STROUDWATER

RURAL VALUE: EVALUATING PARTNERSHIP OPTIONS

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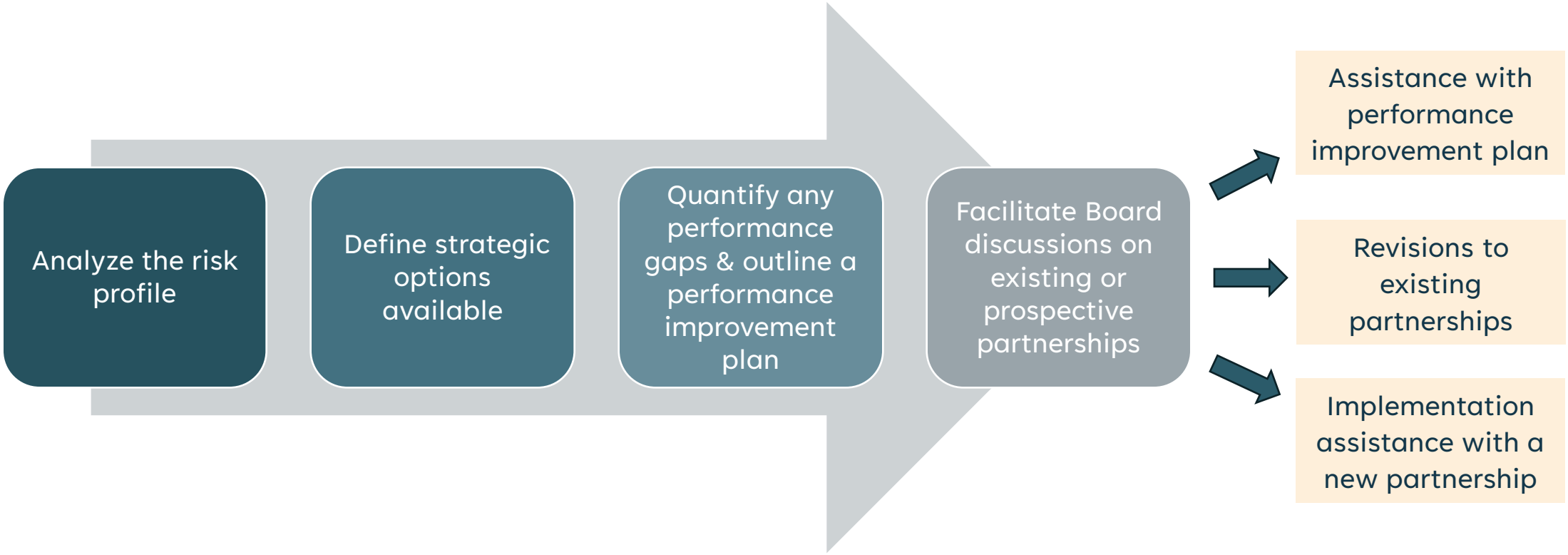
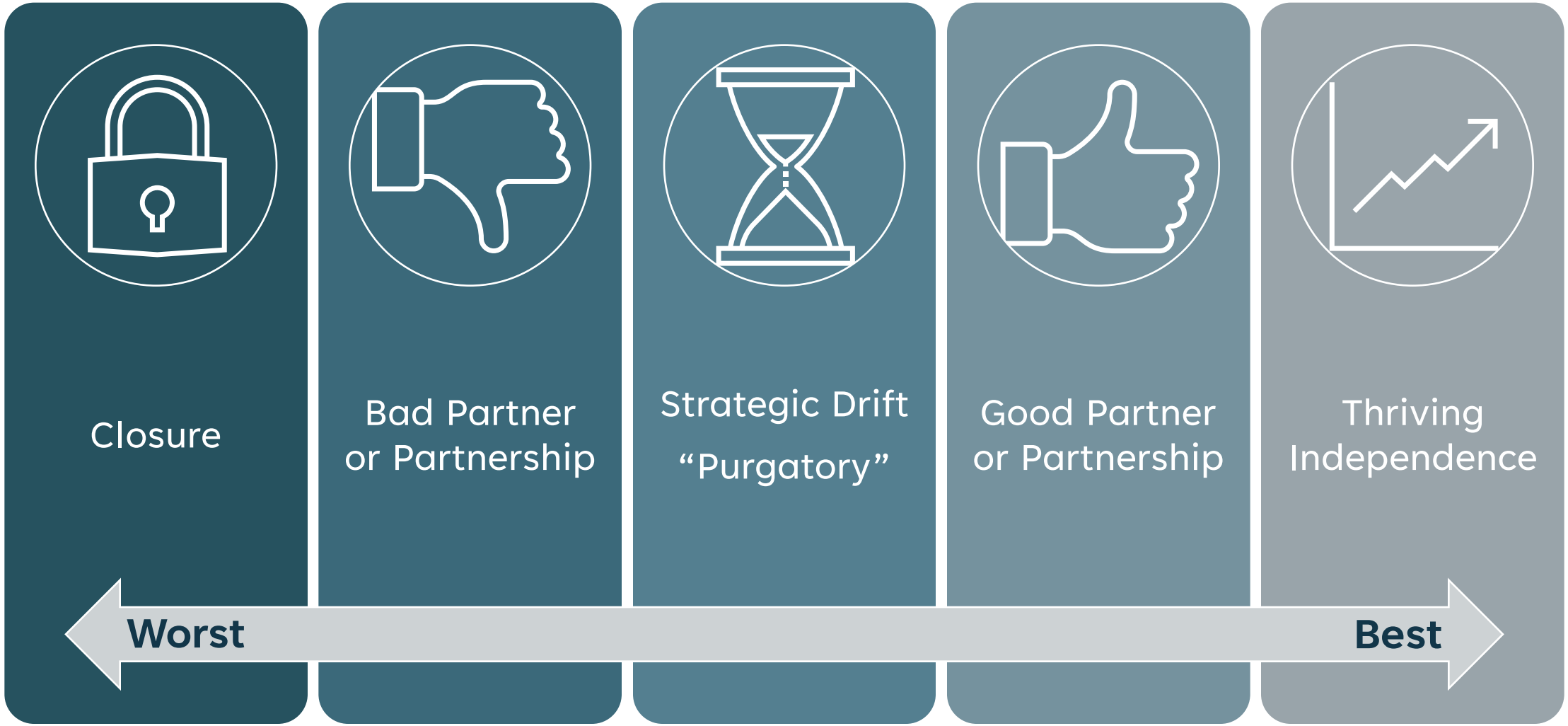
Stroudwater is a leading national healthcare consulting firm specializing in mission-critical strategic, operational, and financial opportunities for healthcare leaders' most pressing challenges

KEY POINT: SOUND OPERATIONS UNDERPIN ALL OPTIONS

When we talk to a client about strategic options, we focus on mitigating strategic risks. Sound operating results are foundational to those efforts regardless of the strategic option selected. From there, we can evaluate strategic options to find the right strategy based on the organization's risk profile.



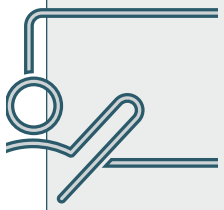
COMMON OUTCOMES



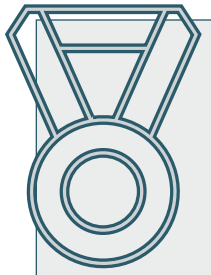
90%+/- of hospitals are within these three options

WHAT DO YOU NEED TO KNOW?

For the 60% of rural hospitals in a partnership, most systems miss critical aspects of rural value



No one is going to stumble across your value if you do not quantify it and show the path to operationalizing it



Identify win-wins with existing partners – it's about making better decisions and better allocating scarce resources

Does a partner understand your value?

- Variable vs fixed costs
- Contribution margin vs. fully allocated costs
- Incremental cost vs. reallocated costs
- The value of incremental referrals

The Four Know/Nos:

- Know your risk profile
- Know your value
- No one else will promote your value
- No risk-free options

OUR AGENDA

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WHAT ARE WE GETTING WRONG?

WHAT ARE WE GETTING WRONG?

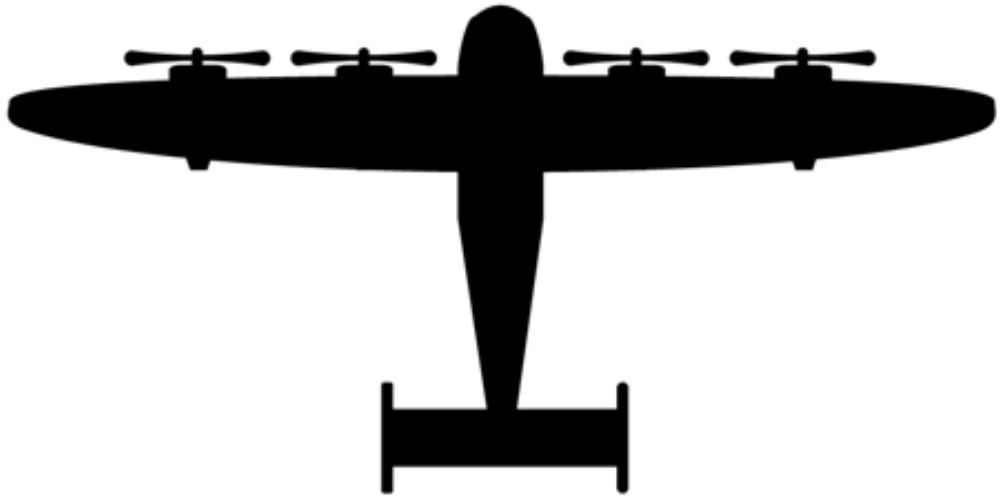
- Rural healthcare is a dumpster fire
- With fully allocated costs the result is clear: the economics are unsustainable and dilutive
- We need to shut down or curtail rural operations to reduce costs and conserve resources
- These statements confirm what many believe they know

➢ **But are these statements correct?**

➢ **What are they getting wrong or missing?**

WHEN DATA MISINFORMS

- 60% of the Allies' bomber crews were being killed (46%), wounded (7%), or taken prisoner (8%) during bombing runs over Germany in WW2
- Researchers at the Center for Naval Analysis knew they needed hard data to solve this problem
- After each mission, the damage from each bomber was painstakingly reviewed and recorded
- The data began to show a clear pattern: most damage was to the wings and body of the plane
- The solution was clear: increase the armor on the plane's wings and body
- But the analysis was completely wrong. Why?
- Every plane that had been shot down was missing from the data collected
- **The researchers' data had created a map of the places where the bomber could be shot and still survive**
- **In our opinion, something similar is frequently occurring regarding rural healthcare affiliates**

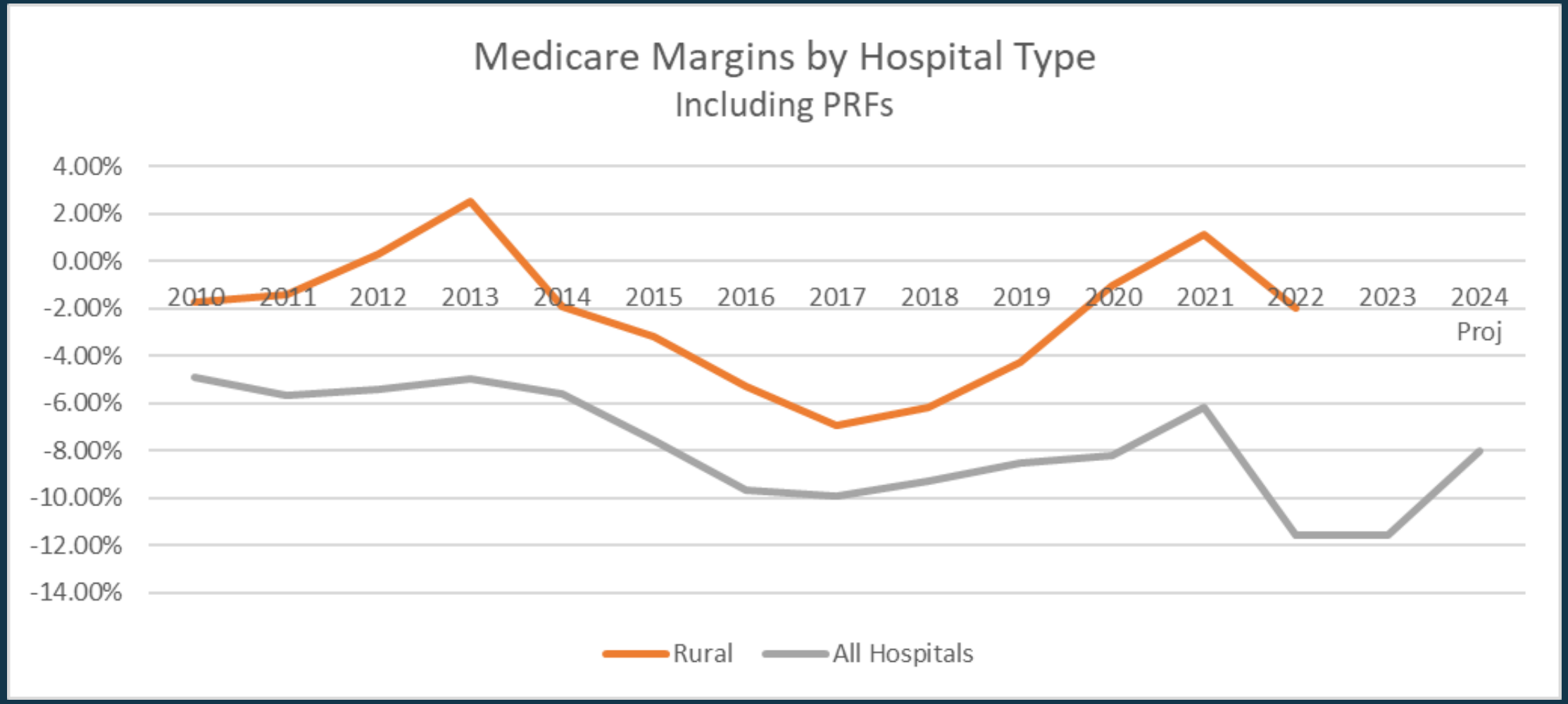


AFFILIATE ACCRETIVE VALUE

- Northeastern seven-hospital system, including a 120-bed community hospital affiliate
- System allocates $25M of overhead to the affiliate's general ledger, resulting in a **$13M operating loss**
  - As a result, the system slashed capital investment at the affiliate
  - The operating loss included $7M in non-cash depreciation expense and excluded $3M in non-operating income
- Of the $25M in system-allocated overhead costs, only 20% were estimated to be variable (or incremental) while the remaining were estimated to be fixed (reallocation of existing costs)
  - The fixed portion should not have been considered when evaluating the contribution margin of the affiliate
- Actual contribution margin to the system, before considering the value of incremental patient volume from the affiliate service area, was $17M
- The affiliate provided $22M in incremental contribution margin to the system from additional service area referrals
- **Total contribution margin to the system from the rural affiliate: $39M**

HEALTH INDUSTRY FACTORS THAT ARE DRIVING PARTNERSHIPS

INDUSTRY OVERVIEW: DECLINING MEDICARE MARGINS



Source: MedPAC Report to the Congress: Medicare and the Health Care Delivery System, March 2024

NOT-FOR-PROFIT HEALTHCARE 2024 OUTLOOK

Moody's Outlook: From Negative to Stable

- Reduced reliance on expensive contract labor may be offset by increased union activity. Contract negotiations could become more contentious, resulting in work stoppages and hefty wage increases.
- Though reimbursement rate increases from insurers will rise in the mid-single-digit percentage range on average in 2024, they will not fully compensate for the recent expense increases due to inflation, Moody's said.

Fitch's Sector Outlook: Deteriorating

- In 2023, Fitch reported a credit downgrade-to-upgrade ratio of 3:1 — alarmingly close to the ratio seen during the 2008 financial crisis — calling it a "make or break" year
- 2024 will again be categorized as another 'make or break' year for a sizeable portion of the sector
- Out of these ongoing struggles has emerged a 'trifurcation' of credit quality that will only become more prominent in 2024.

S&P Outlook: Negative

- S&P Global Ratings expects a constrained operating environment in 2024 largely due to persistently high labor and operating costs.
- Although acute contract labor expenses have dropped, many providers continue to contend with an imbalance between the rate of growth across expenses and revenue.

Sources:
https://www.chiefhealthcareexecutive.com/view/hospitals-can-expect-weak-margins-for-the-rest-of-2023-and-into-2024
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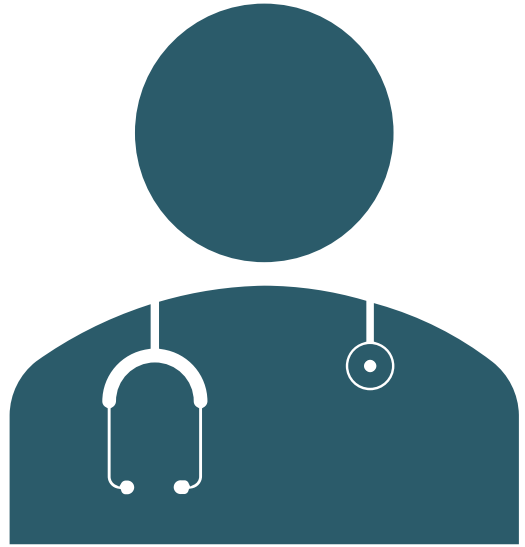
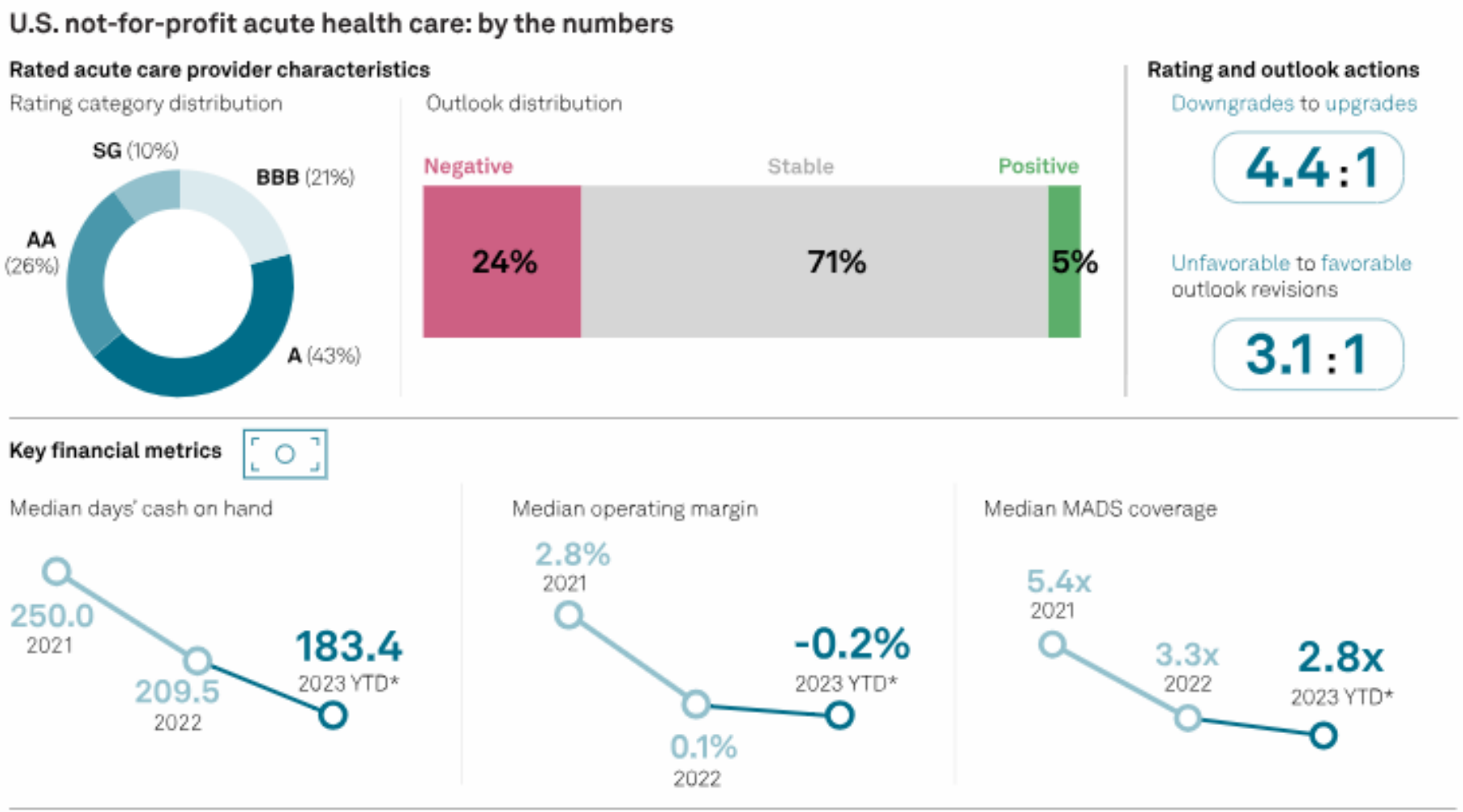
INDUSTRY RISKS

- Medicare reimbursement levels that are not keeping up with inflation
- The end of a pandemic-era provision preventing states from Medicaid disenrollment
    - Nationally, 22M+ disenrollees (24% of Medicaid enrollment) as of 5.23.24 per KFF
- Continued scrutiny of the 340B program
- Increased scrutiny of mergers by federal and state governments
- Growth in Medicare Advantage leading to more denials by insurers
- Bond covenant breaches



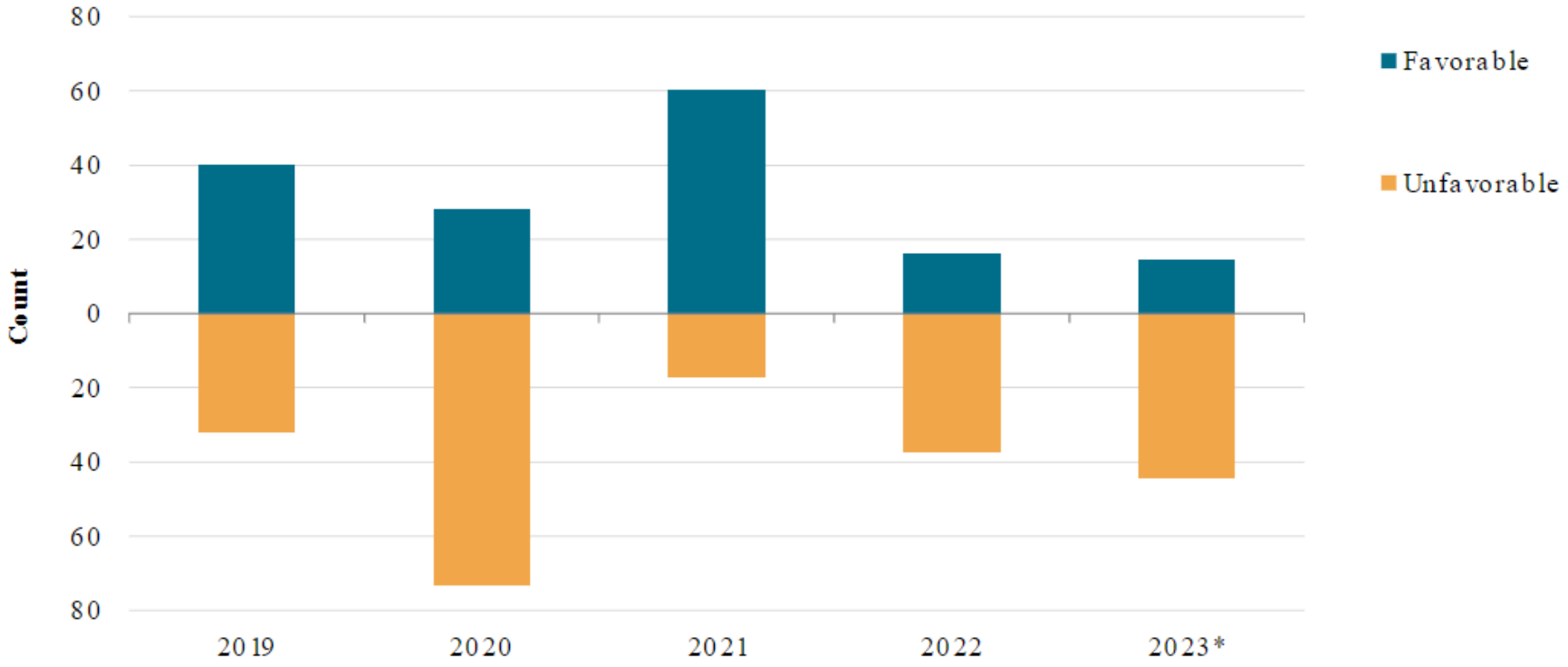
2024 STATISTICAL ANALYSIS BASED ON 2023 DATA



S&P Global Ratings' data as of Oct. 31, 2023. SG-- Speculative-grade. MADS--Maximum annual debt coverage. Outlook distributions exclude two ratings with developing outlooks and one rating placed on CreditWatch. *Includes small sample size of available audits for 2023 and is not necessarily representative of all rated not-for-profit acute health care organizations.
Sources: S&P Global Ratings; U.S. Bureau of Labor Statistics (seasonally adjusted data).

2024 STATISTICAL ANALYSIS BASED ON 2023 DATA, CONT.

U.S. not-for-profit acute health care outlook revisions

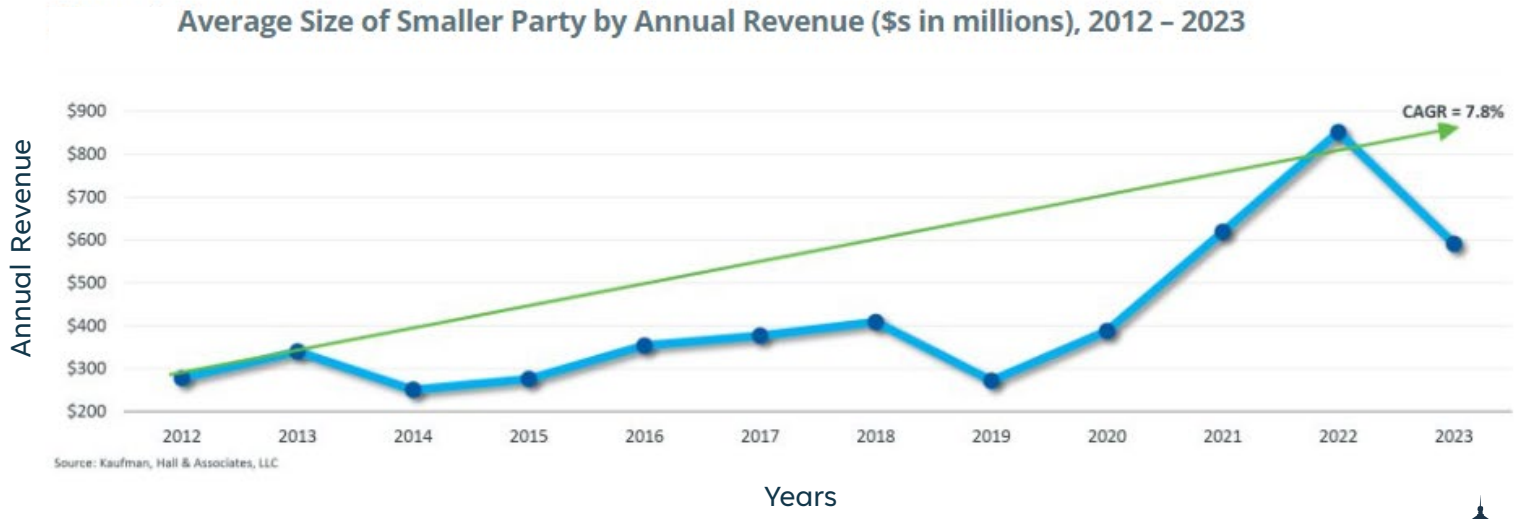


*Through Oct. 31, 2023. Data is for all outlook revisions unaccompanied by a rating change. Favorable outlook revisions include stable to positive and negative to stable. Unfavorable outlook revisions include positive to stable, stable to negative, and positive to negative. Excludes outlook revisions to developing and ratings that were removed from CreditWatch.

AFFILIATION DRIVERS: INDUSTRY CONSOLIDATION

Catalysts

- Margin pressure
- Heightened competition
- Staffing crisis
- Rising bad debt from high-deductible health plans
- Declining inpatient admissions
- Changing payment models
- Quality initiatives
- Provider shortages
- Economies of skill



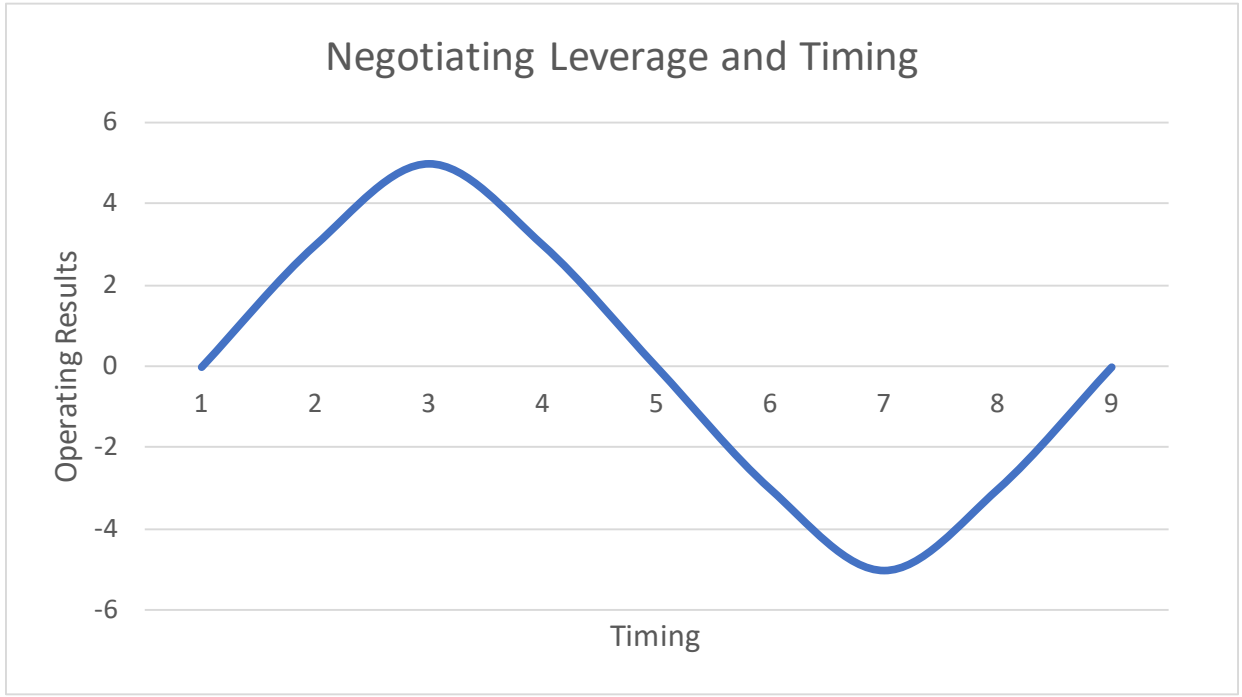
https://www.kaufmanhall.com/insights/research-report/2023-hospital-and-health-system-ma-review

WHEN TO THINK ABOUT PARTNERSHIPS

TIME IS NEVER A NEUTRAL FACTOR

A struggling hospital must weigh the pros and cons of the following timing factors:

- Time to demonstrate results from a performance improvement plan
- Time for major developments
- Time for adverse market developments to have an effect (state and federal budgets, competitor response, etc.)



CASE STUDY: COST OF DELAY

- The hospital was a strong rural PPS health system facing major capital investment needs
- Previously, the rural system had affiliated its multi-specialty group with a regional health system with a strong track record of operating multi-specialty groups
- The rural system Board elected to defer a proposed affiliation that met substantially all their requirements and included a $25M capital infusion toward investment needs
- 12 months later, the regional system had entered into other commitments and had to pull back their capital commitment
- Six months later, the rural system elected to affiliate on the same terms negotiated previously less the $25M investment commitment
- **Time is never a neutral factor**

UNDERSTANDING THE RISKS

What is the best strategy to achieve mission and vision?

Independence vs. Affiliation/Partnership

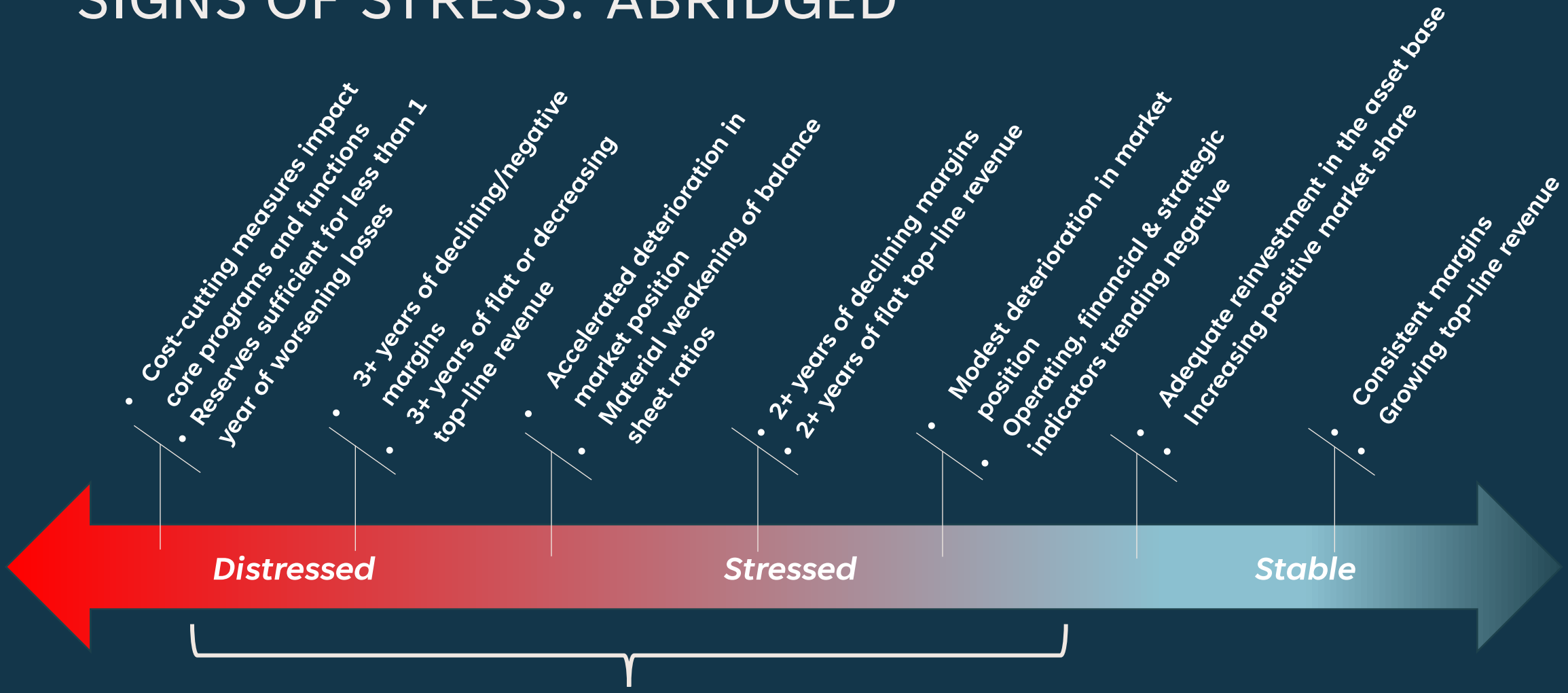
How do you minimize Operating Risk?

- **Accountability around strategic objectives** between the board, the management team, and the medical staff
- Maintain annual **operating cash flows** at least equal to debt service plus 120% of depreciation expense
- Create access to a **robust primary care base**
- Achieve required value metrics re: **quality and cost** and selectively assume risk
- Invest in a distributed and efficient **ambulatory network**

How do you minimize Partner Risk?

- Design a well-structured affiliation process with clear objectives
- Select a **strategically aligned partner**
- **Vet alternative partners' track records and capabilities**
- Vet alternative **affiliation structures** for their fit with our strategic objectives
- **Contractually enforceable key terms**
- **Involve key stakeholders** from the beginning and emphasize communication
- **Make candidates earn the right to be your partner**

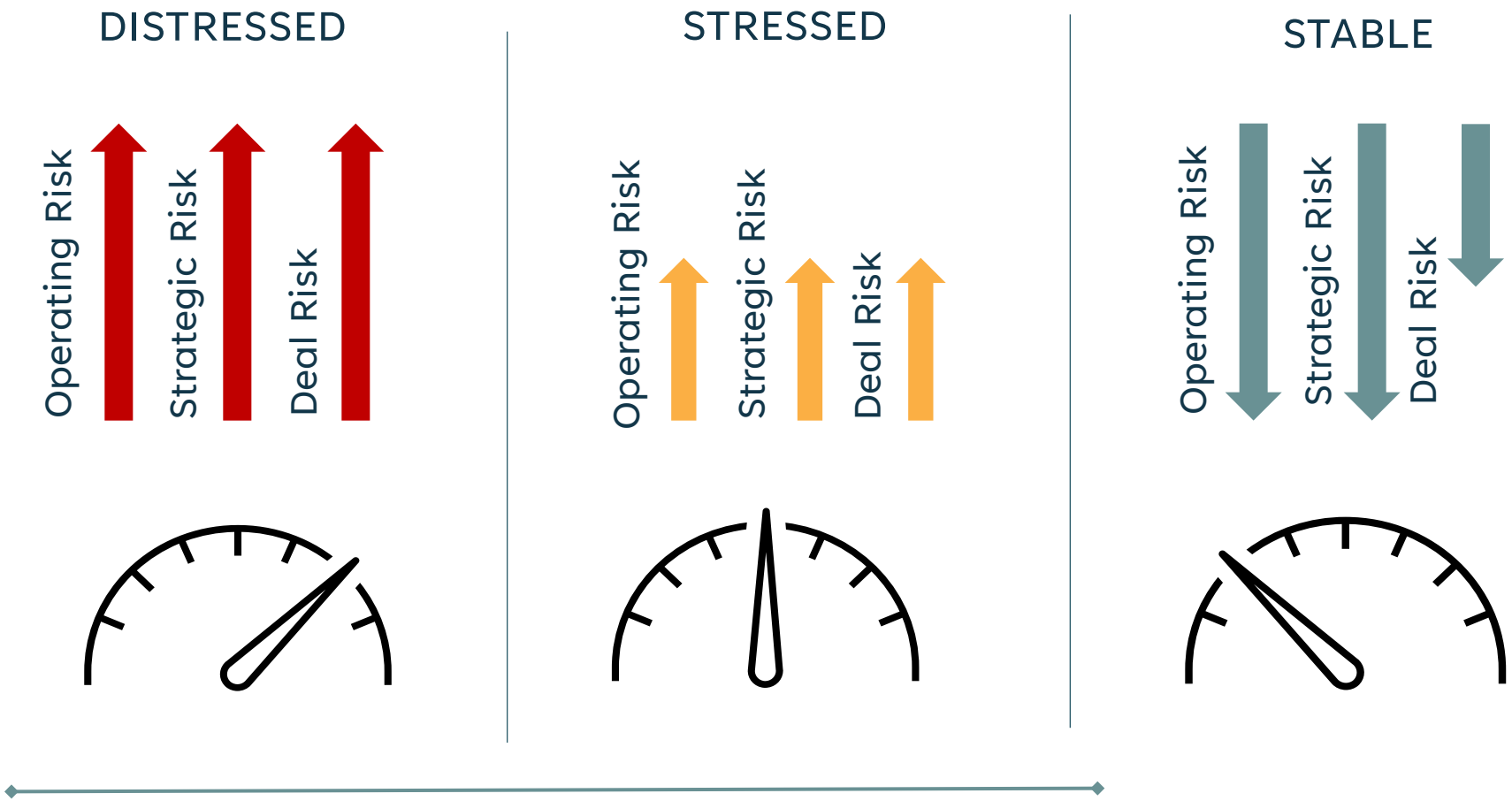
SIGNS OF STRESS: ABRIDGED



Examine/re-examine the benefits of performance improvement and/or partnership

Note: A more detailed version of the graphic is available.

HOW STRESS AND RISK ARE RELATED



Examine/re-examine benefits of performance improvement and/or partnership

FACTORS THAT AFFECT RISK

- The four risk domains depicted to the left describe the major sources of strategic risk in today's environment
- Poor performance in one domain will have collateral or "spillover" effects on one or more of the other domains
- Key trends within each risk category should be monitored annually and long-term trends should be quantified. Over time, the cumulative impacts can be very significant.

Boards may not appreciate the cumulative effects of changes in risk factors that can take place over several years.

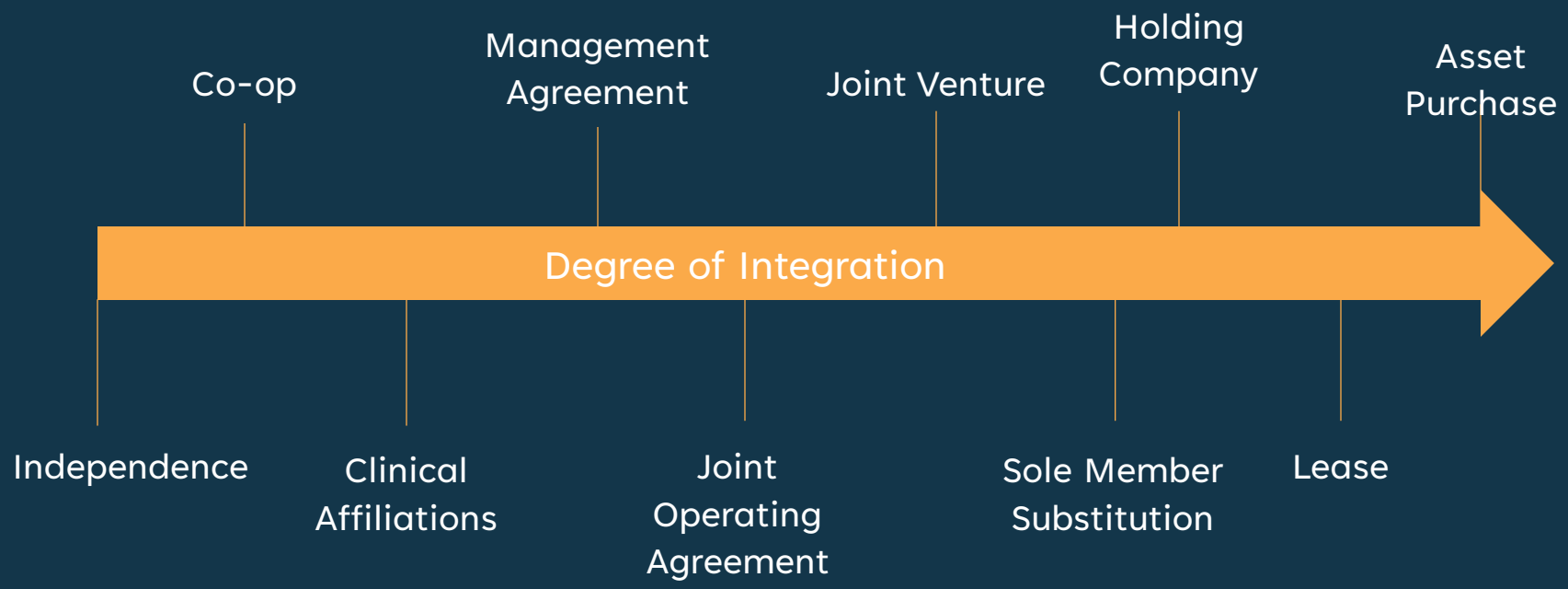
HOW TO ENSURE YOUR PARTNERSHIP CREATES VALUE

BUILDING PARTNERSHIPS AND TRUST

Board and stakeholder education	• What are the strategic risks facing hospital • Understand the hallmarks of good governance and sound management
Develop a common fact base	• Quantify performance gaps • Develop strategic objectives
Involve key leaders from boards and/or stakeholder groups	• Provide a format for communication and sharing of perspectives • Engage around key issues and concerns • Remove emotion and make objective data the basis for decisions • Seek consensus vs. unanimity
Develop a shared vision for the future	• What key attributes do board members and key stakeholders want the organization to have in 5-10 years?
Don't lose sight of the fundamentals	• Sound governance and management • Strategic alignment • Operational performance

CONTINUUM OF PARTNERSHIP STRUCTURES

- There are a variety of partnership structures at different degrees of integration

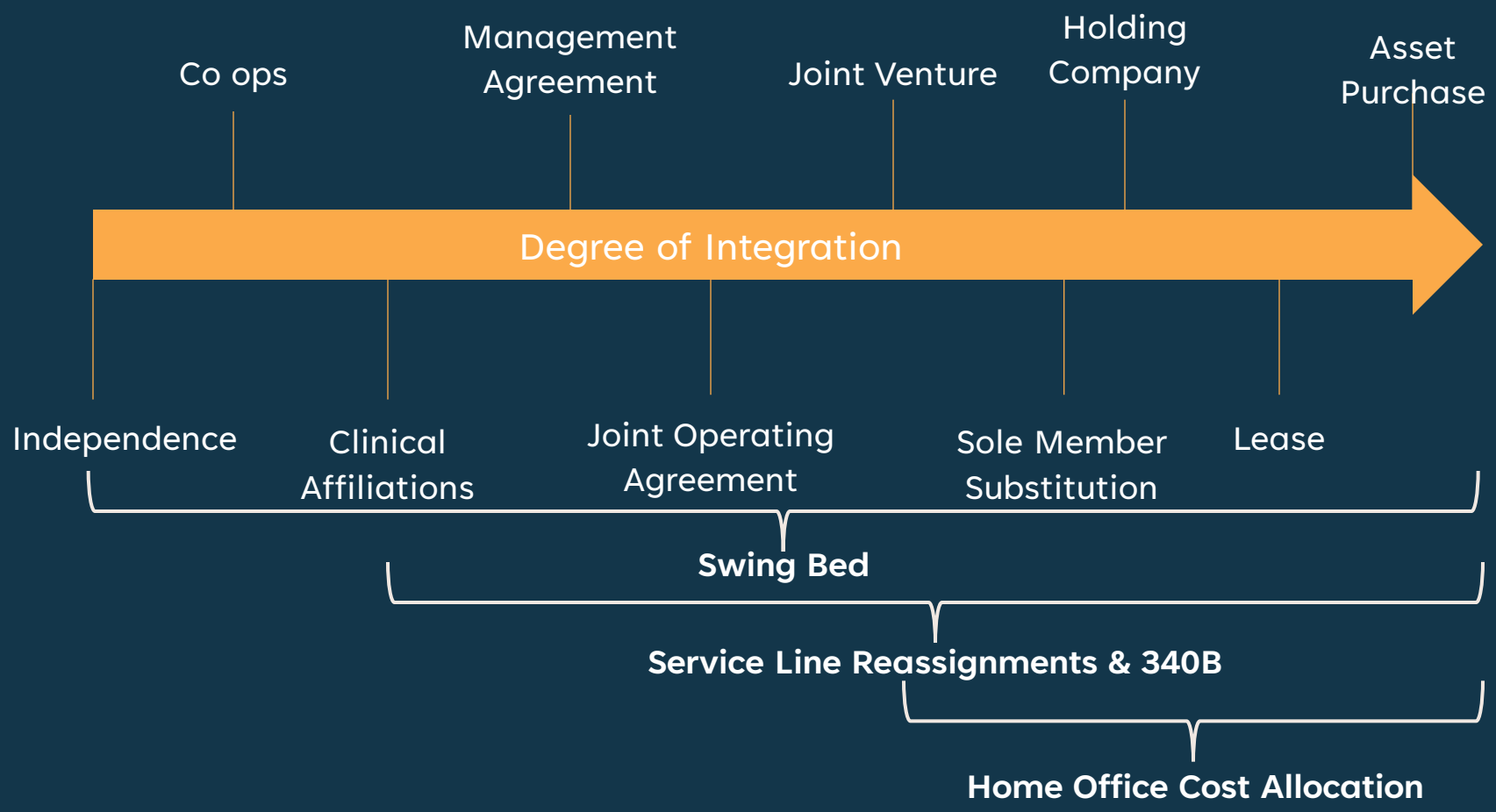


VALUE LEVERS FOR RURAL HEALTH SYSTEMS

- The following value levers are often misunderstood or undervalued by existing and potential partners:
  - Cost-based payment
  - Cost report optimization opportunities
  - Home office cost allocation
  - Access to 340B
  - Swing beds
  - Rural health clinics (RHCs)
  - Decanting volume and utilizing Critical Access Hospitals (CAHs) as specialized components of the continuum of care
  - The value of attributed lives and a primary care base that is cash flow positive
  - The “true” value of incremental referrals

CONTINUUM OF PARTNERSHIP STRUCTURES

- There are a variety of partnership structures at different degrees of integration



PROCESS FOR ENHANCING EXISTING PARTNERSHIPS

- Unleashing previously untapped value should benefit both the rural affiliate and the parent
- Quantify opportunities with a pragmatic and realistic mindset—do not overpromise and under-deliver
- Get some early wins on the board to build confidence and buy-in
- Prioritize opportunities based on:
  - Low cost to implement
  - Quick ROI/time for payback
  - Ability to execute
  - Value to partner, affiliate, and system
  - Strategic fit of the opportunity
- Focus on educating colleagues about recurring benefits and including benefits in future capital allocation decisions

PROCESS RECOMMENDATIONS FOR NEW PARTNERSHIPS

Have prospective partners compete for the privilege of being your partner

- Use the process to gather information about your options
- Use the process to educate prospective partners as to your value
- Assess whether a partner is willing to adjust terms and commitments to reflect the quantification of your value
- Leverage the analyses of your value, the competitive process, and the asymmetry of information to negotiate improved terms
- Evaluate prospective partners' track records with their rural affiliates
- Do not sign an exclusive Letter of Intent (LOI) until you have an acceptable term sheet in hand

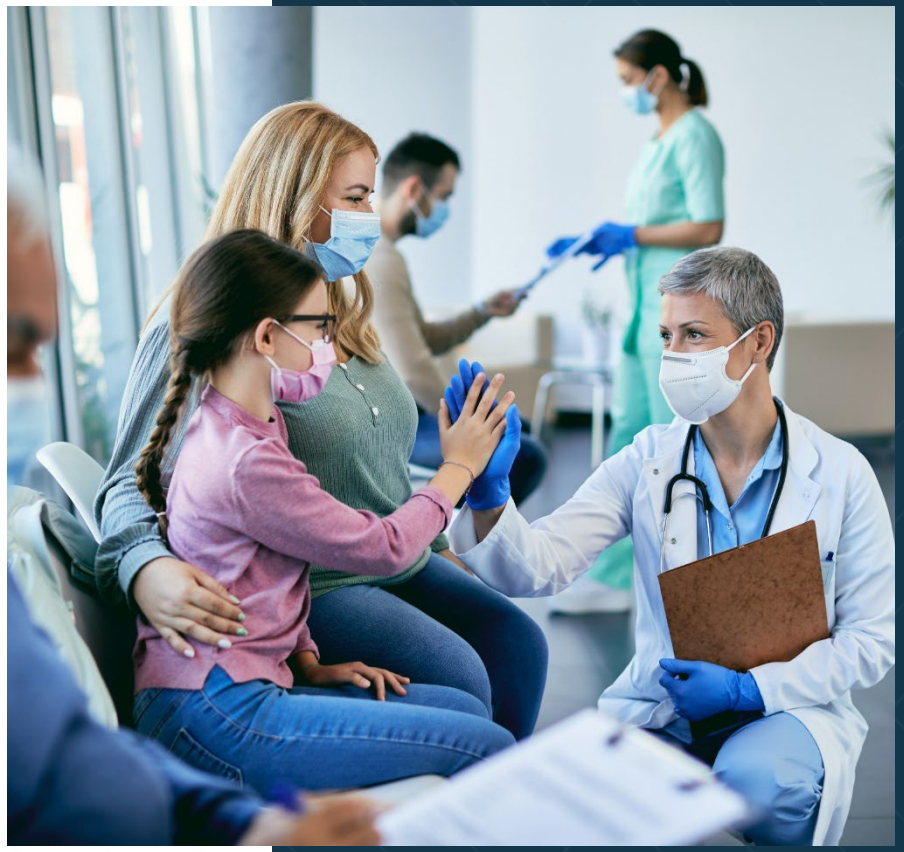
CASE STUDY: QUANTIFYING YOUR VALUE

CAH was projected to have a negative cash balance within two years and needed to partner

Using the value levers, Stroudwater determined our client would be able to fund investments and increase operating performance by about $670K annually through a partnership – net of debt service on $3.6M of needed investments

By quantifying the value levers, our client received robust proposals with strong commitments for the community

As of April 2024, our client has signed an LOI with a preferred partner and is set to close on the definitive agreement on June 1, 2024



CASE STUDY: QUANTIFYING YOUR VALUE, CONT.

Performance Improvement Initiatives	Client
Swing Bed Estimate	$ 120,000
340b Opportunity	$ 250,000
Cost Report Opportunity	$ 170,610
Home Office Cost Allocation Low Estimate	$ 470,000
Home Office Cost Allocation High Estimate	$ 780,000
Total Savings Low Estimate	$ 1,010,610
Total Savings High Estimate	$ 1,320,610

Required Investment Over 5 Years	
Required Investment	3,587,639
Percentage Debt Financing	100%
Cost Based Reimbursement	40%

- The table to the left demonstrates the savings incurred by different value levers for our client
- The table below demonstrates the effect of the performance improvement initiatives on operating performance inclusive of required investments

Projection Estimate

	Year 1	Year 5	Year 10	Year 15	Year 20	Year 25	Year 30	Year 35
Principal Balance Outstanding	$ 3,587,639	$ 3,114,290	$ 2,491,503	$ 1,684,434	$ 777,344	$ 350,054	$ (0)	
Annual Depreciation Expense	$ (160,148)	$ (160,148)	$ (160,148)	$ (158,498)	$ (140,165)	$ (59,315)	$ (39,254)	$ -
Annual Interest Expense	$ (195,209)	$ (174,450)	$ (141,196)	$ (98,039)	$ (48,818)	$ (22,109)	$ (2,340)	$ -
Total Annual Depreciation Plus Interest	$ (355,357)	$ (334,598)	$ (301,344)	$ (256,537)	$ (188,983)	$ (81,424)	$ (41,594)	$ -
Incremental Cost-Based Payments	$ 141,041	$ 132,802	$ 119,603	$ 101,820	$ 75,007	$ 32,317	$ 16,509	$ -
Net Interest and Depreciation Cost	$ (214,316)	$ (201,796)	$ (181,741)	$ (154,718)	$ (113,975)	$ (49,107)	$ (25,086)	$ -
Annual Principal Payment	$ (84,575)	$ (105,334)	$ (138,588)	$ (179,596)	$ (201,854)	$ (95,084)	$ (77,897)	$ -
Total Annual Cost (after Cost Based Payment)	$ (298,891)	$ (307,130)	$ (320,329)	$ (334,314)	$ (315,829)	$ (144,191)	$ (102,983)	$ -
Projection Low Estimate								
Total Annual Operating Improvements	$ 1,010,610	$ 1,010,610	$ 1,010,610	$ 1,010,610	$ 1,010,610	$ 1,010,610	$ 1,010,610	$ 1,010,610
Net Change In Operating Performance - Low Estimate	$ 711,719	$ 703,480	$ 690,281	$ 676,296	$ 694,781	$ 866,419	$ 907,627	$ 1,010,610
Projection High Estimate								
Total Savings High Estimate	$ 1,320,610	$ 1,320,610	$ 1,320,610	$ 1,320,610	$ 1,320,610	$ 1,320,610	$ 1,320,610	$ 1,320,610
Net Change In Operating Performance - High Estimate	$ 1,021,719	$ 1,013,480	$ 1,000,281	$ 986,296	$ 1,004,781	$ 1,176,419	$ 1,217,627	$ 1,320,610

PARTNERSHIP PITFALLS AND HOW TO AVOID THEM

CASE STUDY: NON-COMPETITIVE PROCESS

A CAH retained Stroudwater to assist with a partnership process where the preferred partner had already been identified

The client had not run a competitive process. The preferred partner at the time was the third organization they had approached sequentially.

Due to the client's one-at-a-time approach, our client's leverage with negotiations was affected

Result: Without a competitive process, our client lost leverage and did not receive strong proposals and missed out on capital and service continuation commitments

CASE STUDY: THE WRONG PREFERRED PARTNER

- A distressed Critical Access Hospital (CAH) had a preferred affiliation candidate identified and a signed letter of intent when they approached Stroudwater for assistance because the affiliation process was stalled
- Their preferred partner—a large regional referral center—did not understand the value proposition of having a CAH as part of their health system
- Stroudwater recommended that the client conduct a process to evaluate a broader selection of affiliation options alongside their preferred partner
- Stroudwater educated all interested parties about the unique value proposition of having a CAH affiliate (home office cost allocation, rural health clinics, 340B eligibility, swing beds, cost-based payment, etc.)
- Despite these education efforts, their prior exclusive prospective partner could not incorporate these value drivers into their proposal
- Thankfully, an alternative preferred partner emerged with previous experience with distressed rural hospitals, a track record of successful turnarounds, and expertise in operating rural affiliates
- Our client vetted its options and selected the newly identified partner based on its expertise, track record, and the quality of the terms of its proposal

CASE STUDY: THE WRONG PARTNER/STRUCTURE

- Two financially stressed rural health systems combined into a single health system using a joint operating agreement (JOA)
- The JOA agreement called for the members to share profits and losses, while member boards and assets remained separate
- The practical effect was that the member who lost more was owed a check by the member who lost less
- Resentment, distrust, and hostility became the common language at the combined system and on each member board
- Stroudwater was called in to ”fix” this situation.
  - **Goal 1: Avoiding bankruptcy of one member and forestalling litigation among the parties**
  - **Goal 2: Find a partner(s) that could recapitalize each member and enter into separate affiliation agreements with each member given the complete breakdown in trust**
- 18 months later, these goals were realized. Both communities maintained their health systems despite this multi-year misadventure.

CASE STUDY: DID NOT UNDERSTAND RURAL VALUE

- Our CAH client entered discussions with a large multi-state health system regarding a potential affiliation
- The large health system misunderstood the value of the home office cost allocation, placing only $100K incremental value on this allocation vs. an estimated $3M+ annual value calculated by Stroudwater
  - A greater than 50% share of cost-based payment
- The benefit of a modest change in referrals (+2.5% market share gain)
- Result: The prospective partner revised their offer from minimal capital commitment and virtually no local role in governance to an offer that included major investment commitments, major service commitments, and a significant continuing affiliate role in governance

BETTER DECISIONS FOR BETTER HEALTHCARE

The objective: to make the best decisions about resource allocation and performance evaluation to improve system performance and optimize access to needed healthcare services sustainably

Those decisions should be based upon:

- Variable/incremental costs (20%) not reallocated fixed costs (80%)
- Contribution margin – after variable costs are considered – 80%
- Cost-based payment (for CAHs) is unique and should inform management decisions

Access to unique rural-based programs; don't take conventional wisdom as definitive

The value of incremental referrals and having an aligned primary care base that cash flows

KEY TAKEAWAYS

OPERATIONAL PERFORMANCE IS FOUNDATIONAL TO ANY STRATEGIC OPTION

TIME IS NEVER A NEUTRAL FACTOR; DON'T KICK THE CAN DOWN THE ROAD

KNOW YOUR VALUE, DO THE HOMEWORK

THERE ARE NO RISK-FREE STRATEGIC OPTIONS

PROCESS, PARTNER, STRUCTURE, TERMS

STROUDWATER

THANK YOU

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