Five Key Takeaways From the Public Healthcare Operators in 2021

As we enter 2022, we look back to reflect on the major trends that shaped the healthcare sector over the past year. COVID-19 continued to be a major player throughout 2021, forcing healthcare systems to adapt to new variants, rising labor pressures, financial activity, and new regulations. Despite these challenges, the sector remains optimistic and ready to adapt.

Here are five key takeaways we believe defined the healthcare sector over the past year:

Financial Recovery From the Pandemic

After the Q2 earnings season, VMG Health released an article analyzing post-COVID healthcare operator guidance. Generally, we found that healthcare operators were optimistic about the recovery of their revenue and adjusted EBITDA metrics over pre-pandemic levels, with most operators increasing their FY 2021 guidance with each subsequent reporting period.

While optimism for recovery to pre-pandemic levels remains, it appears that the post-acute operators have tempered some of their recent growth expectations. Based on disclosures of the public operators, the recent resurgence of COVID-19 through the Omicron variant has caused additional strain on the post-acute sector. During the J.P. Morgan Healthcare Conference, Universal Health Services ("UHS") CFO, Steve Filton noted that the company was struggling to find providers who can accept COVID patients once they are ready to be discharged from the hospital.

Post-acute providers appear to have been hit especially hard by the recent labor shortages in the healthcare industry (discussed further below). As compared to the hospital operators, the financial performance of these post-acute providers has been affected disproportionally by the labor shortages. While hospital operators have been receiving additional reimbursement for COVID patients, helping to offset a portion of the increased staffing costs, the post-acute care providers have not received a similar subsidy.

Due to these recent pressures, Select Medical Holdings Corporation ("SEM") released an expected earnings announcement in advance of the actual results, in which it noted "the unpredictable effects of the COVID-19 pandemic, including the duration and extent of disruption on Select Medical's operations and increases to our labor costs, creates uncertainties about Select Medical's future operating results and financial condition."

While we have seen increasing optimism by healthcare providers over the past few quarters, the recent disclosures from the post-acute sector illustrate that the effects of COVID continue to ripple through the healthcare sector. With the fourth quarter results being released over the coming weeks (HCA and Encompass recently released), it will be interesting to hear if other sectors report similar headwinds.

$ in Millions	Provider Type	CY 21 Guidance, As of Q4 20	Q1 21	Q2 21	Q3 21	Q3 Growth from Q4 20	Q1 21	Q2 21
Midpoint Adjusted EBITDA Figures								
CYH	Hospital	$1,700	$1,725	$1,750	$1,800	5.9%	4.3%	2.9%
HCA	Hospital	10,600	11,100	12,300	12,650	19.3%	14.0%	2.8%
THC	Hospital	3,000	3,100	3,250	3,300	10.0%	6.5%	1.5%
UHS	Hospital	1,794	1,794	1,922	1,922	7.2%	7.2%	-
EHC	Post-Acute	940	1,015	1,060	1,035	10.1%	2.0%	(2.4%
SEM [1]	Post-Acute	860	885	985	990	15.1%	11.9%	0.5%
AMED	Post-Acute	320	347	317	297	(7.2%)	(14.4%)	(6.3%
LHCG	Post-Acute	274	295	295	268	(2.4%)	(9.3%)	(9.3%
Adjusted EBITDA Margin								
CYH	Hospital	14.0%	14.3%	14.5%	14.7%	4.6%	3.1%	1.6%
HCA	Hospital	19.4%	20.3%	21.4%	21.4%	10.2%	5.8%	0.2%
THC	Hospital	15.5%	15.8%	16.7%	16.8%	8.6%	6.2%	0.8%
UHS	Hospital	14.6%	14.6%	15.5%	15.5%	5.6%	5.6%	-
EHC	Post-Acute	18.5%	19.7%	20.5%	20.3%	9.7%	2.8%	(1.0%
SEM [1]	Post-Acute	15.0%	15.3%	16.8%	16.2%	8.5%	6.4%	(3.6%
AMED	Post-Acute	13.9%	14.9%	13.7%	13.5%	(3.3%)	(9.8%)	(1.8%
LHCG	Post-Acute	12.3%	13.2%	13.2%	12.1%	(1.8%)	(8.4%)	(8.4%

Rising Expense: Potential Impact to 2022 Performance

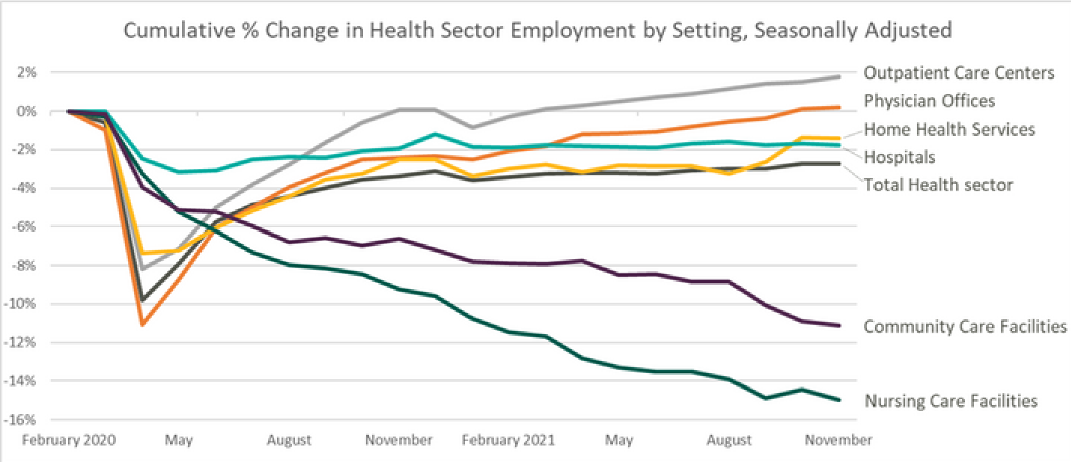
Healthcare labor expenses continued to exceed historical levels with a 12.6% year-over-year increase based on a recent analysis of over 900 hospitals. Labor expenses grew at a faster rate than the number of clinical hours worked, which supports the notion that rising labor costs were not due to increased staffing levels but rather due to labor shortages driving higher pay to improve employee retention. Part of the labor shortage can be credited to the surge of Delta and Omicron variants in the second half of 2021 that resulted in high volumes of quarantined staff and a reliance on costly contract labor and travel nurses.

At the Bank of America December 2021 Home Care Conference, LHC Group announced a decrease in quarantined staff throughout Q4 from a high of 4% down to 1% in December. This indicates that the labor market issues will see some improvement as health systems' dependence on pandemic-related contract labor declines as COVID-19 surges dissipate going into 2022.

A more concerning challenge faced by all sectors was the shrinking workforce, coined the "Great Resignation." The Bureau of Labor Statistics reported healthcare and social assistance workers had the second highest quit rate in November 2021 at 6.4% due to increasingly high levels of professional burnout. The waning labor force has prompted companies to offer additional incentives such as shift and retention bonuses. For example, HCA reported during Q3 a 10-12% annual increase in FTEs being in the premium pay categories. Many large public players have voiced an anticipation of continued high levels of premium pay, competitive bases, and higher annual wage inflation to attract and maintain adequate staffing levels in 2022.

Leaders in the industry have announced initiatives to decrease labor pressure primarily by focusing on recruiting and retention to bounce back to pre-pandemic levels of employment. With a heightened focus on attracting and maintaining adequate levels of hired staff as opposed to contract labor, it appears the overall industry expectation for 2022 is that labor costs will likely decrease compared to 2021 although not to pre-pandemic levels.

The chart below shows the percentage change in employment across the healthcare sector from the Bureau of Labor Statistics Job Openings & Labor Turnover Survey from February 2020 to November 2021. This highlights the steady recovery toward pre-pandemic staffing levels for outpatient care and physician offices, the continued employment challenges in home health and hospital settings, and the notable struggle for community and nursing care facilities to return to a state of normalcy.



Robust M&A Activity

Deal activity within the healthcare sector was strong in 2021 with industry-specific multiples that reached or in many cases exceeded 2019 levels. Experiencing a noticeable rebound from 2020, volume and value of deals grew by substantial margins on a year-over-year basis. Deal volume in the health services industry rose by 56% while value rose 227% in the TTM 11/15/21 period. Long-term care led all sectors with the highest volume of deals, as seen historically, and continues to remain a hot spot in the transaction space. Similarly, physician medical groups and the rehabilitation sector experienced the largest growth transaction volumes year-over-year.

Physician medical groups have received vast interest in physician employment from private equity firms, new-age value-based care organizations, services arms of managed care giants (Optum, Neue Health), and health systems. This, coupled with independent physician group operating challenges from COVID-19 related volume impact and looming Centers for Medicare and Medicaid Services (CMS) cuts, is creating a robust transaction environment that is expected to continue during 2022. For the rehabilitation sector, strong demographic tailwind, along with the lifted CON moratorium in Florida and continued joint venture interest between health systems and strong rehabilitation operators (Select, Kindred, Encompass), has resulted in material deal volume in the space.

Hospitals and health systems were the only sector to see a decline in volume of deals, down 26% from the previous year. Despite the decline, the total transaction size of deals only dropped slightly year over year, indicating larger deal-size on a per-transaction basis. The acceleration of megadeals taking place, the shifted focus on scale, and the diversification of their business models all drove average total size per deal higher than seen before in 2021.

Highlighted Sectors M&A	***Volume***	***Value ($ Billions)***
Long-Term Care	445	$18.6
YoY Growth	*26%*	*132%*
Physician Medical Groups	407	$5.5
YoY Growth	*119%*	*55%*
Rehabilitation	81	$3.4
YoY Growth	*145%*	*408%*

Source: PwC "Health Services: Deals 2022 Outlook", LTM 11/15/2021

Price Transparency

Effective January 1, 2021, the Centers for Medicare and Medicaid Services (CMS) implemented a price transparency rule requiring hospitals in the United States to provide accessible pricing information to patients about the cost of the care they may receive. Hospitals must display negotiated rates for all items and services, in a machine-readable format, so that patients can compare prices before arriving at the hospital.

Though, in July 2021, a study was published by PatientsRightsAdvocate.org detailing that a vast majority of hospitals were not compliant with the new rule. At the release of the study, the penalty for non-compliant hospitals was $300 per hospital, per day. While many patients advocate for CMS to stiffen penalties for non-compliant hospitals, healthcare professionals argue against the rule, stating CMS did not provide enough clarity on what the rule should entail.

A vice president of a large U.S. health system discussed the ambiguities around the rule with Fierce Healthcare. "One interpretation is you simply publish your rate schedule – whatever your rate exhibits are in your contracts, publish that and that's compliant. Another one is to summarize these [CMS] packages [and] what your negotiated charges are."

For many health systems, the resources required to implement their rates in a machine-readable format far outweigh the penalty of remaining non-compliant. The VP stated that he believes many hospitals already provide their rates in a clear, understandable way, but the rule's lack of clarity and the requirement for a machine-readable format make compliance difficult and costly.

In November 2021, CMS released the 2022 Outpatient Prospective Payment System (OPPS)/Ambulatory Surgery Center (ASC) Payment System final rule (OPPS Final Rule). Within this rule, CMS increased penalties for hospitals that are not compliant with the price transparency rules and removed barriers for patients accessing online pricing information.

OPPS Final Rule	Amount in USD
Maximum Penalty for Full Year	$2,007,500
Minimum Penalty for Full Year	$109,500
Daily Penalty per bed *hospitals with beds counts greater than 30*	$10
Maximum Daily Penalty *hospitals with beds counts greater than 30*	$5,500
Maximum Daily Penalty *hospitals with beds counts less than 30*	$300

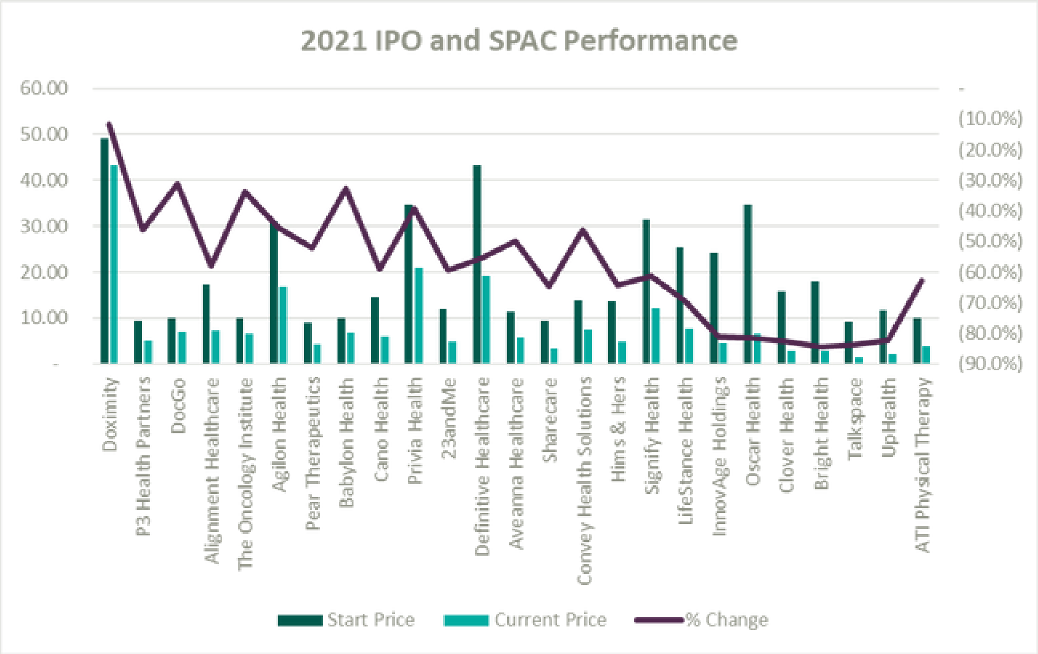
The new penalties, visible in the chart to the right, went into effect on January 1, 2022.

IPO and SPAC Stock Price Performance

A record number of health and health services companies went public during 2021 by way of SPAC or IPO. Rebecca Springer, a private equity analyst with PitchBook noted, "The multiples in public markets are very, very strong right now, so you can get, all else equal, a better return on your investment if you go public with your company rather than selling it to a strategic investor."

Unfortunately, while the stock market might be performing well, the recently public healthcare operators have not faired as well since their initial offerings. The Healthy Muse Health Tech Index ("HTI") generally underperformed the overall performance of the stock market, with the majority of the players finishing in red; the HTI declined 35% as opposed to the 27% gain for the S&P 500 during 2021. The public markets seemed like a perfect place for an exit strategy given the multiples observed in the public markets.

All recent entrants finished the year below the original IPO price and while the reasons for the price declines varied it is clear the public markets are less forgiving with valuations if an organization does not achieve expectations.



Conclusion

Overall, the healthcare sector experienced highs and lows during 2021 as it continued to navigate a post-COVID world. As pandemic pressures continue into 2022, healthcare institutions will have to keep a close eye on staffing costs and abide by new regulations. Despite these challenges, the appetite for M&A transactions and market participation in the sector remains strong. We look forward to a new year of challenges, wins, and continued changes in this interesting industry.

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This article was published by VMG Health's Valuation & Transaction Advisory Division

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