How Integrated Delivery Systems Drive Financial Stability

Lessons on Diversification and Scale from the 2/20 Club

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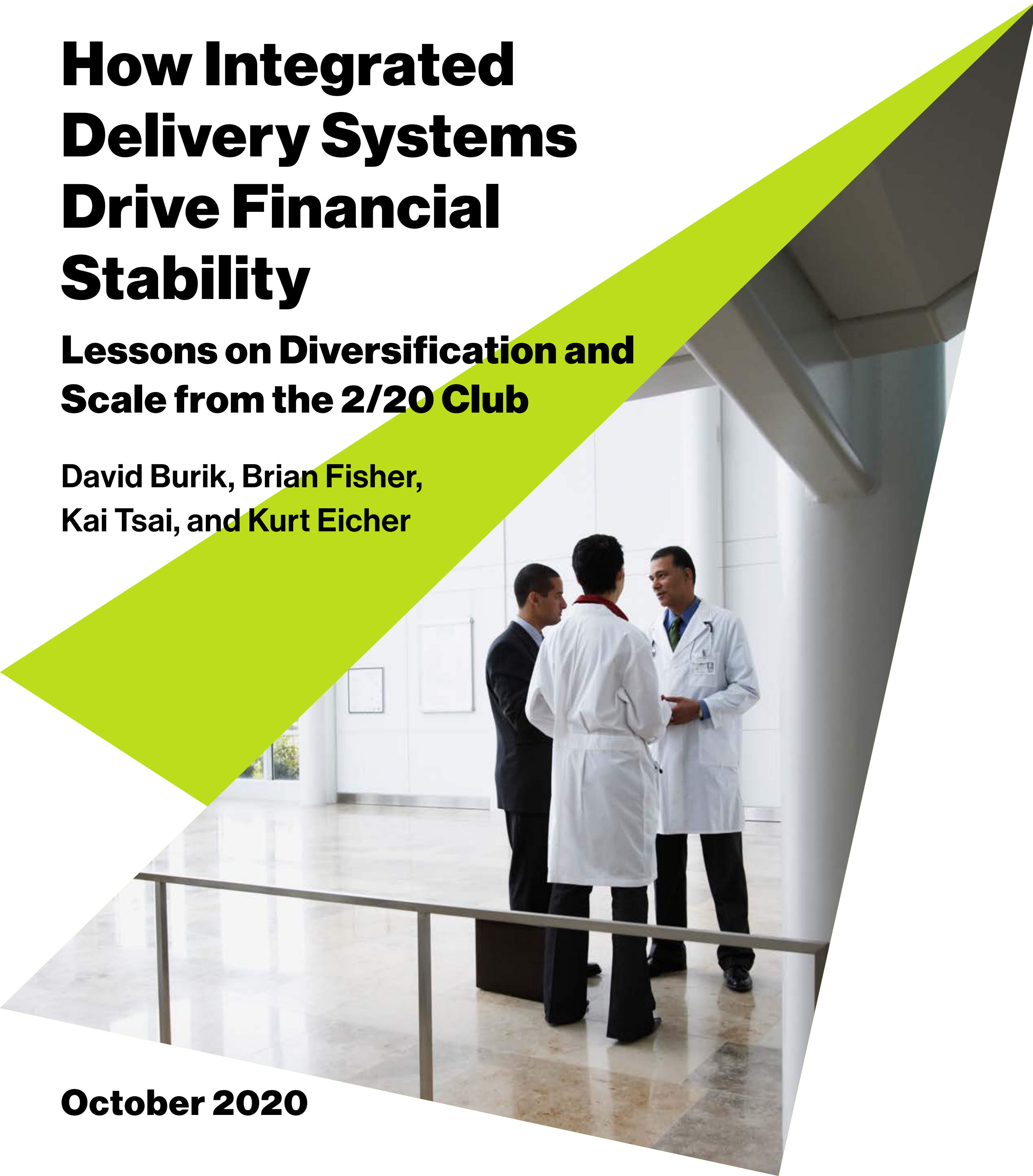

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Summary

Health systems of all varieties continue to experience financial challenges from shifting market headwinds, new/large/innovative competition, regulatory uncertainty, and most recently, a national and worldwide pandemic.

In the wake of COVID-19, many providers are experiencing a 20% to 40% decrease in net operating revenue cash flow and a 5% to 10% increase in operational expenses, causing added financial stress to even the most stable organization. A recent analysis estimated that as many as 100 hospitals could close by the end of the year.[1]

As providers look for opportunities to financially recover and stabilize, those systems with a diversified revenue stream portfolio are better positioned to weather market downturns. More specifically, health systems with direct access to the insurance premium dollar through provider-sponsored health plans (PSHPs) exhibit greater financial stability and revenue predictability.

Yet, the solution to financial stability is not quite that simple. If owning the premium dollar through a PSHP was the answer, everyone with access to capital would do it. Incorporating (or merging) new businesses into a provider portfolio adds complexity, and PSHPs are not always immediately (or inevitably) successful.

Into September, the tumultuous conditions created by COVID-19 have stalled or dismantled multiple transactions where providers eyed expanding their business, including some where PSHPs were a critical component to the arrangement. However, health systems navigating successfully through these systemic shocks have multiple levers available to them to deliver high-quality care while balancing strategic and financial goals.

Prior to the pandemic, we began evaluating the structural components and performance of providers with PSHPs, with a specific lens on integrated delivery systems (IDSs). An analysis of 12 of the most advanced IDSs uncovered several key success indicators with one overarching commonality: Each organization is a member of what we have deemed the "2/20 Club" with at least $2 billion in enterprise revenue, 20% of which is generated by their health plans.

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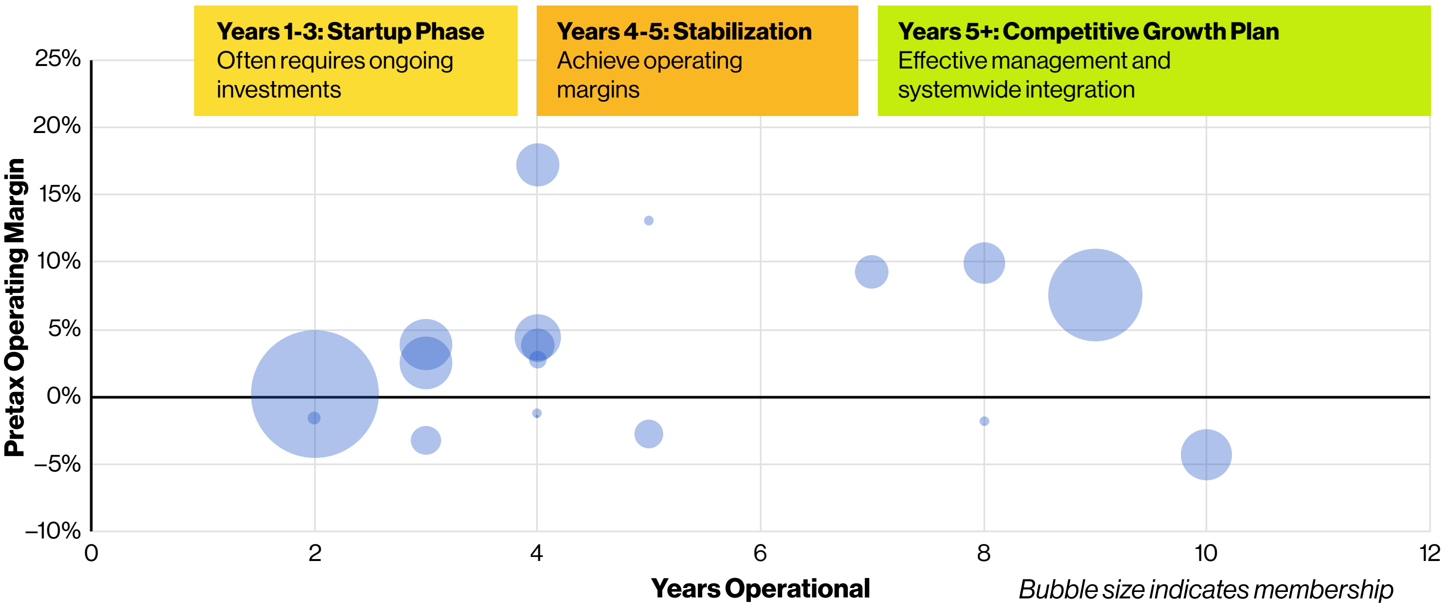
1. Josh Salman and Jayme Fraser, "Coronavirus strains cash-strapped hospitals, could cause up to 100 to close within a year," USA Today, April 25, 2020, https://www.usatoday.com/story/news/investigations/2020/04/25/coronavirus-strains-cash-strapped-hospitals-could-cause-mass-closures/2996521001/.

Provider Access to Premiums: Aggregation Gains Popularity While PSHPs are Finding Their Footing

While some PSHPs have struggled, the industry is getting smarter, and several PSHPs are emerging from a 10-year startup runway. Yet, with aggregation comes growing pains. Not all providers are committed to the strategy, patience, or capital necessary to become a functioning IDS.

Exhibit 1: Sample PSHP Financial Performance and Age



Sources: AIS, Company-Published Financials, and SNL Financials

Above: Data represents fully insured population only. If a plans membership is more than 50% self-insured, information is not reflected here. Data excludes PSHPs with margins less than –10%.

What New and Potential "Aggregators" Can Learn From the 2/20 Club

Following are observations from our 2/20 Club analysis which providers should be mindful of as they evaluate their structures, portfolios, and redesign strategies in the new post-COVID-19 normal.

I. Diversification

Diversification sits at the core of the IDS discussion from various perspectives. Conceptually, being truly integrated means investing resources into a range of care delivery, financing, and management capabilities. These capabilities are inherently more diverse than the traditional provider model but must also operate in synchrony.

From a revenue perspective, IDSs achieve financial stability and predictability from diversification of revenue sources. Those IDSs within the 2/20 Club generate at least 20% of their revenue from health plan premiums. Furthermore, eight of these organizations have health plan revenues exceeding 30% of total enterprise revenue.

Kaiser Permanente, arguably the most widely referenced IDS in the industry, reported net income for Q2 2020 more than doubled to $4.5 billion compared to last year, while operating revenue increased more than 3% to $22.1 billion and expenses fell 1.5%, illustrating the efficacy of a diversified revenue portfolio and operating model.[2]

From a membership perspective, diversification also plays a role in success. The most successful IDSs have diversified their membership as the growth and emergence of Managed Medicaid and Medicare Advantage have created a new set of opportunities for health plans. Maintaining some level of material health plan membership in both commercial and government lines of business appears to be crucial for success. This concerted effort to diversify membership hedges against systemic shocks to specific business lines; for example, as current commercial membership decreases with COVID-19-induced unemployment. Seven of the 2/20 Club IDSs have more than 20% of their membership in government business lines with average enterprise operating margins at 2.4%.

Of note, just three of the profiled IDSs have announced any sort of employee furloughs, even in June 2020 when unemployment levels reached near record-highs, indicating their ability to sustain short-term turbulence. Interviews with several of the IDSs profiled also indicate that, while market turbulence has been challenging to manage, their financial performance remains strong and has outperformed traditional health systems over the past two-months.

Health System Redesign Principles Post-COVID-19

Analysis of the COVID-19 strategic response and recovery of more than 30 health systems representing 350 hospitals led to the development of a series of nationally emerging redesign principles that directly inform the strategies of provider-payer aggregation and integration.

1. **A significant decline in cross-subsidization opportunities** – There will be fewer opportunities for cross-subsidization as insured patients are unable to shoulder greater cost sharing with their plans, commercial enrollees decline due to unemployment increases, and volume recovery is slow and/or incomplete. Systems will unlikely be able to continue subsidizing integrated physician groups as rising costs outpace revenue growth.
2. **Best-in-class digital solutions will be a necessity, not a luxury** – Those who can pivot nimbly, utilizing technology that enhances access to care and customization, will win back consumer confidence and volume. Reimbursement changes and suspension of regulations are also accelerants to startup digital providers.
3. **Greater standardization and more effective corporate functionality will necessitate a move from fixed to variable costs** – Virtual (telecommuting and telehealth), cloud, robotic process automation, and outsourcing are the tools to bring performance common in other industries. There is a need to identify practices that could be best supported by hardware and software to enable both caregiver and patient engagement.
4. **Capital will be much more difficult to secure** – The need to unload "dead capital assets" and achieve a quicker return on investments will be magnified.
5. **Most regions will experience greater market turbulence** – Uncertainty and crisis further breed and accelerate disruption. Major employers are taking innovation into their own hands as historical payer/provider actions have not sufficiently moved the needle on healthcare spend.
6. **A marked increase in thoughtful provider consolidation** – Historic pricing power and scale alone will not define systems that grow. While provider consolidation has led to much criticism, the pandemic has created an opportunity to devise a more thoughtful – and necessary – approach to consolidation.

2. "Here's how nonprofit hospitals weathered the first half of 2020", Healthcare Dive, Sept. 3, 2020, https://www.healthcaredive.com/news/heres-how-nonprofit-hospitals-weathered-the-first-half-of-2020/584636/.

II. Scale

As the 2/20 Club classification suggests (with $2 billion being the floor for the Club), scale certainly matters. About 60% of the 2/20 Club have enterprise revenues exceeding $5 billion, with over 40% achieving enterprise revenues greater than $7 billion. Each organization evaluated operates at a positive enterprise margin, providing further opportunity to cross-subsidize and make investments necessary on both sides of the business.

Exhibit 2: 2/20 Club Members At-a-Glance

IDS	Enterprise Revenue (B)	Enterprise Op. Margin	% of Revenue from Plan	Health Plan Margin %	Total Plan Member-ship	% Members from Gov't LOB	Region	CBSA Size
IDS 1	$10.9	0.2%	25.3%	3.2	97,795	39%	East/ Northeast	1M – 3M
IDS 2	$7.9	6.9%	39.0%	4.5	1,044,695	13%	West	1M – 3M
IDS 3	$7.3	0.6%	36.5%	3.7	548,760	54%	East/ Northeast	500k – 1M
IDS 4	$7.1	3.3%	45.0%	3.9	752,569	35%	Midwest	1M – 3M
IDS 5	$7.1	2.1%	63.7%	1.5	1,100,100	20%	Midwest	3M – 5M
IDS 6	$6.4	5.2%	37.4%	5.8	478,650	39%	East/ Northeast	1M – 3M
IDS 7	$5.9	2.4%	33.5%	0.3	425,607	16%	Midwest	3M – 5M
IDS 8	$4.6	1.7%	19.8%	0.9	181,218	11%	Midwest	<499K
IDS 9	$3.9	4.9%	19.1%	Break even	145,964	1%	West	3M – 5M
IDS 10	$3.6	1.9%	59.7%	1.7	436,238	58%	West	500k – 1M
IDS 11	$2.7	5.3%	45.8%	1.4	224,471	13%	Midwest	<499K
IDS 12	$2.5	1.9%	54.7%	2.0	279,589	22%	Midwest	500k – 1M

From a geographic footprint perspective, all profiled organizations have overlapping payer and provider "home market" geographies. This indicates the role geographic presence plays in driving clinical and financial performance and how true integration relies not only on the shared vision of the payer and provider entities, but also on the shared community of "patients-members-customers."

When looking at health plan membership of the 2/20 Club, 75% have at least 200,000 members across all lines of business, and approximately 60% have membership topping 400,000. Provider, and even more so health plan, expansion is very capital-intensive, suggesting these diversified organizations are efficient in reinvesting, reaching a point in which "scale begets scale." As such, driving membership growth through price competitiveness and product differentiation are critical issues that successful IDSs navigate. And as we discussed earlier, it takes time in the market to establish that level of size and scale.

Scale also allows high-performing IDSs to establish a favorable financial position by way of diversified revenues, capital reserves, and lender-friendly credit ratings (all profiled IDSs have ratings in the A-range). And in response to COVID-19, to weather financial pressures and keep operations steady, these organizations are better able to access low-interest lending on a much larger scale. With recent funding from the CARES Act Provider Relief Fund based on the share of total net patient service revenue, the scale IDSs have established on the provider side position them to access both private and public funds more actively. This, coupled with premium revenue and anticipated medical payments due to reduced utilization, are only a few of the levers IDSs have available to manage market volatility, including unforeseen circumstances such as the COVID crisis, that result in 30% to 50% utilization reductions.

There is also something to be said about care being best delivered on a more focused, intimate, and local level. Matthew Kolb, executive vice president and system chief operating officer at Urbana, Ill.-based **Carle health system**, described scale in terms of balance. Carle includes Health Alliance Medical Plans, a leading PSHP serving nearly a quarter-million members in five states.

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The scale of these organizations allows them to be a valuable part of the communities they serve. National health plans often dominate member market share with advanced platforms and lower operating costs, making it difficult for PSHPs to compete. The scale of these IDSs is mission-critical to compete with the national players, while fostering local business that is not only focused on the communities, but also aligns (instead of being at opposition) with the delivery system.

III. Location

The 2/20 Club IDSs also display similar characteristics of the markets in which they have formed. Geographically, these organizations are clustered into three regional pockets: Midwest, East/Northeast, and West.

When looking closer at each specific core-based statistical area (CBSA), the majority of IDSs are found in relatively smaller or midsize CBSAs, with seven in markets ranging from half a million to three million people, and no 2/20 Club members operating in markets with more than five million people. Furthermore, the majority of 2/20 Club IDSs operate within highly concentrated health system markets, which could be a reason or a byproduct of the IDS itself.

We believe IDS midmarket success is largely related to geographic coverage, cost, and competition. IDSs can leverage strong provider brand presence in smaller and midsize markets, while requiring lower barriers to entry to differentiate their health plan offerings and provide adequate network coverage with the provider enterprise.

While market design can indeed play a pivotal role in IDS development and success, 2/20 leaders contributing to this analysis describe markets as a matter of advantage. Put another way, some markets offer certain advantages versus others, providing more fertile ground for an IDS to emerge and thrive. The resulting charge to IDS leadership is to evaluate how one can use the market's gifts as an advantage, rather than how to control it outright.

In response to COVID-19, we find a strategic growth framework emerging in context of provider positioning within their respective markets. The members of the 2/20 Club typically find themselves in the upper right quadrant.

Exhibit 3: Emerging Strategic Framework

Market Growth (Population)

Positioned to Grow: Position as low cost provider with differentiable, new value proposition to defend against stronger players getting stronger. Characteristics: A growing market – Provider has a strong market share and competitive financial position. Strategy: Differentiate based on ease of access and targeted growth segments. Requirement: Achieve minimum of 4%+ operating margin to profitably grow.	**Positioned to Shape:** Leverage strong market position and sizable balance sheet to reshape the market while redesigning operating model. Characteristics: A growing market – Provider has leading market share and financial strength. Strategy: Shape the market and innovate delivery and portfolio to continue to grow share. Requirement: Achieve 6%-8%+ operating margin to invest in a new business model.
Positioned to Survive: What's the path to financial and operational viability, given role in stagnant market? Characteristics: A stagnant market – Provider has lagging market share and declining financial position. Strategy: Maintain independence or pursue consolidation partner. Requirement: Rapid action to return to breakeven.	**Positioned to Defend:** Focus on ease of access and innovation to reduce costs, and targeted market expansion. Characteristics: A flat market – Provider has strong market share and financial position. Strategy: Win the market by gaining share of wallet. Requirement: Build on 4%+ operating margin to win the market.

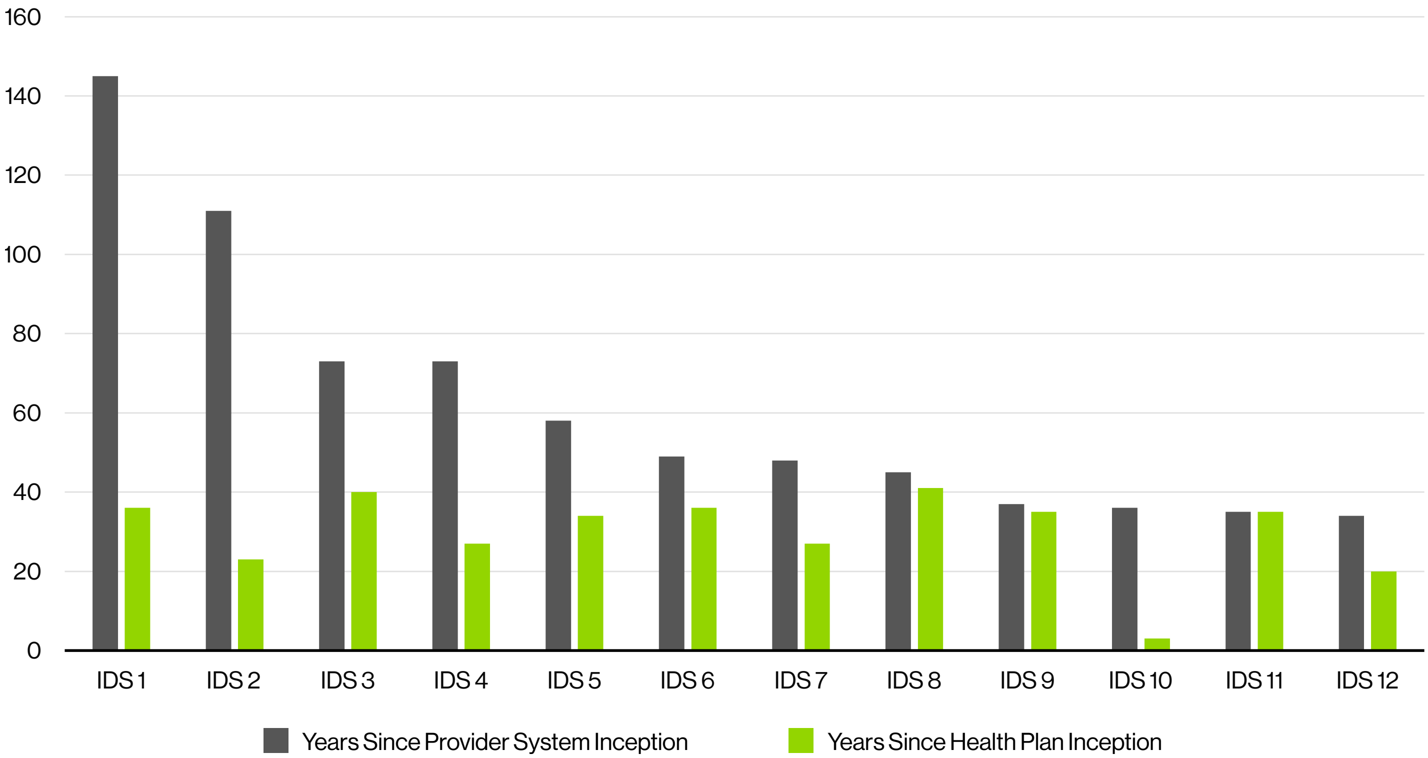
Competitive Position (Market Share)

IV. Timing

While many high-performing IDSs have operated for over 25 years as a coordinated provider and payer business, a strong delivery chassis can accelerate the path to profitability for PSHPs. Of recently developed PSHPs, the first three years of operation typically focus on startup and ongoing investments, while years three through five more often show operating margins breaking through into profitability.

Of those more mature organizations within the 2/20 Club, five have provided care delivery for more than 50 years, while none have provided care delivery for less than 30 years. For health plan operations, all but one have had membership for more than 20 years. All this being said, entering the health plan business as a provider must be a long-term leadership strategy versus a short-term one.

Exhibit 4: 2/20 Club Member Age of Provider System and Health Plan



There is also something to be said for the age of the organization and financial performance. Of those organizations with payer-provider operations older than 25 years, average margin is 3.7%, while those under 25 years of age for either payer or provider operations averaged about 1.7%, lending credence to the phrase "good things come with time."

V. Strategic Alignment

We believe there's an industry gray area in defining or labeling systems as "integrated." Our basic point of view is an integrated funding and delivery portfolio must be designed for those businesses to have interoperability and interdependence, which begins with a shared vision between both sides of the business.

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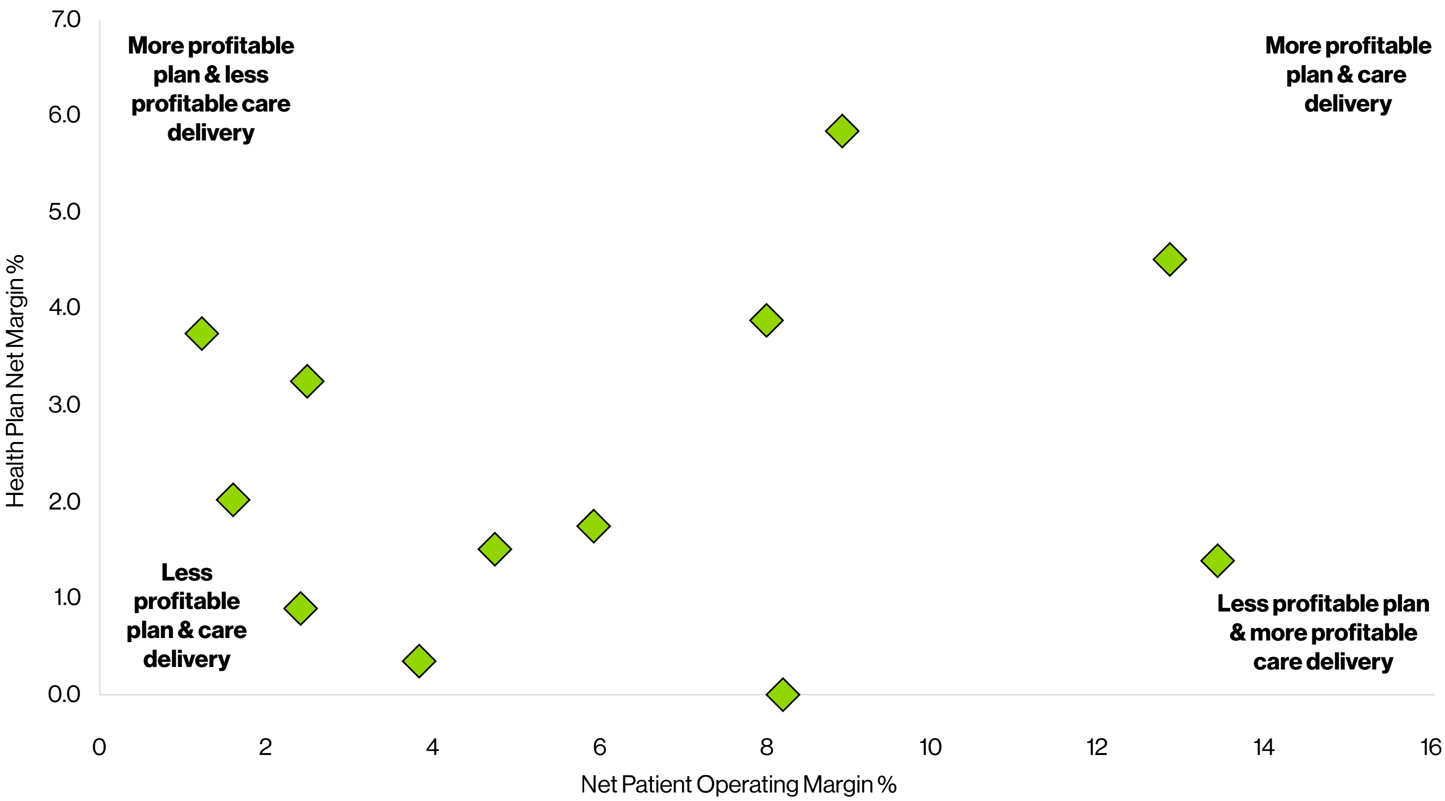
In addition to aligned vision and mission, alignment is required in a more tactical sense: geography. A vast majority of profiled organizations have their largest health plan membership and primary delivery system within the same market. Moreover, the health plan portfolio aligns with the delivery portfolio, again pointing to the significance of offering all lines of business in the PSHP (health plan offerings for the same patients and populations that are treated within the delivery system).

While data is not widely available, our experience is these organizations have a large portion of their provider revenue coming from their own health plan. This "management within the family" creates insulation and more predictable revenue streams for the business, while reducing consumer confusion on navigating the health system.

However, interoperability of the family of businesses creates complexity with pricing and revenue transfers between both sides of the house. Despite strong enterprise financials and profitability, not all IDSs achieved strong financials across both health plan and provider assets. These IDSs are often intentional in selecting and structuring their profit strategies, frequently with one business subsidizing the other. Selecting a strategy is very dependent on market dynamics and understanding the underlying structures that allow IDSs to succeed within said markets. Those positioned in the upper right quadrant will likely emerge from COVID in a position to reinvent and shape the delivery and financing of care for their respective markets.

Exhibit 5: 2/20 Club Members Net Patient and Health Plan Margin Percentages



Source: 2018 S&P Financials

Aggregation, Integration, and Redesigning Strategic Plans

Now, perhaps more than ever, health systems are readdressing their organizational strategic plans. For many systems, financial portraits from Q4 2019 have faded while operating models have contracted and expanded to meet the needs of evaporating electives and surging COVID cases. Central to how systems emerge stronger is the implementation of rapid cycle strategic planning in direct response to COVID-19, compared to the traditional approach of creating long-term strategies driven by consensus building.

For those organizations positioned to do so, now may be as good a time as any to consider the role of premium dollars as part of their redesign strategic plan and aggregation of assets.

And for those that have or are aggregating assets — and more specifically, health plans — now is the time to:

- **Evaluate current and future portfolio diversification goals**
- **Determine short- and long-term ability to access capital, scale, and financial performance**
- **Establish a roadmap for advanced capabilities: care management, digital/technology advancements, joint workflow design, and automation**
- **Assess if a partner is required to successfully aggregate, diversify, and create alignment in a sufficient time frame (with access to the premium dollar)**
- **Establish strategic growth framework in context of market and location**
- **Determine if an IDS is part of your health system redesign strategy**

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