



# Healthcare

## Sector Overview & Trends

June 2023

# Executive Summary

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- Healthcare is the third-largest sector of the U.S. economy, representing ~18% of GDP, with total 2021 spending in excess of \$4.3 trillion
- Long-term macro tailwinds including substantial growth in the aging population; improvements in the diagnosis and maintenance treatment of chronic diseases; and pharmaceutical, device, and procedural improvements and innovations, have combined to drive a sector CAGR of ~5.6% over the past two decades
- This robust growth through economic cycles, combined with record low interest rates has allowed the sector to experience a multi-year period of high valuations, robust M&A activity, and favorable financings
- However, recent changes in the economic environment - higher interest rates, lower valuations, and investor risk aversion - coupled with specific industry challenges, have left certain healthcare companies vulnerable to refinancing risks, and, in the case of more highly levered companies, outright financial distress
- Specific sector challenges include:
  - Macro headwinds, *e.g.* skilled labor shortages for physicians and nurses and the rising cost of delivering care;
  - An unfavorable regulatory environment for certain subsectors, including the implementation of the “No Surprises Act” which has compressed margins for physicians, hospitals, and air ambulance providers; and
  - Innovation-specific factors impacting pharmaceutical and medical device manufacturers, including business model viability, greater pressure from generics, and the risks inherent in “make-or-break” single-product success
- These materials provide an overview of the healthcare sector, a detailed analysis of the headwinds presently impacting the sector, and a watchlist of those credits that are most likely susceptible to these headwinds in the near-term

# Ducera's Extensive Healthcare Capabilities

- Ducera professionals have direct, relevant transaction experience across the healthcare company lifecycle and have experience representing healthcare companies and creditors on transformational M&A, financings, and restructurings/liability management transactions

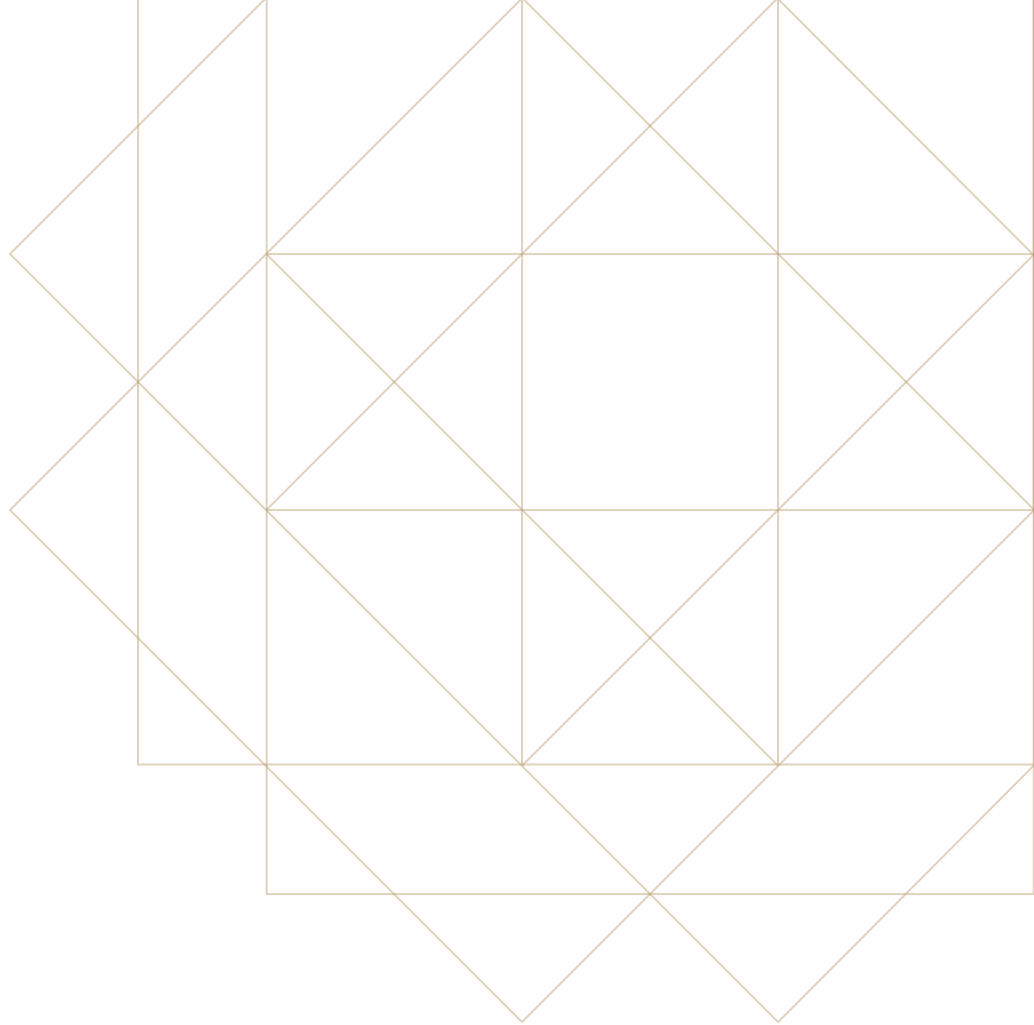
<p><b>Deep Healthcare Sector Expertise</b></p>	<ul style="list-style-type: none"> <li>Ducera has extensive experience representing companies and other stakeholders in the healthcare sector               <ul style="list-style-type: none"> <li>Aegerion Pharmaceuticals</li> <li>Clovis Oncology</li> <li>Invacare Corporation</li> <li>National Dentex Labs</li> <li>Endo</li> <li>Elara</li> <li>Envision</li> <li>HCR Manorcare</li> <li>Lannett</li> <li>Lumara Health</li> <li>Mallinckrodt</li> <li>Nalproprion Pharmaceuticals</li> <li>One Call Care</li> <li>Pernix Therapeutics</li> </ul> </li> </ul>	
<p><b>Representation in Complex Restructurings</b></p>	<ul style="list-style-type: none"> <li>Ducera has extensive experience representing constituents at various levels of the capital structure, including secured and unsecured debt, trade creditors and other interested parties               <ul style="list-style-type: none"> <li>Delphi</li> <li>EFIH</li> <li>GenOn</li> <li>iHeartMedia</li> <li>Imerys Talc America</li> <li>Mallinckrodt</li> <li>McClatchy</li> <li>Puerto Rico</li> <li>Westinghouse (SCANA &amp; Santee Cooper)</li> </ul> </li> </ul>	
<p><b>Extensive M&amp;A and Strategic Advisory Experience</b></p>	<ul style="list-style-type: none"> <li>Ducera specializes in advising on complex M&amp;A and strategic advisory mandates               <ul style="list-style-type: none"> <li>Redfin</li> <li>Remington</li> <li>Monsanto</li> <li>Iconix</li> <li>Loudpack</li> <li>NFLPA</li> <li>GenOn</li> <li>FTS International</li> <li>Bristow</li> <li>Franklin Equipment</li> <li>Noble</li> <li>Currax Pharmaceuticals</li> </ul> </li> </ul>	

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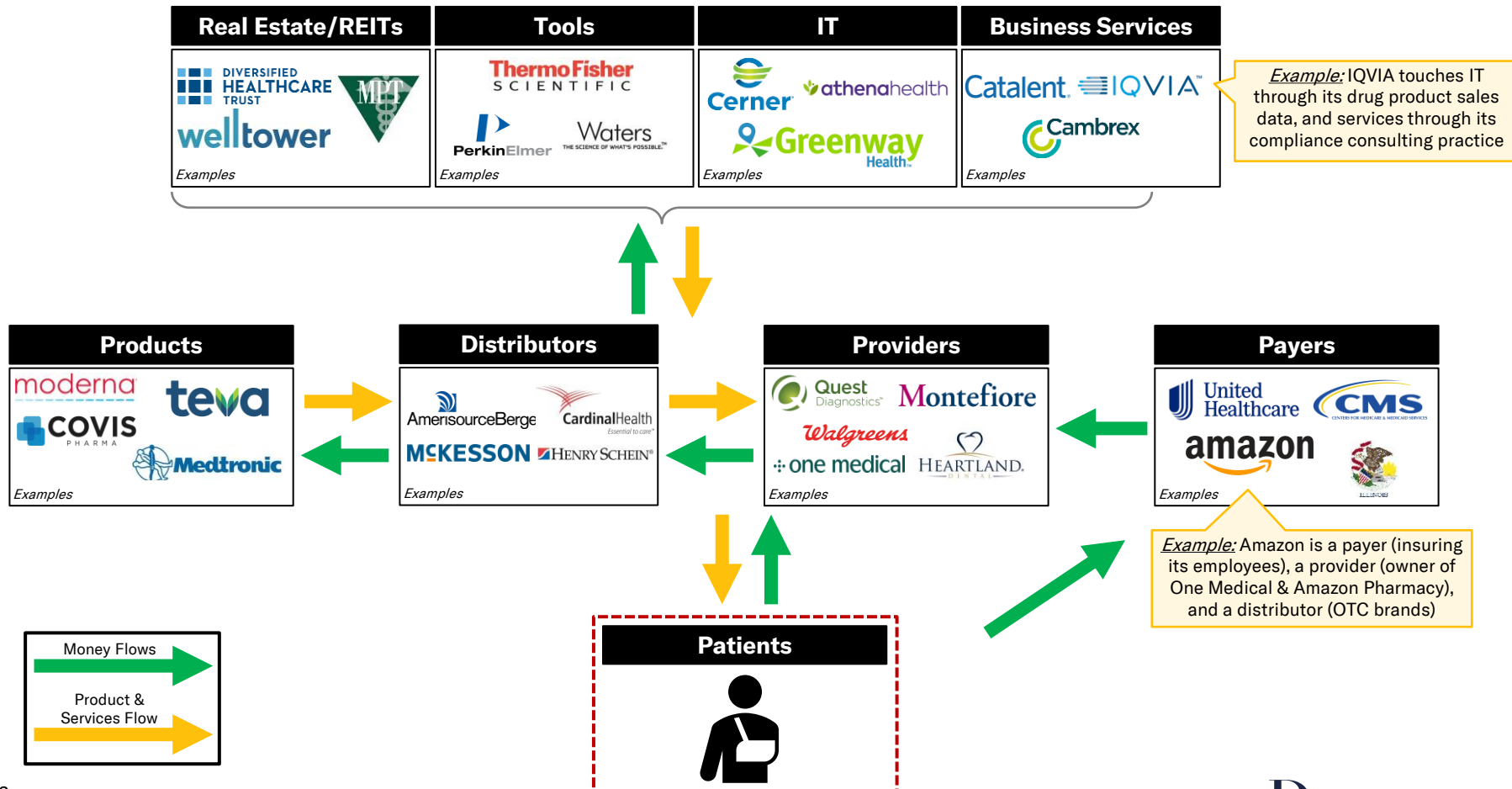
# I. Sector Overview



# Introduction to the US Healthcare System

- Mapped below is a simplified, non-exhaustive view of the US healthcare system and key participants in the system
- The lines often blur as companies fulfill roles and responsibilities across multiple segments, and to multiple types of participation, in the value chain

## Highly Simplified Segmentation of U.S. Healthcare Market

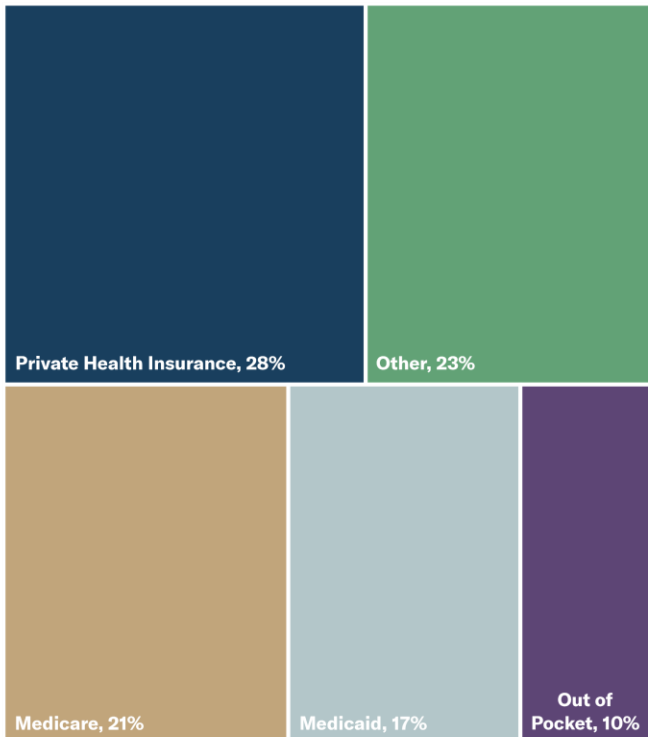


# National Healthcare Expenditures in the U.S.

- Healthcare reflects ~18% of the U.S.' GDP and its share of the U.S. economy has steadily increased notwithstanding the typical peaks and troughs of the economic cycle
- Most of the national healthcare expenditure is funded by the federal government and private health insurance payers with hospital and physician/clinical care representing the largest use of funds

## National Health Expenditures (2021): Sources & Uses of Funds

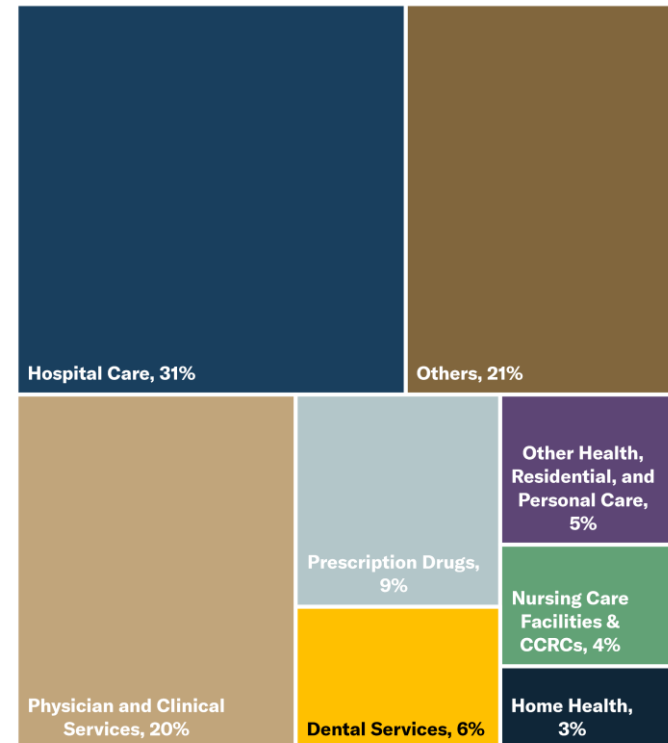
Payer/Source of Funds (2021)



U.S. National Healthcare Expenditure was ~\$4.3tn in 2021, accounting for ~18% of US GDP

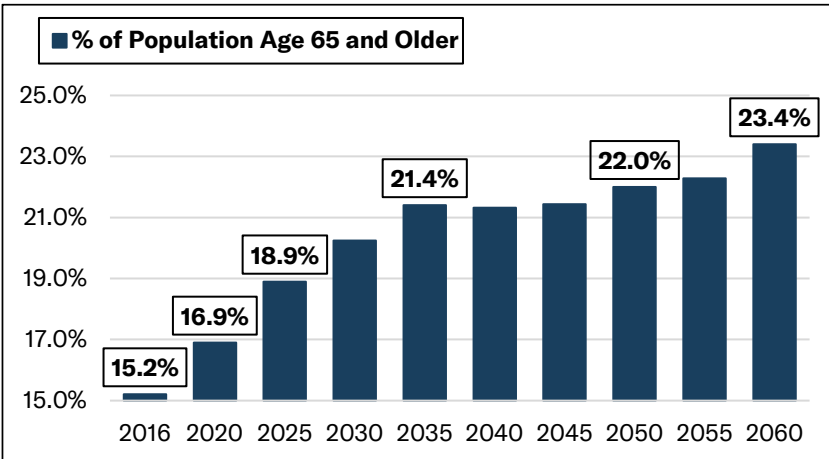


Use of Funds (2021)



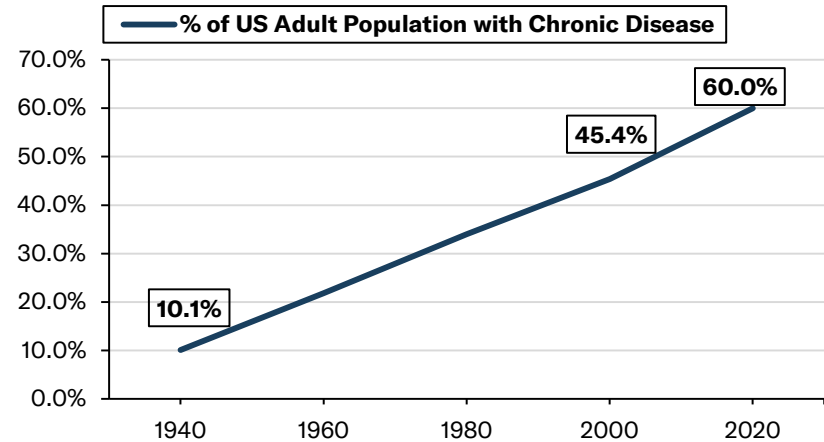
# Healthcare's Macro Tailwinds Provide Strong Fundamentals

## Growing & Aging U.S. Population...



**Bottom line:** The population is projected to continue growing and aging in coming decades. An aging population is the primary influence that contributes to healthcare spend forecasts in excess of population growth and GDP growth. These are foundational influences on the secular thesis for healthcare sector investment.

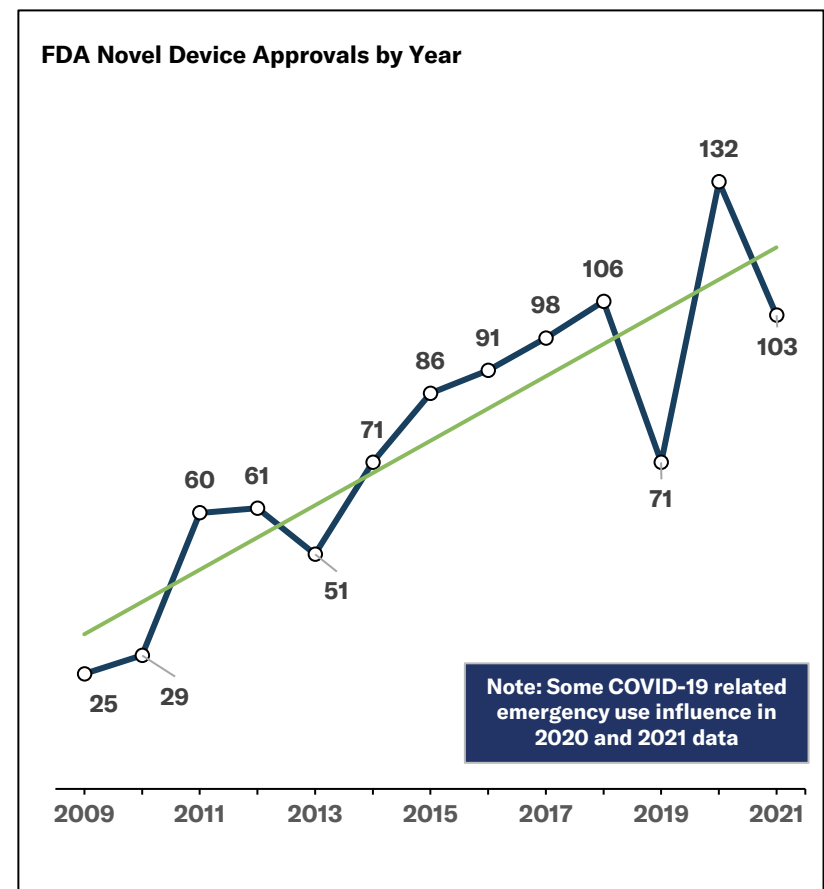
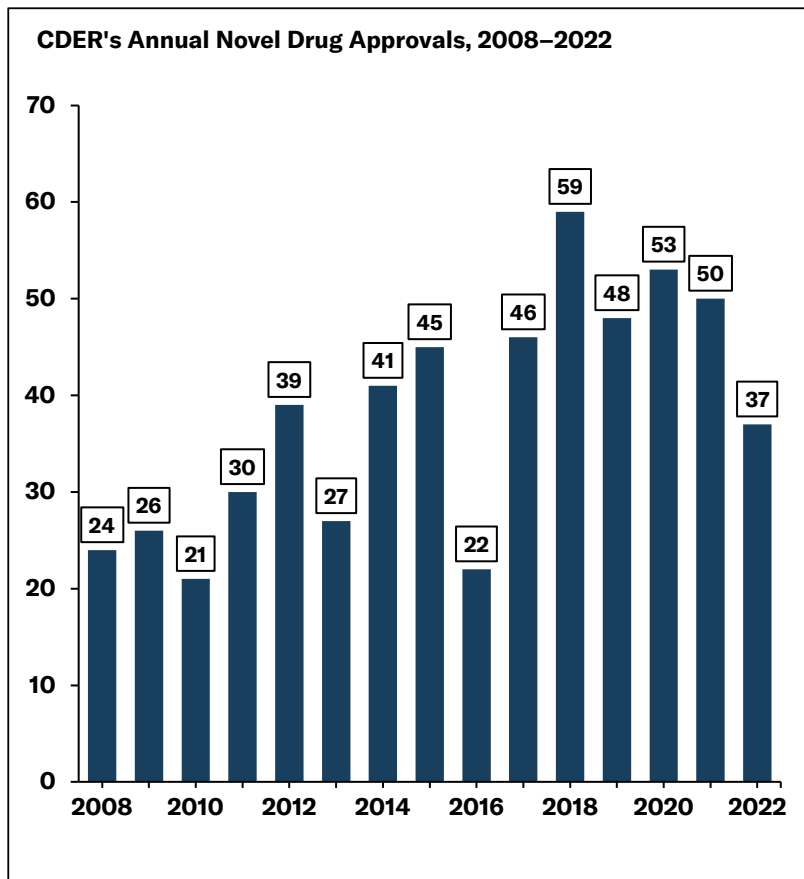
## ...That is Increasingly Becoming Sicker



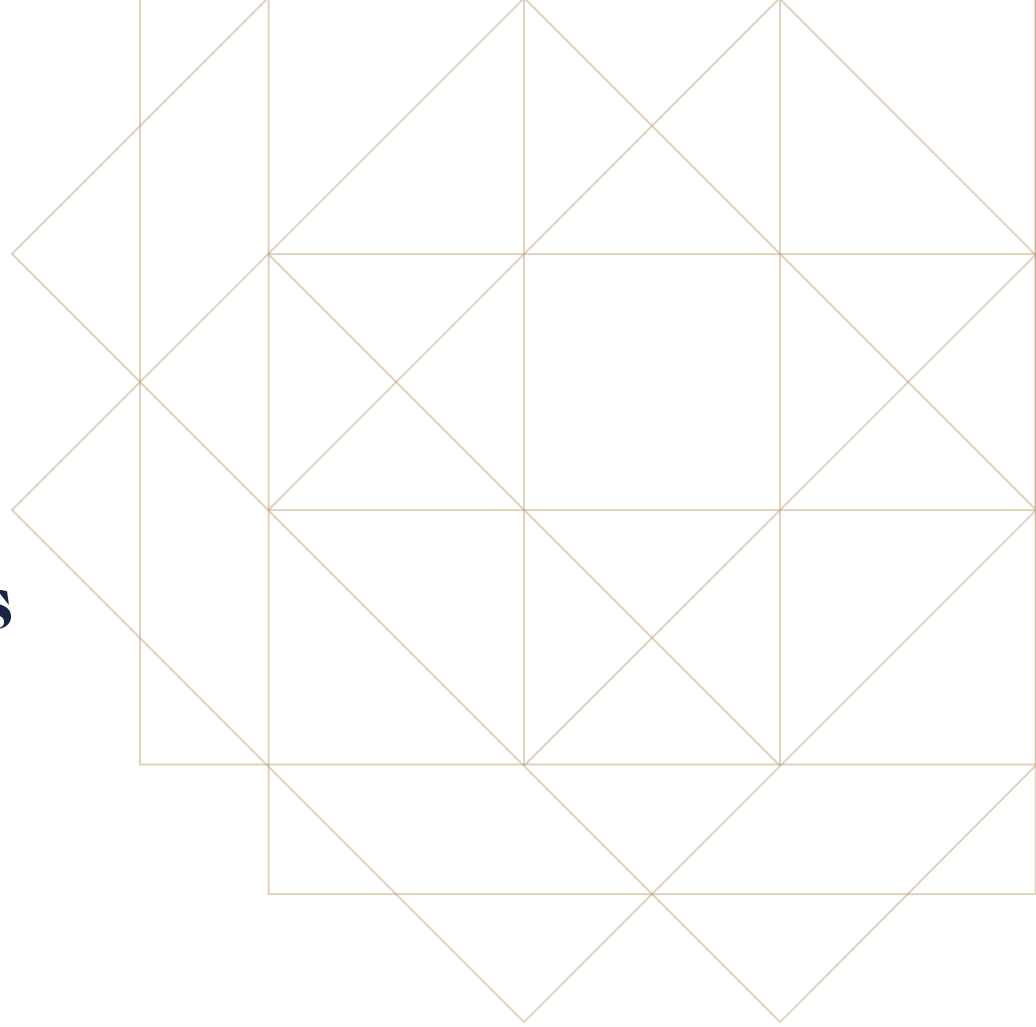
**Bottom line:** An estimated 60% of Americans have a chronic disease, with a multi-decade trend of increasing prevalence. Scientific advances have contributed to this trend due to greater disease identification and diagnostic tools, but an aging population and negative lifestyle changes are large contributors.

# Financing Pharma & MedTech Innovations

- Drug and device innovation consumes significant capital and time, creating a structural need for incremental liquidity to support research & development budgets and other related pre-commercial expenses
  - As the cost of capital has rapidly increased and liquidity in private and public markets has retrenched, certain issuers are facing limited, or zero, pathways to fund ongoing cash burn



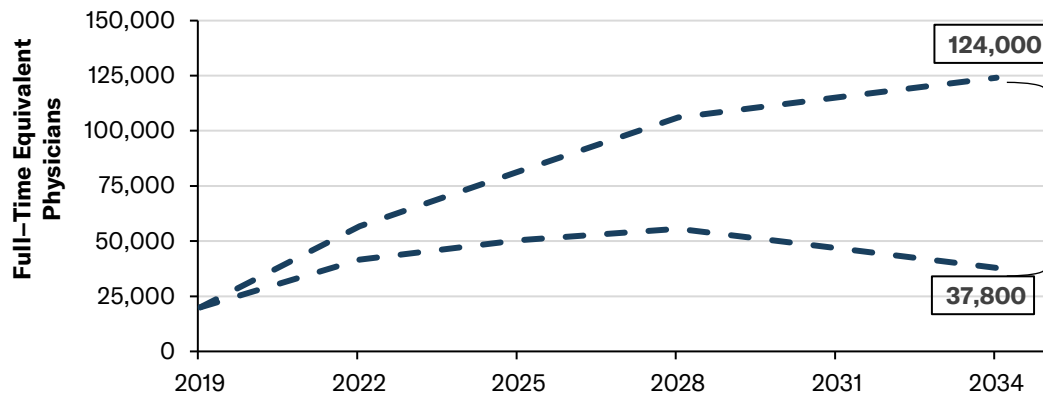
## II. Select Key Themes



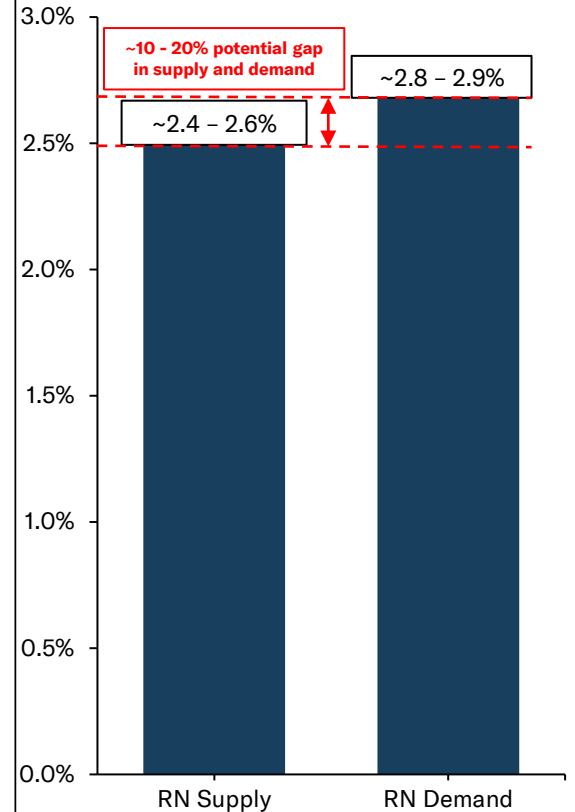
# Theme: Macro Headwinds - Clinical Labor Shortage

## Shortage of Clinical Talent Pressures Labor Costs

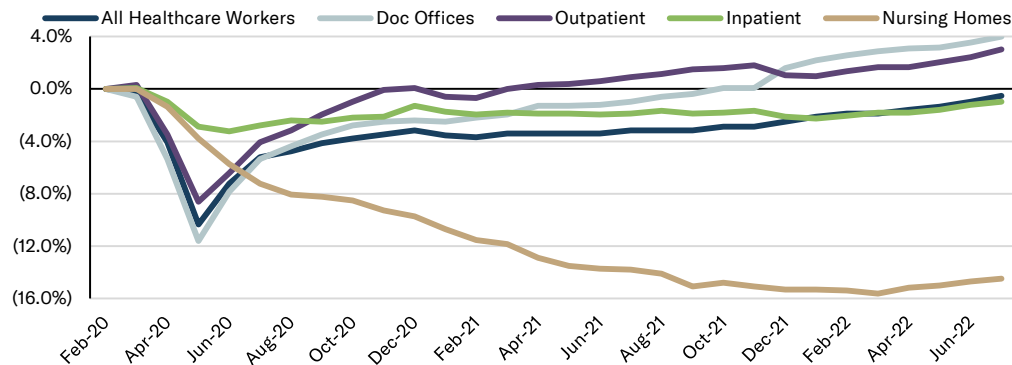
Total Projected US Physician Shortage Range, 2019–2034



Potential US Registered Nurses in Direct Patient Care, 2025 (M)



Cumulative Change in Healthcare Employment Across Setting Since Feb 2020



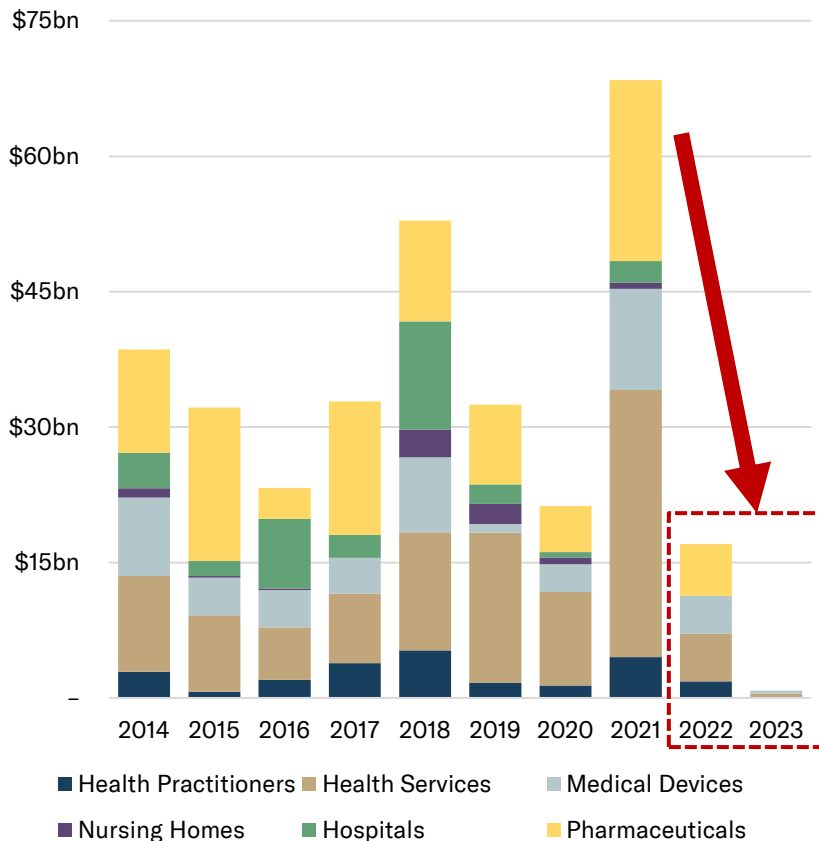
**Bottom line:** Structural shortage of clinical talent due to (i) retirements/burn outs, (ii) time, cost, and artificial restrictions on open slots in medical school, and (iii) medical education that is increasingly focused on hyper specialization resulting in shortages of qualified primary care talent. This has been exasperated post-COVID. Labor shortages have impact on both costs and revenues in the form of higher wages and lower capacity utilization/volume realization, respectively

# Theme: Reduced Access to Financing

## As Financing Access has Cracked with Rising Rates

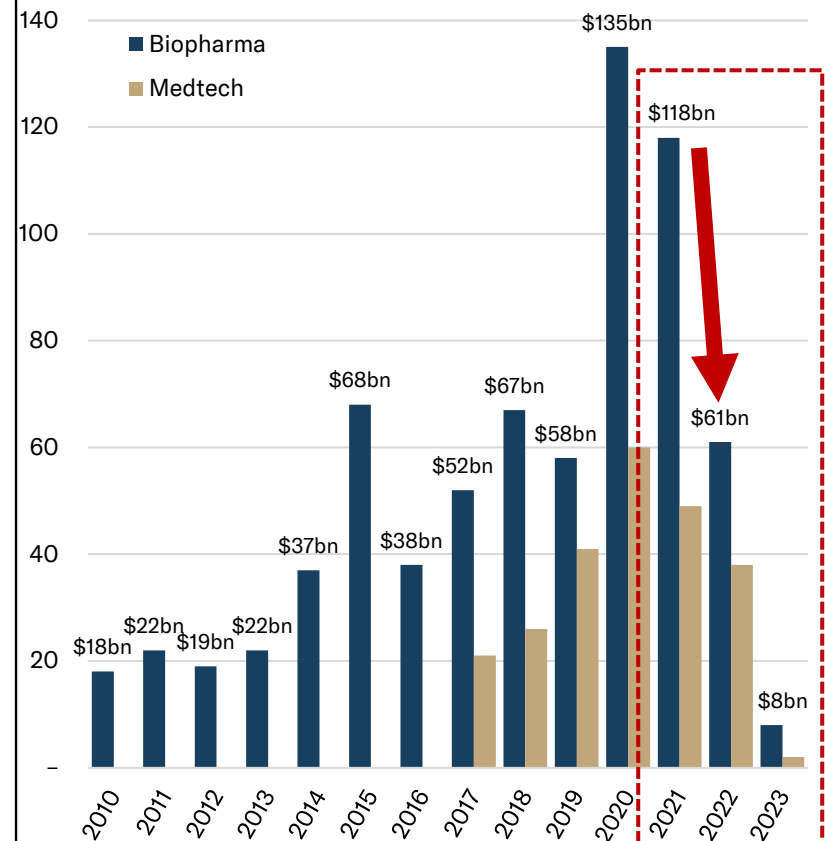
### Healthcare Leveraged Loan Volume (2014- YTD 2023)

(U.S. Issuers of USD Debt, by Subsector)



### Public & Private Pharma & Medtech Financings

(BioWorld Data, MedTech data unavailable before 2017)



**Bottom line:** Rising interest rates have significantly reduced financing access for healthcare issuers, reflecting both adverse market conditions, as well as investors' response to sector-specific headwinds.

# Theme: Innovation Costs & Risks in Medtech & Pharma

## Reduced Investor Appetite for Binary Risks

- Many developers of healthcare “products” have an inherent level of “binary risk” in the business model
  - Pharmaceutical companies, except for large, diversified developers with R&D pipelines, often have high dependence / concentration on one or a small number of products
  - Development stage companies will often require substantial development capital (often hundreds of millions) to complete necessary regulatory trials / approvals with no certainty of commercial launch or success
  - Product value and earnings/cash flow are dependent on patent protection – a lost patent can massively erode value and an ability to service debt
- Many Pharma & MedTech companies benefited from higher risk tolerance in recent years through easy access to debt financing for (i) development stage assets, (ii) limited commercial portfolios with relatively binary risk, or (iii) to monetize portfolios with high revenue concentration from a single mature product or patent
- A more risk-averse market that is more aware of binary risks, coupled with higher financing costs, is leading to more difficult initial financings and refinancings

## Business Model Viability

- Historically, specialty pharma companies were able to acquire a portfolio of assets or companies, realize synergies (i.e., cut OpEx & R&D cost structures), and pass on meaningful price increases to drive value creation
- **What Changed?**
  - **Competition:** Increased regulatory and political support for easing barriers and reducing timelines to launch generic and biosimilar competitors to drugs
    - **Branded Impact:** Higher likelihood of patents being challenged & invalidated prior to their expected LOEs or market share loss to biosimilar product
    - **Generics Impact:** More generic competition results in generic portfolios holding less value and declining more quickly due to increased market competition
  - **Pricing:** Ability to take price has been significantly curtailed due to pressure from payors/CMS, public, and increased regulatory scrutiny
  - **Harder M&A Market:** Market overall seems to be smarter on the pharma space. Hard to find “value” products to acquire, meaning companies either have to pay full value or have a development pipeline to offset declines in existing portfolio

**Bottom line:** Pharma & MedTech companies often have high concentration risk – either (i) risk that an asset doesn’t grow as expected (or even loses patent protection), or (ii) fails to secure regulatory approvals necessary to launch or expand, resulting in a business unable to support their current capital structure

# Theme: Legislative & Policy Headwinds

## No Surprises Act 2022

- **The No Surprises Act 2022 (“NSA”) regulates surprise billing for out-of-network services**
  - Limits cost-sharing and balance billing in emergency care, non-emergency care at in-network facilities, and air ambulance services from out-of-network providers
  - Requires good faith estimates for uninsured or self-paying patients
  - Cost-sharing payments are applied as if the provider is in-network
- **Establishes an arbitration process to determine the amount billed**
  - The arbitrator must choose between the payor or provider’s suggested amount
  - Factors considered include median in-network rate, training, experience, quality of outcomes, market share, complexity of service and good faith efforts to enter into network agreements
- **Continued to be litigated with uncertain outcome long-term, but leading to substantial business disruption currently (e.g., Envision)**

## FTC Enforcements in Healthcare

- **FTC continued to reassess and expand its approach to antitrust enforcement in 2022, including expanded use of reinstated “prior approval and prior notice policy”**
  - Merging parties to FTC-contested acquisitions must provide prior notice and seek FTC approval for future transactions for at least 10 years
  - Divestiture buyers must obtain FTC approval before selling divested assets for at least 10 years following the purchase
  - Chairwoman Khan stated FTC will aim to “tackle problems at the[ir] incipency” by addressing competition concerns *before* markets are dominated by a few firms
- **FTC Focus on the Healthcare Sector**  
Chairwoman Khan has reiterated the FTC is “prioritize[ing] deterring and stopping anticompetitive conduct in the healthcare sector”
- **Private Equity in the Crosshairs**
  - Private equity firms will be a significant focus for prior notice and approval provisions in future settlements
  - Sponsor-backed rolls up strategies are subject to greater regulatory scrutiny and could limit potential exits

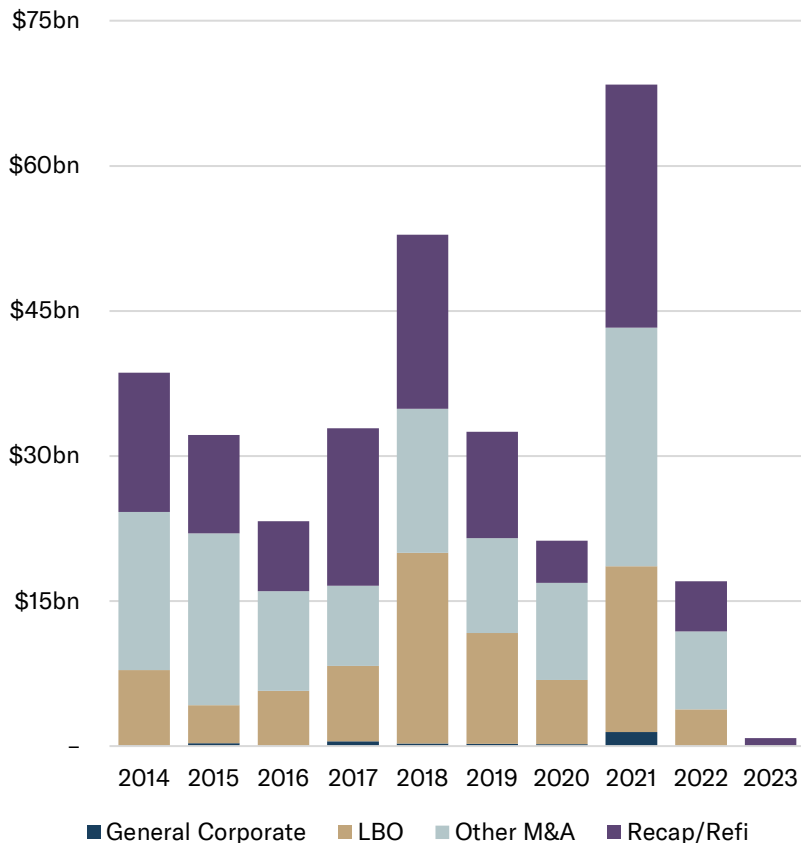
## Changes in Reimbursement / Payer Coverage

- **Court and legislative changes to reimbursement can lead to substantial challenges for providers, particularly those focused on a single offering**
- For example, the Supreme Court decided in June 2022 in *Marietta v. DaVita* that a group health plan that uniformly provides limited benefits for outpatient dialysis to all plan participants does not violate the Medicare Secondary Payer statute (“MSPS”)
  - Davita had argued that Marietta’s plan discriminated against patients with end-stage kidney disease and intended to move patients from commercial insurance to Medicare prematurely
  - While Davita is expected to be large enough and diversified enough to absorb any earnings impact, the more focused and highly levered operator U.S. Renal would have an unsustainable capital structure absent legislative changes to reverse the Court’s decision
- **CMS Reimbursement Rates Don’t Fill the Gap**
  - 2024 CMS Reimbursement rates, while in line with expectations, are below labor and other inflationary costs

**Bottom line:** Legislation and policy choices affect the Healthcare sector at nearly every level of participation. The above legislation and policy changes are by no means exhaustive. The legislative landscape for patients, providers, service providers, and payers (among others) is constantly evolving.

# Theme: Sponsor Strategies in Healthcare

## Healthcare Leveraged Loan Volume (2014 – YTD 2023) (U.S. Issuers of USD Debt, by Use of Proceeds)



Sources: LCD Comps

## Select Trends Affecting Sponsor-Backed Credits

- Recent US sponsor activity has been most actively focused on Healthcare Services including hospitals, roll ups of provider practices / MSOs, physician staffing, and nursing / home health, among others
- The rich multiples paid in 2021 and early 2022 have compressed as a result of rising interest rates and general industry headwinds
  - Lower implied valuations, coupled with rising rates and enhanced underwriting scrutiny have created a harder refinancing environment for sponsor-backed issuers
- Further complicating refinancing & M&A exits are:
  - Lower growth than expected in many instances due to themes covered previously (reimbursement / legislative changes, cost pressures, staffing shortages, etc.); and
  - Existing business models and capital structures were underwritten with an expectation for inorganic growth via roll-up strategies which have failed to materialize, or has been offset by negative pressures
- Bottom line:** Reduced valuations and access to capital limit M&A “support” levels for exit, trapping many sponsor-backed issuers with unsustainable capital structures that need to be addressed in some fashion

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