How Home Healthcare Thrives with Healthcare Reform

October 22, 2010

Wyatt Matas
& Associates
An Investment Banking Firm

1776 I Street NW • Washington, DC 20006 • 202.599.8996 • www.WyattMatas.com

How Home Healthcare Thrives with Healthcare Reform

As with the rest of healthcare, home care is plagued by business models that are driven by reimbursement rates rather than the value they offer patients. No matter how hard-working or well-intentioned home care executives and their staffs are, they have been limited in their ability to deliver real value to patients, payers, and referral sources as a result of the structural flaws of the current reimbursement system.

This paper will serve as an update to Wyatt Matas & Associates' "The Delineation of Healthcare: The Natural Evolution of a Healthy Industry" ("Delineation"). In it we will describe the dramatic shift of industry dynamics occurring as a result of the sweeping overhaul of healthcare signed into law on March 23, 2010 by President Obama. As a result of this legislation, a new Medicare reimbursement penalty for hospitals with high avoidable readmission rates and economic incentives created by the Independence at Home Act (IAH) will force the home care sector to add greater value to the larger healthcare industry in order to thrive. This new legislative framework positions home care to be the solution to the problems plaguing the entire healthcare system. Home care agencies will now have a unique opportunity to provide real value to the health care system while earning significant financial gains.

These changes will benefit all home care stakeholders, including patients, providers and payers. This new framework represents the beginning of a period of sustained opportunity, innovation and industry prominence for those home care organizations that are able to take advantage of this structural industry shift. Those who can adapt to these inevitable environmental changes and emerge as industry leaders will have a substantial and defendable competitive advantage in the future of US healthcare. However, home care agencies wishing to take advantage of these opportunities will need to move away from general, episodic care toward sustained, coordinated care of all patient needs by becoming coordinated care management companies.

Avoidable Hospital Readmissions

In an effort to control the increasing rates of avoidable readmissions, a new Medicare regulation will go into effect October 1, 2012.[i] This new regulation will penalize hospitals with avoidable readmissions higher than the national average by cutting 1% of their gross Medicare reimbursement. If a hospital is not able to improve its rates of readmission, the penalty will escalate. As hospitals nation-wide strive to reduce their avoidable readmission rates, the national average rate will in turn be lowered, forcing hospitals to continually improve.

Avoidable readmissions use limited, expensive hospital resources

One out of five Medicare hospital discharges results in an avoidable readmission.[ii] Of these readmissions, patients with chronic condition co-morbidity experience the highest rates of avoidable readmissions.[iii] Most of these patients returning to the hospital as avoidable readmissions are already unprofitable even before the imposition of the coming reimbursement penalty.[iv] These patients also have high average lengths of stay, crowding out capacity for more profitable, surgical patients. Therefore hospitals not only experience real-time loss of cash flow but also the opportunity cost of not devoting resources to higher margin business, such as joint replacements. With many hospitals already over burdened, this expensive trend cannot continue.

Home care agencies tend to shift costs to hospitals

Home care agencies have traditionally been the low-cost care providers for patients transitioning home after hospital discharge. However, while on a *per diem* basis home care is the lowest-cost option, much of the actual costs of caring for a post-facility discharge patient are shifted to hospitals and other facility-based providers through avoidable readmissions. Some agencies have hospital readmission rates within 30 days of discharge as high as 30%. Because of this the home care sector has experienced significant reimbursement cuts and criticism. In fact, CMS recently announced its recommendation to cut home care's reimbursement rate by 4.75% starting January 1, 2011.[v]

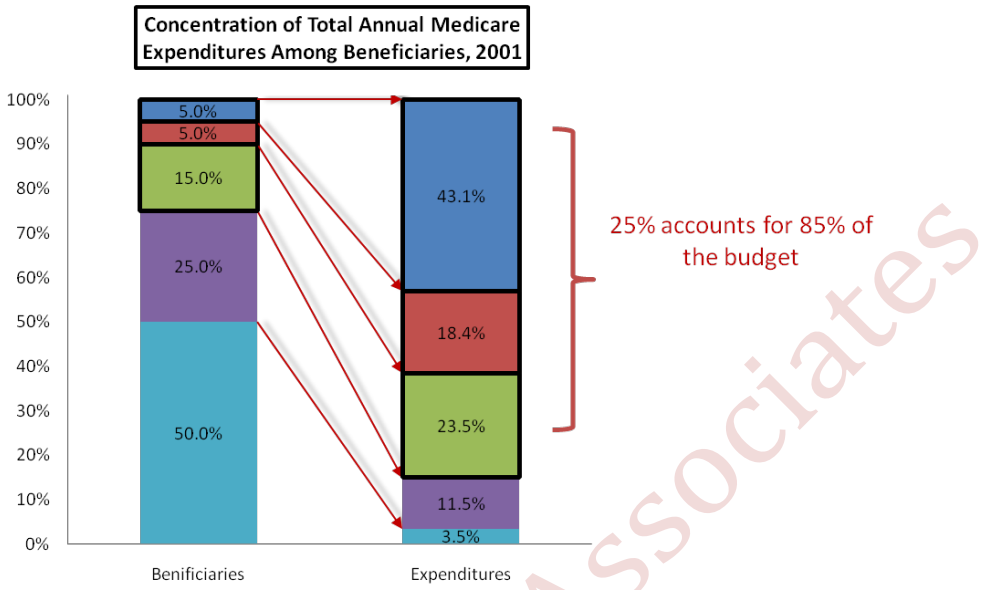
Home care has opportunity to grow but must meet healthcare needs

All indications make clear that when it comes to evaluating the results of health care providers only one measure of cost and quality will ultimately matter - the percentage of avoidable readmissions. Factors such as federal and state budget cuts, an aging baby boomer generation consuming increasing levels of healthcare services, and a shortage of nurses and other healthcare professionals will add to the stress for payer sources to find ways to cut costs and lower avoidable readmissions. Home care is positioned better than any other healthcare sector to play a significant role as a solution to this enormous challenge. However, if homecare does not step forward as a leader to solve or at least manage these challenges, another sector will. *Homecare's ability to adequately address and provide solutions to the avoidable readmission problem is what will prevent the industry from becoming marginalized and have the opportunity to thrive.*

Independence at Home Act (IAH)

Currently, 25% of Medicare beneficiaries account for 85% of the cost of Medicare spending, while 50% only account for 4% of total cost (See Figure 1.).[vi] The most costly of these beneficiaries all have one or more chronic diseases. IAH (H.R. 2560, S. 1131) became law on March 23rd, 2010, as a component of the Patient Protection and Affordable Care Act (PPACA), in order to control increasing Medicare expenditures and at the same time provide effective and efficient care for these high-risk patients.[vii]

Figure 1.



IAH allows for physicians and other licensed, independent practitioners (LIPs), such as nurse practitioners, and physician assistants, to serve as primary care providers (PCPs) for high-risk patients with one or more chronic diseases. Most importantly these healthcare professionals will coordinate care with other providers such as home care, hospice and specialty pharmacy (e.g. infusion therapy). This high level of coordination will produce substantial net savings to the healthcare system at the same time a higher quality of care than is currently being delivered.

IAH will lower costs and incentivize savings

Unlike the current business models that are designed entirely around reimbursement, the IAH program will be funded primarily from the cost savings it achieves. For care providers who are able to achieve a 5% annual savings of forecasted costs for an individual patient's care, the savings will split such that 80% goes to the provider and 20% goes to CMS. Given the annual costs associated with caring for high-risk patients, those providers who achieve the outlined objectives stand to reap substantial financial benefits.

Figure 2 (page 4) illustrates the savings of four institutions that developed physician and nurse practitioner lead home visit programs. The middle column shows that expenditures for visits in the home increased as part of the program. However, overall costs associated with caring for this patient population decreased dramatically.

Figure 2.

Visit costs vs. Total Costs
(in 80 year olds with 5+chronic conditions)

Hospital	Cost Per Visit	Total Costs
University of Pennsylvania	+ 10%	- 45%
Virginia Commonwealth University	+ 24%	- 68%
VAHBPC	+ 460%	-24%
Nevada SHMO	+ 42%	-13%

Figure 3 shows the Veterans Administration's most recently published data for its Home-Based Primary Care program.[viii] Although costs associated with home care and outpatient services increased, there was significant savings in the more costly hospital and nursing home settings because chronic disease patients were more effectively able to manage their health at home.

Figure 3.

Cost of Care Per Patient Before vs. During Use of Home-Based Care

Type of Care	Before HBPC	During HBPC	Change
Total Cost of Care in Virginia	$38,168	$29,036	- 24% P<0.0001
Hospital	$18,868	$7,026	- 63%
Nursing home	$10,382	$1,382	- 87%
Outpatient	$6,490	$7,140	+ 10%
All Home Care	$2,488	$13,588	+ 460%

Initially, IAH will be a three-year demonstration, including only 50 providers and serving 10,000 patients. However, given the Congressional Budget Office's projection that IAH will be budget neutral with likely savings and the expected positive response from patients and their caregivers, its implementation is likely to accelerate.

New Opportunities for Home Care

Given the new avoidable readmission penalties and the introduction of IAH's economic incentives, home care is positioned better than any other healthcare sector to adapt and meet the demands of the changing healthcare industry. Through low-cost, patient-centered care, home care will be able to attract a much greater percentage of healthcare dollars.

Hospitals will refer to companies with lowest readmission rates

Neither home care nor hospitals can continue operating home healthcare the way they have been given the new penalties. Currently, the best performing U.S. hospitals produce 1- 3% net operating margins, while 20% of all U.S. hospitals have negative operating margins.[ix] With narrow to negative margins, a 1% Medicare reimbursement penalty could prove catastrophic for any hospital that is not able to rein in its avoidable readmission rate.

However, this reimbursement change will prove to be an opportunity for independent home care agencies, in particular, because hospitals have a greater incentive to refer their patients to the most efficient agencies that are least likely to readmit the hospital's patients. Hospital-owned agencies may no longer receive preferential referrals. ***Independent agencies that are able to demonstrate low avoidable readmission rates will have a competitive advantage in receiving referrals from hospitals that are particularly concerned with their readmission rates.*** Some hospitals may even have to consider closing or spinning off their agencies to be certain they can shop for the best possible provider. Even the largest hospital-owned home care agencies' profits would have a difficult time off setting a 1% or greater reduction in Medicare reimbursement.

Home care becoming primary care source will bring more money to sector

Medicare will not be the only payer wanting to pursue cost savings programs similar to IAH. Given the substantial budget deficits faced across the country, state Medicaid programs will be looking to develop similar programs to enroll individuals with multiple chronic diseases. Commercial insurers will also be highly motivated to enact similar programs to effectively care for the previously 40 million uninsured they are required to extend coverage to as part of the PPACA. Since proactive monitoring and care is the only means by which to minimize often unnecessary hospitalizations and other healthcare costs, all payer sources will be looking to these types of providers to manage patients with costly chronic diseases.

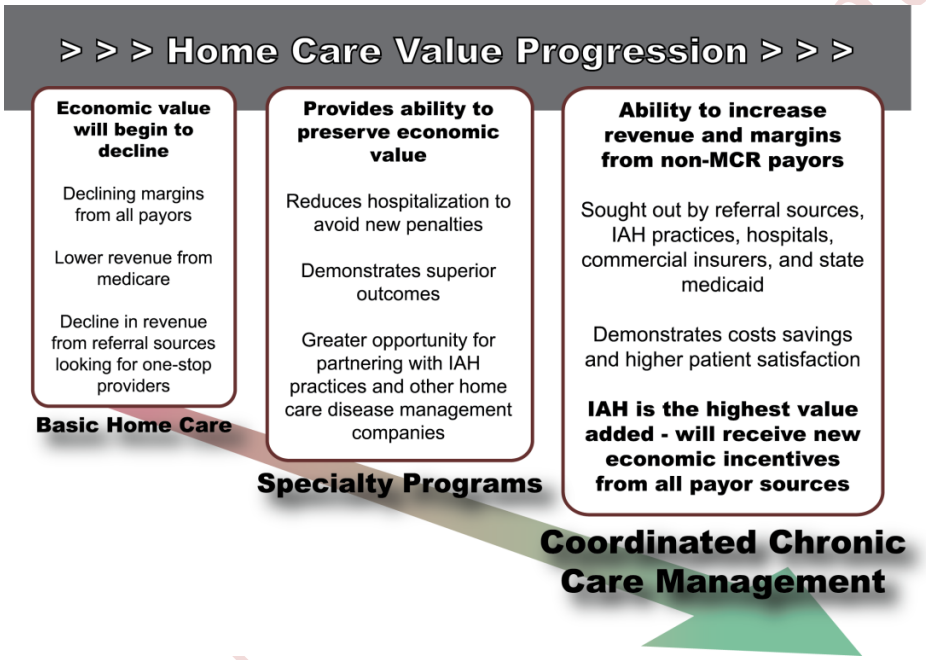
IAH model will attract new, talented physicians to primary care

Although the primary care physician shortage is often cited as a significant obstacle to the success of IAH, we believe it will actually attract new, young talent to the field. The IAH model of care will allow physicians and other LIPs to serve patients in need of care at the same time they are earning a substantial living. Economic incentives from payers will also allow them to earn more money based on their outcomes. As IAH-type care becomes standard it will attract younger physicians who might otherwise go into an office-based practice as well as attract those currently practicing as hospitalists. Additionally, more medical students will choose internal medicine rather than becoming specialists as the pay off becomes greater.

The Value Progression

While a new and tremendous opportunity exists for the home care sector, agencies still face significant challenges to maximize the value they add to the healthcare industry. One view is that the home care sector will create and preserve value along a Value Progression (see Figure 4). To maximize value, agencies will have to advance along the Value Progression from providing basic home healthcare to more comprehensive, coordinated chronic care management. This section of the paper will outline the specific health care delivery and expertise levels that agencies will need to achieve in order to thrive.

Figure 4.



Basic Home Care

Home care, at its most basic level, is episodic such that a hospital or other provider will refer a patient to an agency because of a specific event or episode for a specified amount of time. As Wyatt Matas & Associates discussed in the "Delineation" white paper, in the mid-2000's the US experienced a proliferation of home care agencies, all boasting the highest quality of care, taking all insurances, accepting weekend referrals, etc. However, in general, it very difficult for referral sources to differentiate one agency's services from another's.

While some home care agencies offering this basic type of care may maintain profitable margins right now, they will not be able to sustain growth or profitability into the future. Basic Home care providers will experience real losses given the changes in avoidable readmissions penalties and the new economic incentives in IAH. Moving along the Value Progression will not just be a way for companies to gain a competitive advantage, it will be necessary for agencies' survival.

Specialty Programs

In an effort to differentiate its services and provide patients with more effective care, Gentiva Health Services began to offer specialty programs designed for specific conditions in the mid-2000s. These programs offered referral sources identifiable products that they could recommend to their patients, thereby distinguishing Gentiva's services from other agencies'. However, the rest of the home health sector quickly jumped on the trend and now most specialty programs tend to be points of parity rather than sources of competitive advantage.

Furthermore, with lawmakers and other entities looking to reduce healthcare expenditures wherever possible, specialty programs that focus on high levels of therapy utilization, such as joint replacement and fall prevention, will face the greatest challenges in the near future. Firstly, these programs are perceived as addressing or managing "expensive" chronic diseases like diabetes and heart failure. Secondly, although they can save the system significant sums in avoided trips to the ER and hospitalizations, not to mention the improved quality of life for patients served, the lack of variability in the physical therapy visit frequency for these programs brings them into question.

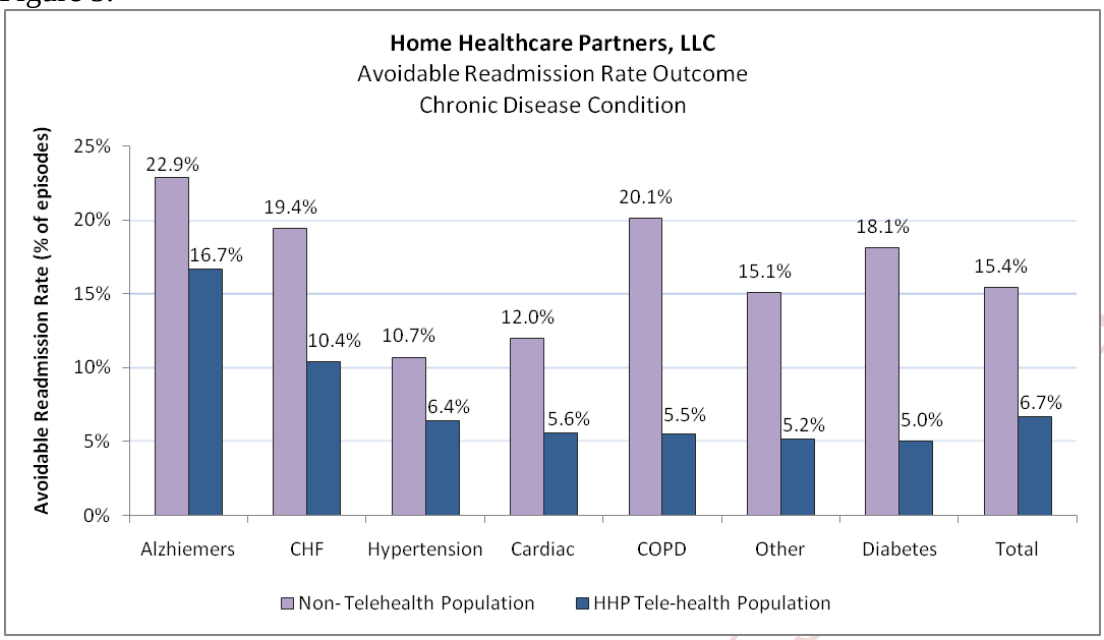
Coordinated Chronic Care Management

Coordinated chronic care management companies look beyond episodic, event-based care and consider the entire process of a chronic disease. They serve as health educators, care coordinators as well as care providers for their patients. We maintain our position we set forth in "Delineation" that those companies that effectively become coordinated chronic care management companies will have a clear competitive advantage over providers that do not.

IAH will, in effect, serve as a subset of coordinated chronic care management. To provide effective care and benefit from the economic incentives, IAH practices will seek to partner with home care agencies that demonstrate high-level coordination. While the details of the contract have not yet been disclosed, we believe Amedisys' recent partnership with Humana is an early example of this.

Figure 5 (page 8) illustrates a dramatic example of the profound impact an effective coordinated chronic care management initiative. Home Healthcare Partners of Dallas, Texas has successfully implemented tele-health and other active patient monitoring and intervention techniques to lower its avoidable readmissions.

Figure 5.



Considerations for Home Care Agencies

While the future profitability of home care is far from certain, the rapid and significant change within the industry is undeniable. Organizations of all sizes and ownership structures must determine if and how they will adapt to the changing landscape. Home care organizations will to evaluate their options and what financial, clinical and operational resources will be required to move along the Value Progression.

Those organizations choosing to advance towards coordinated chronic care management will need to have a clear strategic plan and talented staff able to execute it. Some companies will choose to acquire the talent to make by acquiring an organization that already possesses the requisite expertise. Other companies will enter into joint ventures or other formal partnerships to gain access to the skills they lack.

Organizations that choose to remain focused on specialty programs will have to critically examine their competitive landscape and indentify the skills and resources they need to differentiate themselves. Maximizing efficiency to maintain margins and cash flow will also be essential as reimbursements continue to be cut. It is clear that agencies will no longer be able to be all things to all referral sources and must select a specialty program in which they can truly excel.

Regardless of the organization's choice to differentiate its specialty programs or move towards coordinated chronic care management, this is an exceptional time to create value and position the company for continued growth and profitability into the future. Failure to act however will result in real and significant economic losses and for the company. The only option to thrive in this new healthcare environment is to advance.

About Wyatt Matas & Associates

Wyatt Matas & Associates is an investment banking firm that specializes in advising healthcare service providers on strategic and financial matters. We aim to provide thought leadership regarding opportunities and challenges facing the rapidly evolving healthcare services industry. Our focus in this process is establishing enduring relationships based on performance, trust and integrity.

We provide buy and sell-side mergers and acquisition, equity and debt capital sourcing, restructuring and strategic advisory services. Unlike larger and less specialized investment banks, Wyatt Matas & Associates is not owned by a larger financial institution. This allows us the time to focus on custom solutions to ensure our clients' success. Also, unlike other investment banks, in certain circumstances we deploy our own capital and expertise in joint ventures and direct investment in client companies. We only pursue these opportunities that can benefit from our unique experience, relationships and skill-sets.

Given the unique nature of the healthcare sectors Wyatt Matas & Associates has developed a healthcare management consulting group. WMA Strategic Healthcare Advisors develops strategies and tactics for growth oriented healthcare service clients. Our primary objective is to capitalize on our team's deep industry experience combined with our extensive network of operators, financiers, consultants and other expert professionals to help our clients achieve their goals. The Strategic Advisors unit delivers customized, practical and actionable solutions to provide its clients with a clear understanding of the steps required to create significant value. If needed, our team will step in on an interim management basis or find the appropriate professional to help take a company to the next level.

[i] Jencks, S.F., M.V. Williams, and E.A. Coleman. "Rehospitalizations among Patients in the Medicare Fee-for-Service Program." *New England Journal of Medicine* 360.14 (2009).
[ii] Jencks.
[iii] *Chronic Conditions: Making the Case for Ongoing Care*. *Partnership for Solutions*. Johns Hopkins University, 2004. Web. <www.partnershipforsolutions.org>.
[iv] Jencks.
[v] Jencks.
[vi] Congressional Budget Office, Based on Data from Centers for Medicare and Medicaid Services.
[vii]. *Chronic Conditions*
[viii] Home Healthcare Partners, LLC
[ix] "Should Chronically Ill Patients Be Treated in the Hospital Setting?" Healthcare Economist, 18 Mar. 2010. <http://healthcare-economist.com/>.