Non-Profit/For-Profit Joint Ventures: 
Structuring & Valuing the Deal

Hospitals and Health Systems Law Institute

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These materials and associated remarks are intended to facilitate a general discussion of the legal and valuation issues that may arise in the context of healthcare transactions. They are not intended to be comprehensive or to serve as a substitute for legal or valuation advice, and they should not be relied upon as such. Attorneys, valuators and other professionals need to draw their own conclusions relative to the facts and circumstances of any particular situation when formulating advice.
I. Overview of Non-Profit/For-Profit Joint Venture trends

II. Operational and Financial Considerations

III. Joint Venture Structures

IV. Regulatory and Compliance Issues

V. Valuation Process

VI. Hypothetical Transaction

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Overview of Joint Venture Trends

Market Dynamics Driving Joint Ventures

I. Reimbursement Arbitrage and Flexibility

II. Management Specialization and Expertise

III. Market Response to Healthcare Reform Initiatives

IV. Quality Initiatives

V. Monetization of Non-Core Assets

VI. Synergies

Joint Venture – the cooperation of two or more businesses in which each agrees to share profit, loss, and control in a specific enterprise. Forming a JV is a good way for companies to partner without having to merge, are typically formed to undertake a particular business transaction or project, and are intended to exist for a limited time period.
Overview of Joint Venture Trends

Available Joint Venture Partner Universe

There is an Active Group of For Profit Companies pursuing Joint Ventures with Reputable Non Profits
Overview of Joint Venture Trends

Ambulatory Surgery Center Joint Ventures

<table>
<thead>
<tr>
<th>Top 10 Healthcare Systems (in order)</th>
<th>Number of Hospitals</th>
<th>ASC Management Company Partners</th>
<th>Number of ASCs Joint Ventured</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ascension Health</td>
<td>67</td>
<td>USPI</td>
<td>22</td>
</tr>
<tr>
<td>Catholic Health Initiatives</td>
<td>76</td>
<td>Medical Consulting Group</td>
<td>1</td>
</tr>
<tr>
<td>Trinity Health</td>
<td>49</td>
<td>USPI/Blue Chip Surgical Partners/SCA</td>
<td>13</td>
</tr>
<tr>
<td>Adventist Health System</td>
<td>44</td>
<td>Health Ventures</td>
<td>1</td>
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<tr>
<td>CHRISTUS Health</td>
<td>40</td>
<td>USPI</td>
<td>2</td>
</tr>
<tr>
<td>Catholic Health East</td>
<td>39</td>
<td>Unknown</td>
<td>-</td>
</tr>
<tr>
<td>Dignity Health</td>
<td>39</td>
<td>USPI</td>
<td>25</td>
</tr>
<tr>
<td>Kaiser Foundation Hospitals</td>
<td>37</td>
<td>Unknown</td>
<td>-</td>
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<tr>
<td>Sanford Health</td>
<td>34</td>
<td>Unknown</td>
<td>-</td>
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<tr>
<td>Carolinas HealthCare System</td>
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<tr>
<td>Catholic Healthcare Partners</td>
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<td>Unknown</td>
<td>-</td>
</tr>
<tr>
<td>Providence Health System</td>
<td>32</td>
<td>USPI</td>
<td>2</td>
</tr>
<tr>
<td>Mercy</td>
<td>31</td>
<td>Health Ventures</td>
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</tr>
<tr>
<td>Baylor Health Care System</td>
<td>30</td>
<td>USPI/SCA/Physicians Endoscopy</td>
<td>33</td>
</tr>
<tr>
<td>Sutter Health</td>
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<td>SCA</td>
<td>6</td>
</tr>
<tr>
<td>Marian Health System</td>
<td>28</td>
<td>Unknown</td>
<td>-</td>
</tr>
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</table>

Most of the Top Healthcare Systems have ASC JV Partners

Overview of Joint Venture Trends

USPI ASC Joint Ventures

<table>
<thead>
<tr>
<th>Healthcare Systems</th>
<th># of Centers Joint Ventured</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baylor Health Care System</td>
<td>31</td>
</tr>
<tr>
<td>Ascension Health</td>
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</tr>
<tr>
<td>Memorial Hermann Healthcare System</td>
<td>19</td>
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<tr>
<td>Dignity Health</td>
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<td>Marian Health</td>
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<td>Bon Secours Health System</td>
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<tr>
<td>Centura Health</td>
<td>4</td>
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<tr>
<td>McLaren Health Care</td>
<td>4</td>
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<tr>
<td>NorthShore University Health System</td>
<td>4</td>
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<tr>
<td>Integris Health</td>
<td>4</td>
</tr>
<tr>
<td>North Kansas City Hospital</td>
<td>3</td>
</tr>
<tr>
<td>Christ Health</td>
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</tr>
<tr>
<td>Providence Health System</td>
<td>2</td>
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<tr>
<td>Baptist Health</td>
<td>1</td>
</tr>
<tr>
<td>Christ Hospital</td>
<td>1</td>
</tr>
<tr>
<td>Legacy Health</td>
<td>1</td>
</tr>
<tr>
<td>Saint John’s Mercy Rehabilitation Hospital</td>
<td>1</td>
</tr>
<tr>
<td>Scripps Health</td>
<td>1</td>
</tr>
<tr>
<td>SSM Health Care</td>
<td>1</td>
</tr>
<tr>
<td>Sutter Health</td>
<td>1</td>
</tr>
<tr>
<td>Marian Health</td>
<td>1</td>
</tr>
<tr>
<td>TOTAL (21)</td>
<td>130</td>
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</tbody>
</table>

USPI’s mission is to help health systems deliver high quality outpatient surgery
Overview of Joint Venture Trends

Inpatient Rehabilitation

Examples:
- Select Medical – Baylor
- Centerre – Texas Health Resources
- HealthSouth - Vanderbilt

Key Issues:
- Management
- Efficiency
- Branding
- Capacity
- Market Positioning

Overview of Joint Venture Trends

Imaging

Examples:
- Envision – Texas Health Resources
- SimonMed – Dignity Health

Key Issues:
- Reimbursement
- Pricing
- Management
- Access to Capital
Overview of Joint Venture Trends

Oncology

- Examples
  - US Oncology – Memorial Hermann
  - Vantage Oncology – Tri Health
  - OnCure – Simi Valley Hospital

- Key Issues
  - Reimbursement
  - Management Expertise
  - Strategic Positioning

Overview of Joint Venture Trends

Urgent Care – ER

- Examples
  - Baylor – Emerus
  - OLOL - Premiere
  - Ohio Health – Nextcare

- Key Issues
  - Strategic Location
  - ER Capacity
  - Retail Expertise
  - Market Share
Overview of Joint Ventures

Quotes from Joint Venture Partners

“We do see reception of systems interested in having discussions and we are having discussions. I am not pleased with the speed at which we have been able to add joint ventures. I certainly would commit capital and we are committing to do that”

Bob Ortenzio, CEO – Select Medical

“We seek to improve financial performance at our joint ventures by adding clinical programs that attract commercial payors, centralize administrative functions, and implement standard resource management programs”

Select Medical 2011 10K

“We feel that it is a very low risk way to grow, even in times of uncertainty. Hospitals understand that is going to be a tough reimbursement environment and thinking they ought to unlock the value of services not in the core. Rehab is often one of those services.”

Jay Grinney, CEO – Healthsouth

Operational and Financial Considerations

Issues to Consider

I. Reimbursement Impact

II. Branding

III. Management Expertise

IV. Cost Efficiencies

V. Pros and Cons of Joint Venturing
Operational and Financial Considerations

Reimbursement Impact - 250 ASC Sample

Average Net Revenue Per Case

Without JV Partner

With JV Partner

$1,873

$2,109

12.6%

Source: 2011 VMG Health Intellimarker

Operational and Financial Considerations

Reimbursement Impact - 250 ASC Sample

Ophthalmology Average Net Revenue Per Case

Orthopedics Average Net Revenue Per Case

Gastroenterology Average Net Revenue Per Case

Obstetrics & Gynecology Average Net Revenue Per Case

Source: 2011 VMG Health Intellimarker
Operational and Financial Considerations

Branding and Other Qualitative Factors

I. Joint Ventures can extend the health system brand
II. Health system brand has value
III. Joint ventures allow brand to extend geographically
IV. Health systems are very careful regarding the quality of organization that shares the brand

Management Expertise – Cost Efficiencies

I. Management expertise is valuable in certain niches
II. Outside parties can add efficiencies, billing, and insight
III. Can carve out significant staffing savings
IV. Can centralize management services away from the hospital
Operational and Financial Considerations

Weighing Pros and Cons of Joint Venturing

**PROS**
- Market Share
- Reimbursement
- Expertise
- Capacity Relief / Flexibility
- Geographic Penetration
- Branding

**CONS**
- Lower Effective Ownership
- Regulatory Issues
- Slow Development Process
- Complexity
- Complex Accounting
- Loss of Control

Joint Venture Structures

Typical ASC JV Structure

ASC Mgmt Co 49.9% Ownership

Hospital 50.1% Ownership

ASC Management Company / Health System Joint Venture

51%

51%

51%

ASC #1
Physicians 49%

ASC #2
Physicians 49%

ASC #3
Physicians 49%

Hospital System Payor Contracts

Mgmt Agreements: ASCs & JVs
Joint Venture Structures

Key Considerations on Structuring JVs

– Formation and capitalization
  • Asset versus stock contributions
  • Valuation of contributions
  • State law or bond restrictions on charitable assets
  • Equity / debt structure

– Ownership and governance
  • Tax implications for nonprofit partner
  • Payor contracting
  • Balancing charitable/religious mission
  • Physician ownership

Joint Venture Structures

Key Considerations on Structuring JVs

– Ancillary agreements
  • Management services (typically for-profit partner)
  • Other centralized services (e.g. payor contracting)
  • Leases and other arrangements with partners

– Licensure and reimbursement
  • Free-standing versus hospital-based
  • Assignment versus new Medicare provider agreements
  • Impact on physician ownership and reimbursement
Regulatory and Compliance Issues

Stark Law

— Financial relationship with physician results in prohibition on referral and billing of designated health services to Medicare patients under the Stark Law unless the financial relationship meets an exception

— Stark Law exceptions typically require:
  • Written agreement specifying terms
  • Fair market value consideration set in advance that does not vary based on referrals
  • Commercially reasonable

Regulatory and Compliance Issues

Stark Law

— Will the transaction create financial relationships with referring physicians?
  • Physician ownership
  • Compensation arrangements

— What exceptions apply?
  • ASC procedures
  • Radiologists and radiation oncologists
  • In-office ancillary services
  • Grandfathered whole-hospital ownership
  • Exceptions for compensation arrangements
Regulatory and Compliance Issues

Anti-Kickback Statute

- Prohibits knowing and willful offer, payment, solicitation or receipt of remuneration to induce or reward referrals of services reimbursable by a federal health care program
  - Prohibits remuneration if “one purpose” is inducement of referrals even if other appropriate purposes
  - Certain facts can create inference of improper purpose (e.g. payments greater than fair market value or payments tied to volume or value of anticipated referrals)
- Important to consider:
  - Commercial reasonableness
  - Documentation of fair market value
  - No special treatment related to volume or value of referrals

Regulatory and Compliance Issues

Anti-Kickback Statute

- Are parties in position to make referrals to each other?
  - Referrals from facilities owned by partners
  - Referrals from JV facilities
  - Referrals from physician owners or hospital employed physicians
- Is there an applicable safe harbor?
  - ASC ownership safe harbor
  - Personal services and management contracts safe harbor
- Compliance with OIG guidance?
  - OIG advisory opinions, compliance guidance and fraud alerts
  - Any indicia of improper intent to induce referrals?
Regulatory and Compliance Issues

Tax Exempt Issues

– Contribution of charitable assets
  • Must be at fair market value
  • May require Attorney General approval under state law

– Activities of JV attributed to nonprofit partner
  • Income will be treated as taxable unrelated business income unless activities are substantially related to charitable purposes
  • If JV is a substantial part of nonprofit partner’s activities, it could also impact overall tax exempt status

– Remuneration paid by nonprofit partner
  • Purchase price, management fee, etc.
  • Must be fair market value to ensure no private inurement issues

Regulatory and Compliance Issues

Tax Exempt Issues

– Are JV activities substantially related to charitable purposes of nonprofit partner?
  • Nature of activities – are they consistent with charitable activities contemplated by IRS (e.g. direct patient care)?
  • Governance control – can nonprofit partner ensure that activities will be solely in furtherance of charitable purposes?

– Key governance considerations from St. David’s case and Rev. Rul. 2004-51
  • Board control
  • Reserved powers
  • Term of management agreement
  • Charity care policies
Regulatory and Compliance Issues

Antitrust Issues

– Analysis of JV formation
  • Are JV partners currently competitors?
  • How is competitively sensitive information treated during transaction – limitations on sharing of information, third-party analysis of sensitive information?
  • Does JV result in concentration of market power that may be subject to challenge?
  • Does JV transaction require Hart-Scott-Rodino filing?
  • Will FTC / DOJ require any divestiture of facilities?

Antitrust Issues

– Analysis of JV activities
  • Key concern is concerted payor contracting between partners and JV
  • Concerted activities must be related to business interests of JV rather than separate business interests of the partners
  • Copperweld Doctrine protection when there is unity of interest between partner and JV (typically requires majority control)
Regulatory and Compliance Issues

Licensure and Reimbursement Issues

– Hospital-based facilities must comply with Medicare provider-based rules
  • Requirements on location, integration, signage, etc.
  • Prohibits off-campus joint ventures
  • Limitations on management arrangements
– Free-standing facility options
  • ASC, ITDF, free-standing radiation therapy center, physical therapist in private practice (PTPP), free-standing emergency medical center
  • Services billed through physician practice (e.g. JV provides facility through services agreement)
  • Options may depend on state licensing and payor requirements

Regulatory and Compliance Issues

Licensure and Reimbursement Issues

– Will Medicare or Medicaid provider numbers be assigned, consolidated or new ones established?
  • Impacts assumed liabilities, delays in reimbursement and grandfathered facilities (e.g. hospital-within-hospitals and physician-owned hospitals)
– Limitations on transfer of certificates of need
– Other special reimbursement rules
  • Requirements for LTACHs and rehab hospitals
  • Requirements for Hospitals-within-Hospitals
The Valuation Process

VMG Engaged

Gather
- Discussion on Potential Structure of Agreement
- Introduction to the Target Entity
- Collect Data (Standard Data Request)

Analyze
- Review, Analyze and Adjust Financials
- Review Assumptions and Quantify Performance
- Assess the risk of the Business
- Apply the Cost, Market, and Income Approaches

Benefits of Receiving a FMV

Compliance
- Stark
- Anti-Kickback

Knowledge
- What the target is worth?

Credibility
- Thousands of valuations
- Both sides of the table

Independence
- No emotional involvement
- Just the facts
Market Approach

- Guideline Public Company Method
  - Data gathered from health care M&A research
- Similar Transaction Method
  - Information is also gathered from experience
- EBITDA and Revenue Multiples differ depending on Center Specific Characteristics including:
  - Sector (ASC, Imaging, Phy. Practice)
  - CON
  - Earnings & Margins
  - Specialties/Modalities
  - Number of Owners
  - Number of Centers
  - Size
  - Location

Income Approach

A Discounted Cash Flow ("DCF") Analysis

- Financial Analysis
  - Analyze historical financial and operational performance
  - Adjust Financials to create a base year
  - Remove non-recurring expenses
- Quantitative Assumptions
  - What are factors contribute to the future of the Center (qualitative and quantitative)?
  - What is the expected growth rate and reimbursement trends of the industry?
  - What are the future operating expenses and capital investments requirements?
- Discount Rate
  - Weighted average cost of capital build-up methodology
  - Based on risk of projected cash flows
  - All qualitative and quantitative factors considered (offered services, concentration of owners, revenue and expense projections, demographic and industry factors)
- Run DCF
  - Inclusion of above operating expenses and capital expenditures assumptions
  - Forecast a 5 year projection period and terminal year (operations past 5 years)
  - Apply calculated Discount Rate
Valuation Process Summarized

- **Cost Approach**
  - Value to recreate the business (asset build up)

- **Market Approach**
  - Application of accepted market multiples (Revenue, EBITDA, etc.)

- **Income Approach**
  - Discount Cash Flow analysis

Reconcile appropriate Approach(es) to arrive at

- Total Invested Capital
  - Deduct outstanding interest bearing debt

- Total Equity Value
  - Include Industry data, finalize report, present to management

The Valuation Process

**Standard of Value / Allowable Adjustments:**

**Fair Market Value**
- No buyer synergies
- Considers a typical "hypothetical" buyer
- Revenue / reimbursement changes have to reflect "market" and not a particular buyer
- Expenses have to account for all expenses to operate business as a freestanding business
- Cash Flows have to represent what any willing buyer can generate

**Strategic Value**
- Incorporates synergies to specific buyer
- Hospital based reimbursement would be equal to a specific buyer or group of buyers
- Any reflection of a hospital paying greater than the market could be deemed "paying for referral"
- Under allocating expenses to a business being purchased
Key Takeaway: All Businesses are Not Created Equal with Respect to Valuation Multiples

Acquisition Multiples have remained High but Widened

Minority Multiples have Declined by Widened

It is crucial to understand the level of cash flow being JV’d
Hypothetical Transaction

**Medical Imaging JV**

- **HOSPITAL**
  1. Brand
  2. Location
  3. Physician Base
  4. Manufacturer Relationships
  5. Radiologists

- **JV Partner**
  1. Expertise
  2. Marketing
  3. Billing
  4. Radiologists
  5. Efficiencies

**Valuation Issues**
1. Level of Reimbursement
2. Risk of Future Volume
3. Staffing Levels
4. Management, Billing
5. Facility Lease Rates

**Legal Issues**
1. Contribution structure
2. JV structure / governance
3. Ancillary agreements
4. Licensure / reimbursement

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Questions?