Where Healthcare Reform is *Really* Going:

Thoughts on Strategy, M&A and Survival

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Sheppard Mullin

- Healthcare Law Practice Group of the Year, Law360 (January 2014)
- Winner, 2013 Global Healthcare Deal of the Year, for DaVita's $4.4 billion purchase of coordinated care leader HealthCare Partners
- 85+ attorney full service National Healthcare Team, led by 2013 National Healthcare MVP Eric Klein (Law360)
- US National Tier 1 Healthcare Law Firm, US News & World Report
- Doing Innovative, Cutting-Edge, Creative Work

Eric Klein

- Advises hospital systems, HMOs, PE Funds and strategic investors nationally on physician alignment strategies, value-based reimbursement systems and healthcare reform.
  - Physician group mergers and acquisitions
    - Primary care, multi-specialty and single specialty
  - Commercial and Medicare ACOs, HCC-RAF programs and innovative contracting
  - Leading Knox-Keene expertise – 4 new restricted Knox-Keene applications/licenses in last 12 months
  - Hospital M&A, joint ventures and alliances: 30 hospital purchase/sale, joint venture and alliance projects in last 8 years
  - Multiple multi-million dollar EMR/EHR/HIE projects

Introduction to Sheppard Mullin

- Global 100 full service law firm of 650+ attorneys with 90 year history
- Focused on middle-market and large-cap markets, such as healthcare, technology, aerospace and defense, and banking
- 11 US offices and 5 international offices
- Significant growth during the recession
- Priced below Wall Street law firms for the middle market

The Healthcare Market Today

Some Assumptions?

- Americans will get thinner and healthier soon?
- Seniors will require less medical care?
- Reimbursement rates will increase?
- Less lawyers and litigation?
- Continuing pressure on healthcare costs?
- Continuing focus on quality?
- Large increase in primary care MDs in the next 5 years?
- More mergers & acquisitions to come?

Continuing Mergers and Acquisitions

- Hospital systems
  - Tenet/Vanguard
  - Community Health Systems/Health Management Associates
  - Trinity Health/Catholic Health East
  - Mt. Sinai/Continuum Health Partners (NY)
  - Baylor/Scott & White (TX)
  - Northwestern/Cadence (IL – announced 3/14)
  - Providence/St. John's
  - USC Keck/Verdugo Hills
  - Alecto/St. Rose & Olympia
  - Prospect Medical/East Orange General (NJ)
- Between 2007-2012, 432 hospital deals occurred, involving 835 hospitals (JAMA, 11/13/13)
- 60% of hospitals now part of health systems (JAMA)

Continuing Mergers and Acquisitions

- Payors – very active in Medicare Advantage & Medicaid
  - Aetna/Coventry
  - Anthem/Amerigroup
  - Highmark/Blue Cross of Northeastern Pennsylvania
- Physician services
  - DaVita/HealthCare Partners
  - United Optum/North American Medical Management
  - Humana/Metropolitan Health Networks
  - McKesson/Med3000
  - Welsh Carson/Greater Houston Anesthesiology/Pinnacle Anesthesia/JLR
  - Tenet/Lakewood IPA and Premier Health Plan

Continuing Reimbursement Pressures

- Sequestration
- Medicare Rates

The New York Times

Politics

U.S. Proposes Cuts to Rates in Medicare Payments

By ROBERT PEAR FEB. 21, 2014

WASHINGTON — The Obama administration on Friday proposed cuts in Medicare payment rates for managed-care plans serving more than one-fourth of all beneficiaries, and Republicans immediately pounced on the proposal, which appears likely to become a significant issue in this year's midterm elections.

Too Many Hospitals?

- Ezekiel Emmanuel, MD, commenting on the economic role of hospitals today
  - "Hospitals are a grossly inefficient way of providing jobs. We don't need 5,000 hospitals."

    (3/4/14, *Daily Princetonian*, discussing his new book *Reinventing American Healthcare*)
- 20% of hospitals could merge in the next 5-7 years – recent Booz Allen study
- Many of the smaller hospitals in the US are operating at a loss
- Even large systems are feeling the effects of industry changes - Sutter Health announced its first operating loss since 1999 (3/6/14), with a decrease in 2013 of more than $570 million in operating profit

Healthcare Through the Looking Glass?

Looking at the Revenue Side

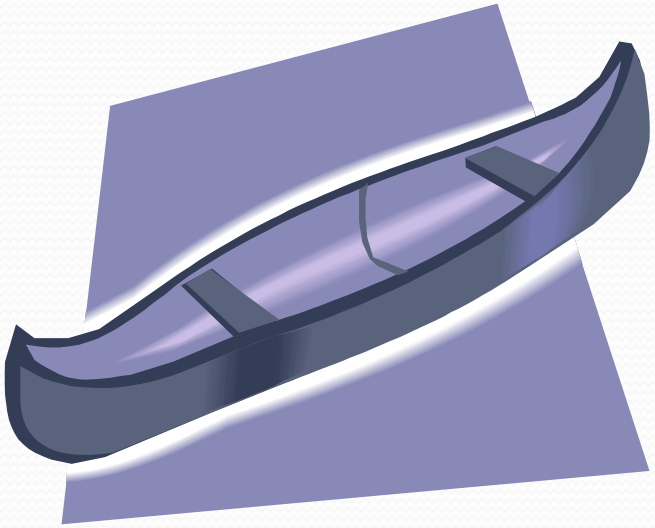
- The Strange Case of Hospital Revenue
  - Who believes that reimbursement rates in the next five years will:
    - Increase?
    - Stay flat?
    - Decrease?
  - Will you have more or less volume/care needs with:
    - Medicare patients?
    - Medicaid patients?
    - Commercial?
  - So, more services to be provided at generally lower rates…
  - Where are the savings supposed to come from to fund healthcare reform?
    - Hospitals … because of course there's up to 30% waste in hospitals today, right?

Looking at the Expense Side?

- So, if perhaps not revenue growth, then perhaps better control of expenses?
  - Who believes that you can cut expenses as a viable pathway to hospital profitability?
  - Who believes that labor/staffing costs will stay stable for the next five years?
  - Who believes that you could eliminate 25% of expenses in your current business model during the next year or two and still remain open and viable?
- Many expenses are not easily curtailed or materially changed in the current business model

So, If That's True…

- Then what does that mean for our healthcare system and your companies?
- Are we really *up the creek*?



Is this a No-Win Scenario for Hospitals?

Time to Change the Rules (& Business Model)?

- Who is Your Primary Customer?
  - Health Plans?
  - Government Agencies?
  - Patients?
  - Employers?
  - Physicians?
- Is Your Primary Customer Generating Your Highest Margin Opportunities?
  - If not, why not?
  - Can that change? If not, what does that mean for you?
  - What direction is your primary customer taking (i.e., narrow networks)?
  - Can you maintain margin in a wholesale/volume-oriented arrangement?
- How much of your Primary Customer related expenses do you really control? Is this level of control really comfortable for you?

Time to Redefine the Business Model?

- What is Your Value Proposition to that Primary Customer?
  - Are you doing "good enough" or doing "better than?"
  - What is their pain that you can solve/reduce?
    - If they don't see it, can you help them see it in the near term?
  - If you solve that pain, will it – for both them and you:
    - Increase/stabilize market share?
    - Increase/stabilize revenue?
    - Increase/stabilize EBITDA?
    - Provide competitive advantage?
    - If not, are you selecting the right customer?
- Will your Primary Customer pay more for that value proposition?
  - If not, is it truly valuable then?

Time to Redefine the Business Model?

- Is your value proposition sufficiently differentiated from your market competitors?
- Can your value proposition be your brand?
  - Solving pain = brand?
- OPM: Will third party money (grants, pilots, CMMI, other payments) be available to help your efforts?
- Are you leading or following your customers?

Leading or Following?

- Have you decided to be a market leader, or are you more comfortable following?
  - If following, who are you following…and why them?
    - What economies do you get by following?
  - If leading, how well defined is your destination objective?
    - If we asked every stakeholder in your community (employees, physicians, patients, health plans, community members, etc.), what percentage would be able to identify your organization's destination objective?
    - Are compensation bonuses aligned to that objective?
    - If leading, what extra resources do you require?

Should We Realign Our Priorities?

- Generate More Revenue!
- Generate More Revenue!
- Drive to Greater Market Share…and More Revenue
- Build and Support Your Value Proposition/Brand
- Control Expenses and Quality

- BUT HOW?

What Strategies/Tactics Can We Use?

Strategy Choices - #1

- GO WIDE in your "distribution channel" and capture new product revenue/margin
  - Look at Amazon – books, electronics, now food
  - How much revenue relates to your patients?
  - Case Study: Ascension
    - Group Purchasing Organization (GPO)/supply chain
    - IT/Big Data (analytics)
    - Medical malpractice insurance
    - Facilities management
    - Asset management
    - Shared services
  - Only 50% of Ascension revenue comes from its hospitals

Strategy Choices - #2

- GO BIG!
  - Capture more market share
    - Market power – pricing and competition
    - Expand into higher reimbursement geographies
    - Lower unit cost
    - Economies of scale
    - Reduce cost of customer acquisition
    - Vertical integration to allow margin shifting
  - How big is big? Regional or national possibilities?
  - Acquisition, alliance or affiliation?

Going National

- Goal setting: DaVita HealthCare Partners, Ascension, Tenet
- Why? The low hanging fruit:
  - National payor contracting
  - National employer accounts
  - Spread infrastructure costs nationally
  - Ability to centralize shared services and eliminate duplicative expenses

Going National

- But wait, there's more…
  - Walmart, Amazon, Home Depot – what happened?
  - Effective national companies tilt the playing field
    - Brand awareness = market share/capture
    - Reduces/eliminates competition from local players
    - Drives supply chain reform
    - Sets the bar not only for "best practices," but also pay scales
    - Recruiting effect (look at Kaiser in California)
  - Using your size – who defines "good, cost-effective healthcare?"
    - Do you accept the market's definition?

Strategy Choice #3 - Partner Up?

- Partnering can achieve multiple objectives
- Partnering to meet the "triple aim"
  - Allspire – 25 hospitals in 7 health systems in NJ, NY, PA & MD
    - Population health management & quality initiatives
    - Group purchasing/sourcing & distribution
- Systems can have a market or cost advantage through shared services
- Can titrate level of shared services and integration
  - Could be first step in greater integration strategy

Non-Profit/For-Profit Partnering

- Trend toward partnering of non-profit and for-profit hospitals
  - **Tenet/Yale** (3/14) – initial four joint venture hospitals in CT with aim to move toward value-based contracting, clinical integration and care coordination
  - **Duke LifePoint/Conemaugh** (3 hospitals) (3/14) – After this most recent PA acquisition, the joint venture between for-profit LifePoint and non-profit Duke University Health System would have 11 hospitals
  - **Community Health Systems/Cleveland Clinic** (2013)
    - Quality: Cardiovascular, clinical integration, operations
  - Private equity & health systems – urban hospitals

Strategy Choice #4 - Expanding Your Reach

- What's the lowest cost approach to broadening your revenue base/service area/branding efforts?
- Can you build an ambulatory care network?
  - Urgent Care Centers
  - Community Health Centers
  - Senior Centers
- MemorialCare Health/UC Irvine Health – Orange County primary care health centers partnership (10/13)
  - UC Irvine PCPs and MemorialCare health plan contracts
  - Integration of electronic health records systems
- What's more effective – billboard advertising or a clinic?

Opportunity: Aggregate Small Practices

- The market needs good models to rapidly aggregate/affiliate small physician practices and educate them as industry reimbursement trends from volume to value-based systems
- Can your hospital assist in educating and leading smaller physician practices? Contractual vs. purchase? Adding to physician revenue (PPO, risk adjustment)?
  - Clinically integrated networks?
  - Building an IPA?
  - Building a Foundation?
- There is a lot of investor money to support this

Opportunity: Employer Health

- Employee wellness
  - Cracking the code – the ASO hurdle
  - Enough is enough! The employers wake up…
    - Traditional smoking cessation programs
    - Employee weight (CVS)
    - Employee health assessments and info (*Penn State*, *WSJ* 8/16/13)
    - Private exchanges growing (*New York Times*, 3/6/14)
    - Penalties are permitted under ACA, but limited
- What are healthcare delivery systems doing to directly provide support to employers
- Do you have a private exchange strategy?

Opportunity: Population Health Management

- Not enough expertise nationally in population health management
  - Lot of high level consulting, but how do you actually transition and operate successfully?
- Existing knowledge base being bought rapidly
  - HealthCare Partners, NAMM; others at high multiples
- Private equity is investing in PHM start-ups
- What's your PHM strategy?
- Can you monetize your own expertise?

Organizing for Successful Growth

- Common problem in the healthcare industry
  - Thinly staffed/underwhelming business development function
  - Comparing yourself to other industries
  - Effect:
    - High number of failed deals and bad market reputation
    - Too much senior management intervention, creating distractions and high opportunity costs
    - Inability to created organized process
- If you want to grow, build for it

Strategy Choices - #5

- MOVE UP THE "FOOD CHAIN"
  - Hospital systems seeking payor licenses
    - Go direct to employers
    - Offer insurance products
    - Eliminate third party margins (system employee health)
  - Not if, but when…Sutter, Ascension, Tenet
  - Multiple new restricted Knox-Keene licenses issued and in process (2013-2014)
    - Providence Health & Services
    - Brown & Toland
    - DaVita HealthCare Partners
    - Prospect Medical
    - Other medical groups

Strategy Choices - #6

- PLAY SMARTER – you don't have to get big, just have to get better
- Get your people engaged and incentivized
- Tighten your focus to what works for you and your patients/customers
  - Do you really need an ACO?
  - De-emphasize or close service lines
- Brand it – loudly and constantly tell people what you do and why you're good at it

Strategy Choices - #7

- USE TECHNOLOGY to accelerate transparency and business process – consumers demand information
  - Walmart App on Smartphones
    - Allows customers in the store to:
      - Find desired products
      - Keep a running tab on their shipping costs before check-out *and choose what they can afford to buy*
  - Could technology provide a real-time cost accounting structure that accelerates billing cycles, suggests lower cost treatment alternatives and notes deviations from "best practice" protocols? If so, why isn't this in use already?
  - What does accelerating billing by two weeks do for you?

Strategy Choices - #8

- GO VERTICAL – align hospitals and physicians
  - If you didn't notice, it's a war out there right now between hospitals and payors – and it's not going to get better soon
  - So, you bought a physician group…now what?
  - Hospital systems that have significant aligned physicians can:
    - Affect pricing
    - Innovate
    - Drive quality and results (Star ratings, HCC-RAF)
    - Disintermediate payors
  - Communicate and brand your physician vision and strategy to retain, grow and support productivity
  - Do your physicians have a seat at the table? Any responsibility for managing your financial results?

Strategy Choices - #9

- REDESIGN DELIVERY
  - Care redesign is one of the best ways to reduce costs and improve quality
  - Setting a BHAG – X% more revenue, Y% less cost
  - Trends to watch:
    - Care delivery teams
    - Rise of the mid-levels
    - E-visits
    - Group visits
    - Managed post-acute care
    - Unified care management

Opportunity: Re-Design Compensation

- Compensation *always* drives behavior
- Too much of the healthcare system has misaligned financial incentives – and we are letting it continue year after year
- How much of your payroll is directly tied achieving your true goals?
  - For many companies, it's less than 10%
  - Physician groups that have 40%-60%+ of compensation based on criteria achieve (and often overachieve) those criteria)

M&A Outlook

- Given the foregoing, there's much more M&A to come at all levels of the healthcare industry
- Expect a pause from time to time after large transactions as the market recalibrates
- Expect pricing (absent surprises) to stay consistent with current levels, except for distressed and game-changing transactions

Questions?

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