



DRCHSD Summit

Delta Region Community Health
Systems Development Program

2023



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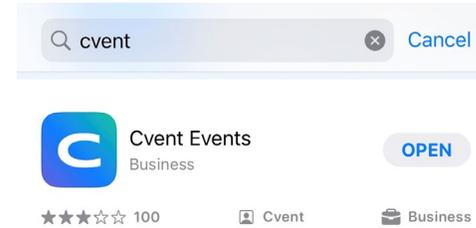
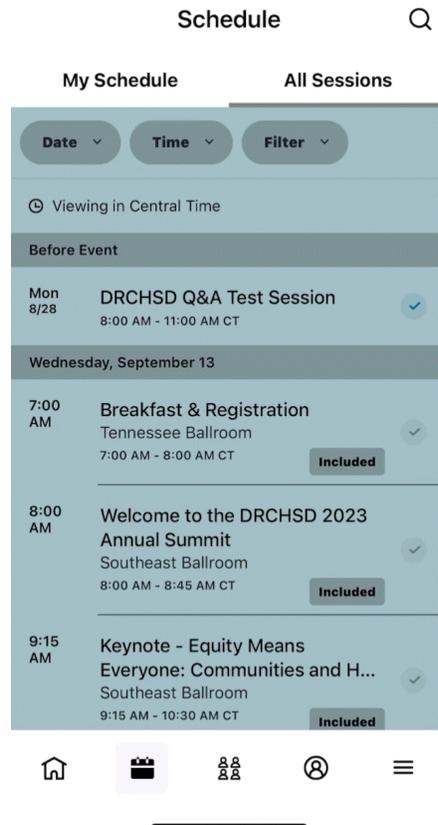
Affiliations and Partnerships



DRCHSD Summit

Delta Region Community Health
Systems Development Program | 2023

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**OPERATIONALIZING THE RURAL VALUE
PROPOSITION FOR EXISTING AND
PROSPECTIVE PARTNERSHIPS**

Jeffrey Sommer – September 2023

MEET THE SPEAKER



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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



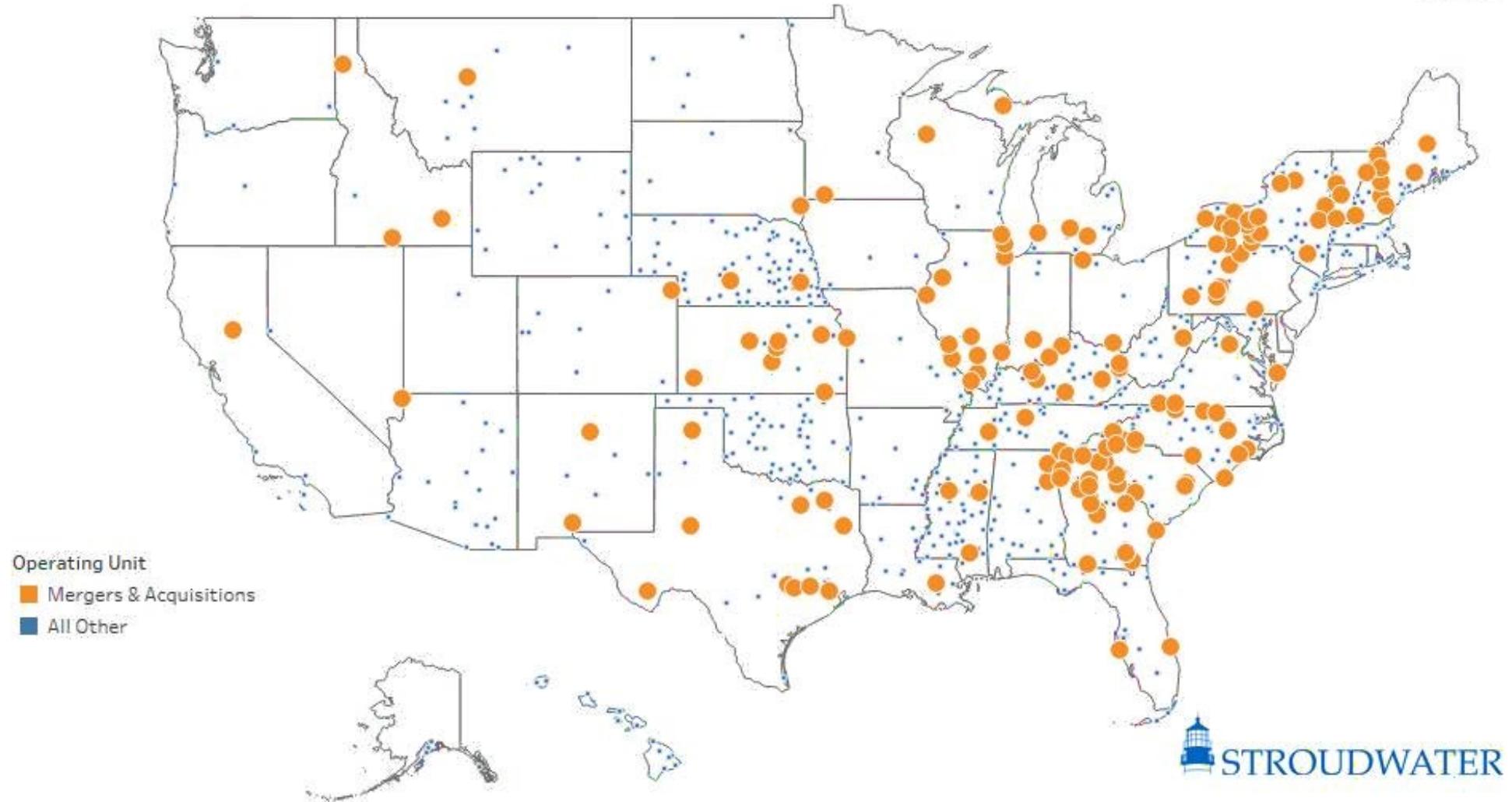


RURAL AFFILIATIONS

The State of The World

STROUDWATER: A NATIONAL RURAL HEALTH PERSPECTIVE

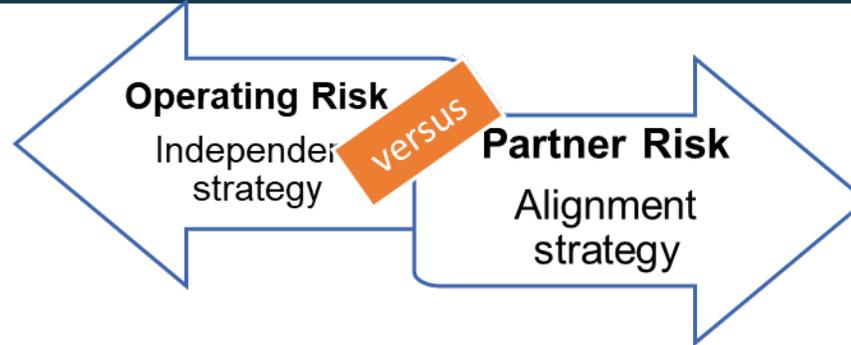
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STRATEGIC OPTIONS: THERE IS NO RISK FREE OPTION

“What is the best strategy to achieve our mission and vision?”

Independence vs. Affiliation/Partnership



How do you minimize Operating Risk?

- Accountability and coordination 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 affiliation structures for fit with our strategic objectives
- Craft key terms to be contractually enforceable
- Involve key stakeholders from the beginning and emphasize communication
- Make candidates earn the right to be your partner



IS THERE A SYSTEMIC UNDERVALUING OF RURAL HEALTH SYSTEMS?

- **Our experience says *yes***
- Many system parents that have significant rural operations do not optimize these operations:
 - ❑ Experience: missed annual payments approaching eight figures annually via flawed designations and alignment
 - ❑ Experience: cost-accountants undervalue incremental referrals from rural affiliates
- Rural health systems have too few or unattractive partnering options:
 - ❑ Experience: initial skepticism replaced by awareness of the value proposition and much more robust affiliation terms
 - ❑ Experience: initial, flawed LOI replaced by LOI that reflects value proposition and includes major investment commitment, service commitments, and reserve powers
- **Many decision-makers bring assumptions regarding existing and prospective rural affiliates based on flawed or incomplete data, resulting in missed opportunities, flawed decisions, and suboptimal affiliation structures.**



WHY DOES THIS MATTER?

When larger health systems fail to understand the value of rural affiliates, the following happens:

- Under-investment or disinvestment in rural operations, resulting in a sub-optimal allocation of resources and diminished access to needed services
- Risk of “leakage” of referrals and attributed lives for the parent system
- Failure to capitalize on opportunities, resulting in insufficient returns from rural operations, which depresses future investment
- Partnership terms not representing the value of the prospective affiliate
- Rural health systems’ partnership options not reflecting their actual value





INDUSTRY CONTEXT

NOT-FOR-PROFIT HEALTHCARE 2023 OUTLOOK

DECEMBER 2022

Moody's Not-For-Profit Healthcare 2023 Outlook Remains Negative, as Inflation and Labor Drive Higher Expenses

- Labor shortages will remain a primary driver of elevated expenses, which will restrain growth in margins. Higher inflation, persistent COVID-19 surges, supply chain disruptions, and continued cybersecurity investments will also increase expenses.
- "While operating cash flow will grow in 2023, the high expense environment, coupled with modest revenue gains, will limit the profit margin for the not-for-profit healthcare sector. This level of operating cash flow production will likely prove insufficient over the long term to enable adequate reinvestment in facilities, maintain investment in programs, or support organizational growth – key considerations that drive our negative outlook," said Brad Spielman, Vice President – Senior Credit Officer for Moody's Investors Service.

Fitch's Sector Outlook: Deteriorating

- Fitch expects that core credit drivers for the sector will remain challenged for 2023 as highlighted by its mid-year sector outlook revision to Deteriorating in August 2022. The sector is seeing labor pressures and generationally elevated inflation, compressing margins for virtually all providers.
- 75% or more of a provider's expenses are currently under intense expense pressure, and operating metrics are down significantly in 2022 for most providers, with 2023 not expected to show a rapid operational recovery for most.

S&P Outlook: Negative

- S&P revised their not-for-profit healthcare sector review as of December 2022 to "negative given the persistent operating pressures coupled with investment market volatility."
- "We do not expect full margin recovery in 2023 and will likely see continued operating losses, albeit at lower levels than 2022, for many institutions," the S&P report states. "Meaningful improvement will likely take multiple years."

Sources:

<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.moody's.com/research/Moodys-Not-For-Profit-Healthcare-2023-Outlook-Remains-Negative-as--PBM_1351244

<https://www.spglobal.com/ratings/en/research/articles/221201-outlook-for-u-s-not-for-profit-acute-health-care-a-long-road-ahead-12573554>



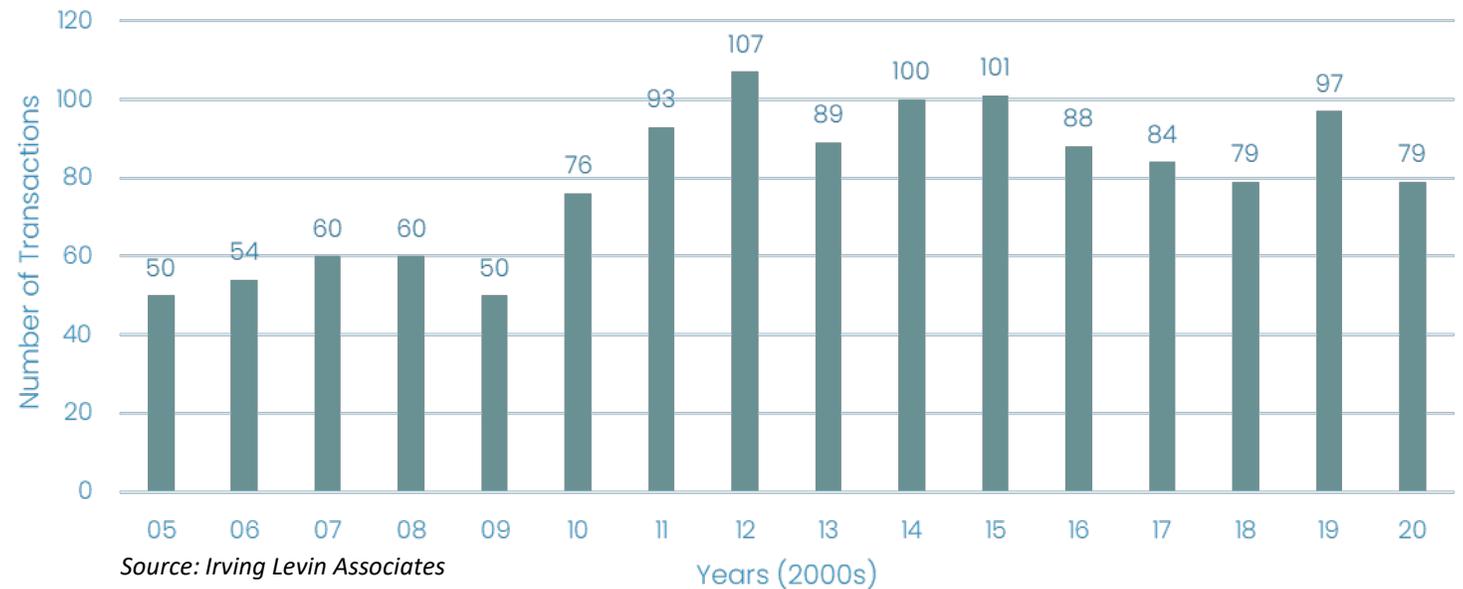
AFFILIATION DRIVERS: INDUSTRY CONSOLIDATION

Catalysts:

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

In response to industry disruption and regulatory changes, 993 hospital affiliations have taken place since 2010.

Number of Hospital Affiliations from 2005 - 2020



EVALUATING & MITIGATING STRATEGIC 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

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



OVERALL RISK RATING

Why does this matter?

- High indicates a strong elevated level of risk, and this trend is increasing
- High – Level Risk Mitigation Strategies Include:
 - Financial Risk – Closing the EBIDA gap and working toward the sustain and thrive levels would mitigate this risk
 - Operating Risk – Increasing [Hospital A]’s discharges by marketing services to more patient populations
 - Value Risk – Renewed focus and emphasis on HCAHPS scores to surpass [Competitor A] will play a crucial role
 - Market Risk – Reducing outmigration and recruiting additional providers to the area will be critical for [Hospital A] to reduce market risk
- [Hospital A] leadership must examine opportunities to mitigate at-risk components by 2024 and look to take advantage of their current stable position regarding strategic options

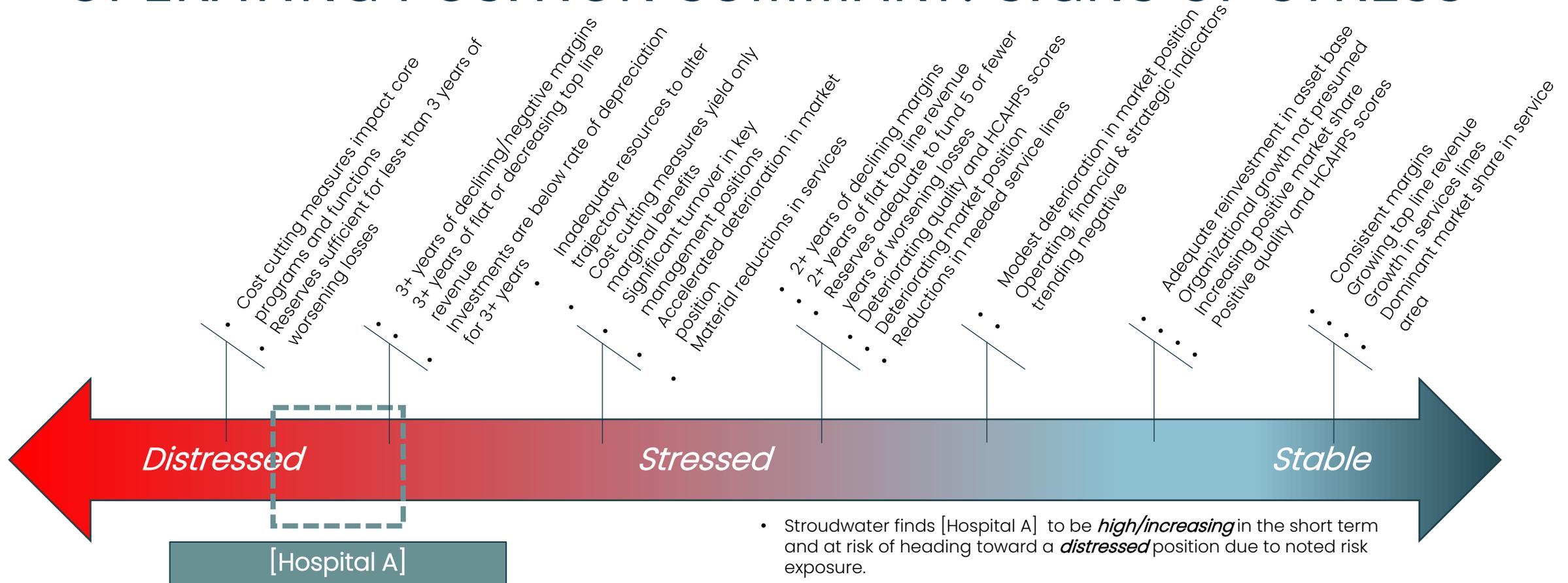
WEIGHT OF RISK



Indicators	Weight	Risk	Direction of Risk Trend
Financial Risk	40%	High	Increasing
Operating Risk	25%	High	Increasing
Value Risk	15%	Medium	Increasing
Market Risk	20%	High	Increasing
Overall	100%	High	Increasing



OPERATING POSITION SUMMARY: SIGNS OF STRESS



- Stroudwater finds [Hospital A] to be *high/increasing* in the short term and at risk of heading toward a *distressed* position due to noted risk exposure.
- High risks include:
 - 1) Continued growth of unfavorable payor mix
 - 2) Decreasing market share
 - 3) Decreasing discharges
 - 4) Growth in total operating expenses



INCREASING REGULATORY SCRUTINY

- The federal government is ratcheting up scrutiny for large hospital transactions and acquisitions.
 - Memphis, Tennessee – based Methodist Le Bonheur backed out of a bid to buy two Tenet-owned hospitals in the city after pushback from the FTC.
 - A federal judge halted a proposed merger between Hackensack Meridian Health in New Jersey and Englewood Health after the FTC challenged the deal.
 - The NH attorney general objected to the proposed merger of Dartmouth Health and GraniteOne Health due to it violating the state’s constitution that requires “free and fair competition in the trades and industries.”
- **President Biden has issued an executive order calling for federal agencies to take a closer look at the impacts of such mergers.**

Given the increased scrutiny, it is critical that potential and existing partners understand the value of rural hospitals before embarking on this journey.





RECOGNIZING A RURAL AFFILIATE'S VALUE

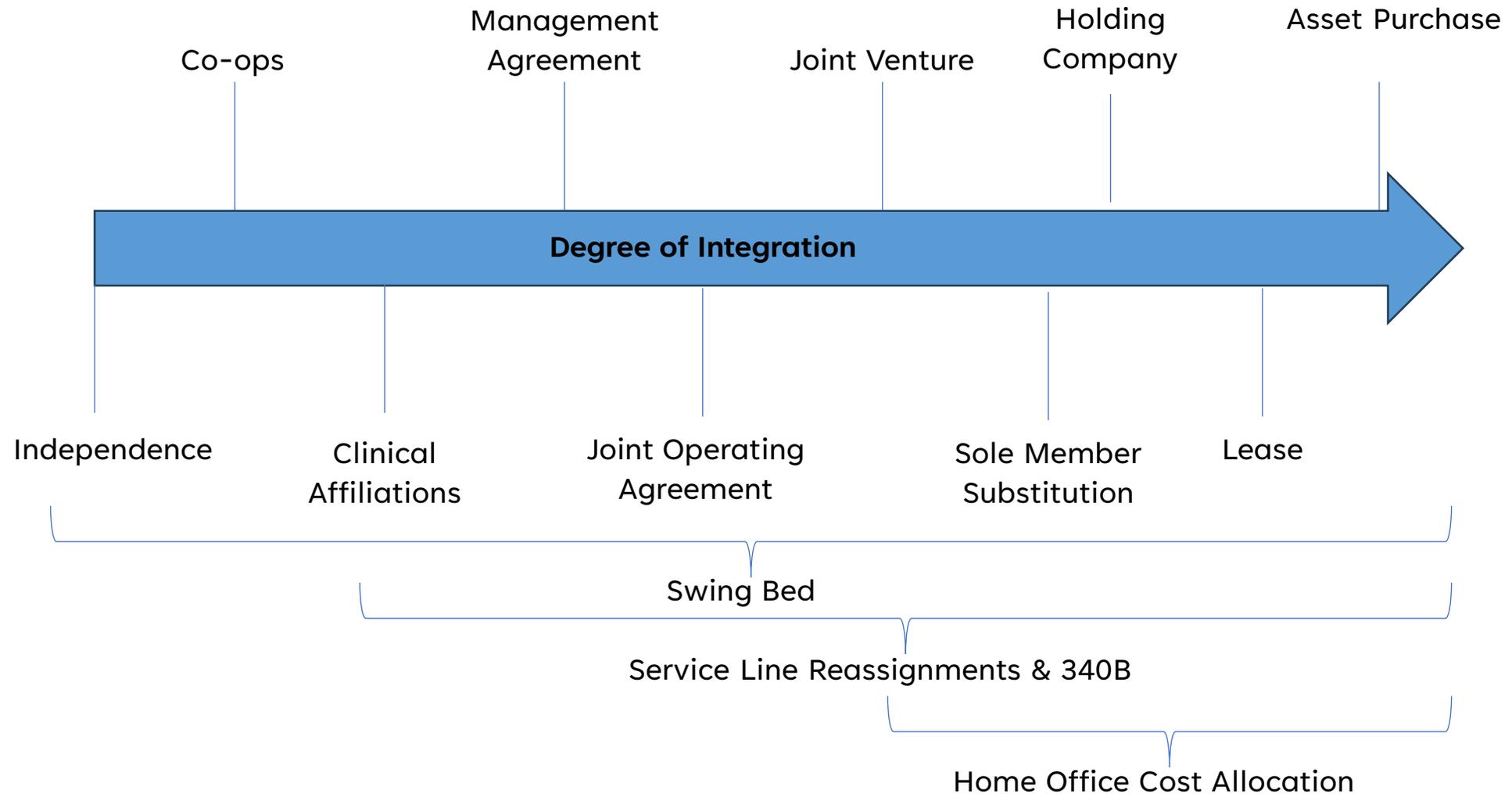
VALUE LEVERS FOR RURAL HEALTH SYSTEMS

- 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
 - Decanting volume and utilizing 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.



EXAMPLE: NC HOME OFFICE COST ALLOCATION ANALYSIS

- › The table below shows the home office allowable costs the System can transfer to the associated critical access hospitals in North Carolina. From this amount, the specific CAH's cost-based percentage would be applied to determine the annual cost-based pickup for the CAH. The average allowable cost is \$6.2M.

NC CAH Hospital Name	System Name	Home Office Allowable Costs Worksheet A-8-1 - FY21
Alleghany Memorial Hospital	WakeBaptist/Hugh Chatham	\$ 908,134
Angel Medical Center	HCA	\$ 7,721,771
Blue Ridge Regional Hospital	HCA	\$ 6,440,883
Cape Fear Bladen County Hospital	Cape Fear Valley Health System	\$ 5,179,510
Charles A. Cannon Jr. Memorial Hospital	Watauga Medical Center	\$ 6,335,304
Chatham Hospital	UNC Health System	\$ 5,997,974
First Health Montgomery Hospital	First Health	\$ 2,455,575
Highlands-Cashiers Hospital	HCA	\$ 5,541,272
LifeBrite Community Hospital of Stokes	Lifebrite Hospital Group	\$ 647,476
Murphy Medical Center	Erlanger Health System	\$ 7,164,800
Outer Banks Hospital	ECU Health/CRH	\$ 14,027,561
Pender Memorial Hospital	Novant Health	\$ 11,839,947
Swain Community Hospital	LifePoint Health	\$ 1,074,814
Transylvania Regional Hospital	HCA	\$ 10,086,135
Vidant Bertie Hospital	Vidant Health	\$ 3,649,013
Vidant Chowan Hospital	Vidant Health	\$ 10,942,210



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





EXAMPLES FROM THE FIELD

CASE STUDY: CAH & LARGE MULTI-STATE HEALTH SYSTEM



- Our 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.



CASE STUDY: QUANTIFYING THE VALUE

- Stroudwater was engaged by a CAH and regional referral center to explore the potential opportunities that an affiliation could create for both organizations.
- The scope of work focused on the following potential value drivers:
 - Service line operational and clinical opportunities, including decanting volume
 - Swing bed program opportunities
 - 340B program opportunities
 - Rural health center opportunities
 - Home office cost allocation opportunity
- Both organizations were concerned that the affiliation would be a good “fit” strategically and not become a distraction relative to the potential value to be realized.



CASE STUDY: QUANTIFYING THE VALUE, CONT.

- The following table quantifies the financial opportunities based on the ability of each initiative to be operationalized at various levels of system integration ranging from each organization maintaining complete independence up through a formal affiliation.
- The deeper the level of integration, the greater the benefits produced through the formal establishment of a system relationship.

Summary Financial Opportunities	Independent	Limited Partnership	Full Affiliation	Clinical and Operational Benefits
Service Line Reassignments		\$1.12M	\$1.12M	<ul style="list-style-type: none"> Capacity constraint at Regional Referral Center is distributed to Critical Access Hospital (“CAH”) in need of volume Decanting volume to CAH will increase clinical capabilities
Swing Bed Program Growth	\$140K	\$180K	\$180K	
RHC/340B Drug Pricing Program Net Revenue			\$270K	<ul style="list-style-type: none"> Creates improved financial environment for expanding qualified clinics
Net Impact of Home Office Allocation			\$2.0M+	<ul style="list-style-type: none"> Improved cost-based reimbursement on system overhead costs
Total Annual Impact of Opportunities	\$140K	\$1.3M	\$3.6M+	





CAPTURING THE VALUE PROPOSITION

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 until you have an acceptable term sheet in hand.





KEY TAKEAWAYS

KEY TAKEAWAYS (CONTINUED)

- The significant intrinsic value of rural health systems is too often missed or undervalued by existing and prospective partners.
- Know your value! Do your homework and engage with prospective and existing partners.
- Your value will be obscured and overwhelmed by poor fee-for-service-based operating results.
 - Very few prospective partners will be interested in a prospective affiliate with a negative trajectory and no workable plan or turnaround progress.
 - If you have poor operating results, you need to have a plan to improve operations and be working on that plan before your talk to prospective partners.
- You need to be able to explain and quantify your value to partners – either existing or prospective.
 - Ensure that your rural health system is appropriately valued to craft a sustainable, win-win partnership.
- Be persistent; don't assume that partners or leadership know the intricacies of rural payment, designations, or cost reports.



QUESTIONS AND THANK YOU

At Stroudwater, we have an all-encompassing devotion to rural healthcare nationwide. Our team is driven each day by the conviction that every rural community deserves a compassionate and quality healthcare delivery system.



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Real-world, mission-critical, actionable advisory services as you and your community navigate the dynamic risks of today's healthcare environment.

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We're proud of our 37-year track record with rural hospitals, community hospitals, healthcare systems, and large physician groups.

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