Physician Owned Hospitals:  
Market Analysis/Benchmarking, Valuation Trends, Current Strategies

Kevin McDonough, CFA  
Partner

Colin Park  
Manager

No Relevant Financial Relationships to Disclose.
Presentation Overview

I. Observation & Trends – Healthcare Market

II. Financial & Operational Benchmarking – POH Industry

III. Market Analysis – POH Industry

IV. Valuation Trends

V. What Does the Future Hold?
I. Observation & Trends – Healthcare Market
Current Macro Healthcare Trends

- US Healthcare Spending is out of Control

## 2011 Health Expenditures Per Capita

<table>
<thead>
<tr>
<th>Country</th>
<th>2011 Health Expenditures Per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States of America</td>
<td>$8,233</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>$6,712</td>
</tr>
<tr>
<td>Norway</td>
<td>$5,391</td>
</tr>
<tr>
<td>Switzerland</td>
<td>$5,297</td>
</tr>
<tr>
<td>Netherlands</td>
<td>$5,112</td>
</tr>
<tr>
<td>Denmark</td>
<td>$4,467</td>
</tr>
<tr>
<td>Canada</td>
<td>$4,443</td>
</tr>
<tr>
<td>Germany</td>
<td>$4,342</td>
</tr>
<tr>
<td>France</td>
<td>$3,997</td>
</tr>
<tr>
<td>Sweden</td>
<td>$3,760</td>
</tr>
<tr>
<td>Ireland</td>
<td>$3,720</td>
</tr>
<tr>
<td>Australia</td>
<td>$3,685</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>$3,433</td>
</tr>
<tr>
<td>Finland</td>
<td>$3,252</td>
</tr>
<tr>
<td>Japan</td>
<td>$3,120</td>
</tr>
<tr>
<td>Greece</td>
<td>$3,069</td>
</tr>
<tr>
<td>Spain</td>
<td>$3,057</td>
</tr>
<tr>
<td>Italy</td>
<td>$3,046</td>
</tr>
<tr>
<td>Portugal</td>
<td>$2,729</td>
</tr>
<tr>
<td>Singapore</td>
<td>$2,592</td>
</tr>
</tbody>
</table>

World Health Organization National Health Account database (see http://apps.who.int/nha/database/DataExplorerRegime.aspx)
Current Macro Healthcare Trends

- Healthcare is currently 17.9% of GDP
- Healthcare spending in the United States grew 3.9% in 2011, which was equal to the increase in 2010
- By 2020, national health spending is expected to reach $4.5 trillion and comprise 19.2% of GDP
- Contrary to popular belief, healthcare spending appears to be slowing
In the chart below, year over year growth in healthcare expenditures is shown from 2000 to 2011.

Contrary to projections of out of control growth, healthcare expenditures are shown to be decelerating.
Current Market Observations

- Healthcare is Headed in a New Direction

- Fee-for-Service
- Physicians/Hospitals Acting Independently
- ASC’s Operating Independently
- More Facilities/Capacity
- Shared Savings / Value Based Reimb. / Bundled Payments
- Physicians & Hospitals Collaborating
- ASC’s Becoming Part of the Continuum of Care
- More Efficient Operating Facilities
Drivers of Greater Integration

- Need for Efficiency
- Budget
- Aging of Population
- Changes in Reimbursement
- Value-based Payment
- Economic Climate
- EHR
- Regulatory & Payment Complexity
- Demand for HIT/Capital

Current Market Observations
II. Financial & Operational Benchmarking – POH Industry
Hospitals are beginning to rely less on revenue growth to enhance their margins.
Hospitals are having to become more efficient with expenses to fight declines in reimbursement.
# Benchmark Analysis – POH

## VMG Benchmarking Analysis

### Operating Expenses as a Percentage of Net Revenue

<table>
<thead>
<tr>
<th></th>
<th>FY 2010</th>
<th>FY 2011</th>
<th>FY 2012</th>
<th>TTM 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Employee Salaries &amp; Benefits</strong></td>
<td>23.9%</td>
<td>24.7%</td>
<td>24.7%</td>
<td>24.7%</td>
</tr>
<tr>
<td><strong>Drugs &amp; Medical Supplies</strong></td>
<td>23.9%</td>
<td>24.7%</td>
<td>24.4%</td>
<td>24.3%</td>
</tr>
<tr>
<td><strong>General &amp; Administrative</strong></td>
<td>17.2%</td>
<td>16.9%</td>
<td>17.3%</td>
<td>17.6%</td>
</tr>
<tr>
<td><strong>Occupancy Costs</strong></td>
<td>5.9%</td>
<td>6.0%</td>
<td>5.7%</td>
<td>5.4%</td>
</tr>
<tr>
<td><strong>Other Operating Expenses</strong></td>
<td>2.3%</td>
<td>2.7%</td>
<td>2.9%</td>
<td>2.8%</td>
</tr>
<tr>
<td><strong>EBITDA Margin</strong></td>
<td>26.7%</td>
<td>25.1%</td>
<td>25.0%</td>
<td>25.3%</td>
</tr>
</tbody>
</table>
Benchmark Analysis – POH

VMG Benchmarking Analysis

### Operating Expense Growth (YoY)

<table>
<thead>
<tr>
<th></th>
<th>FY 2010</th>
<th>FY 2011</th>
<th>FY 2012</th>
<th>TTM 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Salaries &amp; Benefits</td>
<td>-</td>
<td>12.7%</td>
<td>6.7%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Drugs &amp; Medical Supplies</td>
<td>-</td>
<td>12.3%</td>
<td>5.2%</td>
<td>0.9%</td>
</tr>
<tr>
<td>General &amp; Administrative</td>
<td>-</td>
<td>6.8%</td>
<td>9.5%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Occupancy Costs</td>
<td>-</td>
<td>10.1%</td>
<td>1.5%</td>
<td>-3.4%</td>
</tr>
<tr>
<td>Other Operating Expenses</td>
<td>-</td>
<td>25.7%</td>
<td>13.5%</td>
<td>-1.3%</td>
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<tr>
<td>EBITDA Margin</td>
<td>26.7%</td>
<td>25.1%</td>
<td>25.0%</td>
<td>25.3%</td>
</tr>
</tbody>
</table>
Total Debt Ratio (Debt/Assets)

Revenue growth allowing Hospitals to pay down debt – continued deleveraging from recession

Result of low interest rates
Benchmark Analysis – POH

VMG Benchmarking Analysis

Average Surgical Case Volume Growth

+4.5%  +2.2%  +1.2%

Net Revenue per Surgical Case Growth

+4.5%  +3.3%  +0.2%

FY 2010  FY 2011  FY 2012  TTM 2013

FY 2010  FY 2011  FY 2012  TTM 2013
Benchmark Analysis – POH

VMG Benchmarking Analysis

Surgical Case per OR Growth

- FY 2010: 9,800
- FY 2011: 10,000
- FY 2012: 10,200
- TTM 2013: 10,400

Growth:
- +4.0%
- +3.0%
- +1.0%

Net Revenue per OR Growth

- FY 2010: 90,000
- FY 2011: 95,000
- FY 2012: 100,000
- TTM 2013: 105,000

Growth:
- +8.7%
- +6.4%
- -2.7%
Benchmark Analysis – POH

VMG Benchmarking Analysis

Surgical Cases per Bed Growth

- FY 2010: 4,200
- FY 2011: 4,300
- FY 2012: 4,400
- TTM 2013: 4,600

Growth:
- FY 2010 to FY 2011: +5.3%
- FY 2011 to FY 2012: +5.2%
- TTM 2012 to TTM 2013: +2.5%

Net Revenue per Bed Growth

- FY 2010: $30,000
- FY 2011: $32,000
- FY 2012: $34,000
- TTM 2013: $38,000

Growth:
- FY 2010 to FY 2011: +13.4%
- FY 2011 to FY 2012: +7.8%
- TTM 2012 to TTM 2013: -1.3%
III. Market Analysis – POH Industry
Current Market Observations

- Current Macro Healthcare Trends
  - Supply of New Physicians will Likely not Meet Demand

![Projected Physician Supply and Physician Demand](image)

*This analysis includes the effects of healthcare reform*
Current Market Observations

- Current Macro Healthcare Trends
  - Aging Physician Demographic Will Further Limit Recruitment & Volume

Demographics of the Physician Workforce

Source: “Physician Characteristics and Distribution in the US” by American Medical Association
(2011 Edition)
Physician-Owned Hospitals

- New Competition: Growth in Hospital Employment

Other Competitors Include:
- ASCs
- General Acute Care Hospitals
- Other POHs
POHs Compete with ASCs for the Same Physician Investor Pool

- Growth in ASCs and POHs has Far Exceeded Growth in the Physician Pool

Number of Eligible Physicians per ASC/POH

- 2-3% Annual Growth in Eligible Drs
- >40% Decline In Eligible Drs Per ASC/POH
Physician-Owned Hospitals

➤ The Good News

- POHs are a part of a “Market Driven” solution
- A Superior Cost-Benefit Equation
- Demonstrated Higher Quality and Superior Patient Outcomes
- Higher Community Benefit
- Lower Costs
- Newer and More Efficient Facilities
- High Profit Margins – More Room for Error
- Pent-up Demand
- Survivors will Emerge Stronger
- Creation of new Capacity Winding Down
Physician-Owned Hospitals

- Now, The Bad News - POHs Still Face Numerous Obstacles
  - Long-term Impact of Healthcare Reform
  - Competition is Fierce for Specialists in Common POH markets
  - Reimbursement is Challenging Across Most Markets
  - Cost Savings = More Reimbursement Cuts/Denials
  - Patient Volumes in some Markets Continue to be Soft
  - Expect to See Fewer Elective Procedures
  - Physician Availability is Declining as Facilities Proliferate
  - Physicians are Trending Towards Hospital Employment
  - Unconventional Competition is Increasing
IV. Determining the Value of POHs
How is the Value of your Hospital Measured?

- **Cost Approach**
  - Provides a Floor for Value – Tangible Assets + Identifiable Intangibles

- **Income Approach**
  - Discounted Cash Flow Value – Measure Future Benefits of Ownership

- **Market Approach**
  - What are Transaction Values of Comparable Companies

_Fair Market Value Opinion should Consider these Three Approaches to Value_
Income Approach

- Keys to Value
  - **Future Cash Flow** – The ability of the hospital to generate cash flow to the investor after all operating expenses, capital requirements, and debt service
  
  - **Risk** – The likelihood of projected levels of cash flows realized given the operating and strategic environment under which the hospital operates
Primary Factors Affecting Future Cash Flow

- Historical Performance Trends
- Payor Mix – Mgd Care Strength
- Historical Recruitment Efforts/Ability
- Case Mix / Service Line Mix
- Market Patient Demographics
- Ownership Flexibility
- Growth Potential
- Facility Capacity
Income Approach

➢ Primary Factors Affecting Risk

- Financial Leverage (Debt Load)
- Physician Diversification
- Reliance on Non-Owner Physicians
- Service Line Diversification
- Out-of-Network Exposure
- Market Competition
- Barriers to Entry (CON)
- Stable Past Performance (Longevity)
- Healthcare Reform
- Facility & Equipment Age / Condition
- Legal / Partnership (Non-Compete)

Income Approach
The characteristics of each POH will dictate the appropriate strategic response and their position in the value spectrum.
How facilities manage and adjust to these and other realities will determine whether they become more or less valuable.

Primary Impact on Valuation

1. Limitation on physician ownership strengthens the value of grandfathered JV facilities that start strong (+)
2. Reimbursement cuts in high volume/high margin procedures reduces margins and value (-)
3. Reduction in elective procedures to manage costs reduces margins and value (-)
4. Continued push into outpatient settings to reduce payments (+)

Income Approach
Market Approach

ASC Acquisition History

Merger & Acquisition Trends
Hospital M&A activity has been driven by market consolidation, healthcare reform initiatives and cheap capital.
Activity has steadily risen over the last 5 years and was exceptionally high in 2012.
The number of large, multi-site “chain” transactions has risen.

**Hospital Merger and Acquisition Trends**

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Deals</th>
<th>Facilities Involved</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>60</td>
<td>163</td>
</tr>
<tr>
<td>2003</td>
<td>68</td>
<td>100</td>
</tr>
<tr>
<td>2004</td>
<td>81</td>
<td>164</td>
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<tr>
<td>2005</td>
<td>85</td>
<td>172</td>
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<tr>
<td>2006</td>
<td>107</td>
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<td>2007</td>
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<tr>
<td>2008</td>
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<td>139</td>
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<tr>
<td>2009</td>
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<tr>
<td>2010</td>
<td>89</td>
<td>227</td>
</tr>
<tr>
<td>2011</td>
<td>92</td>
<td>212</td>
</tr>
<tr>
<td>2012</td>
<td>109</td>
<td>352</td>
</tr>
</tbody>
</table>
Market Approach

- Hospital Transaction Market

  - Transaction multiples have been on the rise.

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**Acute Care Hospital Transactions (2009-April 2013)**

- **Average:** 0.8x 1.0x 1.1x
- **Median:** 0.8x 1.0x 1.1x
- **Number of Transactions:** 32 17 6

Source: VMG Research, Irving Levin Associates
Market Approach

- Recent Stock Performance has Fueled Rising Values
  - Both publicly traded and private companies are keenly aware of their Wall Street value
  - Recent growth in transaction multiples largely driven by rising public equity valuation
Market Approach

- Recent Stock Performance has Fueled Rising Values
  - Both publicly traded and private companies are keenly aware of their Wall Street value
  - Recent growth in transaction multiples largely driven by rising public equity valuation
Hospital Share Prices Reflected the Good News from the Passage of the Healthcare Law
ASCs continue to have strong performance against the S&P regardless of Healthcare Reform
POH Valuation Trends

- Primary Impact on Valuation

POH Valuation Trends as Multiple of EBITDA

- Acquisition Multiples have remained High but Widened
- Minority multiples have Declined and Widened
IV. What Does the Future Hold
Future of POHs

Attracting Physician Investment & Volume will be the Greatest Challenge

Increase in Mergers & Limited Failure

Survival of the Fittest will Favor POHs in Large Markets

As Low Cost Provider, POHs Will Have a Seat at the Table

Outside of the Box Options

Focus Efforts on Implementing Efficiencies

Strong POHs will Remain Well Positioned
The Physician Owned Hospital Market Has Evolved...
New Strategies Emerge

- Non-Medicare certified physician owned hospital
  - Some states don’t require Medicare licensure
  - May be out-of-network with payers and still be successful
  - Success stories in Texas, Arkansas, etc

- Indirect Ownership Methods – Professional Service Arrangements
  - Real estate / Equipment Leasing Arrangements
  - Comprehensive Management Relationships

- Physicians as the Providers of Service
  - Physicians lease surgical time from non-physician owned hospital
  - Limited payer acceptance
New Strategies Emerge

- Physician Affiliation thru Employment
  - POHs have begun to explore ways to affiliate with physicians without offering direct equity ownership

- The Patient Bed Shuffle
  - Pursuit of growth and capacity by swapping patient beds for operation rooms

- The Public Equity Market Strategy
  - Roll-up IPO strategy
  - Hospital merger into a large corporation that could be traded on the stock market — essentially converting their physician shares into a publicly held company
Summary

- Growth restrictions imposed by the PPACA will have varying impact on existing POHs
- Besides gov’t legislation, in-market consolidation by large systems will pose greatest threat
- Given their scarcity, POHs in certain markets will drive significant interest from buyers
- POHs specialized nature and efficiency will serve them well in an environment that increasingly will stress cost containment and quality
- Independent POHs will have greatest exposure to risk and we’ll see increasing affiliations between independent POHs and health systems
- Entrepreneurial spirit that serves as the bedrock of the POH industry will ensure that these facilities will continue to thrive
Questions?

Kevin McDonough, CFA
Partner
KevinM@vmghealth.com
214.369.4888

Colin Park
Manager
ColinP@vmghealth.com
214.369.4888