Island Hospital

2013 Board Retreat

November 8 and 9, 2013
What Is Our Purpose?

The goals of the 2013 Island Hospital Board Retreat are listed below.

• Arrive at a consensus regarding the near-term affiliation decision.
• Develop tactical action plans based on this decision, to include:
  – If applicable, the desired level of affiliation and timing to implement.
  – The identification of key milestones (financial, competitive, operational, other) that will prompt IH to pursue an exclusive alliance.
Review of Healthcare Trends Impacting Hospitals
Review of Healthcare Trends
Acute Care Hospital Pressures

There are three main areas of pressure facing acute care hospitals in today’s environment; declining revenue, capital demands, and new payment/business models.

<table>
<thead>
<tr>
<th>Declining Revenue</th>
<th>Increased Costs/ Capital Demands</th>
<th>New Payment/ Business Models</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Decrease in governmental reimbursement.</td>
<td>• IT needs.</td>
<td>• Business models needed for ACO success.</td>
</tr>
<tr>
<td>• Commercial payor pressure.</td>
<td>• Physician strategies.</td>
<td>• Capitation and similar payments.</td>
</tr>
<tr>
<td>• Lower utilization.</td>
<td>• Technological and physical plant investments.</td>
<td></td>
</tr>
</tbody>
</table>

Review of Healthcare Trends
Declining Revenue – Pressure From Governmental Payors

2011 marked the first overall reduction to Medicare rates since the highly disruptive Balanced Budget Act of 1997.

- Medicare, the single largest source of hospital revenue, introduced rate adjustments for FY 2011 and FY 2012 to recollect on presumed overpayments that occurred in 2008 and 2009.
- These adjustments took the form of a 5.8% payment reduction, to be spread evenly over 2 years.
- In addition, Medicare RAC audits are further cutting back on the payments hospitals receive from Medicare.
- Further, in 2013, sequestration cut Medicare reimbursement by an additional 2%.

1 “U.S. Not-For-Profit Healthcare Sector Negative Outlook for 2012,” Moody’s, January 2012.
Review of Healthcare Trends
Declining Revenue – Lower Utilization

Inpatient use rates are projected to fall across all populations.

National Inpatient Use Rates, 2011–2021

Source: Milliman, Kaiser State Health Facts, AHA.
Outpatient use rates are also projected to fall over the next decade.

MRI Usage

Ambulatory Surgery

CT Scans

Office/Home/Urgent Care/Physical Exam Visits

Source: Milliman, Kaiser State Health Facts, AHA.
Although there has not yet been a major shift, payment models based on fee-for-service are incorporating value components that will transition greater risk from payors to providers.

The Risk Continuum Associated With Existing and Proposed Reimbursement Structures

- Consumers
- Employers
- Health Plans
- Governmental Payors

1 Medical homes that receive extra dollars for patient management.
2 P4P = pay for performance.

Review of Healthcare Trends
Healthcare Exchange

Revenue is projected to decrease with additional patients enrolling in Medicaid or the lower-paying exchanges.

• Initial enrollment numbers show that 85% of the enrollees in the Washington State insurance exchange are signing up for Medicaid; this is a much higher percentage than originally projected.¹

• Reimbursement from exchanges is widely expected to be below other payors.

• A number of concerns have been raised about the effect of exchanges on the commercial insurance market, including the following:
  – The penalties for failing to offer coverage to employees are much lower than the cost of premiums. Therefore, many employers are expected to drop coverage, shifting high-paying commercial patients into lower-reimbursing exchanges.
  – The penalties for individuals failing to purchase through an exchange are also much lower than premiums. Therefore, the extra premium dollars from these relatively healthy patients (needed to subsidize care for others) may not materialize.

¹ Source: “In first month, the vast majority of Obamacare sign-ups are in Medicaid,” Washington Post, November 1, 2013.
Five of the six nonprofit hospitals downgraded by Moody’s Investors Service in 1Q 2013 were small hospitals, due in large part to smaller margins.¹

Trends in the Largest 50/Smallest 50 Hospitals²

Five of the six nonprofit hospitals downgraded by Moody’s Investors Service in 1Q 2013 were small hospitals, due in large part to smaller margins.¹

1 Source: “Moody’s: Small Hospitals Bear Brunt of 1Q Downgrades.” Small hospitals are those with less than $500 million in annual revenue (http://www.beckershospitalreview.com/racs/-/icd-9/-/icd-10/moodys-small-hospitals-bear-brunt-of-1q-downgrades.html).

2 Source: “Hospital Revenues In Critical Condition; Downgrades May Follow,” Moody’s Investors Service, Inc., August 10, 2011. Numbers do not necessarily sum to 100% because each is a separate median calculation.
Given these trends, hospital success will depend upon the ability to drive quality and service in an efficient manner.

1. Enhance Service Line Structure
2. Affiliate to Gain Economies of Scale Where Possible
3. Explore Network Development
4. Develop a Medicare Strategy
5. Collaborate With Payors
6. Align Physician Incentives
7. Build and Optimize IT Infrastructure

Given these trends, hospital success will depend upon the ability to drive quality and service in an efficient manner.
Current State of Island Hospital
Since 2000, IH management has undertaken a number of strategic cost-reduction and revenue growth initiatives that have improved and maintained its financial health.
**Current State of Island Hospital**

**Financial Trends**

IH’s financial situation has been stable over the past 3 years, with net revenue growing each year.

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
<th>2013 (annualized)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Revenue</strong></td>
<td>$70,938,456</td>
<td>$77,618,595</td>
<td>$80,130,201</td>
</tr>
<tr>
<td><strong>Operating Margin</strong></td>
<td>$(1,430,226)</td>
<td>$272,333</td>
<td>$(1,155,165)</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>$(14,692)</td>
<td>$1,544,984</td>
<td>$869,443</td>
</tr>
<tr>
<td><strong>Days Cash On Hand</strong></td>
<td>98.66</td>
<td>107.40</td>
<td>95.62</td>
</tr>
</tbody>
</table>

1 Annualized 2013 data includes performance through September. Net income and DCOH is inclusive of expected meaningful use payments.
Current State of Island Hospital  
Year to Date 2013

IH’s financial situation is stable, though margins are thin.

• Currently IH holds approximately $19.2 million in cash, with a days cash on hand measure of 91 days.
  – This means that if no more payments came in, IH could continue to pay its bills for 91 days.
  – This is below the national average\(^1\) but higher than the IH bond covenant minimum of 75 days.

• IH’s age of plant is 8.95, which is below the S&P national average of 10.4, indicating that IH has appropriately invested in facilities and capital upgrades.

• YTD 2013, IH has a negative operating margin ($864,000) and a negative net income ($61,000), although expected meaningful use payments of $951,000 will positively impact the bottom line.

\(^1\) Source: Median DCOH for Baa2-rated hospitals: 124.9.
As early as next year, Island Hospital is projecting capital needs in excess of available cash.

### Island Hospital Projected 5-Year Capital Need

<table>
<thead>
<tr>
<th>Capital Equipment Projections</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Facility Updates</td>
<td>$733,522</td>
<td></td>
<td>$3,500,000</td>
<td></td>
<td></td>
<td>$4,233,522</td>
</tr>
<tr>
<td>Routine Equipment (includes patient care &amp; IT)</td>
<td>$2,574,830</td>
<td>$2,750,000</td>
<td>$2,750,000</td>
<td>$3,000,000</td>
<td>$3,000,000</td>
<td>$14,074,830</td>
</tr>
<tr>
<td>Diagnostic Imaging Equipment</td>
<td>$108,200</td>
<td>$2,034,160</td>
<td>$2,164,000</td>
<td>$541,000</td>
<td>$3,137,800</td>
<td>$7,985,160</td>
</tr>
</tbody>
</table>

| Total Capital Budget               | $3,416,552    | $4,784,160    | $4,914,000    | $7,041,000    | $6,137,800    | $26,293,512    |
| Island Hospital Foundation         | $222,500      | $187,500      | $187,500      | $187,500      | $187,500      | $972,500      |
| Depreciation (non-cash item)       | $4,270,000    | $3,802,404    | $3,986,344    | $4,032,329    | $4,299,042    | $20,390,117    |
| Excess/(Shortfall)                 | $1,075,948    | (794,256)     | (740,156)     | (2,821,171)   | (1,651,258)   | (4,930,895)    |

**In addition, in IH’s master plan, there are $65 million in non-routine planned capital needs.**
Current State of Island Hospital Master Plan

The strategic/facility upgrades in the Island Hospital master plan are substantial and will outpace capital that is generated from operations.

- The near-term strategy, within the next 5 to 10 years, addresses the most pressing needs of the hospital, including:
  - Increase surgical volumes.
  - Improve OR efficiency.
  - Increase parking capacity.
  - Resolve cross-flow issue and modernization needs of ICU.
  - Locate the helipad above ground.
- A hospital addition is proposed, which would include a lower-level MOB, level-one obstetrics (OB), a level-two Intensive Care Unit (ICU), and a prefabricated roof-mounted helipad.
- The plan also proposes that a parking structure be developed at the Northwest corner of the campus.
Island Hospital Financial Projections
Financial Projections
Introduction and Data Sources

For the initial financial modeling, ECG Management Consultants, Inc., has projected IH’s 5-year financial performance under four scenarios.

- Baseline.
  - Island Hospital financials, including:
    » YTD financial statements through September 2013 (annualized).
    » Capital budget.
  - Population growth estimates from Kaufmann Hall.
- Implications of the Affordable Care Act (ACA).
  - Lewin Group ACA projections.
- Implications of the IH master facility plan.
- Implications of accelerated expense growth.
  - Island Hospital Advisory Board report.
  - Publicly available benchmarks and rating agency material.

Each scenario is additive and includes the effects of the previous scenario(s).
Financial Projections
Baseline Scenario

In this scenario, revenue and expense continues to grow at a steady rate, IH does not make any non-routine capital investments, and there is limited to no impact from health reform.

- Revenue and expenses grow at the same rate as the population (0.9%).
- Routine capital needs (including IT and imaging equipment) are funded through cash that is generated from operations; there is no strategic capital spending.
- The anticipated effects of the ACA on payor mix and reimbursement do not manifest.
- The expected meaningful use payments are received in 2013 ($951,000) and 2014 ($750,000).
- The near-term service line opportunity is carried out, and the net benefit to IH is an additional $500,000 in contribution margin.
- The days cash on hand benchmark used is 75 days; this is an IH bond covenant.
## Financial Projections

### Baseline Scenario (continued)

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Base Operating Revenue</strong></td>
<td>$ 80,130</td>
<td>$ 80,851</td>
<td>$ 81,579</td>
<td>$ 82,313</td>
<td>$ 83,054</td>
<td>$ 83,802</td>
</tr>
<tr>
<td>Lewin Report</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Change in Revenue</td>
<td>-</td>
<td>-</td>
<td>500</td>
<td>504.50</td>
<td>509.04</td>
<td>513.62</td>
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<tr>
<td><strong>TOTAL OPERATING REVENUE</strong></td>
<td>$ 80,130</td>
<td>$ 81,351</td>
<td>$ 82,084</td>
<td>$ 82,822</td>
<td>$ 83,568</td>
<td>$ 84,320</td>
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<td><strong>Base Operating Expense</strong></td>
<td>$ 77,090</td>
<td>$ 77,784</td>
<td>$ 78,484</td>
<td>$ 79,190</td>
<td>$ 79,903</td>
<td>$ 80,622</td>
</tr>
<tr>
<td>Depreciation</td>
<td>4,195</td>
<td>4,195</td>
<td>4,195</td>
<td>4,195</td>
<td>4,195</td>
<td>4,195</td>
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<tr>
<td>Additional Interest Expense</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<td>-</td>
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<tr>
<td>Change in Expenses</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>TOTAL OPERATING EXPENSES</strong></td>
<td>$ 81,285</td>
<td>$ 81,979</td>
<td>$ 82,679</td>
<td>$ 83,386</td>
<td>$ 84,098</td>
<td>$ 84,817</td>
</tr>
<tr>
<td><strong>OPERATING MARGIN</strong></td>
<td>(1,155)</td>
<td>(628)</td>
<td>(596)</td>
<td>(563)</td>
<td>(531)</td>
<td>(498)</td>
</tr>
<tr>
<td><strong>Nonoperating Revenue/(expense)</strong></td>
<td>$ 1,074</td>
<td>$ 1,833</td>
<td>$ 1,093</td>
<td>$ 1,103</td>
<td>$ 1,113</td>
<td>$ 1,123</td>
</tr>
<tr>
<td><strong>NET INCOME</strong></td>
<td>(82)</td>
<td>1,205</td>
<td>497</td>
<td>540</td>
<td>582</td>
<td>625</td>
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<tr>
<td>Noncash Items (Depreciation)</td>
<td>$ 4,195</td>
<td>$ 4,195</td>
<td>$ 4,195</td>
<td>$ 4,195</td>
<td>$ 4,195</td>
<td>$ 4,195</td>
</tr>
<tr>
<td>Routine Capital</td>
<td>(4,784)</td>
<td>(4,914)</td>
<td>(3,541)</td>
<td>(6,137)</td>
<td>(5,164)</td>
<td></td>
</tr>
<tr>
<td>Strategic Capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Purchases</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Cash From Debt</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Principal Repayment</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Change in Cash</td>
<td>617</td>
<td>(221)</td>
<td>1,194</td>
<td>(1,359)</td>
<td>(343)</td>
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<tr>
<td><strong>CASH POSITION</strong></td>
<td>$20,195</td>
<td>$20,812</td>
<td>$20,591</td>
<td>$21,785</td>
<td>$20,426</td>
<td>$20,082</td>
</tr>
<tr>
<td><strong>DAYS CASH ON HAND</strong></td>
<td>95.62</td>
<td>97.66</td>
<td>95.76</td>
<td>100.41</td>
<td>93.30</td>
<td>90.92</td>
</tr>
<tr>
<td>Bond Covenant Days Cash on Hand</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
</tr>
</tbody>
</table>
The projections done by the Lewin Group focus on the impact of the following:
- Increased revenue from the newly insured patients.
- Reductions to uncompensated care.
- Reduced revenue from Medicare and Disproportionate Hospital Share (DSH) cuts.

Two scenarios were given:
- Scenario A: Exchange Enrollees at Current Trended Commercial Rates.
- Scenario B: Exchange Enrollees at Current Trended Medicare Rates.

It is unknown what the exchange rates will eventually be, but there are indications that they will pay below commercial rates. To reflect a moderate projection, the analysis assumes rates would be between Medicare and commercial levels.
## Financial Projections

### ACA Projections (continued)

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Base Operating Revenue</strong></td>
<td>$80,130</td>
<td>$80,951</td>
<td>$81,579</td>
<td>$82,313</td>
<td>$83,054</td>
<td>$83,802</td>
</tr>
<tr>
<td><strong>Lewin Report</strong></td>
<td>-</td>
<td>(1,091)</td>
<td>(1,713)</td>
<td>(2,099)</td>
<td>(2,616)</td>
<td>(3,184)</td>
</tr>
<tr>
<td><strong>Depreciation</strong></td>
<td>4,195</td>
<td>4,195</td>
<td>4,195</td>
<td>4,195</td>
<td>4,195</td>
<td>4,195</td>
</tr>
<tr>
<td><strong>Change in Expenses</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>TOTAL OPERATING EXPENSES</strong></td>
<td>$81,285</td>
<td>$81,979</td>
<td>$82,679</td>
<td>$83,386</td>
<td>$84,098</td>
<td>$84,817</td>
</tr>
<tr>
<td><strong>Operating Margin</strong></td>
<td>(1,155)</td>
<td>(1,719)</td>
<td>(2,309)</td>
<td>(2,662)</td>
<td>(3,147)</td>
<td>(3,682)</td>
</tr>
<tr>
<td><strong>Nonoperating Revenue/(expense)</strong></td>
<td>$1,074</td>
<td>$1,833</td>
<td>$1,093</td>
<td>$1,103</td>
<td>$1,113</td>
<td>$1,123</td>
</tr>
<tr>
<td><strong>NET INCOME</strong></td>
<td>$ (82)</td>
<td>$114</td>
<td>$(1,216)</td>
<td>$(1,559)</td>
<td>$(2,034)</td>
<td>$(2,559)</td>
</tr>
<tr>
<td><strong>Noncash Items (Depreciation)</strong></td>
<td>$4,195</td>
<td>$4,195</td>
<td>$4,195</td>
<td>$4,195</td>
<td>$4,195</td>
<td>$4,195</td>
</tr>
<tr>
<td><strong>Routine Capital</strong></td>
<td>$(4,784)</td>
<td>$(4,914)</td>
<td>$(3,541)</td>
<td>$(6,137)</td>
<td>$(5,164)</td>
<td></td>
</tr>
<tr>
<td><strong>Strategic Capital</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Capital Purchases</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Cash From Debt</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Principal Repayment</strong></td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Change in Cash</strong></td>
<td>$(475)</td>
<td>$(1,934)</td>
<td>$(905)</td>
<td>$(3,976)</td>
<td>$(3,528)</td>
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<tr>
<td><strong>Cash Position</strong></td>
<td>$20,195</td>
<td>$19,720</td>
<td>$17,786</td>
<td>$16,881</td>
<td>$12,906</td>
<td>$9,378</td>
</tr>
<tr>
<td><strong>DAYS CASH ON HAND</strong></td>
<td>95.62</td>
<td>92.54</td>
<td>82.72</td>
<td>77.81</td>
<td>58.95</td>
<td>42.46</td>
</tr>
<tr>
<td><strong>Bond Covenant Days Cash on Hand</strong></td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
</tr>
</tbody>
</table>
IH recently completed a 2035 Master Facility Plan; an estimated $65 million in strategic capital needs were identified over the next 10 years.

Near-Term Strategic Capital Needs (5 to 10 Years)

<table>
<thead>
<tr>
<th>Project</th>
<th>Project Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hospital Addition</td>
<td>$34,639,976</td>
</tr>
<tr>
<td>Surgery Remodel</td>
<td>$21,395,800</td>
</tr>
<tr>
<td>Outpatient Remodel</td>
<td>$2,630,706</td>
</tr>
<tr>
<td>Structured Parking</td>
<td>$5,119,000</td>
</tr>
<tr>
<td>Building Demolition</td>
<td>$365,700</td>
</tr>
<tr>
<td>Surface Parking Lot</td>
<td>$447,902</td>
</tr>
</tbody>
</table>

• For modeling purposes, we assumed the surface parking lot would be built in Year 2 ($448,000), the surgery remodel would occur in Year 4 ($21.4 million), and the remaining capital projects would be conducted after 5 years.

• For all strategic capital, debt of 100% LTV with a 30-year term was assumed, with current interest rate for A-rated municipal bonds of 5.05%.
Financial Projections
Implementation of Master Facility Plan (continued)

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
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<td>(2,616)</td>
</tr>
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<td></td>
<td></td>
<td>500</td>
<td>504.50</td>
<td>509.04</td>
<td>513.62</td>
</tr>
<tr>
<td>TOTAL OPERATING REVENUE</td>
<td>$80,130</td>
<td>$80,260</td>
<td>$80,370</td>
<td>$80,723</td>
<td>$80,951</td>
<td>$81,135</td>
</tr>
<tr>
<td>Base Operating Expense</td>
<td>$77,090</td>
<td>$77,784</td>
<td>$78,484</td>
<td>$79,190</td>
<td>$79,903</td>
<td>$80,622</td>
</tr>
<tr>
<td>Depreciation</td>
<td>4,195</td>
<td>4,195</td>
<td>4,210</td>
<td>4,225</td>
<td>4,954</td>
<td>5,682</td>
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<tr>
<td>Additional Interest Expense</td>
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<td></td>
<td>23</td>
<td>22</td>
<td>1,103</td>
<td>1,087</td>
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<td>Change in Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
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<td>$81,979</td>
<td>$82,717</td>
<td>$83,438</td>
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<td>$(2,346)</td>
<td>$(2,714)</td>
<td>$(5,008)</td>
<td>$(6,255)</td>
</tr>
<tr>
<td>Nonoperating Revenue/(expense)</td>
<td>$1,074</td>
<td>$1,833</td>
<td>$1,093</td>
<td>$1,103</td>
<td>$1,113</td>
<td>$1,123</td>
</tr>
<tr>
<td>NET INCOME</td>
<td>$(82)</td>
<td>$114</td>
<td>$(1,253)</td>
<td>$(1,611)</td>
<td>$(3,895)</td>
<td>$(5,132)</td>
</tr>
<tr>
<td>Noncash Items (Depreciation)</td>
<td>$4,195</td>
<td>$4,195</td>
<td>$4,210</td>
<td>$4,225</td>
<td>$4,954</td>
<td>$5,682</td>
</tr>
<tr>
<td>Routine Capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategic Capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Purchases</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash From Debt</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principal Repayment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in Cash</td>
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<td>$(934)</td>
<td>$(5,405)</td>
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<td>Bond Covenant Days Cash on Hand</td>
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<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
</tr>
</tbody>
</table>

1650/08/224548(pptx)-E1
Financial Projections

Expenses Grow Faster Than Revenue

Many industry experts believe that hospital expenses will grow faster than revenue in the coming years. This scenario takes those projections into account.

• Revenues continue to grow at the same rate as the population, at 0.9%.

• On average, expenses are assumed to grow by 2.23% per year. However, this assumption is based on several line-item-level assumptions:
  – Staffing costs increase at an annual 2% rate.¹
  – Supplies are expected to grow at a CAGR of 11% through 2016; this is approximately 4 percentage points above hospital costs as a whole.²
  – The growth rate of 4% was applied to supplies, drugs, and purchased services.
  – All other expenses continue to grow at 0.9%

¹ Source: Assumptions made from the Advisory Board Company report, “Medicare Breakeven Project Margin Improvement Analysis.”
² “Hospital Supplies Market to 2016,” GBI Research.
## Financial Projections

### Expenses Grow Faster Than Revenue (continued)

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
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<td>Base Operating Revenue</td>
<td>$80,130</td>
<td>$80,851</td>
<td>$81,579</td>
<td>$82,313</td>
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<tr>
<td>Lewin Report</td>
<td>-</td>
<td>$(1,091)</td>
<td>$(1,713)</td>
<td>$(2,099)</td>
<td>$(2,616)</td>
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<td>Change in Revenue</td>
<td>-</td>
<td>500</td>
<td>504.50</td>
<td>509.04</td>
<td>513.62</td>
<td>518.24</td>
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<tr>
<td>TOTAL OPERATING REVENUE</td>
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<td>$80,260</td>
<td>$80,370</td>
<td>$80,723</td>
<td>$80,951</td>
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<td>Base Operating Expense</td>
<td>$77,090</td>
<td>$77,784</td>
<td>$78,484</td>
<td>$79,190</td>
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<td>4,195</td>
<td>4,210</td>
<td>4,225</td>
<td>4,954</td>
<td>5,682</td>
</tr>
<tr>
<td>Additional Interest Expense</td>
<td>-</td>
<td>-</td>
<td>23</td>
<td>22</td>
<td>1,103</td>
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<tr>
<td>Change in Expenses</td>
<td>-</td>
<td>1,025</td>
<td>2,083</td>
<td>3,174</td>
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<td>TOTAL OPERATING EXPENSES</td>
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<td>$84,800</td>
<td>$86,611</td>
<td>$90,257</td>
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<td>$(11,712)</td>
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<tr>
<td>Nonoperating Revenue/(expense)</td>
<td>$1,074</td>
<td>$1,833</td>
<td>$1,093</td>
<td>$1,113</td>
<td>$1,113</td>
<td>$1,123</td>
</tr>
<tr>
<td>NET INCOME</td>
<td>$(82)</td>
<td>$(912)</td>
<td>$(3,336)</td>
<td>$(4,785)</td>
<td>$(8,193)</td>
<td>$(10,589)</td>
</tr>
<tr>
<td>Noncash Items (Depreciation)</td>
<td>$4,195</td>
<td>$4,195</td>
<td>$4,210</td>
<td>$4,225</td>
<td>$4,954</td>
<td>$5,682</td>
</tr>
<tr>
<td>Routine Capital</td>
<td>$(4,784)</td>
<td>$(4,914)</td>
<td>$(3,541)</td>
<td>$(6,137)</td>
<td>$(5,164)</td>
<td>$(5,164)</td>
</tr>
<tr>
<td>Strategic Capital</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Purchases</td>
<td></td>
<td></td>
<td></td>
<td>$(21,400)</td>
<td></td>
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<tr>
<td>Cash From Debt</td>
<td></td>
<td>$447</td>
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<td>$21,400</td>
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<td></td>
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<tr>
<td>Principal Repayment</td>
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<td>$(7)</td>
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<td>$(326)</td>
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<td></td>
</tr>
<tr>
<td>Change in Cash</td>
<td>$(1,500)</td>
<td>$(4,047)</td>
<td>$(4,108)</td>
<td>$(9,703)</td>
<td>$(10,414)</td>
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<tr>
<td>Cash Position</td>
<td>$20,195</td>
<td>$18,695</td>
<td>$14,648</td>
<td>$10,541</td>
<td>$838</td>
<td>$(9,576)</td>
</tr>
<tr>
<td>DAYS CASH ON HAND</td>
<td>95.62</td>
<td>86.58</td>
<td>66.34</td>
<td>46.70</td>
<td>3.59</td>
<td>40.10</td>
</tr>
<tr>
<td>Bond Covenant Days Cash on Hand</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
<td>75.00</td>
</tr>
</tbody>
</table>
Within a few years, regardless of the challenges that may affect IH, days cash on hand is projected to drop below 75.

Of the scenarios presented, what is the most likely?
Financial Projections
Revenue Growth and Expense Reduction Opportunities

There are a variety of opportunities to increase revenues and decrease expenses; below is a partial list of opportunities identified by ECG.

- Joining a large GPO for purchasing supplies may decrease supply expenses by up to 15%.
- There may be an opportunity to cut additional expenses by outsourcing select support services through an alliance with a regional provider.
- IH currently has a negative contribution margin on certain services; by selectively eliminating services that are too costly, IH could reduce its financial vulnerability.
- Examining IH’s market share, there appear to be several opportunities to keep patients in the community in profitable service lines.
- In addition, there are services that IH does not currently provide that have the potential to add to the bottom line.
- Finally, given IH’s status as a district hospital, there is the opportunity to ask for additional funds by raising the levy.

The strategies identified by retreat participants are outlined in the last section of the document.
# Financial Projections
## Revenue and Expense Assumptions

The estimated opportunity is based on several sources, including IH financial data, proprietary market data, and ECG experience.

<table>
<thead>
<tr>
<th>Opportunity</th>
<th>Assumptions</th>
<th>Opportunity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Join a large GPO</td>
<td>Gain 15% savings on supplies.</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Outsource Select Support Services</td>
<td>Gain 20% savings on select support services.</td>
<td>600,000</td>
</tr>
<tr>
<td>Discontinue Select Unprofitable Services</td>
<td>Discontinue select services and decrease the negative contribution margin.</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Keep Patients Local(^1)</td>
<td>Gain additional surgical volume (outpatient and inpatient) that is currently performed at other hospitals in the region.</td>
<td>600,000</td>
</tr>
<tr>
<td>Develop New Services or Programs(^2)</td>
<td>Develop new services that bring in additional surgical revenue.</td>
<td>500,000</td>
</tr>
<tr>
<td>Increase Tax Levy</td>
<td>Depending on magnitude of levy increase, could require approval by 51% of district residents.</td>
<td>2,600,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>$6,900,000</strong></td>
</tr>
</tbody>
</table>

*NOTE:* Figures may not be exact due to rounding.

\(^1\) 30% of volume from local providers. 45% contribution margin ratio.

\(^2\) New services that bring in an additional 8% in surgical revenue at a 45% contribution margin ratio.

What is the probability of realizing each opportunity?
Assuming a 25% realization of the opportunities identified on the preceding page, days cash on hand would improve as shown below.\(^1\)

1 Assuming complete realization of opportunities in 2016.

**This scenario helps IH remain above 75 DCOH on average 1 year longer.**
Assuming a 50% realization of the opportunities identified on the preceding page, days cash on hand would improve as shown below.\(^1\)

IH is projected to remain above 75 DCOH in all but the last scenario.

\(^1\) Assuming complete realization of opportunities in 2016.
The map below depicts the IH primary service area (PSA) and the percentage of IH inpatient admissions that comes from each area.

NOTE: PSA includes 98221, 98277, 98257, and 98250.
The chart below depicts the IH primary service area (PSA) inpatient market share.

Financial Projections

Competition Increases

Any number of potential competitors expand their outreach and take market share in key service lines:

- Peace Island Medical Center gains surgical volume.
- PH invests in the region.
- Providence Health & Services expands into the market.

Competitors may become more aggressive in the market, which could impact IH volumes.

Discussion:

- What scenarios are most likely?
- How quickly is volume likely to shift?
- What is the likely impact of the scenario?
- What are the most significant threats?
Refinement of Strategic Direction
Rarely do hospitals seek partnerships as a result of a single event or performance against a handful of indicators. More commonly, it is a combination of forces and market factors that make a partnership necessary.

Sequential Stages of Distress (Example)

- Loss of Key Physician(s)
- Decline in Patient Volumes
- Increasing Expenses/Payables
- Erosion in Payor Mix
- Cash/Cash Flow Deterioration
- Inability to Fund Capital Budget
- Bond Covenant Default
- Urgent Partnership Need

At Risk, Financial Health, Insolvency
A myriad of indicators exist to monitor hospital operational and financial performance; however, there are several “red flags” that, when triggered, warrant additional scrutiny.
Warning Signs
Timing Is Paramount

Most (but not all) hospital partnerships are born out of mounting operational and financial distresses among the partner-seeking organization.

- Many hospitals choose to remain independent for too long, letting market and economic forces erode the organization’s long-term viability.
- Although local autonomy is maintained for a longer period under this approach, remaining independent too long lessens or eliminates partnership opportunities over time because “best fit” partners have already committed to other providers or are not interested in a rescue mission.
- Stand-alone hospitals that consider partnerships before financial and operational challenges arise, do so from a position of strength, which broadens their partnership options.
- Proactively seeking partnership opportunities from a position of strength can also improve negotiating leverage related to clinical programs and services, community goals, capital and facilities, and other key objectives.

The role of the board and senior leadership is to identify the “red flags” early on in order to improve performance or to position the organization for a partnership while it still has significant value.
If an organization elects to remain independent, its future success generally depends on eight key factors.
### Key Success Factors for Independent Hospitals: Location, Physician Alignment, and Payor Relationships

<table>
<thead>
<tr>
<th>Factor</th>
<th>Consideration</th>
</tr>
</thead>
</table>
| Location/Geographic Coverage  | • Both geographic coverage and long distances to other competitors offer a strong advantage to the independent hospitals that enjoy them.  
  • While location is difficult to influence, geographic coverage can be improved through careful planning and physician alignment.                       |
| Physician Alignment           | • Because physicians influence all parts of the organization’s growth and effectiveness, strong physician alignment is the *most critical indicator* of success as an independent hospital.  
  • Moreover, physician alignment is an element that can be developed and improved upon by the hospital.                                           |
| Payor Relationships           | • The payor mix of various communities plays a large role in determining the financial resources available to hospitals.  
  • Markets with large concentrations of payors or high percentages of lower-reimbursing payors have a lower margin for error; a competitive cost position is paramount.  
  • Additionally, hospitals that have not developed the relationships and infrastructure necessary to manage risk-based payments will face significant challenges in the future payment environment. |
### Key Success Factors for Independent Hospitals

**Cost Structure, Quality, and Capital Assets**

<table>
<thead>
<tr>
<th>Factor</th>
<th>Consideration</th>
</tr>
</thead>
</table>
| **Cost Structure** | • Hospitals that have dramatically reduced overhead and leveraged economies of scale have strengthened their financial position and thereby their ability to remain independent.  
      • Prospective partners will also not offer much in the way of cost savings to these organizations, reducing the value of joining a system. |
| **Quality of Care** | • Successful independent hospitals have solidified their reputations as providers of high-quality care.  
      • Creating a high-quality signature in the market can also be difficult for competitors to emulate, as it requires coordination and cooperation with various stakeholders, especially physicians. |
| **Capital Asset Base** | • Organizations that have not advanced their facilities and technologies, or those that have a poor balance sheet position, are likely to face challenges if they remain independent.  
      • Moreover, hospitals with insufficient cash reserves may be one organizational emergency away from possible insolvency. |
# Key Success Factors for Independent Hospitals

**Community Support and Continuum of Care**

<table>
<thead>
<tr>
<th>Factor</th>
<th>Consideration</th>
</tr>
</thead>
</table>
| Community Support       | • Hospitals that have been successful in forging strong ties with their communities are also more successful in maintaining their independence over the long term.  
• In most cases, communities demonstrate their support through their care-seeking behaviors and directly through philanthropy. |
| Continuum of Care       | With increasing emphasis on population health, the ability to lead and manage the continuum of care offers a strong, durable competitive advantage beyond simply providing the acute care, hospital component. |
Affiliation Benefits and Concerns
Is Exclusive Affiliation the Right Answer?

Affiliations are not always a panacea for today’s challenging operating environment, but successful affiliations can be mutually beneficial endeavors.

**Competitive Position**
- Increase number of patients through geographic expansion.
- Enhance or solidify key service lines (possibly reduce duplicative services).
- Solidify and enhance physician relations and referral patterns.
- Provide protection from competitor expansion in the market.
- Coordinate care among a wider network of providers.

**Financial/Operational Position**
- Lower supply costs.
- Distribution of high fixed costs (e.g., information systems, other technical infrastructure) over a greater number of facilities.
- Access to more favorable credit rating and financial resources of partner organization.
- Improved coordination of care along continuum.
- Access to “care networks” as ACOs begin to develop in marketplace.
Affiliation Benefits and Concerns  
Potential Drawbacks of Partnership

Partnerships can also have drawbacks, and those need to be fully vetted before making a decision.

- Loss of local control.
- Unrealistic expectations and goals.
- Disruptions to physicians’ referral patterns.
- Possible changes in leadership.
- Potential loss of community support.
- Difficulty achieving goals/objectives of the partnership.
Community Advisory Committee
Overview of CAC Survey

The eight community members who presented their findings were well prepared, had clearly put great effort into their assignments, and offered to continue supporting the board in being the voice of the community.

- The CAC members spoke to and received feedback from approximately 300 area residents.
- The community members surveyed by the CAC members ranged in age from their mid-20s to their 90s.
- Each member was well-connected in the community and provided excellent feedback for the IH board to consider.
- People were grateful for the opportunity to provide feedback and appreciated being informed of the decision-making process.

There was a strong voice asking for continued education about IH’s direction and what an affiliation would mean for the community.
What do you want most from your community hospital?

- The major themes expressed by nearly all CAC members included:
  - Comprehensive and competent clinical service.
  - Care that is high quality.
  - Care delivered by good people who give personal attention with the right attitude.
- Concerns about seeing a midlevel provider rather than a physician and not having enough specialty care were voiced, but were not the dominant theme.
- “Friendly, competent service; basic care delivered by good people with the right attitude.”

The CAC members all indicated that IH excels at meeting the expectations.
What does local healthcare mean to you?

- When considering “local healthcare,” the majority of respondents think Anacortes; a smaller subset think of care provided in or near Skagit County.
- Community members appreciate being able to stay locally with family for care.
- The majority of care is provided locally, yet there is access to a larger network of care provided in the region.
- The community members understand that having everything local is not realistic but noted that travel adds to the stress of receiving a medical care.

Local healthcare is a major decision factor in where people live.
Questions
Local Services

What services must be in our community?

• This question was answered from the perspective of what services should not be removed from the community, not what services need to be added.

• Emergency services were the top answer, with a variety of others mentioned, including OB/GYN, cardiac care, primary care, wellness, cancer care, advanced technology, neurology services, palliative care, mental health, GI, and several mentions of holistic care options/alternative medicine.

• There was a recognition that the hospital did not need to provide everything but should provide information for support services, such as addiction recovery programs and social services.

IH is not expected to offer all services, but area residents would like IH to provide those services for which there is a large enough volume to justify a program.
Questions
Collaboration Rationale

If Island collaborates with a larger organization, what should be the main reason for doing so?

• Most believe that financial stability, such as saving the hospital from distress, should be the major consideration for collaboration; however, many thought that collaboration should be the last resort to improve financial performance.

• In addition, many of the community members thought that positive improvements for IH could be a reason to align, such as:
  – Expand medical expertise.
  – Advance technology.
  – Improve physician recruitment.
  – Bring more local healthcare options.

• “I don't want to just save money, I want access to the best doctors. I don't want less qualified doctors just to save money.”

In general, the responses were in favor of remaining autonomous and maintaining the strong culture of IH.
Questions
Religious Collaboration

Should we consider collaborating with a religious organization?

• Responses varied. The majority said no or were unsure, with a minority saying yes.

• Those that said no often indicated that they would approve of a religious collaboration if there would be no restrictions on patient choice (i.e., a firewall). However, there was a strong sentiment that the only way to guarantee a firewall is to not affiliate with a religious partner.

• End-of-life care was a bigger issue than women’s issues, but both were mentioned.

The feedback from the CAC was clear that partnering with a religious organization would be a hard sell to the community.
Questions
Autonomy

Should we seek all options possible to remain autonomous?

• The large majority of respondents wanted to stay independent and keep the identity of IH.

• There was a distinction made that while local control is essential, autonomy should not be the main objective.

• It was expressed that IH will have to collaborate, but it should collaborate rather than integrate.

• A levy increase was brought up several times as a worthy option to keep IH’s identity and continue to offer the same services; however, to sell the idea of a levy increase, the community needs to be educated on the issues.

• Potential patients who leave the area when care is available in Anacortes often leave because they (and their physicians) do not always know that quality services are offered locally.

*Maintaining IH’s culture was an important aspect of everyone’s comments.*
Questions
Health Needs Met

Are your healthcare needs being met? How or why not?

• The majority of people believe that their healthcare needs are being met.
• For those that felt their needs were not being met, the reason was almost unanimously due to the lack of certain specialty services (e.g., GI, neurology, rheumatology) offered in the community.
• At the same time, people understood that they might need to leave the community to receive specialty care.
• "I am happy with the quality of care, and the only time we leave is when we can’t find the specialist we need."

The healthcare provided in the community is viewed positively, but there is a desire to obtain additional specialty care locally.
Refinement of Strategic Direction
The IH strategic plan will include the following elements:

- **Optimization** – Streamlining/reducing operating expenses.
- **Growth** – Targeted growth of key clinical services.
- **Physician Strategy** – Integration with and expansion of the medical staff.
- **Communication/Education** – Education of key constituencies (physicians, staff, and community members) will be critical to the success and adoption of the strategic plan.
Strategic Direction Optimization

The optimization element of the strategic plan involves targeted cost reductions; potential opportunities are outlined below.

- **Supplies** – IH will evaluate opportunities to reduce supply costs through (1) switching GPO contracts and (2) increasing standardization of supplies.

- **Process Improvement** – IH will explore opportunities to improve operational procedures in order to reduce costs and improve service levels.

- **Workforce Optimization** – IH will adopt policies and procedures to more closely manage staffing.

- **Outsourcing** – IH will assess potential support services that could be aligned in order to reduce operating costs and improve operational performance.

- **Staffing Reduction** – IH would consider targeted reductions in force as a last-resort strategy to maintain financial solvency and address acute financial issues (e.g., prevent default on loans).
IH identified a number of areas for potential volume and revenue growth, substantially capitalizing on existing services and programs.

- **Primary Care** – It was believed that there is need for improved access to PCPs in Anacortes. Potential tactics to improve access could include hiring additional physicians or midlevels and/or increasing the physical space available to providers.

- **Surgical Services** – Specific opportunities were identified in orthopedics and spine surgery. In both cases, it was agreed that IH needs providers with a dedicated practice in Anacortes.

- **Oncology** – There is considerable out-migration of cancer services despite IH’s investment in the cancer program. Program and marketing enhancements need to be made to better retain patients in the community.

- **Subspecialty Physicians** – There is need for additional subspecialty providers in the community.

- **Marketing** – Many believed that there is a need for better marketing and messaging about the products, services, and quality of care available at IH.

- **Military Volume** – Attract surgical cases from the navy base.
Given the challenges of out-migration from Anacortes and the dearth of subspecialty providers in the community, the planning committee identified the need for a more integrated physician strategy.

- **Employment** – IH will seek to increase the number and breadth of employed providers in the community, both to meet community need and to address strategically problematic areas.

- **Targeted Partnerships** – As necessary, in order to gain access to additional subspecialists on a part-time basis, IH will develop strategic partnerships with Seattle-area groups or systems.

- **Referral Management** – IH will develop tighter coordination of the patient referral processes utilized by employed physicians.
Throughout the retreat, opportunities for enhanced communication with various constituencies were identified.

- **Physicians** – Key messages to the medical staff include:
  - Providing education on the profitability of various services/procedures
  - Explaining the costs of medical supply items and need for streamlining choices
  - Creating a culture that promotes keeping patients in the local community when at all possible.

- **Staff** – Explaining the upcoming financial and operational challenges that the hospital is likely to face and the rationale in preparing for and responding to these challenges.

- **Community** – Two messages need to be communicated to the community at large:
  - Better conveying the capabilities and quality of care at IH.
  - Impressing upon them that keeping care local is vital to the IH’s survival as an independent community asset.
Given the resources (human, capital, etc.) required to execute on the identified strategies, IH will need to develop a prioritization of the potential strategies.

Criteria to consider in evaluating the potential strategies includes:

• Cost to execute.
• Speed or time to implement the strategy.
• Potential financial benefit.
• Political hurdles or implications.
• Probability of success for the strategy.
Group Exercise: Given the criteria articulated on the preceding page, please select the top three strategies for IH administration to begin evaluating for adoption.

- Optimization.
  - Supplies.
  - Process improvement.
  - Cost savings.
  - Workforce optimization.
- Growth.
  - Primary care.
  - Surgical services.
  - Oncology.
  - Subspecialty physicians.
  - Marketing.
  - Military volume.
- Physician strategy.
  - Employment.
  - Targeted partnerships.
  - Referral management.
- Communications/education.
  - Physicians.
  - Staff.
  - Community.
The retreat participants were asked to vote for the top three initiatives that management should pursue. They are listed below in order of importance.

- **Supplies** – Received the most support, with 16 votes. IH should immediately pursue a strategy to reduce supply costs through both switching GPO contracts and increasing standardization of supplies.

- **Process Improvement** – Also received broad support, with 13 votes. IH should initiate opportunities to streamline operational processes, which would improve service levels and decrease costs.

- **Surgical Services** – The third-highest ranking strategy, with 8 votes, was to pursue growth in profitable surgical services.

- **Other Opportunities** – Several other opportunities were identified as high-priority (at least 5 votes) from the retreat participants, including:
  - Targeted partnerships.
  - Referral management.
  - Marketing.
  - Educating physicians.