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Acute Care Hospitals: Exciting Times Ahead

In June 2015, the Medicare Payment Advisory Commission ("MEDPAC") issued a report to Congress titled "Medicare and the Health Care Delivery System," that analyzed the current state of healthcare services delivery and identified three factors of great importance to healthcare providers:

1. **A forecasted rapid increase** from 2016 onwards in the percentage of the total population of Medicare-Eligible aged 65+.
2. **A significant decline** starting in 2009 in the number of workers per Medicare Part A (hospital) beneficiaries.
3. **The aging** of the Medicare-eligible population, after years of decline, to begin in about 2020.

What MEDPAC did not examine that we did are the implications of these three trends for healthcare providers regarding utilization and cost-shifting.

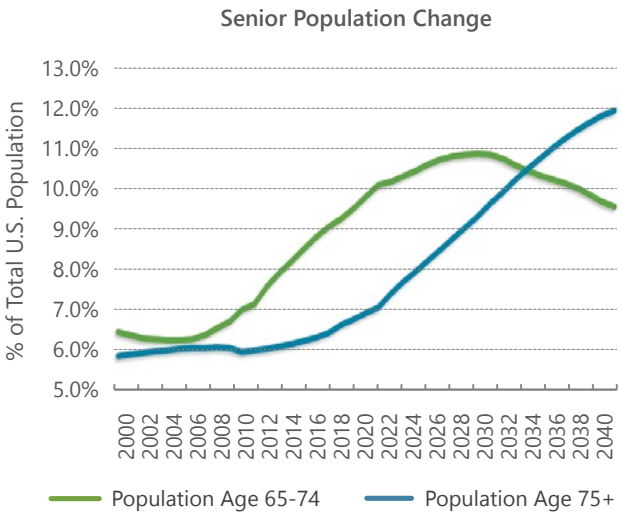
Demographics • More Utilization Ahead

Until recently, many hospitals across the nation experienced flat or declining inpatient admissions among seniors. At least some of this reduction is the result of a decline in the average age of the senior population since about 2006. In addition, the impact of increasing outpatient utilization, shorter average lengths of stay ("ALOS") and Medicare observation day requirements have helped reduce inpatient utilization. Demographic changes aside, whether this trend could or would continue is yet unknown.

While it is clear that the U.S. population as a whole is aging, what is unclear is the potential impact of the rise of older seniors on healthcare providers.

Exhibit 1 illustrates that beginning around 2020, the Medicare-eligible senior population will begin aging rapidly in a trend that will last until around 2040.

Exhibit 1: Projections • Changing Demographics



Source: Census Bureau 2012

Seniors in total utilize inpatient services at more than three times the rate of non-seniors and more than five times the rate of the typical commercially-insured enrollee. Furthermore, the rise of seniors over the age of 75 is an extremely important trend because those seniors utilize inpatient services at about twice the rate of seniors below the age of 75. This fact is crucial, as commercially-insured workers tend to underwrite healthcare providers' costs because commercial rates tend to be significantly higher than government rates for the same services. The declining percentage of workers in relation to Medicare-eligibles exacerbates this problem. Similar differences in utilization exist with other types of healthcare services, with the exception of long term care services, which are consumed predominantly by those aged 75 and above.

Exhibit 2: Comparative Inpatient & ER Utilization Rates

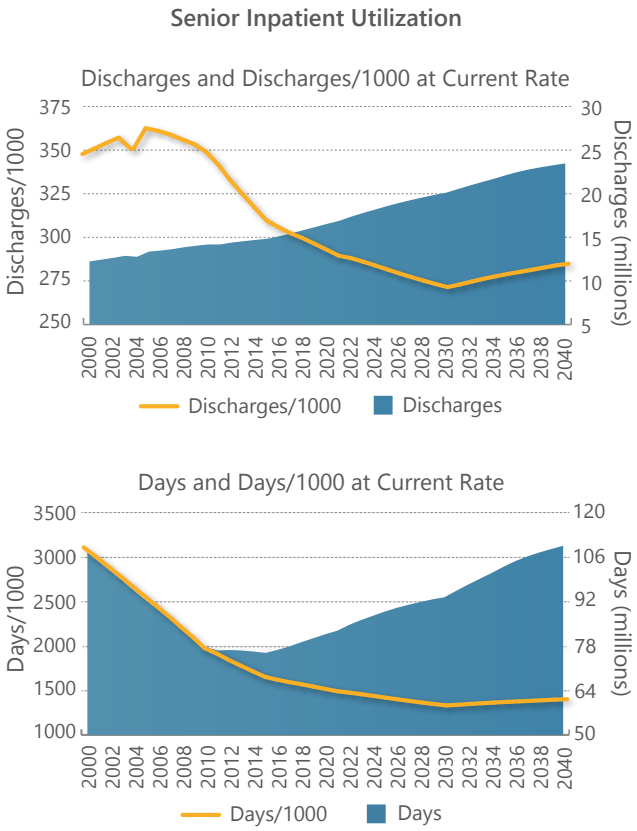
	Population Age Cohort		
	<65	65-74	75+
Inpatient Discharges / 1000	93	253	464
ALOS	4.6	5.2	5.6
Inpatient Days / 1000	424	1,317	2,614
ER Visits / 1000	388	398	651

Sources: CDC, NCHS, 2012 National Ambulatory Medical Care Survey. CDC, NCHS, National Hospital Discharge Survey: 2006 Annual Summary, December 2010. CDC, NCHS, National Hospital Ambulatory Medical Care Survey: 2011 Emergency Department Summary Tables. CDC, MCHS Data Brief No. 130 October 2013: Emergency Department Visits by Persons Aged 65 and Over: United States, 2009-2010.

As a result of these demographic and utilization trends, hospitals should anticipate substantial increases in inpatient volumes in the future (see Exhibit 3) even when assuming significant continuing reductions in the senior population's admission rates and ALOS. In fact, many hospitals are already experiencing such increases after previous years of decline. However, the rate that admissions and ALOS may decline further for senior patients is debatable. Some experts believe that there remains considerable overutilization of inpatient care which, among seniors, will lead to declines in senior admissions. However, ALOS trends are more difficult to predict as many experts believe that the increasing use of outpatient services may actually result in higher acuity for those admitted for inpatient care and lead to longer lengths of stay.

In either case, admissions and days nationwide could have the potential to increase significantly over the next 25 years according to our analysis, which applies age-related utilization rates to population trend forecasts and continues utilization rate reductions. This could have major implications for providers' long term resource planning.

Exhibit 3: Increasing Utilization Due to Aging Population



Note: Assumes 230 Discharges/1000 and 1,120 Days/1000 for those aged 65-74 and 420 and 2,220, respectively, for those aged 75+. Admits/1000 is assumed to decline by 15%, and ALOS by 10%, respectively, by 2030 and remains flat thereafter.
Source: H2C analysis.

Cost-Shifting Returns

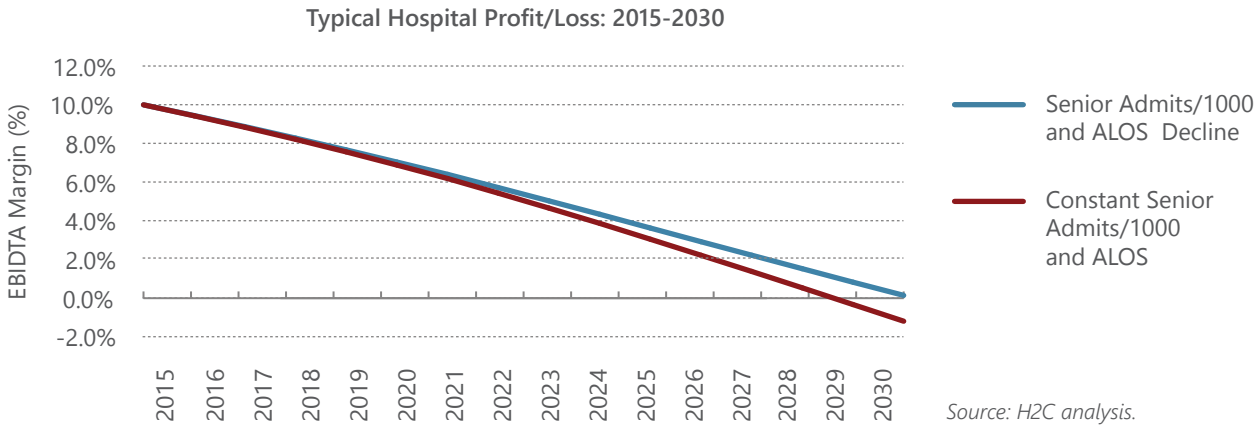
Perhaps even more important and troubling is that many healthcare providers expect government reimbursement to grow at less than one percent annually while healthcare costs, particularly human resource costs, are expected to grow between three and five percent annually. This is especially unsettling, given that for most acute care hospitals, costs appear to be largely variable on increasing volumes and largely fixed on declining volumes.

This challenging reimbursement environment means that acute care organizations that cannot increase commercial rates to offset a less profitable government business will face growing financial hardships. However, those health systems that enjoy competitive positions that have traditionally allowed cost-shifting to make up the difference, risk causing increases in commercial health insurance premiums, or patient out-of-pocket costs, of a magnitude that might reasonably invite adverse legislation or regulation. In both cases, increasing utilization will require significant additional capital and investment.

The following Exhibit 4 illustrates the prospective financial performance, represented by EBITDA, of a "typical" acute care hospital's inpatient business assuming: (a) senior admits/1000 decline by 15% and senior ALOS declines by 10% by 2030; and (b) no change in senior inpatient utilization rates by 2030. The analysis assumes "representative" charges and revenues per senior and non-senior admission, costs related to charges that yield a 10% EBITDA margin, an 80% variable cost assumption (excluding capital), medical cost inflation of 3% p.a., Medicare reimbursement growth of 1% p.a. and non-senior reimbursement growth of 3% p.a. (which is a mix of Commercial and Medicaid.)

This analysis implies that hospital profitability is likely to suffer as a growing senior population consumes increasing amounts of expensive resources that are reimbursed by Medicare at rates growing at less than healthcare cost inflation. Any potential further decline in senior utilization rates help offset only some of this unfavorable trend.

Exhibit 4: Hospital Cost / Loss Model



Source: H2C analysis.

Causes and Solutions

To be an acute care provider today is to provide a service that is both vitally important and in high demand. But it also represents a cost that payors and employers are trying to reduce either by cutting reimbursement, creating ways to move business to lower cost of service venues such as outpatient or urgent care settings, or finding ways to pre-empt the need for acute care services altogether.

Case-rate reimbursement, bundled payments, value-based reimbursement, pay-for-performance, ACOs, shared-savings, capitation (for professional services but usually not for hospital-based services) are all intended to address healthcare costs in general and acute inpatient costs specifically. Even the enormous private investment into healthcare technology often funds investment intended to avoid or lessen the need for acute care services.

While the problem acute care hospitals face might seem to be a central challenge between under-reimbursement and growing costs, the real issue is the undeniable fact that the traditional fee-for-service reimbursement model promoted incentives that ran contrary to good medicine and good business. Without fundamental change to the fee-for-service reimbursement model, providers cannot rationally change behaviors. For example, a focus on cost control, utilization management and use of least-cost alternatives, much of which defines success under a "population health" model, is frequently contrary to a hospital's self-interest unless there is a clear path to market share gain, which there seldom is because access to the market is controlled by health plans. Similarly, the current separation of insurance from the provision of services does little to address the fundamentally important role that only providers can play in engineering more efficient care that results in reduced utilization of costly services and higher quality. To do that, providers would need to take risk and be compensated much more generously for it than they currently are under value-based reimbursement programs.

The forecasted trends in demographics, utilization and reimbursement will produce winners and losers. Winners will come in two flavors: Those that can find ways to deliver cost effective care at acceptable quality; and those who can provide the very high levels of customer service, perceived quality and consumer engagement for which consumers might pay a premium. How to achieve this while controlling or reducing the cost of service, making the large investments necessary, and dealing with growing demand is an enormous challenge for hospitals. In any case, providers' direct access to the consumer and employer market will be critical. Fortunately, never before has there been a time when the provider network has been such an important part of product differentiation. This works to providers' advantage. How to navigate this competitive landscape, gain more direct access to the market, raise capital and secure the right partnerships to make all this happen are the key strategic questions.

How H2C Can Help

Changing fee structures and other challenges facing healthcare providers and payors, and the employers, governments and individuals that fund the healthcare system, will make health care an ever more exciting business over the next decade. The professionals of H2C have been providing strategic and capital markets advice to healthcare providers since the 1980s. We have personally experienced and helped our clients navigate the many changes that have occurred since then. The future is certain to be even more challenging than the past.

Unlike many other firms, H2C focuses on the strategic context for financings, acquisitions, divestitures and joint ventures. A common starting point for our engagements is to work with our clients' management teams to develop a strategy assessment that sets forth options, opportunities and risks. While this work may sometimes lead to a strategic transaction, it often does not because not every problem can be solved by a merger. Each client's particular circumstances and goals shape the scope of the project.

H2C has two unique abilities in helping our clients to make the best decisions: First is the ability to help our clients bring the focused attention necessary to organize senior leadership's views, perspectives and ideas into actionable plans. Approaching an engagement from this starting point is based on the premise that a provider's senior leadership team is likely to have a great deal of knowledge and depth of experience but is often pulled in many different directions. The challenge is to elicit and organize that depth of capability. Second, H2C has the ability to *quantify* the implications and results of various strategic alternatives. Measuring and evaluating the return on investment, energy and time is frequently absent from many strategic planning processes but is critical to determine how realistic and achievable a given course of action might be.

H2C would be pleased to discuss with you the challenges and opportunities facing your organization. H2C is committed to our clients' success and can demonstrate our value to your strategic thinking as your organization navigates the future.

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About H2C

HAMMOND HANLON CAMP LLC ("H2C") is an independent strategic advisory and investment banking firm with an exclusive focus on healthcare services companies and related organizations. Our commitment to exceed our clients' expectations begins with senior leadership on every engagement and continues with independent and objective strategic advice. Our belief in the markets and in the power of competition has resulted in loyal clients and long-term relationships.

The experienced professionals at H2C are well positioned to serve as trusted advisors to healthcare providers. We have the expertise to understand the unique complexities of the healthcare industry and an in-depth knowledge of the range of potential alternatives essential to designing and implementing highly successful business strategies. We bring in-depth knowledge and experience across the full continuum of care and across those businesses that support healthcare providers.

H2C offers services in the following areas:

- Strategy design, development and execution
- Mergers, acquisitions and divestitures
- Capital planning and management
- Capital markets financial advisory and private placements
- Real estate
- Bankruptcy and restructuring

Contact Us

With offices in New York, Atlanta, Chicago and San Diego, the professionals at H2C are committed to providing superior strategic and financial advice as a trusted advisor to the healthcare community.

If you would like to know more about any information in this report, or wish to better understand how H2C's healthcare advisory services can benefit your organization or project, please contact inquiries@h2c.com or visit our website at h2c.com.