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Envision Healthcare Corp's future mired in uncertainty

by Toh Yong Hui Desmond

Envision Healthcare Corp, a leading provider of physician-led, medical services in the US, experienced a plunge of its market capitalization by 43.7% from USD 7.43bn on January 3, 2017 to USD 4.18bn on December 29, 2017. This was mainly due to investors' concerns on its high leverage and future profitability. Correspondingly, the RMI-CRI 1-Year Probability of Default (PD) increased from about 0.5bps to about 475bps in the same period, indicating a weaker credit profile.

From Q3 2016 to Q3 2017, Envision engaged in a series of acquisitions, such as the acquisitions of physician practices, and the merger with AmSurg Corp, a healthcare company. Consequently, Envision's net debt surged from USD 2.686bn to 6.045bn in the same period, causing it to have a higher net debt/equity ratio and higher net debt/EBITDA ratio than its industry peers (see Table 1). Besides the increase in leverage, the profitability of the company has also declined, causing its EBITDA/Interest Expense ratio to be lower than that of its industry peers (see Table 1). Following the acquisitions, the trailing 12-month EBITDA margin actually decreased from 22.3% in Q4 2016 to 16.5% in Q3 2017, with operating expenses surging by 183% and surpassing the revenue growth of 152% in the first nine months of 2017. These figures suggest that Envision has been unable to achieve rationalization and reduce costs after the acquisitions. In the event that these acquisitions continue to fail to deliver cost savings, impairment losses could be recognized in future financial periods.

	Net debt/Equity (%)	Net debt/EBITDA (X)	EBITDA/Interest Expense (X)
Envision Healthcare Corp	83.5	7.3	4.8
Mednax Inc	67.6	3.3	8.2
Amedisys Inc	4.6	0.3	20.6
Almost Family Inc	23.0	3.0	5.6

Table 1: Financial Data for Envision Healthcare Corp and its Competitors in Q3 2017. *Source: Bloomberg*

Furthermore, the outlook for Envision's future earnings is bleak. In its third quarter financial results released on October 31, 2017, Envision lowered its forecast for Q4 2017 earnings, which led to a drop in market capitalization by 33% on the same day. For Q4 2017, Envision expects to generate EBITDA of between USD 182mn and USD 202mn, which was below analysts' consensus estimate of USD 294mn, and this was mainly due to higher-than-anticipated start-up costs, and a decline in expectations for emergency medical volume and anesthesia growth rate. Further clouding the outlook for Envision's future earnings is the headwind due to other healthcare providers pursuing consolidation and making the market more competitive. Indeed, such mergers between healthcare providers could potentially annul the benefits reaped from the acquisitions made by Envision, and put pressure on the profits of Envision.

	Q4 2016	Q1 2017	Q2 2017	Q3 2017
Net debt/Equity (%)	77.0	78.6	81.5	83.5
Net debt/EBITDA (X)	10.8	9.0	8.1	7.3
Net income (USD mn)	-135.5	-445.2	56.3	28.3
Trailing 12-month EBITDA margin (%)	22.3	19.4	17.8	16.5
Current Ratio (X)	2.1	3.1	2.8	3.0

Table 2: Financial Data for Envision Healthcare Corp. *Source: Bloomberg*

To sharpen its focus on its core businesses, on August 7, 2017, Envision signed a definitive agreement to sell American Medical Response (AMR), a unit that provides community-based medical transportation services, in a cash transaction valued at USD 2.4bn. While such a move would improve Envision's cash position, it casts doubt on the long-term sustainability of Envision's business, given that AMR generated 36.1% of Envision's net revenue in the nine months ended 30 September 2016, and had exhibited steady growth over the years.

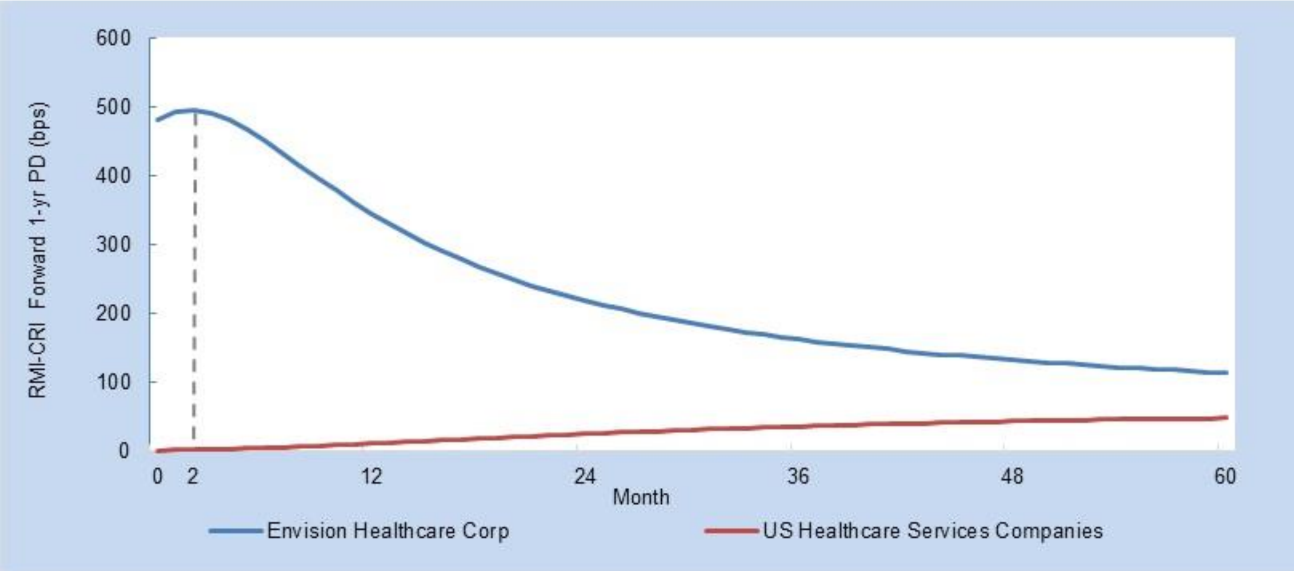

Figure 1: Term structures of RMI-CRI Forward 1-year PD of Envision Healthcare Corp and Aggregate Forward 1-Year PD of Healthcare Services Companies in the US on December 29, 2017. *Source: RMI-CRI, Bloomberg*

Despite these adverse developments, the term structure of the RMI-CRI Forward 1-Year Probability of Default (Forward PD) for Envision on Dec 29 indicates an increasing probability of default in the first 2 months, and thereafter decreased sharply (see Figure 1). Intuitively, the Forward PD computes the credit risk of the firm on a future period, which works like a forward interest rate. For instance, the 3-month Forward 1-Year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. The Forward PD term structure of Envision suggests that based on the market information available as of December 29, 2017, Envision's credit profile is likely to improve in the near future. This could be because the company is fundamentally sound, with current ratio and free cash flow to total debt ratio improving from Q4 2016 to Q3 2017. Furthermore, Envision does not have significant debt with near-term maturity, with the first significant debt of USD 750mn maturing in July 1, 2022.

However, it must be noted that the Forward PD of Envision was higher than the aggregate Forward PD for 15 companies in the Healthcare Services sector with market capitalization over USD 1bn. This could be because Envision is highly leveraged as compared to its industry peers, thus rendering Envision's credit profile to be weaker than that of its industry peers. Overall, while the declining Forward PD of Envision suggests that the credit outlook for Envision would improve in future periods, the Forward PD of Envision remains higher than that of its industry peers. Its credit profile might be improved if Envision could achieve cost synergy and higher profitability of its businesses.

Credit News

Lowest loan rate since 1956 sparks regulatory fears and raise pressure on debt

Jan 1. Australia's borrowing rates have fallen to their lowest level for 62 years, triggering debate that increasing household debt will force regulators to raise further speed limits to contain new lending. Westpac Group and other lenders including ING, Newcastle Permanent and Virgin Money all cut the rates. Housing loans grew at the lowest rate in 20 months in November as the regulators' moves to cool the investor segment continue to work. Investment bank JP Morgan argues macro prudential controls will remain restrictive during 2018 and Morgan Stanley claims that political and public pressure will make it difficult for lenders to increase rates on investment loans. The principal of Digital Finance Analytics, an independent consultancy, said that the Reserve Bank of Australia could be forced to raise base rate as the US president Donald Trump's tax cuts and planned infrastructure spending will still put pressure on global markets. (AFR)

Asia US dollar bond issuance hits record in 2017 as demand moves from America

Dec 31. Driven by greater liquidity and demand from investors, Asian US dollar-denominated bond issuance has hit a record in 2017 as subscriptions shifted away from America. Total new issuance of dollar bonds in

Asia excluding Japan has jumped 40% to USD 377bn from 2016, a rise on the back of a low interest rate environment and a weak US dollar resulting in narrower credit spread. The year's increased volume was, in large part, bolstered by mainland Chinese issuers who accounted for over two-thirds of bond issuance in Asia-Pacific excluding Japan, with financial sector, especially banks, dominating the sales. ANZ Bank predicted the size of the dollar debt market for Asia excluding Japan to reach a total value of USD 1tn by 2020. (SCMP)

Beijing warns of 'grim' bond default risks as it orders local government checks

Dec 30. The National Development and Reform Commission (NDRC) has asked local authorities to monitor the likelihood of corporate bond defaults as the risk of more company defaults remains high in 2018. A number of high profile firms have defaulted, including the failure of Dandong Port Group to settle bond payment. Increasing financial regulation and deleveraging efforts have pushed up the cost of bond issuance. There were nearly CNY 12bn of corporate defaults in 2017 and the NDRC wants to improve risk management processes within the local governments. (SCMP)

Gulf Arab energy producers issue record debt to fund expansion

Dec 28. Gulf Arab energy companies issued record debt of USD 28.7bn in 2017 as they opted to exploit lower borrowing costs to fund expansion plans. Those companies borrowed about USD 71.4bn in the past three years, more than twice the amount of the previous period. The annual average of the J.P. Morgan Middle East Composite Index's debt yield declined 12bps to a two-year low rate of 4.58%. OPEC estimated the global energy demand will jump 35% by 2040 and oil investment needs to meet that growth. According to the CEO of Qamar Energy, even after record borrowing, the debt levels of Gulf energy producers lag behind that of publicly traded companies and those state energy companies may raise more debt in 2018. (Bloomberg)

RCom to exit debt recast plan with zero write-offs to lenders

Dec 27. Reliance Communications Ltd (Rcom) announced the abortion of a strategic debt restructuring plan that would have seen a conversion of INR 70bn in debt to equity. Currently holding a debt of nearly INR 4.5tn, RCom plans to cut the figure to INR 250bn through prepayment after asset monetization and the transfer of spectrum liabilities. With lenders agreeing to the debt resolution plan, RCom also intends to resolve issues with unsecured creditors in the next few weeks. However, there are doubts as to whether RCom will be able to find buyers for their asset sale. RCom's problems have also prompted Fitch to suspend its coverage on RCom for the last two years. Despite the concerns, Chairman Anil Ambani is optimistic in transforming RCom to a B2B services company. RCom's shares rose nearly 35% to a 4-year high after the announcement. (Bloomberg)

Malaysia's 1MDB settles debt owed to Abu Dhabi with China backing (Straits Times)

Dim Sum bond sales slump to 2010 low (Bloomberg)

13 firms fined for skirting lending rules in Guangfa bank scandal (Caixin)

Regulatory Updates

European finance sector scrambles over Mifid II rules

Jan 2. European banks may be working through the Holiday season as they prepare to implement the second iteration of the Markets in Financial Instruments Directive (Mifid II) on Jan 3. The new legislation requires financial institutions to provide more information about trades and dozens of trading and compliance systems are due for upgrades. Mifid II also requires fund managers to pay for research, which could affect analyst compensation and the price for access to research. Trading in dark pools, or private markets that allow investors to buy and sell large block of shares, will be limited to 8% of trading volume under new Mifid II rules. (FT)

The sovereign-debt doom loop still threatens banks

Dec 26. The recent sign off on the Basel III rules for bank capital is a step forward to making banks safer and stronger. However, there is still a concern regarding the treatment of sovereign bonds on banks' balance sheets. National regulators can treat these bonds as safe, which then allows the freedom to set their risk weights at zero. Banks will be able to load up on sovereign bonds without needing to raise more capital. This poses a huge danger, especially when governments have to step in to quell the negative effects on banks when investors lose faith in sovereign bonds. The bonds value will further fall, leading to a "doom loop". There should be caution when dealing with this matter since a sudden regulatory might be too drastic and itself trigger a sovereign debt crisis. (Business Times)

China regulator tightens rules related to bad asset recovery (Caixin)

SEBI plan on loan defaults runs into RBI hurdle (Livemint)

China's leaders fret over debts lurking in shadow banking system (Reuters)

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