

Introduction:

My name is John Ransom. Thank you for the privilege of speaking today.

I am currently employed by Raymond James & Associates as the Director of Healthcare Research, a firm I joined in June 1996. Formerly, I spent 10 years at First Union National Bank, the last eight of which I spent financing health care companies, including many hospital and nursing home companies.

In my current position, I, along with two other analysts, provide research coverage on publicly held health care service companies for consumption by institutional and retail investors. As part of that effort, we provide research coverage on Beverly and Manor Care, the last two major publicly held nursing home concerns. I estimate that less than 5% of our effort and economics are derived from our efforts in the nursing home sector.

I have volunteered to testify today to give the financial community's perspective on the developments in the industry. I hope the committee will appreciate that I have very little financial stake in the current status of the industry, which, hopefully, will lend some credence to my commentary. I must also add that I am encouraged by the thought process evident in the Breaux-Thomas proposals that the legislative branch appreciates the seriousness of the issues and the need for reform.

Below, I have outlined a condensed "take" on the industry's evolution:

Background: Robust Growth in the Late 1980s to Early 1990s:

- During the late 1980s, hospital DRG price increases flattened dramatically, causing hospitals to become increasingly sophisticated with respect to DRG management. As hospitals shortened average Medicare lengths of stay (which have declined by over 50% since the advent of hospital inpatient PPS), a surge of Medicare enrollees needed care from the emerging "post-acute" care sector, which included SNF, rehab and home health providers.
- There were a number of entrepreneurial responses to the surge in demand for post-acute services. Both hospitals and independent operators rush to capitalize efforts to build out capacity. Integrated Health is the first company to public in April 1991, **the first of 41 IPOs in the 1990s.**
- These entrepreneurial long-term care companies expanded rapidly. The business model: acquire/develop SNFs and open "Medicare" or "sub-acute" units inside of traditional nursing homes. The result: \$70-100/day Medicaid patients were replaced with \$300-400/day Medicare patients. In addition, other companies established "non-facility" streams of revenue, also reimbursed by Medicare, most notably Pharmacy, Rehab and Home Health units. Another important consideration: SNF care was reputed to be 30-50% "cheaper" than comparable care in a hospital
- From 1991-1995, Medicare SNF payments care grew by more than 30% per annum. Medicare also implemented an exception system in the early 1990s, allowing additional payments for higher acuity patients. Liquidity of all kinds - debt, equity, subordinated debt and REIT financing - was ample. Public companies, especially Genesis Health Ventures, Integrated Health Services, Vencor, and Sun Health rose to prominence.
- Investors were heartened by robust revenue growth (both absolute and "same store"), plus the rising margins associated with the addition of therapy and pharmacy services. Medicare was viewed as a "low-risk" payer, as payments were rising rapidly on an absolute basis and were tied to costs incurred.

- Despite the explosion of Medicare revenues, Medicaid continued to serve as the main revenue contributor, funding over 60% of industry revenues.

The mid-to-late 1990s: A Period of Maturation and Consolidation:

In 1996 there were over 20 public nursing home chains. Investors became confused by many "me too" business models often obscured by complex financing. The stronger management teams began to acquire their public competitors. A sampling of transactions follows:

- In June 1997, Genesis Health purchased Multicare for \$1.4 billion (11x EBITDA).
- In November 1997, Extendicare purchased Arbor for \$450 million in October 1997 (11x EBITDA).
- In April 1998, Investcorp purchased Harborside (11x EBITDA) for \$291 million.
- In 1995-1997, Vencor purchased Hillhaven, TheraTx and Transitional Hospital for cumulative purchase price of over \$2 billion.
- From 1997-1998 Mariner Post Acute was created from the mergers of Grancare, Mariner and LCA, three former public companies.
- Integrated Health makes numerous purchases of rehab and home health companies. Larger transactions included the purchase of bankrupt ABC Home Health and RoTech.
- HCR purchased Manor Care in a pooling of interests transaction (i.e., an exchange of equity with no additional debt incurred).
- Against the grain, Beverly begins to shed assets, including its Texas nursing homes and its institutional pharmacy.

As a result, the public companies added over \$5 billion in transactional debt at high EBITDA multiples. Market caps peak at \$14 billion in March 1998, despite the gathering storm clouds:

- In the fall of 1997, Congress passed the Balanced Budget Act ("BBA"), intended to reduce Medicare spending on skilled nursing by \$19.8 billion over 5 years with a new prospective pay system.
- In the early days following the passage of PPS, industry managements believe that "PPS creates a profit opportunity thru efficiency," much like the hospital industry.
- Despite the gathering storm clouds, public market valuations peak on March 31, 1998 at approximately \$14 billion.

In the second half of 1998, fundamentals begin to weaken:

- Vencor is the first major nursing home company to experience an earnings shortfall, disappointing Wall Street with a disappointing forecast for the fourth quarter of 1997. It cites concerns that independent nursing homes won't sign long-term therapy contracts in light of PPS uncertainty.

- Beverly announces an extensive investigation into its Medicare billing practices in July 1998.
- Vencor, Sun Healthcare, Beverly, Genesis and NovaCare report 3Q98 EPS numbers indicating severe operating difficulties and weak revenue trends. Confusion about the impact of PPS is rampant, and equity valuations begin to collapse.

1999-Present: the Collapse of Public Valuations and the Spiral into Bankruptcy:

- Fears about Medicare spending are more than realized. The PPS cuts are currently estimated to reduce Medicare spending by almost \$40 billion vs. the original \$20 billion estimate. After a period of 30% growth, Medicare SNF spending grows in the mid-single digits in 1998 and drops by approximately 10% in 1999.
- Public company Medicare revenues/day peak in 2Q98 at approximately \$365/day and decline to approximately \$290/day by 4Q99, a 20% decrease. Public company market caps decline from a peak of \$14 billion in March 1998 to \$1.7 billion in May 2000.
- After the repeal of the Boren Amendment (effective for federal fiscal 1998-2000), Medicaid rate increases (average: < 3.0%) have lagged underlying estimated cost inflation (average: 4-7%).
- The underlying Medicare PPS updates were 1.8% in federal fiscal 1999 and 2.0% in federal fiscal 2000.
- A recent Standard & Poor's credit ratings survey showed marked deterioration from October 1998 to December 1999, with only 2/12 companies having debt rated better than "single B."
- Vencor is first public company to file for Chapter 11 bankruptcy. Filings by Sun, Integrated, Genesis and Mariner soon follow.
- In Florida, entrepreneurial attorneys begin filing claims that nursing homes are violating provisions of the Patient's Bill of Rights. The result: Florida has 10% of the country's nursing home beds but 40% of the liability claims, and 20% of all beds are operated out of bankruptcy. Liability costs are currently running at 8x the national average. A study is under way under the direction of the Lt. Governor.
- Labor shortages, a shortage of nurses (fewer women entering the profession) and a difficult work environment begin to accelerate labor cost trends, especially for nurses and administrators, the most expensive labor.
- Occupancy rates begin to decline, as Medicare lengths of stay are reduced, and competition for private pay patients increases from emerging assisted living companies.
- Banks and REITs write off hundreds of millions of loans, and capital flight is rampant.

Bottom Line - the combination of a 20% reduction in Medicare revenue/day, already low margins, a fixed cost structure, rising debt costs and rising operating costs = Chapter 11. In the interim, lenders and landlords will become the temporary owners of nursing home beds at a cost of a 40-70% reduction in their investment basis.

With 20/20 hindsight, how could one have survived this perfect storm?

- Low Historical Medicare Rates
- Low Leverage
- Low Exposure to Ancillary Revenue Streams
- High Private Pay

Only BEV and HCR managed to produce variations of this business model. Note that some of these tenets were in direct opposition to public company mandate to grow quickly and maximize short-term profits.

So Where are We Now?

- REITS and commercial banks have written off or taken reserves against billions in nursing home investments: Sun, Integrated, Vencor, Genesis, and Mariner account for the lion's share of the exposure.
- Approximately 13% of all industry nursing home beds are operating in bankruptcy.
- Beverly and HCR remain the only viable public companies. Market cap: less than \$2 billion vs. a state market value exceeding \$10 trillion.
- The industry persists in a state of shock and demoralization with extreme difficulty attracting labor and capital.

Where Should We Go? Some Unsolicited Recommendations from a Wall Street Dilettante:

If nothing changes, we will be faced with rising demand and shrinking capacity. Some suggestions:

- **SIMPLIFY PPS** (do we need 50+ reimbursement categories?), **UPDATE MEDICARE/MEDICAID RATES FOR COST INFLATION** and **INCREASE PAYMENTS FOR HIGHER ACUITY LEVELS**. Nursing homes are not hospitals (smaller/lower margins) and do not have the infrastructure to administer complex payment schemes. Without a workable post-acute network, patients will stay in hospitals "step-down" units at 2x the cost. Hint: some former Florida HMOs make do with 4-6 payment categories.
- **ADOPT TORT REFORM** but continue state oversight and continue to allow malpractice suits. Uncapped liability vs. vague Patient Bill of Rights standards will enrich the few but has no redeeming social return.
- **RESTORE THE BOREN AMENDMENT**. Allow nursing homes to argue for higher rates in court. With shrinking welfare roles, a glut of tobacco money and soaring tax receipts, we can afford it.
- **ELIMINATE THE 3 DAY HOSPITAL STAY REQUIREMENT** but ensure that the MDS confirms "RUGS" diagnosis. Reasons include (1) save \$ on the front end, and (2) patient proceeds immediately into a lower cost environment.

Bottom line, capital flight will continue until lenders and other potential investors perceive that the industry has stabilized and that increases in prospective Medicare/Medicaid reimbursement rates will cover increased operating and capital costs.