Poison Pen: The ACA Executive Order

Summary

So much for a slow and smooth transition: immediately upon taking office, President Trump signed an executive order directing his administration to ease the burden of the ACA, including empowering it to take steps to write new regulations under legislative authority granted by Congress and to ease off the enforcement of the mandates, taxes and other regulations implemented to carry out the ACA. While pundits suggest that the order is mostly symbolic, we disagree.We see risk to real 2017 exchange enrollment if the mandate is not enforced and the potential for a roll-back of bundling and other risk-sharing, outcome-improving regulations. We further expect the administration to halt the appeal of the out-of-pocket subsidy case, essentially making coverage unaffordable for millions.We do not underestimate this President and believe that our negative view of hospital stocks remains warranted.

Key Points

We expect the new HHS Secretary, once confirmed and sworn in, to immediately take steps to, at the very least:1) halt the enforcement of the mandatory nature of bundling (a slight positive for SNFs, a slight negative for home health) while potentially considering introducing revised regulations; 2) combined with the IRS, halt the enforcement of the mandates which, while too late for 2017 open enrollment, likely causes plans to seriously reconsider bidding on 2018 exchange business; 3) Perhaps make Medicaid waivers easier to get, especially if coverage is a little thin or put employment or copay mandates on individuals, given that the Executive Order alludes to granting states more flexibility; 4) stop the appeal of the court decision that the Obama administration improperly disbursed funds for out-of-pocket subsidies for low-income exchange participants. As the ACA was rife with instances of 'the Secretary shall ....,' (maybe about 2000 of them), there are a veritable host of other regulations that could be affected by this Order. For example, LTACH admit criteria that shifted from a 25-day length of stay was enacted with the ACA; so was home health rebasing. The full text of the Executive Order is available here.

While Congress mandated HHS to come up with those rules, the specific regulations were developed by the Obama CMS; the Trump CMS could halt enforcement and/or delay implementation and issue an interim rule followed by a new proposed rule and rule-making process. Until there is a new Secretary we probably won't know what stays and what goes, but we think it is prudent to assume that if Tom Price is confirmed, he will likely want to do many of the things he proposed in his May 2015 repeal/replace (hardly) legislation. The Kaiser Family Foundation has a nice graphic available here that outlines his bill in English. It eviscerates virtually every program, takes especial aim at value-based initiatives and would replace subsidies with a $900 per person/$3,000 per family tax credit to buy insurance. That's hardly sufficient to buy more than three months' worth. His high risk pools would have been funded at $1B per year of Federal money. That too seems hardly sufficient (she said with restraint). We strongly suggest that investors become familiar with this bill as it could well become the road map for the administration's repeal/replace efforts and its execution of the Executive Order.

If we are right about the exchange issue, i.e., that those who signed up purely because of the mandate (we don't know how many lives that represents) stop paying their premiums, then adverse selection in the exchange pool likely increases and hospitals are at least somewhat more at risk for uncompensated care, a negative cash flow event. Ditto if out-of-pocket subsidy payments cease to be made. And that would happen in 2017. We think that this Order throws 2018 exchange bids into chaos. So we have to wonder

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why the hospital companies and investors who have pushed the stocks back up to pre-election levels would be so enthusiastic? Indeed, the tone of our recent conversations, especially among long-only investors, has become notably more negative: how, they ask, can hospitals go up from here? What is the positive catalyst? Those were the questions last week....before Trump signed the first death warrant for the ACA. Our answer then was to call attention to our volume work (11/21/17 report, page 21, Exhibit 5) which shows a long-term decline in industry discharges, even through reform's boom years. Even without the poisonous politics we'd be negative on the sector's outlook. But with this first move, we are even more convinced that we must even more strongly warn investors of the risks associated with the fundamentals of the industry (volume drives performance, in our experience) and the highly uncertain, but almost certainly not positive, politics of health care. The best case was the status quo. The worst case is yet to come. We reiterate our ratings and negative/cautious view on our acute care hospital coverage as well as our post-acute companies. As UNH essentially exited the exchange business and as we remain convinced that private sector payer population health and value-based initiatives are likely to accelerate and benefit both segments of its business, we reiterate our Buy rating and $178 PT.

Price Target Calculation and Key Risks

Amedisys, Inc. (AMED)

Our $33 one-year PT is based on a PEG of 0.5x on 34% projected EPS growth from ’16E to ‘17E and an 8.1x EV/EBITDA multiple on 2017E.

Risks to our target include: repeal/replacement of the ACA and bundling, execution, reimbursement, investigation (an active hospice investigation is ongoing in New England and West Virginia and AMED currently operates under a corporate integrity agreement) and legislative risk, among others.

Community Health Systems, Inc. (CYH)

Our valuation of $3 is based on 6.7x our 2016E EV/EBITDA and 7.5x our 2017E EBITDA on a guidance basis, including the assumed $1.2B in sale proceeds as cash. We now expect FCF to be negative in 2016, along with further margin compression in 2016 and 2017, which argues for a below peer multiple in our view. However, the high degree of leverage prevents the multiple from going much below 6.5x. These reflect likely volume and mix pressures, coupled with high leverage as well as the remaining CVR risk.

Risks to our rating and price target include, but are not limited to, better than expected asset sale results or the involvement of an activist investor, or the acquisition of shares by deep value investors. Factors weighing on valuation include, but are not limited to, relief of the following: pricing pressure from government and private payers, continued soft volume growth, additional labor cost pressures, further deterioration of bad debt, integration of HMA and turnaround of HMA, physician losses, competition for acquisitions, the pending spin-off and a highly levered balance sheet. However, CYH may be more successful at cost cutting and growing volume than we think and that could cause upside surprise to be reflected in the stock price. CYH has not yet finalized the value of the CVR, which could result in unexpectedly higher settlement and/or legal costs above the reserve level. ACA repeal risk, along with the risks associated with Medicaid block grants and Medicare privatization also exist.

HCA Holdings, Inc. (HCA)

Our valuation of $78 is based on 7.3x our 2016E EV/EBITDA less NCI.

Risks to valuation include, but are not limited to, repeal/replacement of the ACA, pricing pressure from government and private payors, continued soft volume growth, further deterioration of bad debt, competition for acquisitions, increasing labor costs and labor market shortages, HITECH payment risk, a levered balance sheet and the repeal of all of the provisions of the ACA and the implementation other recent legislation (MACRA and IMPACT), along with the potential for privatization of Medicare and block grants for Medicaid.

Kindred Healthcare, Inc. (KND)

Our one-year PT of $5 for KND shares is based on 11.9x EV/Core EBITDA less NCI and 6.3x EV/Core EBITDAR. Given our post-acute sector concerns, we see these multiples as reasonably valuing KN, especially given risks to LTACH criteria, bundling and potentially Medicare reimbursement.

Risks to our PT and rating include but are not limited to: repeal/replace the ACA, execution risk, reimbursement risk, changes in upstream (hospital volume) and referral patterns in response to changing reimbursement methods (especially for KND's LTACHs) and incentives, changes in regulations and the potential for M&A (both as a buyer and as a target).

LifePoint Health, Inc. (LPNT)

Our valuation of $50 is based on a 6.5x multiple on our 2017E EV/EBITDA less NCI, which rises to 7.5x when we include an estimate of future capex liabilities as 'debt.' We think this multiple is appropriately reflecting likely inpatient volume pressures, the dilutive impact of acquisitions in the near term plus capex commitments associated with them and balanced by its moderately levered balance sheet and smaller, but still positive, FCF. Risks to valuation include pricing pressure from government and private payors, continued soft volume growth, further deterioration of bad debt and competition for acquisitions, excess dilution from acquisitions due to slower than expected improvement in margins and execution risk and the risk of repeal, Medicaid block grants and Medicare privatization.

Quorum Health Corp (QHC)

With our below-guide $170mm EBITDA estimate and with serious total net leverage of 6.0x our corresponding $233mm LTM CA EBITDA estimate, the EV multiple explodes in our target price model. At our new target of $3, the stock would trade at 8.2x guidance-basis EBITDA. But if the assets are sold, $3 is only 6.7x our new estimate. While our PT is more than 10% from the current stock price, the low dollar price makes the stock highly volatile.

Risks to our rating and price target include, but are not limited to: repeal/replace the ACA, execution, reimbursement, litigation, regulation, investigation and other market and government-based risks. In addition, QHC, formed through a spin-off from CYH, is a very new company just having been formed on 4/29/15. Thus, it has a limited track record and has had much time to execute on its strategic plan. Our estimates, and therefore our rating and price target, are thus based on extremely limited company-specific information. We expect the shares to be very highly volatile given the small float and high degree of leverage, and the risk of repeal of the Medicaid expansion and the potential for the privatization of Medicare and Medicaid block grants.

Tenet Healthcare Corp. (THC)

Our $13.00 PT is based on 7.4x our 2017E EBITDA less NCI of $2.157B, which corresponds to 6.6x our 2016E EBITDA and 6.3x our 2017E EBITDA. Risks to our price target include, but are not limited to, repeal/replace the ACA, pricing pressure from government and private payors, continued soft volume growth, HITECH payment risk, execution risk (including closing transactions in a timely fashion) and further deterioration of bad debt. Risks associated with health policy changes, ACA repeal, Medicaid block grants, privatization of Medicare all factored into our target multiple as well.

Companies Mentioned (prices as of NaN/)

Amedisys, Inc. (AMED- Neutral $46.35)
HCA Holdings, Inc. (HCA- Neutral $79.71)
LifePoint Health, Inc. (LPNT- Neutral $60.40)
Tenet Healthcare Corp. (THC- Underperform $18.10)
Community Health Systems, Inc. (CYH- Underperform $6.57)
Kindred Healthcare, Inc. (KND- Neutral $7.40)
Quorum Health Corp (QHC- Neutral $8.81)

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Investment Risks and Valuation Methods can be located in the following section of this research report - Price Target Calculation and Key Risks.

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Neutral:	Stocks for which the anticipated share price appreciation is within 10% of the share price.
Underperform:	Stocks for which the anticipated share price falls by 10% or more.
RS:	Rating Suspended - rating and price objective temporarily suspended.
NR:	

No Rating - not covered, and therefore not assigned a rating.

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(As of NaN/)	% of coverage	IB service past 12 mo
Buy (Buy)	45.55%	42.19%
Hold (Neutral)	51.25%	36.81%
Sell (Underperform)	3.20%	44.44%

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