HealthCare Appraisers

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As part of our ongoing research into the healthcare industry, HealthCare Appraisers, Inc. follows commentary of publicly-traded health systems, physician service 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.

Value-Based Payments

Providers across the spectrum are increasingly focused on implementing value-based payment arrangements as payors and regulations shift the reimbursement landscape from volume to value. Examples of these arrangements discussed in recent quarters include 90-day bundled payments involving ASCs and post-surgical rehabilitation providers, as well as capitation arrangements between health insurers and outpatient imaging center management companies.

Expert Insight

Much of the healthcare sector is in a dynamic and transitioning state right now. The 2010 Patient Access to Protection and Affordable Care Act- commonly known as "the ACA"- set in motion a transformation from mostly volume-based to largely value-based healthcare payment systems. It brought new and unprecedented focus on the methods, settings and outcomes of healthcare delivery, even delivering a whole new

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

Supporting Quotes:

“During the quarter, we placed a lot of operational focus on implementing the EmblemHealth capitation agreement that we announced publicly in August. Throughout the quarter, we hired the employees necessary to staff the 26 AdvantageCare locations for which we assumed operations on October 1. We spent much of the quarter training the newly hired staff and instituting RadNet operating protocols and quality measures. We also replaced or upgraded much of the equipment in these locations and are now very excited about how these locations look and operate. We began seeing patients on October 1. As you might recall, much of the focus of the arrangement with EmblemHealth is to direct as many of the AdvantageCare, or ACP, membership into RadNet's freestanding facilities, including those operations within the ACP offices as opposed to having these patients find themselves in hospital outpatient departments. The early data from October looks promising. Not only is the leakage of the hospitals close to what we projected, we are capturing more fee-for-service business than we anticipated from the same ACP physicians. But there's still a long way to go to decrease the leakage, and we are aggressively meeting with the ACP physicians and educating them on the benefits of directing their patients to our facilities. As a result, we expect the economics of this contract to improve throughout the coming quarters.”

Howard Berger, CEO of RadNet, Inc. on its capitation agreement with EmblemHealth *language to healthcare - "accountable care organizations", "bundled payments" and so on. The ACA and its progeny have increased the value of and attention to information technology as a means to increase the capacity and usefulness of data (and access to it) for care planning and care decisions.*

The 2015 bipartisan Medicare Access and CHIP Reauthorization Act ("MACRA"), with its introduction of the Quality Payment Program for physicians and other clinicians, and its collateral effect of encouraging gainsharing and participation in clinically integrated networks (CINs), has turbocharged the transition. Although, currently, the future of the ACA is messy and uncertain, most industry insiders believe MACRA is here to stay. Insiders also believe data-driven, quality-focused healthcare is here to stay. This means providers are, and in the near future will be, actively investing the human and monetary capital necessary to meet the challenges of value-driven healthcare, whether it be planning and entering into bundled payment programs, joining a CIN or ACO for better access to human and technological capital, and/or undertaking internal efforts to optimize readiness for value-based payments.

These activities are occurring in the context of a regulatory framework mostly developed for fee-for-service payments. This means there are significant challenges related to navigating regulatory pitfalls. In particular, pitfalls of financial relationships and collaborations falling outside the parameters of historical notions (meaning based in fee-for-service principles) of what is "commercially reasonable" or "fair market value." This is where HealthCare Appraisers is most helpful to clients. Given our breadth of past and recent experience, we have a unique vantage point to assess what is reasonable and what has value, and how much value, in the current market. – Andrea Ferrari, JD, MPH, LHRM, Partner at HealthCare Appraisers

Supporting Quotes:

"Another bucket I would highlight is around bundling… and we've been working with [payors to discuss not just the] bundle for the day, which is what our focus has been so far, but we're actually now exploring opportunities to bundle many of these procedures over potentially a 90-day window, and we're looking at partners. Obviously, we don't perform past the surgical facility, it's what we do, it's what we're good at. But we like the idea of getting that initial bundle and then working with others that do a lot of post-rehab care."

Wayne Scott DeVeydt, CEO of Surgery Partners, Inc. on bundled payments

"So today there's really not a risk component, because what we've done is we've been able to negotiate new bundles at rates that are much higher than we would have gotten before, meaningfully higher in one case as much as 5x higher than what we received before, but substantially less cost than what [payors have paid] in the hospital environment… so we pay the anesthetists, pay our surgeons and then the rest goes to [the] facility. What we are exploring is whether or not we want to take risk over time on an enhanced bundle that goes over a 90-day window. And in that case, we would mitigate our risk, in theory, by working with the right partner to basically take our fees off the top, because, again, we don't want to expand beyond what we're great at, and then allow another partner who is great at something else, which would be that post-rehab care to take that portion of the bundle. That is our -- I would call, our innovative next step that we're looking at doing."

Wayne Scott DeVeydt, CEO of Surgery Partners, Inc. discussing 90-day bundling opportunities

"Today we have about $69 billion in value-based constructs. That represents a little under half of our total medical surgical spend. And we had set a goal to get to $65 billion and we got there early. So we've reset our sights towards $75 billion by 2020."

Dan Schumacher, President of UnitedHealth Group on value-based payments

Ambulatory Surgery Centers

ASCs are evaluating creative ways of partnering with payors in order to drive growth, including joint-ownership of surgical facilities and bundled payment agreements. Case mix at surgery centers continues to shift toward higher acuity and more complex procedures, including total hip and knee replacements.

Expert Insight

We continue to observe consolidation of the continuum of care, with payors increasingly aligning themselves with providers, and providers across the spectrum consolidating through M&A activity, joint ventures, and/or service agreements. In the coming years, as more complex procedures migrate to outpatient settings and value-based reimbursement becomes a larger component of provider compensation, we believe the types of arrangements discussed throughout the article (i.e., 90-day bundles) where multiple providers share responsibility for patient care are likely to become more prevalent. Recent regulatory changes to the 25 Percent rule impacting long-term acute care hospitals could also accelerate joint venture and collaborative partnership activity[2]. In addition, the ability to perform these high-reimbursing procedures in outpatient settings represents an opportunity for ASC margin expansion and higher valuation multiples, as we frequently observe orthopedic-focused surgery centers achieving EBITDA margins in excess of 40 percent. - Daniel I. Levin, CFA, Senior Associate, HealthCare Appraisers

Supporting Quotes:

"And so we're looking at not only ways to actually take joint ownership in some facilities together right now [with] some of the payors, but [also in] other ways."

Wayne Scott DeVeydt, CEO of Surgery Partners, Inc. on partnerships between ASCs and payors

"…we've got 5 facilities starting to do total knees and hips which is very encouraging for us and we expect that to ramp up."

Wayne Scott DeVeydt, CEO of Surgery Partners, Inc. on joint replacement procedures migrating to ASCs

Physician Service Providers

Unlike transactions involving anesthesia, radiology, ophthalmology and dermatology, acquisition multiples in neonatology have remained relatively steady in recent years. Specifically, public operators are citing acquisition multiples ranging from 4x to 5x EBITDA, in-line with historical valuations.

Expert Insight

There are several differences between neonatology and the specialties referenced above that have contributed to the divergent valuation trends. In particular, less favorable payor trends (i.e., heavy Medicaid component for neonatology), declining birth rates and a lack of movement away from the hospital setting limit the financial attractiveness of these medical practices. Because of these factors, groups like Mednax, Inc. face less competition from private equity groups or other potential acquirers that have been driving up valuation multiples in other sectors within the physician services space. - Daniel I. Levin, CFA, Senior Associate, HealthCare Appraisers

Supporting Quotes:

"Historically, we bought neonatology practices in the 4x to 5x multiple range, and that's exactly where we were able to accomplish this very large acquisition."

Roger Medel, CEO of Mednax, Inc. on transaction multiples in the neonatology space

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[2] https://www.cms.gov/newsroom/fact-sheets/fiscal-year-fy-2019-medicare-hospital-inpatient-prospective-payment-system-ipps-and-long-term-acute-0

Physician service providers are increasingly evaluating ways to improve staffing efficiency to reduce costs and maintain profit margins in the face of declining reimbursement. Such efficiencies include honing staffing models by analyzing utilization data to ensure the appropriate number of FTEs are on-site at all times, as well as structuring compensation arrangements to include productivity and value-based components instead of sole reliance on base salaries.

Expert Insight

Hospitals continue to face challenging economic conditions characterized by provider group consolidation, payor pressure to move care from inpatient to outpatient settings, and increasing reimbursement tied to value-based outcomes. One area in which we have seen hospitals sharpen their pencils is their hospital-based service arrangements with anesthesiology, emergency medicine, hospitalist, and critical care practices. When structured correctly, hospitals and their affiliated practices have found opportunities within these contracts to align incentives, improve patient care, and contain costs. In addition to our work providing fair market value opinions, HealthCare Appraisers routinely assists our clients with structuring their hospital-based service arrangements to help them achieve their goals – Luis A. Argueso, Partner, HealthCare Appraisers

Supporting Quotes:

"We've deployed resources across our practices with a heavy focus on our anesthesia organization to support enhancements to the service delivery model. This includes engagement of our consulting organization, Surgical Directions, to work in tandem with our clinical services leadership to identify opportunities for more efficient coverage and scheduling. It also entails the rollout of additional IT capability to improve a practice's clinical staffing efficiency as well as to measure, benchmark and reduce premium and agency labor costs."

Roger Medel, CEO of Mednax, Inc. on improving staffing efficiency within the anesthesia service line

Outpatient Imaging Facilities

Independent diagnostic testing facilities (IDTF) are increasingly partnering with health systems through a variety of arrangements including joint ventures, some of which include capitation agreements. As with many of the arrangements discussed throughout this article, valued-based payment components are becoming more prevalent within the imaging space.

Expert Insight

The increase in joint venture partnerships has been driven by a variety of factors. From the IDTF's perspective, partnering with health systems can provide additional referral sources and improvements in reimbursement through increased negotiating power with payors. Health systems benefit from recapturing some of the lost volume migrating to an unaffiliated facility, which has been amplified by recent payor policies directing patients to IDTFs. For example, insurers like Anthem and United no longer reimburse for MRI scans and CT scans performed in a hospital setting in certain states unless deemed to be medically necessary in that setting. The cost differential between the inpatient and outpatient setting can range from a few hundred to more than one thousand dollars per scan, and some hospitals generate a significant percentage of their total profit from these service lines. We expect transactions in IDTF equity to accelerate in the coming years as more health systems and imaging facilities look to align with each other, which could lead to upward pressure on valuation multiples. - Daniel I. Levin, CFA, Senior Associate, HealthCare Appraisers

Supporting Quotes:

"First with respect to our joint ventures, we are in discussions with both existing health system JV partners and prospective new ones about establishing new joint ventures and expanding existing ones. Today, 86 of our 341 facilities, or 25%, are held in joint ventures with health system partners. These relationships have been quite successful. In virtually every health system partnership we have -- our hospital partners have been effective in driving patient volumes into our jointly owned centers. Many of these hospitals own or manage physician practices that become important referral sources for our centers. In general, we have seen that health systems are becoming more and more interested in purchasing or affiliating with physician practices. Whether or not they own or manage physician groups directly, all of our health systems have relationships with doctors in their communities. These physicians become loyal referral sources to our jointly owned centers. In addition to assisting us in driving patient volume, our health system partners provide us with negotiating strength in reimbursement discussions with private payers. Most of our hospital partners have significant leverage in their markets because of their importance to providing the more acute and expensive services to the insured populations. Our goal over the next several years is to grow our JV business to incorporate 50% or more of our total imaging centers. Our objective is to become the outpatient alternative to hospital inpatient radiology departments, offering fair pricing, high-quality service and easy access for patient populations."

Howard Berger, CEO of RadNet, Inc. on the benefits of joint venture arrangements

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[3] https://www.modernhealthcare.com/article/20170826/NEWS/170829906

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Daniel I. Levin, CFA *is a Senior Associate in the Firm's Denver office where he specializes in a wide variety of healthcare business and compensation valuation assignments. Mr. Levin's business valuation experience includes valuing hospitals, health systems, dialysis clinics, imaging centers, ambulatory surgery centers, physical therapy clinics, urgent care clinics and physician practices in connection with a wide range of transactions. Prior to joining HealthCare Appraisers in 2016, Mr. Levin was an Equity Research Associate performing industry research and investment analysis on publicly-traded healthcare companies. Mr. Levin graduated summa cum laude from Florida Atlantic University in 2013, and has been a CFA charterholder since September 2017.*

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