Impact of Financial Uncertainty on Capital Formation for the Nursing Facility Industry

Prepared for

American Health Care Association/
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Prepared by

The Lewin Group, Inc.
Keith Hearle, M.B.A.
Al Dobson, Ph.D.
Robin Rudowitz, M.P.A.
Kate Kochendorfer

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Executive Summary

- This study confirms and builds on prior work indicating that removal of the Medicare BBRA & BIPA* "add-ons" would decrease the financial stability of the nursing facility industry.
  - We provide financial data representative of the entire nursing facility industry as we compare uses for capital to sources of capital.
- In recent years, the industry's capital spending has fallen below the level needed to replace buildings and equipment. If the Medicare add-ons expire:
  - Individual nursing facility margins would decrease and the percent of facilities with negative margins would increase.
  - Nursing home company margins would fall, significantly decreasing capital used to maintain and replace buildings and equipment, and also to repay lenders.
  - The number of financially insolvent facilities would increase.
  - The nursing facility industry's ability to generate and raise capital from cash flow, borrowing, or equity may remain below replacement needs.
- The result of the expiration of the Medicare add-ons would be that access to an essential health care service would be at greater risk for current and future patients.

*Balanced Budget Act (BBA) of 1997, Balanced Budget and Refinement Act (BBRA) of 1999, Beneficiary Improvement and Protection Act (BIPA) of 2000.

Purpose

- This study builds on a recent analysis prepared by The Lewin Group entitled *Payer-Specific Financial Analysis Of Nursing Facilities.* That study assessed the implications of the expiration of Medicare add-ons for nursing facility margins.
- This study examines the magnitude and implications of reduced Medicare revenue on the industry's ability to generate and access capital in the future.
- Nursing facilities and nursing home companies require ongoing access to capital to repair and replace nursing facility infrastructure. This study documents the uncertainty surrounding the Medicare add-ons has affected the ability of the industry to obtain needed capital.

Background

- The BBA and SNF PPS contributed significantly to the financial distress of nursing facilities.
  - The BBA was intended to reduce Medicare nursing facility expenditures and control expenditure growth.
  - Under the PPS system, nursing facilities are reimbursed a "prospective" rate for services that includes all therapy and ancillary services provided during a Medicare Part A stay.
- Then BBRA & BIPA authorized Medicare add-ons in response to the financial distress that followed BBA implementation.
  - The BBRA & BIPA Medicare add-ons are scheduled to expire.
- The elimination of these Medicare add-ons could impact access to capital for the nursing facility industry and subsequently access to nursing facility services by Medicare beneficiaries.

The add-on payments included in BIPA and BBRA are scheduled to expire.

Legislation	Medicare "add-on"	"Add-on" Tentative Expiration Dates	
BIPA Section 312	16.67% increase applied to nursing component of all RUGs categories	October 1, 2002	Medicare "Sunset" add-ons
BBRA Section 101	4% increase applied to the adjusted federal rate for FY 2002 to all RUG categories	October 1, 2002	
BBRA Section 101 & BIPA Section 314	6.7% increase applied to the adjusted Federal per diem rate for rehabilitation group RUG categories	Triggered by the RUGs case mix refinement*	Medicare "Refinement" add-ons
BBRA Section 101 & BIPA Section 314	20% increase applied to the adjusted Federal per diem rate to certain RUG categories	Triggered by the RUGs case mix refinement*	

Source: 42 CFR Parts 410, et.al, "Medicare Program; Prospective Payment System and Consolidated Billing for Skilled Nursing Facilities-Update; Final Rule," Federal Register, July 31, 2001.

*On April 23, 2002 HHS Secretary Tommy G. Thompson announced the RUGs refinement will be delayed until FY2004.

Study Methods

- Facility Level Analysis
  - Only the 4,757 facilities with complete income statement and balance sheet information for 1996 through 1999 were used for the analysis (survey panel = 4,757 out of ~ 13,000 facilities that filed Medicare Cost Reports).
  - This study panel is broadly representative of ownership categories (non profit, proprietary, and government) and geographic distribution.
- Company Level Analysis
  - Company Security Exchange Commission (SEC) filings
  - Research conducted by Wall Street analysts
- Interviews with debt and equity analysts, companies, industry suppliers, and other key informants
- Using these data, we examined the impact of the expiration of the Medicare add-ons on the relationship between capital uses and capital formation in the nursing home industry.

The study panel of 4,757 facilities is geographically distributed in a similar way as the nursing facility industry.

Regional Distribution*	By Percent of Facilities		By Percent of Beds	
	Study Panel	Nursing Facility Industry	Study Panel	Nursing Facility Industry
New England	8.1%	7.5%	7.3%	7.0%
Mid Atlantic	18.4%	12.4%	24.5%	16.5%
South Atlantic	15.3%	15.6%	15.2%	15.9%
East North Central	20.4%	19.6%	20.2%	20.4%
East South Central	5.4%	6.2%	4.9%	6.1%
West North Central	7.9%	10.4%	6.6%	8.5%
West South Central	8.2%	12.0%	7.4%	11.2%
Mountain	4.6%	5.0%	4.1%	4.6%
Pacific	11.9%	11.5%	9.8%	9.8%

Note: Region 10 (Marshall Islands, Puerto Rico, Virgin Islands, Guam, and American Samoa) was excluded from this analysis. See Appendix for states comprising the various regions.

Capital Uses: The nursing facility industry uses capital to sustain ongoing operations and to maintain and replace buildings and equipment, and also to repay lenders.

Capital Uses

- Replace buildings
- Invest in equipment
- Repay existing long-term debt
- Provide return on invested equity

- Support nursing facility operations (labor, food, supplies, etc.)

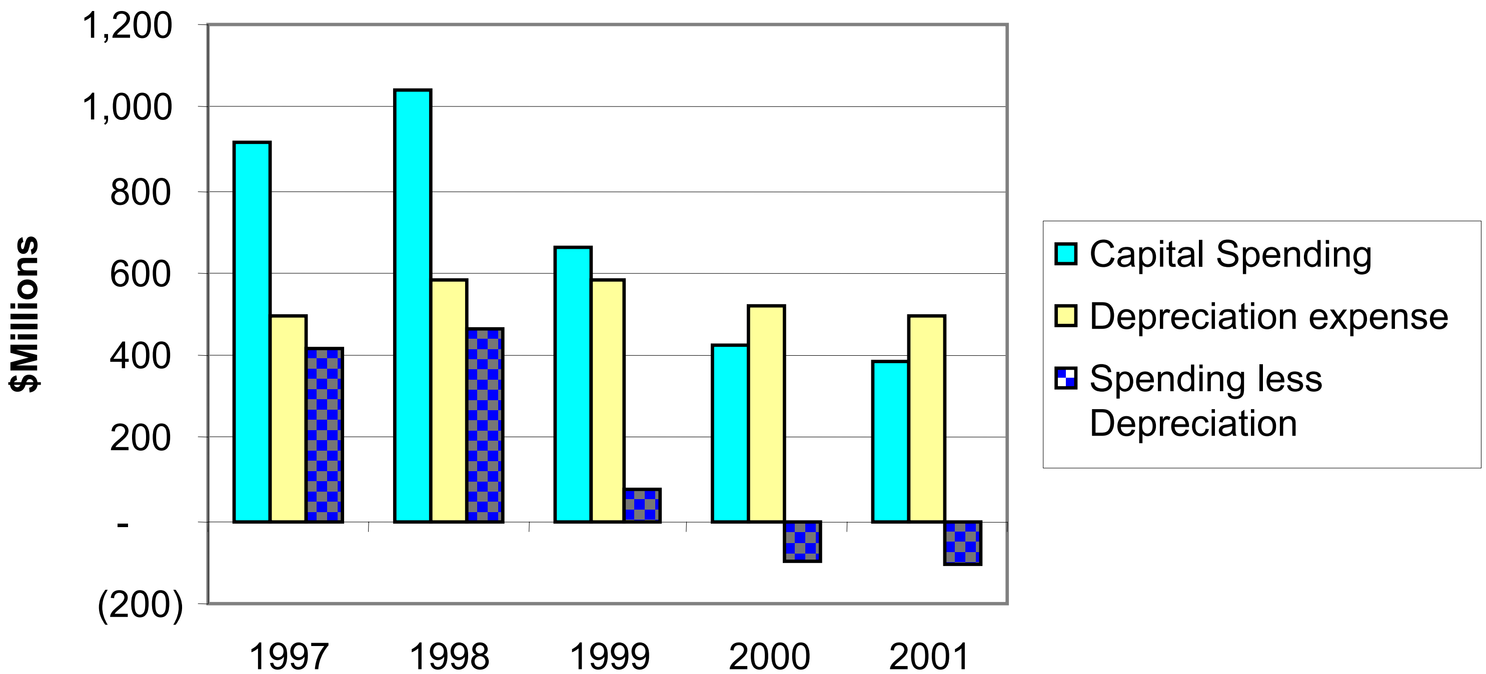
Capital Sources

- Cash flow from operations
- Borrowing
- Equity
- Other sources*

Surplus or Deficit?

*Facility sales and leases, venture capital, banks, bond markets, sub-debt markets, HUD, etc…

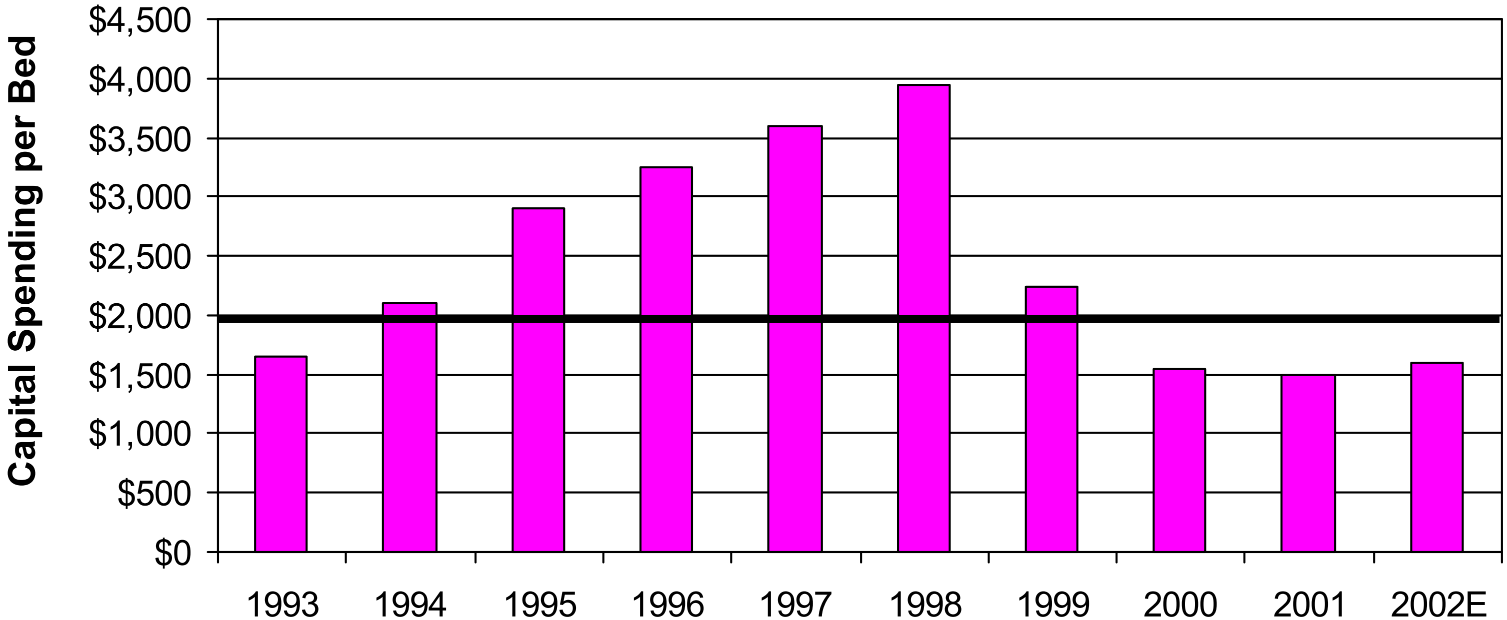
Capital Uses: Nursing home company financial reports confirm that facilities have depreciated faster than they have been replaced.



Source: The Lewin Group analysis of nursing home company financial data.

- Annual depreciation expense is a proxy for the capital spending required to maintain nursing facility buildings and equipment at acceptable levels.
- The result of sustained capital spending below depreciation expense is a failure to repair and replace the asset base. This could result in a restraint in available service at a time when an aging population could require and demand complex medical services within the nursing facility setting.

Capital Uses: In recent years, due to financial and capital availability constraints, capital spending levels have fallen below an annual $2,000 per bed replacement threshold.*

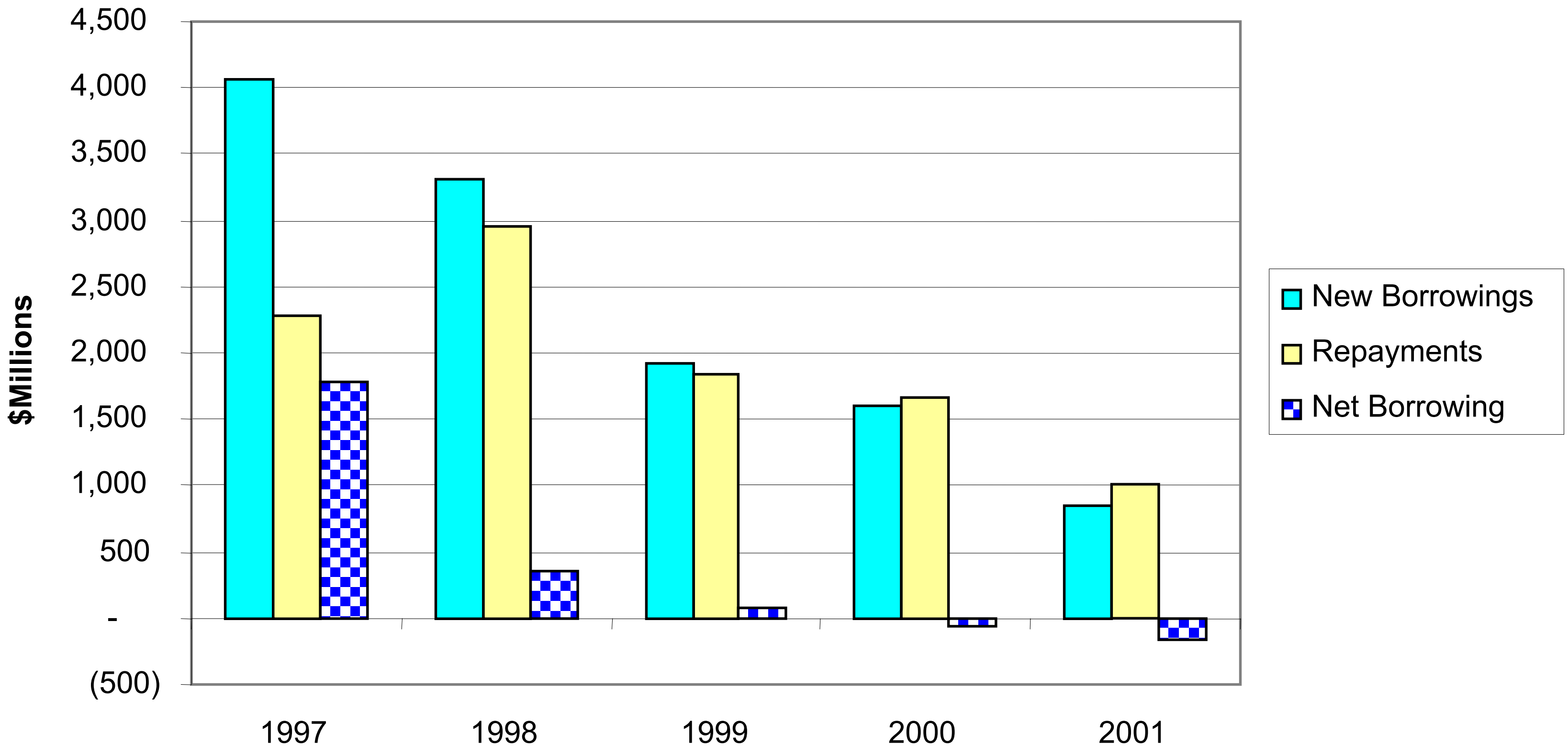


Source: Company reports, CIBC World Market estimates. Reformatted by The Lewin Group.

- The annual $2,000 per bed replacement threshold is based on the estimated cost to build and maintain a nursing facility bed.

*See Appendix for background on the annual $2,000 per bed replacement threshold.

Capital Uses: Historically, borrowing has been a capital source. *Repayment* is a capital use. Borrowing has *not* been a source of capital since 1999.



Source: The Lewin Group analysis of nursing home company financial results.

- As banks demand repayment of principal in light of the financial instability of the industry, there are limited opportunities for new borrowing.

All capital sources are being affected by the uncertainty associated with the expiration of the Medicare add-on payments.

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Surplus or Deficit?

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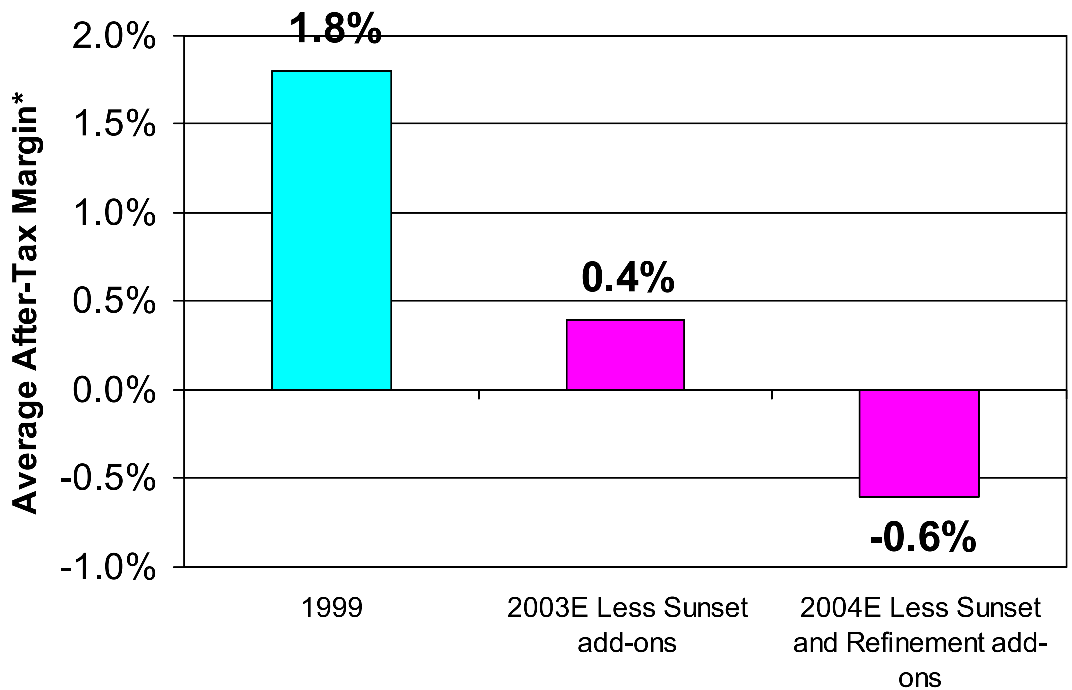
Capital Source: Cash flow from operations
The expiration of the Medicare add-ons would reduce facility cash flow and after-tax margins.



Source: The Lewin Group analysis of a consistent panel of 4,757 facilities drawn from Medicare cost reports from 1996 to 1999.

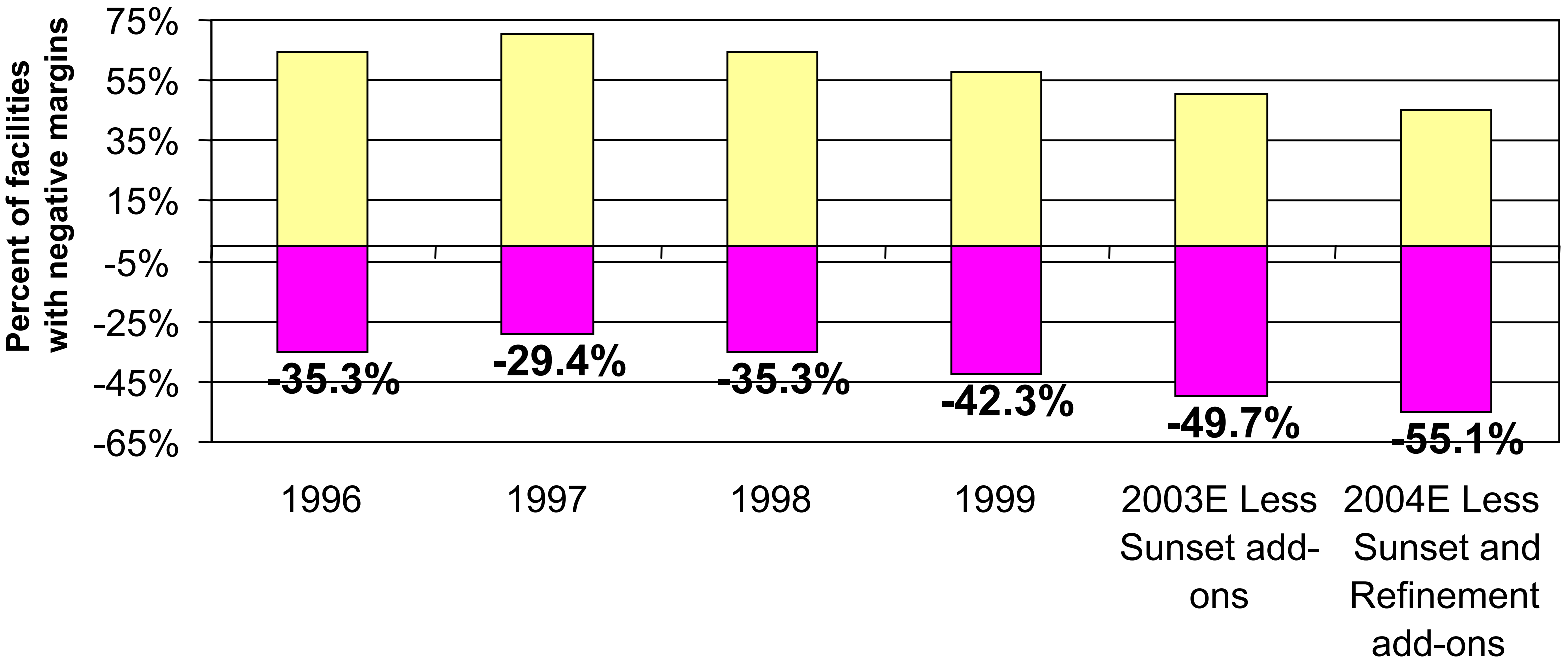
- Margins are projected to fall with the expiration of the Medicare Sunset and Refinement add-ons, reflecting a decline in after-tax net income and operating cash flow.**

*Investors and lenders focus on after-tax margins and cash flow.

**Cash from NF operations = Net income + depreciation expense + working capital needed

Capital Source: Cash flow from operations

The expiration of the Medicare add-ons would increase the percent of facilities with negative margins.

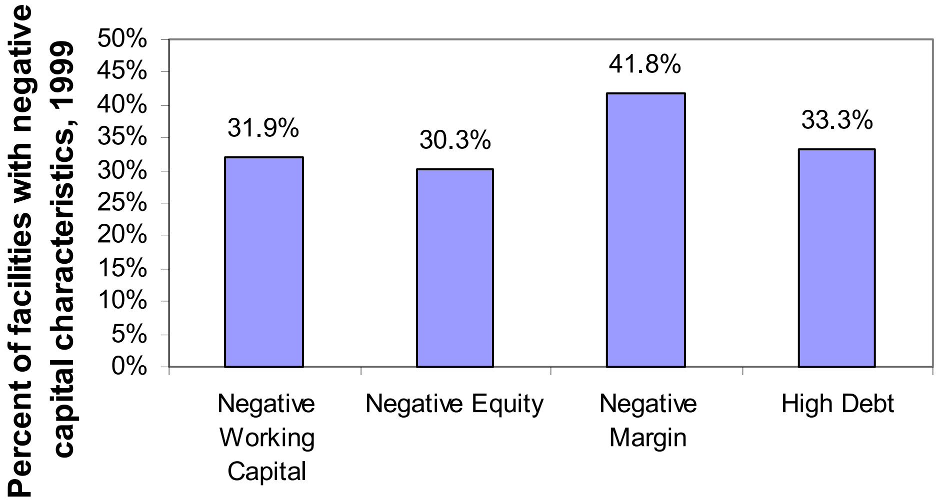


Source: The Lewin Group analysis of a consistent panel of 4,757 facilities drawn from Medicare cost reports from 1996 to 1999.

- The implementation of BBA significantly increased the percent of facilities with negative margins.
- The removal of the Medicare Sunset and Refinement add-ons would further increase the percent of facilities with negative margins.

Capital Source: Borrowing

Lenders have been reluctant to advance funds to all financially unstable facilities and companies.

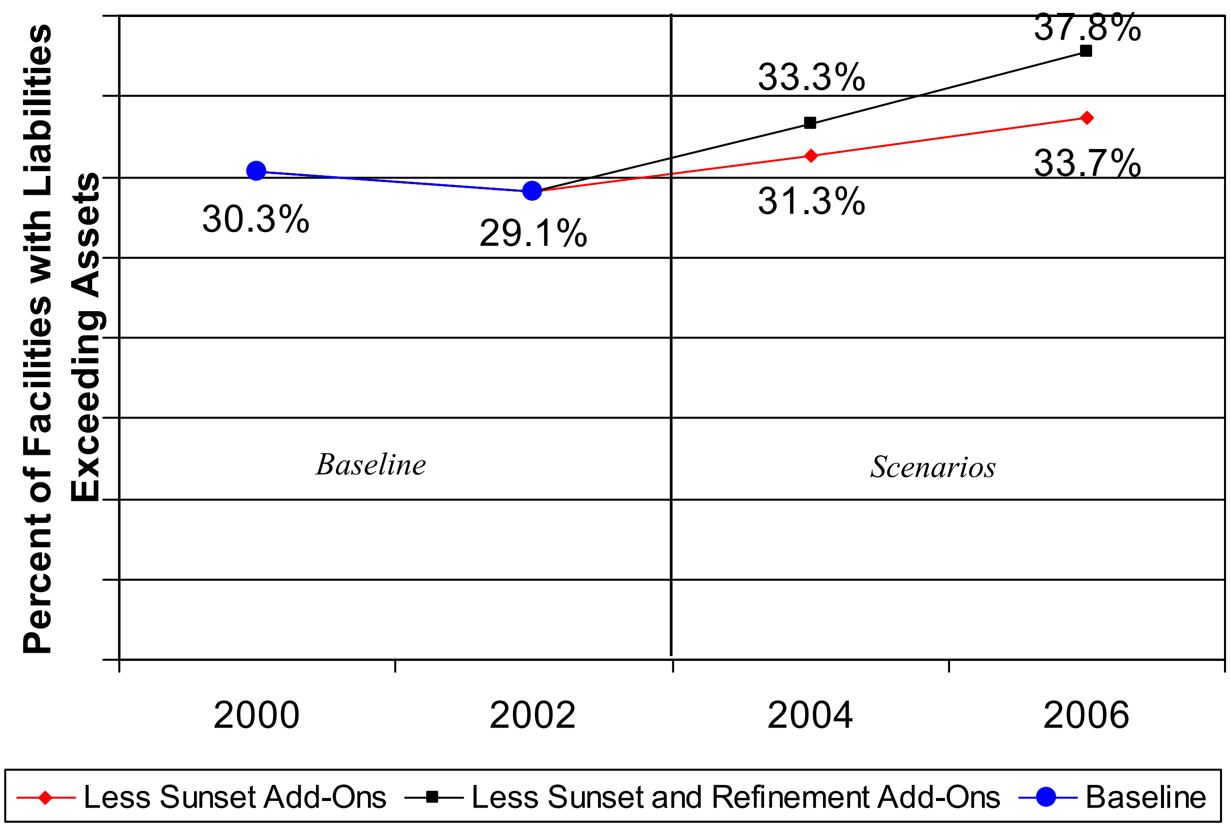


Source: The Lewin Group analysis of a consistent panel of 4,757 facilities drawn from Medicare cost reports from 1996 to 1999.

Criteria	Definition	Implication
Negative Working Capital	Current liabilities exceed current assets	Indicates upcoming cash flow problems.
Negative Equity	Total liabilities exceed total assets	Owners are not receiving the expected/required return on investment and stand-alone facilities may be technically insolvent.
Negative Margin	Total margins are negative	Sustained negative margins lead to solvency problems and difficulty generating and accessing needed capital.
High Debt	Long term liabilities are greater than 80 percent of total assets	Lenders require lower "loan to value" ratios before advancing funds.

Capital Source: Borrowing

The expiration of Medicare add-ons would decrease credit worthiness and increase the percent of facilities with negative equity (liabilities that exceed assets).



Source: The Lewin Group analysis of a consistent panel of 4,757 facilities drawn from Medicare cost reports from 1996 to 1999.

Capital Source: Equity

Raising equity and other capital depends on predictable earnings and a return on investment.

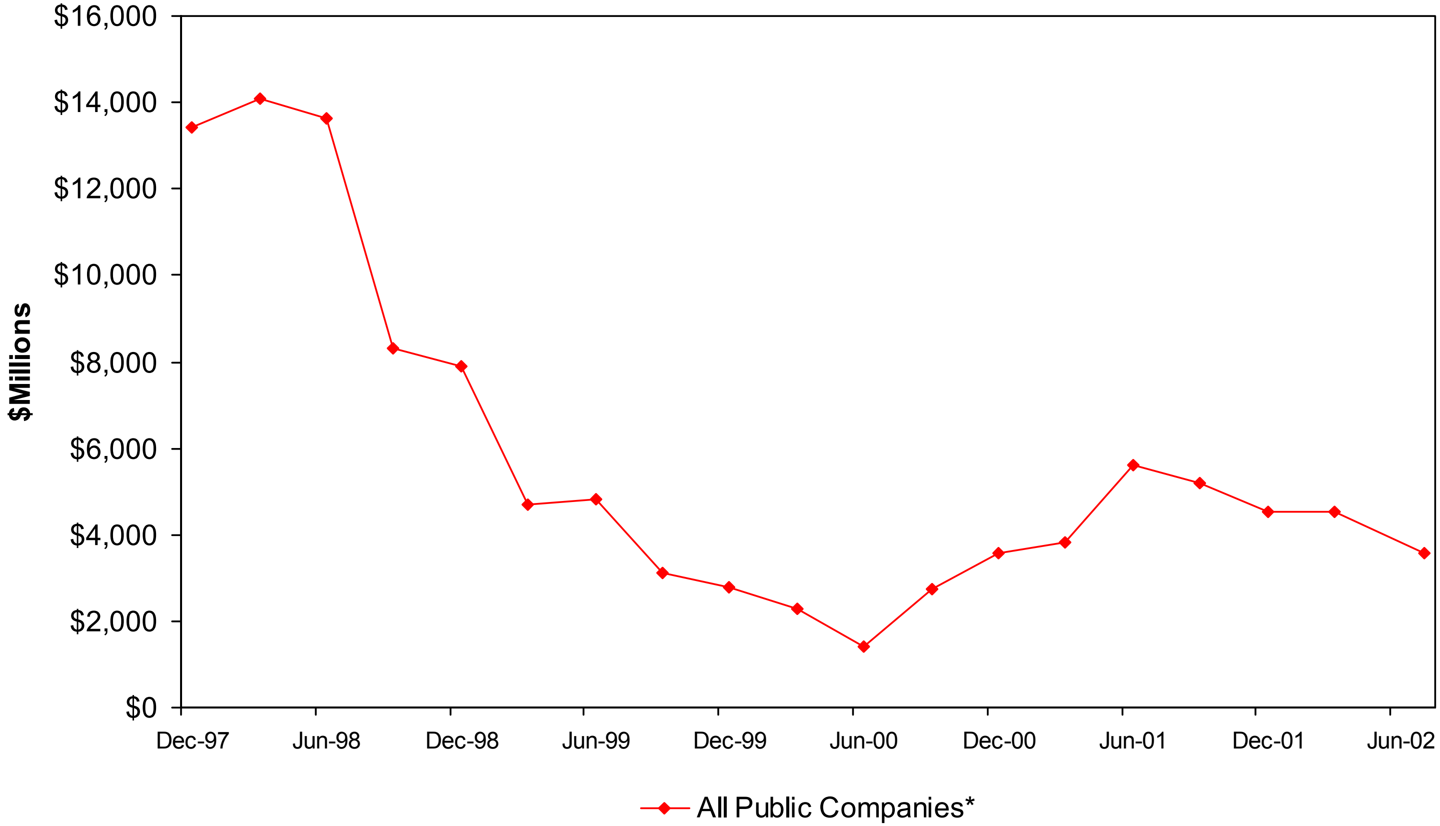
	Average Company Margin with add-ons	Average Company Margin without add-ons	Percent Change in Margin
Sunset add-ons	**2.2%**	**1.0%**	-54%
Sunset and Refinement add-ons	**2.2%**	**0.1%**	-95%

Source: The Lewin Group Analysis of the Impact of Expiration of Medicare add-ons on Nursing Home Companies.

- Equity investors expect predictable earnings and a return on investment.
- Removing the Medicare Sunset and Refinement add-ons would reduce earnings.
- A small decline in company margins has a magnified impact on a company's stock price.

Capital Source: Equity

The equity value of nursing home companies declined dramatically after the introduction of BBA in 1997.



Source: The Lewin Group analysis.

*This graph excludes Kindred, GHVI, and SHG equity raised by converting debt to equity as compensation to creditors during their reorganizations from Chapter 11 bankruptcy proceedings.

If a deficit exists between capital uses and sources, the removal of the Medicare add-ons would increase capital deficits.

Capital Uses

- Replace buildings
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- Support nursing facility operations (labor, food, supplies, etc.)

Capital Sources

- Cash flow from operations
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Surplus or Deficit?

*Facility sales and leases, venture capital, banks, bond markets, sub-debt markets, HUD, etc…

Capital Surplus or Deficit
The elimination of the Medicare add-ons would intensify current capital deficit levels.

	All add-ons Retained	**Sunset add-ons Expire**	**Sunset and Refinement add-ons Expire**
Capital Uses			
Amount per bed	$2,000	$2,000	$2,000
Beds	1,800,000	1,800,000	1,800,000
Annual needs ($mm)	$3,600	$3,600	$3,600
Debt repayment ($mm)	$1,464	$1,464	$1,464
Total Uses	$5,064	$5,064	$5,064
Capital Sources ($mm)			
Nursing Facility Operations	$4,729	$3,366	$2,437
Equity	-	-	-
Total Sources	$4,729	$3,366	$2,437
Capital Surplus (Deficit) Total Sources –Total Uses	($335)	($1,698)	($2,627)

Source: The Lewin Group analysis.

Summary of Key Findings

- Capital is essential for the industry to survive and for essential services to be available to beneficiaries.
- The uncertain future of the Medicare add-ons currently is decreasing the nursing facility industry's access to capital.
- In 1999, 30 percent of facilities reported negative equity.
- If the Medicare Sunset add-ons are removed, we estimate that in 2006, 33.7 percent of facilities, regardless of ownership, would report negative equity.
  - The total after-tax margin of publicly traded companies would fall from 2.2 percent to 1.0 percent.
- We estimate that the joint removal of the Sunset and Refinement add-ons would lead 37.8 percent of facilities, regardless of ownership, to report negative equity in 2006.
  - The total after-tax margin of publicly-traded companies would fall from 2.2 percent to 0.1 percent.

Summary of Key Findings (cont.)

- Current constraints on all capital sources (nursing facility operations, borrowing, equity, and other) challenge the ability to meet evolving capital needs.
  - In recent years, capital spending levels have fallen below the annual $2,000 per bed replacement threshold.*
- The declines in company margins, triggered by the expiration of the Medicare add-ons, would:
  - Have magnified impacts in capital markets
  - Dramatically lower all traditional measures of stock valuation
  - Affect capital ratios and statistics evaluated by lenders

*See Appendix for background on the annual $2,000 per bed replacement threshold.

Summary of Key Findings (cont.)

- In the short run, the recently experienced BBA-related Chapter 11 bankruptcies (restructuring) could be followed by another round of Chapter 7 bankruptcies (liquidation) if the Medicare add-ons are removed, thereby resulting in forced asset sales and facility closures.
- In the long run, the major consequence of near term budget reductions would be a lack of capital needed to modernize and replenish physical plants and equipment, acquire new technologies, and meet changing community health care needs. This comes at a time when an aging population could require and demand complex medical services within the nursing facility setting.

Policy Implications

- The aging infrastructure of the nursing facility industry should be of great concern.
- Access to all sources of capital for the nursing home industry is at risk primarily due to the uncertainty surrounding the future of Medicare add-ons.
- For some companies and facilities, the add-ons mean the difference between bankruptcy and financial solvency.
- Medicare currently is cross-subsidizing Medicaid payment. Medicare and Medicaid payment policy need better coordination.
  - Until Medicaid under-payment is addressed, Medicare add-ons in some form need to be preserved.

Impact of Financial Uncertainty on Capital Formation for the Nursing Facility Industry

Appendix

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Definition of Regions

New England	Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut
Mid Atlantic	New York, New Jersey, Pennsylvania
South Atlantic	Delaware, Maryland, District of Columbia, Virginia, West Virginia, North Carolina, South Carolina, Georgia, Florida
East North Central	Ohio, Indiana, Illinois, Michigan, Wisconsin
East South Central	Kentucky, Tennessee, Alabama, Mississippi
West North Central	Minnesota, Iowa, Missouri, North Dakota, South Dakota, Nebraska, Kansas
West South Central	Arkansas, Louisiana, Oklahoma, Texas
Mountain	Montana, Idaho, Wyoming, Colorado, New Mexico, Arizona, Utah, Nevada
Pacific	Washington, Oregon, California, Alaska, Hawaii

Source: United States Census.

The $2,000 per bed threshold is based on the estimated cost to build and then maintain a nursing facility bed.

Average replacement cost per bed*	
Building	$42,000
Equipment	$4,500
Land	$7,500
Total	$54,000
Annual depreciation expense	
Building	$1,333
Equipment	$667
Total	$2,000

**Source: National Investment Center for the Seniors Housing and Care Industries.*