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Renaissance

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Turnaround and Restructuring in the Hospital Industry

By *Michael S. Miller* and *Daniel Smigelski*, Centre Health Partners (CHP)

When it comes to turnarounds and restructuring, the hospital industry is unique. There, I said it. It is the same thing that everyone says or at least thinks about their industry. And, like everyone else, I know I am right.

Unlike most businesses, hospitals can be owned and managed by people who, in fact, cannot generate a single product or service or produce a dollar's worth of revenue on their own. That's right. I worked as a hospital CEO for over twenty years, and I never generated a single dollar in revenue. I employed highly educated and trained personnel (nurses, respiratory therapists, etc.) that participated in life and death decisions and, on their own, could not generate one dollar's worth of revenue. All services must start and stop by an order of a physician (whether the physician is on-site giving the order, giving it by phone or by documented protocols). Therefore, physicians control the revenue stream.

Hospital ownership models are also unique. Generally, physicians do not own or manage hospitals. Most industries have an individual or corporate entity that has direct ownership and exposure to personal loss if the business fails. Most hospitals are not owned by a single individual so I will not even discuss that model of ownership. The basic hospital ownership models are:

For-Profit Ownership (Tax Paying)

Most for-profit ownership is some form of corporate structure and can be either public or private. Some of the publicly traded corporate owners are HCA, Triad, HMA, and Community Health Systems, among others. These corporations employ highly educated and trained professional managers to operate the hospitals. Each also has a highly developed operational market strategy. For example, Community Health Systems owns and operates hospitals in rural markets where it can be the sole hospital provider to the community. HCA on the other hand operates larger hospitals in highly competitive urban markets. The primary fact to remember is that an organization or a group of individuals have an ownership stake and the prospect for a financial profit or loss.

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"DebtQuity" A Perspective on the Current Blur Between Debt and Equity

By *Michael Cavan* and *Ken Yager,* Morris Anderson & Associates, Ltd.

"DebtQuity"… this term might either become folklore or part of a new lexicon of deal language for small to middle-market private companies. Right now it is a wake up call to the credit world and equity investors alike.

Never in recent decades has so much money been available to structure the transfer of value from one owner to another — or to cover operational shortcomings. The amount of capital currently available is staggering and has resulted in an era of hyper-liquidity.

This situation has placed a new kind of pressure on both lenders and equity sponsors to place funds and enter deals that may have been avoided in the past (or had more restrictive covenants). This glut of capital is being poured into every crevice by lending institutions and equity sponsors, resulting in a blur between assuming the risk of debt vs. the risk of equity.

As investors will note, rational investment decisions are based on what each investor sees in the market, as well as the immense pressure to deploy portfolio funds. Lenders face a similar situation and have taken some comfort from the cushion frequently provided by equity-sponsored capital infusions. What has resulted is that the current market has many over-leveraged deals that mask underlying operational issues. We now stand at a place not seen before where debt and sub-debt have eerily taken on the risk of equity; hence, the emergence of "DebtQuity."

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A Short History of the Middle-Market Private Company Debt and Equity World

Traditionally, small-to-medium size private companies grew up with bank debt and shareholder equity often funded by the original owner and those involved in the business. Fast forward to today. It seems that the recent explosion of hedge funds and the resulting hyper-liquidity in capital markets has caused a blur between debt and equity along the lines noted above.

The over-abundance of funds in the market has put pressure on lenders that would have followed more traditional financing terms and related due diligence to place debt in situations where they would have had tougher covenants and higher pricing on debt. Funds are being layered on by equity sponsors who, in smaller transactions, often have no involvement/interest in the business other than financial. On larger transactions, the investment group traditionally demands a seat on the board and/or management intervention, but is still adding capital to under-performing debtors. Over-leverage, combined with ignoring the root cause of why the business is under performing, has resulted in a potential house of cards when working capital tightens due to real operational issues or, on the capital structure side, when economic conditions tighten, i.e., a rise in interest rates. As these falsely supported companies begin to unravel, the decline may end up being so great that, in conjunction with the new bankruptcy laws, the implosion will result in liquidations where the debt will have a similar risk to what, in the past, was reserved for equity players.

Professionals that deal in lending or equity are aware that the nature of deal-flow and deal-terms has changed dramatically. Thirty years ago, standard equity deals were done by venture capitalists. Leveraged buy-outs ensued as the next big trend. That led to trouble as highly-leveraged deals were structured with almost no equity content.

This problem corrected itself with a multitude of painful restructuring. Leveraged buy-outs were cleaned up through private equity investors. That was fine, but the equity still needed more debt than before to get the deals done. A seemingly novel form of debt was invented, as banks were not able to provide enough sufficient debt to satisfy the deal formulas (or debtors' couldn't shoulder the traditional financing interest loads). The junior unsecured debenture market evolved. Some of it was mezzanine and some of it was high yield debt. To be sure, high yield debt had been around for a little while by the time the term private equity had come into existence but its role in the market was evolving.

It was under the growth of private equity that high yield came into its own. That did not go over so well either. It appears that, whether you were in the middle market or the large cap market, junior unsecured debt was often falling prey to performance issues and the debt did not fare well. It was as if the debt, during its natural life, was akin to equity risk vs. debt amortization risk due to the instability of cash flow.

Similar to golf where it only takes one good shot to keep the adrenaline running, despite significant losses in various leverage buyouts and a significant amount of expensive deal restructuring, the private equity market has re-emerged larger than ever in recent years. Clearly, this larger market needs more debt so, like a magician and his hat, the private equity market discovers another set of tools and tricks for its needs — welcome second lien debt and the uni-traunche. While each presents itself to the market differently, ultimately in a down market, each will act upon the deal recovery dynamics about the same. This article was not written to explain these products but, suffice it to say, to point out that they are the same debt structures wearing new clothes.

What is clear is that capital has reinvented itself. Nevertheless, while legal documents change and stake out individual claims to priority, the principals of sound business have not changed and those principals still apply to cash flow generated by operations. Deals are only successful based upon the underlying cash flow generated by solid business operations; hence the "EBITDA" calculations and covenants included in leveraged deals. EBITDA goes up and down and owes no allegiance to the deal-makers and business buyers, rather only to the underlying operations.

In the history of deal-making, a yardstick exists for measuring good debt. If your deal debt is below this line (measured as a multiple of EBITDA), and appropriate due diligence has been performed on all aspects of the company, you are likely to have a solid deal. Above that line, it is likely that restructuring pressure will build. Restructuring means that someone has to assume repayment risk that, without operational improvements, may become very costly. There is a zone within these deals that fits the term "DebtQuity." The definition of this zone is that point where debt becomes under-compensated for its risk — a zone that arguably, on an overall basis, has been entered into in the current market of private middle-market companies.

The DebtQuity Zone

DebtQuity might just be viewed as yet another brief cliché. But, given what most professionals, whether practitioners, lenders or equity sponsors are discussing at the water-coolers these days (i.e., the hyper-liquidity due to the massive amounts of debt and equity funds available to debtors), it appears that DebtQuity is real and shouldn't be easily dismissed.

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