JS|HELD

PERSPECTIVES

Inside the Healthcare Industry: Challenges Facing Investors, Lenders, and Leaders of Behavioral Health Companies

Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

INTRODUCTION

Behavioral health is a hot area in the healthcare sector, and for good reason. Globally and nationally, society has failed to figure out how to effectively address and prevent the world's behavioral health crisis. As a result, behavioral health companies are seeking innovative approaches to expand access to services and ready their organizations for scale. But as growth occurs quickly, and investor dollars pour into the industry, many behavioral health companies are facing unique operational challenges that affect their bottom line and – in the most serious cases – their future sustainability.

In this abridged Q&A conversation, Healthcare expert Magi Curtis, and Turnaround Management experts, Brian Gleason and Michael Gaul, provide insights into how behavioral health organizations should be thinking and acting to improve both their finances and operations. They also discuss the concerns of investors and lenders by pointing out both the pitfalls and opportunities in this healthcare subsector.

Magi: Brian and Mike, your legacy company, Phoenix Management recently joined J.S. Held to bolster our strategic capabilities with companies in transition. I know your team specializes in partnering with companies to provide operational and financial solutions across industries but the two of you have worked quite a bit in behavioral health. Can you provide a high-level overview of the work you each do in this space?

Brian: As you noted Magi, our team specializes in transformation, especially where there is stress and distress. I would say that in behavioral health broadly, as in most of the healthcare industry, there is always disruption going on. With the changes that brought some parity to the mental health space, a lot of money flowed into that subsector. People made a lot of money in behavioral health, particularly in the addiction space very quickly. In our experience when money quickly floods into any industry, inexperienced and bad operators tend to become over-represented. This of course brings scrutiny from payers and regulators. So, our initial introduction to the space was that timeframe when big changes were occurring.

Michael: I would add that we are beneficial to our clients in the behavioral health space because we quickly influence results. We serve in a variety of roles, from financial advisor to interim management to investment advisor. We have taken executive leadership roles such as interim CFO, controller, or Chief Restructuring Officer (CRO). Treasury management, or managing liquidity, is critical when looking at improving the turnover of the receivables as well as identifying the optimal use of cash relative to the payables.

Essentially, we ask a series of questions. What are we doing every day and how can we look at it with a fresh set of eyes to identify improvements in those everyday processes? Is there new technology that can automate time-consuming tasks? Are there new processes that competitors are using that we can apply to our clients? Can we identify best operating practices going forward that can quickly improve financial performance? Do we need to look at the balance sheet and identify a way to either restructure debt or refinance debt?

Finally, we serve as our clients' advocate to third parties. Those could be regulators, lenders, investors, vendors, or attorneys. Oftentimes the existing management team is so overwhelmed that they are looking for someone to be their advocate in negotiating the structuring of go-forward plans or just providing information with a fresh voice. This role can often speed negotiations with critical outside constituents.

Magi: Who usually brings you into these behavioral health organizations? Is it the company leadership or is it investors or lenders who bring you in?

Brian: It is often somebody with a trusted relationship around the management team that brings us in. While we have been brought in by management teams, the existing management is often overwhelmed and therefore it is often trusted advisors – lenders, investors, and attorneys or accountants – who see that somebody from the outside may be of help. In many situations, management knows what to do, however, they do not have the resources or time to think strategically to act. We come in with a fresh set of eyes, and years of experience in similar situations. This gives everyone the confidence to make required changes.

Magi: I know that your team puts out a quarterly report on the lending climate in America. Are there any trends from the last few quarters that might be of particular interest to our clients who operate or invest in the behavioral health space?

Michael: Phoenix has been conducting and publishing its quarterly lending survey for 30-plus years.

We are all aware of the inflationary pressures that both corporations and individuals are feeling. Where it is applicable in the behavioral health space are the tight margins that the industry is generally experiencing. It's the increasing costs for energy, transportation, or food and how that just eats away at the margins. The companies are feeling the incremental costs and the corresponding impact on their bottom line. Next is the capital markets and the constrained liquidity that defers a new capital project or prevents them from getting over a short-term funding issue. It presents some near-term equity challenges. So those are the negatives.

On the plus side, the longer-term outlook is more positive than the more immediate six-month outlook. The survey respondents see improvements on the horizon.

Brian: What we're seeing is companies with a lot of |debt and much of it is variable rate debt. It has gone up, but the pricing of the services hasn't gone up equally. We're seeing some failures in the non-profit space with significant debt. They could afford the debt two years ago. But the interest on that debt has more than doubled in the past two years and they are unable to afford to pay both their debt and their ongoing operating expenses. Their price to the customer doesn't seem to be going up, but their costs, plus their cost of capital as Michael said, and the cost of their debt have gone up.

For any company that is highly levered or even moderately levered in this business, it is imperative to examine how much cash flow is going to support debt, because if they're not putting it into patient care, if they're not putting it into capital replacement, those organizations will begin a downward spiral. Each quarter, with increased debt service coming at the expense of investing in the business and its employees, the company will see the quality of patient care go down. It's a slow process, but it's a very hard process to turn back around once it starts.

Magi: Both of you have served in various roles from CRO to CFO. What are some of the more interesting behavioral health projects that you have done and how did you work with the client to navigate the situation?

Brian: I tend to find myself working with clients in very difficult circumstances. I was working with a behavioral company in the South with multiple facilities including in-patient psychiatric facilities. It had been indicted by the local district attorney for holding patients against their will. We went in to try and figure out what to do. The company had to let a bunch of patients leave the hospital quickly and some of these former patients were literally living in tents in the woods on the property. The company hadn't paid their employees for several weeks and the particular location we walked into had just been closed. The employees were banging on the doors trying to get in so they could get paid. We were able to actually sell that business to someone who restarted it. That was a successful outcome. It was quickly apparent that the current operators would not be able to re-open these facilities, but we were able to convince them it would be best for everyone to quickly find a new operator to keep these critical community assets operating.

In another case, I went into a company in Florida, which was an addiction recovery firm with a large national footprint of 17 facilities across the country. The owner had made a lot of money over an 18-month period. When I say a lot of money, I mean the kind of money that makes rich people's lives change; not the kind of money that makes normal people's lives change.

The insurance companies were after this business. Regulators were after it for its patient care and its billing practices. I went in as CRO. The CEO was eventually terminated from that company and eventually sued by lots of people. However, the company was able to continue to operate.

In both those cases you're dealing with people – patients – whose lives are in your care. In a crisis, you can shut down a ball bearing manufacturer and send the employees

home, certainly a real impact to those employees. However, in behavioral health, you have people at their most vulnerable moments counting on you for continuous care. Because of this we find that lenders and investors will often do more than they might for that ball bearing company. We've had experiences where we've been able to get lenders to support a company they wouldn't normally support because there was too much at stake for the community at large. I do think that bringing the humanity of these cases into the conversations with the external constituents is helpful because you understand that these companies are doing important work.

Michael: I worked closely with a nationwide provider of drug and alcohol treatment services, which had been in place for more than 50 years, to do a complete financial and operational turnaround of the company. Operating facilities in 12 different states, they offered a full range of services from assessment to treatment planning to recovery support. The company's problem emanated from the significant turnover in the senior management team resulting in ineffective daily management of the finance department. Critical performance initiatives and operational improvement initiatives were delayed. In addition to turnover at the top, there was significant attrition in the field operations.

The challenge was to provide a consistent quality of care across the nation with employees who, frankly, weren't being trained well enough to do what was needed of them. The lack of financial leadership and absence of cohesive organizational strategy resulted in the company's various regions operating independently.

I went in as the Interim CFO to provide overall financial leadership and strategy for the company. This included managing the day-to-day operations of the company's financial personnel, accounts receivable, accounts payable, billings, and treasury – both at the headquarters and at the regional offices, and more.

It was clear that we needed to develop and then implement performance improvement initiatives, both on the revenue side and on the expense side.

Expense reductions are often unique for behavioral health companies because you can't do the proverbial 20% cut due to the linear relationship between the number of licensed therapists and the number of patients the organization serves. We needed to make sure that we had enough staff so that when we were able to identify new patients that we could serve, we had – from a regulatory perspective – the right number of staff, and to ensure we were providing quality care.

We also knew that it was important employees understood the key performance indicators leadership was tracking, the role each team member played in achieving those metrics, and how the organization and regional offices were performing versus the metrics. So, we established regular communication sessions that provided current updates to regional teams, fostering common ownership in organizational performance, and enabling real-time strategic adjustments, if necessary.

Another role as interim CFO was leading the ongoing discussions and negotiations with the lenders for the proposed refinancings and then ultimately to make a recommendation to the CEO, the chairman, and the board of directors.

Finally, we onboarded a new CFO, which is consistent with most of the situations in which we take an interim role. We also provided an interim period of counsel where we served shoulder-to-shoulder with that person. It allowed the company to have a little more stability in the first 30 to 60 days with the new CFO on the job. The organization transitioned from being unable to simultaneously pay its employees and vendors on time, to a cohesive, nationwide critical service provider with improved liquidity and organizational culture. Overall, this engagement took 11 months and involved coordinating, driving, and ultimately finalizing the annual budgeting process.

Magi: Can you point out non-financial changes you have implemented to improve operations?

Brian: During our exploration and analysis of one provider we determined that they were particularly good at dual diagnosis patients. In this case, mental health and AIDS diagnoses. This was something that they had the skills to effectively manage, and they were reimbursed at higher rates. This was a profitable business segment for them. When we enquired how

they used that in their marketing the answer was: they did not. We quickly developed a communications plan to share with their referral network that this was something that they had the ability to manage effectively. By creating this awareness with their referral network, we immediately saw an increase in dual diagnosis patients.

On a separate project, an addiction recovery company had some facilities which had a strong alumni network. Understanding the relapsing nature of addiction, we developed a program to ensure the alumni network understood that we had expertise in assisting patients who relapsed. The program was different than the new patient program and focused on the issues of relapsing patients who had already been through treatment. The company also developed alumni networks with this program at all facilities. This had an immediate impact on performance for the company and outcomes for the patients.

Michael: In one engagement we needed to improve patient census. We identified two critical census issues: 1) patient intake appeared to drop off most Fridays, and 2) their intake was built exclusively on referrals – there was no proactive outreach. To address the first problem, we identified why intakes on Friday afternoons slowed. We analyzed the intake pipeline and found there was no significant drop-off in referral calls. Rather, the intake staff was not responding to calls as quickly. We assumed that they did not want to stay late if a patient came late in the day.

As a result, we immediately changed management and staffing resulting in a quick increase in Friday admittance. On the referral side, we determined that the company's referral network would regularly call to determine if they had space available. To reduce the effort for the referrer personnel and increase the company's census, we created a proactive communications system to let referral providers know we had an open space.

Magi: Michael, when you're working with investors who are evaluating a new opportunity, what advice would you have for them?

Michael: First, when investors are assessing the management team, they need to be focused on the organizational long-term trends and management's ability to assess data and act accordingly.

Second, examine communication and culture. Investors should be looking to see engaged, communicative executive leadership that shares the company vision with employees and fosters an inclusive culture. There are many ways to do this, but management has to let employes know how the vision will be executed. And if the company is healthy, anyone in the organization should be able to say: "Hey, I see this" and "What if we did this?" If investors are seeing this type of culture, they are likely looking at a company that is focused on improving patient care and operations.

Finally, I'd suggest that they look at employee turnover. If the company is constantly suffering 20%, 30%, 40% attrition or turnover, it is a sign that it will be very difficult to execute the company mission.

Brian: I would add to what Michael has identified and include the analysis of how a target company focuses on patient acquisition. Have they focused on this? If not, this is likely an area for quick improvement. I would also recommend doing an analysis of accounts receivable, identifying where the money comes from, how have the days revenue outstanding changed, and if it has increased – why has it? Finally, look at deferred maintenance. As companies deal with downward pressure on margins, maintenance is one of the first areas affected.

Magi: What advice would you give to C-Suite leaders who are proactively looking to improve their behavioral health business?

Michael: The development and sharing of an organizational mission and vision is critical. You need to empower your people with the "why" and the "what" of the organization and where you're headed. As a leader, you can ask your team to do anything, but if they know why they are doing it and what the benefit is to them as well as to the patient and the community they serve, they'll do it a lot more willingly.

Furthermore, the mission and the vision have to be consistent. You can't have a different mission and vision in July than you had in January. You can tweak or improve

them, but you can't change them fundamentally on a regular basis.

Also, the ability to articulate the recent past and deliver a forecast often speaks to management's involvement and level of understanding of the business. Leadership in the most successful organizations regularly meet and engage with their direct reports to learn about current operating conditions, share best practices and feedback from the field, and make real-time decisions.

Magi: Finally, Brian is there one approach that investors, lenders, or leaders of behavioral health companies should be thinking about?

Brian: Our message to prospective or current behavioral health clients is that it's critical to take a consistent approach to operating challenges. Don't bury your head in the sand. Declare that this is our plan, here is how we execute against it, and how we will measure our performance against it. Also, keep a respectful eye on the organizational mission and the community being served.

Non-profit entities should apply a for-profit mindset to the quantitative aspects of their respective business models. This is a very, very tight margin sector and it needs to be run extremely efficiently to continue to provide these important services. We must be able to maintain the mission and create strong financial performance.

ACKNOWLEDGMENTS

We would like to thank our colleagues, Magi Curtis, Brian Gleason, and Michael Gaul, for their insights and expertise that greatly assisted this research.

Magi Curtis, is an Executive Vice President and leads J.S. Held's Healthcare Transformation practice. She has spent her career in healthcare, in both the policy and business sides of the industry. She has guided some of the nation's leading health systems and provider-based organizations as they navigated enterprise level change management initiatives, strategic partnerships and post-merger integration, strategic positioning, government relations, significant issue campaigns, crisis events, and internal and external engagement efforts. She has also worked closely with the founders of emerging healthcare companies to scale their business and establish operational structures to maximize productivity and enable growth. Prior to joining J.S. Held, Magi was a partner at a top national healthcare consulting firm. She also worked in Washington, D.C. in health policy as a staffer in the U.S. Senate, at Navigant Consulting, and the Children's Hospital Association.

Magi can be reached at magi.curtis@jsheld.com or +1 615 626 0023.

Brian Gleason, CTP, is a Senior Managing Director at Phoenix Management, a part of J.S. Held. He joined the company in October of 2023 as part of J.S. Held's acquisition of Phoenix Management Services. As a Certified Turnaround Professional (CTP), Brian has managed or participated in excess of 250 turnaround engagements over the past 28 years using his executive, operational, financial, and negotiating skills. He has significant experience in interim management roles, including CRO, CEO, COO, and CFO of sponsor-backed, privately held, and publicly reporting entities. He has been a board member in many companies including private and public companies and is often engaged in these roles when there is significant disruption in the company, or at the board level. In certain circumstances, he represents capital providers directly to advise on operational and restructuring matters for their portfolio companies.

Brian can be reached at brian.gleason@jsheld.com or +1 610 659 8118.

Michael Gaul, CTP, CFE, is a Senior Director at Phoenix Management, a part of J.S. Held. A Certified Turnaround Professional and Certified Fraud Examiner, Michael joined J.S. Held in October of 2023 as part of J.S. Held's acquisition of Phoenix Management Services. He has approximately 20 years of experience in financial and crisis management. He served in interim management and advisory roles in a multitude of corporate environments – private, equity-sponsored, family-owned, and start-up ventures. Michael has experience in companies reorganizing under Chapter 11 protection of the US Bankruptcy Code. He is experienced with transactions involving Section 363 of the Bankruptcy Code in which debtor companies

transfer their assets to a buyer with speed, efficiency, and the approval of the Bankruptcy Court. He holds FINRA Series 7, Series 63, and Series 24 licenses.

Michael can be reached at Michael.gaul@jsheld.com or +1 610 937 0651.