



## **Academic Practice Plan Directors Fall Roundtable**

September 28, 2013

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## **Healthcare Affiliation Trends and Key Drivers**

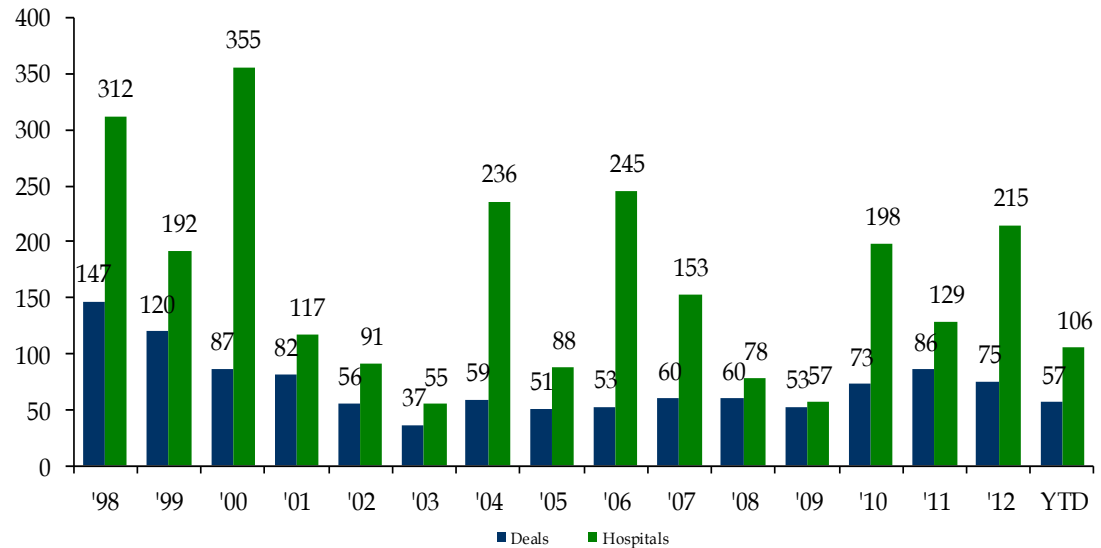


## Healthcare Affiliation Trends

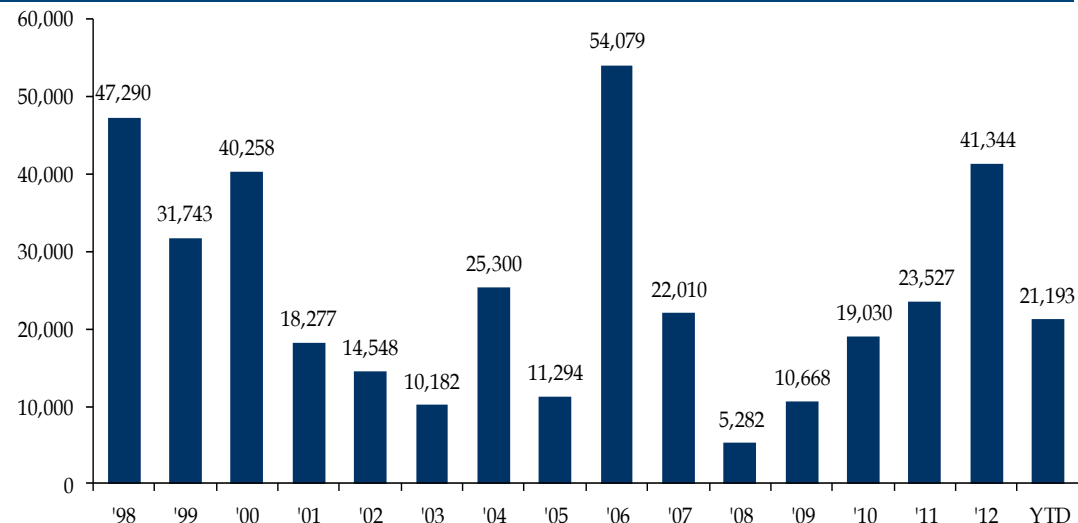
Transaction Volumes Are Growing

- Hospital transactions have been exceptionally strong over the last two years
- Over the past 15 years the average number of deals was 72 annually
- Among major 2011 & 2012 transactions include:
  - Catholic Health East announced merger with Trinity Health
  - John C. Lincoln and Scottsdale announced a merger to create a new system (Cain Brothers' client)
  - Baylor Health Care System announced merger with Scott & White Healthcare (Cain Brothers' client)
  - Beaumont Health System's announced merger with Henry Ford Health System
  - Vanguard's joint venture with Valley Baptist Health System (Cain Brothers' client)
  - HCA purchase of Catholic Health East's Mercy Hospital in Florida
  - Jewish Hospital & St. Mary's Healthcare merger with Saint Joseph Health System
  - Lahey Clinic's affiliation with Northeast Health System (Cain Brothers' client)

### Hospital M&A Volume (# of Deals and Hospitals)<sup>(1)</sup>



### Number of Acute Care Hospital Beds Acquired<sup>(1)</sup>



Sources: Irving Levin Associates, Inc. and Cain Brothers

(1) YTD statistics are as of June 30, 2013

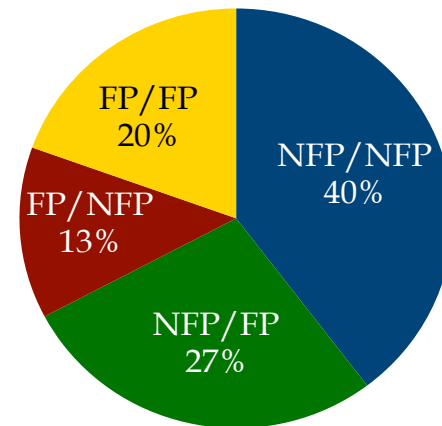


## Healthcare Affiliation Trends

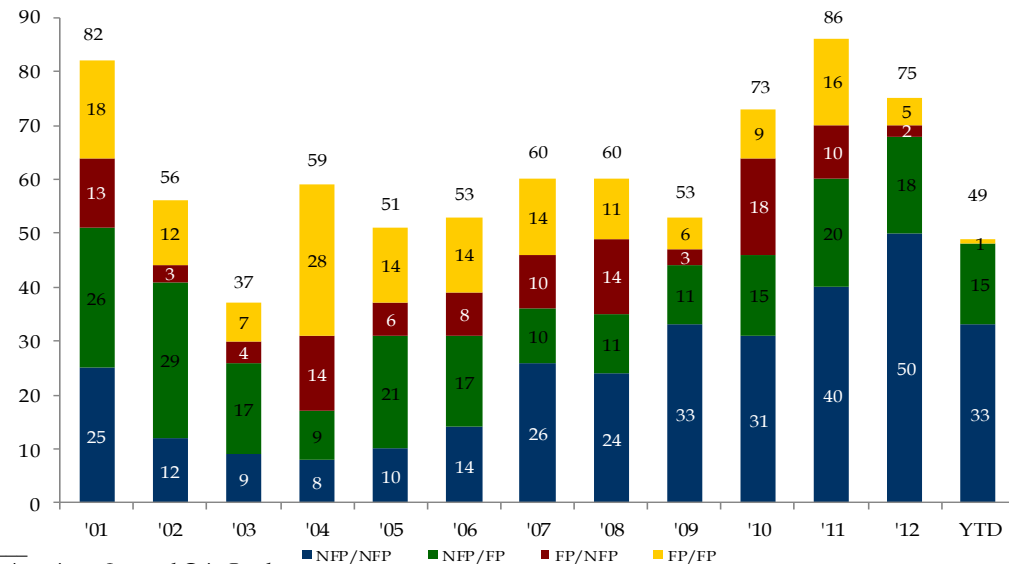
Affiliation Activity Significant Among All Provider Sectors

- Affiliations with for-profit health care systems are increasingly used to address key challenges
  - Capital constraints
  - Market consolidation
- Not-for-profit systems continue to have a significant role in transaction activity
  - 80% of all transactions since 2001 have involved a not-for-profit system as either a target, acquirer or both

Cumulative 2001 to 2013YTD Type of Transaction (Target / Acquirer)<sup>(1)</sup>



Not-for-Profit vs. For Profit Transactions (Target / Acquirer)<sup>(1)</sup>





## Healthcare Affiliation Trends

### Overview of Key Drivers Behind Affiliation Activity

#### ■ Revenue Pressure

- Unsustainably high cost of health care
- Budget pressures for governmental payors
- Private payors and employers won't allow more cost shifting
- Low GDP growth exacerbates current challenges
- Growing role of consumer choice is leading to flat or declining patient volumes

#### ■ Reorganization of Care Delivery

- Fragmented, un-organized model deliver inconsistent, lower quality care
- Care management and improved coordination between physicians, hospitals, ambulatory care and post-acute care providers will be necessary to generate structurally lower health costs
- More robust IT and EHR systems are needed and are very expensive
- Payors and patients will demand greater transparency as they pay a larger share of costs
- Physician shortages will create a challenge and opportunity for academic centers
- Consolidation will likely lead to much larger regional and multi-regional systems

#### ■ Re-oriented Economic Models

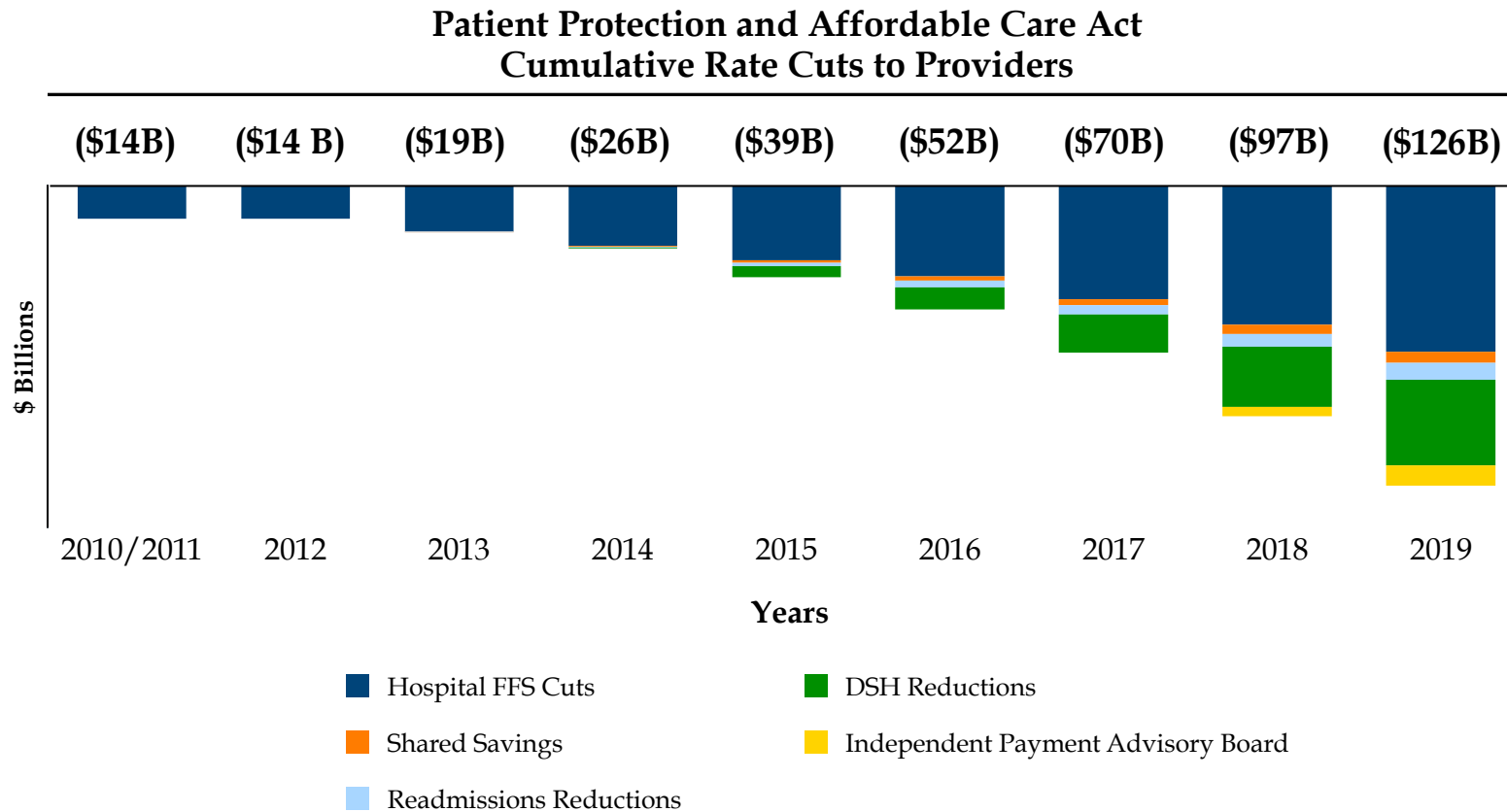
- Bending the cost curve will require a shift from fee-for-service to new payment models
- The delivery of health care services will become an increasingly commoditized service
- The value-added element will be the systems that reduce costs and improve outcomes and population health



## Key Healthcare Affiliation Drivers

### Reimbursement Pressure

The cumulative rate cuts in PPACA are staggering and will drive consolidation across the industry



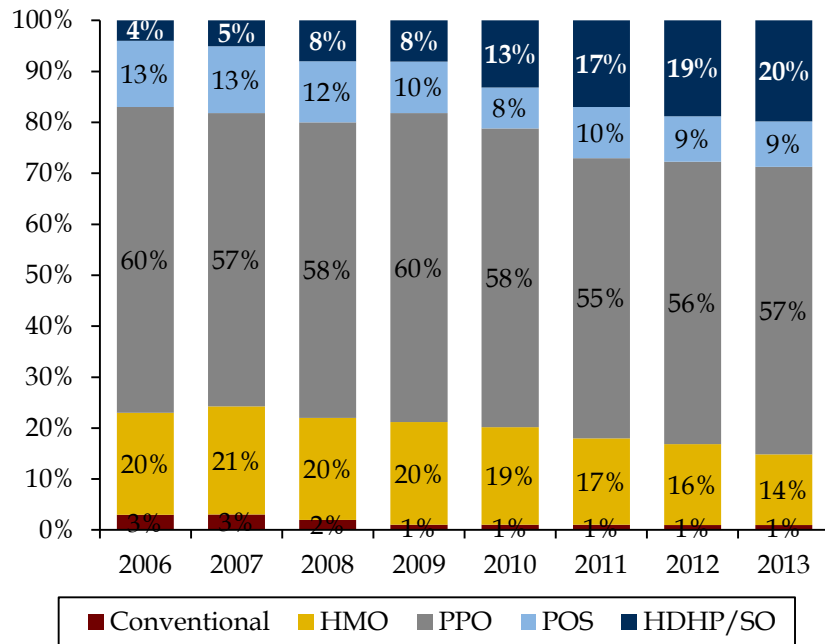


## Key Healthcare Affiliation Drivers

### Increasing Patient Responsibility for Costs

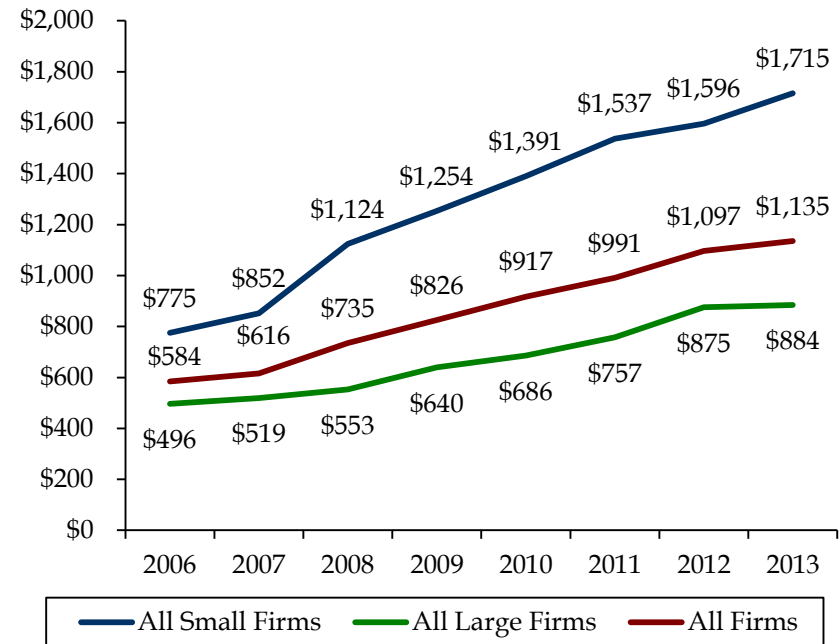
**Patients are bearing a greater portion of health care costs as a result of health benefit redesign**

**Distribution of Health Plan Enrollment for Covered Workers**



- High-deductible health plans constitute 20% of enrollment for employer-sponsored insurance

**Average Deductible for Individuals among Covered Workers**



- Individual deductibles for covered workers have nearly doubled over the past seven years



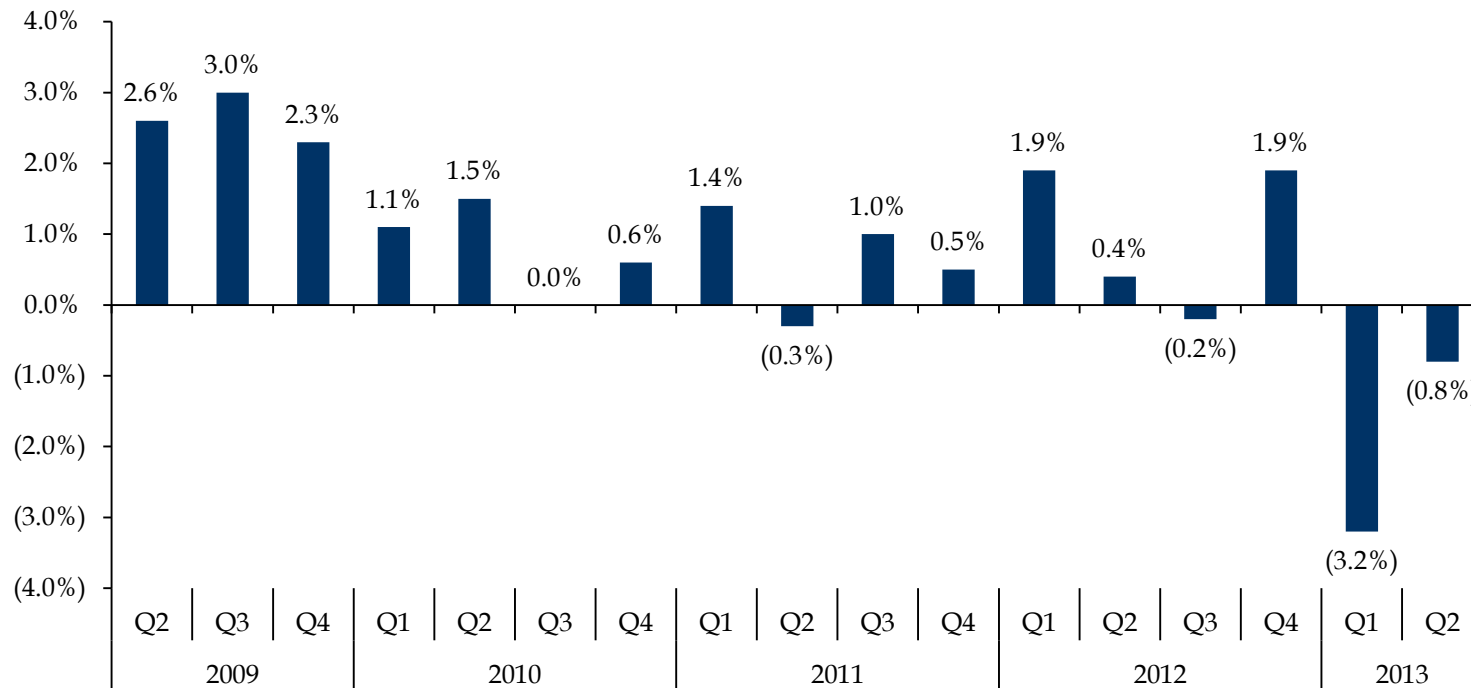


## Key Healthcare Affiliation Drivers

### Flat to Declining Patient Volumes

Patient volumes have been challenged by many factors, including the economy, technology, competition from specialty providers, a shift toward higher deductible health plans, and payor contracting terms

### Year-over-Year Same-Store Adjusted Admissions Trends for Publicly Traded Hospital Management Companies

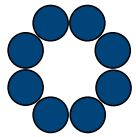


## Key Healthcare Affiliation Drivers

### The Need to Create Organized Patient Care Models



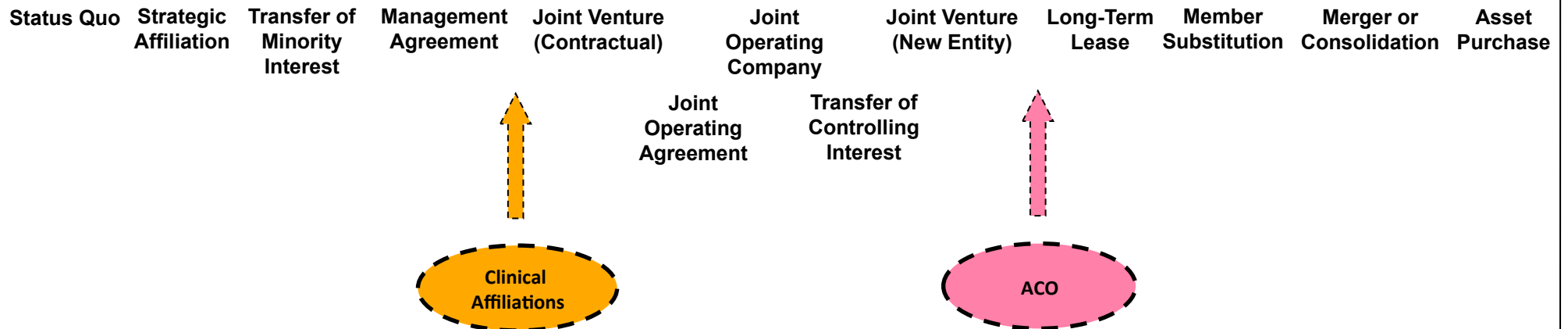
## **Affiliation Model Case Studies**

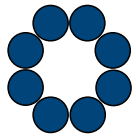


## Continuum of Strategic Transaction Models

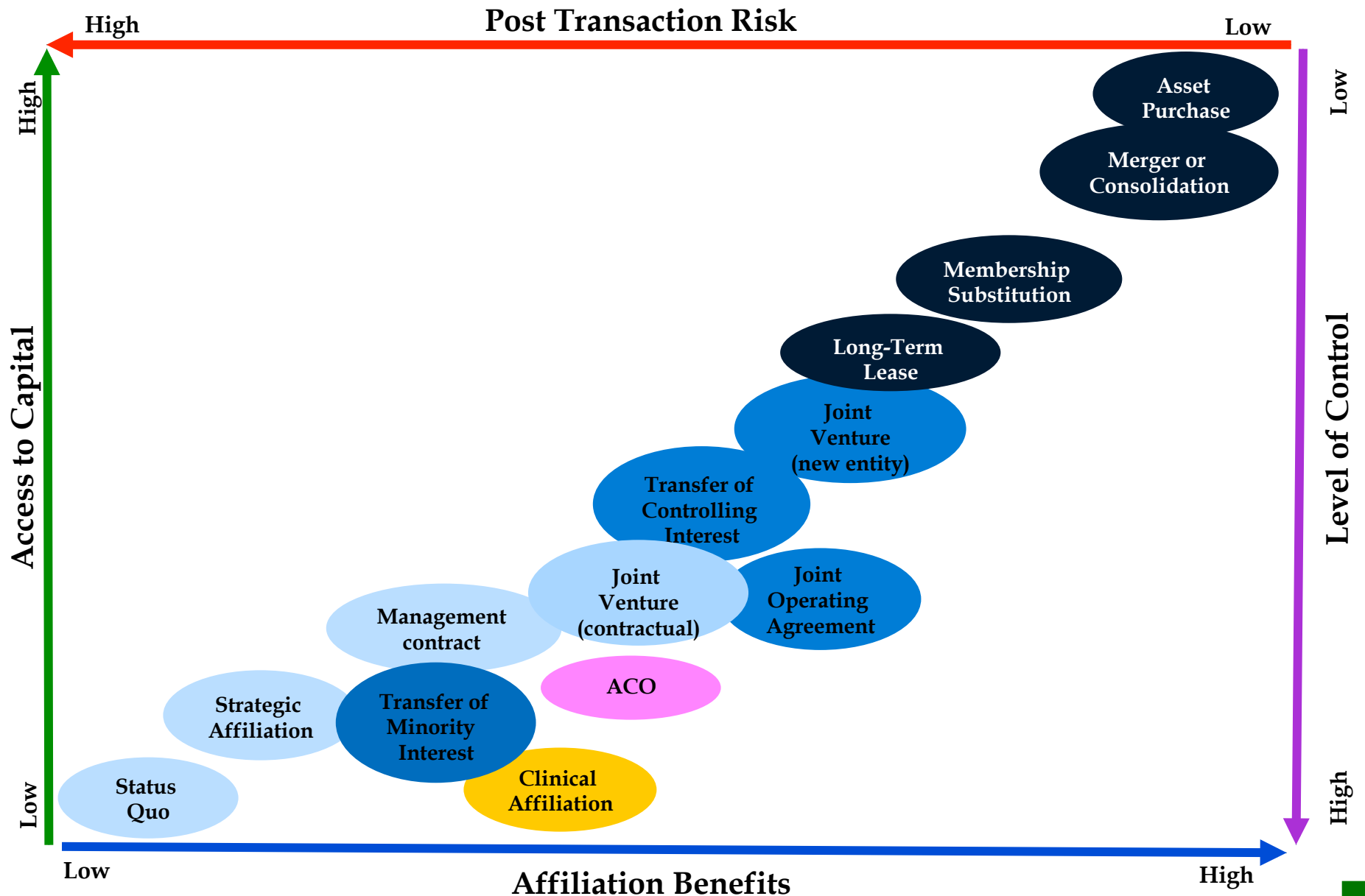
Less Integration

More Integration





# Strategic Alternatives – The Tradeoff Matrix





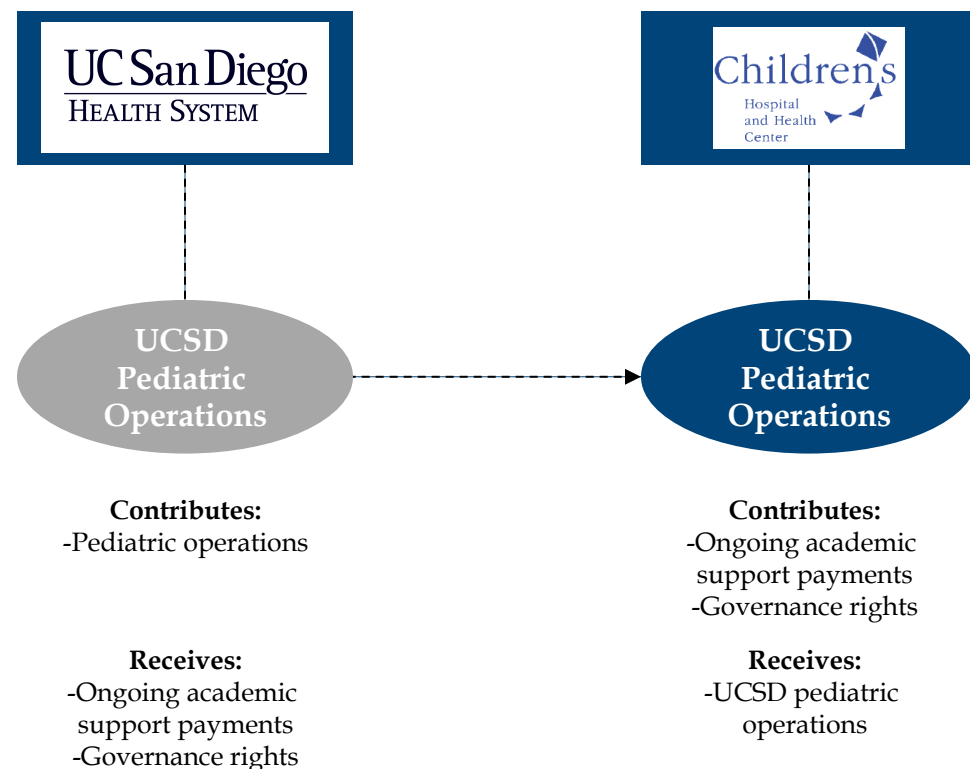
# UC San Diego and Children's Hospital and Health Center (2001)

## Clinical Affiliation Case Study

### Key Transaction Terms

<b>Overview</b>	<ul style="list-style-type: none"> <li>Through a Joint Powers Affiliation Agreement and related contracts, UC San Diego (UCSD) transferred virtually all of its pediatric operations to Children's Hospital and Health Center (CHHC)</li> </ul>
<b>Consideration</b>	<ul style="list-style-type: none"> <li>CHHC established an Academic Fund to replace the financial support traditionally provided by the UCSD Medical Center to the UCSD School of Medicine for pediatrics</li> <li>CHHC provided facilities to house UCSD personnel and a commitment for the construction of a research building</li> <li>A new leadership position of Physician-In-Chief was established to guide the vision of creating a world-class academic children's health center</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>CHHC increased the size of its Board from 15 to 18 Trustees, of which a third of the positions are to be held by UCSD</li> <li>Similar amendments were made to Children's Hospital, San Diego's Board</li> </ul>
<b>Reserve Rights</b>	<ul style="list-style-type: none"> <li>CHHC's governing documents were amended to include the clinical, research, and academic missions of UCSD Health Services as a purpose of the corporation</li> </ul>
<b>Other</b>	<ul style="list-style-type: none"> <li>CHHC became the primary pediatric teaching and research site for UCSD</li> <li>Pediatric specialty physicians of UCSD Medical Group became members of Children's Specialists of San Diego</li> </ul>

### Transaction Structure



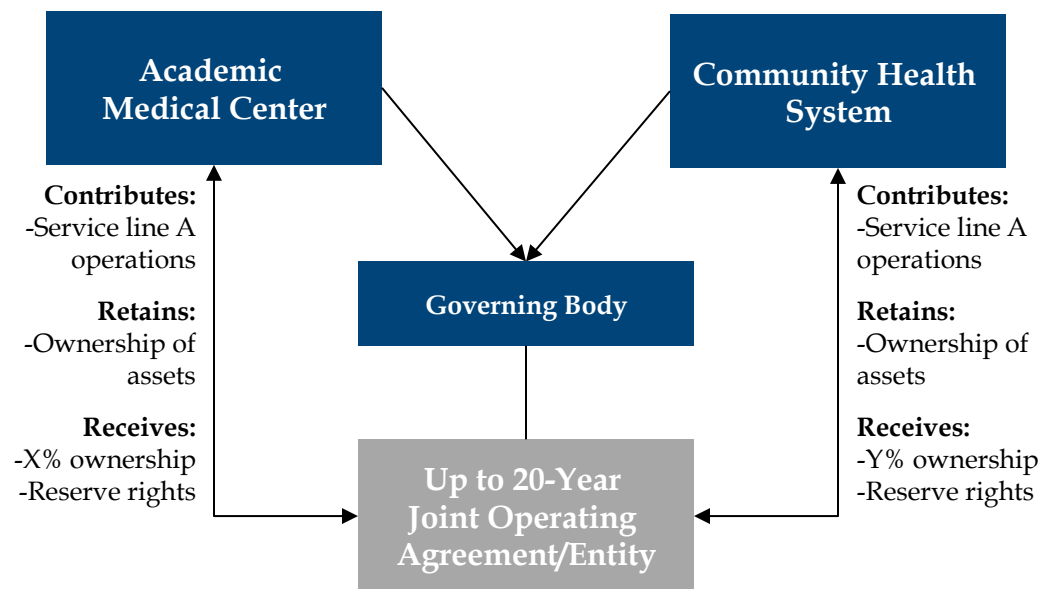
## Pending Transaction

### Service Line Joint Operating Agreement (JOA) Case Study

#### Key Transaction Terms

<b>Overview</b>	<ul style="list-style-type: none"> <li>The Academic Medical Center and Community Health System have agreed in principle to combine the operations of a particular service line through a JOA</li> <li>The contractual relationship may be augmented through the creation of a separate entity to retain earnings and own/develop joint assets</li> </ul>
<b>Consideration</b>	<ul style="list-style-type: none"> <li>While still preliminary, each entity's contribution will likely be valued based upon their relative historical EBITDA contribution, subject to certain adjustments</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>A governing body will be formed to oversee operations of the JOA</li> <li>Each party will have equal representation on the governing body</li> <li>Each Parent retains reserved powers over key decisions</li> </ul>
<b>Reserve Rights</b>	<ul style="list-style-type: none"> <li>Each entity will maintain autonomy over capital expenditure decisions related to its contributed assets</li> </ul>
<b>Other</b>	<ul style="list-style-type: none"> <li>JOA encompasses teaching and research activities and contemplates an academic support payment</li> </ul>

#### Transaction & Governance Structure



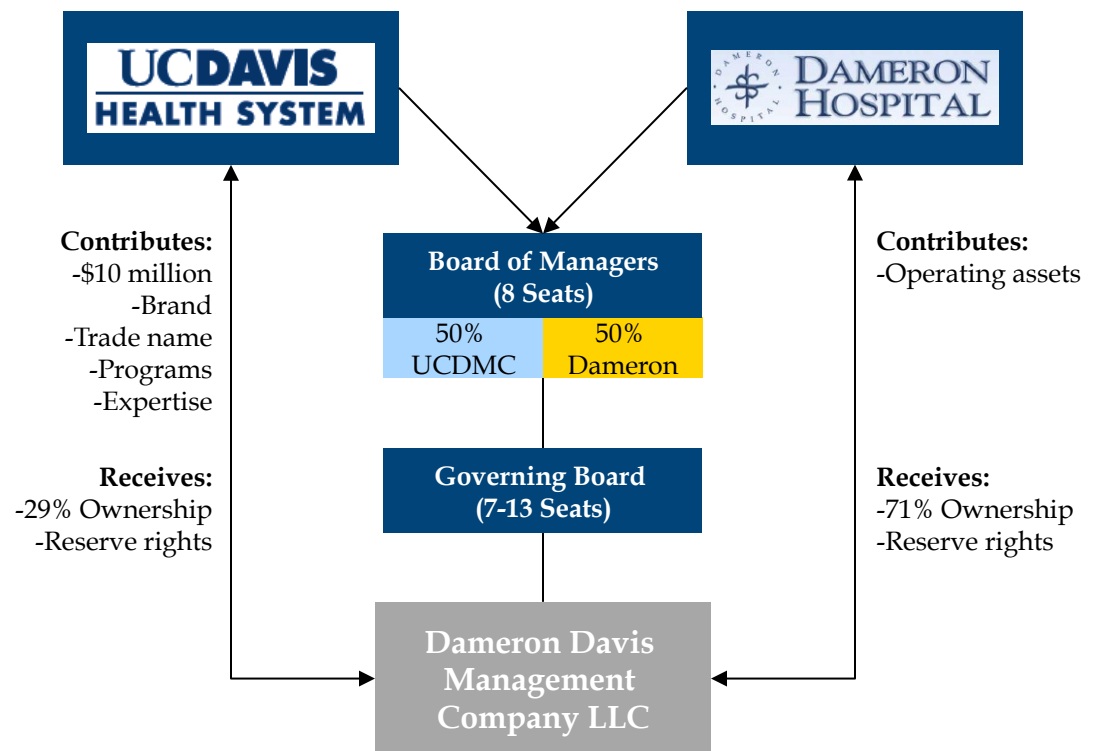
## UCDMC and Dameron Hospital Association (2012)

### Whole Hospital Joint Operating Company (JOC) Case Study

#### Key Transaction Terms

<b>Overview</b>	<ul style="list-style-type: none"> <li>UC Davis Medical Center (UCDMC) and Dameron Hospital Association (Dameron) will form a two-member, nonprofit LLC to own and operate Dameron Hospital, a 202-bed acute care facility in Stockton, CA</li> <li>UCDMC will own 29% of the LLC and Dameron the remaining 71%<sup>(1)</sup></li> </ul>
<b>Consideration</b>	<ul style="list-style-type: none"> <li>UCDMC will contribute \$10 million in cash as well as the University's brand, trade name, programs and expertise (~\$30 million in-kind value)</li> <li>Dameron will contribute hospital assets worth \$97.5 million</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>Both parties will appoint four members to the Board of Managers</li> <li>UCMDC representative will serve as chair and cast deciding vote in case of deadlock</li> <li>Board of Managers will appoint Governing Board comprised of medical staff and active community leaders</li> </ul>
<b>Reserve Rights</b>	<ul style="list-style-type: none"> <li>Both parties must consent to: <ul style="list-style-type: none"> <li>Sale, exchange, or disposition of all of the LLC's assets</li> <li>Sale, merger, consolidation, or dissolution of the LLC</li> <li>Financing other than non-recourse</li> <li>Capital calls</li> </ul> </li> </ul>
<b>Other</b>	<ul style="list-style-type: none"> <li>In the event the LLC is dissolved, UCDMC will receive first \$10 million of net cash</li> </ul>

#### Transaction & Governance Structure



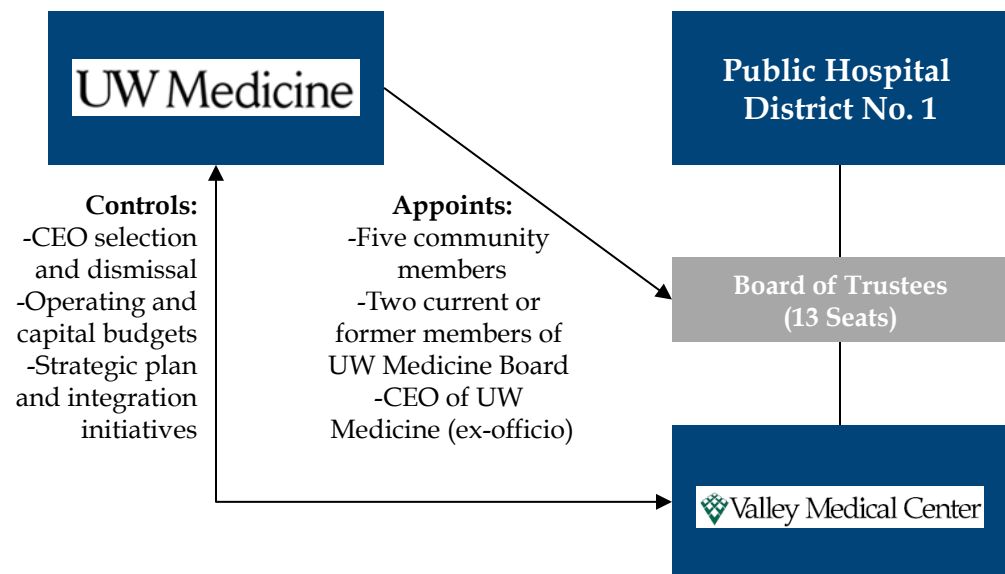


## UW Medicine and Valley Medical Center (2011) Strategic Alliance Case Study

### Key Transaction Terms

<b>Overview</b>	<ul style="list-style-type: none"> <li>Public Hospital District No. 1 of King County, Washington (the District), d/b/a Valley Medical Center (VMC), became part of University of Washington (UW) Medicine through a Strategic Alliance Agreement executed between the District and UW Medicine</li> <li>The Strategic Alliance Agreement grants effective operating and governance control of VMC to UW Medicine</li> <li>Public Hospital District No. 1 still maintains the same legal structure and ownership of VMC as before the alliance</li> </ul>
<b>Consideration</b>	<ul style="list-style-type: none"> <li>N/A</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>A new Board was created comprised of the five elected District Commissioners, five Community Trustees, two current or former members of UW Medicine Board and the CEO of UW Medicine (ex-officio) <ul style="list-style-type: none"> <li>UW Medicine appoints all non-Commissioner trustees</li> </ul> </li> <li>Two Community and Commissioner Trustees will be recommended to the Board of Regents for appointment to the UW Medicine Board</li> </ul>
<b>Reserve Rights</b>	<ul style="list-style-type: none"> <li>District's statutory responsibilities and authorities are unchanged (e.g., ability to levy taxes, authority over capital decisions)</li> </ul>
<b>Other</b>	<ul style="list-style-type: none"> <li>UW Medicine will explore potential areas for business and clinical integration</li> </ul>

### Transaction & Governance Structure

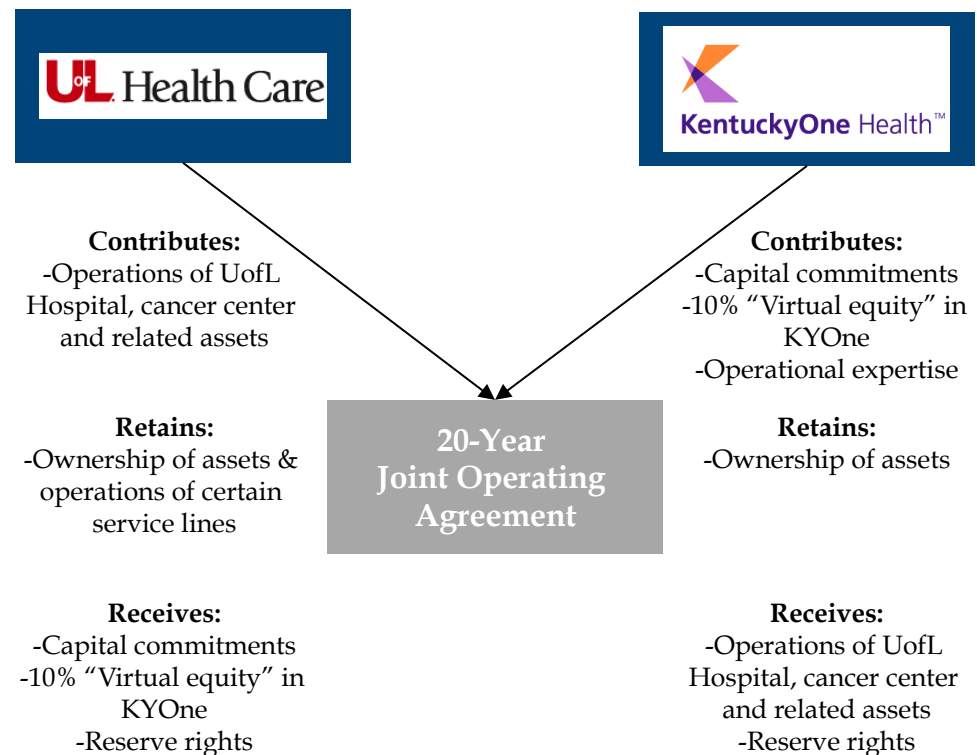


## UofL Health Care and KentuckyOne Health (2012) Joint Operating Agreement (JOA) Case Study

### Key Transaction Terms

<b>Overview</b>	<ul style="list-style-type: none"> <li>University Medical Center (UMC), an affiliate of the University of Louisville (UofL), entered into a 20-year JOA with KentuckyOne Health (KYOne) to operate UofL Hospital, James Graham Brown Cancer Center and related businesses</li> <li>KYOne concurrently entered into an academic affiliation agreement with UofL and a lease agreement with the Commonwealth of Kentucky</li> </ul>
<b>Consideration</b>	<ul style="list-style-type: none"> <li>UMC contributed the operating assets listed above, although maintains financial and operational control of NICU, obstetrical and reproductive services</li> <li>KYOne contributed 10% "virtual equity" in KYOne and \$543.5 million of investment during the first five years, expanding to \$1.4 billion over 20 years, including:</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>UMC assigned day-to-day operations to KYOne through certain Delegated Powers</li> <li>KYOne board of directors expanded from 15 to 18 members with the three additional members appointed by UofL</li> </ul>
<b>Other</b>	<ul style="list-style-type: none"> <li>KYOne has the right to terminate the JOA should UMC lose access to certain state and federal funding streams</li> <li>If UMC terminates the JOA, it must make a payment from UMC to KYOne for value creation</li> </ul>

### Transaction Structure

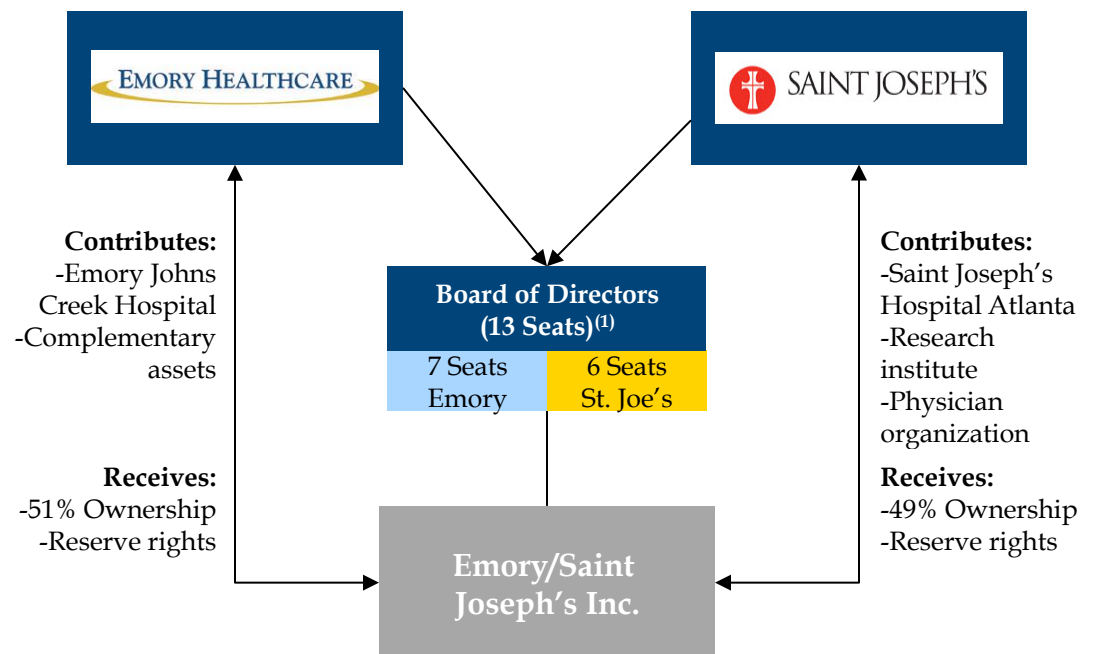


## Emory Healthcare and Saint Joseph's (2011) Joint Operating Company (JOC) Case Study

### Key Transaction Terms

<b>Overview</b>	<ul style="list-style-type: none"> <li>Saint Joseph's Health System (Saint Joseph's) and Emory Healthcare (Emory) formed a nonstock, nonprofit company to own and operate two hospitals and related businesses in Atlanta, GA</li> <li>Emory owns 51% of the JOC and Saint Joseph's the remaining 49%</li> </ul>
<b>Consideration</b>	<ul style="list-style-type: none"> <li>Saint Joseph's contributed the assets and operations of Saint Joseph Hospital Atlanta, its research institute and physician organizations</li> <li>Emory contributed certain complementary hospital assets and operations</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>At all times the Board of Directors shall be an odd number between nine and 15 directors <ul style="list-style-type: none"> <li>Emory always appoints one additional director and designates the board chair</li> </ul> </li> </ul>
<b>Reserve Rights</b>	<ul style="list-style-type: none"> <li>Saint Joseph's contributed assets will be operated in accordance with Catholic Ethical and Religious Directives</li> <li>Emory's contributed assets will continue sponsored teaching and research activity</li> <li>Material transactions, changes to the organization, and certain other events require Supermajority approval (i.e., at least two Saint Joseph's directors in favor)</li> </ul>
<b>Other</b>	<ul style="list-style-type: none"> <li>Emory provides management services to the JOC</li> </ul>

### Transaction & Governance Structure



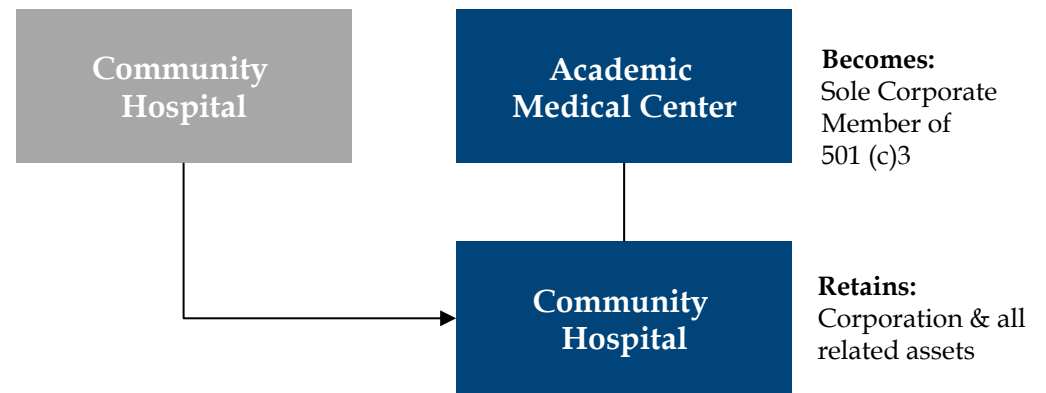
## Pending Transaction

### Membership Transfer Case Study

#### Key Transaction Terms

<b>Overview</b>	<ul style="list-style-type: none"> <li>The Academic Medical Center (AMC) will become the sole corporate member of the Community Hospital (CH) through a membership substitution process</li> </ul>
<b>Consideration</b>	<ul style="list-style-type: none"> <li>The AMC will become the sole corporate member and all assets and liabilities of the CH would be consolidated from an accounting perspective</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>The CH Board will remain the governing board of the hospital, with additional members nominated by the AMC</li> <li>A new CH advisory board consisting of community leaders, CH board members, and the AMC's advisory board members will provide strategic guidance for the CH</li> </ul>
<b>Reserve Rights</b>	<ul style="list-style-type: none"> <li>The AMC has numerous reserved rights including <ul style="list-style-type: none"> <li>Approve or change CH board members</li> <li>Approve major capital expenditures</li> </ul> </li> </ul>
<b>Other</b>	<ul style="list-style-type: none"> <li>As part of the integration plan, the AMC and CH will combine fundraising and research efforts</li> </ul>

#### Transaction Structure



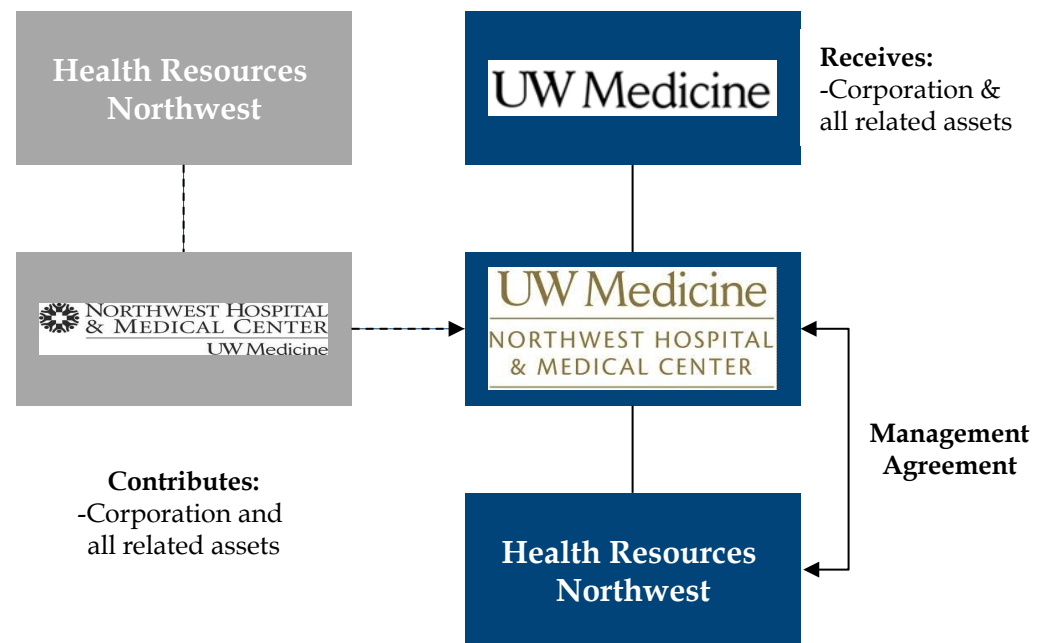
# UW Medicine and Northwest Hospital & Medical Center (2011)

## Membership Transfer Case Study

### Key Transaction Terms

<b>Overview</b>	<ul style="list-style-type: none"> <li>Northwest Hospital and Health Center (Northwest) joined UW Medicine through a membership substitution and was renamed UW Medicine/Northwest</li> <li>Northwest became the sole corporate member of Health Resources Northwest (HRN), its former parent corporation, to minimize the impact on operations (e.g., employee status, medical staff structure, relationships with wholly owned physician practices and joint ventures, etc.)</li> </ul>
<b>Consideration</b>	<ul style="list-style-type: none"> <li>UW Medicine has assumed substantially all assets and liabilities of Northwest</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>The new Northwest Board has 13 trustees, nine of whom were existing trustees of the HRN/Northwest Board</li> <li>All 13 trustees approved by UW from a list of trustees proposed by Northwest's Board</li> <li>Two existing seats on the UW Medicine Board will be filled by members of the UW Medicine/Northwest Board</li> <li>The UW Medicine Board has oversight of all UW Medicine/Northwest activities</li> </ul>
<b>Reserve Rights</b>	<ul style="list-style-type: none"> <li>UW Medicine has approval rights over operating and capital budgets</li> <li>UW Medicine has committed to maintaining or expanding certain core clinical services and continuing Northwest's open medical staff model</li> </ul>
<b>Other</b>	<ul style="list-style-type: none"> <li>HRN will provide management services</li> </ul>

### Transaction Structure



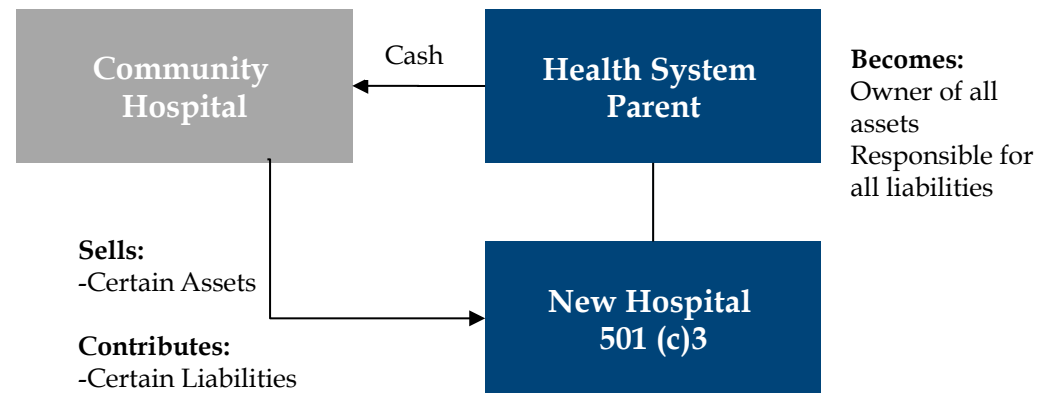
## Pending Transaction

### Asset Purchase Case Study

#### Key Transaction Terms

<b>Overview</b>	<ul style="list-style-type: none"> <li>The acquiring health system parent will become the owner of all hospital assets or the sole corporate member of the Community Hospital (CH) of a new 501(c)3 corporate entity</li> </ul>
<b>Consideration</b>	<ul style="list-style-type: none"> <li>The net value after assumption of liabilities will be paid in cash to selling hospital</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>Either the hospital will be governed by its existing Board or, if a newly created 501(c)3 is used, create a new Board</li> </ul>

#### Transaction Structure

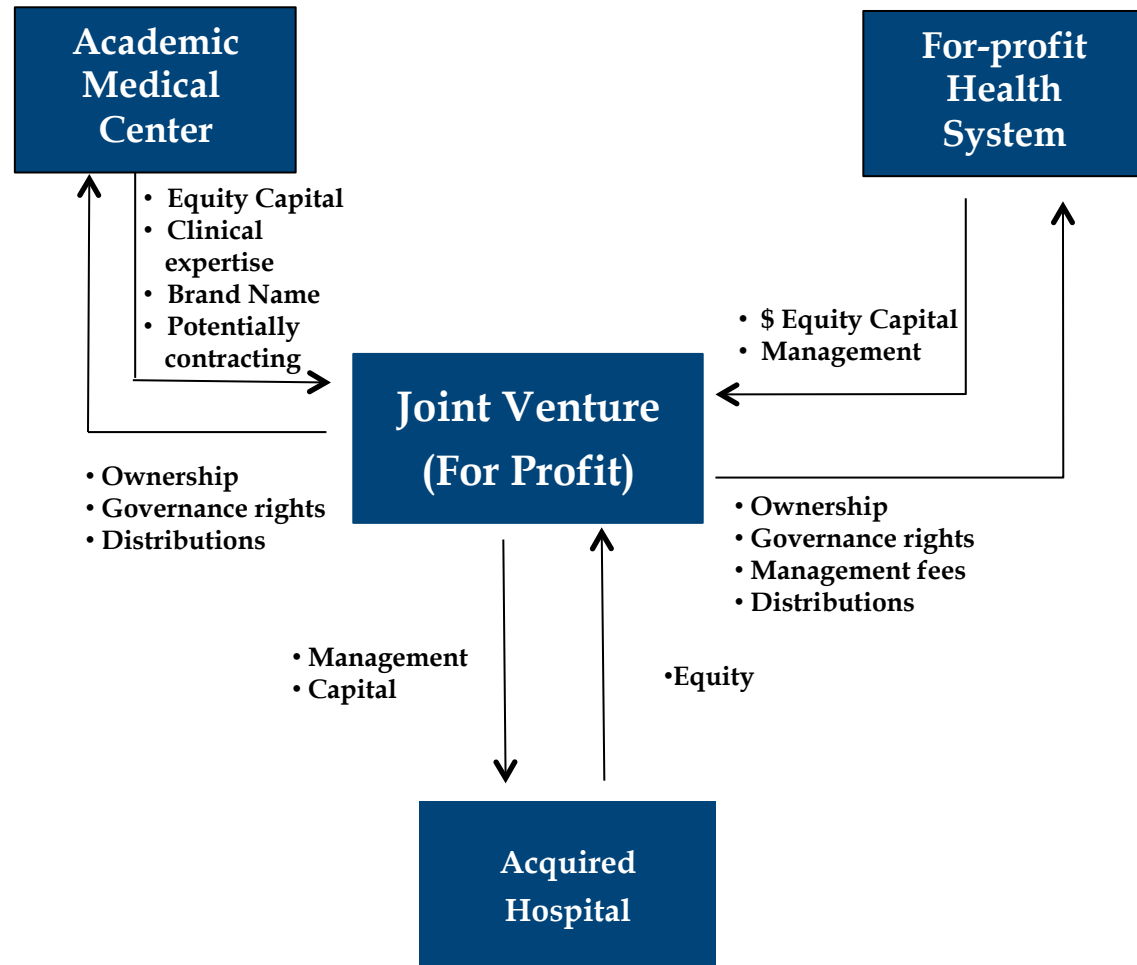


## Academic Medical Center / For-profit Joint Venture

### The Joint Venture Model for Acquisitions

#### Key Transaction Terms

<b>Overview</b>	<ul style="list-style-type: none"> <li>▪ The Academic Medical Center and For-profit health system create a joint venture (for-profit)</li> <li>▪ The joint venture acquires certain assets and assumes certain liabilities of the acquired “target” hospital</li> </ul>
<b>Consideration</b>	<ul style="list-style-type: none"> <li>▪ The joint venture is funded by both parties based on their negotiated JV % interests</li> <li>▪ To benefit from joint contracting, the Academic Partner must own a majority interest in the JV</li> <li>▪ It is most common that the for-profit JV partner will own the majority interest and be the primary capital partner</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>▪ A governing body will be formed to oversee operations of the JOA</li> <li>▪ Each party will have equal representation on the governing body</li> <li>▪ Each Parent retains reserved powers over key decisions</li> </ul>
<b>Other</b>	<ul style="list-style-type: none"> <li>▪ JOA encompasses teaching and research activities and contemplates an academic support payment</li> </ul>



## **Process Considerations**

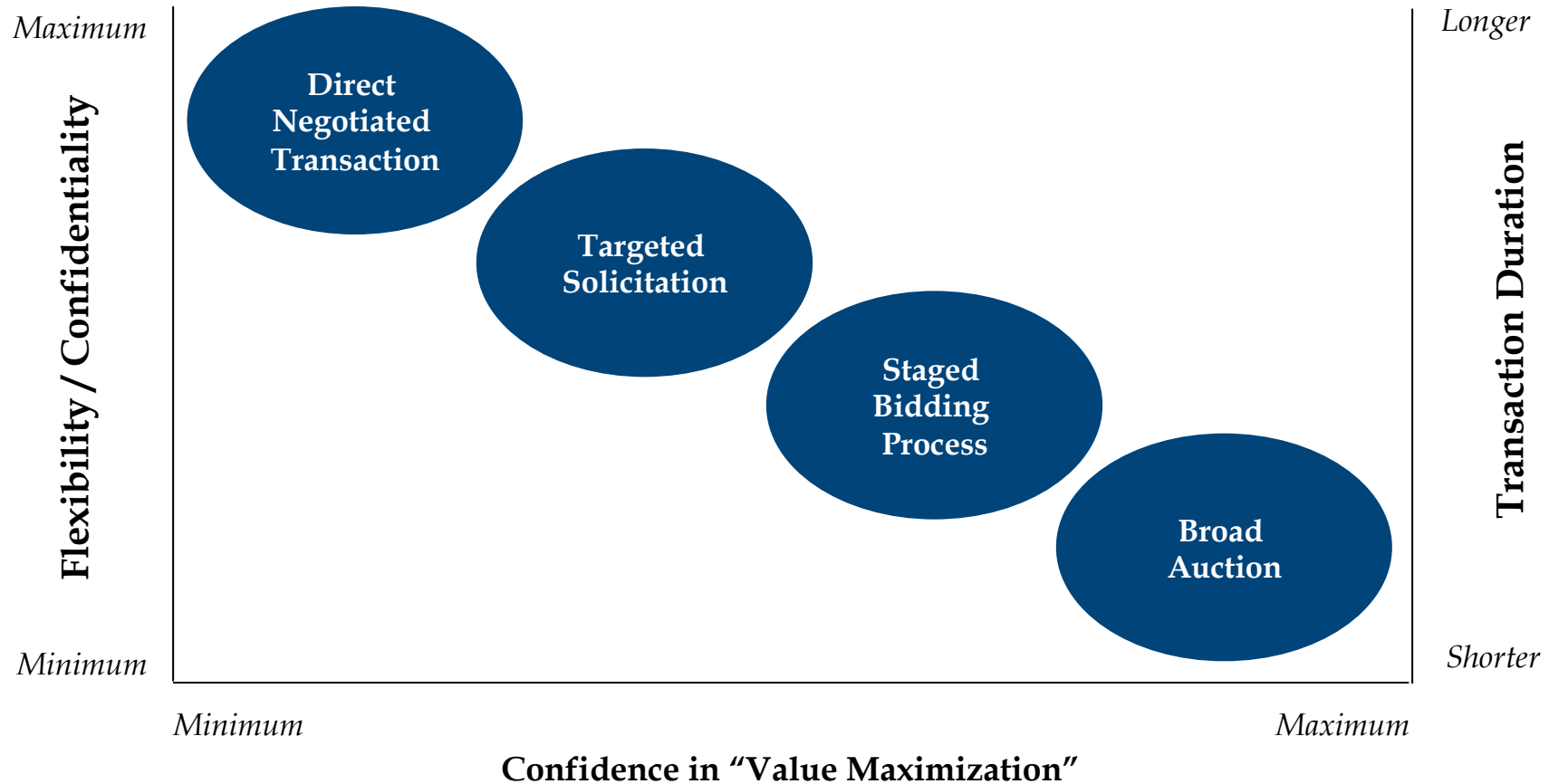


- **Establish Goals and Objectives Upfront**
  - Discussing and establishing a clear and succinct set of core objectives is critical
- **Complete an objective assessment of strengths and weaknesses**
  - Clarify the strengths that would be important to partners and strategic / financial weaknesses or risks that need to be addressed through the affiliation
- **Evaluate the universe of potential partners**
  - Begin with a comprehensive review of all potential partners
  - Focus the list to those that could meet the objectives, improve the position with respect to key weaknesses or risks and is a strong cultural fit
- **Retain experienced transaction counsel and advisors**
  - Experienced legal and financial advisors are expensive but are critical to managing an effective process
- **Complete a thorough due diligence review**
  - Preparing the data for a transaction is time consuming but organizing all critical data and documents in an electronic data room can speed the process and reduce back-end costs
- **Maintain a tight timeline and a controlled process**
  - Establish a transaction cadence that ensures consistent process and drives parties to resolve issues

## Process Considerations

### Various Approaches

While a negotiated approach offers maximum confidentiality and flexibility, a competitive auction produces greater confidence in maximizing financial value through multiple potential proposals



## **Discussion and Questions**