AN ALERT FROM THE BDO CENTER FOR HEALTHCARE EXCELLENCE & INNOVATION

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CREATIVE CAPITAL STRATEGIES HOSPITALS CAN USE TO GENERATE REVENUE AND FUEL INNOVATION

Civica Rx, which unveiled the location for its headquarters on April 19, could provide the new blueprint for how hospitals innovate to generate alternative sources of capital.

The company, a nonprofit formed by a group of hospitals to reduce drug prices and boost competition among the generic drug industry, will be governed by seven health organizations (representing about 500 U.S. hospitals), and has pledged to create 14 hospital-administered drugs this year alone.

And it's not alone.

As credit rating degradation continues—and taxable financing options to innovate out of debt become less viable—coming up with new ways to address liquidity challenges and raising capital is becoming a growing trend and a business imperative for hospitals.

Expense growth continues to outpace revenue growth for U.S. non-profit and public hospitals, according to Moody's August 2018 analysis. The growing gap places the sector in an unsustainable spiral with data showing that 28.4 percent of hospitals recorded operating losses in 2017, up from 16.5 percent in 2016. A total of 59 percent of providers, meanwhile, reported lower absolute operating cash flows—the highest percentage in five years.

In the face of these numbers, alternative sources of capital—a burgeoning trend in healthcare as leadership teams look to maximize revenue through innovation—could be hospitals' saving grace.

No two alternative financing solutions are identical, but the following examples could be particularly meaningful transformational opportunities for hospitals:

- Digital and physical B2C value chains
- Pooled asset management strategies
- Commercial Property Assessed Clean Energy (C-PACE) financing vehicles

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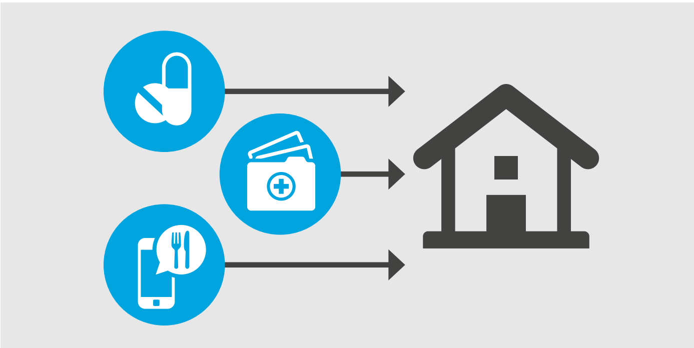
B2C VALUE CHAINS DRIVE NEW VALUE



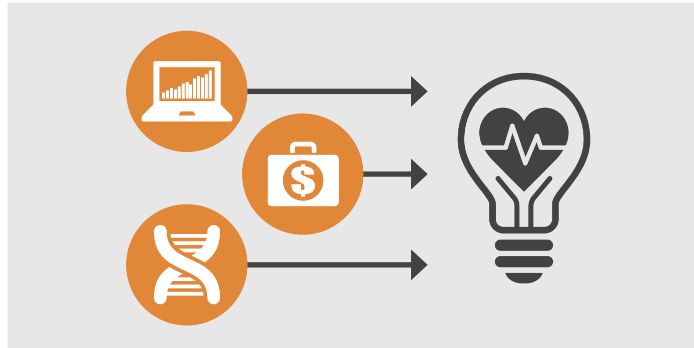
Hospitals are finding innovative ways to create value from their electronic health records (EHRs) without sacrificing patient privacy. By digitizing the back office of a hospital ecosystem, providers can partner with for-profit, tech savvy enterprises to innovate new products and solutions or profit-share while providing better care experiences and improved outcomes for patients.

One example of this approach is Washington-based Providence St. Joseph Health (PSJH) system, which successfully incubated tech startup **Xealth**, an EHR-integrated application that recommends non-medical purchases customized to a hospitalized patient's condition. For-profit vendors who partner with Xealth are given enough information to improve patient outcomes without compromising **anonymity**. Proceeds from purchases on the platform are then shared between vendors and PSJH in a non-exclusive digital marketplace with room for growth. Current for-profit adoptees of Xealth include providers of health materials, devices, meal delivery services, **Lyft and Amazon**.

Another B2C value innovation comes from Beaumont Health, a Michigan-based health system leveraging its ownership of the Woodward Corners mall adjacent to its **Beaumont Hospital Royal Oak campus**. Beaumont, which has owned the property since the 1980s, announced in February 2019 plans for a $38.2 million commercial development that would incorporate a shopping center, food court, five-story hotel and a Beaumont-branded urgent care center in a "retailizaton" of its profit model.

The Los Angeles-based Barlow Respiratory Hospital, meanwhile, is charting a course similar to Beaumont Health with its proposed development of a **large residential community** next to Dodgers Stadium on land it owns. In the middle of a **housing crisis in Los Angeles**, Barlow's plan seeks to convert hospital property into housing for lower and middle-class households, reinventing the use of its underutilized outlier property.

POOLED ASSETS FUEL NEW INNOVATION ACROSS THE HEALTH ECOSYSTEM



Another alternative capital strategy that hospitals and health systems may find even more attractive is to calibrate their data, IP, talent and assets with legal help, experienced consultants and private investors. The resulting budded entity can be a company, fund, venture capital group or technology transfer office that manages out-licensing.

In one case, five different health systems—including Children's Hospital of Orange County, Avera Health and Bon Secours Mercy Health—contributed their pooled assets to establish **The Innovation Institute**, a healthcare incubator focused on innovation and growth. The ensuing shared revenue generated from The Institute includes proceeds from medical billing, software architecture, biomedical engineering and medical office buildings. The Institute has, to date, demonstrated success with 15 portfolio companies and revenues exceeding $300 million.

In another creative example, City of Hope, a private non-profit hospital, clinical research center and medical school in Duarte, California, established its **Office of Technology Licensing.** The office works with City of Hope inventors to identify, protect and create strategies that commercially advance their technologies and products. The office's patent portfolio led to the formation of Genentech, Inc., which, through a lucrative royalty contract agreement, developed **human recombinant gene technologies,** including a new source of insulin that was the first biologic approved by the FDA. While not every out-licensing agreement results in a completely novel product, royalties are an attractive—and often overlooked—alternative capital option hospitals should investigate.

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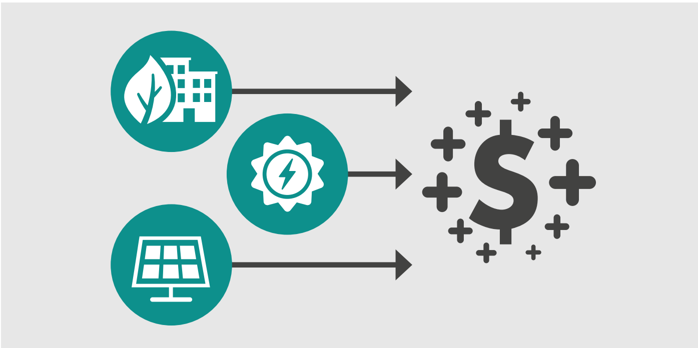
C-PACE FINANCING VEHICLES OFFER CASH FOR GOING GREEN



For hospital administrators seeking to make upgrades to facilities currently under management, the **C-PACE** financing structure could be their answer.

Thirty-three states have approved the C-PACE financing structure, which allows building owners to borrow money for energy efficiency, renewable energy and other projects and then make repayments through an assessment on their property tax bill. Funds raised through C-PACE remain with the **building property**, enabling long-term investments in building performance. Financing for C-PACE projects are repaid after 10 years and have reduced liability relative to other taxable financing strategies.

A recent $40 million PACE package was awarded to Seton Medical Center in Daly City, California, to earthquake-proof its facilities. Protection of existing assets can not only pay off in the long run, but also extend to privately owned commercial properties through the commercial side of the program. C-PACE financing can even help a hospital fund its B2C value chain if funds are used to improve long-term assets under management.

Finding alternative sources of capital to fuel revenue, maximize profitability and enable innovation is becoming a business imperative for hospitals—but no one solution fits all. Reach out to us for more information about what creative capital strategy is best for your organization.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