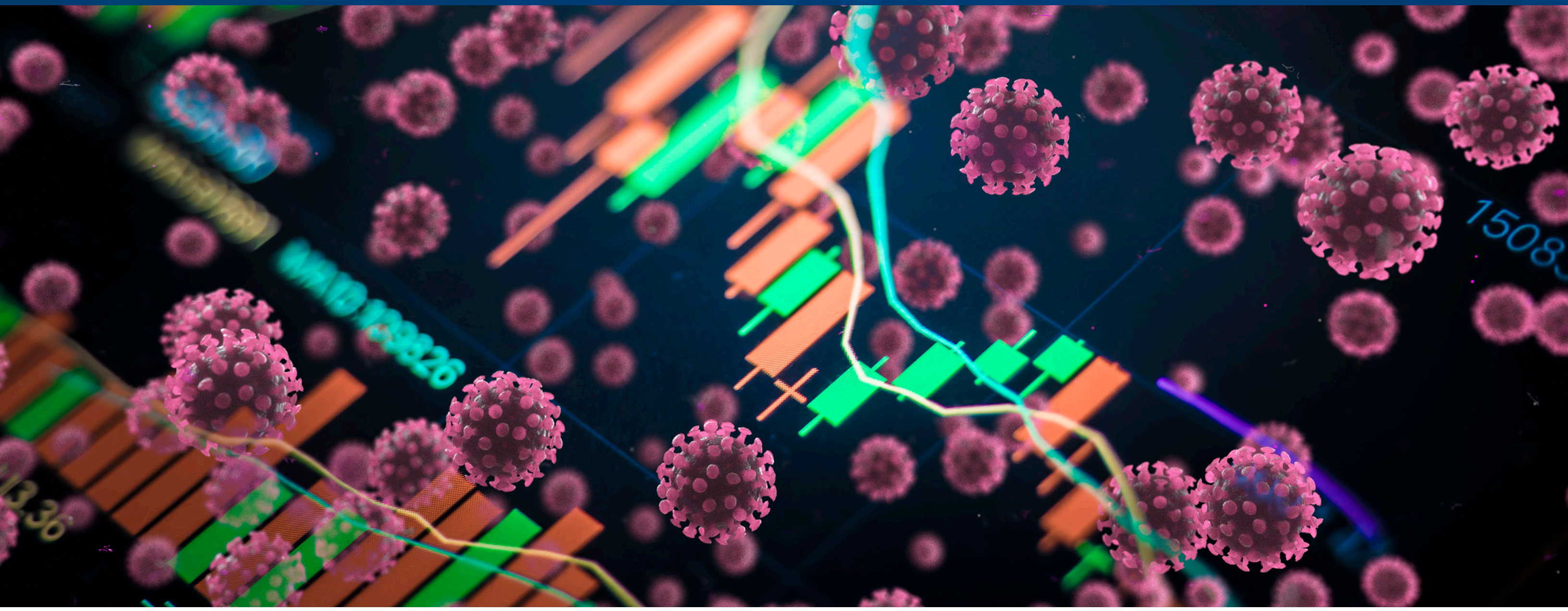
Commercial Bank



How Will Lenders Assess Healthcare's COVID-19 Financial Performance?

More than a year after an unprecedented government-mandated shutdown of non-emergency treatment, many lenders are evaluating the financial performance of their clients as part of regular reviews or for M&A financing. How will they approach this task given the unique circumstances?

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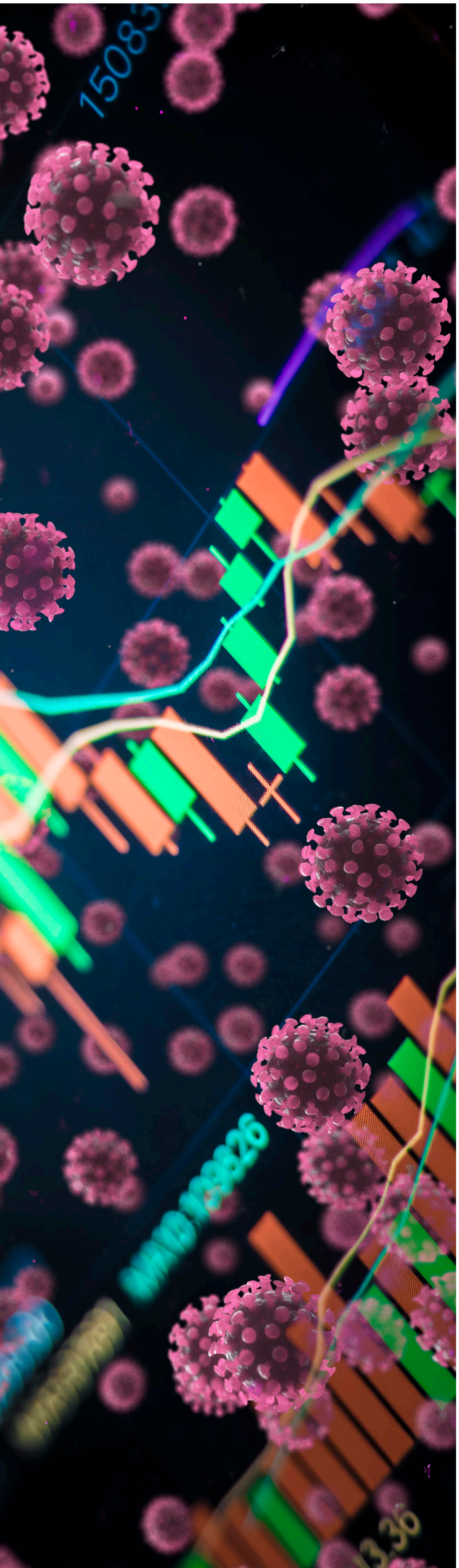
The past 18 months have been turbulent for healthcare, with the first three of those months particularly challenging. From March to mid-May 2020, medical and dental offices were closed to patients for non-emergency treatment as a result of COVID-19. Most practices had no revenue and limited or diminished collections during this period. The shutdown was a catastrophic event for cash flow-based businesses, and significantly impacted their financial performance. Uncertainty about the length of the shutdown resulted in understandable anxiety for clients, managers, investors and lenders.

As restrictions were lifted in May 2020 in some states, patients began receiving treatment and revenue began to flow once again. But for healthcare companies and their lenders, uncertainty continued. The collapse in earnings during the early part of the year left a void in companies' annual figures, creating considerable challenges for healthcare companies. Those with plans to grow organically or through acquisition, or put themselves up for sale face particular problems. Moreover, the impact continued for much of the remainder of 2020, as practices (and banks) worried about further shutdowns. There were also concerns about whether patients would delay treatment or simply skip it altogether.



At the same time, some healthcare businesses, notably urgent care and emergency medicine, enjoyed an increase in activity as a result of the pandemic. Nevertheless, these businesses also faced uncertainty — around how long COVID-19 testing (and subsequent vaccine) revenue could be sustained, and what implications this would have for their financial performance over the medium term. It remains unclear whether such firms will return to more regular patterns of financial performance or if the continued prevalence of the virus could create a "new normal."

Lenders' key questions

Lenders have taken a pragmatic view of the events of the past year. They have chosen to differentiate between the shutdown period and the subsequent re-opening. When evaluating financial performance, most lenders have focused on the following key questions:

1. Will the business return to being a viable concern (i.e., will patient activity resume at the same level as in the past)?
2. How quickly will the company return to its pre-COVID-19 performance?
3. Does the company have sufficient liquidity to cover its expenses during the recovery?

To answer these questions, lenders are deploying numerous strategies to attempt to normalize their assessment of healthcare companies. Their chief objective is to understand, through analytics, the potential impact of the disruption in 2020 on short-, medium- and long-term trends and consider the financial implications for healthcare businesses. The principal ways that they assess these impacts include:

- **Trailing 12 months:** As it is more than 12 months since the initial shutdown, this trend analysis tool is the one most commonly used by banks to assess post-COVID-19 performance. Most practices re-opened in May 2020, so May 2021 collections will facilitate a full 12-month analysis. The hope is that monthly collections (and production) over this period meet (or are close to) 2019 levels. In a high proportion of cases, this has proved to be the case.
- **Trailing six months:** In some cases, there was a delayed opening of practices (some as late as September 2020) as a result of illness, employees' reluctance to return to work and staffing problems relating to generous unemployment benefits. In such cases, banks are taking a flexible approach and performing trend analysis from when the practice re-opened.
- **Last quarter annualized:** This evaluates performance on a one quarter basis, and multiplies it by four in order to annualize it. While this method may be less reliable than other longer term methods, it can be a helpful proxy for how a company is integrating or performing over a short period of time (for example, under new ownership or management) and may be used when considering M&A opportunities. This measure should be used with discretion and considered alongside sellers' historical financials.

THE PANDEMIC HAS PUT THE SPOTLIGHT ON HIGH QUALITY FORECASTING TO A GREATER EXTENT THAN IN THE PAST. COMPANIES SHOULD DEVELOP PROJECTIONS TO SHARE WITH THEIR BANKS AND BE ABLE TO ARTICULATE THE DIRECTION OF THE BUSINESS IN ORDER TO FACILITATE DISCUSSIONS ABOUT CREDIT.

- **Earnings Before Income, Taxes, Depreciation, Amortization & COVID Adjustment:** While not a GAAP-recognized accounting statement, lenders are adjusting clients' financials to take into account COVID-19 in an attempt to normalize EBITDA. There are a number of methods to achieve this objective. For instance, the performance of March, April and May 2020 can be replaced with the same period in 2019 to help banks assess the year as a whole. In other cases, more sophisticated adjustments relating to the shutdown have been used (and accepted by banks). The goal of this trend analysis is to assess future capacity to cover expenses.

Information is critical

To perform all of the above analyses satisfactorily, it is important to consider the following:

- Without high quality internal and/or CPA prepared financials, the above analyses cannot be executed. If healthcare firms cannot produce high quality month-over-month financials, trend analysis is impossible. In such circumstances, banks are likely to be less flexible and potentially unwilling to support a company's current and future needs.
- The pandemic has put the spotlight on high quality forecasting to a greater extent than in the past. Companies should develop projections to share with their banks and be able to articulate the direction of the business in order to facilitate discussions about credit.
- Having a clear understanding of operating costs, particularly around administrative or non-clinical staffing, has become more important. Finding staff, particularly for administrative roles, is expected to continue to be challenging. Being able to understand whether the company has adequate staffing to serve its current patient base and scale is also important.
- Adjustments and analysis can go both ways. In some parts of the healthcare industry, such as urgent care or emergency medicine (and especially among companies that perform testing and administer vaccines), COVID-19 had a hugely positive impact on company financials. This has resulted in a temporary spike in collections, which may not be sustained. Similarly, in some cases operating expenses fell sharply during the shutdown due to fewer employees on payroll, rent abatements and other allowances: this could create a falsely inflated EBITDA margin. Furthermore, many companies have benefited from Coronavirus Aid, Relief, and Economic Security (CARES) Act funding, Paycheck Protection Program loans, Department of Health and Human Services grants, and advances from the Centers for Medicare & Medicaid Services, which have potentially increased EBITDA.
- No trend analysis methods are perfect and they are not the only tool banks use; they help provide certain data points that lenders use to establish evaluate a company's strategy and outlook. Strong management remains one of the most important factors considered by lenders when making decisions.
- Communication is critical. Clients that have been proactive and open with their lenders during the crisis and afterwards have found it easier to reach agreement with their banks. Banks want to work with their clients and support their strategy. More open communication improves companies' relationships with their banks and can lead to enhanced support and better performance and results.

Conclusion

The past 18 months have been challenging for healthcare providers and the sector is eager to focus on FY2021. However, despite companies' desire to move on, lenders and banks will continue to assess and evaluate 2020, including the shutdown period, given its importance in determining the future financial trajectory of companies.

Accommodating lenders' needs through the provision of data, including high quality financial statements, is advantageous to healthcare businesses. A commitment to clear and candid communication should be at the heart of all engagement with lenders so that they can understand companies' performance and evaluate credit risk, which will determine their subsequent willingness to continue — or increase — lending capacity.

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