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Wishing you an enjoyable Labor Day weekend.

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Medicare cuts SNF PPS payments by 11.1% for 2012 -- Sink or Swim -- or stay vigilant for great buying opportunities...

As summer winds down and we all reset for the fall, our focus turns to the remainder of 2011 and the challenges that lie ahead for 2012. One sector of healthcare that has perhaps the greatest challenge facing it is in long term care, specifically the skilled nursing facility (SNF) sector. The Center for Medicare and Medicaid Services (CMS) has put in place a daunting 11.1% rate cut for Medicare PPS payments, effective fiscal year starting October 2011.

What are the ramifications of this rate cut, not only for the SNF industry and the public entities directly and indirectly affiliated, but also for the vendor community that sells into long term care?

The public sector has seen an immediate negative impact. Nursing home operators led by Kindred Healthcare and Sun Healthcare Group will see Medicare payments drop by $3.9 billion. The 11.1 percent cut follows Medicare's finding that a new payment system put in place in 2011 let for-profit nursing homes drive up reimbursements for patients. The new rates "correct for an unintended spike in payment levels and better align Medicare payments with costs," according to a statement by Medicare, the U.S. health plan for the elderly and disabled. The market impact of this rate cut, double-digit losses in market value for these operators.

What was the driving force behind this apparent punitive rate cut? Medicare wanted to clamp down on a practice allowing nursing homes to categorize patients as getting the most intense services that the program will pay for. This past year's new payment system left a billing code open that allowed nursing homes to bill for higher rates while providing the same amount of service. Companies used that process to avoid lower revenue and the regulation shuts down that billing method, according to Medicare. It will also require nursing homes to report in more detail the therapies Medicare pays them to provide.

Healthcare REITs, with concerns over rental revenue declines from their SNF tenants, have lost significant value. Omega and Sabra Healthcare REITs, with almost a 100% exposure to SNF renanats, declined 11.8% and 25.6% respectively. While short-term defaults are unlikely, the longer-term outlook could put SNF portfolio valuations at risk, effecting long-term lease agreements. Health care real estate has long been considered

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"Surveys show that many employers will scrap their own health care plans and "dump" their employees into exchanges."

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a safe-haven investment particularly during the downturn. The conventional wisdom of the market is this rental revenue was relatively immune from economic volatility because medical and health care is a more of a needs-based industry and that demand will grow as baby boomers reach retirement age.

Nonetheless, skilled nursing tenants are deemed riskier compared to hospitals, assisted living and medical office buildings because their earnings are linked to federal spending. Jeff Theiler, an analyst at Green Street Advisors, said investors probably anticipated a more modest Medicare rate reduction of between 5% to 6% and as a result there is growing concern of the credit quality of SNF operators.

The vendor community, providing ancillary services selling into the SNF market, and which has exposure to SNF payments rather than Medicare payments directly, may not only see SNFs negotiate on price, but could also see a delay in SNF payments, resulting in significant operating cash flow problems. In addition, if there is any hint of another round of SNF bankruptcies, similar to that of the late 90's, the exposure of vendors, especially those selling into large chains, is significantly increased. Companies that provide therapy, pharmacy services, diagnostics including lab and many others, need to consider their own strategy to mitigate this very real exposure.

Private Equity, a long time buyer of ancillary service companies selling into SNFs, will undoubtedly need to evaluate the short term problems facing these companies as well as their long term growth prospects. While revenue pressures will occur, this may be balanced by lower seller valuation expectations, especially in those highly fragmented sectors common to this industry. In addition, deal structure should be tied to future performance of these vendor companies, mitigating these likely revenue pressures.

Quality of care, according to SNF operators and the long-term care lobby associations, could be at risk. It is estimated that as many as 100,000 jobs could be lost, many from the direct care side, such as nursing and therapy. In addition, the vendor community, reliant on SNF reimbursement in many instances, will likely feel the pinch from this rate cut indirectly. This may lead to the potential of limited services being offered by SNFs. The result could be an increased risk that quality of care standards are not maintained.

In summary, as either holders of stock in these public operators and affiliated REITs, or as owners in the private and private equity held companies, this is a time to be prudent, wait and watch to see how this rate cut will impact performance in 2012, but as always, stay vigilant for lower cost and favorably structured buying opportunities.

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