VA–DC HFMA
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Outsourcing Nonperforming Service Lines: How to Make This a Win Win Transaction

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Premise

- Financial picture for hospitals continues to be difficult
  - Extreme pressure on cash flows.
  - Healthcare reform and new industry dynamics have increased the need for capital:
    - Changes in care management.
    - Buying and integrating physician practices.
    - Information technology – capital investments and operating costs.
    - Facility improvements and expansion - capacity to accommodate new Medicaid and insured volume – whether real or perceived.

Premise

- Financial Picture (cont'd.)
  - Debt markets continue to be difficult.
  - Many hospitals continue to operate with negative margins.
  - Continued budget cuts from government payor programs.
- Hospitals continue to look for new sources of revenue and cash.

Premise

- Traditional operational strategies to improve liquidity and generate capital include:
  - Revenue cycle improvements.
  - Operational efficiency efforts.
  - Expense reduction programs.
  - Deference of capital expenditures.

Premise

- Such strategies have been fully implemented in many cases.
- There is no more cash to squeeze out.
- Some cost cuts are unsustainable.
  - Deferred capital investment in plant and IT will need to be satisfied at some point.

Scarce Resources

- There continues to be an allocation process for scarce capital resources, including:
  - Cash capital.
  - Management resources capital.
  - Physical space capital.

Scarce Resources

- Certain ancillary functions and/or service lines can be classified as non-core, such as:
  - Clinical laboratory.
  - Imaging centers.
  - Pharmacy.
  - Home health agencies.
  - Long term care.
  - ASCs.
  - Dialysis centers.
  - Sleep centers.
  - Other.

Divestiture Program

- Hospitals can seek to monetize, and/or lower the ongoing costs associated with:
  - Non-core assets and service lines.
  - Underperforming assets and service lines.
  - Real property (not addressed in this presentation).
- Can be accomplished through:
  - Joint ventures.
  - Outright sales.
  - Outsourcing.
  - Strategic affiliations / management contracts.

Divestiture Program

- Benefits of an ancillary divestiture program
  - Generates immediate and substantial cash proceeds for a healthcare system.
    - Can be used to improve the balance sheet and improve ongoing access to capital.
    - Allows redeployment of capital (cash, management, space) into more optimal strategic areas.
  - Can reduce a health system's ongoing cost for ancillary services.
  - Ensures the ancillary's offerings will be at the technological cutting edge.

Divestiture Program

- Benefits of an Ancillary Divestiture Program (cont.)
  - Can improve the clinical offerings of the program.
  - Enables the avoidance of capital investment in the ancillary.
  - Preserves employment in the community - often critical to a mission statement.
  - Maintains or improves current service levels.
  - Allows management to focus on core assets/business.

Divestiture Program

- Need to assess ancillary divestiture program within context of overall strategic plan.
  - Analyze strategic financial position.
  - Analyze market and competitive positions.
  - Look at key market demand and volume trends.
  - Identify the strengths and weaknesses of clinical programs and service lines.
  - Research facility development needs.
  - Future capital needs (core and non-core businesses).

Divestiture Program

- Need to determine if an ancillary divestiture program is a medium or long term solution.

- Should not be used to defer dealing with the new world of healthcare reform and the ACO environment.

Divestiture Program

- From a buyer's/partner's perspective, former hospital assets/service lines can be attractive.

- Compared to a hospital, a third-party specialty operator can often/sometimes:
  - Operate businesses more efficiently and profitably, with no decrease in quality.
  - Lower cost structures, primarily wages and benefits.
  - Have additional clinical expertise - can demonstrate better clinical outcomes at lower costs.

Process

- Need to develop a strategic framework to identify high potential arrangements.
  – Take an inventory of non-core and underperforming assets and/or service lines.
  – Determine the strategic implications of disposing of, or entering into a joint venture on, the identified assets and/or service lines.
  – Conduct a preliminary valuation in order to quantify the monetization opportunity.
  – Determine preference for complete sale vs. joint venture/partial sale.

Process

- From system's perspective, it is important to:
  – Find the partner/buyer best able to meet your organization's strategic needs.
  – Maximize the transaction value (economic and non-economic) and purchase terms.
  – Protect access to care and quality of care by minimizing the risk of clinical and quality degradation post-transaction.
  – Minimize organizational disruption during sale process.
  – Minimize continuing exposure to claims relating to divested business.

Process

– Structure a process and a transaction that facilitates regulatory approval.
– Consummate transaction which leaves service line consistent with mission statement and charitable objectives.
– Consummate a transaction which optimizes the solution for all stakeholders:
    - The patients
    - The healthcare system
    - The employees
    - The caregivers
    - The payors
    - The vendors
    - The community

Process

- Sell/partner process – pre going to market.
  - Identify assets/service lines to be divested.
  - Conduct an assessment to identify and resolve any regulatory, legal, tax, or business issues.
  - Identify team members: internal and advisors.
  - Construct data room.
  - Consider special bonus/retention arrangements with key employees.
  - Make certain that noncompetes are in place for key employees.

Process

- Pre Going to Market (cont.)
  - Set clear and preferred objectives related to:
    - Valuation.
    - Deal structure.
    - Post-transaction operating model.
    - Post-transaction costs and service levels.
    - Timeline – the longer the deal period, the more likely to be diverted.
  - Identify potential deal partners.

Process

- Selling/partnering process – going to market.
  - Execute confidentiality agreements.
  - Preliminary information exchange.
  - Negotiations.
  - Letter of intent execution.
  - Due diligence.
  - Preparation/negotiation of definitive documents.
  - Regulatory filings.
  - Transaction closing.

Clinical Laboratory Case Study

- Clinical laboratory case study.
  - Focus on clinical laboratories owned by healthcare systems.
  - Real world examples of clinical lab liquidity events.
  - Many concepts applicable to other service lines.

Clinical Laboratory Industry Overview

The lab industry is large with strong volume-related fundamentals.

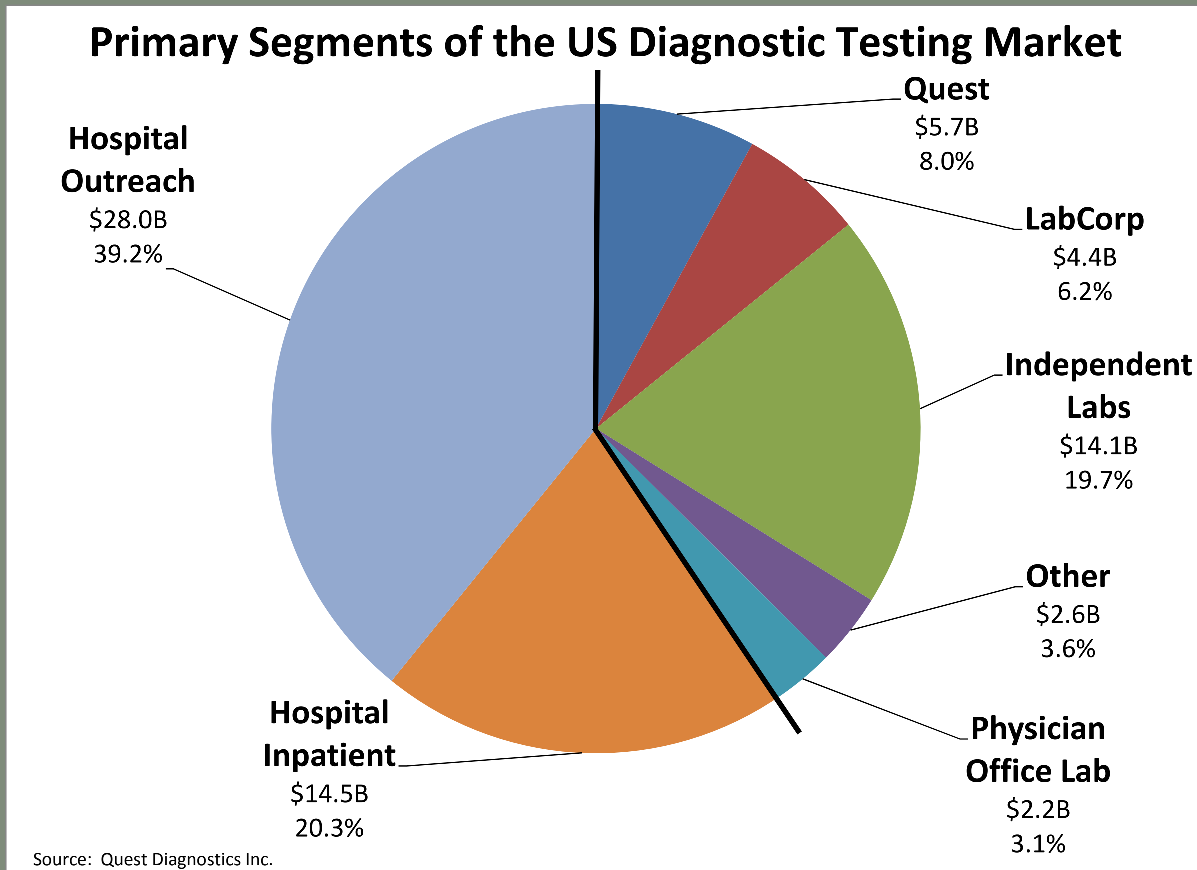
- Of the $2.4 trillion in 2012 health consumption expenditures, labs drive 70% of healthcare decisions while only representing 3% of costs, or $72 billion.
- Early detection can reduce downstream health care costs.

Clinical Laboratory Industry Overview

- Aging of the U.S. population. The number of individuals 65 years old and older will increase to 55 million, or by 36%, over the next decade; a growth rate that is nearly four times faster than that of the overall population.
- Despite years of consolidation, the lab industry remains highly fragmented.
- Technological advances in genomics, pharmacogenomics / companion diagnostics, and molecular diagnostics is a major growth driver.

Clinical Laboratory Industry Overview

Quest Diagnostics recently estimated the size of the lab industry at $72 billion.



Clinical Laboratory Industry Overview

Hospitals control approximately 60% of the $72 billion lab market and are providing stiff competition to the national commercial laboratories.

- The single biggest headwind facing the large commercial labs today is the erosion of their physician client base due to physician practice acquisitions by hospitals.

Clinical Laboratory Industry Overview

- Hospitals are benefiting from the higher reimbursement on acquired physicians’ lab testing due to the hospital laboratory fee schedule.
- Most industry observers expect that this reimbursement differential that hospitals now enjoy will erode over the medium term.
- In the meantime, however, volume growth at the big commercial labs is suffering.

Clinical Laboratory Industry Overview

Continuum of strategic partnership options for labs and hospitals.

Less Collaborative

- **Reference Testing** — Contractual relationship based upon price and service level.
- **Cooperative Testing / Shared Services** — Commercial lab and hospital lab share facilities, test volume and logistical services within a defined geography.
- **Lab Mgmt. & Outsourcing** — Outsourcing of laboratory services by hospital in exchange for long-term laboratory services agreement with commercial laboratory.
- **Outreach Acquisition** — Acquisition of the outreach client list with or without a lab management or lab outsourcing arrangement.
- **Joint Equity Venture** — Involves shared equity ownership or profit sharing by the hospital and commercial laboratory.

More Collaborative

Divestiture of Outreach Client List

Fundamental premise:

- Hospital sells intangible and tangible assets relating to Hospital's outreach business:
  - Outreach client list only
  - Patient service center real estate leases / FF&E
  - Phlebotomy placement arrangements between Hospital and its clients
  - Support staff (couriers, salespersons, etc.) and support assets (IT and logistical) relating to pre- and post-analytic activities

Divestiture of Outreach Client List

- Post-transaction, Hospital continues to operate its current laboratory which would now process only IP and OP test volume.
- Typical buyer will be forced to realize “price compression” based on lower fee schedules.
- Buyer will achieve:
  - Reductions in the variable cost per test based on purchasing power.
  - Reductions in the marginal cost per test if testing relocated to existing buyer facility.
  - Expense reductions in excess of price compression.

Divestiture of Outreach Client List

Preliminary Conclusions for Stakeholders:

- Healthcare System
  - Results in substantial cash proceeds.
  - Still owns and controls its IP / OP lab ops.
  - 5 year non compete in outreach lab market.
  - Unlikely that Hospital will be able to shed much more than the Outreach client list's proportionate share (by test volume) of variable direct operating expenses.
  - Minimal organizational disruption.
  - Avoidance of future Outreach CAPEX.
  - May provide physical space in Hospital.

Divestiture of Outreach Client List

Preliminary Conclusions for Stakeholders:

- Patients and Caregivers
  - Better clinical outcomes at lower costs.
  - Stronger, healthier Hospital.
- Employees and Community
  - Maintain employment due to IP/OP testing needs.
  - Stronger, healthier employer.

Comprehensive Outsourcing

Fundamental premise:

- Hospital sells 100% of all Hospital lab operations to a third party, including:
  - All of the assets included in the Outreach client sale
  - All IP/OP-related assets, intangible and tangible
  - Hospital enters into a 5 year non compete
  - Buyer's name appears on the Hospital lab license

Comprehensive Outsourcing

- Hospital and buyer enter into a long-term Laboratory Services Agreement (LSA)
  - Pricing to Hospital for lab services is assumed to be set at the estimated IP/OP direct costs, with escalation provisions.
  - Term ranges from 5 to 10 years.
  - Include lease arrangements for lab space, IT infrastructure, ongoing shared services.
  - Complex arrangements with comprehensive service level and quality requirements.

Comprehensive Outsourcing

- Typical buyer will be forced to realize “price compression” related to Outreach portion.

- Buyer will achieve:
  - Reductions in the variable cost per test based on purchasing power.
  - Reductions in the marginal cost per test if testing relocated to existing buyer facility.
  - Expense reductions in excess of price compression.

Comprehensive Outsourcing

Preliminary Conclusions for Stakeholders:

- Healthcare System
  - Substantial cash proceeds for Hospital – highest among alternatives.
  - Divests ownership of its IP / OP lab operations subject to the LSA.
  - 5 year non compete for provision of lab services (or at least lab outreach market).
  - Contractual stability in future lab costs.
  - Could be substantial organizational disruption.
  - Avoidance of future lab CAPEX.
  - May provide physical space in Hospital.

Comprehensive Outsourcing

Preliminary Conclusions for Stakeholders:

- Patients and Caregivers
  - Better clinical outcomes at lower costs.
  - Stronger, healthier Hospital.
- Employees and Community
  - Maintain employment if testing is not relocated.
  - Stronger, healthier employer.

Joint Equity Venture

Fundamental premise

- Hospital contributes 100% of all Hospital lab operations (or, just outreach business) to a new entity and immediately sells a 50% stake in the new entity ("Newco") to a commercial lab partner.

Joint Equity Venture

- Hospital and Newco enter into an LSA
  - Pricing to Hospital for lab services is assumed to be set at the estimated IP/OP direct costs, generally with escalation provisions.
  - Term ranges from 5 to 10 years.
  - Includes lease arrangements for lab space, IT infrastructure, ongoing shared services.
  - Highly negotiated, complex arrangements.

Joint Equity Venture

Preliminary Conclusions for Stakeholders:

- Healthcare System
  - Substantial cash proceeds for Hospital, although cash/control tradeoff.
  - Entitled to share in the ongoing profits generated by Newco in proportion to its ownership. Such profits may be improved by synergies derived from an affiliation with the commercial lab partner.
  - Contractual stability in future lab costs.
  - 5 year non compete for Hospital; commercial lab commits to an exclusive JV territory.

Joint Equity Venture

Preliminary Conclusions for Stakeholders:

- Healthcare System (cont'd.)
  - Hospital divests ownership of its IP / OP lab operations subject to the LSA and governing documents of JV entity.
  - Staff and lab physical presence in Hospital is largely maintained; ongoing service level and quality metrics are managed under the LSA.
  - Governance of 50-50 joint ventures involving hospitals and commercial enterprises present numerous challenges.

Joint Equity Venture

Preliminary Conclusions for Stakeholders:

- Patients and Caregivers
  - Better clinical outcomes at lower costs.
  - Stronger, healthier Hospital.
- Employees and Community
  - Maintain employment if testing is not relocated.
  - Stronger, healthier employer.

Technical Resource Management

Fundamental premise:

- Commercial lab partner/vendor hires the current Hospital lab manager and enters into a Technical Resource Management contract with Hospital.
- The nexus afforded by this contractual relationship enables the commercial lab partner to extend the very favorable terms of certain of its various vendor relationships to Hospital.

Technical Resource Management

- Typically, the Hospital lab would switch its primary reference lab to the commercial lab partner/vendor – compliance issues.
- Savings result primarily in the areas of laboratory supplies, equipment related expense, and reference lab services.
- Terms of such relationships range from 2 to 3 years.

Technical Resource Management

- Sometimes minor purchase price consideration is paid to the Hospital by the vendor for tangible assets – i.e., equipment that is taken out of service and replaced by the vendor's preferred equipment platforms.

Recap of Strategic Alternatives

	Actual 2010	Actual 2011	Actual 2012
Inpatient, Outpatient, and Outreach Units:			
Inpatient Units of Service	790,000	760,000	750,000
Growth Rate		***-3.8%***	***-1.3%***
Outpatient Units of Service	810,000	1,000,000	1,150,000
Growth Rate		***23.5%***	***15.0%***
Outreach Units	500,000	600,000	650,000
Growth Rate		***20.0%***	***8.3%***
TOTAL UNITS	2,100,000	2,360,000	2,550,000
Growth Rate		***12.4%***	***8.1%***
Inpatient and Outpatient Payments/Net Revenue:			
Inpatient Estimated Net Charges/Revenue	$5,500,000	$5,300,000	$5,200,000
Growth Rate		***-3.6%***	***-1.9%***
Outpatient Estimated Net Charges/Revenue	5,600,000	7,000,000	7,800,000
Growth Rate		***25.0%***	***11.4%***
Outreach Payments	17,200,000	21,100,000	21,300,000
Growth Rate		***22.7%***	***0.9%***
Total Payments/Net Revenue	$28,300,000	$33,400,000	$34,300,000
Growth Rate		***18.0%***	***2.7%***
Payments/UNIT	$13.48	$14.15	$13.45
Growth Rate		***5.0%***	***-5.0%***

Recap of Strategic Alternatives

- Divestiture of Outreach Client List
  - Substantial proceeds ($35.0mil) / potential losses on ongoing operations
- Comprehensive Lab Outsourcing
  - Highest proceeds ($46.0 mil) / costs controlled via vendor relationship
- Joint Equity Venture
  - Substantial proceeds ($23.0 mil) / opportunity to participate in future profits / challenges of JV governance

Recap of Strategic Alternatives

- Technical Resource Outsourcing
  - Opportunity for moderate savings / experience some lack of control
- Maintain Status Quo
  - Enjoy current high outreach reimbursement / opportunities to pursue strategic alternatives should exist for at least 12 to 24 months

Laboratory Industry Transaction Trends

- Dramatic surge in the level of acquisition activity in recent years
- National commercial laboratories are paying “synergistic” valuations
- Sustained and growing interest in hospital clinical lab segment
- Scarcity of large acquisition targets
- Increased number of clinical laboratory acquirers

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Transaction Advisory and Business Valuation Services

Paoli Executive Green I
43 Leopard Road, Suite 102
Paoli, PA 19301
Tel: (610) 407-4023
Fax: (610) 407-4028
www.haverfordhealthcare.com

Kirk A. Rebane, ASA, CFA
Managing Director
krebane@haverfordcapital.com

McDonald Hopkins LLC

Attorneys at Law

600 Superior Avenue, East
Suite 2100
Cleveland, Ohio 44114
Tel: (216) 348-5400
Fax: (216) 348-5474
www.mcdonaldhopkins.com

Richard S. Cooper, Esq.
Member (Partner)
rcooper@mcdonaldhopkins.com