HealthCare Appraisers

FMVantage Quarterly Insights

Quarter 2 ▪ 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 services providers. The following paragraphs are important takeaways from quarter two of 2018, as well as supporting quotes[1] from publicly-traded operators.

Dialysis Centers

Dialysis clinics are experiencing higher net revenue per treatment and higher cost per treatment due to changes in reimbursement policies. Specifically, beginning in 2018, CMS transitioned calcimimetics from Medicare Part D reimbursement to Part B reimbursement due to the introduction of an intravenous calcimimetic drug. Dialysis centers now receive reimbursement for these drugs as part of the bundled payment they receive through Part B reimbursement. Whether or not commercial reimbursement will change is dependent on the patient's plan.

Expert Insight:

From a valuator's perspective, it is important to understand the drivers of increases or decreases in net revenue per treatment. Changes in payor mix are likely to have a large impact on margins, while the inclusion of drugs in the Part B bundle will also increase cost per treatment and be less accretive to margins.

Supporting Quotes:

"Starting on January 1, 2018, CMS implemented Medicare reimbursement for oral Sensipar and a new IV calcimimetic called Parsabiv under the Transitional Drug Add-on Payment Adjustment or TDAPA. Calcimimetics are prescribed to dialysis patients to control secondary hyperparathyroidism, and these drugs are an important therapy in the management of bone mineral health… As mentioned during our first quarter 2018 conference call, some patients on this therapy were still consuming the oral calcimimetic supply into the early part of 2018 because they had 90-day prescriptions filled during the latter part of 2017. As a result of that dynamic as well as broader payer coverage, we have seen an increase in the number of patients receiving calcimimetics through their dialysis clinic as opposed to their prescription drug plan."

Michael S. Anger, Chief Medical Officer of American Renal Associates on changes in CMS reimbursement

"The transition from Part D to Part B reimbursement continues to go well…Across our Kidney Care business, we expect the net impact of calcimimetics to be a mid-single-digit margin before our indirect costs to administer the drug."

Javier J. Rodriguez, Chief Executive Officer of DaVita Kidney Care on the Transition from Part D to Part B

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

Physician Service Providers

Physician services providers are seeing elevated multiples among anesthesiology and radiology groups as private equity firms pour money into the space.

Expert Insight:

In addition to anesthesiology and radiology, we continue to observe private equity interest in ophthalmology, gastroenterology, otolaryngology, dermatology, urgent care, and dental practices. In our experience, the higher multiples are often justified by growth and margin expansion that may be predicated on executing a more comprehensive growth strategy (e.g., bolt-on acquisitions). These were common discussion topics by experts at McDermott Will & Emery's 2018 Health Care Services Private Equity and 2018 Physician Practice Management & ASC Symposiums.

Hospital Services

On the hospital side, strategic buyers continue to scale-up to improve their negotiating position with payors. We note that even the acquisition of LifePoint Health by Apollo Global Management was a combination of a financial buyer with a strategic position because LifePoint is merging with Apollo-owned RCCH HealthCare Partners. Part of the stated rational for this acquisition was the benefit from the size and scale of the new organization.

Expert Insight:

The outlook for a hospital may change considerably when acquired by a larger organization with better payor contracts and ability to negotiate with physicians. When valuing hospitals, it is often appropriate to consider market participant adjustments to both revenue and expenses. Improvements in reimbursement resulting from being a part of larger organization can lead to double digit increases in revenue on a percentage basis and cause unprofitable hospitals to significantly improve profit margins.

As lower acuity volumes continue to migrate toward outpatient settings, several large hospital operators are expanding and investing in higher acuity service lines, including cardiology and cardiovascular, orthopedics, oncology and trauma.

Expert Insight:

Hospitals have faced declining emergency department volumes as more patients seek non-emergent care from low cost settings, including urgent cares and primary care practices. In addition, higher acuity surgical procedures, including orthopedics, have been shifting toward ambulatory surgical centers. In response, hospitals have increased ownership of these outpatient settings through de novo expansion and joint venture arrangements. We have also observed hospitals build out free-standing emergency rooms as part of their effort to increase touch points in the community. While hospitals continue to invest in the free-standing emergency room within traditional general acute care hospitals, we note that several large independent operators including Adeptus Health and Neighbors Emergency Center recently declared bankruptcy. Longer-term, the trend toward lower volume and higher acuity is likely to persist within the traditional general acute care hospital space, driven in part by CMS's continued push toward site-neutral payments.

Supporting Quotes:

"The multiples in anesthesia have gotten to a point where it's just not workable…On the radiology side, we're finding the same thing. There's been a couple of private equity firms that have jumped into that specialty. And we are finding that with the larger groups, that the multiples have gotten out of hand, and we're not going to play that game."

Roger J. Medel, Chief Executive Officer of Mednax, Inc. on valuation multiples

"I would just add that when you look at the buyers of our hospitals, most of them had been strategic buyers trying to build out their market and their bargaining power with payers."

Tim H. Hingtgen, President and Chief Operating Officer of Community Health Systems on hospitals and health systems adding scale to increase leverage with payor

"We're continuing to invest our capital towards high-growth opportunities [in] our markets such as additional access points as well as service line build-outs around cardiology, orthopedics and other higher acuity areas."

Thomas Aaron, CFO of Community Health Systems on investing in higher acuity service lines

"…Some of that we think is a result of programmatic development in key service lines, whether it's trauma, cardiovascular, deeper capabilities in orthopedics and oncology."

Samuel N. Hazen, President and COO of HCA Healthcare, Inc. on programmatic development of higher acuity service lines

Long-Term Acute Care Hospitals

The proposal to eliminate the 25 Percent Rule is expected to open new opportunities for partnerships between general acute care hospitals and long-term acute care hospitals (LTCH). Generally, the 25 Percent Rule lowered Medicare reimbursement for LTCHs accepting more than 25 percent of their patients from a single referring hospital.[2]

Expert Insight:

The elimination of the 25 Percent Rule could make partnerships between acute care hospitals and health systems and LTCHs more financially feasible. In addition, favorable reimbursement trends for certain post-acute care providers (e.g. skilled-nursing facilities, inpatient psychiatric facilities, inpatient rehabilitation facilities) could lead to increased investment in the space. This sentiment was echoed at the HFMA Fall Summit by experts anticipating consolidation activity within the sector as hospitals and health systems increase their efforts to provide post-acute treatment at affiliated facilities. We have already seen private equity buyers come into the market with large acquisitions, many of them from real estate investment trusts. As an example, Kindred Healthcare, Inc., one of the largest operators of LTCHs in the country, was recently acquired by a consortium of Humana, TPG Capital and Welsh, Carson, Anderson & Stowe at an enterprise-to-EBITDA multiple of 9.2x.

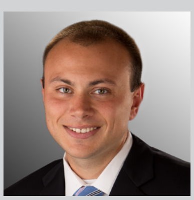
[2] For more details on the 25 Percent Rule's implementation over time, visit https://www.cms.gov/Outreach-and-Education/Medicare-Learning-Network-MLN/MLNProducts/Downloads/Long-Term-Care-Hospital-PPS-Fact-Sheet-ICN006956.pdf

Supporting Quote:

"The 25 Percent Rule has been an overhang on this industry since 2004. And now that we have a complete elimination of the rule, I think it will open up more opportunities for [Select Medical Holdings Corporation]. As you know, we have a lot of strong partnerships with a lot of big systems. And as all the health care systems are looking more to expand and complete the continuum of care in their markets, we think there will be greater opportunities. And it is a solid policy and a good policy to eliminate the 25 Percent Rule because, as you have bigger and bigger systems that are more tertiary, that have a majority of the ICU beds, you would expect a greater number of the LTAC-compliant population to be coming from fewer, larger, more sophisticated medical centers."

Robert A. Ortenzio, Co-Founder & Executive Chairman of Select Medical Holdings Corporation on elimination of 25 percent rule

Editor



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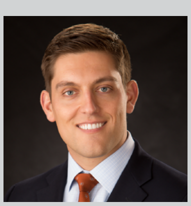

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Nicholas J. Janiga, ASA is a partner in HealthCare Appraisers' Denver office, where he leads the firm's business valuation and capital equipment valuation service lines. He has been providing his clients analysis and consultation in business valuation, litigation support, intellectual property and healthcare provider compensation relationships since 2006. His experience includes working with healthcare organizations, attorneys, administrators, providers, developers, consultants, investment bankers, and private equity groups in connection with transactions in the healthcare industry. Many of the transactions he analyzes involve Stark, Anti-Kickback, IRC 501(c)(3), and/or other regulatory implications, which requires analysis of fair market value and the determination of commercial reasonableness. He also has experience providing expert testimony in deposition and trial settings.