2010 Physician Hospitals of America 10th Annual Conference

Value Drivers for Surgical Hospital Joint Ventures and Mergers in the Wake of Healthcare Reform

Presented By:

Todd A. Zigrang, MBA, MHA, FACHE

Senior Vice President

HEALTH CAPITAL CONSULTANTS

1143 Olivette Executive Parkway

St. Louis, MO 63132-3205

(800) FYI-VALU • www.healthcapital.com

September 23, 2010

This presentation addresses information and developments in the admittedly broad and rapidly changing regulatory environment as it relates to healthcare assets. Neither the presenters nor the sponsor intend this presentation to render any legal or accounting advice, but rather to provide general information and sources. Neither the presenter, nor the sponsor, assume any liability with respect to the use of information contained in this presentation. For legal or accounting advice, individuals and their firms are urged to consult their attorney or CPA.

PHYSICIAN HOSPITALS OF AMERICA PHA

2010 Physician Hospitals of America 10th Annual Conference

Presenter Biography

Todd A. Zigrang, MBA, MHA, FACHE, is a Senior Vice President of HEALTH CAPITAL CONSULTANTS (HCC), where he focuses on the areas valuation and financial analysis for hospitals and other healthcare enterprises. Mr. Zigrang has significant physician integration and financial analysis experience and has participated in the development of a physician-owned multi-specialty MSO and networks involving a wide range of specialties; physician-owned hospitals, as well as several limited liability companies for the purpose of acquiring acute care and specialty hospitals, ASCs and other ancillary facilities; participated in the evaluation and negotiation of managed care contracts, performed and assisted in the valuation of various healthcare entities and related litigation support engagements; created pro-forma financials; written business plans; conducted a range of industry research; completed due diligence practice analysis; overseen the selection process for vendors, contractors, and architects; and, worked on the arrangement of financing. Mr. Zigrang holds a Master of Science in Health Administration and a Masters in Business Administration from the University of Missouri at Columbia. He is a member of the American College of Healthcare Executives and Healthcare Financial Management Association. He has co-authored "Research and Financial Benchmarking in the Healthcare Industry" (STP Financial Management) and "Healthcare Industry Research and its Application in Financial Consulting" (Aspen Publishers). He has additionally taught before the Institute of Business Appraisers and has presented healthcare industry valuation related research papers before the Healthcare Financial Management Association; St. Louis Business Valuation Roundtable; and, Physician Hospitals of America (f/k/a American Surgical Hospital Association).

PHYSICIAN HOSPITALS OF AMERICA PHA

I. Physician Owned Hospital (POH) Marketplace

- **There are approximately 265 POHs located in 34 states**
  - Employ more than 75,000 full-time and part-time workers
  - Average staffed bed size:
    - 233 (general acute care)
    - 65 (heart)
    - 40 (multispecialty)
    - 34 (rehabilitation)
    - 30 (long-term acute care)
    - 24 (orthopedic)

"Physician-owned hospitals: Endangered species?" By Chris Silva, American Medical News (June 8, 2010).

I. Physician Owned Hospital (POH) Marketplace

- **Types of POHs:**
  - Multispecialty - 149
  - General acute care - 54
  - Heart - 18
  - Orthopedic - 18
  - Rehabilitation - 12
  - Long-term acute care - 8
  - Emergency care - 3
  - Heart and general acute, Multispecialty children, and Multispecialty women - 1 each

"Physician-owned hospitals: Endangered species?" By Chris Silva, American Medical News (June 8, 2010).

I. Physician Owned Hospital (POH) Marketplace

- **POHs range from fully-owned by physicians to a small percentage of physician ownership, with most POHs having an average ownership of 2%.**
  - Westfield Hospital – Allentown, PA: wholly physician owned
  - Doctors Hospital at Renaissance – Edinburg, TX: 80 percent physician-owned
  - Indiana Orthopaedic Hospital – Indianapolis, IA: physicians represent 1 percent ownership

II. Restrictions on POH Growth

Patient Protection and Affordable Care Act of 2010 (PPACA) & CMS August 3, 2010 Proposed Rule

- **Limits on Development**
  - Physician Owned Hospitals (POHs) that do not have a provider agreement prior to December 31, 2010 are prohibited from participating in Medicare
  - Ambulatory surgical centers cannot be converted into a POH after March 23, 2010
  - Those that have a provider agreement prior to December 31, 2010 can continue to participate, provided that certain conflicts of interest, bona fide investments, and patient safety issues are addressed

II. Restrictions on POH Growth

Patient Protection and Affordable Care Act of 2010 (PPACA) & CMS August 3, 2010 Proposed Rule

- **Limits on Expansion**
  - The percentage of the total value of the physician ownership or investment interests in the hospital cannot increase beyond the percentage held by the physician on March 23, 2010
  - POHs may not increase the number of operating rooms, procedure rooms, and beds beyond the number for which the hospitals are licensed as of March 23, 2010
  - Procedure rooms include rooms in which the following procedures are performed:
    - Catheterizations
    - Angiographies
    - Angiograms
    - Endoscopies

II. Restrictions on POH Growth

Patient Protection and Affordable Care Act of 2010 (PPACA) & CMS August 3, 2010 Proposed Rule

- **Limits on Expansion**
- Current estimates indicated that approximately 29 POHs are scheduled to open and receive Medicare certification by the cut-off date of December 31, 2010.
- There are 45 additional POHs under construction, which will most likely not meet the December 31, 2010 deadline

"Federal Lawsuit and Injunction filed Challenging Limitations on Physician Owned Hospitals in Healthcare Reform," By Medical News Today (June 4, 2010), www.medicalnewstoday.com.printerfriendlynews.php?newsid=190925, (Accessed 6/4/10).

II. Restrictions on POH Growth

Patient Protection and Affordable Care Act of 2010 (PPACA) & CMS August 3, 2010 Proposed Rule

- **PPACA Sec. 6001 – Exception to Limits on Expansion**
  - Grandfathered POHs classified as "*high Medicaid facilities*" are eligible to apply for expansion permission
  - To be considered a *high Medicaid facility* the following criteria must be met:
    1. Hospital is located in a county that has population growth that was at least 150% of the state's population growth for the 5 years prior to the application
    2. Hospital's Medicaid inpatient admissions annual percentage is equal or greater than the average for all hospital located in the county
    3. Neither the hospital nor physicians practicing at hospital discriminates against beneficiaries of federal health care programs
    4. Hospital must be located in a state which has an average bed capacity less than the national average
    5. Hospital must have an average bed occupancy rate that is greater than the state average occupancy rate

The Patient Protection and Affordable Care Act- Section 6001 of PL 11-148.

II. Restrictions on POH Growth

Patient Protection and Affordable Care Act of 2010 (PPACA) & CMS August 3, 2010 Proposed Rule

- **PPACA Sec. 6001 – Exception to Limits on Expansion**

- DHSS Secretary will establish a process to allow POHs to request an exception to the limitation on expansion
- DHSS Secretary will issue regulations for the application process on January 1, 2012, with an implementation date of February 1, 2012
- POHs may apply for an expansion opportunity once every two years
- Any expansion permitted must be limited to the main campus of the hospital

III. The Future for POHs

Expansion Restrictions and Impact on Value

- Value of POHs is often dependent on future cash flow and risk of sustaining cash flow. Two questions for consideration:

  (1) Is the POH presently or expected to have capacity constraints with respect to patient beds, operating rooms, or procedure rooms?

  - Capacity issues can lead to significant challenges, such as overcrowding and diminished patient/physician satisfaction, decreased flexibility, limited schedules, etc.

  (2) Will current or future capacity constraints threaten market share or profitability?

  - The ability to implement long term expansion plans can serve as a buffer against competition. Growth restrictions could hamper a POHs ability to compete in the market place.

"Do Mandated Growth Restrictions Destroy Physician Owned Hospital Value?" By Elliott Jeter and Kevin McDonough, The PHA Pulse (Summer 2010), p. 13.

III. The Future for POHs

Expansion Restrictions and Impact on Value

- Shrinking Investor Pool: According to some industry experts, the PPACA cap on the number of physician investors that may invest in a hospital plus the ban on the expansion of POHs may cause non-physician investors to no longer consider POHs a viable investment option.
- Government interventions impacting on the liquidity of capital by:

  (a) disrupting the makeup of the market investor pool; and,

  (b) the expected investment holding period time horizon,

  may require a significant discount for lack of control and/or Marketability.

"Physician-owned hospitals: Endangered species?" By Chris Silva, American Medical News (June 8, 2010).

IV. POH Industry Outlook Options for Survival

Proper Prior Planning Prevents Poor Performance

- In order to meet the December 31, 2010 grandfathering date, hospitals should submit no later than October 1, 2010 to ensure enough time for obtaining a Medicare Provider Number
- Document Level of Physician Ownership: Be prepared to address claims that POH did not have physician investor "on board" as of March 23, 2010, with documentation as to:
  - (a) Amount of the hospital's historical revenue stream attributed to a particular service line provided by a particular physician, e.g., historical productivity reports
  - (b) Maintain documentation as to both the commencement and extent of *all* communications with a prospective physician investor sufficient to indicate that the physician investor was "on board" as of March 23, 2010

IV. POH Industry Outlook Options for Survival

Proper Prior Planning Prevents Poor Performance

Document Expansion of POH's Capacity: Be prepared to address claims that POH did not have plans in process regarding expansion of ORs/procedure rooms:

(a) Maintain copies of all architectural drawings, city/county government filings related to facility expansion

(b) Document any rent paid to facility to be utilized for expansion even if build-out of ORs/procedure rooms is not complete

IV. POH Industry Outlook Options for Survival

Proper Prior Planning Prevents Poor Performance

Develop and maintain strategic business plans for business development

- Branding
- Centers of Excellence
- Community Outreach

  (a) Establish network of local community and political support (e.g., testimonials)

  (b) Promote consumer and employer benefits

IV. POH Industry Outlook Options for Survival

Proper Prior Planning Prevents Poor Performance

- Maintain organizational cohesiveness among investors (both physician and non-physician), e.g. covenants not-to-compete

- Maintain financial documentation in "value-friendly" manner

  (a) Economic financial statements

  (b) Keep accounting records on an accrual basis

  (c) Obtain updated real estate and furniture, fixtures & equipment (tangible personal property) appraisals

IV. POH Industry Outlook Options for Survival

Proper Prior Planning Prevents Poor Performance

- Maintain current and constant analysis of:

  (a) Physician referral sources

  (b) Geographic descriptions of patient origin data (e.g., patient zip code analysis)

- Maintain and enhance accreditation status

- Establish and maintain operating and capital budgets

IV. POH Industry Outlook
Options for Survival

Consider Restructuring and Joint Venture Options

(1) Merge/Joint Venture with a hospital or health system to develop a service line *Center of Excellence* whereby the physicians would provide certain professional clinical and co-management services

- Physicians should have the opportunity to:

  (a) Maintain a significant level of control and oversight over delivery of care

  (b) Share in any cost-savings or incentive bonuses tied to patient quality metrics

IV. POH Industry Outlook
Options for Survival
Consider Restructuring and Joint Venture Options

(2) Sell the POH outright and merge the physician practice(s) comprising the existing POH with other practices in the local market service area in order to achieve a critical mass and market leverage

- align the physician practice(s) comprising the existing POH with a local non-profit hospital in preparation for structuring an Accountable Care Organization

V. Concluding Remarks

- The value of any given POH is dependent upon the mix of services provided and the unique circumstances under which that POH operates

- While a given POH's value may be impacted by regulatory changes for the overall POH industry as a whole, the internal operations of a given POH and the competitive landscape in which the given POH operates will often typically have a direct impact on a POH's value

- Accordingly, each POH should be constantly aware of its internal performance metrics, e.g., quality of care and beneficial outcomes, and the ability to measure these metrics