QUARTER 1 2020

FMVantage Point™

HealthCare Appraisers' Industry Insight

QUARTERLY INDUSTRY INSIGHTS

AT A GLANCE

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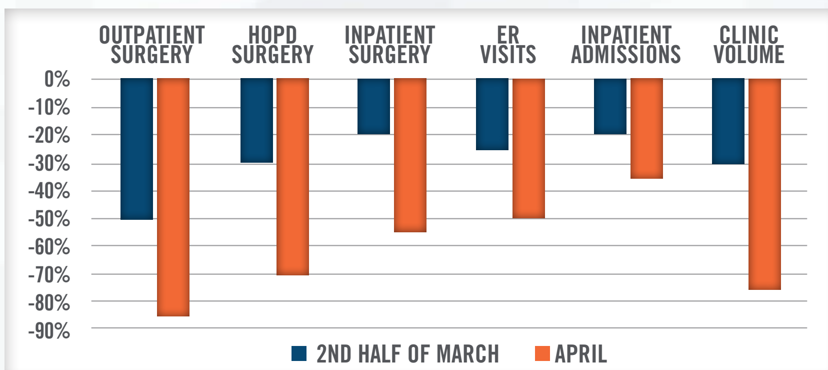
Monitoring Industry Activity from Quarter 1 of 2020

As part of our ongoing monitoring of developments in the healthcare industry, HealthCare Appraisers follows reports from publicly-traded health systems, physician services providers, ambulatory surgical center management companies, and other healthcare service providers. This document summarizes important valuation-related takeaways from recent earnings calls and conference presentations, as well as supporting quotes[1] from publicly-traded operators. In the first quarter of 2020, management teams and investors were primarily focused on the impact from COVID-19 and how the outlook for companies has changed as a result. **Figure 1** below presents the impact of COVID-19 on volumes reported by the various public companies for the second half of March and the month of April.[2] As illustrated by the chart, the largest declines were in outpatient surgical volumes and physician clinic visits due to government orders to postpone non-emergency visits and procedures. This article discusses major developments resulting from the pandemic, and presents the outlooks discussed by some of the largest operators in the healthcare space.

FIGURE 1: VOLUME DECLINE BY SERVICE LINE



HOME HEALTH CONSOLIDATION POSSIBLY DELAYED UNTIL 2021

Coming into 2020, many operators in the home health space anticipated meaningful consolidation as smaller agencies struggled with the implementation of PDGM[3] and reduced cash flow associated with the elimination of Requests for Anticipated Payments (RAP). HAI has observed some transactions close that were started prior to COVID-19, but transactions have largely been put on hold as a result of

[1] *All quotes have been adapted from transcripts provided by S&P Capital IQ.*

[2] *Includes data provided on conference calls from HCA Healthcare, Tenet Healthcare Corp, Universal Health Services, Mednax, Inc., Select Medical Holdings, and Community Health Systems and other publicly available information.*

[3] *The Patient Driven Groupings Model ("PDGM") is the new Medicare payment model for home healthcare providers.*

HOME HEALTH CONSOLIDATION POSSIBLY DELAYED UNTIL 2021 *(CONTINUED)*

the pandemic. The large public operators still expect consolidation to take place, but believe that the timeline could be pushed from 2020 to 2021, as government assistance to providers as a result of COVID-19 have effectively taken the place of RAPs. Specifically, the Medicare advanced payments to providers have provided much needed cash flow and have likely helped sustain home health providers that otherwise would have been pressed for cash due to elimination of the RAP. Importantly, the Medicare advanced payments will have to be paid back in the future, and PDGM and the phase out of RAP are unlikely to change. Therefore, consolidation and transaction activity is likely to occur and may even be more robust than it would have been otherwise, once the pandemic subsides. For more information on the outlook for the home health industry, please see HAI's recent article on this topic.

WHAT INDUSTRY LEADERS ARE SAYING ABOUT *HOME HEALTH CONSOLIDATION*

SCOTT GINN – CFO OF AMEDISYS, INC

"Certainly, [CMS] did throw everyone a lifeline. If you think about it, one of the big impacts we expected to be felt by our competitors was around the RAP elimination. And the ability for people to get advanced payments and the additional dollars from the Cares Act, that will certainly be helpful. But long term, I think when you have to pay some of this money back, I think it becomes problematic."

PAUL KUSSEROW – CEO OF AMEDISYS, INC.

"What's happened with the most severe parts of PDGM is the industry has artificially been propped up through necessary sequestration relief, payroll relief, payroll tax relief, you're getting AR relief. But you owe it all back. So I think what's going to happen is when all of this stops, which we assume will occur sometime in 2021, the impacts of PDGM will kick in. All the money will have to be returned. We're assuming that. And so I think there will be even more of a severe shakeout."

MEDNAX SOLD ITS ANESTHESIA BUSINESS TO A LARGE ANESTHESIA PLATFORM

Mednax announced that it sold its anesthesia business to North American Partners in Anesthesia in a transaction that included a unique deal structure and reflected the struggles Mednax has experienced in its anesthesia business. While Mednax has faced headwinds in its anesthesia service line including payor mix shifting more toward Medicare, as well as high cost inflation due to increases in staffing costs, the company projected losses related to COVID-19 to range from $150 million to $250 million, and indicated revenue for the month of April was down 60 percent to 70 percent compared to budget. Rather than bear those losses, Mednax elected to sell its anesthesia business in a transaction consisting of $50 million in cash with Mednax retaining approximately $110 million in receivables from the business. In addition, Mednax received a contingent interest in the business valued at up to $250 million based on North American Partners in Anesthesia's multiple on invested capital (MOIC) when it ultimately exits the business. This structure is similar to rollover equity used in many private equity transactions, with the payout being contingent upon a certain a hurdle rate, and in this case based on MOIC.

WHAT INDUSTRY LEADERS ARE SAYING ABOUT *MEDNAX SOLD ITS ANESTHESIA BUSINESS TO A LARGE ANESTHESIA PLATFORM*

STEVEN FARBER – CFO OF MEDNAX, INC.

"...we will not incur future financial losses beginning today related to the impact of COVID-19 on American Anesthesiology's operations. It's difficult to predict what that impact would have been, but based upon multiple scenarios that we evaluated, we estimate that those losses would likely be at least in the range of $150 million to $250 million."

ROGER MEDEL – CEO OF MEDNAX, INC.

"We have certainly faced challenges in this [anesthesia] business related to payor mix, scarcity of clinicians in the face of growing demand and reimbursement headwinds."

CERTAIN AT-RISK PROVIDERS PERFORMED WELL

The operators of large, at-risk physician groups and imaging centers indicated that providers in capitated payment arrangements fared better than providers compensated under more traditional fee-for-service ("FFS") models during the shutdowns caused by COVID-19. Specifically, providers under fully-capitated payment models benefited from consistent per member per month ("PMPM") payments while physicians involved in FFS arrangements saw dramatic declines in revenue due to the sharp decrease in utilization in the second half of March and the months of April and May. Depending on how much pent up demand there is for physician services once COVID-19 restrictions ease, these trends could reverse, with FFS physician practices benefiting from higher visit volume while PMPM physicians incur higher expenses associated with higher utilization while PMPM payments remain fixed. While the near-term impact remains uncertain and depends on how much pent up demand comes back to physician practices, the public company operators of these large at-risk practices expect the pandemic to accelerate the shift to value-based payment models for many physicians. We note that the benefits of being at-risk have increased relative to the advantages of forming accountable care organizations, which have experienced greater uncertainty on how COVID-19 will impact their shared savings arrangements. While CMS has indicated that COVID-19 related expenses will be excluded from ACO performance calculations which has alleviated some of this concern,[4] the pandemic is serving to highlight that not all risk-based arrangements are created equal.

WHAT INDUSTRY LEADERS ARE SAYING ABOUT *CERTAIN AT-RISK PROVIDERS PERFORMED WELL*

DAVID WICHMANN – CEO OF UNITEDHEALTH GROUP, INC.

"…the elective and chronic disease management deferrals work both ways in a business that has two-thirds of its business or revenues are risk-based and one-third of them are fee-for-service based. So two-thirds of OptumHealth revenues are premium revenues, capitated revenues. So obviously if there are deferrals of services, their utilization is lower against their capitated base."

BRUCE BROUSSARD – CEO OF HUMANA, INC.

"I would really emphasize the value-based payment model. What we have seen and heard back from providers that have relationships with us that are risk-based, they say, 'I am so thankful I was in a risk-based model where I was getting a consistent cash flow being paid as a percentage of premiums. In addition, I was able to be much more proactive and going and reaching out to my patients. I have both had the motivation and the reason to do it that allowed me to not only have the cash flow, but in addition, the proactive nature of it also benefits me longer term.' So we saw this awareness of what value-based relationships are and the ability to leverage that structure."

HOWARD BERGER – CEO OF RADNET, INC.

"One thing I should mention in regards to the impact on procedural volumes and revenue from COVID-19 is that our capitation business has really been a bright spot. Because under our capitated arrangements, we get paid a fixed amount per enrollee managed by the medical groups within the capitate, our capitation revenue and the associated cash flow has remained constant during the COVID-19 period, despite being required to perform fewer services for these patient populations during this period."

[4] *Centers for Medicare and Medicaid Services; https://www.cms.gov/files/document/covid-medicare-and-medicaid-ifc2.pdf Accessed May 19, 2020*

IMMEDIATE AND LONGER-TERM COVID-19 IMPACTS DISCUSSED BY PROVIDERS

Many providers discussed the near-term and longer-term impacts to their businesses from COVID-19. In the near-term ASC's expect case volumes for certain specialties such as spine, total joint replacements, general surgery, oncology, neurosurgery and cardiology to rebound quickly given the nature of the ailments being treated, while specialties such as gastroenterology, pain management, plastic surgery and ENT may come back slowly. Outpatient therapy clinics are anticipated to open quickly as well given that the layout and structure of these clinics are amenable to social distancing. Nearly every provider, and especially hospitals, noted the importance of making patients feel safe before they will return to receive care, and suggested that the shift to outpatient from inpatient may accelerate as patients feel safer in care settings that are less likely to be treating COVID-19 patients. Longer-term, providers see opportunities to expand the use of telehealth and home healthcare as regulators and consumers become more comfortable with care being provided outside of traditional settings. As a result, organizations have already expanded their telehealth capabilities both in-house and through outside partnerships, and home health joint venture activity is expected to accelerate. Major insurance carriers, including UnitedHealth and Cigna, offer members telehealth coverage through partnerships with large telehealth platforms such as Teladoc (NYSE: TDOC) and Amwell, which recently filed for an initial public offering. From a transactional standpoint, consolidation activity that has already been underway in areas like physician practices, home health and ASCs will likely accelerate as COVID-19 has amplified many of the difficulties already facing smaller, independent providers.

WHAT INDUSTRY LEADERS ARE SAYING ABOUT *IMMEDIATE AND LONGER-TERM COVID-19 IMPACTS DISCUSSED BY PROVIDERS*

STEVE FILTON – CFO OF UNIVERSAL HEALTH SERVICES, INC.

"I think a lot of what's being deferred are things like cardiac procedures, invasive cardiac procedures, pens and pacemakers, cardiac caths, surgeries, like oncology surgery, neurosurgery, heavy-duty orthopedics where patients are in a significant amount of pain. And I think generally, I would have described those procedures as not very deferrable. And I think our point of view is that over a period of time, and I think it's difficult to define exactly what that period is, but I think our perspective is that most of those procedures will wind up getting done."

ROBERT ORTENZIO – EXECUTIVE CHAIRMAN OF SELECT MEDICAL HOLDINGS CORPORATION

"These outpatient rehab locations are pretty much made for social distancing. You don't have a lot of patients in the clinic at the same time. It's really a relatively easy environment to have the kind of safeguards that people are talking about. So it's hard for me to project any kind of systemic change in that industry."

KEITH MYERS – CEO OF LHC GROUP, INC.

"…during COVID-19, we've experienced our existing joint venture partners more fully leveraging our capabilities as an integral part of their healthcare delivery team than ever before. As a result, we fully expect even greater joint venture interest from hospitals and health systems in the future."

BRUCE BROUSSARD – CEO OF HUMANA, INC.

"I also would say home healthcare is continuing to be an area where we're seeing a lot more interest in the ability to provide more acute services. Those services are primary care services that would normally be in an office setting, and even the ability to offer an alternative setting to an institution. We see that as a great complement to the telehealth side."

DAVID WICHMANN – CEO OF UNITEDHEALTH GROUP, INC.

"We quickly shifted more than 4,000 additional OptumCare physicians to our digital care clinics on our way to more than 10,000 in the weeks to come. This rapid response was made possible by the swift work of the regulatory agencies allowing flexibility in state licensure requirements for clinicians across service categories and state lines."

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Daniel I. Levin, CFA, ASA is a manager in the Firm's Denver office where he specializes in a wide variety of healthcare business and compensation valuation assignments. Mr. Levin's business valuation experience includes valuing hospitals, health systems, dialysis clinics, imaging centers, ambulatory surgery centers, physical therapy clinics, urgent care clinics and physician practices in connection with a wide range of transactions. Prior to joining HealthCare Appraisers in 2016, Mr. Levin was an Equity Research Associate performing industry research and investment analysis on publicly-traded healthcare companies. Mr. Levin graduated summa cum laude from Florida Atlantic University in 2013, and has been a CFA charterholder since September 2017.

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