Investing in Health Care – A Story of Political Clout, Successful Niches, and Recurring Cycles

By: Scott Becker, Amber Walsh and Krist Werling

The U.S. health care industry is an estimated $1.8 trillion industry and accounts for more than $1 of every $7 spent in the nation's economy. Investment in health care companies can be a very good bet over the long term for a number of reasons, particularly in certain sectors within healthcare. Investment in certain healthcare sections is much riskier.

Certain niches, such as the hospitals and dialysis industry are characterized by lower price to earning ratios, and moderate growth prospects but greater stability and higher market capitalizations. Other sectors have slightly higher growth rates such as long term care and ambulatory surgery centers but lower size and stability. Finally a few areas, such as large device companies and large specialty pharmaceuticals, at least for the time being, enjoy each high growth and high capitalization. This article provides a brief overview of investment background in several different sectors within health care.

1. Hospitals. There are currently approximately 5,100 acute care hospitals in the United States. The hospital industry has maintained terrific political power through organizations like the Federation of American Hospitals and the American Hospital Association. This has meant over the long term that investments in the right hospital ownership and management companies have been very good long-term investments.[1] Due to political clout, hospitals tend to be able to rebound well from tougher reimbursement cycles. For example, after each downward cycle where Medicare reimbursements decrease, hospitals seem to be able to recover the decrease and more in the following cycle. This can be contrasted with other sectors in which reimbursement has decreased without significant recovery. The hospital industry has also used its clout to discourage competition from new market entrants on federal, state and local levels.

Hospital reimbursement took a significant decrease in the late 1990's. This has been followed by several years of substantial increases which has encouraged significant growth in the hospital industry. It led to several newly formed hospital chains. Newer entrants include Ardent Health Services funded by Welsh Carson, privately funded Essent Healthcare and Iasis Healthcare funded by Texas Pacific Group.

Many for-profit hospital companies seek to operate facilities in "single hospital" towns or markets with limited competition. This strategy can lead to a franchise-like position with some level of "pricing protection" and very strong continued income streams to these companies. Success often also requires a focus on several specific profitable service lines. The hospital investment market remains a relatively stable longer term investment opportunity. This also lends strength to ancillary service providers such as billing companies, reference labs and other outsourcing providers that serve hospitals.

[1] While hospitals have performed substantial well from a reimbursement perspective, certain companies have found themselves in significant regulatory trouble.

Certain factors which impact the profitability of hospitals and hospital companies include the number of in patient admissions, the patient lengths of stay, the payor and case mix, the percentage of uninsured patient, the reimbursement in the local market and the extent to which pharmaceutical and lab services are handled in house or out sourced.

Top For Profit Hospitals Companies by Market Cap As of April, 2007

Company	**Symbol**	**Price**	**Market Cap**	**P/E**
Triad Hospitals Inc.	TRI	52.45	4.63B	20.56
Community Health Systems, Inc.	CYH	35.55	3.34B	20.31
Tenet Healthcare Corp.	THC	6.73	3.17B	N/A
Universal Health Services, Inc.	UHS	57.96	3.12B	12.70
Health Management Associates, Inc.	HMA	11.00	2.66B	14.65
Lifepoint Hospitals, Inc.	LPNT	38.73	2.22B	14.91

2. Medical Device Companies. Medical device companies most often do not sell directly to patients but instead sell through providers that recommend devices to patients. This creates a high level of reliance on physician loyalty and hospital preference. For example, orthopedic implant companies currently are achieving significant success based largely on the success of the hospitals and surgery centers that use their products and the aging baby boomers that demand it.

There are two forms of reimbursement risk ahead for medical device companies. First is risk in the form of garnishing and other hospital cost cutting programs that aim to standardize products. These programs tend to take device selection out of the hands of physicians who were loyal to certain manufacturers. Companies need to ensure that their sales forces are prepared to address these new challenges. The second risk comes in the form of new biotech and nanotechnology solutions that threaten to change certain implant markets. These threats impact the full range of implants from cardiac stents to orthopedic implants which may be replaced in part by new innovations that seek to make implants less invasive and more successful for patients.

Leading medical device makers include companies such as Becton Dickinson and Co., Boston Scientific Corp, Johnson and Johnson, Stryker and Zimmer. These companies are often affected by such items as domestic and international regulatory delays in bringing products to markets, periodic recalls and class action lawsuits, pricing pressure and increased regulatory and government concern regarding relationships with physicians. Companies such as Stryker, Smith and Nephew and Zimmer Holdings rely heavily on knee implants and hip replacement products. The global market for orthopedic treatments is estimated at 21 Billion Dollars a year. The global market for medical devices is estimated at $50 Billion Dollars a year (as reported in Wall Street Journal on April 10, 2007, comment by Milton HSU).

Certain of the public market data as to a few of these companies are as follows as of April 2007:

	Stryker	**Smith and Nephew**	**Zimmer Holdings**
Market Cap:	27.89B	11.89B	20.88B
Employees:	18,806	N/A	6,900
Qtrly Rev Growth (yoy)	14.40%	15.10%	10.10%
Revenue (ttm)	5.41B	2.78B	3.50B
Gross Margin (ttm)	65.80%	21.05%	77.68%
EBITDA (ttm)	1.46B	737.00M	1.43B
Oper Margins (ttm)	20.85%	20.04%	33.51%
Net Income (ttm)	777.70M	394.00M	834.50M
P/E (ttm)	36.15	15.96	25.89

3. Pharmaceutical Distribution Companies, Prescription Benefit Management Companies and Other Intermediaries in the Pharmaceutical and Biotech Sector. The intermediary companies in the pharmaceutical sector, whether resellers or administrators of prescription benefits, remain in an outstanding market position and have remained in such for a long time. These companies are often able to find specific niches within the pharmaceutical industry that allow them to profit through price arbitrage or access to patients without the heavy investments in research and development required of proprietary pharmaceutical and biotech companies. Historically, these intermediaries have thrived in areas where services are provided to high-cost or chronic end-user patients. These niches include hemophilia, fertility drugs, cancer and other types of high-dollar value prescriptions.

In addition to distribution chain companies, pharmaceutical administrators such as prescription benefit management firms have a history of high profits. Traditional market leaders in the PBM space have included Medco, Caremark and Express Scripts. Recent scrutiny into the profits made by these companies has led to increased regulatory scrutiny and a push for transparency in the PBM market. Certain states have passed legislation requiring increased transparency from PBMs related to pricing disclosures and disclosures to patients of product switching and substitution arrangements. While these areas remain under fire from a regulatory perspective, for the most part they do not experience the same scrutiny as pharmaceutical manufacturers and health care providers and this provides a certain amount of comfort and flexibility in terms of continued revenue streams.

The specialty pharmaceutical distribution business is undergoing certain rapid changes. These include the consolidation and vertical integration of the PPM companies with distribution companies, for example, Caremark with CVS and Accredo into Merck-Medco, the continued growth in prescription drugs provided with physician office, the continued dominance of oncology related spending as a portion of specialty pharm, the increased efforts by distribution companies to attempt to be more heavily involved in the care coordination business, the effort by large managed care companies to narrow the number of specialty pharma allowed to serve their beneficiaries. Overall, a great deal of the specialty pharm business remains centered around hemophilia, oncology, fertility, HIV, hepatitis and multiple sclerosis. For example, 200,000 people in the United State suffer from hemophilia and treatments can cost $125,000 per patient or more per year.

The global pharmaceutical business has been estimated as greater than 320 Billion Dollars per year. Many of the specialty pharma distribution companies can avoid the risks that large pharmaceutical companies face. For example, they do not need to spend on research and development, they do not need to be over reliant on one to two blockbuster drugs and they do not face the same litigation risks as the pharmaceutical companies.

4. Ambulatory Surgical Centers. There are currently 4 publicly traded ambulatory surgical center companies. Most ambulatory surgical center companies earn a predominant percentage of their income from commercial pay patients. Depending on that specialty, some centers also serve a large portion of Medicare beneficiaries. For example, centers that provide high levels of gastrointestinal and ophthalmology services tend to cater to an older demographic and thus have higher exposure to Medicare reimbursement than orthopedic and ENT services.

After receiving approval to bill Medicare in the early 1980's, ambulatory surgical centers, have enjoyed reasonably stable reimbursement from Medicare for the last 25 years. However, the ambulatory surgical center market now faces significant changes in the structure of Medicare reimbursement. This change was brought in part by the fact that there are now approximately 4,800 Medicare certified surgery centers and as their popularity grew their visibility as a significant cost to the Medicare program increased. This has led to Medicare proposing substantial reductions and

reimbursement for three of the key services offered by surgery centers: cataracts, endoscopy for gastrointestinal patients and pain management services. Thus, for those centers reliant on Medicare business, this is a shift in the wrong direction in terms of revenues and net income. In contrast, for centers that principally derive their income from commercial patients, such as orthopedic driven centers, spine driven centers and several other types of centers, the Medicare reimbursement changes should be of negligible to positive impact. The bigger challenge for these centers relates to changes in reimbursement in different states that are reducing workers compensation payments and commercial payors taking a more aggressive approach towards surgery centers that bill for services on an out-of-network basis.

While the prognosis for surgery centers and surgery center companies over the long run is fine, the ASC industry does not have the clout that the hospital industry has historically had. Despite the fact that surgery centers are still typically viewed as a lower-cost provider, this lack of political power (albeit group power) creates a larger amount of uncertainty as to continued strong reimbursement.

An examination of the financial status of the four publicly traded ASC companies provides an interesting overview picture of the industry. Of the four companies, two have traditionally had very distinct strategies. United Surgical Partners (USPI) on joint ventures involving both physicians and hospitals. AMSURG has traditionally focused on surgery centers built around a single specialty such as gastroenterology or ophthalmology. By contrast, two other companies do not tend to have quite as distinct a strategy. NovaMed was originally developed as an ophthalmology practice management company and has done a wonderful transformation to a facility driven ASC company. While a number of its original ASCs were built around ophthalmology, it tends to be focused on a multi-specialty model today with most of its centers not having a hospital partner. Symbion primarily owns and operates multi-specialty centers. However, it has shown a tendency recently to invest both in surgery centers with hospital partners and to acquire short stay surgical hospitals.

The financial results of the companies are driven to a great extent by the model that each of these companies has pursued. Currently, for example, AMSURG has profit margins which tend to be among the best in the industry (i.e., 35% operating margins). This is generally driven by the single or limited specialty focus of its centers. This likely allows it to enjoy better staffing radios and better equipment and planning costs. In contrast, the Wall Street view of the USPI model and of NovaMed's growth prospects appear to be very high. Each one is trading at very price earnings ratios: as of early April, 2007, USPI at 40 and NovaMed at 28. The USPI ratio is partially driven by its current deal to be bought out by Welsh Carson. With that stated, its strategy has been widely praised by the industry and it is viewed as propelling significant growth. Its strategy is also thought to bring stability to its pricing.

A few statistics from these four companies as of early April, 2007 are set forth as follows:

	NovaMed	**AMSURG**	**SYMBION**	**USPI**
Market Cap	157.08M	735.70M	424.95M	1.38B
Qtrly Rev Growth (yoy)	37.50%	16.60%	11.40%	34.20%
Revenue (ttm)	108.43M	464.59M	301.53M	578.83M
EBITDA (ttm)	28.81M	187.54M	81.73M	206.33M
Oper Margins (ttm)	21.96%	35.12%	20.69%	22.03%
Net Income (ttm)	5.70M	38.11M	19.35M	40.08M
P/E (ttm)	28.05	19.73	22.67	40.92

5. Specialty Hospitals. There are between 150 to 200 specialty hospitals in the United States, many in various stages of development. These specialty hospitals are often physician-owned and often concentrate on surgical procedures. Surgical hospitals often focus on orthopedic surgery, general surgery, and a few other types of surgery. In addition to surgical hospitals, there is a subset of the specialty hospital market that focuses on cardiovascular services, and there is a growing trend toward specialization in other nonsurgical areas such as special cancer treatment hospitals, children's specialty hospitals and renal hospitals.

Specialty hospitals, if built to the right size, staffed appropriately and focused on the right procedures, can be very profitable. From a Medicare/Medicaid reimbursement standpoint, procedures performed at a specialty hospital are reimbursed at the rate at which hospitals are reimbursed for the same procedures (thus for outpatient surgery, specialty hospitals generally receive higher reimbursement overall for Medicare/Medicaid procedures than ASCs). From a political perspective, physician-owned hospitals do not enjoy anywhere near the clout that general hospitals or even ASCs enjoy. In fact, they have become one of the targets over the last few years of certain sectors of the Washington D.C. establishment and of the American Hospital Association. For much of 2004 through 2006, they were subject to successive moratoria, first on referrals by physician owners for Medicare/Medicaid cases and subsequently on the receipt of Medicare/Medicaid provider numbers. This three year period of prohibitions prevented growth in the industry while policymakers debated whether physician ownership of specialty hospitals were appropriate and beneficial to patients, and the debate on Capitol Hill may continue. Additionally, specialty hospitals are regularly subject to state-imposed moratoria's and reviews and rely on a specific exemption to the Stark law for their existence as physician-owned entities. In addition to these policy debates, specialty hospitals must be built appropriately to be profitable. If built too big with an unnecessarily large infrastructure, they may not be able to achieve revenues necessary to overcome the high costs, particularly given the generally small number of physicians and specialties that they serve.

It is possible that specialty hospitals will continue to grow and proliferate; however, the outlook remains somewhat murky. In states in which physician ownership continues to be legally permissible, and for so long as Capitol Hill supports their expansion, they can, if built and planned correctly, be very profitable.

6. Dialysis Facilities. The U.S. dialysis industry includes more than 4,000 outpatient dialysis facilities (in addition to a large number of home dialysis training programs) and the business remains a very stable cash flow enterprise. The dialysis industry is currently highly concentrated, with the largest four companies controlling 70% of all facilities in the nation. These large companies include DaVita and Fresenius Medical Care, both publicly traded companies, and DSI Renal and Renal Advantage, both relatively new companies backed by private equity funding of Centre Partners and Welsh Carson respectively; however there are still a number of medium sized dialysis chains and some independent regional companies. There are more than 300,000 patients nationwide as of this time, and the growth in the patient population is expected to be a steady 4 to 5% over the next few years.

ESRD patients are recognized as the only patients to receive Medicare/Medicaid coverage regardless of age or need. Thus dialysis businesses are almost entirely dependant upon Medicare reimbursement, with typically 80 to 85% of a facility's reimbursement coming from Medicare, which reimburses at a per treatment rate that varies among facilities based primarily on the facilities'

location, which is known as the “composite rate”. However, the small number of non-Medicare/ Medicaid patients can provide a very important additional income stream to dialysis facilities, and the ability to enter into good commercial payor contracts can be a key determinant of a company’s success. An average treatment generates net revenues of $250 to $350 per treatment. Each patient generally needs 3 treatments each week. In addition, dialysis companies bill for and receive good reimbursement for certain pharmaceuticals that are critical to a dialysis patient’s care, some of which are included in a flat pharmaceutical rate and some of which are billed based on dosage. The most noteworthy of the per dosage drugs are anemia management drugs such as Amgen’s Epogen and other erythropoieten-based drugs. Despite the industry’s anticipation of potential reduced usage of Epogen and other ESAs following a new FDA “black box” warning on risks of overusage (and the resulting reduction in overall revenues for pharmaceuticals), the pharmaceutical revenues of a dialysis company remains an important component. The rates from Medicare have remained fairly steady for 20 years. While the industry would argue for a greater amount of inflation in the rates, this has remained a very profitable cash flow business that does not attract as much negative political attention as other niches.

The large national companies, some of which are affiliated with equipment and supply manufacturers, enjoy much greater economies of scale in buying both the pharmaceuticals and the machines and supplies needed to equip and operate a dialysis facility. The typical facility is relatively inexpensive to build, and as long as the company is able to keep costs down with good vendor contracts and appropriate staffing, dialysis companies in most parts of the company have a very good chance for success.

Below are a few statistics from the two publicly traded dialysis companies, as of April 2007, which provide some interesting perspectives on industry growth.

	DAVITA	**FRESENIUS**
Market Cap	5.87B	4.92B
Qtrly Rev Growth (yoy):	12.30%	31.60%
Revenue (ttm):	4.88B	8.50B
EBITDA (ttm)	936.98M	1.59B
Oper Margins (ttm)	15.11%	15.07%
Net Income (ttm)	289.33M	536.75M
P/E (ttm)	20.44	9.19

7. Home Health Agencies and Home Infusion Companies. While home health agencies and home infusion companies both provide health services to patients in their homes, each is characterized by different reimbursement schemes and payment risks. The number of home health agencies in the United States was more than cut in half in the late 1990’s after Medicare introduced the prospective payment system for home health services. This replaced expensive and fraud-laden cost-based reimbursement with a single payment based on a 60-day episode of care. After initial industry shock and contradiction, it is clear that home health agency chains have recently gotten comfortable with the income stream and can control supply and staffing cost to make reasonable profit off the episodic payment. However, the approximately 8,000 home health agencies remain heavily dependent on Medicare reimbursement and to a lesser extent commercial reimbursement. Similar to nursing homes, it is an industry that does not enjoy the political clout that hospitals and hospital associations enjoy. Thus, periodically, this is an area that also takes a large financial hit and

then can take a long time to recover based on the lack of political clout in Washington.

The leader of the home health companies has been impacted by 2005 and 2006 reductions in Medicare payments, payments for oxygen and oxygen equipment, and reduction for inhalation therapy, and drug reduced reimbursement fees and dispending fees. The companies tend to focus on areas of care such as home respiratory therapy, home infusion therapy and home medical equipment. The stock of Apria Healthcare was downgraded, for example, by UBS in March of 2007 based on potential Medicare cuts. UBS also viewed as a concern the ability of smaller operations to under price Apria simply to survive.

The table below provides information, as of April 2007, on the key publicly traded home health companies, Apria, American Home Patient and Lincore.

	APRIA	**AHP**	**LINCORE**
Market Cap	1.45B	47.62M	3.33B
Qtrly Rev Growth (yoy):	8.70%	0.90%	12.90%
Revenue (ttm):	1.52B	328.08M	1.41B
EBITDA (ttm)	292.11M	48.99M	469.23M
Oper Margins (ttm)	9.73%	2.90%	24.61%
Net Income (ttm)	74.98M	-2.59M	212.98M
P/E (ttm)	19.16	N/A	17.61

8. Skilled Nursing Facilities. The skilled nursing facility industry has historically cycled through some fairly profitable to not so profitable times every few years. These companies have many of the problems of general hospitals and health systems but little of the political clout that hospitals and health systems enjoy. Skilled nursing homes and related facilities rely much more heavily on state funding and Medicaid than Medicare reimbursement. They are reimbursed by Medicare through 54 categories of “resource utilization groups” (or RUGs), which is similar to the Diagnostic Relating Group (DRG) reimbursement model for hospitals. Because they do not enjoy a strong political position, there are long periods of time during which they don’t retain the necessary reimbursement and are not able to increase the patient population that they serve well enough to remain profitable. Thus in this area there are long periods of times during which reimbursement is so bad that they cannot remain viable and they have little power to change it – they often simply cannot bear the bad times while waiting for the good times in reimbursement to return. In one recent example of this trend, although the categories of reimbursable RUGs were expanded in 2006 and/or excepted from the outpatient therapy cap on reimbursement in the Deficit Reduction Act, in 2006 the industry was hit with the elimination of what was previously a 20% payment addition for higher acuity Medicare/ Medicaid patients.

Overall, Medicare pays 2 to 3 times what Medicaid generally pays nursing facilities. There are overall about 16,000 nursing homes in the country with approximately half owned by chains. Skilled nursing facilities also suffer from the fact that the economics of operating a nursing homes differ dramatically from state to state. In states where Medicaid reimbursement is strong, they can have much better results than in other states. Hence, the industry routinely cycles through some very lean years that may vary in particular on a state-by-state basis. Nevertheless, the industry may be on the upswing at the current time, with many companies beginning to recover in 2002 to 2005 from the deep financial problems of the last decade, due in large part to a stabilization of reimbursement for the time being. The industry will continue to watch reimbursement trends on a state-by-state basis.

Certain of the factors that impact the profitability of nursing homes and assisted living companies include the outlook for Medicare reimbursement which has improved slightly, the Medicare to Medicaid move of patients, the focus on facility based services as opposed to ancillaries, the ownership or non ownership of real estate assets, the ownership and profitability of related businesses such as hospice care and shorter stay rehab and sub acute care, and the daily census. For example, as long term care patients become less profitable nursing home operators have fully geared up efforts to serve short term better paying patients. At Manor Care, for example, half of all of its patients are now discharged within 30 days.
Direct Competitor Comparison - As of April 2007

	HCR	**KND**	**SUNH**	**Industry**
Market Cap:	4.06B	1.36B	538.66M	632.42M
Employees:	59,500	40,800	19,350	22.37K
Qtrly Rev Growth (yoy)	8.10%	13.50%	29.80%	8.80%
Revenue (ttm)	3.61B	4.27B	1.05B	542.86M
Gross Margin (ttm)	17.94%	22.06%	37.34%	25.22%
EBITDA (ttm)	481.77M	239.43M	53.79M	53.79M
Oper Margins (ttm)	8.36%	2.75%	3.35%	4.47%
Net Income	169.56M	71.24M	14.69M	19.73M
P/E (ttm)	26.10	17.65	14.72	23.64

KND = Kindred Healthcare Inc.
SUNH – Sun Healthcare Group, Inc.
Industry – Long Term Care Facilities

9. Health Information Technology. Health information technology is a business that goes through broad waves of rapid consolidation and buying and selling. If a company can develop a big enough market position and develop a product that becomes widely adopted such that it can provide service and improvements to the product over time, this can be a very profitable niche. One potential challenge for health information technology companies is that it is often costly and burdensome for large health care companies to implement new technology and they can be loathe to do so unless a very real need is clearly identified and the product can be implemented and maintained in a cost-effective, efficient manner. Another challenge is the often high cost associated with developing and marketing the technologies, securing intellectual property rights and other start-up costs for the company. Additionally, provider clients are becoming increasingly concerned with the use of information technology and its role in compliance with HIPAA standards for the privacy and security of patient health information, and an information technology companies must be able to address these concerns.
The development and wide spread implementation of health information technology has become a stated mission of certain sectors of the federal government and a change in political power in Washington is not expected to divert these efforts. In 2005, the American Health Information Community (AHIC) was chartered as a federal advisory body to make recommendations to the Secretary of the U.S. Department of Health and Human Services on how to accelerate the development and adoption of health information technology and although the AHIC is still a fledgling body, its support and funding of information technology efforts could provide additional stability for the industry. If a company can get over the challenges and develop a cost effective

product that adequately addresses the usability and legal issues, the company has potentially explosive opportunities.

The health information technology business include a handful of companies that are trading at high price to earnings ratio based in part on growth expectations as noted in the chart below. There is tremendous competition between traditional information tech companies attempting to develop a market share in the healthcare sector and companies that have really built their focus around healthcare. Here, certain analysts have asserted that it is not easy to turn the health IT area into a commodity area. Thus, companies like McKesson, Cerner and others tend to enjoy some protection in these areas. Smaller healthcare oriented companies generally need to be focused on a specific niche and need to be able to obtain some level of critical mass to have a chance at success.

	CERN	**ECLP**	**MCK**	**Industry**
Market Cap:	4.48B	1.01B	17.40B	95.15M
Employees	7,419	N/A	26,400	105
Qtrly Rev Growth (yoy)	16.90%	10.30%	3.90%	15.80%
Revenue (ttm)	1.38B	427.16M	92.67B	38.81M
Gross Margin (ttm)	78.89%	41.63%	4.55%	65.69%
EBITDA (ttm)	310.44M	61.65M	1.50B	1.67M
Oper Margins (ttm)	12.06%	2.68%	1.33%	-1.89%
Net Income (ttm)	109.89M	2.13M	926.00M	-526.00K
P/E (ttm)	42.25	484.50	20.75	40.87