



STROUDWATER

**PROTECT YOUR VALUE:
POSITIONING RURAL HOSPITALS FOR
STRONGER PARTNERSHIPS**

MEET THE SPEAKERS



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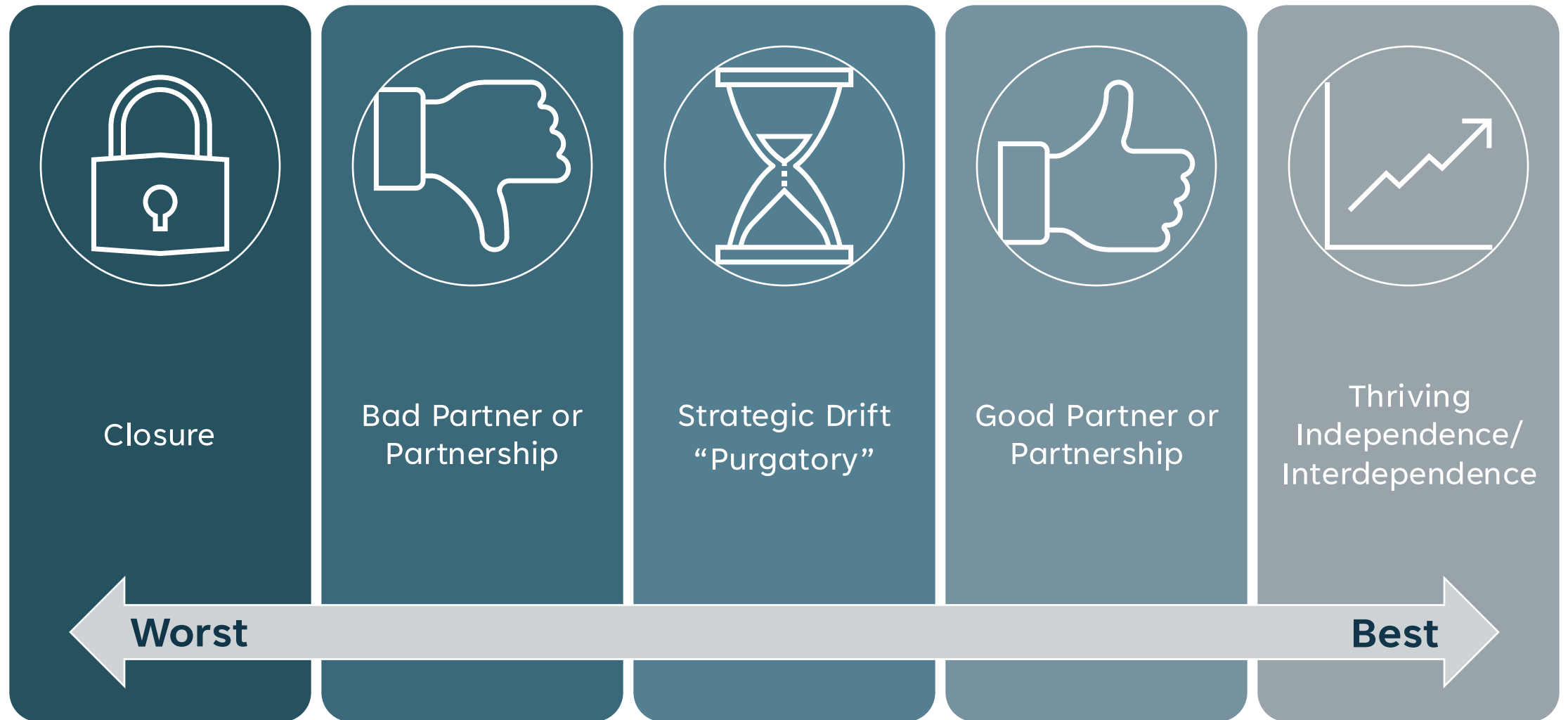
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Stroudwater is a leading national healthcare consulting firm specializing in mission-critical strategic, operational, and financial opportunities for healthcare leaders' most pressing challenges

COMMON OUTCOMES FOR RURAL HOSPITALS



+/- 90% of hospitals are within these three options



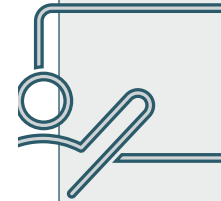
POLLING QUESTION 1



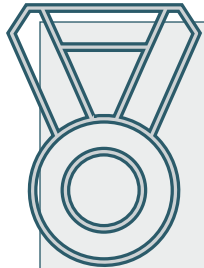
WHAT DO RURAL LEADERS NEED TO KNOW?



For the 60% of rural hospitals in a partnership, most systems miss critical aspects of rural value



No one is going to stumble across your value unless you quantify it and show the path to operationalizing it

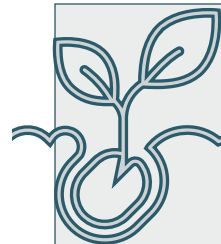


Identify win-wins with existing partners—it's about making better decisions and better allocating scarce resources



Does a partner understand your value?

- Variable vs. fixed costs
- Contribution margin vs. fully allocated costs
- Incremental cost vs. reallocated costs
- The value of incremental referrals



The Four Know/Nos:

- **Know your risk profile**
- **Know your value**
- **No one else will promote your value**
- **No risk-free options**

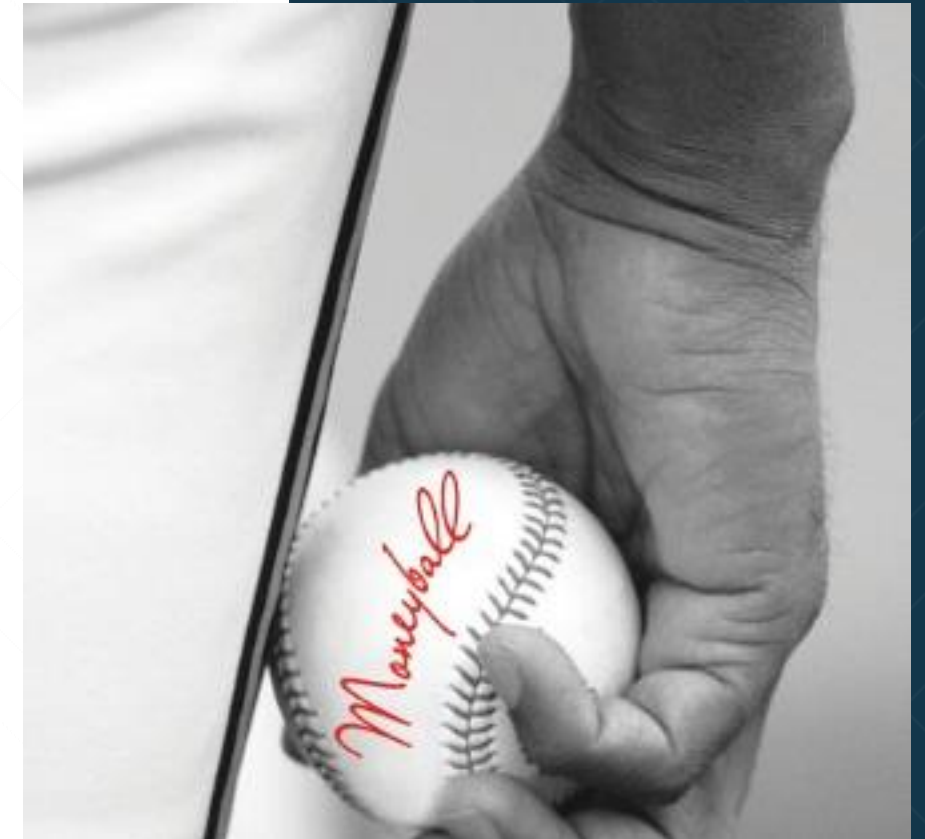




WHAT ARE WE GETTING WRONG?

MONEYBALL: WHAT CAN IT TELL US?

- The central premise of Moneyball (2003, Michael Lewis) is that the collective wisdom of baseball insiders over the past century is outdated, subjective, and often flawed
- The best-known Moneyball theory was that on-base percentage was an undervalued asset and sluggers were overvalued
- At the time, protagonist Billy Beane was correct. Jahn Hakes and Skip Sauer showed this in a very good economics paper
- From 1999 to 2003, on-base percentage was a significant predictor of wins, but not a very significant predictor of player salaries
- **The takeaway: players who draw a lot of walks were cheap relative to their actual value.**



WHAT ARE WE GETTING WRONG?



- “Rural healthcare is a dumpster fire”
- “With fully allocated costs, the result is clear: the economics are unsustainable and dilutive”
- “We need to shut down or curtail rural operations to reduce costs and conserve resources”
 - These statements confirm what many believe they know
 - **But are these statements correct?**
 - **What are they getting wrong or missing?**



AFFILIATE ACCRETIVE VALUE

- Our client was a Northeastern seven-hospital system, including a 120-bed community hospital affiliate
- System allocates \$25M of overhead to the affiliate's general ledger, resulting in a **\$13M operating loss**
 - As a result, the system slashed capital investment at the affiliate
 - The operating loss included \$7M in non-cash depreciation expense and excluded \$3M in non-operating income
- Of the \$25M in system-allocated overhead costs, only 20% were estimated to be variable (or incremental) while the remaining were estimated to be fixed (reallocation of existing costs)
 - The fixed portion should not have been considered when evaluating the contribution margin of the affiliate
- Actual contribution margin to the system, before considering the value of incremental patient volume from the affiliate service area, was \$17M
- The affiliate provided \$22M in incremental contribution margin to the system from additional service area referrals
- **Total contribution margin to the system from the rural affiliate: \$39M**



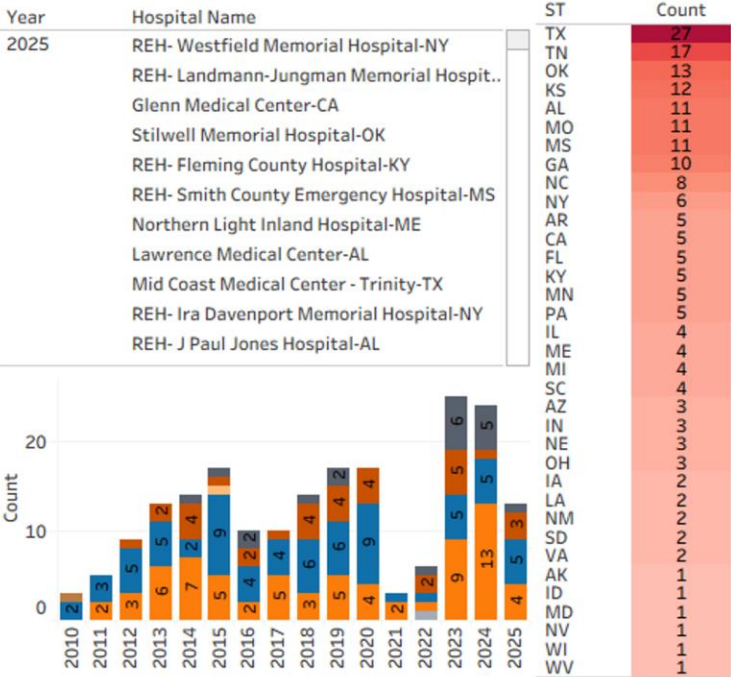
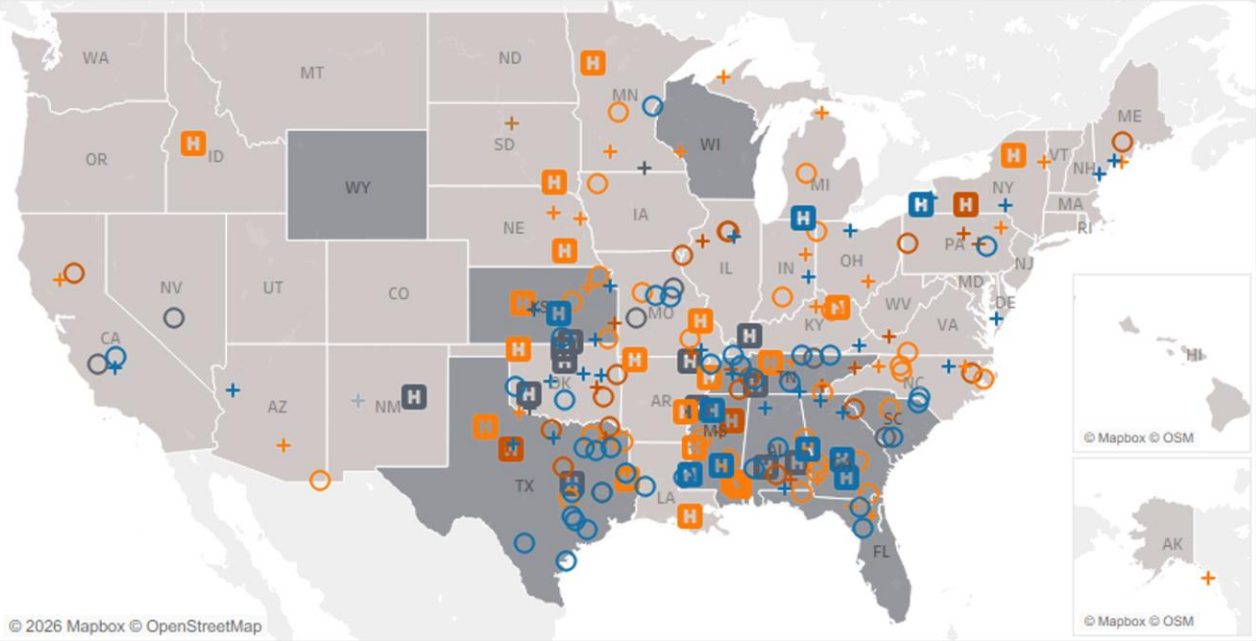


HEALTH INDUSTRY FACTORS INCREASING STRATEGIC RISK

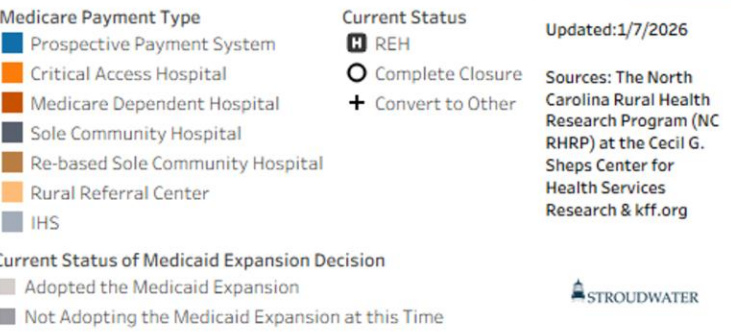
RURAL HOSPITAL CLOSURES SINCE 2010

200 Closed or Converted Rural Hospitals

There have been 200 Rural Hospital closures or conversions since 2010 and 243 since 2005, these numbers include forty-three (43) REH Conversions since 2023



Year	Prospective Payment System	Critical Access Hospital	Medicare Dependent Hospital	Sole Community Hospital	IHS	Re-based Sole Community Hospital	Rural Referral Center	Total
2010	2	2	1	1		1		3
2011	3	3	1	1				5
2012	3	3	1	1				9
2013	2	6	2	1				13
2014	2	7	4	1				14
2015	4	2	1	2			1	17
2016	4	2	2	1				10
2017	4	5	1	1				10
2018	6	3	4	1				14
2019	6	4	4	2				17
2020	9	4	4					17
2021	1	2	2	1	1			3
2022	1	1	2	1				6
2023	5	9	5	6				25
2024	5	13	3	5				24
2025	5	4	3	1				13
Total	72	71	34	20	1	1	1	200

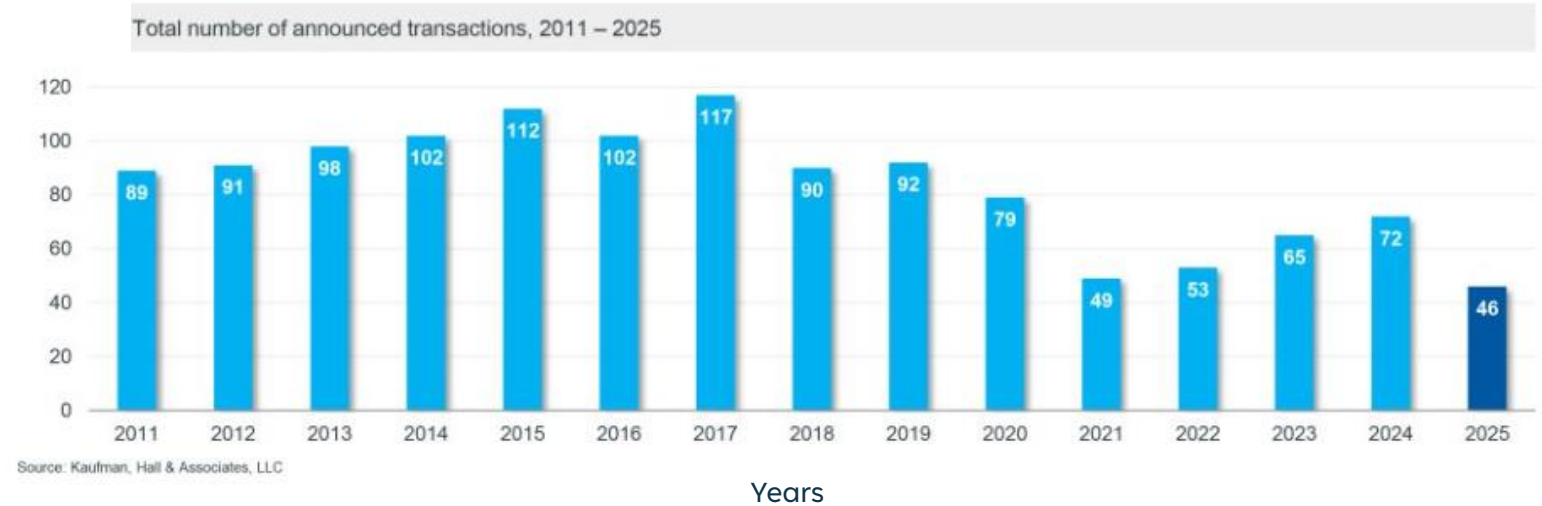


RURAL AFFILIATION DRIVERS: INDUSTRY CONSOLIDATION

Catalysts

- Margin pressure
- Heightened competition
- Staffing crisis
- Increasing bad debt from high-deductible health plans
- Medicare Advantage
- Declining inpatient admissions
- Changing payment models
- Quality initiatives
- Provider shortages
- Economies of skill

Number of Hospital Affiliations



Annual Revenue



RISK MITIGATION VIA IMPROVED PERFORMANCE

- Nearly 30 rural performance improvement projects led by Stroudwater over 30 months delivered a median of \$1.7M in financial improvement per organization, equating to nearly 8% of net patient revenue per organization

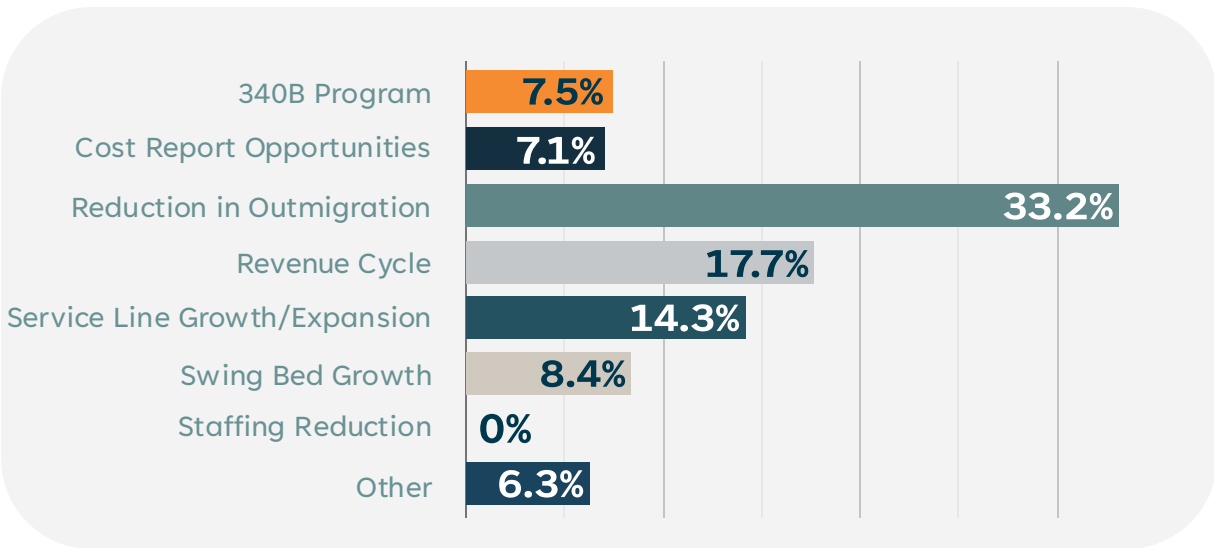
Total Estimated Impact

25th	\$ 1,300,000
Median	\$ 1,700,919
75th	\$ 3,727,000

Impact % of Net Pt Revenue

25th	4.1%
Median	7.8%
75th	11.1%

- These engagements spanned an array of functional areas, with the average share of total improvement realized broken out as follows:





WHEN TO THINK ABOUT PARTNERSHIPS

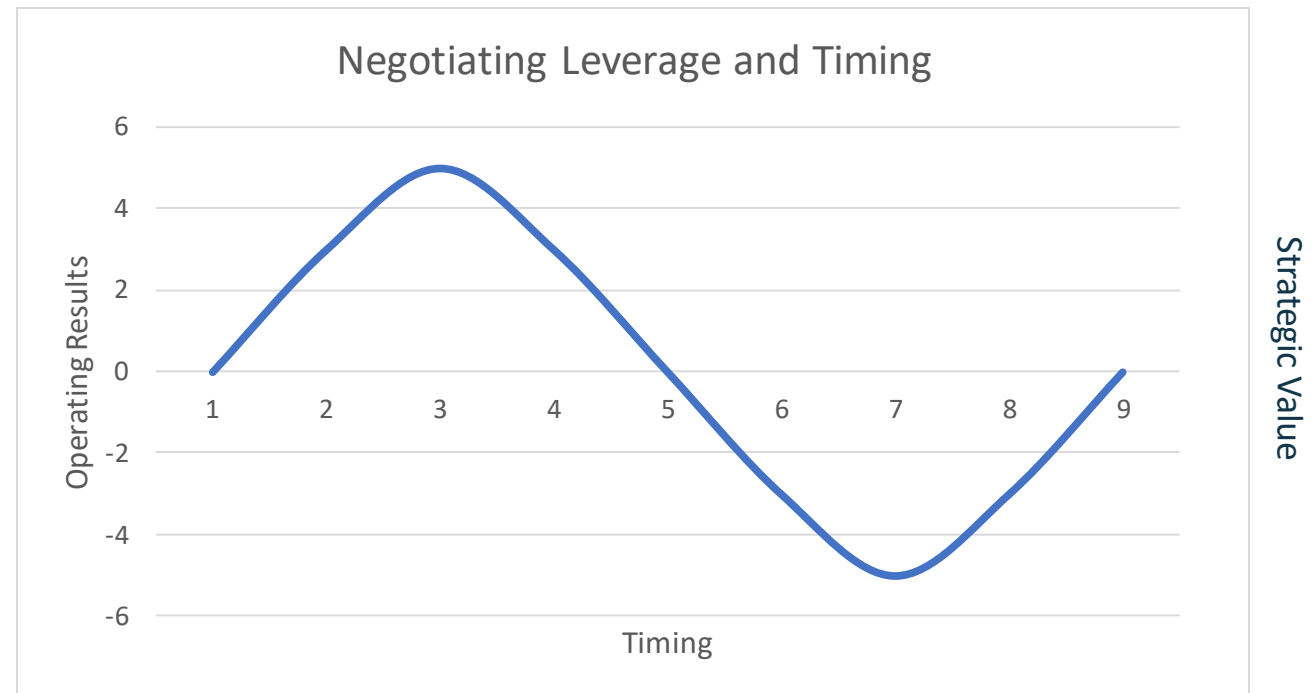
TIME IS NEVER A NEUTRAL FACTOR

A struggling rural hospital must weigh the pros and cons of the following timing factors:

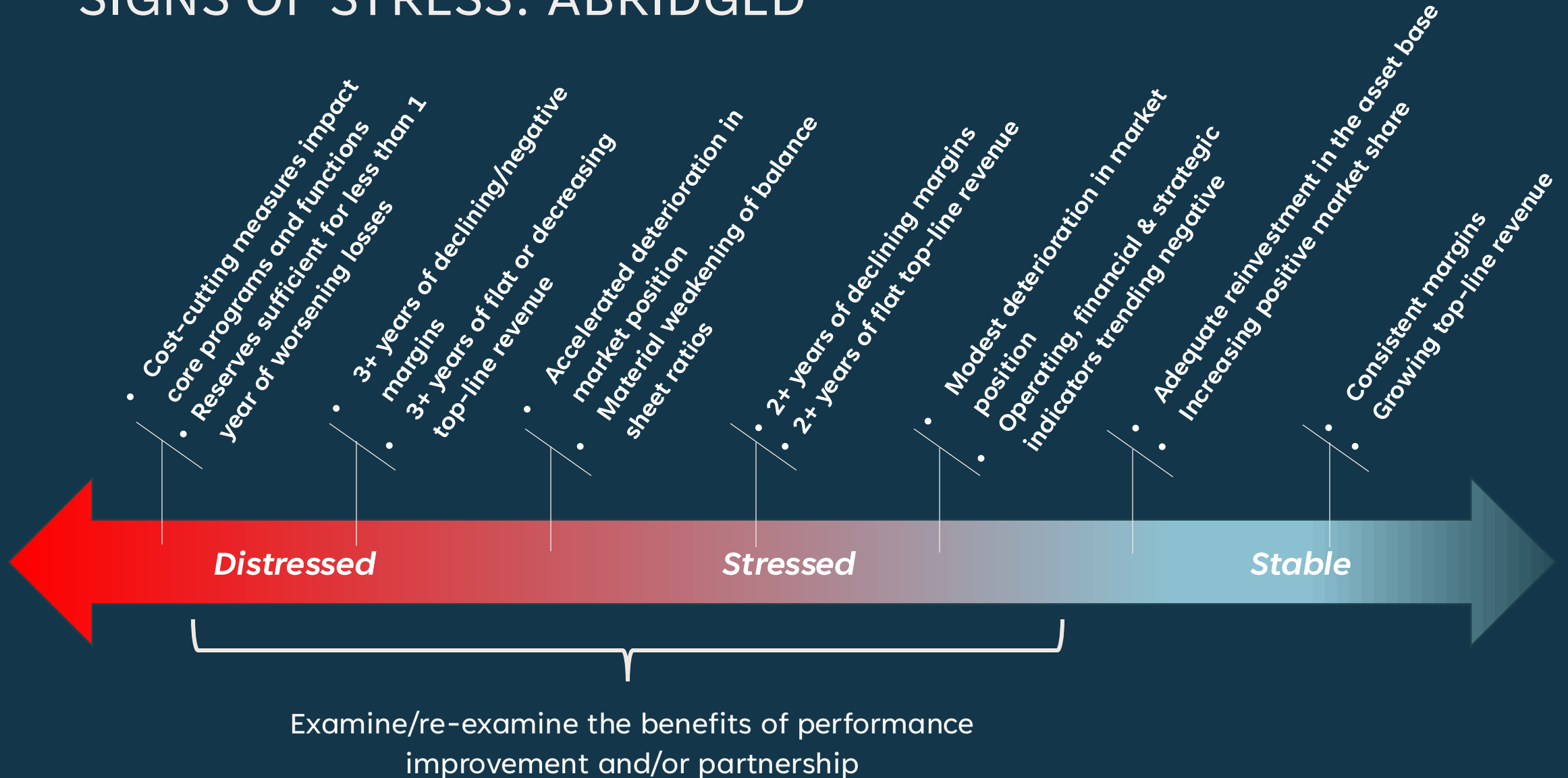
Time to demonstrate results from a performance improvement plan

Time for major developments

Time for adverse market developments to have an effect (state and federal budgets, competitor response, etc.)



SIGNS OF STRESS: ABRIDGED



FACTORS THAT AFFECT RISK



- The four risk domains depicted to the left describe the major sources of strategic risk in today's environment
- Poor performance in one domain will have collateral or “spillover” effects on one or more of the other domains
- Key trends within each risk category should be monitored annually, and long-term trends should be quantified. Over time, the cumulative impacts can be very significant.

Boards may not appreciate the cumulative effects of changes in risk factors that can take place over several years.



POLLING QUESTION 2



UNDERSTANDING THE RISKS

What is the best strategy to achieve mission and vision?

Independence vs. Affiliation/Partnership



How do you minimize Operating Risk?

- **Accountability around strategic objectives** between the board, the management team, and the medical staff
- Maintain annual **operating cash flows** at least equal to debt service plus 120% of depreciation expense
- Create access to a **robust primary care base**
- Achieve required value metrics re: **quality and cost** and selectively assume risk
- Invest in a distributed and efficient **ambulatory network**

How do you minimize Partner Risk?

- Design a well-structured affiliation process with clear objectives
- Select a **strategically aligned partner**
- **Vet alternative partners' track records and capabilities**
- Vet alternative **affiliation structures** for their fit with our strategic objectives
- **Contractually enforceable key terms**
- **Involve key stakeholders** from the beginning and emphasize communication
- **Make candidates earn the right to be your partner**

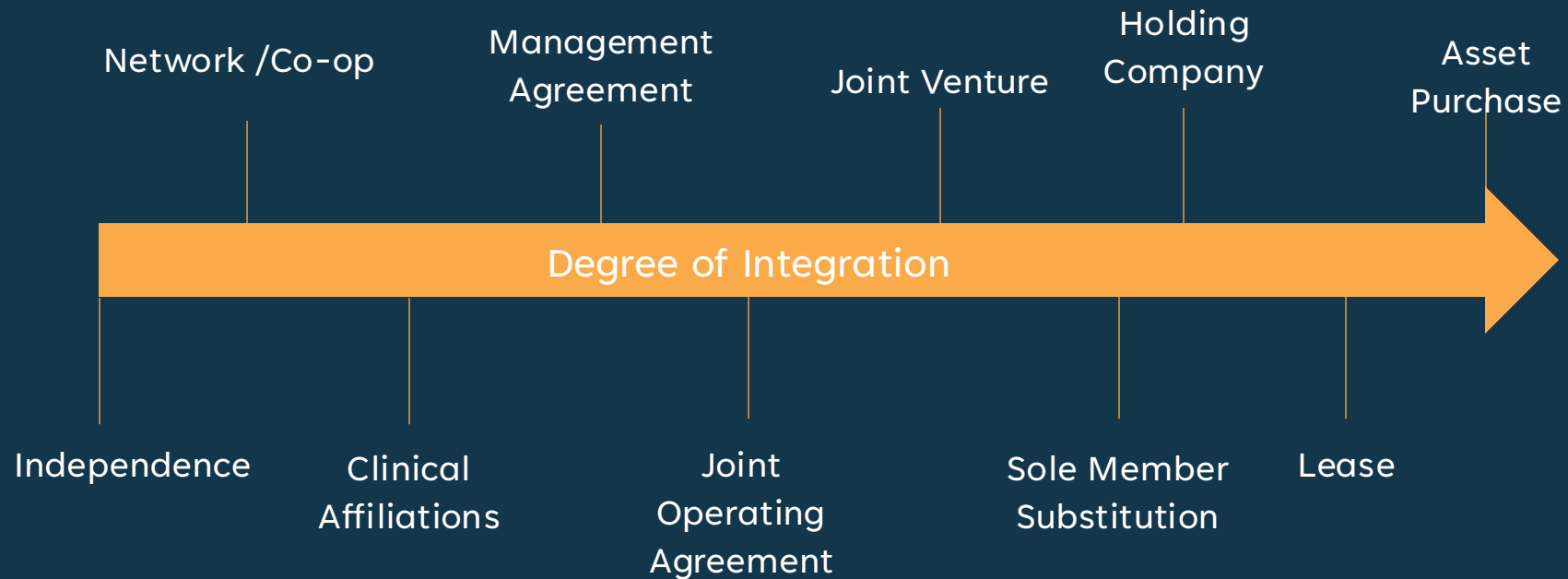




HOW TO ENSURE YOUR PARTNERSHIP CREATES VALUE

CONTINUUM OF PARTNERSHIP STRUCTURES

- There are a variety of partnership structures at different degrees of integration



VALUE LEVERS FOR RURAL HEALTH SYSTEMS

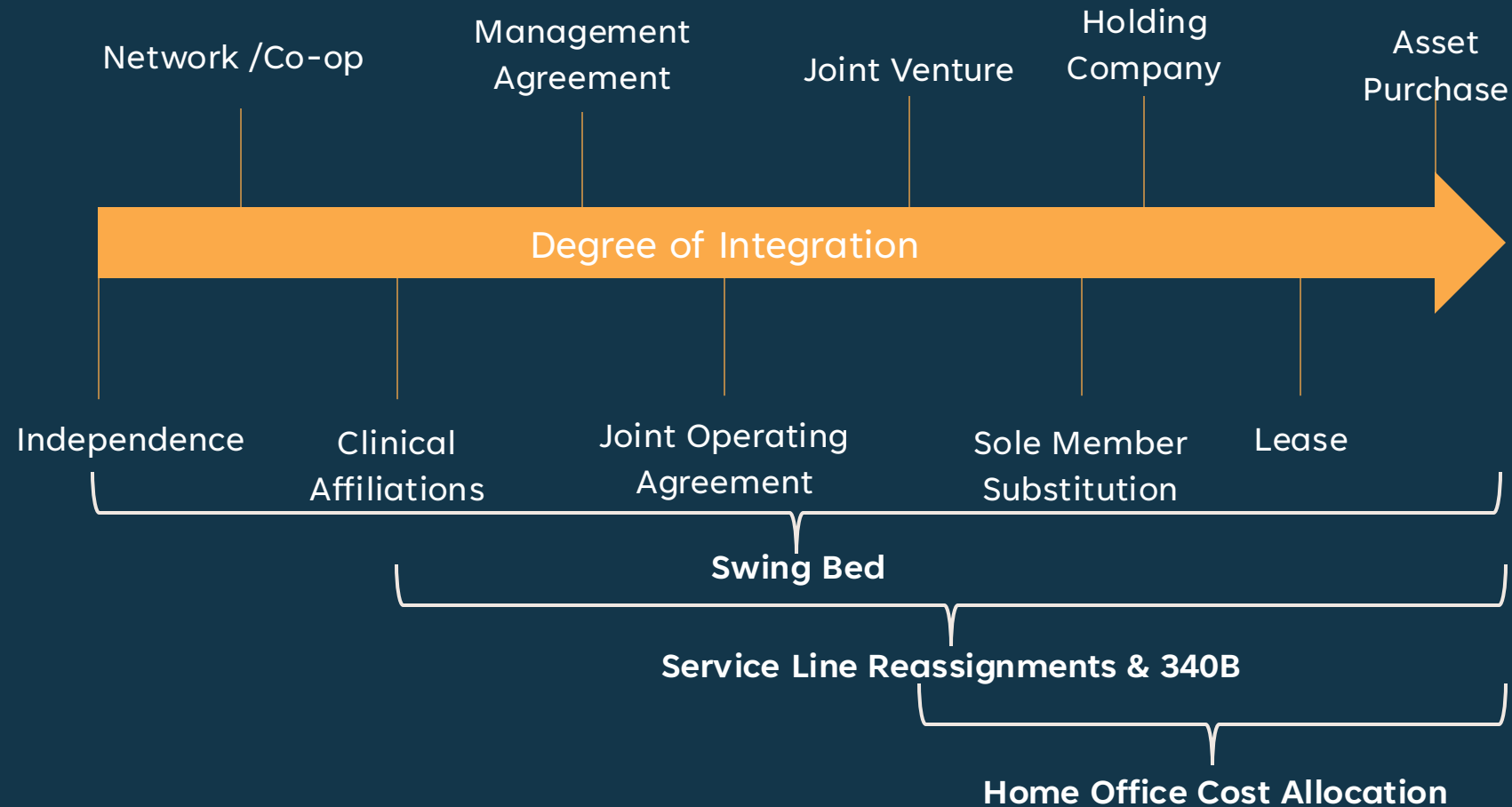


- The following value levers are often misunderstood or undervalued by existing and potential partners:
 - Cost-based payment
 - Cost report optimization opportunities
 - Home office cost allocation
 - 340B eligibility and post-Genesis ruling opportunities
 - Swing beds
 - Rural health clinics (RHCs)
 - Decanting volume and utilizing Critical Access Hospitals (CAHs) as specialized components of the continuum of care
 - The value of attributed lives and a primary care base that is cash flow positive
 - The “true” value of incremental referrals



CONTINUUM OF PARTNERSHIP STRUCTURES

- There are a variety of partnership structures at different degrees of integration



PARTNERING IS NOT A RISK-FREE ENDEAVOR

PROSPECTIVE PARTNERS

- Vet and select a strategically aligned partner
- Assess their track record
- Select an affiliation structure that fits your strategic objectives and constraints
- Craft contractually enforceable terms that reflect the rural value proposition

EXISTING PARTNERS

- Ensure that your partner understands your value proposition
- Ensure your affiliation structure enhances the value provided by the partnership for both parties
- Identify and quantify any missed/potential opportunities
- Quantify the ROI of investments to reflect the unique rural value proposition



PROCESS FOR ENHANCING EXISTING PARTNERSHIPS

- Unleashing previously untapped value should benefit both the rural affiliate and the parent
- Quantify opportunities with a pragmatic and realistic mindset—do not overpromise and under-deliver
- Get some early wins on the board to build confidence and buy-in
- Prioritize opportunities based on:
 - Low cost to implement
 - Quick ROI/time for payback
 - Ability to execute
 - Value to partner, affiliate, and system
 - Strategic fit of the opportunity
- Focus on educating colleagues about recurring benefits and including benefits in future capital allocation decisions



A COSTLY STRATEGIC ERROR AVOIDED



A health system with four Critical Access Hospitals totaling \$55M in operating revenue believed these rural affiliates were a significant drag on operating results

The system engaged Stroudwater to perform an in-depth financial and operational analysis of its rural affiliates



The operational and financial evaluation found a total of \$6M in annual missed operating cash flow improvement opportunities



The review also found an additional \$9M in errors in the System's evaluation of the contribution margin of these rural affiliates



Combined, the \$15M in missed opportunities and performance evaluation mistakes painted a misleading picture of the rural affiliate's contribution margin to the system and revealed previously hidden opportunities



The evaluation provided the system with an actionable roadmap to realize the true accretive value of its rural affiliates



PROCESS RECOMMENDATIONS FOR NEW PARTNERSHIPS

Have prospective partners compete for the privilege of being your partner

- Use the process to gather information about your options
- Use the process to educate prospective partners as to your value
- Assess whether a partner is willing to adjust terms and commitments to reflect the quantification of your value
- Leverage the analyses of your value, the competitive process, and the asymmetry of information to negotiate improved terms
- Evaluate prospective partners' track records with their rural affiliates
- Do not sign an exclusive Letter of Intent (LOI) until you have an acceptable term sheet in hand



POLLING QUESTION 3



CASE STUDY: THE WRONG PREFERRED PARTNER

- A distressed Critical Access Hospital (CAH) had a preferred affiliation candidate identified and a signed letter of intent when they approached Stroudwater for assistance because the affiliation process was stalled
- Their preferred partner—a large regional referral center—did not understand the value proposition of having a CAH as part of their health system
- Stroudwater recommended that the client conduct a process to evaluate a broader selection of affiliation options alongside their preferred partner
- Stroudwater educated all interested parties about the unique value proposition of having a CAH affiliate (home office cost allocation, rural health clinics, 340B eligibility, swing beds, cost-based payment, etc.)
- Despite these education efforts, their prior exclusive prospective partner could not incorporate these value drivers into their proposal
- Thankfully, an alternative preferred partner emerged with previous experience with distressed rural hospitals, a track record of successful turnarounds, and expertise in operating rural affiliates
- Our client vetted its options and selected the newly identified partner based on its expertise, track record, and the quality of the terms of its proposal

CASE STUDY: DID NOT UNDERSTAND RURAL VALUE



- Our CAH client entered discussions with a large multi-state health system regarding a potential affiliation
- The large health system misunderstood the value of the home office cost allocation, placing only \$100K incremental value on this allocation vs. an estimated \$3M+ annual value calculated by Stroudwater
 - A greater than 50% share of cost-based payment
- The benefit of a modest change in referrals (+2.5% market share gain)
- Result: The prospective partner revised their offer from minimal capital commitment and virtually no local role in governance to an offer that included major investment commitments, major service commitments, and a significant continuing affiliate role in governance

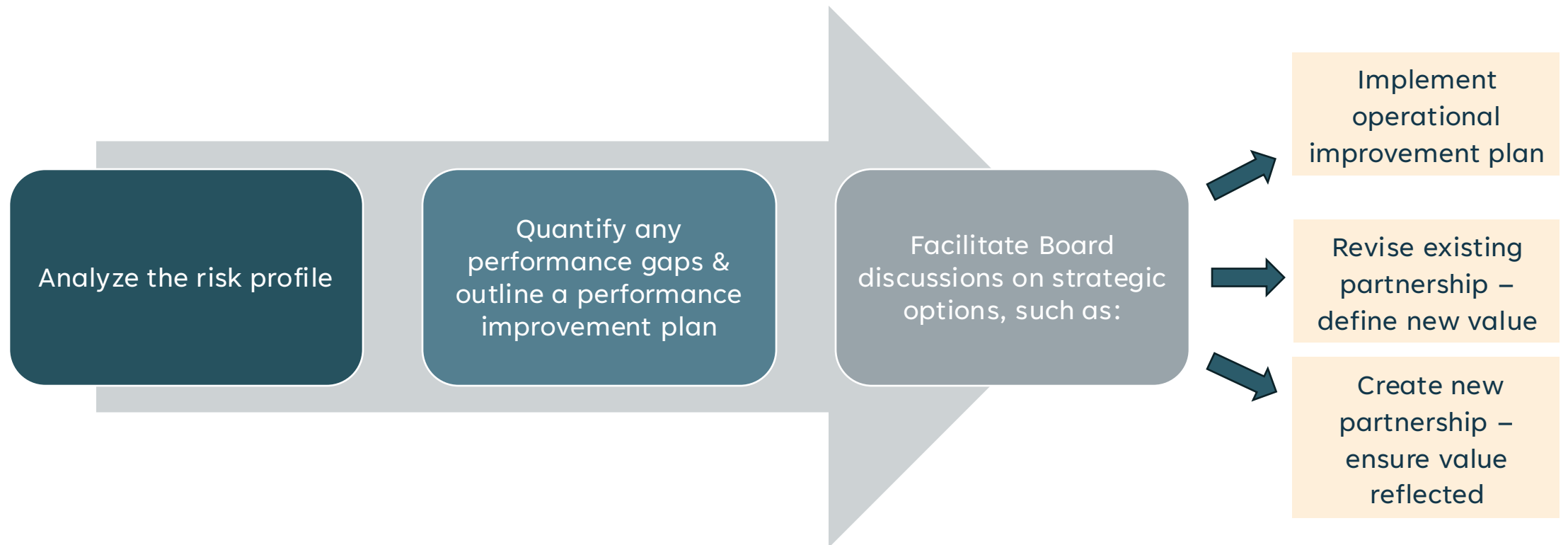




RURAL PARTNERSHIP KEY TAKEAWAYS

KEY POINT: SOUND OPERATIONS UNDERPIN ALL OPTIONS

When we discuss strategic options with a rural client, we focus on mitigating strategic risks. Sound operating results are foundational to those efforts, regardless of the strategic option selected. From there, we can evaluate strategic options to find the right strategy based on the organization's risk profile.



KEY TAKEAWAYS FOR RURAL PARTNERSHIPS

The accretive value of existing and prospective rural affiliates is almost always misunderstood or absent from negotiations or management decision-making.



Adverse Outcome #1: Key deal terms that would reinforce long-term value creation for the rural affiliate and system are absent



Adverse Outcome #2: Systems with rural affiliates miss value-added opportunities and fail to account for rural accretive contribution margin when evaluating performance and allocating resources



Adverse Outcome #3: Chronic underinvestment in rural affiliates



Adverse Outcome #4: System and rural affiliate long term performance is diluted and suboptimized



THE KEY LESSONS LEARNED



**OPERATIONAL
PERFORMANCE IS
FOUNDATIONAL
TO ANY
STRATEGIC
OPTION**



**TIME IS NEVER
A NEUTRAL
FACTOR; DON'T
KICK THE CAN
DOWN THE
ROAD**



**KNOW YOUR
VALUE, DO THE
HOMEWORK**



**THERE ARE NO
RISK-FREE
STRATEGIC
OPTIONS**

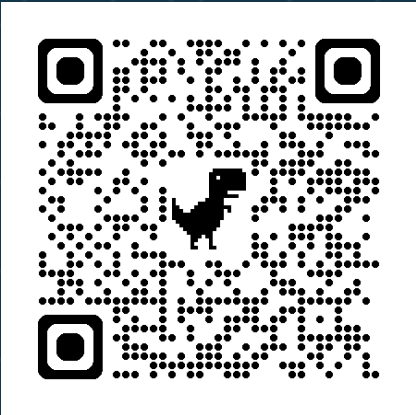


**PROCESS,
PARTNER,
STRUCTURE,
TERMS**





THANK YOU



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APPENDIX

Additional Case Studies

CASE STUDY: COST OF DELAY

- The hospital was a strong rural PPS health system facing major capital investment needs
- Previously, the rural system had affiliated its multi-specialty group with a regional health system with a strong track record of operating multi-specialty groups
- The rural system Board elected to defer a proposed affiliation that met substantially all their requirements and included a \$25M capital infusion toward investment needs
- 12 months later, the regional system had entered into other commitments and had to pull back its capital commitment
- Six months later, the rural system elected to affiliate on the same terms negotiated previously, minus the \$25M investment commitment
- **Time is never a neutral factor**



CASE STUDY: NON-COMPETITIVE PROCESS



A CAH retained Stroudwater to assist with a partnership process where the preferred partner had already been identified



The client had not run a competitive process. The preferred partner at the time was the third organization they had approached sequentially.



Due to the client's one-at-a-time approach, our client's leverage with negotiations was affected



Result: Without a competitive process, our client lost leverage, did not receive strong proposals, and missed out on capital and service continuation commitments



CASE STUDY: THE WRONG PARTNER/STRUCTURE

- Two financially stressed rural health systems combined into a single health system using a joint operating agreement (JOA)
- The JOA agreement called for the members to share profits and losses, while member boards and assets remained separate
- The practical effect was that the member who lost more was owed a check by the member who lost less
- Resentment, distrust, and hostility became the common language at the combined system and on each member board
- Stroudwater was called in to "fix" this situation
 - **Goal 1: Avoiding bankruptcy of one member and forestalling litigation among the parties**
 - **Goal 2: Find a partner(s) that could recapitalize each member and enter into separate affiliation agreements with each member given the complete breakdown in trust**
- 18 months later, these goals were realized. Both communities maintained their health systems despite this multi-year misadventure.



CASE STUDY: QUANTIFYING YOUR VALUE

CAH was projected to have a negative cash balance within two years and needed to partner

Using the value levers, Stroudwater determined our client would be able to fund investments and increase operating performance by about \$670K annually through a partnership – net of debt service on \$3.6M of needed investments

By quantifying the value levers, our client received robust proposals with strong commitments for the community

As of April 2024, our client signed an LOI with a preferred partner and closed on the definitive agreement on June 1, 2024



CASE STUDY: QUANTIFYING YOUR VALUE, CONT.

Performance Improvement Initiatives	Client
Swing Bed Estimate	\$ 120,000
340b Opportunity	\$ 250,000
Cost Report Opportunity	\$ 170,610
Home Office Cost Allocation Low Estimate	\$ 470,000
Home Office Cost Allocation High Estimate	\$ 780,000
Total Savings Low Estimate	\$ 1,010,610
Total Savings High Estimate	\$ 1,320,610

Required Investment Over 5 Years	
Required Investment	3,587,639
Percentage Debt Financing	100%
Cost Based Reimbursement	40%

- The table to the left demonstrates the savings incurred by different value levers for our client
- The table below demonstrates the effect of the performance improvement initiatives on operating performance inclusive of required investments

Projection Estimate

	Year 1	Year 5	Year 10	Year 15	Year 20	Year 25	Year 30	Year 35
Principal Balance Outstanding	\$ 3,587,639	\$ 3,114,290	\$ 2,491,503	\$ 1,684,434	\$ 777,344	\$ 350,054	\$ (0)	
Annual Depreciation Expense	\$ (160,148)	\$ (160,148)	\$ (160,148)	\$ (158,498)	\$ (140,165)	\$ (59,315)	\$ (39,254)	\$ -
Annual Interest Expense	\$ (195,209)	\$ (174,450)	\$ (141,196)	\$ (98,039)	\$ (48,818)	\$ (22,109)	\$ (2,340)	\$ -
Total Annual Depreciation Plus Interest	\$ (355,357)	\$ (334,598)	\$ (301,344)	\$ (256,537)	\$ (188,983)	\$ (81,424)	\$ (41,594)	\$ -
Incremental Cost-Based Payments	\$ 141,041	\$ 132,802	\$ 119,603	\$ 101,820	\$ 75,007	\$ 32,317	\$ 16,509	\$ -
Net Interest and Depreciation Cost	\$ (214,316)	\$ (201,796)	\$ (181,741)	\$ (154,718)	\$ (113,975)	\$ (49,107)	\$ (25,086)	\$ -
Annual Principal Payment	\$ (84,575)	\$ (105,334)	\$ (138,588)	\$ (179,596)	\$ (201,854)	\$ (95,084)	\$ (77,897)	\$ -
Total Annual Cost (after Cost Based Payment)	\$ (298,891)	\$ (307,130)	\$ (320,329)	\$ (334,314)	\$ (315,829)	\$ (144,191)	\$ (102,983)	\$ -
Projection Low Estimate								
Total Annual Operating Improvements	\$ 1,010,610	\$ 1,010,610	\$ 1,010,610	\$ 1,010,610	\$ 1,010,610	\$ 1,010,610	\$ 1,010,610	\$ 1,010,610
Net Change In Operating Performance - Low Estimate	\$ 711,719	\$ 703,480	\$ 690,281	\$ 676,296	\$ 694,781	\$ 866,419	\$ 907,627	\$ 1,010,610
Projection High Estimate								
Total Savings High Estimate	\$ 1,320,610	\$ 1,320,610	\$ 1,320,610	\$ 1,320,610	\$ 1,320,610	\$ 1,320,610	\$ 1,320,610	\$ 1,320,610
Net Change In Operating Performance - High Estimate	\$ 1,021,719	\$ 1,013,480	\$ 1,000,281	\$ 986,296	\$ 1,004,781	\$ 1,176,419	\$ 1,217,627	\$ 1,320,610

