high levels of fixed costs, and this makes them highly susceptible to reimbursement cuts. There are, however, several areas to examine in streamlining operating costs, including staffing levels, overtime policies, bonus structures, and vendor contracts.

Staffing levels: In a portfolio of centers, there are some that operate more efficiently than others. A helpful ratio for determining their relative efficiency is the number of patient encounters divided by the number of FTEs. There will be two sets of outliers: those with ratios higher than the average, indicating greater efficiency, and those with ratios lower than the average, indicating lower efficiency. Using these data, an operator can review the structure of the more efficient centers to determine how to incorporate their staffing and workflow procedures into the whole portfolio. Conversely, one must attempt to reduce staffing levels at the less-efficient centers.

Overtime and bonus structures: In some markets, an MRI technologist could make as much as $75 per hour. At an overtime rate of 1.5, that is $112.50 per hour. If he or she stays two hours late to perform one scan, the center has lost money on that scan. While most overtime cannot be avoided, a manager must look at patient scheduling to ensure that the number of appointments during overtime hours, as well as overall scan volumes, justifies the incremental cost.

Bonus plans are important and tricky. An operator must develop a plan that is properly aligned with the company's financial objectives and not subject to gamesmanship. I encountered a situation in which a company requiring immediate cash flow instituted a bonus plan based solely on scan volume. The business-development representatives proceeded to market services to attorneys for personal-injury scans. As we all know, these personal-injury cases do not pay on a timely basis. Accounts-receivable time can exceed 360 days in this area. Obviously, this bonus plan was not aligned with the company's objectives. The company adjusted the plan to pay bonuses at the time of payment (not service), and the number of personal-injury scans decreased precipitously.

Vendor contracts: Many vendors are not directly on the reimbursement firing line. Don't be shy about having them share the pain. First, review all vendor relationships to determine whether there is a real benefit from the services involved. We once encountered a contract for firewall monitoring for several thousand dollars per month, in what was clearly a hangover from the Internet bubble. We determined that this was a service that could be provided with a few antivirus-software licenses for a one-time payment of $2,000.

Second, institute competitive bidding to minimize the cost of services. We have found that many vendors will be quite flexible in order to retain business in this environment. If the company's operations are too small to gain negotiating leverage with vendors, join a group purchasing organization (GPO). Such memberships typically have an immediate return on investment.

Raising the Roof

In this horrendously tight credit market, cash is king. As a result, it is critical to take steps to preserve (and even raise) cash, including improving working-capital management, divesting the organization of nonstrategic assets, and improving the capital base.

Working-capital management: There are three primary areas to examine here; they are revenue-cycle management, medical supplies, and accounts payable. The revenue cycle is the process of scheduling a patient, filing a report, and turning that report into cash. The key factors in improving cash flow are reducing the number of days required to collect accounts receivable, collecting copayments and deductibles, and minimizing bad debt.

I have come across many situations, for example, in which a company's information systems were not providing the front-desk staff with the information needed to collect copayments and deductibles. Several hungry companies specializing in revenue-cycle management have excellent

systems that can achieve all three management objectives. Some of them are even willing to work on a fee-for-performance basis.

The key medical supplies to be reviewed are film and contrast agents. A supplier should try to minimize the inventory levels of these items; a GPO can assist its members in this pursuit. A provider should also attempt to get good payment terms from its vendors in order to use accounts payable as a cheap source of financing. Again, share the pain. If Medicare is pushing you, you might need to push your vendors.

Nonstrategic assets: In better credit markets, many operators took advantage of liquidity to diversify their operations. This diversification might have taken the form of acquiring centers in noncore markets, purchasing real estate underlying certain centers, and moving into new business areas such as operating ambulatory-surgery centers. If carried out properly, this strategy can work very well. In difficult times, however, new business activities beyond the organization's core competencies could be distracting, and might significantly dilute management's focus on the main operation. If this is the case, it might be appropriate to sell these nonstrategic assets and use the proceeds to amortize existing debt.

Today's markets are not the best in which to sell assets, so managers must check their egos at the door before engaging in the sale process (and should understand that these assets might be sold at a loss). The critical issue is that these sales do not dilute the company's credit ratios.

Capital base: There are several ways to improve a company's capital base, including raising equity and conducting debt exchanges. Yes, this is a horrible market in which to raise equity, but equity is available at a price, mainly from the contrarian (read: vulture) private investors. Once again, managers need to check their egos at the door and take their lumps, particularly if they are concerned about meeting debt obligations. Owning 10% of a solvent, properly capitalized company is much better than owning 80% of an insolvent one.

Debt exchanges are an interesting way to postpone debt maturity. The fundamental idea is to exchange a note with a short maturity for one with a longer maturity in return for more fees, higher interest, or both. If a company needs time to implement a restructuring plan, this is an effective way to get it. In January 2009, Tenet Healthcare Corp completed exchange offers for two tranches of debentures. In the first tranche, the company exchanged notes with a par value of $1 billion, a coupon of 6.4%, and maturity date of 2011 for notes with a coupon of 9% and a due date of 2015. In the second, it exchanged notes with a par value of $600 million, a coupon of 6.5%, and maturity date of 2012 for those with a 10% coupon and due date of 2018.

Hope Is Not a Strategy

Despite efforts to streamline its operations and improve its balance sheet, a

company might still be facing liquidity issues, particularly if there is a significant principal payment looming on the near horizon. The first and most important step is to acknowledge the situation as soon as possible.

Too many times, I have seen CEOs think that they could save the company with a Hail Mary pass. The second important step is to recognize that the company is insolvent. Therefore, the board's obligation shifts from the equity investors to the debt holders. As a result, it is critical to enter frank, transparent conversations with the debt holders. Figure 2 shows the range of options, from least to most invasive, available to a company in this situation.

Forbearance/waiver: If the problem is a short-term one, such as a hurricane temporarily shutting down a center that has since reopened, a company can request a temporary waiver of its covenants. Of course, the waiver comes at a cost (typically, fees and higher interest). The waiver usually expires when the company is back in compliance.

Out-of-court workout: This process, which is the type of debt restructuring most often used, requires the company to provide the banks with a business plan that convincingly argues that the company has good long-term prospects, but needs to align its balance sheet with current realities. The workout takes many forms and is a complex negotiation, but it includes delaying maturities and converting senior debt into a longer-term, more dilutive instrument, such as subordinated debt or equity.

Prepackaged bankruptcy: Sometimes, during the workout process, there might be smaller creditors that resist the new plan. A prepackaged bankruptcy enables the company to drag those holdouts into the restructuring plan. The bankruptcy has the added advantage of allowing the company to put back any leases, whether of equipment or real estate, that it no longer requires as part of the new operating plan.

Chapter 11 protection: This is the most time-consuming and costly option. In addition, the court will become the company's primary decision maker. It is used if the company cannot reach an out-of-court settlement with the banks and fears that its operations might be shut down by the creditors. This protection affords the company some time to pursue its options, including operational restructuring or a section 363 sale of all or part of the business under the supervision of the court. It also gives the company potential access to debtor-in-possession financing, which is senior to all other debt obligations and can be used to provide immediate liquidity to the operation.

Chapter 7 liquidation: This is the final option, which is an orderly liquidation of the company through sales of either the operation or assets, with sales controlled by the court.

Before determining the best option, a manager must ask two questions. First, how severe is the liquidity problem, and is it long term or short term? Second, what are the long-term prospects of the business? Once you have answers to these questions, the restructuring method becomes obvious.

May you live in interesting times is reputedly an old Chinese curse. Given the combination of weak capital markets, reimbursement cuts, and health care reform, we are in the middle of the perfect storm. These are not just interesting times; they are fascinating. RBJ

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LEAST INVASIVE → **MOST INVASIVE**

Forbearance/waiver →	Out-of-court workout →	Prepackaged bankruptcy →	Chapter 11 protection →	Chapter 7 liquidation
Is temporary: ■ gives covenant relief ■ reduces/eliminates interest payments once **Is an important tool:** ■ deals with temporary decline in operations (seasonality) ■ buys time for long-term fix	**Devises a long-term operating plan** **Restructures terms of debt:** ■ lower principal and interest payments ■ debt-to-equity conversion **Provides long-term fix for the problem** **Must be accepted by all creditors**	**Is often used in workouts** **Has tactical advantages:** ■ confers tag-along rights ■ puts back leases	**Is avoided through workout whenever possible by nearly all companies** **Is useful in negotiations with bond holders** **Is not the first choice:** ■ is expensive ■ is managed by judges **Uses debtor-in-possession financing** **Uses section 363 sales**	**Is an orderly sale of operation or assets**

Figure 2. Debt-restructuring alternatives.