How COVID-19 Magnified the Fragility of the U.S. Healthcare Sector

BY AARON NEWMAN, VICE PRESIDENT, & MICHAEL FIXLER, MANAGING DIRECTOR, FOCALPOINT PARTNERS LLC

COVID-19 and its resulting economic impact have taken a destructive toll on society. At its core, the pandemic has been a health crisis, so, not surprisingly, healthcare has been one of the sectors of the economy that has been most severely impacted. Societal measures to "flatten the curve," such as social distancing and sheltering in place, were implemented to reduce the influx of COVID-19 patients that many feared could overrun the United States' healthcare providers, with a secondary intended expectation of lessening the virus' spread to save as many lives as possible.

As a result of potential shortages of hospital beds, personal protective equipment, and requisite practitioners to properly care for COVID-19 patients, a drastic decree halted elective surgical procedures with a goal of preserving capacity in the healthcare system to fight the virus. As a result, healthcare providers have shifted their status quo operations, leading to many disruptions.

Before the crisis, healthcare systems were already operating on thin margins and with minimal liquidity. The halting of higher margin elective surgical procedures has therefore created a vast financial void that abruptly lifted the veil to reveal the fragile state of the healthcare system. While healthcare providers are courageously managing near-term operating challenges, the draconian measures put in place to stave off the spread of the virus are leading to financial distress that will profoundly reshape the delivery of healthcare services.

Healthcare providers have been forced to take sweeping actions to shore up their financial profiles. Measures such as furloughing staff, cutting physicians' compensation, applying for governmental relief programs, and even preparing for bankruptcy have been widespread. A handful of sizable healthcare providers, such as for-profit, publicly traded hospital operator Quorum and private equity-backed, multispecialty physician group Envision, have already filed for bankruptcy protection. Moreover, credit rating agencies S&P, Moody's, and Fitch have put more than 30 not-for-profit hospital systems on credit rating outlook downgrades, indicating a reduction in their ability to service existing debt obligations.

Why was the U.S. healthcare system—an essential service—so fragile? This article explores three distinct provider cohorts—rural hospitals; independent health systems; and large, integrated health delivery systems—that will likely be reshaped by an acceleration of dynamics that preceded COVID-19. More significantly, this article discusses how to restructure healthcare delivery to promote a more sustainable system that will lead to margin enhancements, more efficient allocation of capital, and advancements in care for patients and communities.

Rural Hospitals

Before the outbreak of COVID-19, rural hospitals in the United States faced immense pressure due to myriad factors that had destabilized their financial positions. Barring broad-based government intervention, COVID-19 will likely intensify these pressures, leaving rural hospitals to face challenging decisions about their futures.

A recent study conducted by The Chartis Center for Rural Health showed that one of four rural hospitals is at risk of closing due to a heavy reliance on outpatient services for their revenue bases—which have been disproportionally impacted by COVID-19—ultimately eroding what were already fragile liquidity positions. The communities served by rural hospitals are predominantly less affluent, less healthy, and older than their urban counterparts. Consequently, the destabilizing impact of COVID-19 on rural hospitals could

leave these patient populations at a disproportionally increased risk for lack of necessary clinical services, causing an already vulnerable population to become even more so.

Independent Hospitals and Health Systems

In recent years, independent hospitals and health systems have also experienced a wide array of disruptive challenges. From a financial perspective, operating profiles have been stable to negative, driven by expense growth outpacing revenues. Additionally, these organizations have witnessed a shift in the setting for care from inpatient to outpatient, driven by a change in patient preferences and a push from payors to move episodes of care into lower cost outpatient settings.

Market dynamics have also shifted as independent hospitals and health systems have seen increased competition from vertically integrated market entrants (e.g., CVS and Aetna, UnitedHealth-Optum, etc.) driving consumer-centric strategies, private equity-backed physician groups impacting physician compensation models, and super-regional and national health systems expanding through robust M&A activity.

Given these headwinds, independent hospitals and health systems were faced with difficult strategic decisions even before the outbreak of COVID-19. With scant operating margins and an array of capital-intensive initiatives (e.g., ambulatory service centers, telehealth, electronic medical records, etc.), many of these organizations have minimal balance sheet capacity to adequately endure the economic pressures brought on by COVID-19.

Providers have been dealing with these challenges in the near term by furloughing nonessential staff, reducing compensation, and delaying capital projects to bolster balance sheet strength. These measures, while tactically necessary, are strategically unsustainable.

Large, Integrated Healthcare Delivery Systems

Over the past decade there have been several provider entities that have bulked up their size and scale to address the increased competition from nontraditional market entrants, as well as to gain efficiencies from shared services offerings. As these providers emerged, they often found themselves in increasingly resilient positions with consequently less exposure to the broader challenges experienced by smaller enterprises. The strategic advantage of large, integrated healthcare delivery systems can be attributed to two driving forces—superior access to human and financial capital.

However, the outbreak of COVID-19 has impacted even providers with the strongest human and financial capital profiles, a bleak reminder of the virus' destructive and indiscriminate impact. While large, integrated healthcare systems are in a relatively less compromised position compared to rural and independent hospitals, leadership teams must carefully evaluate the strategic impact of COVID-19 to maintain, or possibly even strengthen, their competitive positions.

A More Sustainable Delivery Model

While hospitals and health systems are experiencing near-term challenges, COVID-19 has the potential to accelerate a restructuring of the broader healthcare delivery model into one that is much more sustainable.

Implementation of Telehealth.

the outbreak of COVID-19, the adoption of new digital health technologies had begun to impact the day-to-day operations of independent hospitals and health systems. However, the sudden and drastic impact of the pandemic vastly accelerated patients' willingness to employ technologies to manage their health. As a result, hospitals need to adequately adapt to changes in consumer demand for healthcare services and explore investments in telehealth and other patient-driven initiatives to sustain their competitive positions.

However, with strained capital positions and competing organizational priorities, these initiatives may prove challenging to sufficiently analyze and implement, potentially leading to volume declines and further financial stress.

Change in Care Setting Dynamics.

Historically, inpatient care drove the economic model for underwriting healthcare infrastructure. However, over the past decade there has been

a shift to the outpatient setting, as societal trends for convenience and consumer-centric strategies have pushed patients to demand different care models. This paradigm shift has led to the fundamental economic conundrum that is at the heart of today's challenging hospital and health system sector dynamics.

As it stands, massive hospital campuses and bricks-and-mortar infrastructure dominate the provider landscape. This infrastructure was funded primarily through bond financings by not-for-profit healthcare systems utilizing tax-exempt capital markets and were based on a fee-for-service model that relied on year-over-year growth in the demand for inpatient clinical services. As a result, hospital systems have ongoing fixed costs comprised of debt service and depreciation, leading to high fixed overhead and inelastic demand dynamics.

However, as demand has shifted from the inpatient to the outpatient setting of care, buoyed by investment in consumer-centric ambulatory models from private equity-backed physician platforms, many hospital systems are left with empty inpatient beds that prolong widening losses. Consequently, the system's current configuration inefficiently utilizes capital resources—funds that could otherwise be directed at rebuilding the system to meet current and future patient needs and clinical service demand.

Innovative Capital Sources and Care Delivery Models. Historically, hospitals and health systems have been reticent to embrace creative investment opportunities, instead favoring financing capital investment through tax-exempt debt capital markets and relying on their relatively large unrestricted cash reserve positions. However, over the past several years innovative models have somewhat evolved, as investors and providers alike have begun to recognize the need for "asset-light," physician-driven, and consumer-centric care delivery models and related infrastructure.

One example of an innovative care delivery model is Warburg Pincus' investment in City MD-Summit Medical Group. In August 2019, the global private equity firm acquired Summit Medical Group and combined the multispecialty physician practice with CityMD, an urgent care provider. The consolidated organization has more than 1,400 providers, 6,400 employees, and 200 locations in the greater New York-New Jersey area.

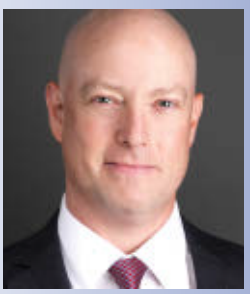
The private equity firm aimed to expand the continuum of care by adding both primary care and specialty physicians from the Summit Medical Group platform and leveraging its previous investment in CityMD to achieve greater size and scale in the hypercompetitive New York Metro healthcare market. The organizational strategy focuses on outpatient care whereby the platform treats patients in the lowest cost of care settings, such as ambulatory surgery centers and urgent care facilities.

The goal is to compete with traditional hospitals and health systems that often focus on lower margin procedures but have higher fixed cost structures, thereby making it difficult for them to produce stable margins. In contrast, the Summit/CityMD platform has flexible capital resources from a global private equity firm.

Closing Thoughts

As more hospitals and health systems take advantage of the benefits of technology, optimized clinical settings of care, and nontraditional capital sources, the delivery of healthcare may transform into a more sustainable construct that benefits patients, providers, and communities alike. Regardless of the extent and degree of COVID-19's impact and its role in the acceleration of the challenges affecting the hospitals and health system sector, all provider organizations should consider embracing the innovative core tenets of the healthcare delivery of the future to ensure organizational sustainability and success. J

Aaron Newman is a vice president in the Healthcare Investment Banking practice of FocalPoint Partners LLC. He has more than a decade of experience in healthcare investment banking, debt capital markets, and strategic advisory. Recently, he served as sellside M&A advisor to Arizona Urology Specialists in its private equity partnership transaction with United Urology and Audax Group Private Equity. Newman specializes in the healthcare provider services sector, advising hospitals, health systems, physician practices, and other provider entities on mergers, acquisitions, and strategic advisory assignments.



Michael Fixler is a managing director in the Special Situations Investment Banking group of FocalPoint Partners LLC. He has spent his more than 20-year career advising companies and their stakeholders in a variety of transactions related to mergers and acquisitions, capital raising, and special situations, including bankruptcy cases, advising clients from both public and private companies, institutional investors, statutory committees, and special situation buyers/investors. Fixler's experience includes crafting and executing a variety of strategic transactions to maximize value for his clients.

September 2020
Journal of Corporate Renewal

This article originally appeared in the September 2020 issue of the Journal of Corporate Renewal, published by the Turnaround Management Association