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HEALTHCARE

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The 'Amazon-ing' of Healthcare

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BY CATHERINE GAO, SENIOR ANALYST & WAYNE P. WEITZ, MANAGING DIRECTOR, HAMMOND HANLON CAMP LLC

The Tax Cuts and Jobs Act of 2017 (TCJA), signed by President Trump on December 22, 2017, has potential implications for nearly every segment of the healthcare industry. For healthcare providers, elements of the TCJA may increase pressure on operating profitability, which may, in turn, lead to an increase in restructuring, workout, and merger and acquisition activity.

The key financial impacts on healthcare providers are expected to be uneven and may also depend on experiments taking place at the state level, where some legislators are contemplating local implementation of the individual mandate. In general, however, many healthcare providers are expected to experience:

1. An increase in patient care bad debt should the repeal of the Affordable Care Act's (ACA's) individual mandate result in fewer people being covered by insurance.

2. Higher borrowing costs resulting from reduced corporate tax rates.

3. Reduced reimbursement of provider costs, exacerbating eventual Medicaid cuts mandated by the ACA.

For the largest, well-capitalized healthcare providers, the financial impact of the TCJA is likely to be minimal. However, for weaker and already vulnerable organizations, those already operating at the margin of financial success, certain provisions of the TCJA could prove to be the difference between success or failure. It is important that these organizations understand the potential effects of the legislation and be aware of its impact as it unfolds, so they can adapt as appropriate to preserve their financial strength and fulfill their missions.

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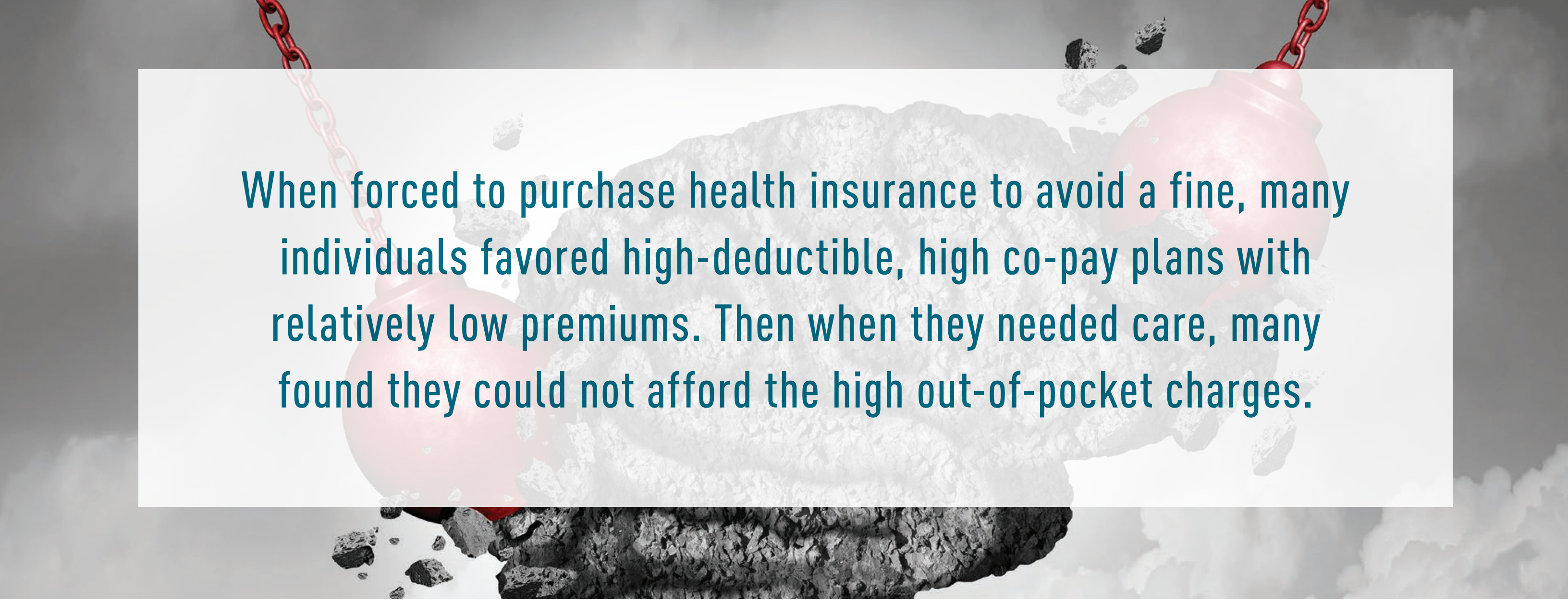

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Repeal of Individual Mandate

Perhaps the most visible and widely discussed healthcare-related provision of the TCJA is the elimination of the individual mandate, an ACA requirement that individuals carry a minimum level of health insurance coverage or face a potential fine. The ACA also requires private health insurance plans sold on the government exchanges to cover 10 essential health benefits and prevents insurers from charging people for coverage based on their health history. These broad coverage requirements led to higher premiums on the exchanges, government subsidies for many who purchased coverage on the exchanges, and higher costs of providing healthcare to an exclusion-free population.

The individual mandate was designed to offset the unfavorable economics of expanded, higher cost coverage under the ACA by requiring that younger, healthy patients with inherently lower healthcare costs purchase insurance. The penalty for noncompliance was the greater of $695 or 2.5 percent of household income in excess of a legislated threshold, subject to caps.

Given the TCJA's repeal of the individual mandate, the threat of a fine also has been eliminated. Although fines were rarely, if ever, imposed, younger, healthier individuals are now expected to eschew coverage in large numbers, leading to a less healthy and riskier patient pool for the remainder of the covered population. The Congressional Budget Office (CBO) initially estimated in November 2017 that the repeal of the ACA's individual mandate would result in 13 million fewer Americans being insured by 2027, with most of the reduction coming from healthier individuals electing not to purchase insurance. The CBO also estimated that repeal of the individual mandate would cause premiums in the markets to increase 10 percent beyond increases that were projected absent the new tax law.

At the same time, the CBO projected federal budgetary savings of $340 billion over 10 years as a result of the reduction in subsidies paid to participants on the exchanges. In another example of the inability to truly measure the prospective impact of the TCJA, the CBO recently revised its previous estimates downward. In addition, an independent analysis by Standard & Poor's estimates that a far smaller group, between 3 million and 5 million individuals, will forgo health insurance over the next decade. Accordingly, it will take time to determine the true magnitude of the impact of eliminating the individual mandate.

The popular perception was that the individual mandate, by forcing individuals to purchase health insurance, would reduce the number of people who used emergency rooms—one of the most expensive types of care—as their main point of care, reducing the charity care load on providers. However, when forced to purchase health insurance to avoid a fine, many individuals favored high-deductible, high co-pay plans with relatively low premiums. Then when they needed care, many found they could not afford the high out-of-pocket charges. So the shortfall that previously had been recognized as a hospital's charity care cost came to be classified as bad debt expense instead.

In other words, it is not clear how the individual mandate impacted the financial condition of hospitals. With repeal of the mandate, arguments can be made on both sides about how patients will behave, so the only certain impact of the change is more uncertainty. And in uncertain environments, organizations hesitate to make long-term investment decisions.

Higher Costs for Not-For-Profit Borrowers

The TCJA reduced the federal corporate tax rate from 35 percent to 21 percent, effective January 1, 2018, and eliminated the corporate alternative minimum tax. This reduction in corporate tax rates is expected to adversely impact certain segments of the market for tax-exempt bonds, a critical source of funding used by not-for-profit hospitals and health systems. The tax exemption for interest earned on qualifying bonds allows borrowers to sell bonds at lower yields than similarly situated taxable borrowers, with the differential roughly corresponding to the federal and state income tax rates. The reduction in federal corporate tax rates reduces the relative attractiveness of tax-exempt bonds to institutional investors and bank direct lenders. In response,

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these investors may require higher yields for new tax-exempt issues.

The federal corporate tax rate reduction has implications for existing tax-exempt debt as well. Many not-for-profit healthcare organizations have directly placed tax-exempt bonds with banks and/or have issued tax-exempt variable rate demand bonds (VRDBs) in the public market. When banks purchase bonds directly, they often include adjustment provisions in the associated loan agreement and bond indentures that allow lenders to increase interest rates on tax-exempt bonds if corporate tax rates decline.

The change in corporate tax rates may affect both fixed and variable rate bank loans. Interest rates on VRDBs are generally reset daily or weekly based on the Security Industries and Financial Markets Association (SIFMA) tax-exempt index, which rises and falls inversely with tax rates.

For financially stable borrowers, the slight increase in interest rates resulting from a drop in the corporate tax rate is likely to have only a minimal effect on profitability and liquidity. However, for smaller, less-competitive providers, particularly stand-alone rural borrowers already operating with thin margins, any interest rate increase attributable to the tax rate cut could have a material impact on operating income. Combine this increase in interest rates with a generally rising rate environment, and the additional borrowing costs and dilution of free cash flow may limit access to capital for some marginal operators.

In addition, the TCJA eliminated the ability to "advance refund" existing tax-exempt bonds with new tax-exempt bonds. Similar to loan defeasance in the for-profit world, advance refunding refers to defeasing tax-exempt bonds more than 90 days prior to their first call date with the proceeds of a new issue of tax-exempt bonds. During the remaining call period, there are two issues of bonds outstanding.

Eliminating advance refunding is intended to prevent multiple bond issues collateralized by the same assets from being outstanding simultaneously and to reduce overall the total amount of tax-exempt debt outstanding. While the TCJA preserved the ability of not-for-profit healthcare borrowers to refinance currently callable debt with tax-exempt financing, the inability to refinance in advance eliminated a potential cost-saving strategy for healthcare systems.

As the cost of capital for not-for-profit healthcare organizations increases, weaker hospitals and health systems may not be able to afford debt financing. Reducing access to capital for these already vulnerable organizations may limit their ability to invest in necessary capital projects and improvements. Purchases and construction of new facilities, renovation of existing operating rooms, and purchases of medical equipment and information technology infrastructure might be delayed or avoided altogether, resulting in some hospitals—particularly rural and critical access hospitals—losing their competitive edge and beginning a downward spiral in which they are unable to attract the best physicians and maintain a broad range of services. Quality of care and operating profitability may suffer. Independent rural hospitals, already affected by a lack of modern equipment and cutting-edge providers, may well be at the greatest risk of being negatively affected by more limited access to capital.

Interestingly, the reduction in the corporate tax rate could also affect for-profit hospitals and healthcare organizations. The TCJA limits the amount of interest expense that can be deducted, capping the deduction at 30 percent of adjusted taxable income starting in 2018. In the short term, the limitation on interest deductibility will increase taxable income for highly levered companies, but this higher taxable income will be taxed at a markedly lower rate. In the long run, the change discourages high leverage, and the deductibility cap could serve to increase the net after-tax effective borrowing rate for more highly leveraged (or less profitable) borrowers.

Potential Medicaid, Medicare Cuts

While expectations vary, the CBO estimates that TCJA will increase the federal budget deficit by $1.4 trillion over the next decade. Increases in the federal deficit may encourage cuts to federal spending. Placing further pressure on the national economy will be the aging of the U.S. population—which is virtually certain to increase the demand and cost for healthcare. Medicare and Medicaid funding levels, which together account for roughly one-third of the federal budget, could be at risk.

In addition, funding under Medicaid's Disproportionate Share Hospital (DSH) program continues to be at risk. The DSH program was created by Congress in 1981 to help hospitals that provide a significant amount of care for which they are not reimbursed. The ACA mandated reductions in payments under the program, but implementation of the cuts has been repeatedly delayed by Congress. In February, Congress delayed implementation of the cuts by two years, until October 2019. Once implemented, the total reduction in payments is estimated at $43 billion through 2025. These cuts will place greater financial stress on organizations serving populations most in need.

Impact on Physicians, Physician Groups, Healthcare Executives

Many physician groups are structured as pass-through entities, meaning that they pay no corporate income tax directly. Rather, each owner pays tax on its share of taxable income, at the owner's tax rate. Under the TCJA, pass-through entities are generally permitted to deduct up to 20 percent of "qualified business income," a provision designed to encourage hiring and investment.

However, most service organizations, including healthcare providers, are subject to a phase-out of this deduction and thus will not receive its full benefit. Like other provisions of the TCJA, the ultimate effect of this phase-out is difficult to determine, since the reduction in the top personal income tax rate, from 39.6 percent to 37 percent, will benefit owners of pass-through entities, including many physicians.

A more talked-about but less significant provision of the TCJA concerns executive compensation. The TCJA imposes on tax-exempt organizations a 20 percent excise tax on individual compensation over $1 million paid to each of the five highest-paid employees. While this makes for a nice populist talking point, organizations that are paying individual compensation in excess of $1 million are generally large, well-capitalized entities that likely will not feel any material financial impact of this luxury tax.

Addressing the Challenges

Passage of the TCJA has imposed a greater level of uncertainty in a healthcare environment in which many providers were already feeling financial and operational stress. The TCJA is likely to increase the amount of bad debt and charity care healthcare providers incur, increase emergency room usage for uninsured patients, reduce reimbursement from governmental payors, and adversely impact borrowing ability. Additionally, the reduction in corporate tax rates may, ironically, increase the cost of capital for many hospitals and healthcare systems.

The combined effects of these forces could threaten the overall operating performance and financial sustainability of smaller or weaker providers. Hospitals and healthcare providers that lack the scale and ability to thrive in this competitive environment may find themselves in need of balance sheet restructuring and at risk of loss of control, bankruptcy, acquisition, or other significant transition. Careful, real-time monitoring and assessment of changes, particularly with the help of qualified advisors, will make a significant difference for providers that are able to adapt to the changes brought on by the new legislation.

Catherine Gao is a senior analyst in the New York office of Hammond Hanlon Camp LLC, where she provides analytical support on a broad range of strategic advisory, merger and acquisition, capital markets, and restructuring engagements. She can be contacted at cgao@h2c.com.

Wayne P. Weitz is a managing director and leader of Hammond Hanlon Camp LLC's restructuring practice, focusing primarily on distressed healthcare situations. He has nearly 30 years of investment banking, turnaround, and restructuring experience, both in and out of court. He can be contacted at wweitz@h2c.com.