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Health Systems Embrace Platforming and Innovative Financing Strategies

Market Corner Commentary
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By David Morlock &
David W. Johnson

In March 2020, we put the finishing touches on a commentary describing innovative capital formation strategies for not-for-profit (NFP) health systems. The research was timely because an increasing number of NFP systems were adopting more flexible funding approaches to develop expansive operating platforms and compete with for-profit and non-traditional competitors.

Then came COVID. Health systems temporarily put aside their strategic investment decisions and prepared for the pandemic. We hit pause on publishing our commentary as the crisis unfolded.

One year later, those strategic decisions are more important than ever. Rather than impede operational transformation, COVID has accelerated the industry's shift to decentralized care, catalyzing a new reliance on virtual, digital, retail and home-based care services.

The migration toward asset-light, tech-heavy care delivery platforms represents a major repositioning for health systems, and a response to the onslaught of retail-savvy, data-informed and customer-focused competitors. New business lines that build out a health system's service platform are now a strategic necessity.

In the race for consumer relevancy, for-profit providers have access to a full range of debt and equity investment vehicles to fund capital investment and growth. Not-for-profit health systems have historically had few alternatives beyond operating cashflows, philanthropy and the issuance of tax-exempt bonds.

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Despite their long duration and low funding cost, tax-exempt bonds are ill-suited for funding consumer-centric delivery platforms. They are ideal for long-lived fixed assets (e.g. hospitals and related equipment) that comply with IRS-imposed use limitations and asset-light requirements. These tax provisions limit or preclude tax-exempt bonds' capacity to fund the shorter duration and/or taxable activities that robust healthcare platforms require. Fortunately, new capital formation vehicles have emerged to meet this compelling need.

As innovative health systems strive to expand their consumer reach through more expansive operating platforms, they are increasingly issuing taxable debt, monetizing assets and leveraging strategic investment partners. Use of these capital formation tools supports strategic growth and flexibility while often generating incremental investment capital and/or reducing facility ownership risk. This article will examine capital strategies that position health systems for future growth and competitive success in a dynamic and challenging environment.

CARE DELIVERY TRANSFORMATION

High-cost, centralized delivery platforms are not well-suited to compete in price-sensitive markets for care services. Despite this known risk, most health systems continue to pursue volume-oriented growth strategies that require ongoing fee-for-service (FFS) payments to achieve targeted ROI levels.

Hospitals, however, are no longer the only choice or even the first choice for care. Instead, lower-cost, decentralized, customer-focused and tech-enabled delivery channels are fast becoming the norm. A wave of innovative competitors is pursuing these models. Consider the following examples:

- Optum Health's recent reported acquisition of Landmark Health for $3.5B represents a move into the home health market, and bolsters its position as the nation's largest employer of physicians in a rapidly growing national care delivery network.
- The Teladoc-Livongo merger creates a new virtual care company that combines telehealth services with remote monitoring and chronic care management services.
- Cigna's acquisition of MDLIVE fortifies its ability to deliver telehealth.
- Humana's partnership with DispatchHealth expands its capacity to provide home-health services.
- HCA continues to make notable investments in home health, hospice and outpatient therapy services.
- One Medical is expanding the reach of its clinics into new markets with a virtual care service called One Medical Now.
- Walgreens is accelerating its rollout of VillageMD with more than 600 clinics in thirty markets over the next four years.

These investments represent significant bets that healthcare's future is more digital, retail and asset light. The current market capitalization of Teladoc-Livongo ($40 billion on projected 2021 revenues of $2 billion with modest profitability) is a striking example of that confidence. Investors understand that high-cost, centralized business models cannot compete effectively with more nimble service providers that offer convenient routine care at lower prices with great customer service.

This poses a challenge to traditional health systems that receive premium prices for routine care. Many hospitals still maximize revenues by optimizing complex third-party FFS payment formularies, not by competing for customers based on value. In FFS healthcare, hospitals prosper by owning facilities and controlling production.

Traditional hospital operators find the "volume-to-value" shift disorienting and disruptive. Despite giving lip service to value-based care delivery, too many cling to FFS-dependent business models. This has created an oversupply of acute care capacity in America, which makes traditional hospital operators increasingly vulnerable to nimbler, lower-cost, customer-friendly competitors.

In response to these changing market dynamics, enlightened health systems are adding a "platforming" approach to delivering healthcare services. Platform health companies link capabilities within integrated networks to offer a more seamless and consumer-focused experience.

In a consumer-driven marketplace, health systems differentiate themselves through brand strength, price and customer experience. Their performance, cashflow and profitability depend on delivering superior outputs at lower costs with robust consumer engagement.

Within this operating paradigm, strategic priorities shift from facility ownership and service line control toward assembling the right configuration of capabilities. That's why leading health systems are expanding their service lines and delivery channels to include physician groups, urgent care clinics, telemedicine services, acute-care-at-home, and other flexible, cost-effective, asset-light delivery channels.

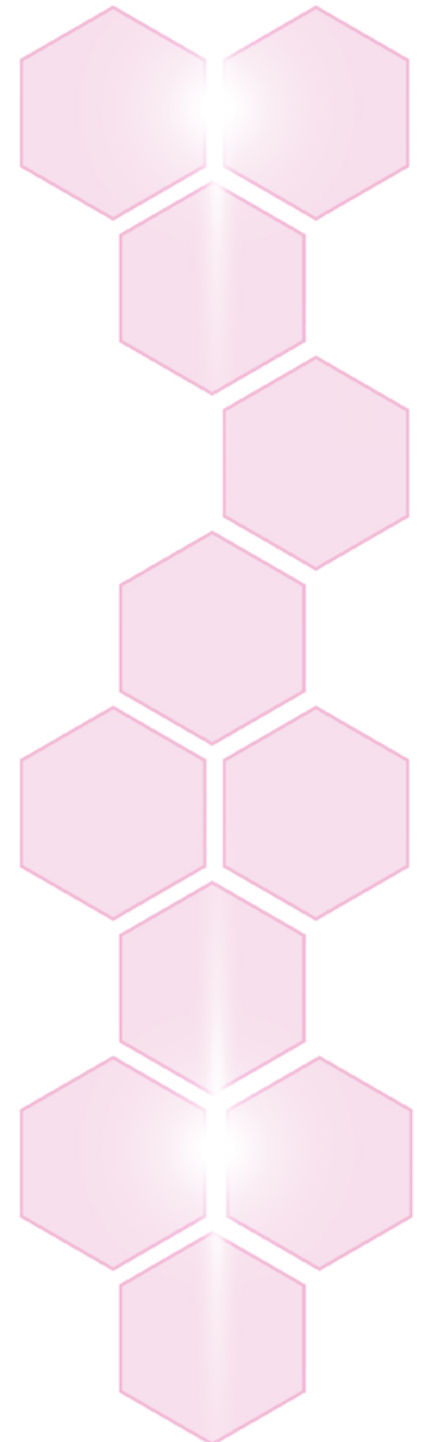
These are not core competencies for traditional healthcare organizations. Health systems must decide which services they should own, outsource, or partner to provide. Getting that formula right requires adaptive capital formation strategies.

MODELS OF PLATFORM-BUILDING CAPITAL FORMATION

Business-as-usual capital formation strategies cannot provide the speed, scale and flexibility necessary to fund evolving asset-light and digitally-enabled business models. Tradition stands in the way of transformation. Managing the complexity of consumer-driven healthcare requires innovative approaches to funding and running new business lines.

In the following examples, health systems used adaptive capital formation strategies to fund and expand their platform capabilities. These types of investments free up capital and position the health systems to compete more effectively on brand, price and customer experience.

Mercy Health and Quest Diagnostics Driven by the desire to reduce its total cost of care and reduce strategic risk associated with the commoditization of lab pricing, Mercy Health intends to sell its outreach lab business to Quest Diagnostics. Post-closing, this will better position Mercy to deliver consumer-friendly, value-based care. Mercy also receives unrestricted investment capital from the asset sale that it can apply to targeted strategic priorities.



Fairview Health Services and AccentCare Seeking growth, capital infusion and better home care and hospice service provision, Fairview Health Services established a joint venture with leading post-acute operator AccentCare in November, 2020. Fairview contributed its home care and hospice assets to the joint venture and AccentCare acquired a majority stake in those assets. This gave Fairview investment capital to apply to other strategic initiatives without the encumbrance of tax-exempt bond rules, improving the health system's competitive profile while strengthening its balance sheet.

Trinity and Premier Health To position itself for consumer-friendly non-hospital-based care, Trinity acquired a controlling interest in Premier Health, one of the leading urgent care operators in the country. The March 2021 acquisition expands Trinity's geographic footprint as well as its portfolio of both urgent care centers and partnerships with other care providers.

Beaumont Health and Alternate Solutions Health Network Recognizing the growing need for home health and hospice services in southeast Michigan, Beaumont Health partnered with Alternate Solutions Health Network (ASHN), a national post-acute solutions provider, to launch Beaumont Home Health and Hospice in January 2019. Their joint venture incorporated Beaumont's home health and hospice assets to establish the health system's equity in the joint venture. ASHN has equivalent arrangements with 20 other health systems.

GoHealth Urgent Care and Multiple Health Systems GoHealth, a national urgent care clinic network, specializes in partnering with health systems to provide consumer-focused urgent care clinics in retail settings. GoHealth's expertise in retail healthcare, optimal staffing, consumer branding and EHR integration facilitates its relationships with numerous systems, including Northwell Health, Legacy Health, Dignity Health, Hartford Healthcare, Novant and Mercy Health.

Jefferson Health and Welltower In January 2020, Jefferson Health and Welltower, a leading real estate investment fund, announced a joint venture integrating financial and clinical strategies. On the financial front, Welltower will acquire some Jefferson Health real estate assets. This will enable Jefferson to fund clinical and academic efforts, such as addressing social determinants of health for aging populations. By providing growth capital, Welltower will accelerate Jefferson's expansion of its network of outpatient clinical services. Meanwhile, Jefferson will support care delivery at Welltower's extensive network of senior living, assisted living and memory care facilities.

CONCLUSION: FUNDING EXPANSION AND GROWTH FOR A NEW ERA

In the not-so-distant past, health systems wondered "How big do we need to be?" to optimize their competitive positioning and financial strength. A successful vision combined investments in new facilities with acquisitions that increased bed count and service volume within fully owned and controlled delivery networks.

That strategic approach is showing its age. In 2017, 50% of hospitals had operating cash-flow margin below 8%, double the percentage from just two years earlier. [1] Business as usual will only get tougher. Health systems cannot be all things to all patients without help.

In the meantime, the transition to value, the rise of consumerism, the expansion of risk-based contracting and the shift away from centralized care settings are accelerating the adoption of business models that emphasize superior outcomes, transparent pricing and the capacity to manage population health and address social determinants of health. New competitors have the resources, focus, scale, flexibility, technology, customer-experience and brand-savvy to succeed in this environment and take significant market share from traditional health systems.

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Health systems must respond by building care delivery platforms that align business capabilities with service offerings. Home care, hospice, post-acute, urgent care, diagnostic labs and ambulatory surgical centers are among the industry segments that are integrating with large, branded platforms to create better service offerings for consumers.

Establishing these networked platforms and investing in new capabilities, technology and brand development requires capital and expertise. As a result, health systems are selling full or partial stakes in their assets and business lines to strategic partners. Even managerial functions and services, such as revenue cycle management, can create new sources of capital and revenue.

These transactions and partnerships provide vital investment capital, optimize service offerings and deepen engagement with consumers. Going forward, success will depend on how adroitly health systems deploy capital to satisfy critical consumer, patient and community needs.

SOURCES

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AUTHORS

David Johnson is the CEO of 4sight Health, a thought leadership and advisory company working at the intersection of strategy, economics, innovation and capital formation. Dave wakes up every morning trying to fix America's broken healthcare system. Prior to founding 4sight Health in 2014, Dave had a long and successful career in healthcare investment banking. He is a graduate of Colgate University and earned a Masters in Public Policy from Harvard Kennedy School. Employing his knowledge and experience in health policy, economics, statistics, behavioral finance, disruptive innovation, organizational change and complexity theory, Dave writes and speaks on pro-market healthcare reform. His first book ***Market vs. Medicine: America's Epic Fight for Better, Affordable Healthcare***, and his second book, ***The Customer Revolution in Healthcare: Delivering Kinder, Smarter, Affordable Care for All*** (McGraw-Hill 2019), are available for purchase on www.4sighthealth.com.

David Morlock is a senior banker in the Firm's Health Systems M&A Group. Mr. Morlock joined Cain Brothers in 2016 with 30 years of experience as a health system executive. His track record includes strategy development, mergers and acquisitions, affiliation agreements, joint ventures, major capital investments, and other unique arrangements tailored to meet the needs of healthcare organizations' specific circumstances. Notable and innovative transactions and advisory engagements include the divestiture of MDwise health plan by Indiana University Health, acquisition of Ohio Valley Health by Alecto, affiliation between Fairview Health and the University of Minnesota, healthcare strategic advisory work for the University of North Carolina, affiliation between ProMedica and the University of Toledo College of Medicine, the University of Michigan Health System sale of M-Care to Blue Cross Blue Shield of Michigan, and the University of Michigan's acquisition of a major research campus from Pfizer. Mr. Morlock is a frequent author of articles and speaker on health care industry mergers and acquisitions and strategic capital insights.

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