STROUDWATER

WHAT RURAL HOSPITALS SHOULD KNOW ABOUT PARTNERSHIPS

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MEET THE SPEAKER

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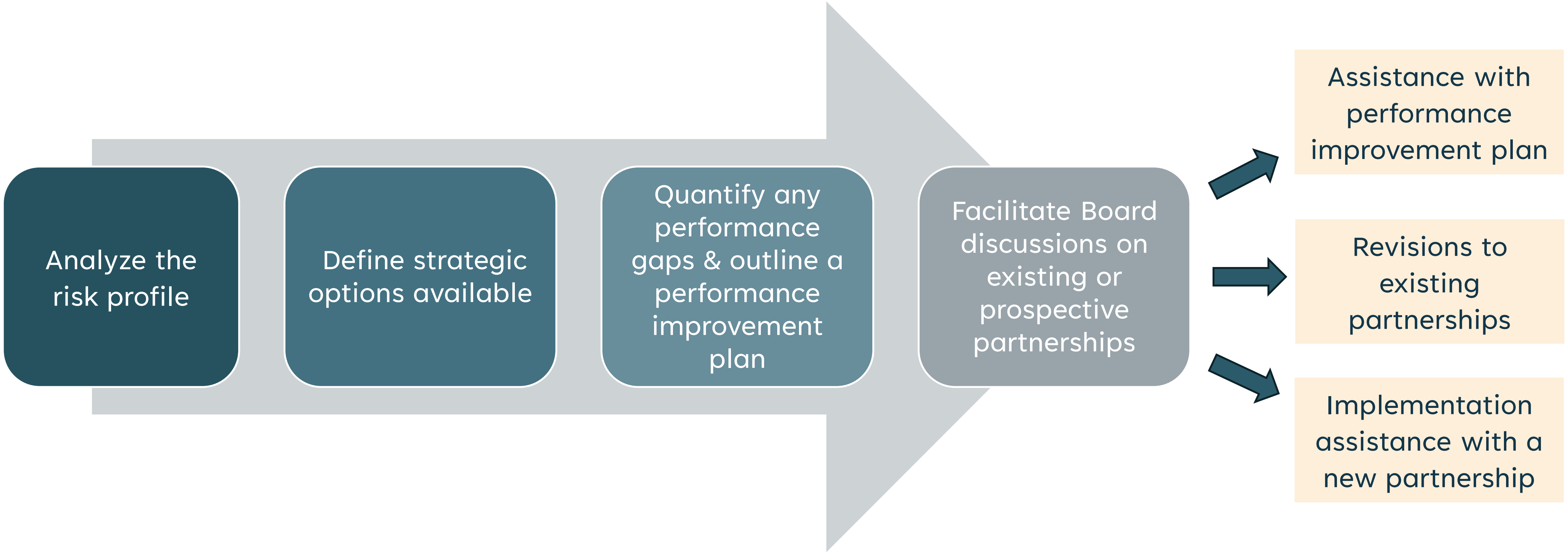
Stroudwater is a leading national health care consulting firm specializing in mission-critical strategic, operational, and financial opportunities for health care leaders’ most pressing challenges.

KEY POINT: SOUND OPERATIONS UNDERPIN ALL OPTIONS

When we talk to a client about strategic options, 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.



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HEALTH INDUSTRY FACTORS THAT ARE DRIVING PARTNERSHIPS

INDUSTRY OVERVIEW: DECLINING OP VOLUME

In 2018, US hospital outpatient visits declined for the first time since 1983, specifically in the number of emergency outpatient visits.

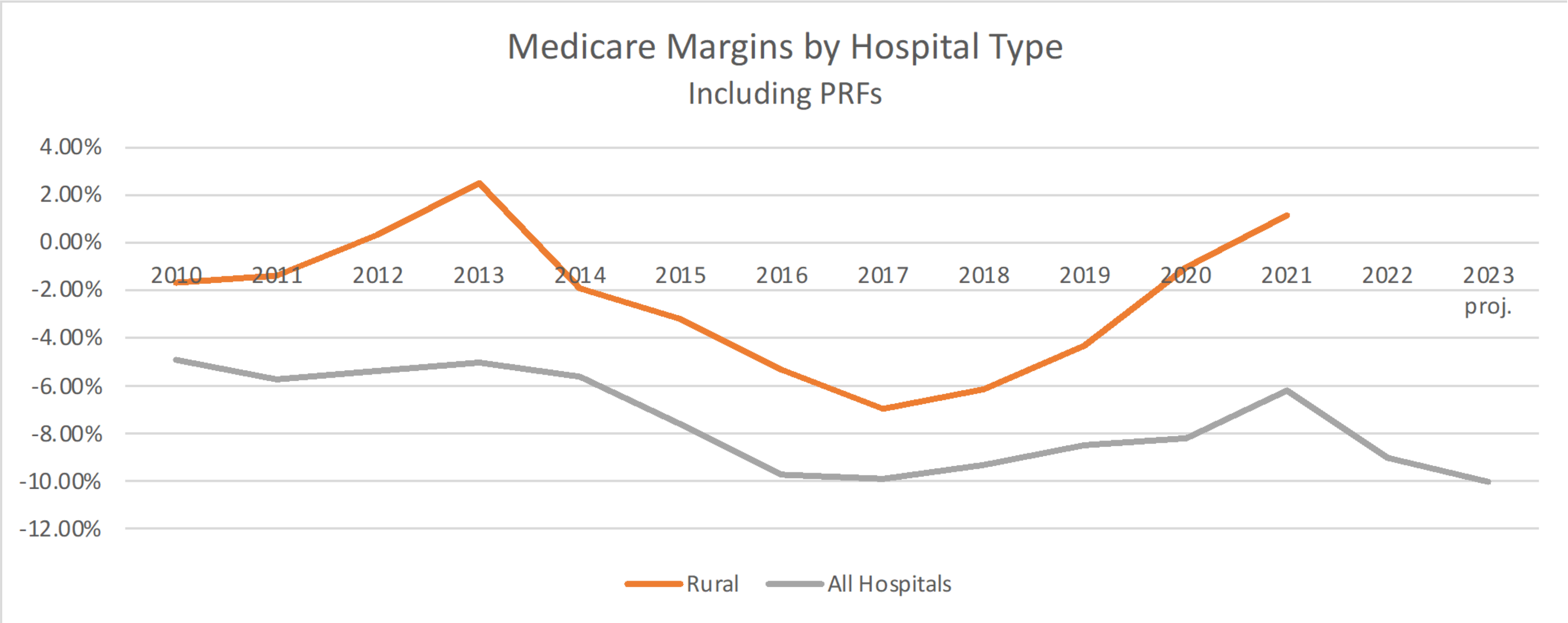
Per the American Hospital Association's 2020 Hospital Statistics report, 6,146 US hospitals delivered 879.6 million outpatient visits in 2018, 0.9% less than in 2017, when they delivered 880.5 million outpatient visits.

The report states that the amount of *outpatient care* delivered *has most likely increased*, but that *care is being delivered in competitive new options* such as urgent care centers and retail clinics such as those recently launched by CVS Health.

Insurers have contributed to the trend, with UnitedHealthcare recently refusing to pay for certain outpatient surgeries in hospital settings to save money.

Source: Modern Healthcare, *U.S. hospitals see first decline in outpatient visits since 1983*, Tara Bannow, 1/7/20, https://www.modernhealthcare.com/operations/us-hospitals-see-first-decline-outpatient-visits-1983?utm_source=modern-healthcare-am-wednesday

INDUSTRY OVERVIEW: DECLINING MEDICARE MARGINS



Source: MedPAC Report to the Congress: Medicare and the Health Care Delivery System, March 15, 2023
http://medpac.gov/docs/default-source/reports/mar22_medpac_report_to_the_congress_sec.pdf

NOT-FOR-PROFIT HEALTH CARE 2024 OUTLOOK

Moody's Outlook: From Negative to Stable

- The bottom line is hospitals' operating cash flows and margins will improve and revenue growth will slightly top expenses.
- While hospitals will continue to grapple with high expenses because of a shortage of skilled labor, particularly nurses, Moody's predicts that the growth in expenses will slow.
- Reduced reliance on expensive contract labor may be offset by increased union activity. Contract negotiations could become more contentious, resulting in work stoppages and hefty wage increases.
- Though reimbursement rate increases from insurers will rise in the mid-single-digit percentage-range on average in 2024, they will not fully compensate for the recent expense increases due to inflation, Moody's said.

Fitch's Sector Outlook: Deteriorating

- In 2023, Fitch reported a credit downgrade-to-upgrade ratio of 3:1 — alarmingly close to the ratio seen during the 2008 financial crisis — calling it a "make or break" year.
- Fitch highlighting the sector's struggles, particularly among smaller hospitals with annual revenues under $500 million.
- 2024 will again be categorized as another 'make or break' year for a sizeable portion of the sector.
- NFP hospitals are mired in an ongoing "labor-demic" with significant staff shortages, intense wage pressure, and heightened inflation.
- Out of these ongoing struggles has emerged a 'trifurcation' of credit quality that will only become more prominent in 2024.

S&P Outlook: Negative

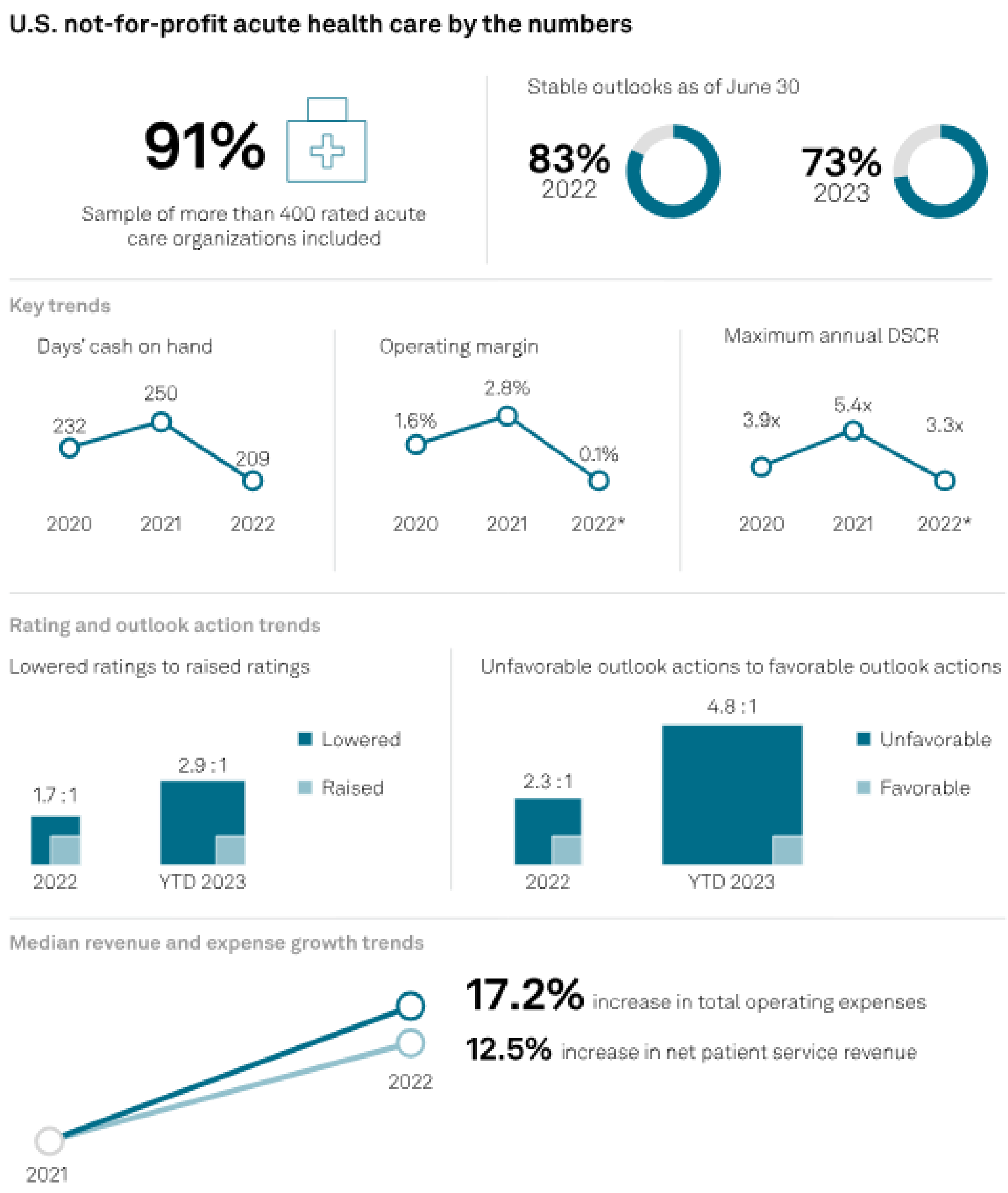
- S&P Global Ratings expects a constrained operating environment in 2024 largely due to persistently high labor and operating costs.
- Downgrade to upgrade ratio of 4.4:1
- Although acute contract labor expenses have dropped, many providers continue to contend with an imbalance between the rate of growth across expenses and revenue.

Sources:
https://www.chiefhealthcareexecutive.com/view/hospitals-can-expect-weak-margins-for-the-rest-of-2023-and-into-2024
https://www.fitchratings.com/research/us-public-finance/us-not-for-profit-hospitals-health-systems-outlook-2023-01-12-2022
https://www.hfma.org/finance-and-business-strategy/healthcare-business-trends/not-for-profit-hospital-outlook/
https://www.moodys.com/research/Moodys-Not-For-Profit-Healthcare-2023-Outlook-Remains-Negative-as--PBM_1351244
https://www.spglobal.com/ratings/en/research/articles/230628-u-s-not-for-profit-health-care-midyear-update-2023-out-of-intensive-care-and-on-the-path-to-recovery-amid-on-12778269

INDUSTRY RISKS

- Medicare reimbursement levels that are not keeping up with inflation.
- The end of a pandemic-era provision preventing states from Medicaid disenrollment, which could lead to higher uncompensated coverage.
- Continued scrutiny of the 340B program with limits on usage of contract pharmacies possibly hurting eligible hospitals through operating income losses.
- Increased scrutiny of mergers by federal and state governments may deprive distressed systems of exit strategies.
- Growth in Medicare Advantage, where insurers have a greater denial incentive than plans in which they simply administer payments with no insurance risk, is leading to more denials.
- Most hospitals will fall into the middle of the trifurcation pack with mixed results in the form of lower margins (though not enough to warrant widespread downgrades) and, despite some success in obtaining staffing, a still-heavy reliance on external contract labor.
- Bond covenant breaches will be another area of concern heading into 2024. “Second year violations, which would occur in calendar 2024 as fiscal 2023 audits are finalized, may intensify the potential for bondholders to declare an event of default and accelerate payment of bonds,” said Holloran.

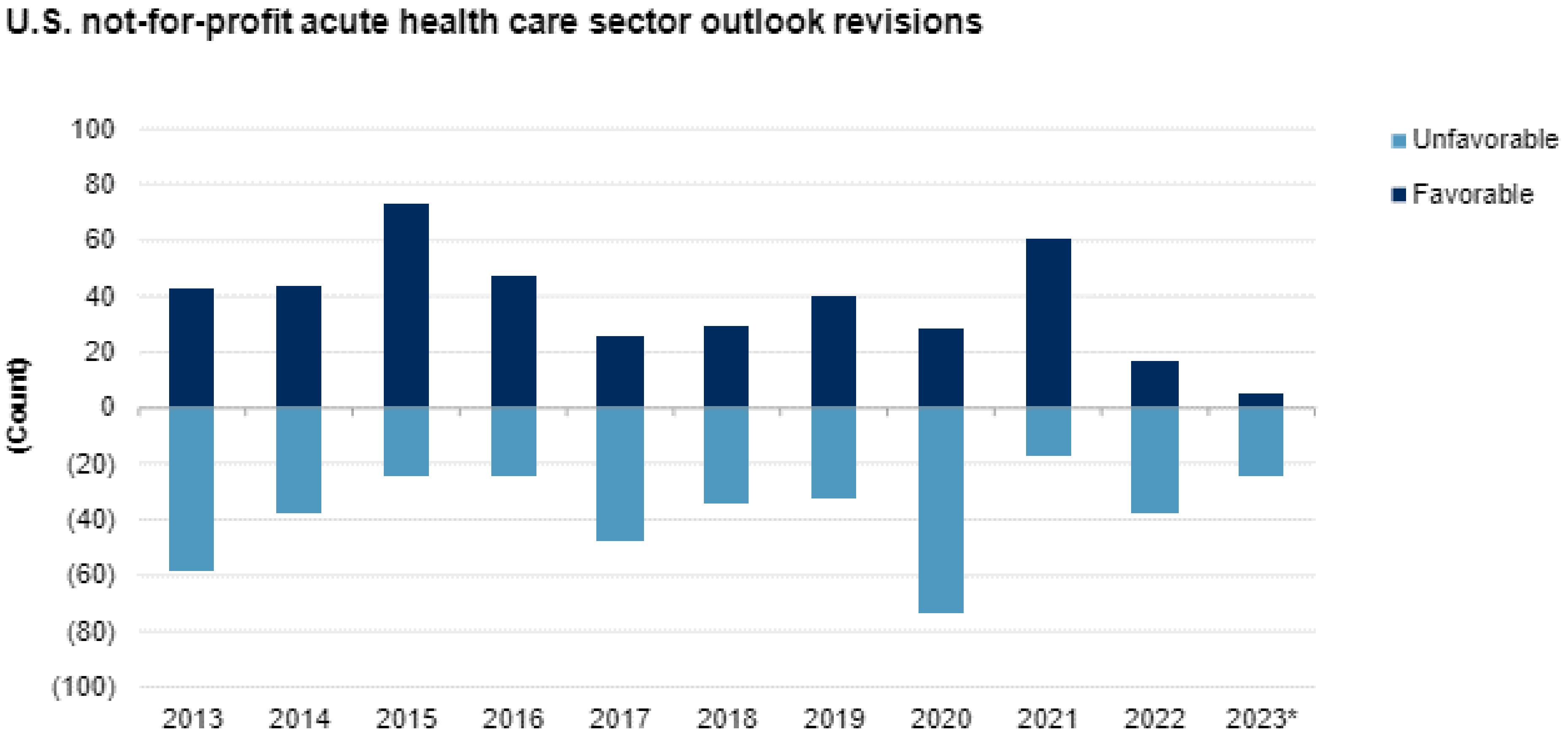
2023 MID-YEAR STATISTICS



*10-year low. DSCR--Debt service coverage ratio. YTD--Year to date. Source: S&P Global Ratings.

Source: Standard & Poor's
https://www.spglobal.com/ratings/en/research/articles/230807-u-s-not-for-profit-acute-health-care-2022-medians-historically-low-metrics-signify-a-long-road-to-a-new-norm-12812703

2023 MID-YEAR STATISTICS, CONT.



Data for all outlook changes unaccompanied by a rating change. *Outlook revisions through June 30, 2023.

Source: Standard & Poor's https://www.spglobal.com/ratings/en/research/articles/230807-u-s-not-for-profit-acute-health-care-2022-medians-historically-low-metrics-signify-a-long-road-to-a-new-norm-12812703

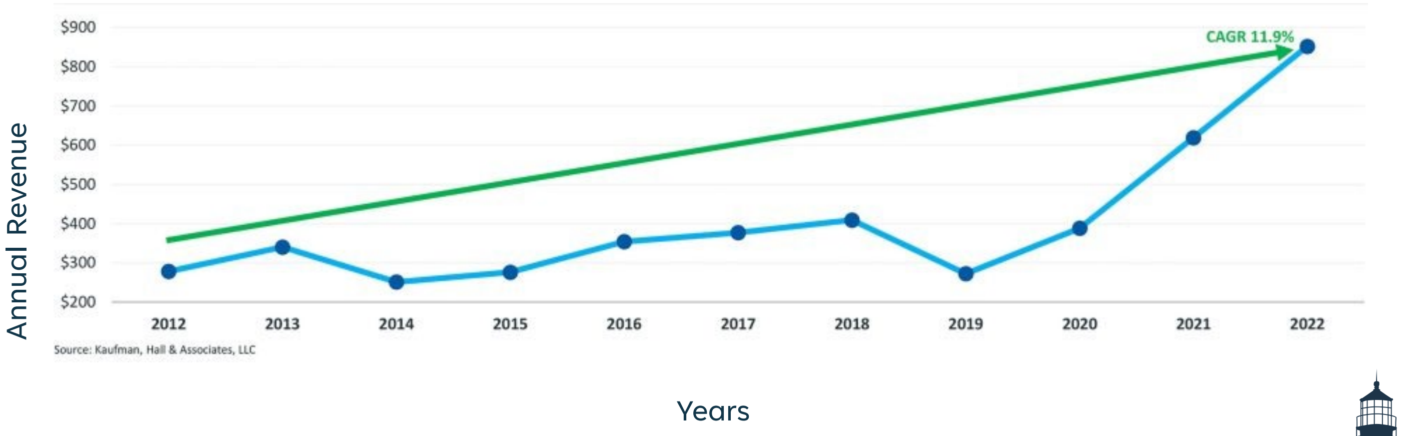
AFFILIATION DRIVERS: INDUSTRY CONSOLIDATION

Catalysts:

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

In response to industry disruption and regulatory changes, 985 hospital affiliations have taken place since 2012.

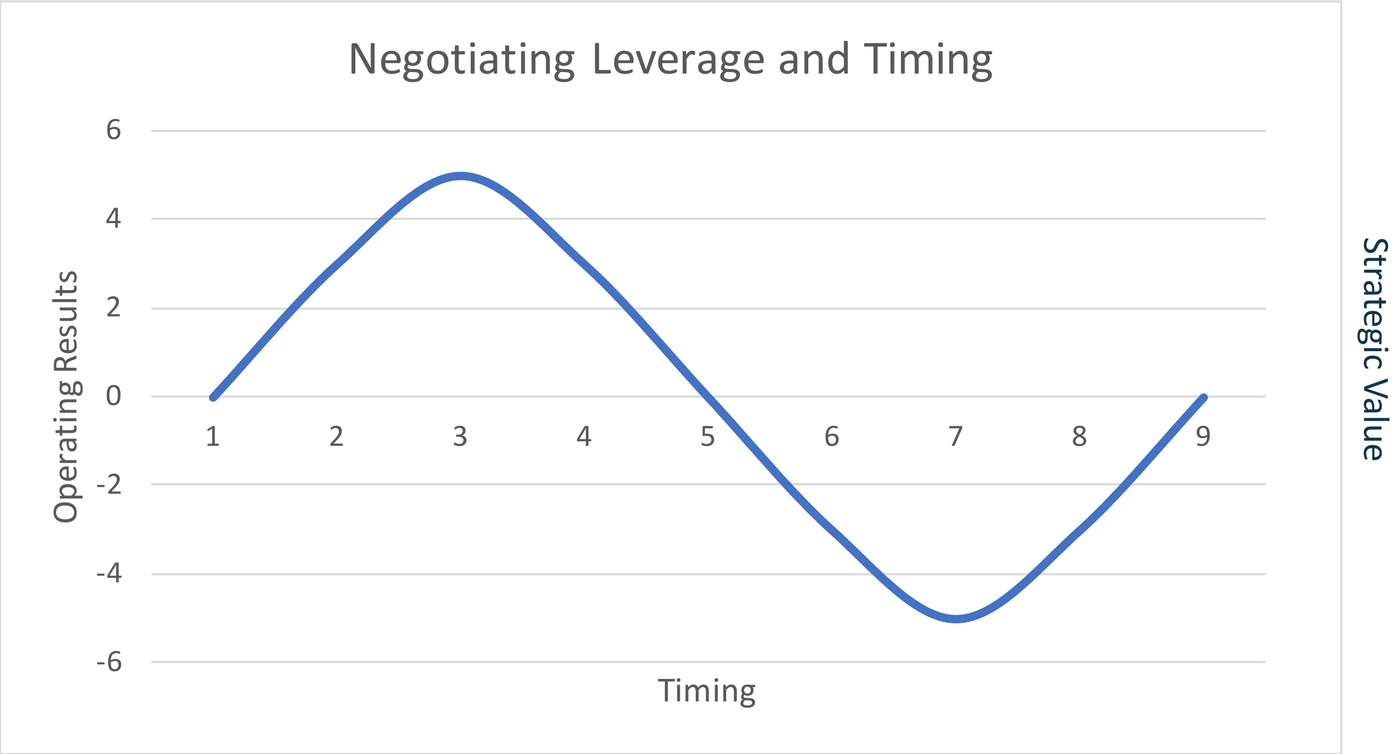
Average Smaller Party Size by Annual Revenue, 2012 - 2022



Source: Kaufman, Hall & Associates https://www.kaufmanhall.com/insights/2022-ma-review-regaining-momentum

TIME IS NEVER A NEUTRAL FACTOR

- A struggling 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.)



REGULATORY SCRUTINY: 2023 MERGER GUIDELINES

- Guideline 1: Mergers Raise a Presumption of Illegality When They Significantly Increase Concentration in a Highly Concentrated Market.
- Guideline 3: Mergers Can Violate the Law When They Increase the Risk of Coordination.
- Guideline 4: Mergers Can Violate the Law When They Eliminate a Potential Entrant in a Concentrated Market.
- Guideline 6: Mergers Can Violate the Law When They Entrench or Extend a Dominant Position.
- Guideline 7: When an Industry Undergoes a Trend Toward Consolidation, the Agencies Consider Whether It Increases the Risk a Merger May Substantially Lessen Competition or Tend to Create a Monopoly
- Guideline 8: When a Merger is Part of a Series of Multiple Acquisitions, the Agencies May Examine the Whole Series.
- Guideline 11: When an Acquisition Involves Partial Ownership or Minority Interests, the Agencies Examine Its Impact on Competition.

WHEN TO THINK ABOUT PARTNERSHIPS

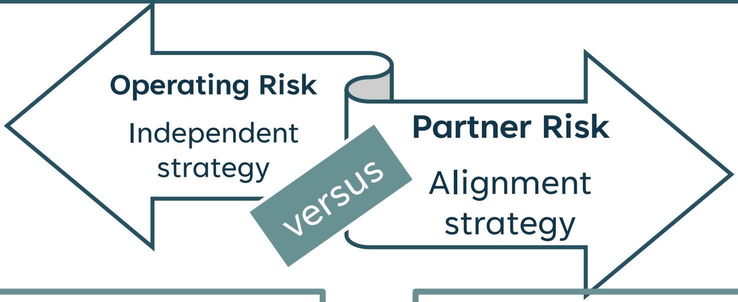
CASE STUDY: COST OF DELAY

- 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.
  - This alignment addressed one of the major concerns they faced: how to sustain their local medical community in the face of declining hospital margins and provider shortages.
  - The rural system was successful in sustaining and building its medical staff – in part because of its alignment with the large system and its affiliated medical school.
  - However, this move effectively eliminated any other partner from consideration.
- The rural system board was concerned about increasing competition, capital investment needs, and growing complexity.
- 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 they had to pull back their capital commitment.
- Six months later, the rural system elected to affiliate on the same terms negotiated previously less the $25M investment commitment.
- Time is never a neutral factor.

UNDERSTANDING THE RISKS

What is the best strategy to achieve mission and vision?

Independence vs. Affiliation/Partnership



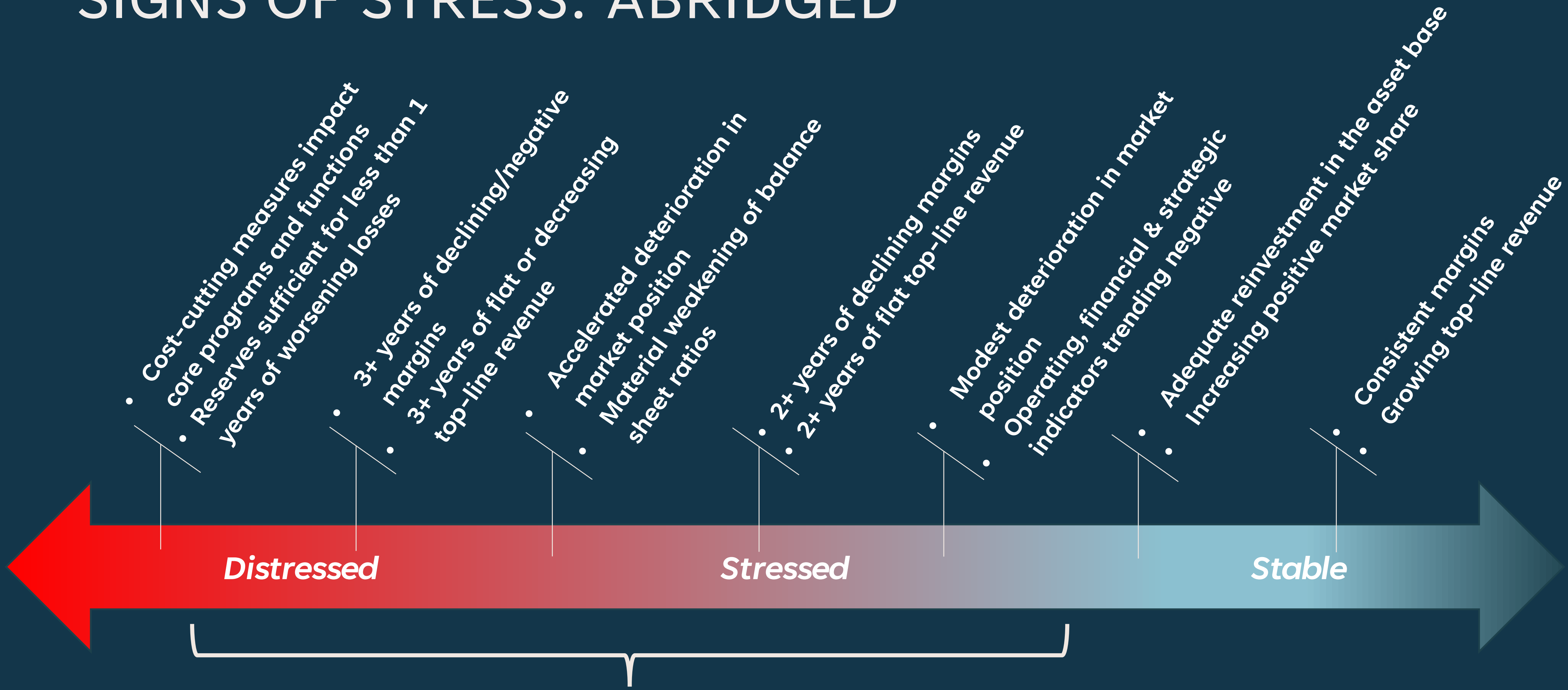
How do you minimize Operating Risk?

- **Accountability around strategic objectives** between the board, the management team, and the medical staff
- Create access to a **robust primary care base**
- Maintain annual **operating cash flows** at least equal to debt service plus 120% of depreciation expense
- 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**

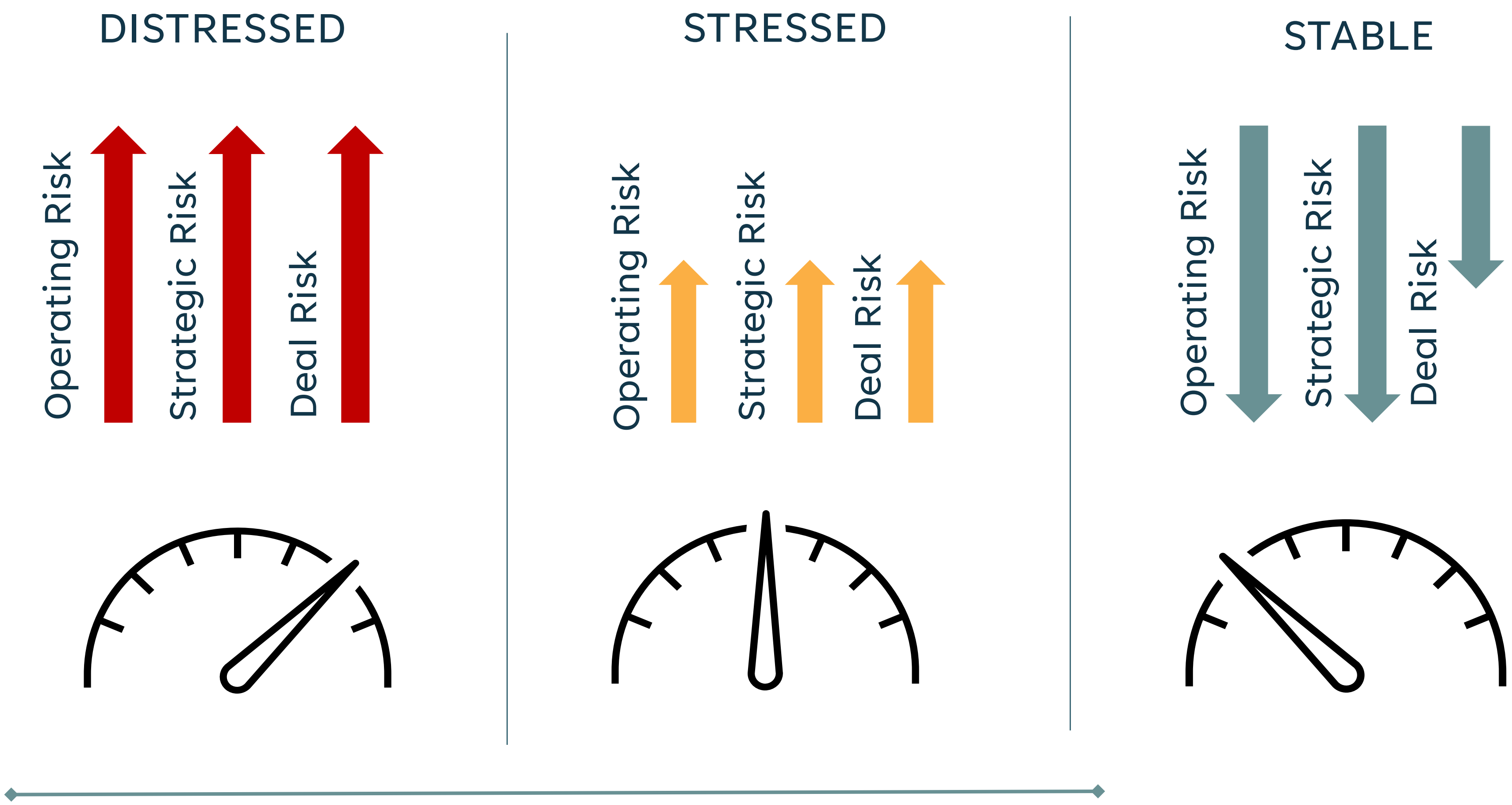
SIGNS OF STRESS: ABRIDGED



Examine/re-examine the benefits of performance improvement and/or partnership

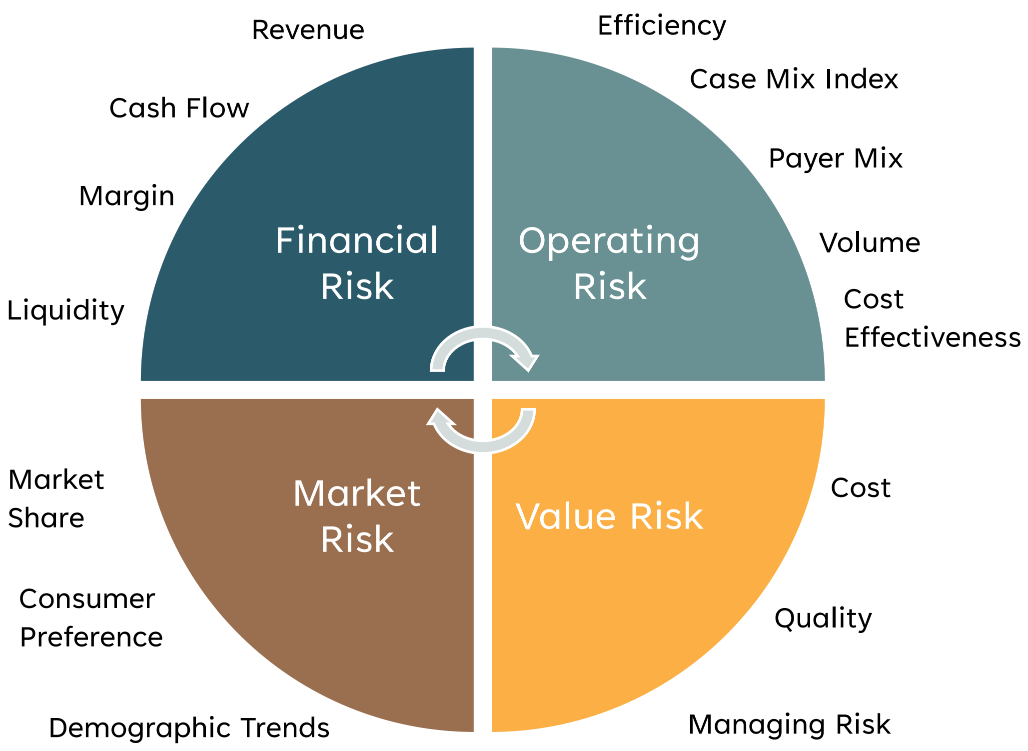
Note: A more detailed version of the graphic is available.

HOW STRESS AND RISK ARE RELATED



Examine/re-examine benefits of performance improvement and/or partnership

FACTORS THAT AFFECT RISK



- The strategic risk profile for most hospitals and health systems is quite dynamic.
- 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 quantified.
- Changes year-to-year can be gradual and indiscernible, but 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.

EVALUATING & MITIGATING STRATEGIC RISK

Financial Risk

- Define “gaps” in performance
- Quantify cash “run rate”
- Examine five-year trends at least annually

Revenue
Cash Flow
Margin
Liquidity

Operating Risk

- Provider practice operations improvement
- Revenue cycle and coding
- Cost report reviews
- Process redesign
- Supply chain & purchasing
- Demand-Based Staffing tools

Efficiency
Case Mix Index
Payer Mix
Volume
Cost Effectiveness

Market Risk

- Identify growth opportunities
- Invest in an aligned provider base
- Implement retail pricing, access strategy
- Direct contracting
- De-escalate conflict between boards

Market Share
Consumer Preference
Demographic Trends

Value Risk

- Annual payor contract reviews
- Value-based payment strategy
- Self-Insured population tools
- Medicare Advantage products
- Manage total cost of care

Cost
Quality
Managing Risk

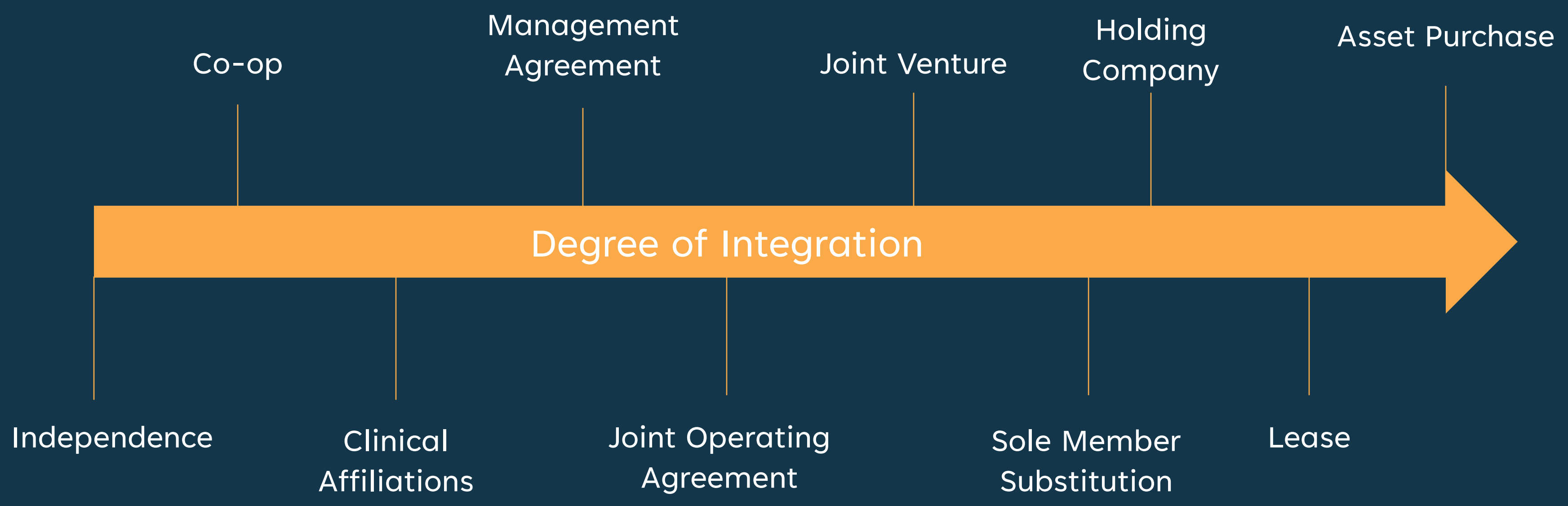
HOW TO ENSURE YOUR PARTNERSHIP CREATES VALUE

BUILD UNDERSTANDING AND TRUST

Board and stakeholder education	• National, regional, and market forces • Organizational constraints and opportunities • Strategic risks facing hospital • Hallmarks of good governance and sound management
Develop a common fact base	• Quantify performance gaps • Understand risk factors • Develop strategic objectives
Convene a task force involving key leaders from boards and/or stakeholder groups	• Provide a format for communication and sharing of perspectives • Engage around key issues and concerns • Remove emotion and make objective data the basis for decisions • Develop working relationships and trust • Seek consensus vs. unanimity
Develop a shared vision for the future	• What key attributes do board members and key stakeholders want the organization to have in 5-10 years? • Engage boards and stakeholders around the shared vision
Develop and implement a communications strategy	• Develop key messages and talking points • Identify spokespeople • Emphasize the shared vision • Anticipate internal and external communication requirements • Repeat
Don't lose sight of the fundamentals	• Sound governance and management • Strategy • Operational performance

CONTINUUM OF PARTNERSHIP STRUCTURES

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

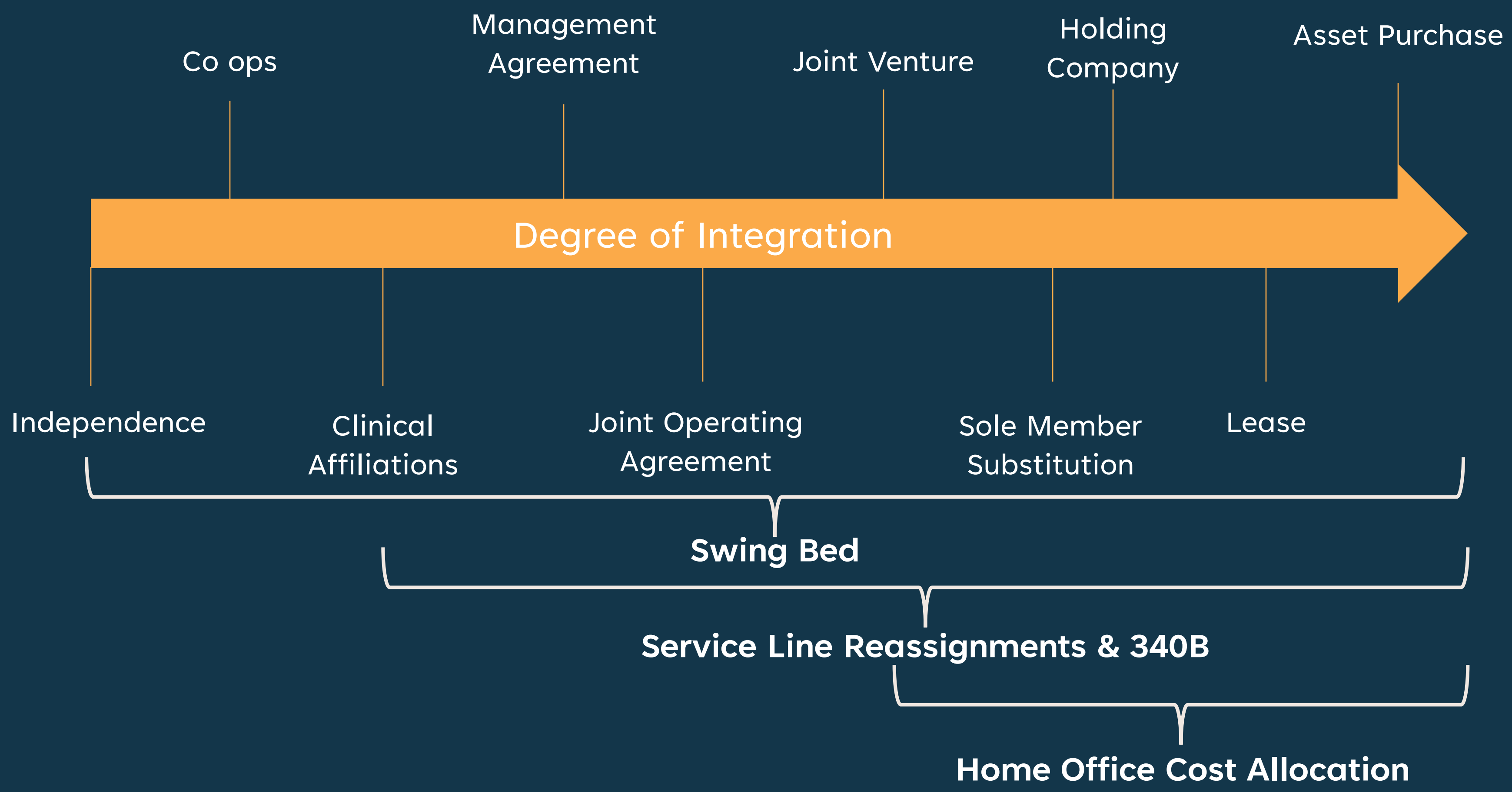


VALUE LEVERS FOR RURAL HEALTH SYSTEMS

- 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
  - Access to 340B
  - 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
- Select an affiliation structure that fits your strategic objectives and constraints
- Craft contractually enforceable terms that reflect the rural value proposition
- Do their strengths and commitments mitigate your risk profile?
- Assess their track record
  - Do they understand rural?
  - Does their track record back up their promises?

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 opportunities
- Quantify the ROI of investments to reflect the unique rural value proposition
  - One size does not fit all
  - E.g., variable vs. fixed cost allocation

PARTNERSHIP PROCESS FOR EXISTING PARTNERS

- 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.

PROCESS RECOMMENDATIONS FOR NEW PARTNERSHIPS

It is beneficial to have prospective partners compete for the privilege of being your partner.

- Use the process to gather information about your options.
- Also, 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.

CASE STUDY: QUANTIFYING YOUR VALUE

- Stroudwater was retained by a CAH that was projected to have a negative cash balance within two years. Through a strategic options process, our client determined that they needed to find a preferred partner.
- Stroudwater quantified the estimated value the CAH could bring to each partner in the process using the different value levers.
  - Through strategic performance initiatives and a partnership, our client would, on a conservative level, be able to fund its required investments and increase operating performance by about $670,000 annually per the Net Change in Operating Performance – Low Estimate on the next slide.
- By quantifying the value of the CAH to our client's potential partners, the proposals received were more robust and reflected strong commitments to help the community.
- Our client was able to find a preferred partner and sign a letter of intent with contractually enforceable terms that will ensure that the CAH continues to provide established services and be a fixture in the community.

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%

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

PARTNERSHIP PITFALLS AND HOW TO AVOID THEM

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 new, combined system struggled to identify early wins that were not seen as "zero-sum solutions" by one or both of its members.
- Every success was viewed jealously by the member that did not receive the investment or resources that led to the success.
- The JOA agreement called for the members to share profits and losses, while member boards and assets remained separate.
- The practical effect was the member that lost more was owed a check by the member that 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: THE WRONG 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.
- It quickly became apparent that 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.
- During that process, Stroudwater educated all interested parties as to 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 was not able to incorporate these value drivers into their proposal.
- Thankfully, an alternative preferred partner emerged that had 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: NON-COMPETITIVE PROCESS

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

The client had not run a competitive partnership process and had been approaching organizations within their area one at a time to potentially negotiate a deal.

The preferred partner at the time was the third organization they had approached.

Due to the client's one-at-a-time approach in the past, the preferred partner at the time knew there were limited options available for them locally, impacting our client's leverage with negotiations.

Result: Without a competitive process, our client lost leverage and did not receive strong capital commitments or firm deal terms around preserving certain service lines.

CASE STUDY: DID NOT UNDERSTAND RURAL VALUE

- Our CAH client entered discussions with a large multi-state health system regarding a potential affiliation.
- While both parties saw strategic value for the engagement, 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 also is critical to include in the prospective partner's evaluation of investment needs and opportunities at the CAH.
- The benefit of a modest change in referrals (+2.5% market share gain) would also generate significant additional ROI.
- 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.

KEY TAKEAWAYS

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

QUESTIONS?

STROUDWATER

THANK YOU

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