



Sitka Community Hospital SouthEast Alaska Regional Health Consortium

Affiliation Planning — Assembly Presentation

March 21, 2017

Agenda

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III. Next Steps

A Appendix A: Capital Funding Summary Calculations

I. Introduction

I. Introduction

Purpose of Engagement

In Spring 2016, Sitka Community Hospital (SCH) and SouthEast Alaska Regional Health Consortium (SEARHC) retained ECG to develop a combined future vision for healthcare in Sitka, evaluating options for collaboration between the two organizations.

ENGAGEMENT OBJECTIVES

- » Complete an internal and external situational assessment detailing organizational strengths, identifying gaps, and summarizing services and infrastructure opportunities.
- » Align the goals and intentions of each party by developing a combined future vision for healthcare in Sitka
- » Analyze the potential structural options for collaboration and alignment.
- » Recommend a strategic alignment model and provide a roadmap and next steps.

I. Introduction

About ECG



We focus on developing and implementing innovative and customized solutions to meet our healthcare clients' specific challenges, no matter how complex.

Transactions in Past Five Years

 **377** engagements  **228** clients  **41** states

ECG Is Recognized and Trusted by Leading Organizations



10 of the 17 members of *U.S. News & World Report's* Best Hospitals Honor Roll

40 of the 100 Great Hospitals in America as ranked by BECKER'S Hospital Review



With nearly 230 consultants in 10 offices, ECG brings considerable depth and breadth of expertise.

I. Introduction

Partnership Planning Process

SCH and SEARHC are nearing completion of the first of four phases in the planning process for an affiliation.



We are here.

I. Introduction

Recap of Affiliation Efforts

Throughout the affiliation planning process the steering committee, composed of equal representation from SCH and SEARHC, has presented frequent updates to the Sitka Assembly and SCH's and SEARHC's Board of Directors. Feedback from these sessions has been incorporated into the planning efforts.



Steering Committee Members	
SCH	SEARHC
Bryan Bertacchi, Board President (joined January 2017)	Kimberley Strong, Board Chair (joined January 2017)
Rob Allen, CEO	Charles Clement, CEO
Steve Hartford, Director of Operations	Dan Neumeister, COO
Kay Turner, Long-Term Care (LTC) Administrator, Director of Outpatient Services	David Vastola, MD, Mt. Edgecumbe Hospital (MEH) Interim Medical Director

II. Alignment Recommendation

II. Alignment Recommendation

Affiliation Guidance

As the steering committee sought to define a potential SCH/SEARHC affiliation, it considered both the strategic direction crafted over the summer and issues important to the Sitka community.

SHARED VISION AND VALUES

VISION

To become the premier healthcare provider in the communities we serve, improving community health through the sustainable provision of a broad array of high-quality clinical services.

VALUES

Ensure equal access to care for all patients.

Provide services tailored to the needs of patients and the community.

Provide high-quality, culturally appropriate care.

Ensure equitable employment opportunities.

KEY ISSUES IMPORTANT TO THE COMMUNITY

- 1) **Protection of Services** — Process addressing maintaining or expanding healthcare services in Sitka
 - » *Commitment to Provide Services* — Agreement to establish a process addressing proposed changes to the service commitments
 - » *Option to Expand Services* — Process to identify opportunities for service expansion and process to enable SCH or the city to provide services if SEARHC declines
- 2) **Job Stability** — Assurance that all employees will be hired and retained for a period of time
- 3) **Financial Commitments** — Minimization of City and Borough of Sitka's financial risks and obligations
- 4) **Governance and Contract Terms**
 - » *Method for Community Input* — Defining the structure and communication process for the Sitka community to maintain a voice in healthcare decisions
 - » *Protections for Key Policies* — Protection for the community from changes in discrimination-related policies

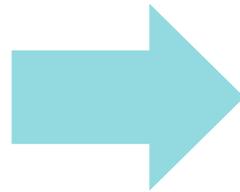
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Affiliation — Hospital Consolidation

Healthcare affiliations have significantly reduced the number of independent hospitals since 2002, a trend that will likely continue.

47%

of hospitals were independent (i.e., not part of a system) in 2002.



34%

of hospitals were independent in 2015.



On average, independent hospitals are smaller than hospitals in a system.

- » *Average beds* —117 in independent hospitals versus 167 in system hospitals
- » *Average IP admissions* — 4,000 in independent hospitals versus 7,000 in system hospitals

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Rural Hospitals — Adjusting to Uncertainty

Rural hospitals will remain vulnerable due to cost containment efforts at the federal, state, and local levels.

32% of U.S. rural hospitals are vulnerable or at risk for closure.¹

SEQUESTRATION

- » In 2013, federal spending cuts went into effect, including a 2% Medicare spending cut.
- » Because of funding deficits, payments for Medicaid claims have historically been delayed by the state, reducing the inflow of cash for operations.

BAD DEBT

- » CAHs were eligible to receive up to 100% reimbursement for bad debt, but the PPACA reduced this in several stages, down to a final reimbursement level of 65%.
- » This cut increased pressure to drive efficiency.

UNCERTAIN REIMBURSEMENT

- » Recent announcements from the state indicated Medicaid cuts of 5% for the FY 2018 budget.
- » Alternative payment models necessitate cost reductions despite Medicare cost-based reimbursement.
- » The market shift to high-deductible plans results in more cost-conscious healthcare consumers.

¹ iVantage 2016 Vulnerability Index, in which 673 rural hospitals are classified as vulnerable out of 2,078 included in the analysis. Accessed via http://www.chartis.com/resources/files/INDEX_2016_Rural_Relevance_Study_FINAL_Formatted_02_08_16.pdf.

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SCH Financial Update

Since the initial assessment of SCH and SEARHC was completed last year, there have been a number of developments at SCH that will have financial implications for the city.

AMOUNT	DESCRIPTION
\$3.4M	Amount needed to purchase an EHR for the hospital, including capital costs, implementation travel costs, and five years of operating costs. A majority of the funding will be requested from the city; the estimate does not include increased staffing expenses for implementation. ¹
\$2M to \$3M	Amount of yearly capital expenditures needed to maintain the SCH plant and equipment and achieve the benchmark age of plant to 10.2 years. SCH's current age of plant is 17.5 years. ²
-\$2.5M	Average annual operating loss from FY 2014 to FY 2016. Operating losses before transfers have ranged from \$800,000 (FY 2017 budget) to \$3.8 million (FY 2016) since FY 2014 (city support averaged \$800,000 during the same time period). ³
-\$5.8M	SCH net position as of January 31, 2017. ⁴

¹ Per the January 2017 Hospital Board Packet detailing the EHR System Proposal from Cerner and the February 2017 Hospital Board Packet indicating that SCH would ask for a loan from the City and Borough of Sitka.

² Based on the FY 2016 fixed asset detail and FY 2016 audited financials detailed depreciation and accumulated depreciation. The benchmark age of plant for a CAH is per the Flex Monitoring Team, which releases an annual report on CAHs by state

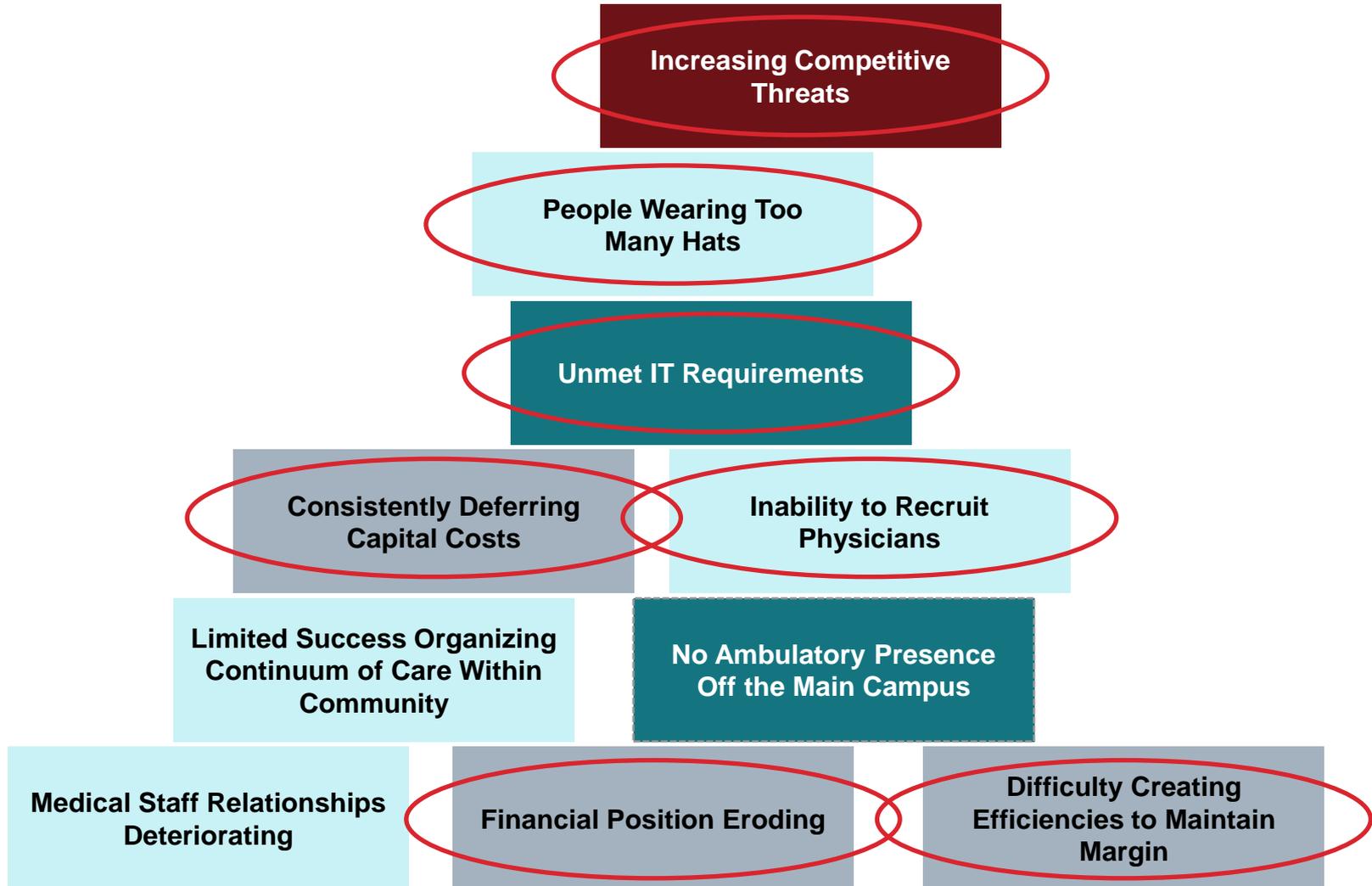
³ Per FY 2017 budget presentation and FY 2014, FY 2015, and FY 2016 audited financial statements. FY 2016 financials include a \$3 million expense accrual related to the pension liability.

⁴ Per SCH January 2017 Financial Reporting Package.

Increased support from the city or meaningful reductions in operating expenses will be necessary to balance the SCH budget.

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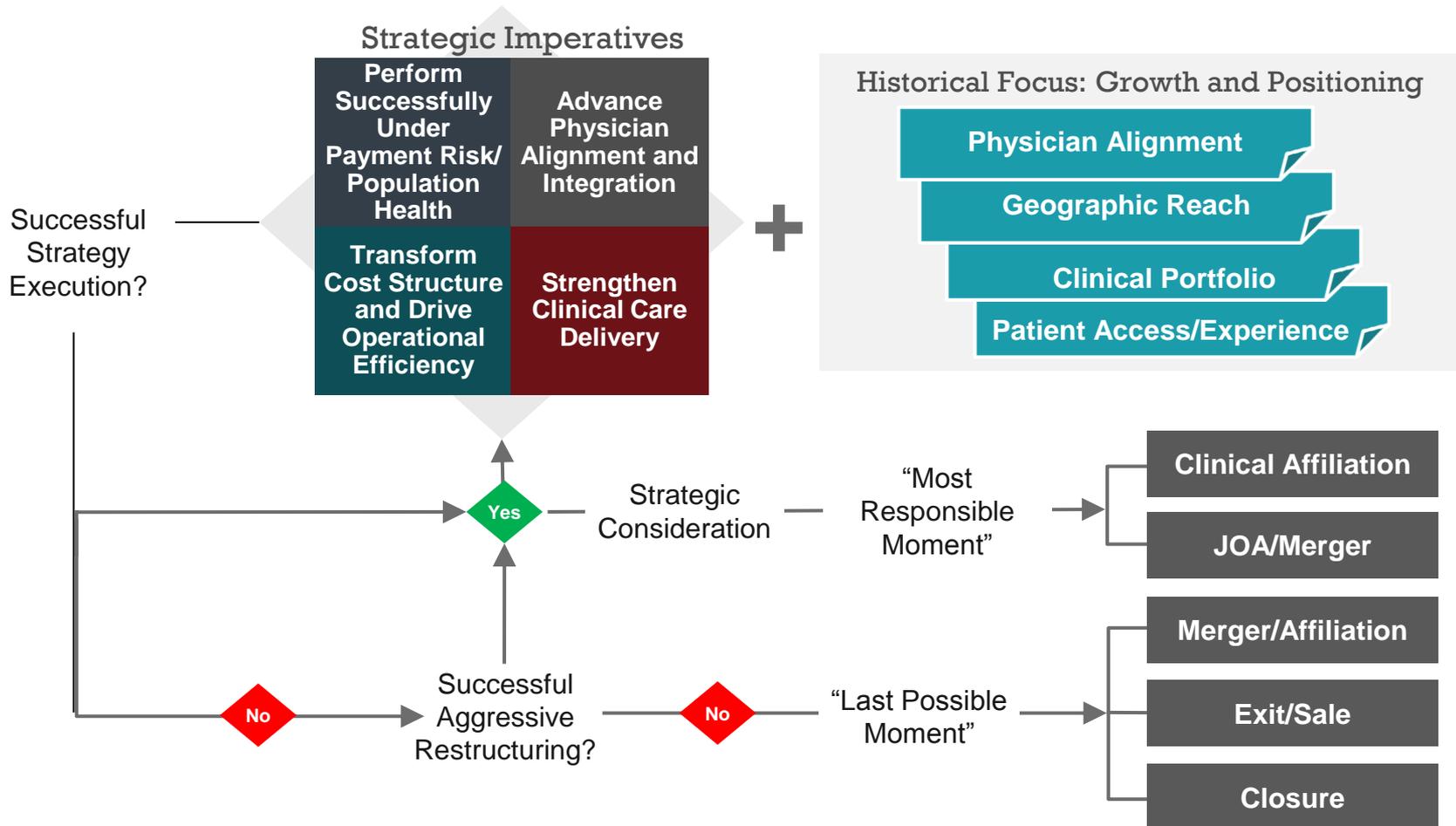
Affiliation — Factors That Threaten Hospital Independence



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Affiliation — The Most Responsible Moment Flowchart

An independent organization should consider its opportunity to execute a partnership in its “most responsible moment” rather than when it is under duress.



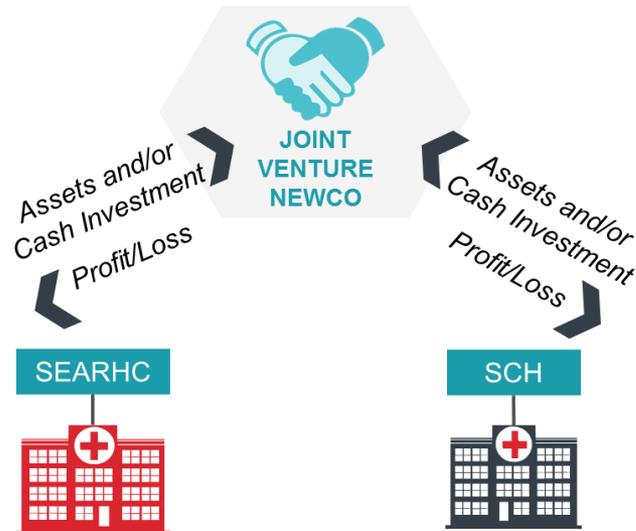
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Structural Models Considered

Two structural frameworks were identified for the SCH/SEARHC affiliation: a joint venture and a full merger.

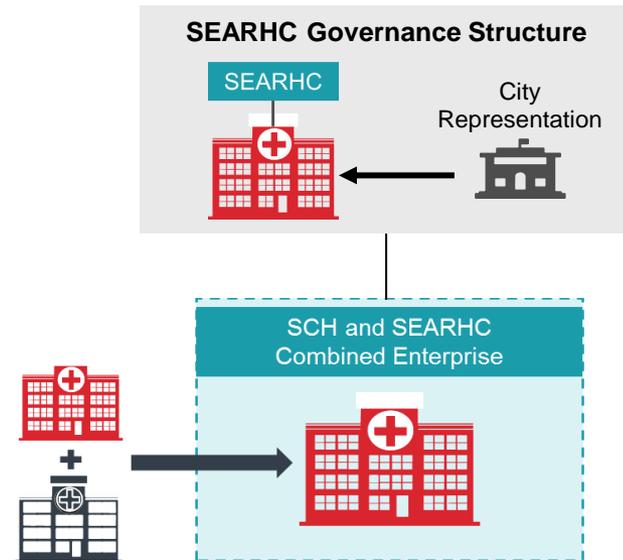
Joint Venture

SCH and SEARHC would contribute hospital assets to a new, jointly owned entity that would manage and control hospital services in Sitka.



Merger

SEARHC would purchase SCH's assets, and SCH's operations would be incorporated into SEARHC.



ECG believes that a merger is the optimal affiliation framework to achieve the shared vision.

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Summary Impact on Key Community Issues

As outlined on the following slides, ECG believes that the merger model best achieves all of the objectives articulated by the City of Sitka.

	Status Quo	JV	Merger
Financial Commitment	<ul style="list-style-type: none"> » 100% risk » Unlikely to resolve liabilities from hospital operations 	<ul style="list-style-type: none"> » \$21.8 million in capital to start » Ongoing liabilities from JV performance or capital needs 	<ul style="list-style-type: none"> » No ongoing financial commitment » Most liabilities covered » City able to retain tobacco tax revenue 
Governance	100% SCH representation 	17% SCH, may decrease based on ability to fund future needs 	<ul style="list-style-type: none"> » Two seats on SEARHC's Accreditation Governing Body (AGB) » Creation of community advisory board 
Job Stability	<ul style="list-style-type: none"> » Operational efficiencies needed to minimize ongoing city support » Strong potential for layoffs if operations do not improve 	Likely most employees will have jobs 	<ul style="list-style-type: none"> » Job offers to all SCH employees in good standing » SEARHC has indicated plans for no staffing reductions 
Access to Care	Declines based on financial performance 	Increases, but constrained by ability to invest in JV 	Meaningful improvements and strongest potential to expand services 

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Joint Venture Operational Concerns

A joint venture would be complex to structure and manage, likely resulting in inefficiencies that would deteriorate financial performance.

- » **Complex Implementation** — New employment structures, renegotiated payor contracts, and credentialing/accreditation for the new entity will need to be addressed.
- » **Disintegration With SEARHC** — Since SEARHC operates as an integrated system, many services would need to be purchased from SEARHC.
- » **Ongoing Financial Relationship** — There would be an ongoing financial relationship between the joint venture and SEARHC, including payments for services for IHS patients and purchase of management services. Relationships like this are often challenging given the impact on the joint venture's financial performance.
- » **Delayed Timeline** — Setting up the new structure will be time consuming and expensive, potentially risking SCH's solvency and delaying services for the community.

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Joint Venture Valuation

The business valuation of SCH and SEARHC's operations would be used to determine each organization's respective ownership percentages in a joint venture. ECG performed a high-level, preliminary valuation of the two businesses.

Valuation

- » The valuation takes into account current performance, as well as likely future performance in a go-it-alone scenario.
- » For SCH, property, plant, and equipment were valued; also, market transaction data for similar organizations was considered.
- » For SEARHC, the valuation was largely based on the present value of future cash flows for services in Sitka.

SCH
Valuation

\$7.6 Million

17% Ownership in
Joint Venture

SEARHC
Valuation

\$37.2 Million

83% Ownership in
Joint Venture

This is a preliminary, nonbinding assessment of value and does not represent agreement or commitment by either party.

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Financial Commitment for the City and Borough of Sitka

The merger and integration framework better protects the financial obligations of the city. The city would not have ongoing capital obligations to SCH or be responsible for any operating losses; as well, it may be able to retain the yearly \$800,000 of tobacco tax revenue and city capital support for other programs within Sitka.

SCH Capital Commitments

	Status Quo	Joint Venture	Merger ³
Working Capital ¹	\$ 0M	\$ 4.3M	\$0
Routine and Other Capital Investments ²	<u>2.0M+</u>	<u>17.5M</u>	<u>0</u>
Total	\$2.0M	\$21.8M	\$0

¹ SCH's portion of working capital cash and A/R with 17% ownership in the joint venture.

² Status quo includes the capital cost of the new Cerner EHR per the January 2017 Hospital Board Packet detailing the EHR System Proposal from Cerner and confirming SCH's FY 2017 capital budget of \$419,976. A majority of the funding for the EHR will be requested by the city. Joint venture capital includes an average of the high and low estimate of building a new hospital in Sitka with 17% ownership in the joint venture.

³ Merger figures do not reflect revenue received from a possible sale of SCH's assets or retention of the tobacco tax.

Please see APPENDIX A for a detailed evaluation of the joint venture commitments.

II. Alignment Recommendation

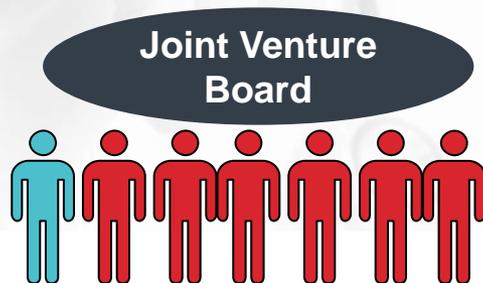
Governance

The delivery of healthcare services in Sitka will be overseen by formal governing bodies and the terms and conditions of the affiliation legal agreement.

GOVERNANCE REPRESENTATION

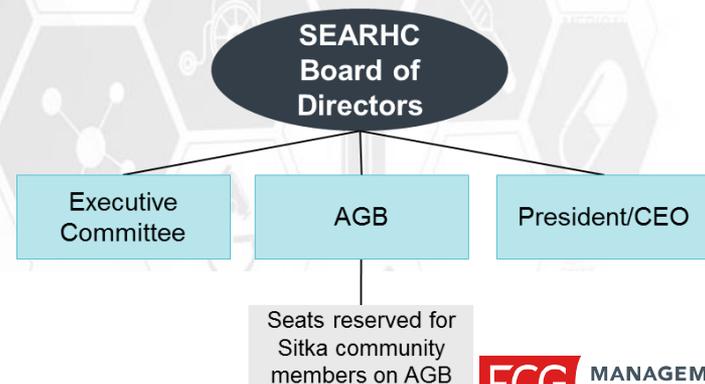
Joint Venture

- » SCH's 17% ownership will translate to one representative on a seven member joint venture board.
- » Ownership percentages may change over time, dependent on the ability of either organization to contribute required ongoing capital to the joint venture. This would impact the makeup of the JV governing board.



Merger

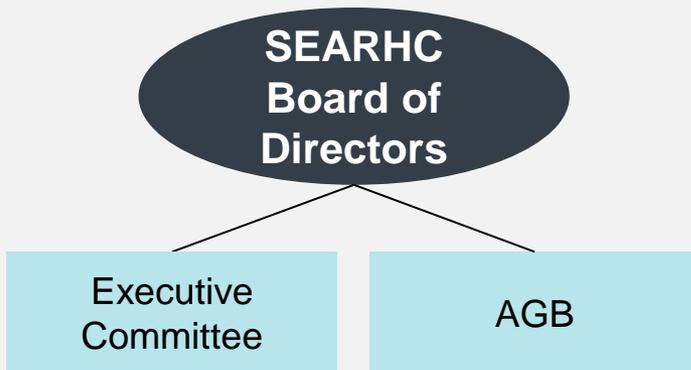
- » SEARHC's governance structure would be amended to include two representatives from the Sitka community on its AGB.
- » In addition, SEARHC would establish an Advisory Council including SEARHC leadership but dominated by Sitka representatives.
- » Governance roles and reserve powers would be contractually obligated for the term of the arrangement.



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SEARHC's AGB

The AGB is a subset of SEARHC's board and consists of the seven Executive Committee members. Two seats on the AGB would be reserved for members of the Sitka community.



Committees Defined in SEARHC's Bylaws

- » The **Executive Committee** consists of seven directors and has the authority to perform the duties and responsibilities of the board between board meetings.
- » The **AGB** consists of Executive Committee members (voting) and the chief of the medical staff (nonvoting). The AGB has authority over the following:
 - › Governs overall operations and programming of the hospital and medical and dental clinics
 - › Maintains decision making on provider and employee staffing and recruitment
 - › Oversees quality improvement and compliance programs and receives regular updates on progress
 - › Directs other areas relevant to accreditation and licensing of SEARHC facilities and programs

II. Alignment Recommendation

Job Stability

The steering committee has reviewed SEARHC's policies that result in hiring the most qualified candidates. In the merger, all employees would be offered a position in the combined organization, which cannot be guaranteed in the status quo or joint venture scenarios.

Status Quo

- » SCH will continue conducting efficiency studies to achieve a positive operating budget.
- » Layoffs are possible within this scenario.

Joint Venture

- » Staffing will be assessed based on the needs and financial capacity of the JV.
- » There is no commitment regarding job preservation.
- » Benefit structures may be more costly.

Merger

- » Employees would be offered jobs by SEARHC.
- » SEARHC's employment structure and credentialing would remain in place, resulting in a quicker and less costly implementation timeline.

Provisions in the affiliation agreement can provide ongoing protection from future policy changes.

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Protection of Services

In the merger, the community would realize benefits from reduced duplication of services. Covenants in the definitive agreement under either the JV or merger scenario would provide long-term protection for the city's interests and are not contingent on SCH's ownership percentage.

- » The definitive agreement may afford specific reserve rights to SCH and/or the City of Sitka related to healthcare operations in Sitka. Issues that may be addressed include:
 - › Changes in policies/procedures related to hiring practices.
 - › Changes in policies/procedures related to access to care.
 - › Elimination of certain services (e.g., the requirement to continue operating a hospital).
- » Typically, reserve rights are fashioned as veto rights, enabling SCH or the city to prevent SEARHC or the JV from taking certain actions.
- » Once incorporated into the definitive agreement, reserve rights typically endure for the term of the arrangement.

II. Alignment Recommendation

Summary Recommendation

ECG believes the long-term interests of the residents of Sitka and shared vision of SCH and SEARHC will be best served by a business combination between SCH and SEARHC, with a merger being the preferred option for this alignment.

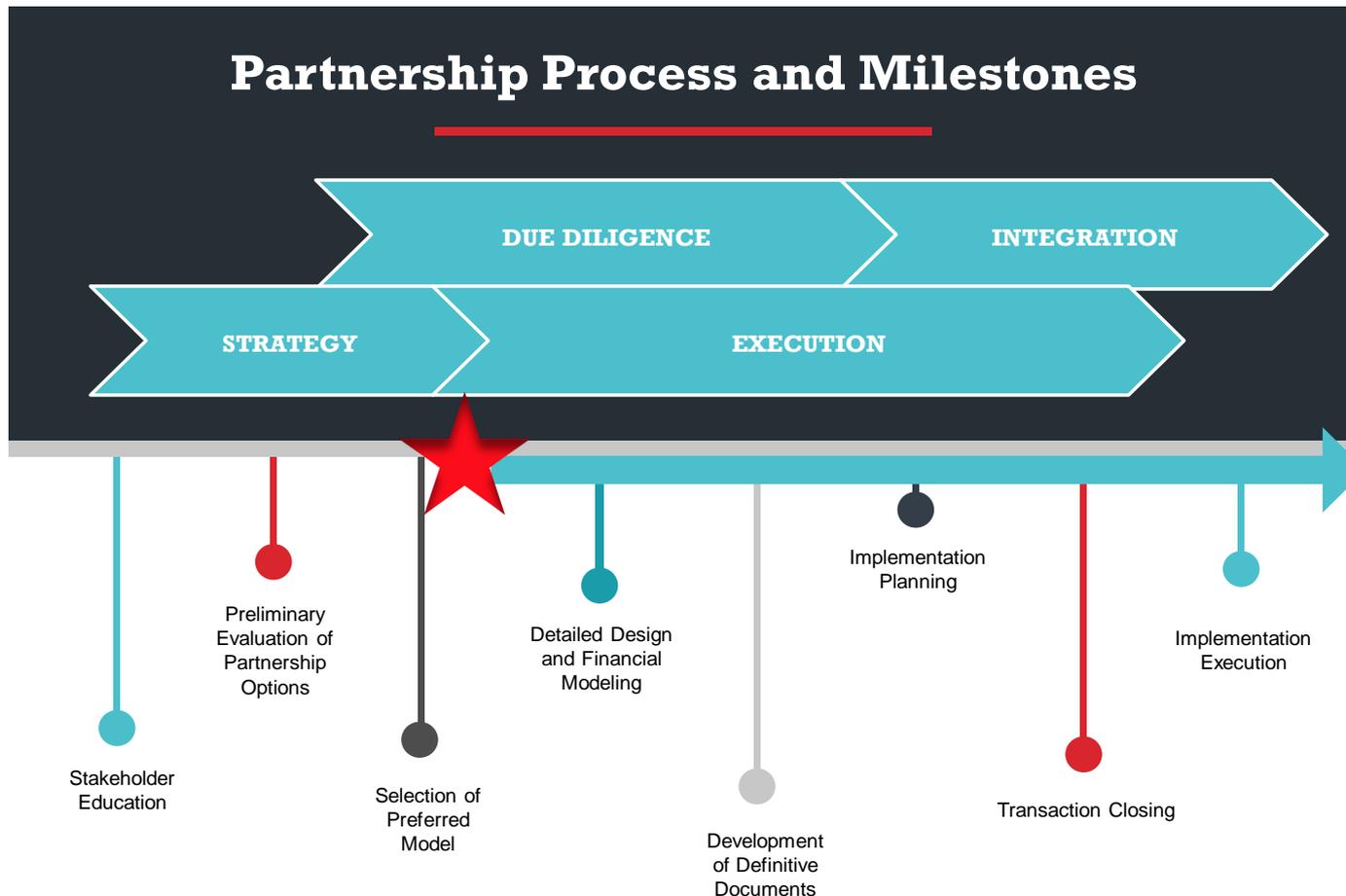
- » **Current system is wasteful** — Costly duplication of services and excess capacity are not affordable and divert resources from other important investments.
- » **SCH is not financially sustainable** — Reimbursement cuts, a weak balance sheet, and significant deferred capital investments all indicate future financial problems.
- » **Timing is right** — The City of Sitka can presently negotiate favorable terms for an affiliation. SCH is exhibiting several warning signs of a troubled institution that may face a deteriorating negotiating position.
- » **A merger makes sense** — The merger model for an affiliation with SEARHC is efficient, simple, and allows for significant governance input for Sitkans in perpetuity. The JV model is complex and costly to set up/administer, requires the City of Sitka to make an upfront investment, and leaves the city vulnerable to future financial problems.
- » **Merger leads to service expansion** — In the merger, high-need services such as dermatology, ENT services, urology, expanded geriatric services, and pediatrics can be brought to Sitka.
- » **Preliminary terms are favorable** — Early discussions with SEARHC have yielded favorable terms, including reserve powers over key care delivery and employment issues, significant governance representation, employment guarantees, and lack of city financial support.

III. Next Steps

III. Next Steps

Next Steps

If SEARHC and the Sitka Assembly agree on an alignment structure, the next steps include SEARHC submitting a merger proposal for the Sitka Assembly to review. The Assembly will decide the best course of action to approve or reject the proposal.



Appendix A

Appendix A

Capital Funding Requirements

SEARHC has expressed interest in developing a new hospital in Sitka. Preliminary planning efforts indicate the cost for the new facility to be \$103 million. In the merger, SCH would not be responsible for contributing to the cost of the new facility.

- » SCH was built in 1983, is nearing the end of its 40-year useful life, and has significant deferred capital needs.
- » MEH was built in the 1940s and has been updated but is also near the end of its life. SEARHC is planning for the facility's replacement.

Current State

New Facility Cost Allocations

Facility and Equipment Cost ¹	\$103,000,000
Status Quo	
SCH	Plan and Finance Own Hospital
JV Cost Share	
SCH — 17% Ownership	\$17,500,000
SEARHC — 83% Ownership	\$85,500,000
Merger Cost Share	
City and Borough of Sitka	\$0
SEARHC	\$103,000,000

¹ Per hospital project cost data received by Dan Neumeister on March 14, 2017. Cost includes the midpoint of project cost in current and future dollars for a new inpatient building.

NOTE: Figures may not be exact due to rounding.

Appendix A

Working Capital Considerations

In the joint venture, SCH and SEARHC will each be responsible for contributing start-up working capital needs. With a 17% ownership state, SCH could be responsible for \$4.3 million in required start-up costs.

Joint Venture Working Capital Needs

	Amount
Cash Build-Up	
Combined Operating Expenses (excludes depreciation) ¹	\$85,600,000
Working Capital Requirement	60 Days Cash
<i>Working Capital Commitment</i>	<i>\$14,000,000</i>
A/R Build-Up	
Combined Net Revenue ¹	\$91,800,000
Working Capital Requirement	45 Days
<i>Working Capital Commitment</i>	<i>\$11,000,000</i>

	Amount
Working Capital Allocation	
SCH — 17% Ownership	\$4,250,000
SEARHC — 83% Ownership	\$20,750,000

¹ SCH net revenue and expenses are per 2016 audited financials, ending June 2016. SEARHC net revenue and expenses are for amounts allocated to operations in Sitka provided by Praveen Mekala, SEARHC CFO, and based on 2016 year-end financials, ending September 2016.