HealthCare APPRAISERS

FMVantage Point

Quarterly Insights

Quarter 4 ▪ 2018

IN THIS ISSUE

As part of our ongoing research into the healthcare industry, HealthCare Appraisers, Inc. follows commentary of publicly-traded health systems, physician services providers, ambulatory surgical center management companies, and other healthcare service providers. The following paragraphs are important valuation-related takeaways from recent earnings calls and conference presentations, as well as supporting quotes[1] from publicly-traded operators.

During fourth quarter conference calls, public companies frequently discuss the outlook for their businesses for the coming year. In this edition of the Quarterly Insights, we highlight the factors that public company operators are focusing on for 2019.

Outlook for Rural Hospitals

Rural hospitals continue to struggle financially as declining populations and deteriorating payor mix put pressure on admissions and profitability. As populations have migrated toward economic opportunities in larger metropolitan areas, rural area hospitals have experienced declining volumes and an uptick in government payors[2] as a percentage of total payors. In addition, lower cost of care settings such as outpatient networks and micro hospitals have taken market share from existing community hospitals. This has impacted public companies in many ways, as LifePoint Health was recently taken private and Community Health Systems has reshaped its portfolio by divesting many of its rural hospitals to improve its growth and profitability profile, as well as deleverage and pay down debt. This trend can be observed over the last several years through the outperformance of companies like HCA Healthcare, which has a more urban and suburban footprint, in comparison to the hospital management companies with more rural portfolios. Going forward, the path to improving financial performance and viability will likely include increasing use of telehealth arrangements, more efficient staffing models for hospital-based services, partnering with and acquiring outpatient providers, and implementation of population health payor contracts.

"Today, we have a stronger portfolio of hospitals in more sustainable markets than we did four years ago or even a couple of quarters ago. 80% of our hospitals today are in combined statistical areas of greater than 50,000 residents. And if you back out anticipated future divestitures and smaller markets that support regional networks, 95% of our hospitals are in markets with greater than 50,000 residents. So our company's hospitals are no longer predominantly in nonurban or rural markets, but instead we have more exposure to suburban and urban markets with better population growth, better economic growth and lower unemployment, all of which provides an opportunity for improved growth potential."

Wayne Smith – CEO of Community Health Systems

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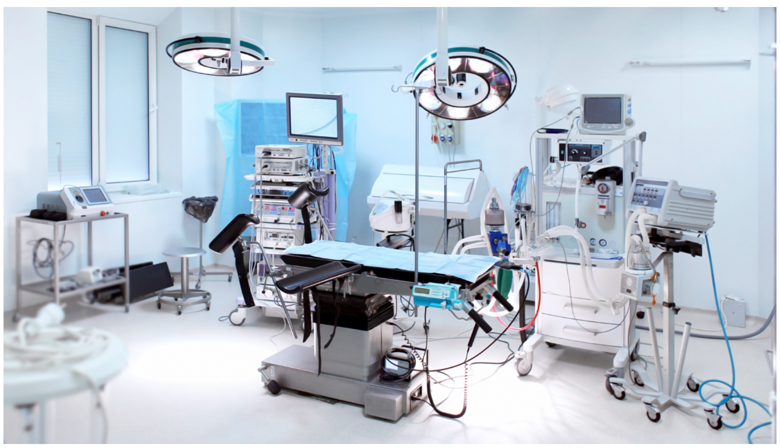
[1] All quotes are taken directly from transcripts provided by S&P Capital IQ. Some quotes have been edited for clarity and relevance.

[2] https://www.modernhealthcare.com/article/20190220/NEWS/190229999/nearly-a-quarter-of-rural-hospitals-are-on-the-brink-of-closure

Outlook for Dialysis Providers

A few trends impacting the outlook for dialysis providers in the United States were highlighted on recent earnings calls. The growth in home health treatments as a percent of total treatments is an area of focus at the large dialysis providers. When clinically appropriate, these treatments improve the patient's quality of life, and technological developments are helping to make this a reality for more people. Another trend highlighted by a dialysis provider is that the growth rate of end-stage renal disease (ESRD) may be slowing in the United States, due in part to the increased availability of transplantable organs. This is leading to less de novo expansion in many markets and less overall capital expenditures among dialysis providers. Whether the growth rate of ESRD is slowing is disputed by some providers, and this will be an important development to track in 2019.



"As we mentioned earlier this year, some recent data suggests that ESRD industry growth may be slowing. While we don't know whether this is a short-term impact of increased transplantation availability or whether there is a long-term implication in the immediate-term, we plan to build fewer centers to keep pace with patient demand."

Javier Rodriguez – CEO of DaVita Kidney Care

"We're not actually seeing that slowdown in ESRD. I want to give you a reference that I think will be helpful for you to kind of make up your own mind, but there's an article that just published on Friday, the 15th of February, by Keith McCullough and it was in The Journal of the American Society of Nephrology. And what it really shows is prevalence of incident rate and prevalence rate. And this is a graph that goes from 1980 all the way to 2030. So where we clearly understand that you may get a quarter where things look like they've slowed down. If you look at this on the long term and you look at the long-term trend, we just don't believe it's sustainable that you're going to see the slowdown. We think it's going to completely continue to go the other way."

Robert Maurice Powell – CEO of Fresenius Medical Care

"We continue to target 15 percent of our total treatments being in the home setting by 2022, and I'm optimistic that we can see better than 15 percent as we move through the next couple of years."

Robert Maurice Powell – CEO of Fresenius Medical Care

Outlook for Imaging Centers

Independent diagnostic testing facilities (IDTFs) are positioned to benefit from imaging volume shifting from higher-cost hospital settings to lower-cost outpatient settings. This shift is being driven both by private payors seeking to reduce costs associated with non-emergent imaging procedures, as well as governmental payors implementing site-neutral payment policies. One public operator of imaging centers noted that since this shift benefits payors, IDTFs may have leverage in negotiating reimbursement rates. In addition, IDTFs and payors are both incentivized to educate and work with physicians to help drive volumes to these facilities, and these groups have been partnering to help accelerate this education process.

"We expect 2019 to have stable reimbursement. Medicare rates for 2019 are commensurate with 2018 reimbursement and our relationships with private payers and capitated medical groups represent potential upside in our rates."

Mark Stolper – CFO of Radnet

"So what we're beginning to have in the way of conversations with virtually all of the major health plans are ways that we can co-market and strategize about how we get to the primary consumers which are the referring physician and the patients, educate them, both on the benefits of going into a more friendly and perhaps even better quality imaging facility as well as the substantially reduced cost that they're likely to incur based on their higher deductibles and co-pays."

Howard Berger – CEO of Radnet

Outlook for Urgent Care

While there are no pure play publicly-traded operators of urgent care clinics, urgent care has become a critical part of health systems' outpatient strategies as these clinics become more popular with patients and payors. Examples of this discussed in recent quarters include Community Health Systems, which operates close to 100 urgent care clinics, Select Medical Holdings, which now owns Concentra and US HealthWorks, and Tenet Healthcare Corporation. In addition, we have observed investment activity from a number of private health systems, as well as payors, private equity platforms, and large retail clinics. HAI has worked with sophisticated urgent care providers that provide not only primary care but also higher acuity care and dental procedures. In our experience, it is not uncommon for hospitals to partner with management and development companies with expertise in the urgent care space. Future strategies will likely include innovative platforms integrating urgent care and telemedicine with larger health systems, similar to the recent transaction in which Zoom+Care was acquired by PeaceHealth.[3]

"There's been an influx in investment, broadly speaking, in the urgent care space, but models are often not the same in certain different populations in that market. Remember, in many markets, including some of ours, there's shortages in primary care as well being fulfilled from a demand perspective by urgent care centers as they develop. And then, of course, you have the retail clinics within big box retail that serve perhaps a different purpose in different populations. I think one of the things that you're seeing is that urgent care centers are increasingly providing slightly higher acuity care as well and taking on patients that may have some more chronic illness as well. So when I add that up at this point, it's not surprising to me that we're seeing more investments come in. There are different models. They're not all the same. And it's not entirely obvious which models will sustain over the long term. But I don't see yet a major problem with oversaturation across the country."

Saumya Sutaria – COO of Tenet Healthcare Corporation

"We're just under 100 total urgent care and walk-in care centers across the company. We should eclipse that 100-number next year."

Tim Hingtgen – COO of Community Health Systems

Outlook for Ambulatory Surgery Centers

Two trends impacting the outlook for ASCs in 2019 are (i) increasingly complex procedures being performed in the ambulatory setting, and (ii) innovative ownership models involving payors, physicians and management companies. These trends are both being driven by the larger shift from inpatient to outpatient that is taking place within the industry due to payor policies. Payors are taking more ownership in ASCs, as evidenced by UnitedHealth Group's acquisition of Surgical Care Affiliates, and potential partnerships between Surgery Partners and large payors. In addition to outright ownership, HAI has observed ASCs entering into arrangements with payors where the center receives higher reimbursement rates as part of an effort to move procedures from the hospital setting to the ambulatory setting. Many of these contracts are similar to a shared-savings arrangement and can be extremely profitable for both the ASC and the payor. Another factor impacting profitability is total joint procedures shifting to outpatient settings. While the ability to perform these procedures requires an upfront investment for certain equipment, our conversations with clients and our 2019 ASC Valuation Survey responses suggest these procedures, and orthopedic procedures in general, are among the most desirable procedures in terms of profitability.

"We piloted the total joint program in four markets in 2018, and we're now rolling it out to four additional markets in 2019, and if we continue to like how this goes, we'll continue to expand."

Wayne Scott DeVeydt – CEO of Surgery Partners

"We are looking at actually doing co-ownership with a name payor that people would recognize and the concept being that we're looking at both de novos with them, and in fact, we're recruiting physicians right now regarding the de novo, and we are looking at potentially even jointly acquiring a facility together at this point."

Wayne Scott DeVeydt – CEO of Surgery Partners

"We complement our medical groups with high-value ambulatory care services, like our SCA surgery centers, MedExpress neighborhood care clinics, Briova infusion capability and Optum HouseCalls, all of which support improving the quality, cost and experience of healthcare."

Andrew Witty – CEO of Optum

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[3] https://www.cainbrothers.com/wp-content/uploads/Zoom-External-Deal-Announcement-FINAL.pdf

ASC Acquisition Multiples

The largest publicly-traded ASC management company indicated that it deployed over $100 million of M&A capital at an effective multiple of less than seven times EBITDA. This is fairly consistent with what HAI has observed in the market in recent years, including in our upcoming 2019 ASC Valuation Survey. In our experience, the multiple is impacted by a variety of factors including case mix, payor mix, ownership structure, and local economic conditions. We have also observed an uptick in interest from private equity platforms, in some cases paying in excess of 10 times EBITDA for single and multi-specialty surgery centers.

> "We also rebuilt our M&A pipeline with over $100 million in capital deployed in 2018 at a sub-7 effective multiple."
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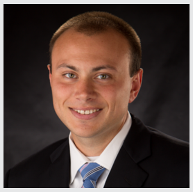
> Wayne Scott DeVeydt – CEO of Surgery Partners

Editor



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