HealthCare Appraisers

FMVantage Quarterly Insights

Quarter 1 ▪ 2018

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As part of our ongoing research into the healthcare industry, HealthCare Appraisers, Inc. follows commentary of publicly-traded health systems, physician services providers and ambulatory surgical center management companies. The following paragraphs are important takeaways from quarter four of 2017 and quarter one of 2018, as well as supporting quotes[1] from publicly-traded operators.

Health Systems

Health systems are developing **free standing emergency rooms** and outpatient clinics in order to increase access points for patients.

The use of emergency departments and free-standing emergency departments for non-emergent events has drawn scrutiny from payors. Insurers in several states have enacted policies to review and possibly deny payment for non-emergent trips to the emergency room at out-of-network facilities.[2]

HAI has observed the increase in free-standing emergency rooms in certain markets drive up the cost of securing emergency department coverage as physicians opt to cover free-standing facilities instead of hospital-based emergency departments.

"We did bring two new freestanding EDs online in the latter part of last year. We have two more ready to come online in the first half of this year. And we have roughly two to three more that should be online by the end of the year as well. So our freestanding EDs are performing well. They are driving incremental volume growth for us in our target markets. We also have seen the ASC development strategies that are working well for us. Urgent care and walk-in care deployment is very solid."

May 02, 2018 – Tim L. Hingtgen
COO of Community Health Systems, Inc. on FSED Outpatient Clinic Development

"We have roughly 75 freestanding emergency room centers across the company with another 45 to 50 that are in development. Again, complementing our inpatient offerings and then also complementing our urgent care center strategy as well. So the combination of both of those are very important to our provider system development."

May 01, 2018 – CFO William B. Rutherford of HCA Healthcare, Inc. on FSED/Outpatient Clinic Development

[1] All quotes are taken directly from transcripts provided by S&P Capital IQ. Some quotes have been edited for clarity and relevance.

[2] BlueCross BlueShield of Texas, Memo date April 18, 2018

Many health systems are increasing their use of **transfer centers** to efficiently transfer patients to care sites with the availability and capability of providing the necessary care.

Expert Insight

"Health systems are implementing dedicated centers to manage patient transfers. These centers often are intended to coordinate referrals among the system's operated hospitals, and they help ensure patients are transferred to facilities that have the appropriate clinical expertise and capacity to treat the patient. In some instances, these centers offer services to third parties (e.g., micro-hospitals, specialty hospitals) to facilitate patient transfers to higher acuity settings. Certain market participants are charging for transfer center services to cover the cost of resources utilized in processing the patient transfer, either in the form of transfer pricing among related parties or service fees under third party agreements. As this practice becomes more common, it will be important for systems operating these centers to consider the compliance implications of offering patient transfer services at "below-market" rates, which may be perceived as an inducement to refer higher acuity patients." – Matthew J. Milliron, Partner, HealthCare Appraisers

"During the middle of 2017, we completed the build-out of our proprietary transfer center and access program here in Franklin, Tennessee, which has the infrastructure to be leveraged across multiple hospitals and markets. As a reminder, this is a program that we centralized and in-sourced to help to better manage the inbound referrals to our hospitals and their emergency departments from both our affiliated and nonaffiliated hospitals in a particular region. To date, we have deployed this model in select regional networks that include 25 of our hospitals, and we will substantially increase the count with our scheduled market implementations through the balance of 2018. While this in-house service has been in operation for a relatively short amount of time, we are experiencing the benefits we expected. First, we are able to safely and promptly transfer patients to the most appropriate care setting. We are also seeing increased admissions in most markets included in the launch, particularly in service lines such as critical care, GI, cardiovascular and neurosciences. In general, we are experiencing better patient retention within our health care systems and increasing referrals from non-CHS hospitals. The program is also providing greater transparency into the daily operations of our emergency department, bed management and case management functions, which has resulted in some refinement of internal processes to improve throughput at the hospital level. And we now have real-time data that shows where we can accelerate strategic service line development to support patient care needs and to appropriately retain even more patients within our health care systems."

February 28, 2018 – COO Tim L. Hingtgen
of Community Health Systems, Inc. on Transfer Centers

Hospitals and health systems are incurring **higher operating costs related to support payments to physician groups** providing hospital-based services. These higher support payments are being driven by lower volume assumptions due to observed decreases in hospital utilization, leading to lower collections for physician groups and higher subsidies necessary to cover each group's costs.

The structure of the support payment (i.e., collections guarantee or subsidy) can impact the timing of the increase in costs. Lower collections will lead to higher payments to physician groups more immediately if collections guarantees are utilized. If the payment is structured as a subsidy, the higher payment will be incorporated when the agreement is renegotiated. For more information, see HAI's recent article on Collections Guarantees and Subsidies.

With respect to support payments, lower volume assumptions represent a significant headwind for hospital-based service lines, leading to lower revenue, higher expenses, and lower profit margins, all else being equal.

"...talked a little bit about some headwinds, some $20 million to $30 million of headwinds around physician subsidies and our insurance programs. And specifically, what we're talking about there, as you know, with regards to physician subsidies, volumes really impact physician subsidies in any particular year. This has been a year where we've had to go through and really look at our contracts and reset. And so what we're seeing from a headwind perspective is that there is a unique resetting that's occurring in 2018 creating some additional cost on a proportionate basis that's existing in '18 that we don't believe will repeat itself as we move into 2019. We'll still see cost increases, but not at the same level."

February 23, 2018 – CFO Michael Coggin
of LifePoint Health on Physician Subsidies

Certain health systems are facing **increasing wage pressure** in larger markets as the economy continues to strengthen. In several quarters during 2017 and into 2018, physician services groups and hospitals have highlighted cost pressure related to employing or contracting with certified registered nurse anesthetists (CRNAs). More broadly, health systems have cited higher nursing costs related to higher turnover.

Expert Insight

"We have directly observed significant increasing compensation trends for CRNAs, and, to a lesser extent, other hospital-based advanced practice professionals. In some marketplaces compensation has increased by over 10 percent year-over-year. This is due to the demand for lower-cost providers and a current shortage of CRNAs and advanced practice professionals specialized in hospital-based service line coverage (e.g., emergency medicine and intensive care)." – Luis A. Argueso, Director, HealthCare Appraisers

"With regards to wage pressure, we have typically been able to not be pressured with wage pressure, but with pressure in some of our smaller markets. In more of our rural markets, we don't see it as significant. In some of our larger markets, the more non-urban areas that we operate in, we have seen some of that pressure. It has been in the areas of -- we've seen an increased contract labor, but it's really on the rate side for the wages. We continue to mitigate that through the recruitment and retention plans that we have in every single one of our markets. So we're very focused on it. We're able to address it most of the time very successfully. But the pressure in some of those larger markets that we operate in have continues to push us a little bit more especially like we talked about earlier as the economy improves, we're seeing just some -- some pressure in some of those larger locations."

February 23, 2018 – CFO Michael Coggin
of LifePoint Health on Wage Pressures

Market-level benefits are expanding due to an improving economy and increase in cash flow resulting from the Tax Cut and Jobs Act of 2017. One health system cited four key areas of investment in workforce development: (i) education programs to improve clinical abilities; (ii) reimbursement for employee education; (iii) scholarships; and (iv) expanded family leave.

"With respect to workforce development. The company is increasing investments in four important areas over the next few years that we believe will create better opportunities for career growth for our employees and better capabilities to serve our patients. These areas include: (i) investments in educational programs to improve the clinical abilities of our nurses and other caregivers; (ii) tuition reimbursement for employees to support advancing their educational opportunities; (iii) scholarship programs for qualifying employees; and (iv) an expanded family leave program. We anticipate spending up to $300 million over the next three years in these areas. We believe these programs will help improve patient experience and create more opportunities for employees."

January 30, 2018 – CEO R. Milton Johnson
of HCA Healthcare, Inc. on Employee Benefit Programs

Physician Services Providers

Both providers and facilities are shifting toward **increasing utilization of advanced practice professionals**, as highlighted by the health systems above. In one instance, the attempted implementation of a new staffing model has caused friction between the facility and the contractor providing hospital-based physician services.

A health system and an anesthesia contractor are ending a 40-year relationship as the health system implements an anesthesia staffing model more heavily dependent on CRNAs, and bills and collects for anesthesiology services.

"Nonetheless, Atrium wished to go further and planned to adopt new staffing patterns that would reduce the number of physicians providing services, and in some cases, have facilities with no physician anesthesiologists."

"…the hospital really wants to own the physicians and bill for the services that the physicians provide and keep the difference between the salaries that the physicians make and the compensation that they are able to generate from billing for the physician services."

May 01, 2018 – CEO Roger Mendel of Mednax, Inc. on Dispute Regarding Anesthesia Staffing Model

Despite sequential quarterly improvements, groups face continued **long-term pressure in anesthesia reimbursement** based on an aging population.

While we do not typically consider Medicare to be a subpar reimbursing payor, Medicare reimbursement rates for anesthesia are significantly below commercial and other payors. The American Society of Anesthesiologists regularly publishes a study reporting the commercial reimbursement rates for anesthesiology services in various marketplaces. The most recent study (published in October of 2017, reported a median commercial conversion factor (the rate paid per unit of anesthesiology services) of $72.00. By contrast, Medicare's national average conversion factor for 2017 was $22.05 (i.e., median commercial rates reflect a premium of over 225% above Medicare rates).

"In anesthesia, our mix was slightly unfavorable, but marked a continued improvement from the trends we saw earlier in 2017, and it was more than offset by a favorable mix in neonatology."

February 8, 2018 – CFO Vivian Lopez-Blanco of Mednax, Inc. on Anesthesia Payor Mix Trends

Physician groups are receiving **higher support payments from hospital partners.** Publicly-traded physician service providers have corroborated some of the statements from the publicly-traded health systems that physician service providers are receiving or negotiating higher subsidy payments.

"Pricing growth was largely driven by improvements in managed care contracting and increases in administrative fees received from our hospital partners."

May 01, 2018 – CFO Vivian Lopez-Blanco of Mednax, Inc. on Physician Subsidies

Physician groups are **renegotiating physician compensation**, in some cases before the contract terms end, due to worse than expected volume or reimbursement.

Market participants are implementing compensation plans based on a percentage of collections.

From an FMV perspective, physicians paid a fixed base-salary typically have a volume or wRVU assumption incorporated into that salary. If the realistic expectation for wRVU production changes, renegotiating terms of the arrangement and the associated FMV compensation for the services could be considered.

"…It's a lot easier to have [these conversations] when the contracts expire and they're renegotiating their contracts. You always want to look towards some opportunities for growth or some opportunities for covering additional services, et cetera. At the end of the day, we have to tell these guys that if they don't agree to taking whatever cut or making whatever reduction, we have to be prepared to take whatever action we think we need to take at that point in time. And so it's not anything that either one of us wants to see happen, it's just a conversation that needs to be had. [If they do leave] they're not likely to get the same kind of managed care contract, the same kind of reimbursement to have the same kind of savings with benefits, the malpractice, this, that and the other. And so when you run the numbers, there are a number of reasons why we -- it might make sense for them to stay. We also again offer them the opportunity for if things turn around, if we can pick up six months from now, a year from now, it's not a -- this is all you're going to get for the next five years. It's a let's work on how to get this back on track."

February 8, 2018 – CEO Roger Mendel of Mednax, Inc. on Renegotiating Physician Contracts

Ambulatory Surgical Centers and Surgical Hospitals

ASCs are focused on **increasing physician alignment** through an expansion of physician recruitment efforts. In order to drive case volume growth at ASCs and surgical hospitals, management companies are increasing physician practice ownership and entering into "friendly-PC" arrangements, as well as recruiting physicians through non-ownership models.

"Regarding physician recruitment, we've begun the process of doubling the physician recruitment team and are already beginning to see some early benefits from our efforts. Specifically, we've already organically added over 100 new physicians that will begin using our surgical facilities in 2018. More importantly, we are using data to identify physicians in both specialties and geographies where we want to focus our growth. While the process to rebuild our physician recruitment pipeline will take time to mature and demonstrate financial impact, we are encouraged by our early results."

May 09, 2018 – CEO Wayne Scott DeVeydt of Surgery Partners, Inc. on Physician Recruitment

ASC management companies are **supplementing their surgical facility portfolio with ancillary services** to help drive growth and diversify.

Expert Insight

"In 2017 and continuing into the beginning of 2018, traditional health systems have been actively acquiring ASCs, imaging centers, and other ancillary service providers. ASCs and Surgical Hospitals are encountering a shrinking market of independent physicians, and must develop physician alignment models to continue competing with traditional health systems. In addition to competing with traditional health systems, competition exists with other vertically and horizontally integrated models being built, such as United Healthcare's Optum, and in the form of private equity investment, such as KKR's definitive agreement to acquire Envision Healthcare." – Nicholas J. Janiga, Partner, HealthCare Appraisers

From FMV and commercial reasonableness perspectives, it is important that the value of referrals is not conveyed in a business transaction, and to structure arrangements with ancillary service providers such that compensation is not being paid for downstream referrals.

"Let me first start with ancillary from the standpoint that ancillary in and by itself is not its own business. While it's currently being run as its own segment, it does create a feeder system in many ways to some of our surgical facilities. So first and foremost, as we evaluate ancillary, we're going to take a much more holistic view of what pieces and components drive a net value to our organization. If the net value doesn't persist, we're going to make a very quick decision on whether we'll be able to fix it or if it's worth fixing; if not, we'll divest."

March 1, 2018 – CEO Wayne Scott DeVeydt of Surgery Partners, Inc. on Ancillary Services

ASCs bringing ancillary services in-network to better align with payors.

"Throughout the back half of 2017 and into the early part of 2018, we have been migrating our out-of-network lab services into commercial networks, a process that is substantially complete. While this puts short-term pressure on revenue and operating earnings, we believe it is aligned with our longer-term strategy of being on the right side of the cost equation and partnering with payers in driving costs out of the health care system."

May 09, 2018 – CFO Thomas Cowhey
of Surgery Partners, Inc. on Ancillary Services

ASCs and other providers are **performing CPT Code level analyses to improve collections.** Providers compare their collections to benchmark collections for the same CPT code to see where there are areas for improvement.

HAI believes this is best practice among healthcare providers to help determine where inefficiencies or deficiencies may be occurring in the collections process, and we frequently assist clients with these types of black box analyses across multiple fee schedules.

"We've looked at the top 100 CPT codes. And we've tried to benchmark ourselves against what we think the average ASC is getting in the market. And while I won't share the specifics of that, what I will tell you is, the opportunity for revenue improvement is very meaningful for our organization, especially for the value we drive."

May 09, 2018 – CEO Wayne Scott DeVeydt
of Surgery Partners, Inc. on CPT Code Analysis

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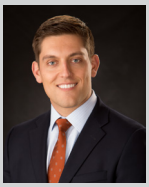

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