Affiliations: The Changing Paradigm

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Presentation Overview

- The changing industry environment
- The drivers for affiliation – past and present
- Why systems want to grow
- Who are potential partners – some surprising new players
- New affiliation structures
- How to design a sustainable affiliation

The Changing Industry Environment

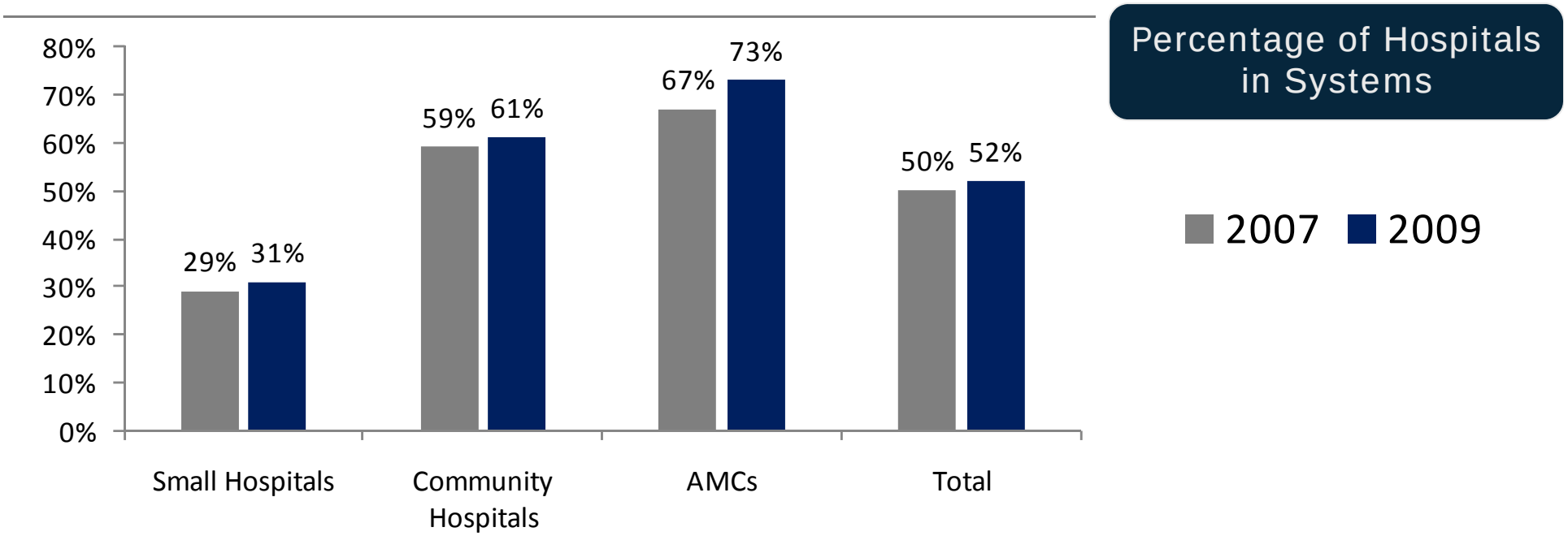
- The healthcare industry is struggling to deal with a number of environmental factors that could change the structure of the industry
  - Healthcare Reform, in whatever form it eventually takes, will push to link payment to quality, require providers to take risk and continue to push reimbursement down
  - The prolonged economic downturn is increasing uncompensated care and causing employers to consider trimming or dropping healthcare coverage
  - State and Federal budget deficits are putting pressure on state Medicaid programs, causing some states to consider cutting reimbursement, cutting enrollment or shifting to a state program
  - Insurance companies are feeling pressure to curtail premium increases, while adding mandated benefits, leading to tougher future negotiations for private reimbursement
  - Physicians, who are also facing payment pressures, are seeking employment by hospitals and systems at an accelerating rate – putting further pressure on hospital margins

The Changing Industry Environment

- All of these factors are requiring providers to balance
  - More ACCESS for more people and higher acuity
  - While increasing QUALITY
  - For lower COST

The National Experience

- Currently 61% of all community hospitals are part of a system, compared to 31% for small, usually rural, hospitals
- The process of affiliation is accelerating, with the number of hospitals in for-profit systems growing from 20% to 25% of all hospitals from 2000 to 2008.
- Physicians are seeking affiliation through employment at an accelerating rate, with over 50% of all physicians now employed by hospitals and health systems

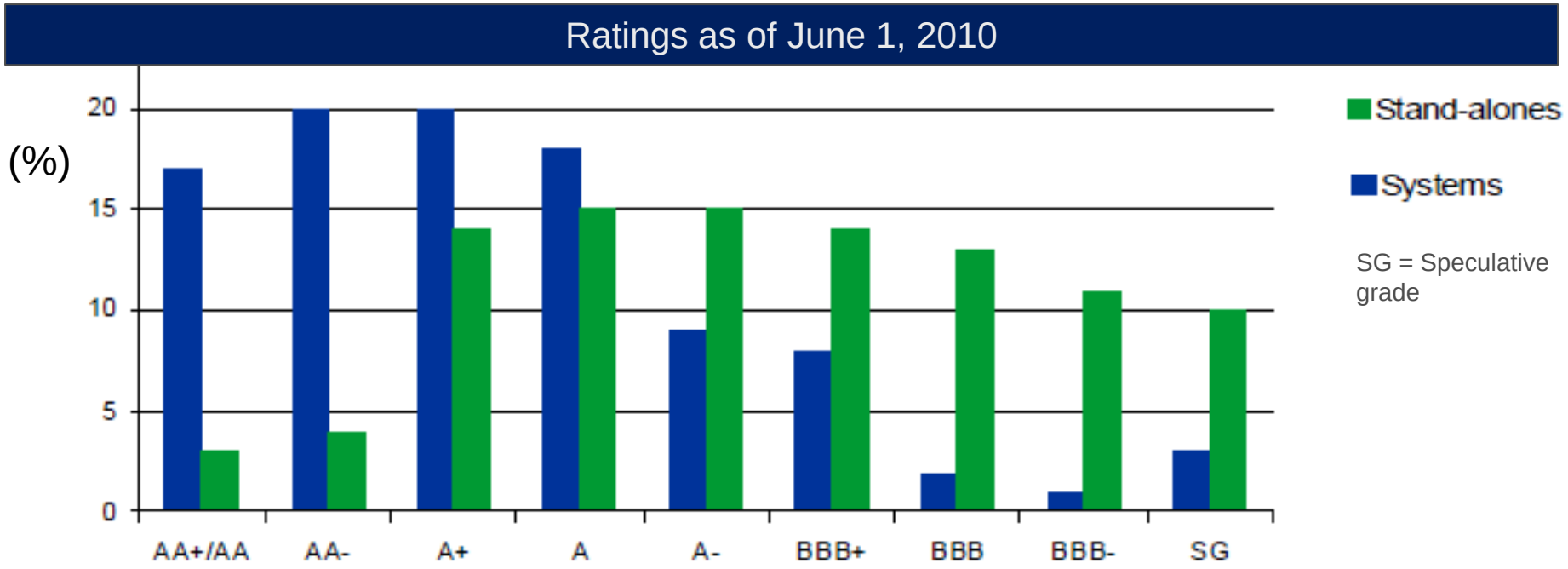


The Drivers for Affiliation

- Until recently the key drivers for hospitals looking to affiliate with a larger hospital or system were:
  - Access to capital – with margins challenged and the debt markets demanding higher credit worthiness, many stand alone hospitals have had difficulty accessing the capital needed for investments in facilities, physicians and infrastructure
  - Financial Distress – many hospitals have sought affiliations to improve their finances through enhanced reimbursement, management infrastructure, branding, recruitment and the like
  - Competition – as larger systems expanded into more markets, particularly with large ambulatory facilities, many smaller community hospitals sought to “join rather than fight” these systems

Not-For-Profit Health Care Ratings 2010

- All things equal, stand alone hospitals have higher cost of capital



"Due to the lack of geographic diversity of stand-alone hospitals, we believe these providers are more vulnerable to market conditions in their single markets, such as immediate competition, local economic swings and demographic shifts.

"As such, in our analysis, we generally look for stronger financial profiles of a stand-alone hospital than of a health system to achieve similar debt rating level" – S&P, 2010

Affiliation Drivers

- In addition to these traditional drivers, which are still important, some new drivers for affiliation for community hospitals have emerged, largely due to the push for health reform:
  - Clinical Integration – as larger hospitals and systems seek to build Accountable Care Organizations, community hospitals are looking to affiliation as one way to participate in future delivery consortiums
  - Enhance Quality – pay for performance requires sophisticated process, monitoring and reporting systems to enhance and maintain quality to ensure the highest reimbursement, which are often not affordable to stand alone hospitals
  - Infrastructure – stand alone hospitals are seeking affiliations to build their infrastructure, including management depth, information systems and new clinical infrastructure to respond to the challenges of the new payment systems
  - Scale – if providers are to assume responsibility for designated populations, episodes of care and quality, they must have the scale to assume and spread risk across a broad population base – causing many systems to look beyond their local markets for affiliations

Why Systems Want to Grow

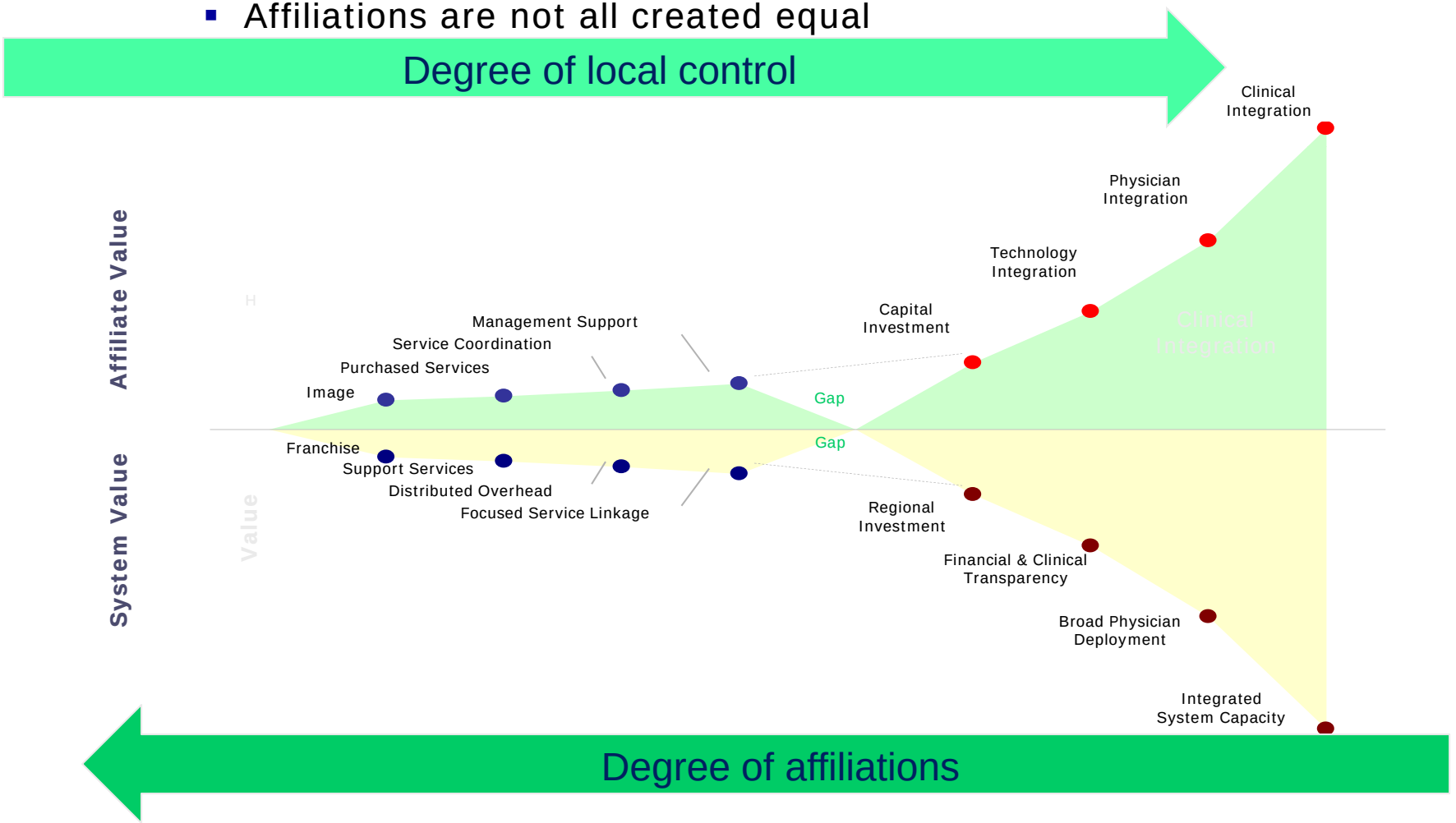
- There is a growing consensus that most urban and regional markets will be dominated by one or more large health systems. Understanding what Systems want and need is important to understanding the market. Systems want from affiliations:
  - Large and diverse populations to spread risk
  - A full continuum of care in the system
  - Distributed access points into the system
  - Ability to provide services in the most convenient, least costly environment
  - Infrastructure to link clinical processes between system hospitals and physicians
  - Opportunity to spread its “Brand”
  - Access to capital to fund all these activities

Potential Partners in Today's Market

- The cast of potential partners for stand alone community hospitals has expanded with the changing healthcare environment to include:
  - Multi-Hospital Systems – these systems have been traditional potential partners for local hospitals, but many are now seeking hospitals outside their normal markets for scale and diversity
  - Academic Medical Centers – many are forming or growing hospital networks in preparation for becoming ACOs, some with innovative structures
  - For Profit Health Systems – the number seeking to buy or partner has increased in recent months, with older companies re-entering the field and newer companies with significant equity funding becoming very aggressive
  - Equity Investors – a new category of partner is emerging as large equity investors seek opportunities to invest in healthcare systems – as with Cerberus Capital's purchase of Caritas Christi
  - Potential Partners – Payors are considering partnering or buying hospitals as their bid to create ACOs
  - Regional Consortiums – the idea of creating a consortium of equals to gain the scale to become an ACO is emerging, along the lines of the old "Super PHOs"

Models for Affiliations

- The Affiliation Curve answers the questions of "why" and "how" affiliations work
  - Think strategically about the desired value and alignment of all parties
  - Affiliations are not all created equal



Affiliation Structures

- As the competition for affiliations increases and the needs for affiliation change, the possible structures for affiliation are increasing. In order of least to most integrated, affiliation structure options today include:
  - Clinical Program Affiliation – affiliation with a tertiary hospital for a specialized program, such as cancer or heart
  - Shared Services Affiliation – Sharing key services with other peer providers, such as purchasing and IT
  - Management Contract – A system provides long term management services, and can, if properly structured, negotiate third party contracts on behalf of the managed hospital
  - Regional Consortium (Super PHO) – A group of hospitals form a regional consortium, with shared services, shared ownership in the consortium and shared risk for contracting
  - Joint Venture with 50/50 governance – A new form of Affiliation where a for profit system buys 80% of the hospital, but creates a JV where the community has a 50% vote in governance

Affiliation Structures

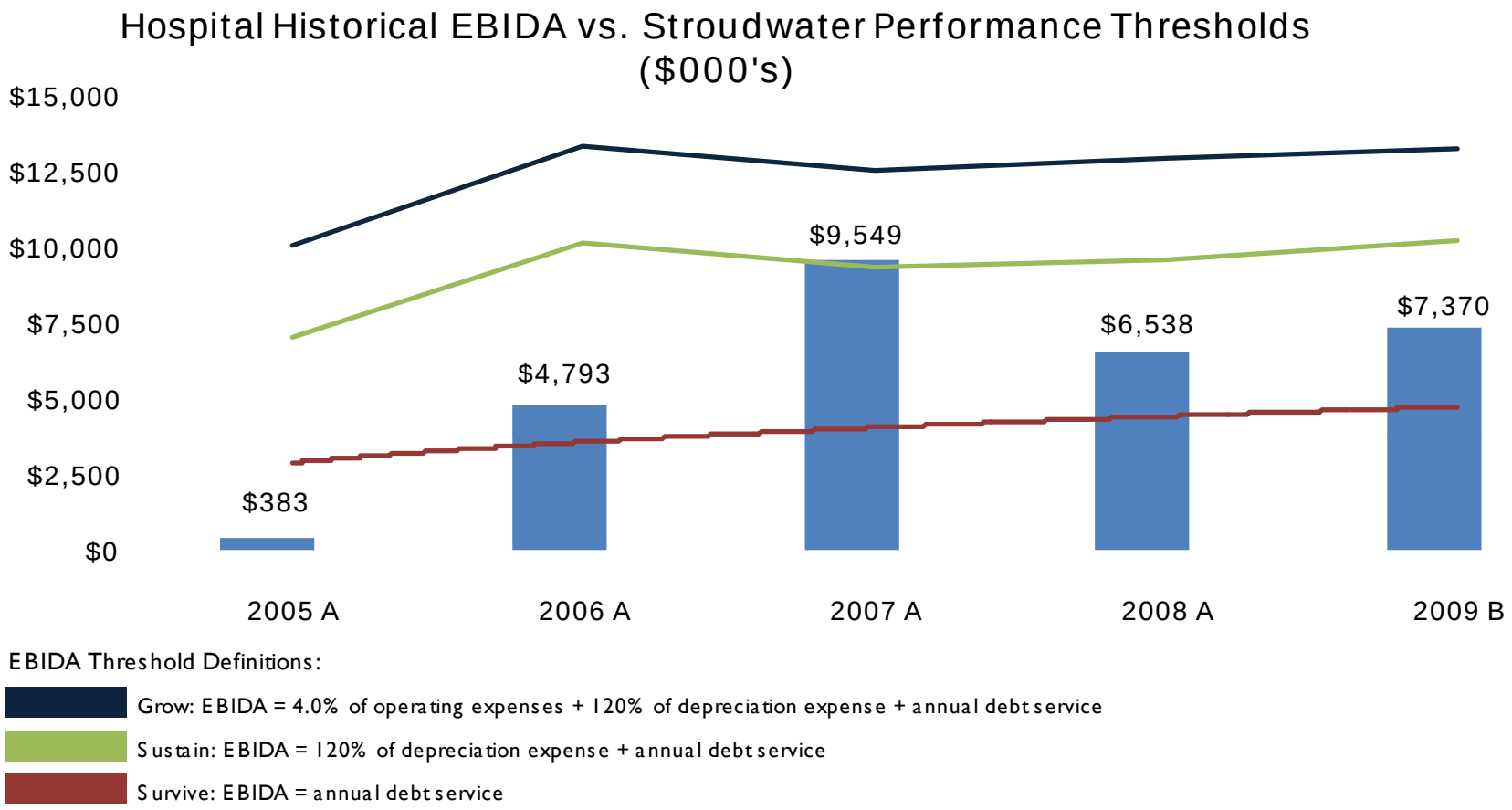
- Joint Venture with AMC and for profit company – A for profit company joint ventures with an AMC to acquire a hospital, with the For Profit company providing capital and management and the AMC providing clinical oversight and branding. Can be combined with the 50/50 Governance JV
- Equity Buyout – An equity fund invests in a hospital or system, with possible further affiliations.
- Sole Member Substitution (not for profit merger) – A large not for profit system and a hospital merge by a sole member substitution, leaving the local corporation intact
- Full Asset Acquisition or Long-Term Lease – A system acquires the assets of the hospital in return for a financial consideration and community covenants

- Which structure is appropriate is a function of the goals and objectives of the affiliation, including access to capital, local control and clinical integration

Key Questions When Considering an Affiliation

- Do we have the scale and resources to achieve our goals as an independent organization?
  - Operating margin and cash flows need to be adequate to access capital and fund required initiatives
  - Can we protect and grow our market share?
  - A physician strategy needs to consider employment and clinical integration
  - Quality and IT infrastructure are critical to future reimbursement
  - Can we meet the requirements of ACOs as a contractor?

Implications of the New Operating Environment



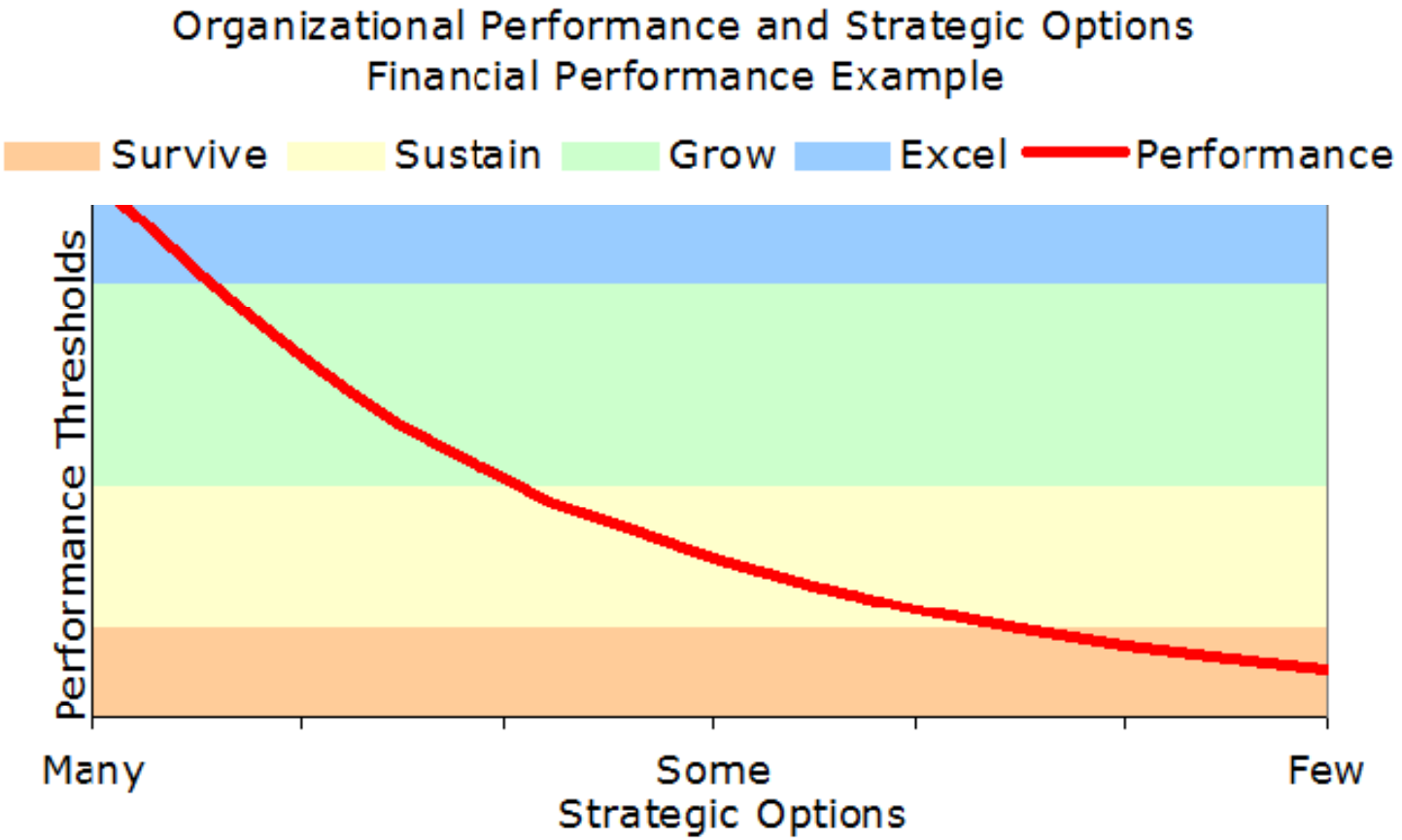
- This community hospital has a modern, recently expanded facility, several successful service line specific clinical affiliations with a highly regarded tertiary provider and consistent profitability since 2005.
- Should they seek a partner?

Weighing the Risks of Your Strategic Options

- The question for hospital leadership is what is the best way to achieve the hospital's mission and vision:
  - Partnering results in "partner risk:"
    - Will your partner meet their commitments?
    - Will you lose local input and control?
  - An independent strategy creates "execution risk:"
    - Do we have the resources and systems to address our challenges?
    - Can we realistically attain our vision on a stand-alone basis?
  - How well do potential partners address these execution and partner risks?

When to Consider an Affiliation

- The timing of consideration of an affiliation is partially dependent on the financial condition of the hospital.
- Dealing from a position of financial strength affords more strategic options



How to Build a Sustainable Affiliation

- To be successful, it is critical that any affiliation is based upon:
  - A clear vision for the future
  - A clear set of goals and objectives from BOTH partners
  - A thorough understanding of the strategic, operational, and financial implications of affiliation vs. the status quo (value proposition)
  - An objective assessment of the range of affiliation options and structures available to the hospital
  - A “win-win” partnership to help ensure a sustainable affiliation
  - An exit strategy in the event the partnership fails or the environment changes
  - A well documented transaction
  - An implementation plan with timetables, measures and accountabilities

What the New Paradigm Means for Affiliations

- Market consolidation and affiliations will continue to accelerate
- ACOs, the need for critical mass for population-based health risks and the throughput necessary to support operating infrastructure will drive consolidation
- Growing emphasis on a partner's ability to deliver on clinical quality, coordination of care, operating efficiency and brand or "halo" benefits
- Execution risks and partnering risks will multiply due to expanded list of critical success factors
- Access to capital is not the primary driver of partnering imperatives in today's environment
- New structures exist that recognize the importance of local input and governance as well as the benefits of adding operating expertise and tertiary affiliations
- There are much greater costs today if affiliation is put off until after the hospital is in financial difficulty

Thank You and Contact Information

If you have questions or feedback, please feel free to contact either presenter of today's webinar.

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