

SURGERY CENTER MARKET OVERVIEW

Outlook for ASCs in 2011: From Andrew Hayek of the Ambulatory Surgery Center Advocacy Committee

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The following is written by Andrew Hayek, chair of the Ambulatory Surgery Center Advocacy Committee and president and CEO of Surgical Care Affiliates.

While we are optimistic regarding our industry over the long-term, from a near-term perspective, 2011 will be as challenging as 2010. Starting from a very broad economic perspective, we believe the nation will continue a very slow recovery in 2011. Interest rates, inflation and GDP growth will remain low, and unemployment will improve only marginally.

Politically, 2011 will be a year of gridlock. House Republicans will introduce various legislation intended to fulfill campaign promises that will not get through the Senate or survive a presidential veto. There will be even more finger-pointing. Republicans will blame Democrats for a lack of cooperation in fulfilling the mandate they believe they received in the mid-term elections. Democrats will argue that Republicans have done nothing with their new power to address the most pressing issues we face, including the economy and deficit.

Expect modest improvement in 2011

From a healthcare industry standpoint, we expect modest improvement in overall consumption for 2011, compared to a weak 2010. Modest improvements in unemployment, personal wealth and consumer confidence will overcome the continued dampening effect of rising deductibles. This will result in flat to very slight growth in overall consumption compared to the decreases we saw in 2010.

We expect the current uncertainty regarding the implications of healthcare reform to continue in 2011. Concepts like bundled payments and accountable care organizations will continue to create fear, uncertainty and very few specifics for hospitals, physicians and most other categories of providers.

We expect the trend of physician employment to continue. It will be driven on the physician side by decreasing reimbursement, increasing complexity, the prospective costs of EMR and greater clinical surveying activity, and the threat of rising taxes. It will be driven on the hospital side by an interest to create greater physician alignment as a prerequisite to creating an ACO or preparing for bundled payments. Physician employment will continue to be concentrated in general practitioners and cardiology, with expansion into other specialties on a market-by-market basis.

Fissures between hospitals, employed physicians

That said, in markets where physician employment has been most active over the past few years, we expect to see the beginning of fissures in employment arrangements, especially as initial contracts coming to term in markets where the hospital is under financial pressure. Original contracts may be amended to the physicians' disadvantage or not renewed altogether.

We expect to see a continuing divergence in the hospital space between the "haves" and "have-nots." Independent community hospitals, which are struggling to maintain break-even economics, will face even greater pressure with lower Medicare and commercial reimbursement increases, and with rising input and technology costs. Larger health systems, both not-for-profit and for-profit, will continue to grow and reap the benefits of contracting power for revenue and cost and will continue to deploy capital by adding new facilities and physicians.

We believe the moratorium on surgical hospitals will remain unchanged in 2011, and the heightened transaction volume for surgical hospital consolidation will continue in 2011, as legislative clarity opens up the market to a range of buyers.

Prospects for ASCs in 2011

In the ASC space, we expect a modest improvement in volume trends, compared to 2010, and continued pressure on reimbursement.

Turning to case volumes, we estimate they declined approximately 5 percent across the industry in 2010. We expect this trend to improve modestly next year, although case volume growth for the industry will likely remain negative.

We expect reimbursement rates across the industry to increase at a similar rate next year, by roughly 2 percent. In the final year of the phase-in of new rates, GI and eye centers will face more Medicare reimbursement reductions. Overall, Medicare rates will increase 0.2 percent in 2011. We expect the final rule next year to reflect an update of zero to 1 percent for 2012.

Although the average Medicare reimbursement change will be roughly flat, there continues to be disproportionate opportunity in certain specialties, due to shifts in RVUs in certain CPT codes and specialties.

The pressure on out-of-network reimbursement will continue. Buyers of surgery centers will discount virtually all profit value of out-of-network reimbursement. This pressure will be particularly acute in states like New Jersey, and many ASCs will face significant changes in their economics.

We expect continued pricing pressure from implants and other medical-surgical supplies, the average price of which continues to grow, despite flatter reimbursement and continued volume pressure. Surgery centers will continue to increase the sophistication with which they address supply purchasing. This is something we are highly engaged on and have seen significant positive impact on our implant, medical, and surgical supply costs as an organization.

Net number of ASCs won't grow much

We expect another year of little to no growth in the total number of ASCs. This year will be the first year on record in which there was almost zero growth in the total number of Medicare-licensed ASCs. New ASCs continue to be built in select markets with committed groups of physicians. However, there is now a roughly equal number of ASCs that are closing or converting to hospital licenses. We expect this general trend to continue in 2011.

Clinically, we expect continued negative press regarding infection control. The results of Medicare surveys will likely reflect modest improvement in adherence to the new infection control practices outlined in the expanded Conditions for Coverage. However, the portion of ASCs with one or more deficiencies will draw significant negative press coverage and significant attention on Capitol Hill. This coverage is particularly disappointing, given that it implies the risk of infection is higher in ASCs than in other settings. This is an implication that we believe to be false and misleading to healthcare consumers.

Greater use of quality measures

From a positive standpoint clinically, we expect greater utilization of the NQF endorsed quality measures by ASCs, allowing the industry to better articulate the outstanding clinical outcomes we provide. We hope there will be material progress in towards reaching the point where there is a valid measure of actual infection rates, such that the safety of ASCs can be compared to hospital outpatient departments. When such data becomes available, we believe the results will be favorable for ASCs and shift the discussion regarding infection control.

We expect to see consolidation to continue in 2011 at a similar rate as this year, mainly through individual centers continuing to join larger organizations, as has been occurring for many years. The largest ASC companies will continue to add ten or more ASCs each in 2011, and we expect the uncertainty around healthcare reform and volume trends to cause EBITDA multiples to decline. The average trading multiple of the publicly traded ASC companies has declined to six to seven times EBITDA, and hospitals and skilled nursing facilities are trading at six times EBITDA. When you adjust for the lack of liquidity in a single-site transaction, this implies a range of high fours to mid fives for individual surgery centers in the foreseeable future.

Looking forward to strong federal advocacy

In terms of federal advocacy, we are very optimistic regarding the leadership of Bill Prentice, ASCA's new executive director. We are hopeful more ASCs will join ASCA and begin to participate in the political process — engaging with lawmakers, making political contributions, and staying connected to the industry's work. We firmly believe a higher level of political engagement is critical for the industry, given that our aggregate spending on lobbying and political contributions is a small fraction of other healthcare provider groups. The American Hospital Association, for example, outspends ASCs by 30 to 1 in lobbying and 50 to 1 in political fundraising.

We continue to view the industry as shifting to a very new phase – that of a mature market, similar to dialysis, radiation therapy, and home health. The era of rapid growth in case volumes and in the number of ASCs has ended, and the new era will be defined by slow case volume growth and consolidation.

Consolidation will continue. Organizations that can provide differentiated levels of support and efficiency to individual centers in areas like clinical services, supply costs, training, and informatics will be in increasing demand. Physician owners of stand-alone centers will continue to explore options to maintain their independence and their economics in the face of volume, rate, cost and regulatory pressures.

ASCs have bright long-term future

Over the long term, we are highly optimistic about the role ASCs will play in the healthcare delivery system. With increasing focus and urgency regarding quality, cost, and access, we believe consumers and payers will continue to seek out the ASC setting, especially with greater transparency of cost and quality.

Ultimately, we are passionate about this space for the same reason we believe greater transparency will benefit the industry. We know ASCs deliver outstanding value to patients and the healthcare system. ASCs are the high-quality, low-cost setting for routine outpatient surgery, and we are proud of the role they will continue to play in improving U.S. healthcare.

In summary, this market is not expected to grow this year. Although many new centers are being constructed, several others are closing down or converting to hospital licensed centers. Also, this market is affected by the changes in healthcare reform affecting Medicare and out-of-network reimbursements. However, the long-term outlook for this market is positive as patients are seeking out the quality, cost, and access of surgery centers versus traditional facilities.