



A PLAYBOOK FOR THE DISTRESSED HEALTHCARE LANDSCAPE

**Strategic options for
businesses with leveraged
balance sheets**

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An oft-cited adage is bull markets ride an escalator while bear markets take the elevator. This maxim proved prescient based on the operational and financial challenges occurring across the healthcare landscape – particularly provider-based businesses – over the last two months. The advent of the COVID-19 pandemic swiftly sent performance through the proverbial elevator shaft and, in its wake, acutely destroyed value across otherwise fundamentally-sound businesses.

The last decade was characterized by healthcare provider consolidation, as private equity investors pursued aggressive buy-and-build strategies financed with accommodative debt financing. Indeed, over half of the 1,500+ healthcare transactions closed annually since 2010 were provider deals. Today, for example, there are 100+ physician practice management platforms across numerous sub-specialties, around 100 dental service organizations, 25+ physical therapy platforms, and an ever-growing number of multi-site investments in areas such as animal health, behavioral health, and urgent care.

"Bull markets ride an escalator, bear markets take the elevator."



Long considered recession-resistant, many provider businesses are now among the economy's most impacted by the nationwide shutdown. Relying heavily on close human contact, these companies are, at best, managing through a reality in which patients avoid all non-emergent care and utilize telemedicine whenever practical. At worst, businesses have temporarily shuttered operations. Depending on the sub-segment, provider businesses have experienced revenue declines of 30% to 60% on the low-end and upwards of 95%+ on the high-end.

Liquidity is King

This level of reduced economic activity – however temporary – will stress any business, but proves particularly painful for those with leveraged balance sheets. Rapid revenue declines have necessitated severe cost-cutting measures and the pursuit of much needed liquidity via (i) lines of credit, (ii) loans from the Paycheck Protection Program or CMS' Accelerated Payment Program, and/or (iii) grants from HHS's Office of the Assistant Secretary for Preparedness and Response. On the whole, liquidity has been secured through short-term measures as opposed to newly contributed capital; however, as discussed below, junior debt or equity likely will need to be part of the strategic solution.

Based on healthcare revenue cycle trends, cash flow was less strained during the first 60 days of the shutdown. During this time, businesses collected cash for services rendered prior to mid-March while quick-to-act operators were also aggressively cutting costs. The real test will begin in late May as operations restart, requiring meaningful working capital investment at a time of limited cash collections due to reduced services rendered after mid-March.

By mid-July, after having managed through the restart, nearly all leveraged provider businesses will trip covenants for the Q2 2020 reporting period. This will necessitate difficult negotiations between (i) equity sponsors, who will resist contributing additional capital to support investments, and (ii) lenders, who will extract improved economics and, likely, require junior debt or equity to bridge new gaps in the capital stack.



Preparing for Lender Negotiations

Over the last few weeks, Livingstone has held extensive conversations with debt providers, revealing several consistent themes. Summarized below are multiple considerations that businesses and private equity investors should heed as they prepare for and, ultimately, approach lender negotiations.

- ✓ Prepare to share daily / weekly operating metrics, as well as 13-week cash flow forecasts, with lenders during the near term
- ✓ Understand the operational and financial impact of social distancing requirements on the business, as the prevailing assumption is that most provider businesses will not return to pre-COVID levels during the short-to-intermediate term (which will impact pro forma leverage levels)
- ✓ Lenders will view amendments and debt restructurings relative to current market leverage and pricing for new, healthy debt issuances. New deals are being underwritten to (i) 0.5x to 1.0x of lower leverage relative to EBITDA and (ii) 150 to 300 basis points higher interest rates relative to pre-COVID levels so debt restructurings will undoubtedly receive less favorable terms
- ✓ Lenders will not unilaterally solve liquidity issues and over-levered situations; assuming or proposing such in a negotiation is ill-advised and will force lenders to pick “winners and losers”
 - If lenders elect to provide liquidity and prop up the business, the lender will likely look to extract meaningful value through fees, rates, and warrants, among other terms
 - If the lender elects not to provide liquidity this action immediately puts the company “in play,” thereby creating a catalyst for a sub-optimal outcome for equity holders (e.g., a forced bankruptcy filing, lenders exercise stock pledge, debt sale, liquidation, etc.)

Potential Strategic Options

Combining (i) lenders' expectations for lower leverage with (ii) a high likelihood that the business will have reduced EBITDA suggests that, in most instances, a "like-for-like" debt refinancing will not be viable, and incremental capital will be required. To that end, depending on pro forma leverage levels, potential options include:

✓ ***Low leverage deals.***

For businesses that were modestly levered pre-COVID, the solutions could include (i) contributing new capital while negotiating an amendment with the incumbent lender or (ii) transitioning from a senior bank structure to a unitranche facility if negotiations break-down.

✓ ***Overly levered deals.***

For more highly levered businesses, owners will need to evaluate all strategic options. Importantly, the following options exist along a continuum and should be explored in a parallel process.

● ***Invest incremental equity.***

Additional equity support will always be well received by lenders and will result in the greatest amount of negotiating flexibility in return

● ***Pursue structured capital.***

There are numerous investment firms focused on providing non-control growth equity, structured / preferred equity, and junior debt. The security from these investors will include a combination of PIK interest and either warrants, a liquidation preference, or other features that will be dilutive to existing equity, but will negate the need to contribute additional capital.

● ***Seek a majority equity partner.***

If the business is fundamentally healthy but its balance sheet is broken, consider seeking an investment from a new equity partner with the existing owners retaining a minority position. The new equity dollars can be used to pay down debt through the new equity partner will require operational control.

● ***Consider a strategic combination.***

Partner with a complementary business that has an unlevered or less levered balance sheet. The larger scale will be attractive to lenders and, depending on relative size of the two businesses, may result in a minority equity position for the higher levered practice.

Potential Strategic Options - cont.

- *Evaluate a full sale.*

In some situations, the value maximizing outcome will be to pursue an exit as opposed to seeking new capital and/or completing a debt restructuring.

- *Explore bankruptcy filing or alternative restructuring mechanism.*

Certain businesses will be in such financial distress that a bankruptcy or similar-type process (e.g. Federal or state receivership, assignment for the benefit of creditors, etc.) will need to be evaluated. To the extent negotiations with existing creditors crater and none of the above options are available to the company (at least not within the required time frame), the company may need to consider these measures. While no business owner relishes the thought of bankruptcy, at the point of insolvency, the company's board has a fiduciary duty not just to equity owners but to all stakeholders. In many situations, hiring experienced professionals to determine and develop the optimal path forward that provides the maximum recovery for all stakeholders may be the prudent (only) decision.

The COVID-19 pandemic has forced difficult decisions during the last two months. And, with the end of the second quarter around the corner, many provider businesses will be facing challenging negotiations with financing providers that could ultimately dictate the success or failure of the investment.

To ensure a fundamentally-sound business prevails through the crisis and the optimal outcome is achieved, the best course of action is to proactively communicate with lenders and begin preparing to pursue any and all strategic options available in the M&A and capital markets.



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Livingstone is an independent, global M&A and debt advisory firm with 85 professionals across offices in Beijing, Chicago, Düsseldorf, Los Angeles, Madrid and Stockholm. Visit www.livingstonepartners.com for additional information.

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