Economic Outlook for Health Systems & Perspective on Recent Events

Leadership Institute Roundtable

August 2022

Disclaimer

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Analysis is focused on economic and business implications and does not address quality and access considerations.

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The COVID-19 pandemic marked the end of a decade of relative calm in healthcare

US growth in national healthcare spending in excess of economic growth
Percentage points of real healthcare spending CAGR minus real GDP CAGR

This material was presented in July 2022 at McKinsey's Healthcare conference and has been summarized. It is not a complete record of McKinsey's analysis on this subject of all possible discussion on this topic and does not constitute advice

Source: National Health Expenditure; The World Bank

Our current economic outlook reveals the degree of disruption

As of July 2022

Highest inflation levels since 1970s "Great Inflation"

8.6%

Consumer Price Index (CPI- U), percent change from prior year, May 2022

Negative GDP growth and decelerating consumer spending

-0.9%

Real GDP, annualized percent change from previous, Q2 2022

Worst stock market performance since 1970

21%

S&P 500 index, percent change from January 1 to June 30, 2022

Lowest level of consumer sentiment ever recorded

-42%

Year-over-year change, June 2022

Rapidly worsening supply chains

>5x

Increase in ocean shipping cost, coupled with 65% increase in trucking costs

Extreme volatility across all segments

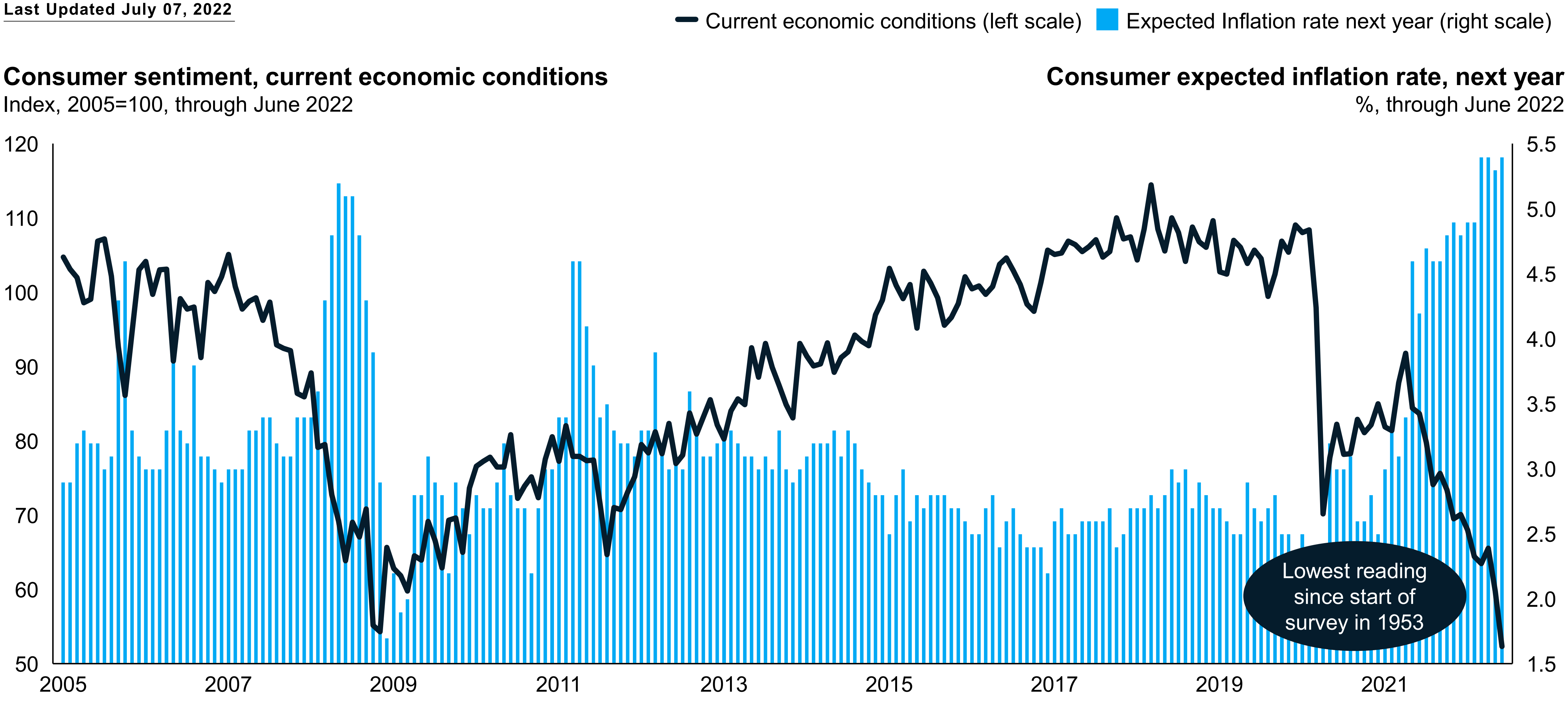
~2x

Increase in world uncertainty since 2010, corresponding with 30+ VIX

Source: BLS, BEA, University of Michigan, Wall Street Journal

Consumer sentiment has fallen to all-time lows as inflation expectations persist

Last Updated July 07, 2022



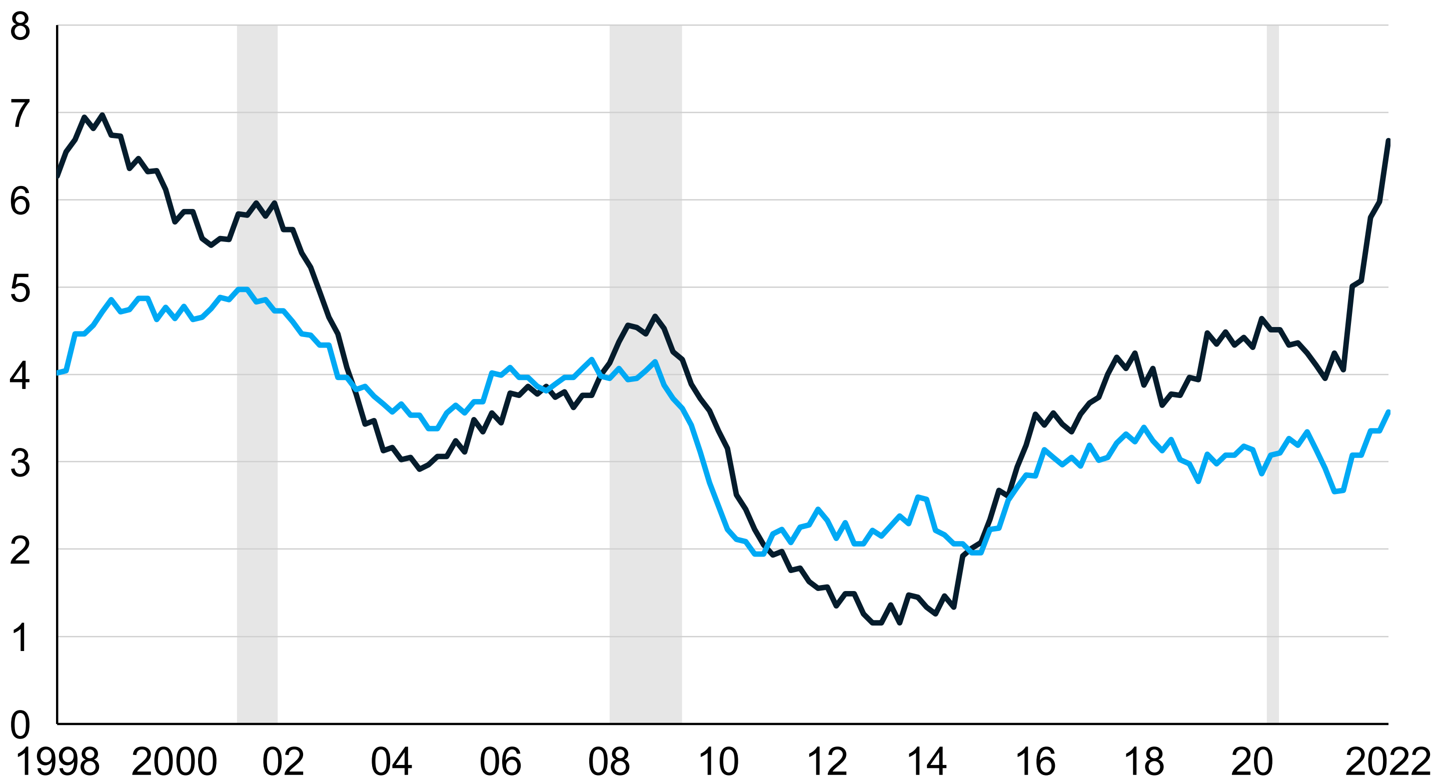
Source: University of Michigan

Wage gains for lower-paid workers are outpacing those of higher-paid workers

Bottom quartile Top quartile

Wage growth tracker by wage level

12-month moving average of median wage growth for each category, hourly data (% growth)



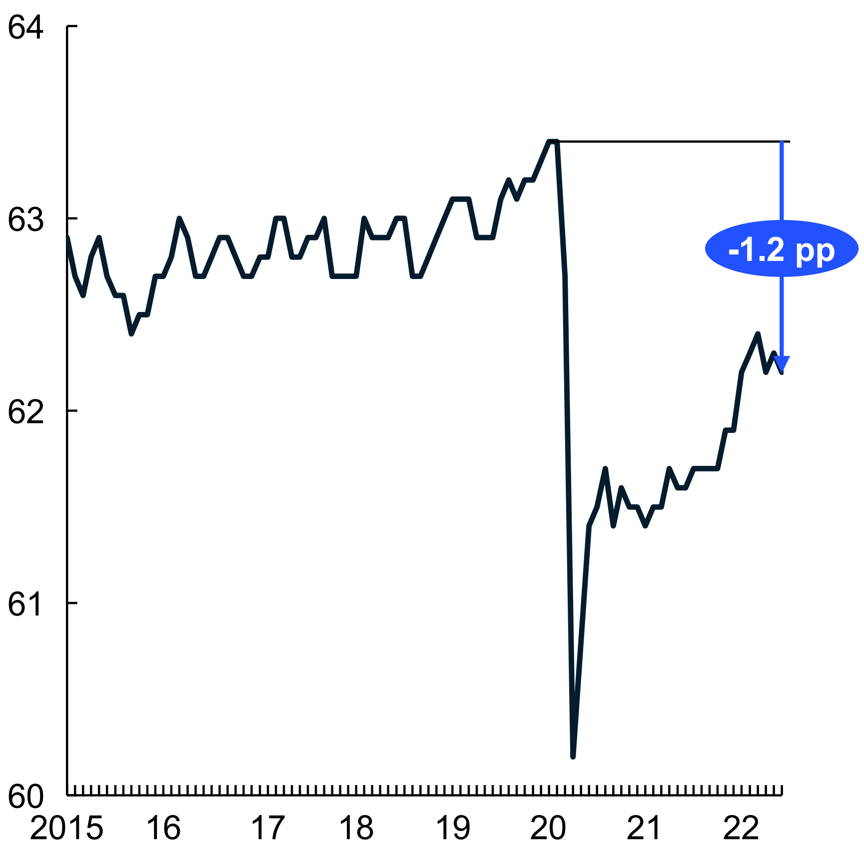
Given disproportionate wage growth, **businesses reliant on lower-paid workers may feel greater economic stress than others**

While real $ compensation per hour has risen, **real $ GDP per hour has slowed through the pandemic** (1.7% for Q1’15-Q4’19 vs. 1.1% for Q1’20 – Q1’22), further impacting performance

Source: Bureau of Labor Statistics, Atlanta Fed’s Wage Growth Tracker (2022), US Bureau of Labor Statistics , US Bureau of Economic Analysis

Labor force participation and employment to population ratios remain below pre-COVID levels

US civilian labor force participation rate, 16+
Percent, through June 2022



US civilian employment to population ratio, 16+
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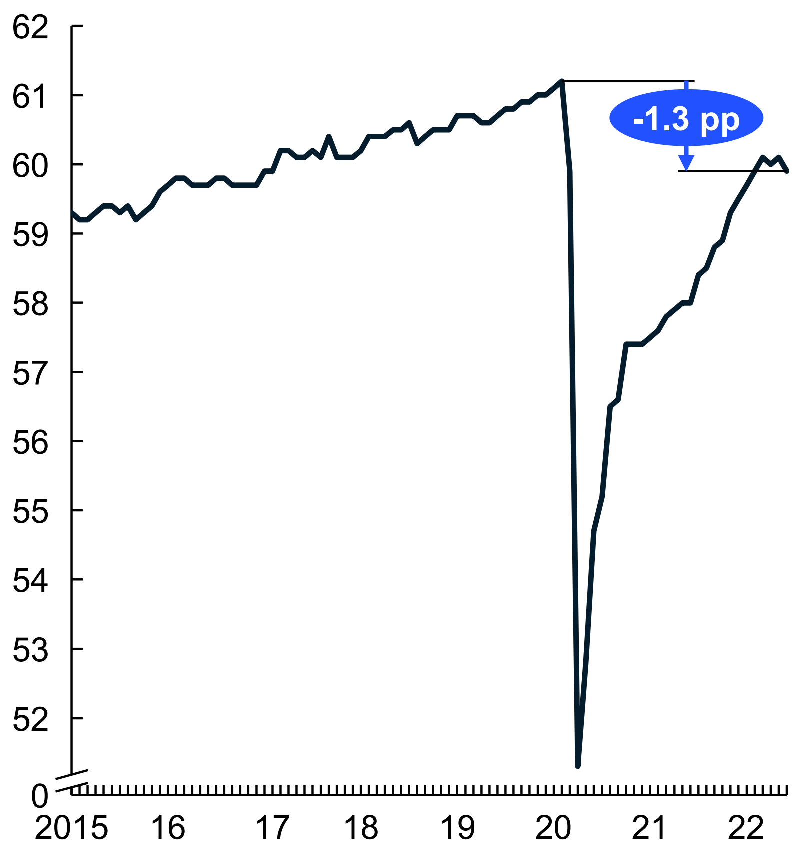


Source: US Bureau of Labor Statistics

-0.6M

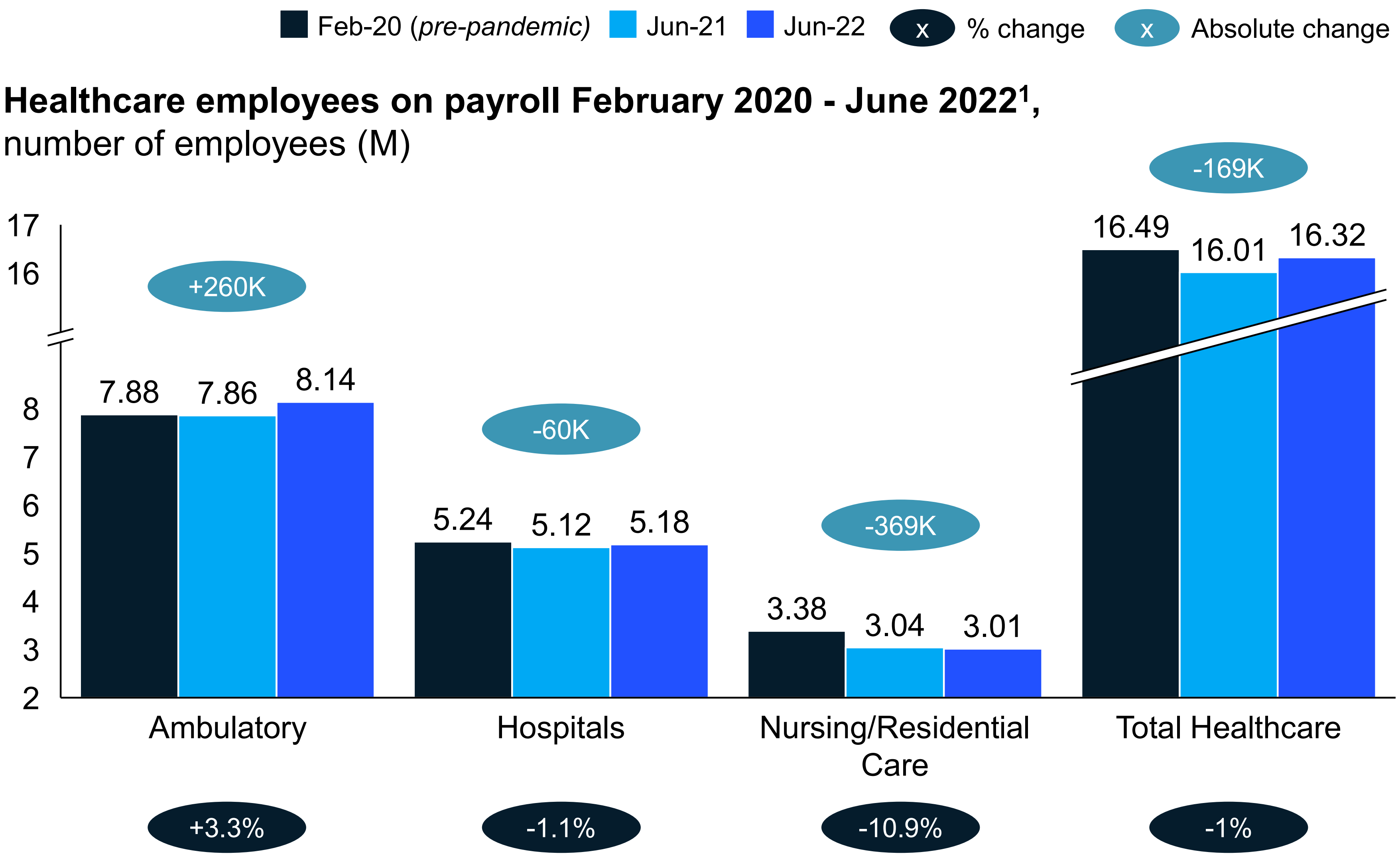
Fewer workers vs. December 2019. Labor force participation rate at lowest level since 1977

-0.7M

Fewer jobs vs. December 2019. Employment population ratio at lowest level since 2017

Healthcare workforce lags pre-pandemic levels, especially in nursing and post-acute care

Healthcare employees on payroll February 2020 - June 2022[1], number of employees (M)



1. May 2022 numbers preliminary, pending revision

Source: US Bureau of Labor Statistics (not seasonally adjusted)

Healthcare job openings relative to hires:

<1K

More openings than hires after the **Great Recession**

~500K

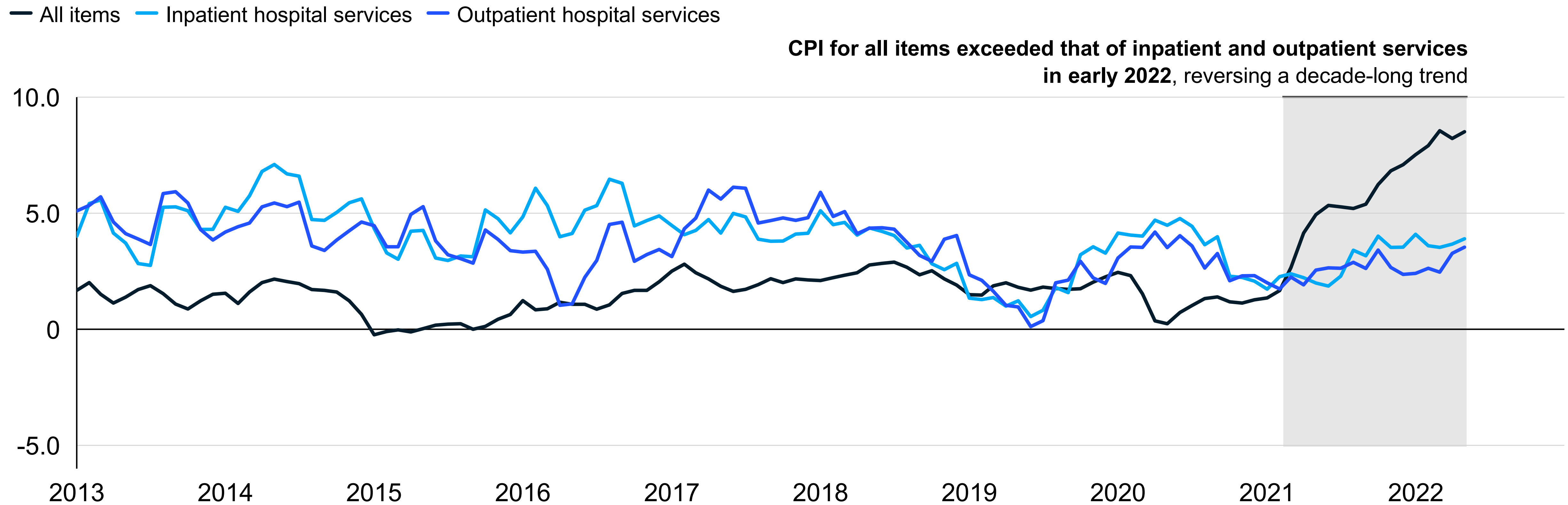
More openings than hires in the **late 2010s**

>1M

More openings than hires in the **Q2'22**

Price increases within hospital services lags overall inflation

Consumer price index (CPI) for all urban consumer (CPI-U), seasonally adjusted, 12-month % change, 2013-22



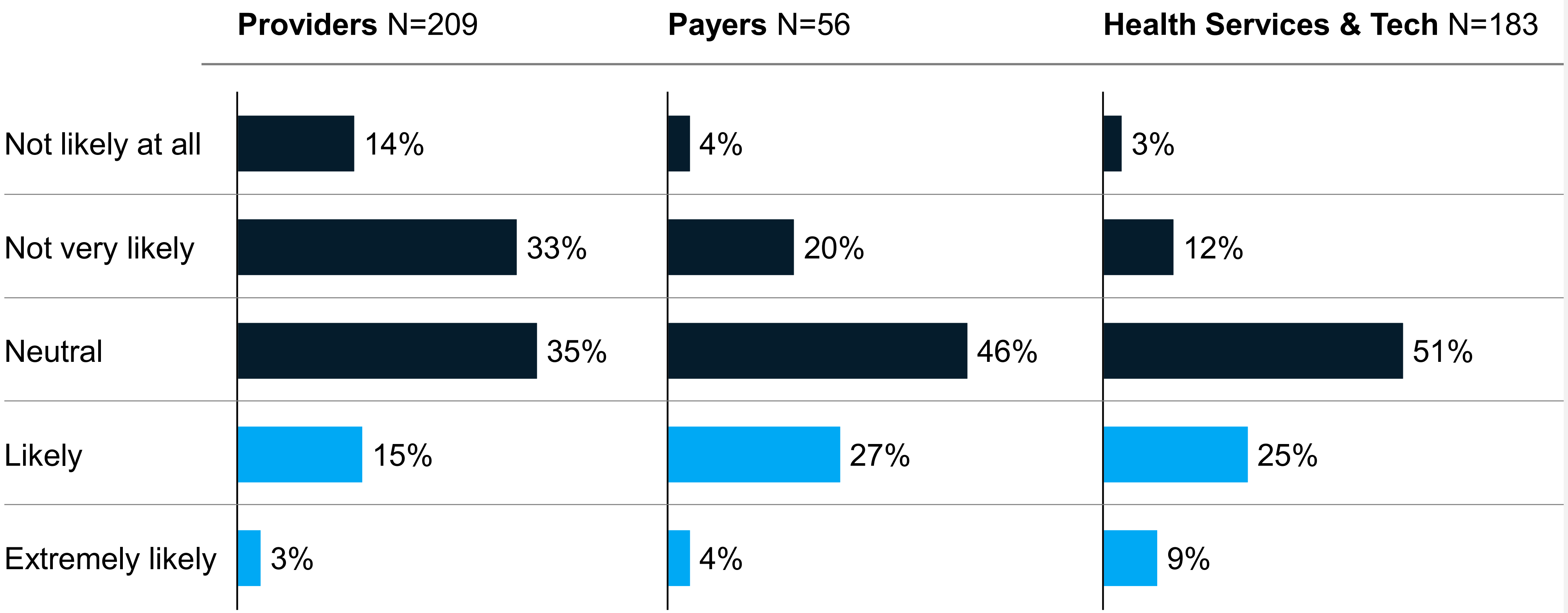
Historically, **medical care services pricing has been tightly correlated with CPI, typically with a 6-month to 2-year lag**

Payers' expectations of median Commercial rate escalators have risen from 2-3% to 4-5% given inflationary cycle

Source: US Bureau of Labor Statistics; 2022 McKinsey Healthcare Stakeholder survey, 7/1/2022

Providers surveyed are more pessimistic that they'll be able to compensate for cost increases

Question: Assuming your underlying costs increase at your organization, what is the likelihood you will be able to receive higher revenue to compensate?



	Providers	Payers	Health Services & Tech
Net sentiment[1]	-29 p.p.	+7 p.p.	+19 p.p.

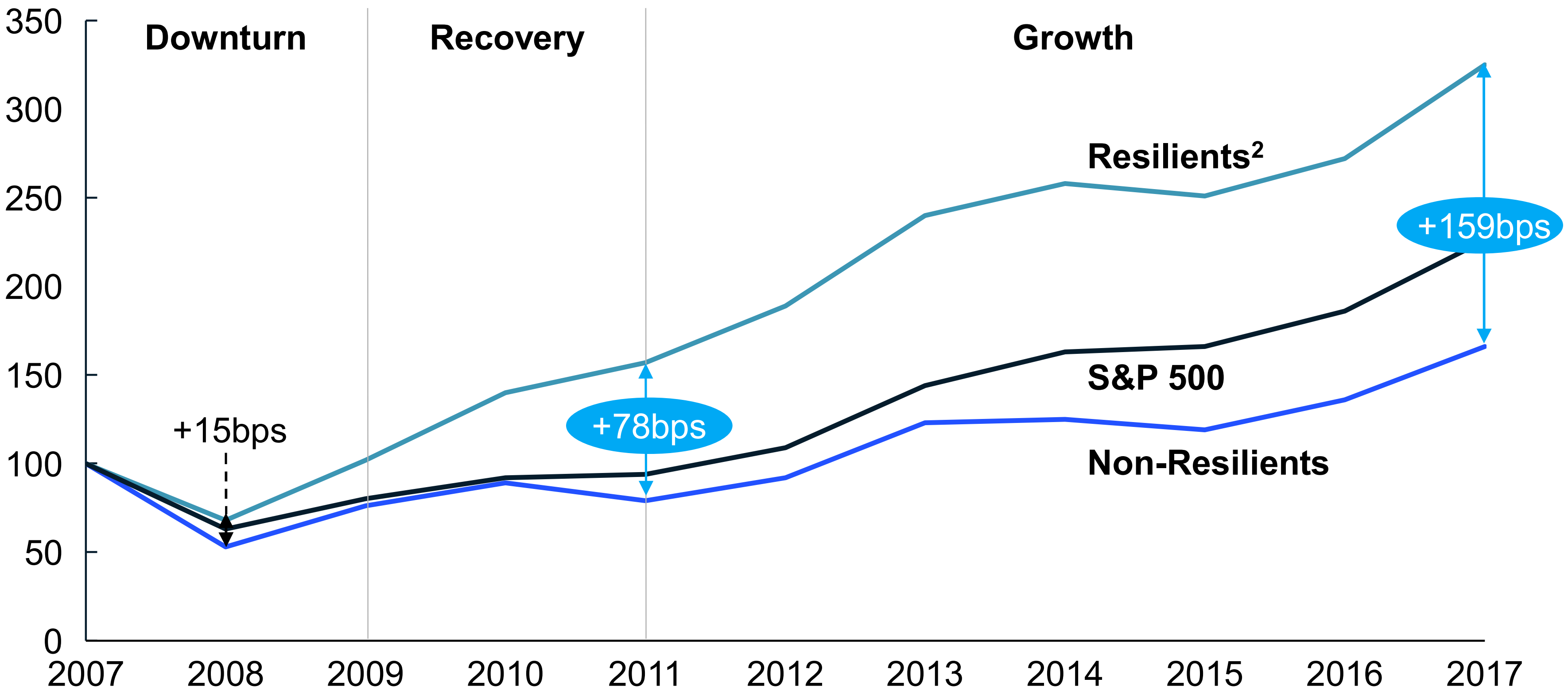
Payers and providers surveyed believe operating margin will fall ~150 bps from '21 to '22, while services and technology players expect only ~20 bps decline

1. Defined as p.p. difference between respondents claiming they're likely to compensate costs vs. unlikely

Source: 2022 McKinsey Healthcare Stakeholder survey, 7/1/2022

History teaches us that resilient companies are much more likely to come out as winners – especially during crisis

TRS performance of ca. 1,000 global companies[1] during the 2007-08 Financial Crisis



Resilient companies achieve + ~ 100bps TRS driven by…

Outperformance in earnings throughout the cycles and revenues in the recovery

Faster and harder moves on productivity, preserving growth capacity

Divestments in downturn phase, **acquisitions when recovery** started

Operational and **financial optionality**

In practically all sectors, resilient companies demonstrate similar attributes

1.Total returns to shareholder; calculated as average of sub-sector medians performance of resilients and non-resilients. Includes 1,140 companies (excludes FIG & REITs)
2.Resilient companies defined as top geometric mean TRS quantile by sector.

Source: CPAnalytics, MSCI

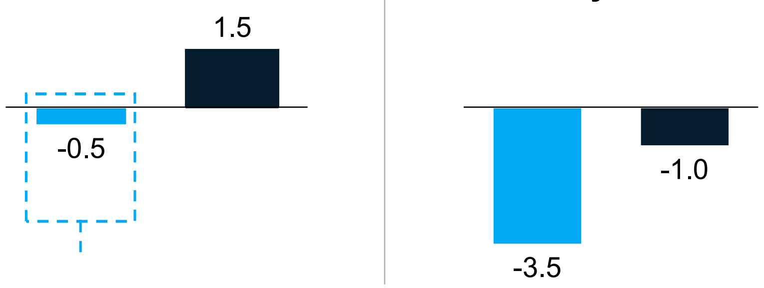
What did resilient companies do differently?

Resilients Non-Resilients

Resilients moved faster, harder on productivity; preserved growth capacity

Operating costs[1], % of revenue change

Downturn **Recovery**



Resilients focused on COGS reduction through operational effectiveness[2]

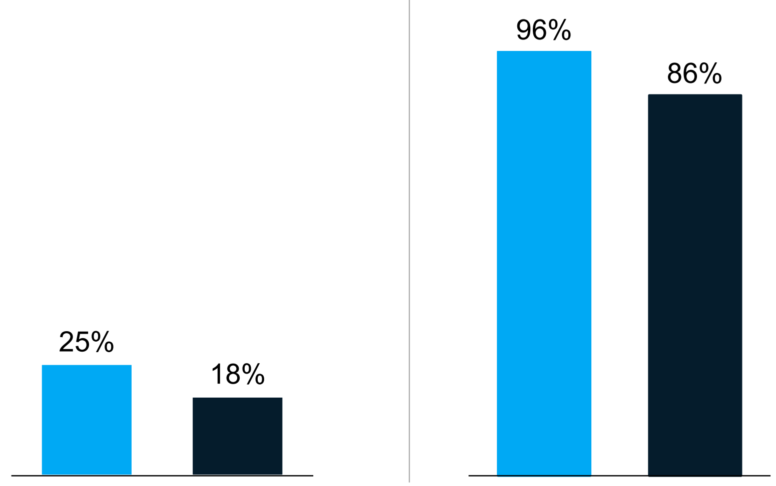
Note: Calculated as an average of different sub-sector medians for 'Resilients' and 'Non-resilients'. Excludes financial companies and REITs
1 Operating Costs = COGS + SG&A - D&A. Change in Op cost (as a % of revenue) between 2007 and 2009 for Downturn period and 2009 and 2011 for Recovery period; 2 Resilients' revenue grew at the same time period; COGS and SG&A not adjusted for D&A (D&A is the primary driver for the discrepancy between operating cost and sum of COGS + SG&A)

Resilient companies ("Resilients") defined as top TRS quantile by sector

Resilients divested more heading into the down-turn and acquired more as the recovery started

Avg. of sector median divestment (or acquisition) %, As % of value of transactions

Divestitures (N = ~25,900) - downturn[1] **Acquisitions (N = ~20,000) - recovery**[2]

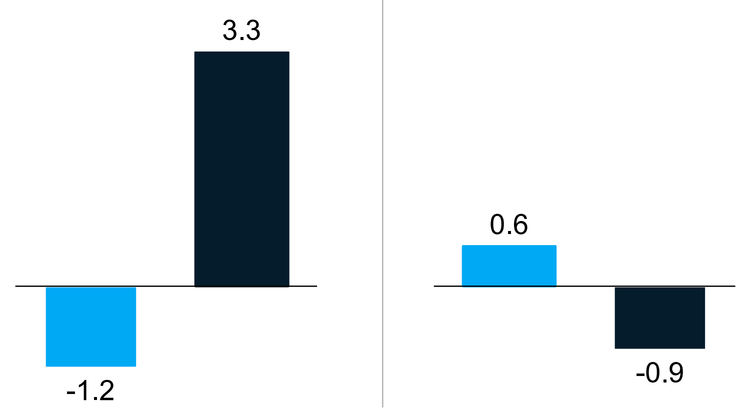


Note: This analysis excludes financial companies, and REITs. This analysis was conducted using fiscal years
1 Downturn is defined as all deals announced between 2007-2009; 2 Recovery is defined as all deal announced between 2010-2011

Resilients created optionality early in the recession – operational and financial

Change in Leverage ratio, (Debt[1]/Capital[2])

Downturn[3] **Recovery**[3]



Note: Calculated as an average of different sub-sector medians for 'Resilients' and 'Non-resilients'. Excludes financial companies and REITs
1 Total Debt (book value) = Short Term Borrowings + Current Portion of Long Term Debt + Current Portion of Capital Lease + Long Term Debt + Long Term Capital Lease + Finance Division Debt Current + Finance Division Debt Non Current; 2 Capital = Total Common Equity + Total Preferred Equity + Minority Interest + Total Debt.; 3 Downturn is defined as 2007 and 2009; Recovery is defined as 2009-2011

Source: McKinsey Quarterly Q2 2019, Bubbles pop, downturns stop; CPAnalytics; Capital IQ

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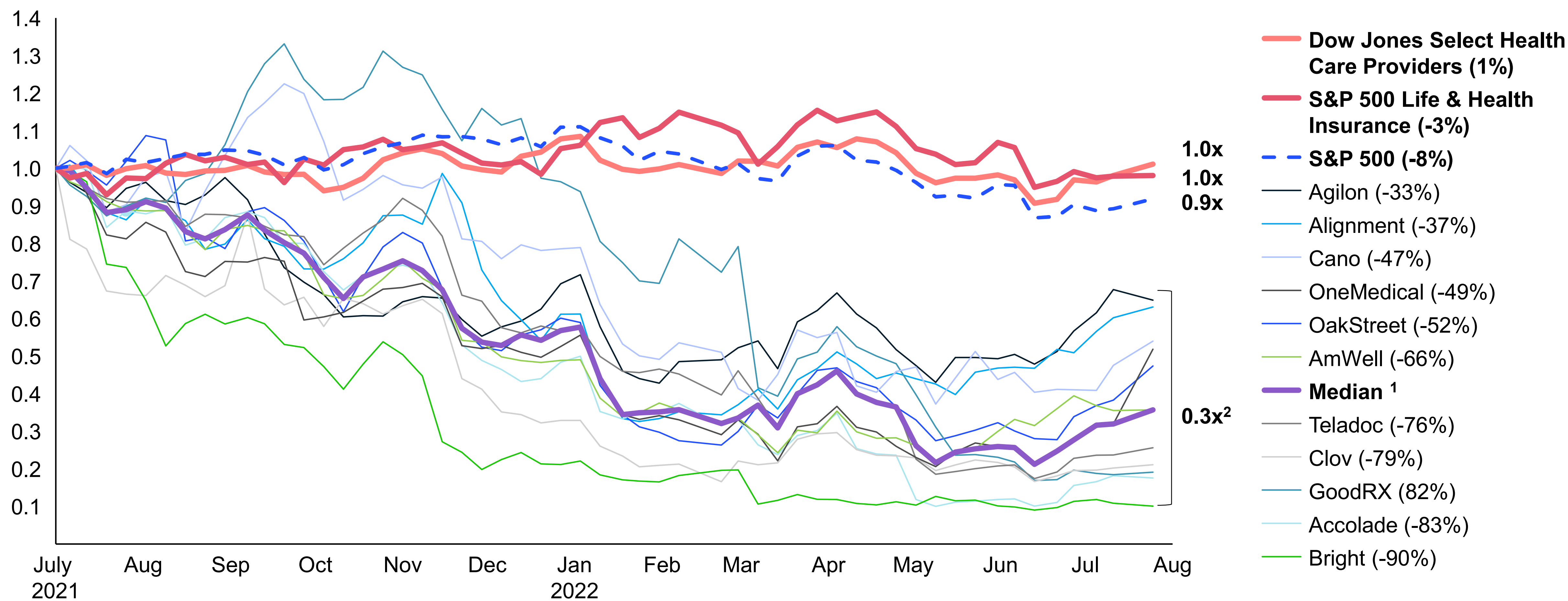
Legacy players in S&P 500 have held their equity value while many entrants have seen declines

Stock Price of Select Companies & Indexes since July 2021, Relative to July 2021 (or post-July 2021 IPO price)

Price change since July '21, Percentage (%)



1. 5-week rolling average median of select public market players; 2. Average July 25th, 2022, stock price for select public market players relative to July 1st, 2021, stock price

Source: Market Watch, Yahoo Finance; stock prices current as of July 25th, 2022

Private companies are also seen declines, and IPO activity has slowed considerably

Industry news

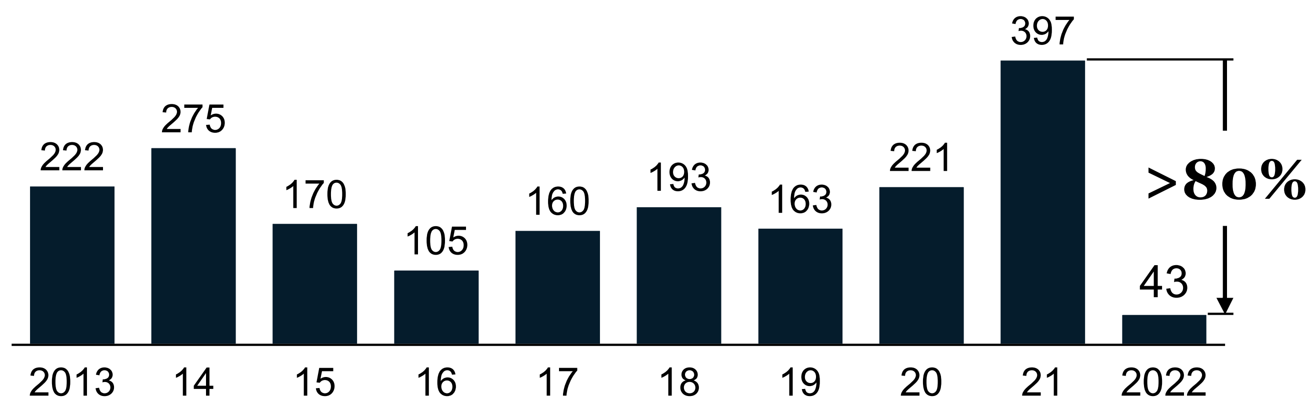
Klarna. Valuation fell to **~$6B from ~$15B** in June '22 in response to inflation, rates, and recession expectation

instacart Lowered private valuation **~40% to $24B** in late March '22

stripe **Announced ~30% valuation decline** in July '22 amidst impact to FinTech

Across industries, **private companies are trading at >20% discount** compared to Q4 2021, while companies that went public in 2021 **are >40% lower than their IPO**[1]

U.S. IPO activity by year,
Number of IPO transactions (#)[2]



Across 1H 2022, **only 43 companies announced IPOs** on U.S. exchanges, the weakest six-months since 2016, and **a >80% drop YOY**

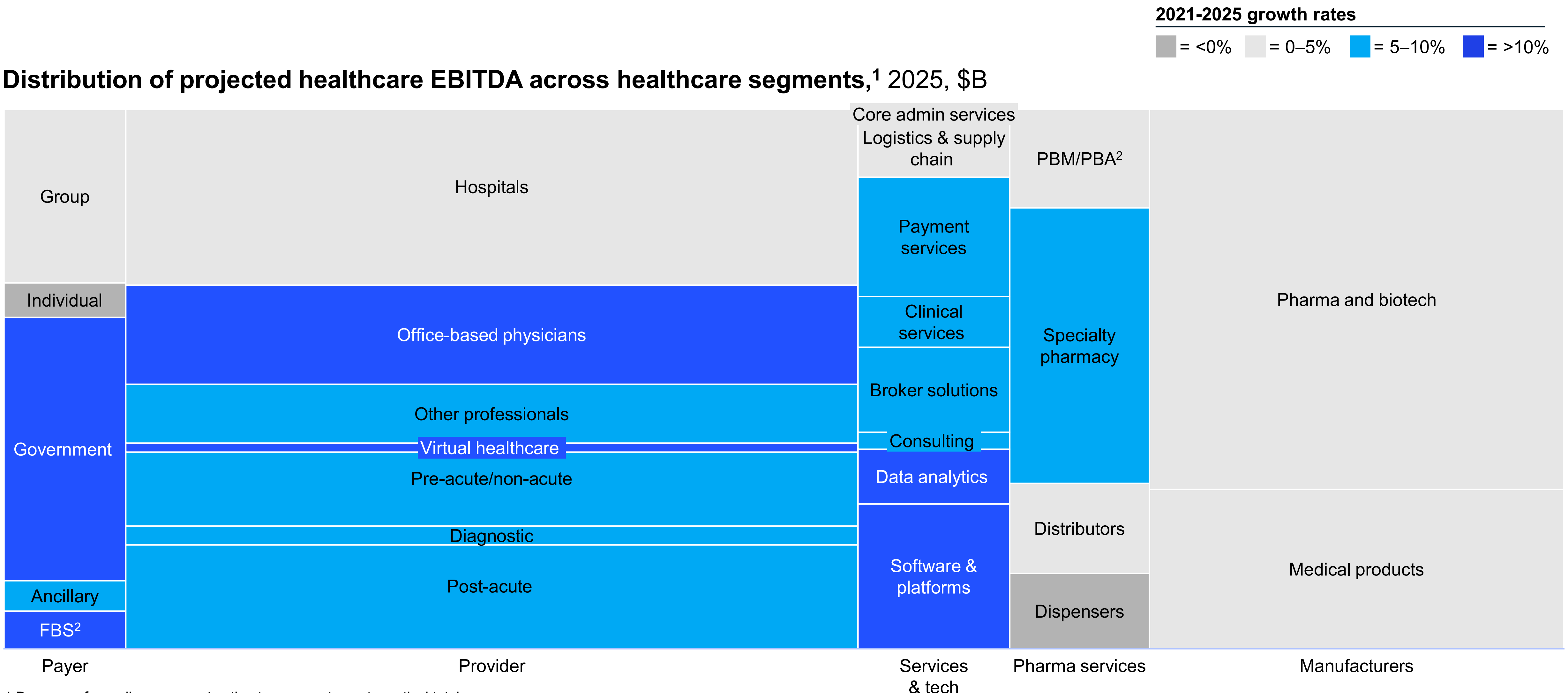
Investments in U.S. tech start-ups fell 23% over the last three months, to $62B, the steepest fall since 2019

1. Ernst & Young and Forge Global
2. Renaissance Capital (as of July 19th, 2022)

Source: Bloomberg, The Wall Street Journal, CNBC

Landscape of healthcare profit pools through 2025

Distribution of projected healthcare EBITDA across healthcare segments,[1] 2025, $B

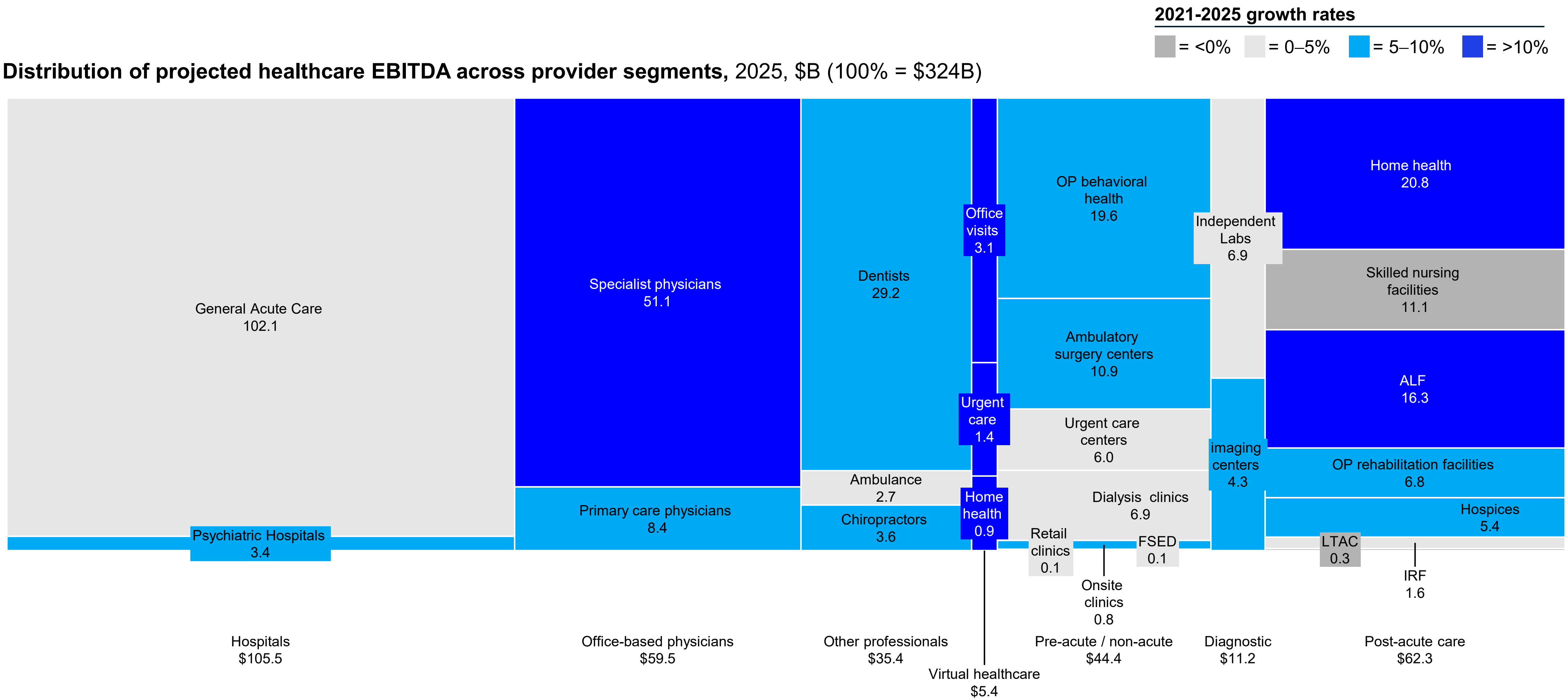


1.Because of rounding, segment estimates may not sum to vertical totals
2.FBS = fixed-benefit and supplemental; PBM / PBA = pharmacy benefit administrator / pharmacy benefit manager

Source: McKinsey Profit Pools Model

Most provider segments are projected for growth, led by specialist physicians and home health

Distribution of projected healthcare EBITDA across provider segments, 2025, $B (100% = $324B)



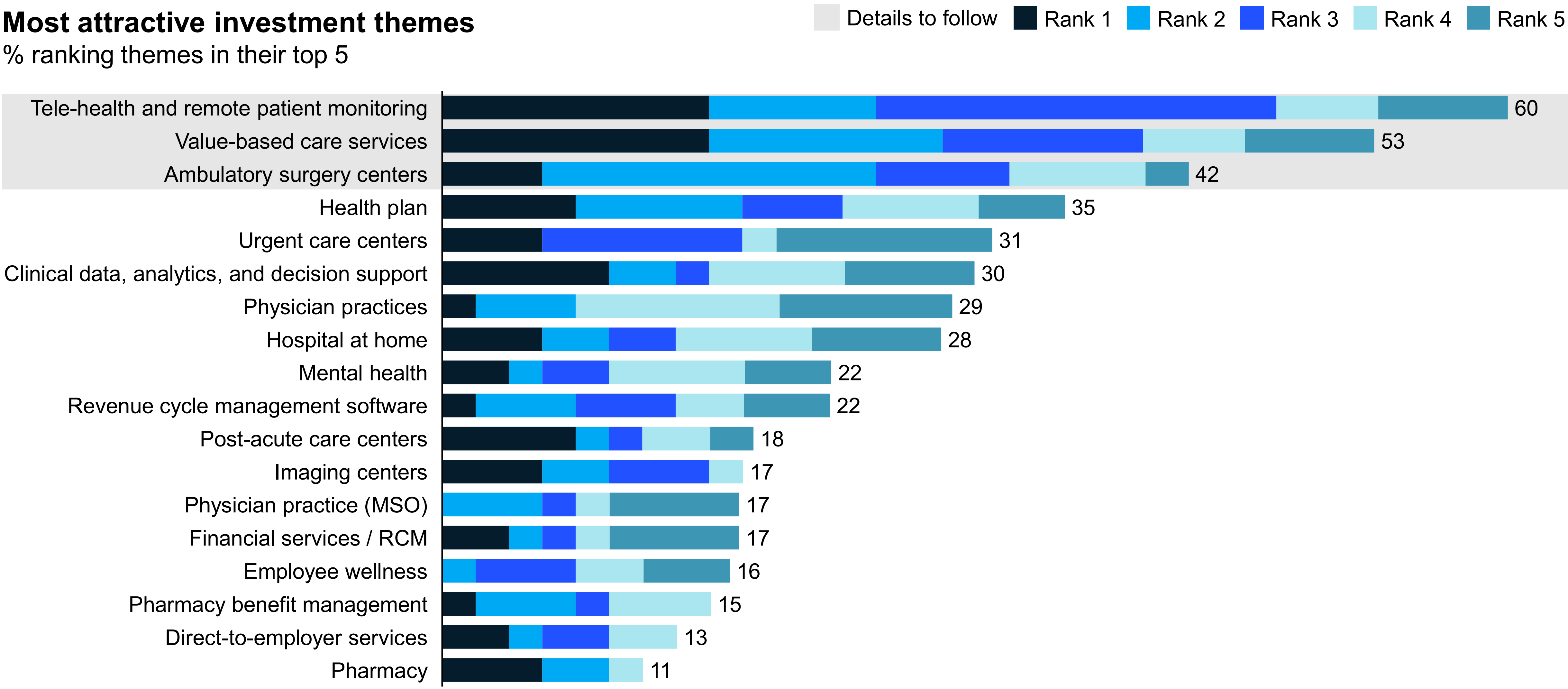
Note : FSED – Freestanding Emergency Department; ALF – Assisted Living Facilities; Hospice – includes palliative care centers; IRF – Inpatient Rehabilitation Facilities; LTAC – Long Term Acute Care Hospitals

Source: McKinsey Profit Pools Model

Health systems surveyed ranked telehealth, VBC services, and ASCs as the most attractive investment themes

Most attractive investment themes

% ranking themes in their top 5



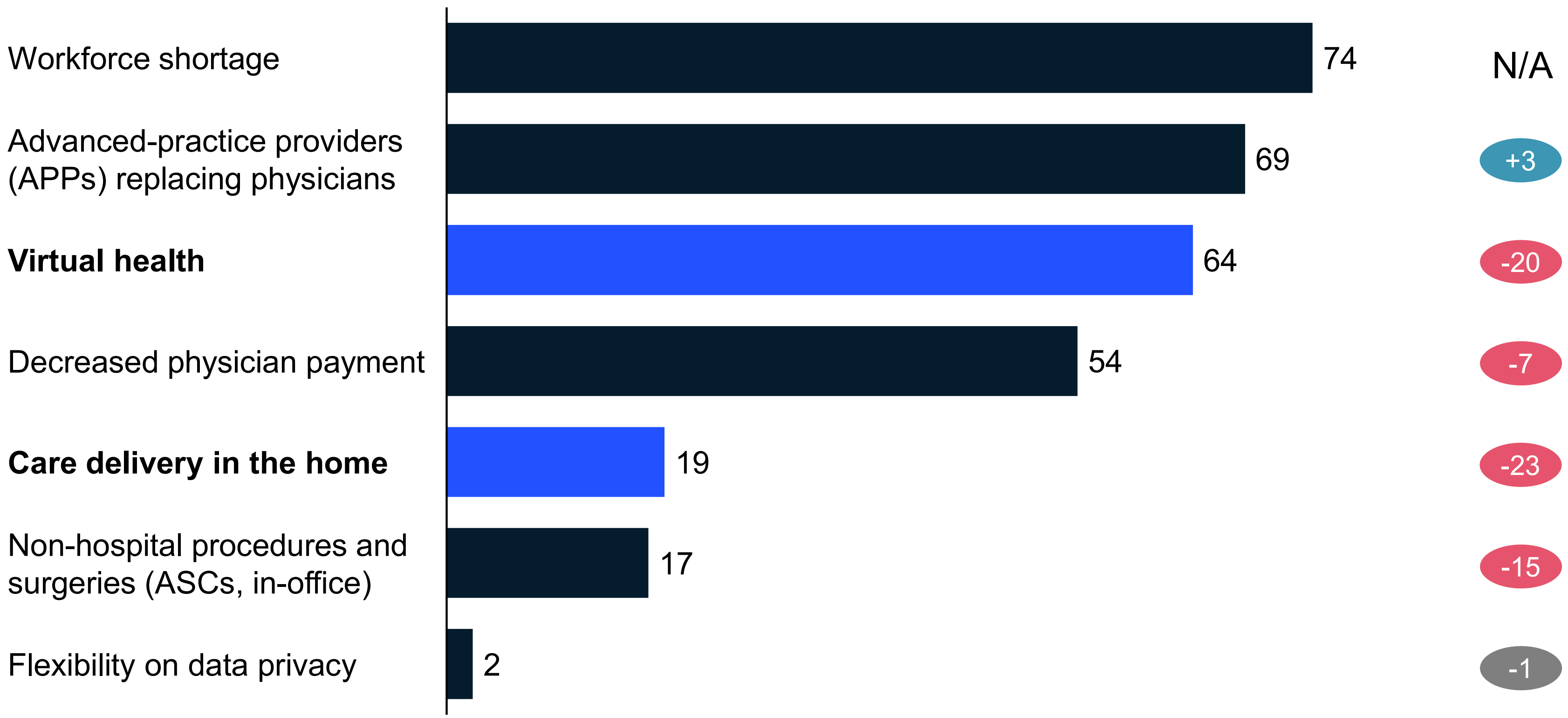
Note: Includes only those themes with at least 10 responses

Source: McKinsey Healthcare Provider CXO Survey on Revenue Diversification (N=53) – April 2022

Physicians' view virtual health as decelerating

Change vs. 2021 pp Increase pp Minimal Change pp Decrease

Physician's ranking of trends with most lasting impact on healthcare coming out of COVID-19,
% of respondents ranking in top 3[1] *(n=705)*



QCOVID_TRENDSRANK: Coming out of the COVID-19 crisis, what trends do you think will have the most lasting impact on healthcare over the next 3-5 years? (Rank 1-3)
1: Excludes those who don't know

Source: McKinsey COVID-19 Physician Survey, 4/5/2021, 3/8/2022

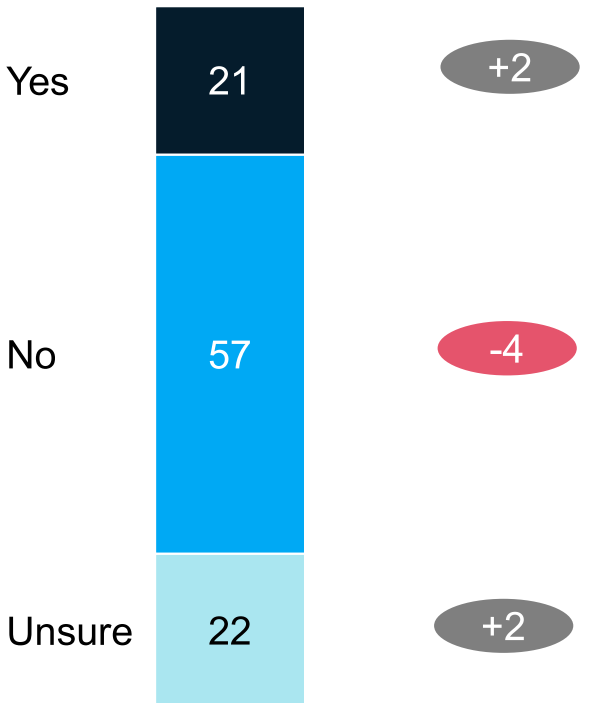
Payers are investing behind consumer themes as key trend, with particular focus on MA and highlighting superior results to traditional Medicare in earnings calls

A minority of physicians report participating in risk-based models, and few who do claim a “very good understanding”

Change vs. 2021 — pp Increase — pp Minimal Change — pp Decrease

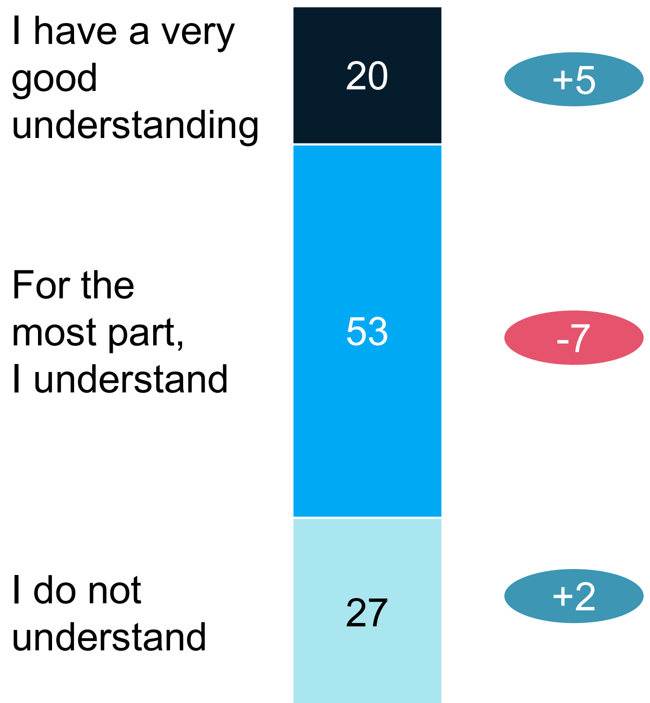
Participation in risk-based alternative payment models

% of respondents, (n=718)



Understanding of operational metrics in risk-based payment programs

% who use risk-based alternative payment models, (n=152)



More surveyed physicians report being less likely to participate in value-based care in the next 6 months than more likely (24% vs. 15%)

Surveyed physicians also **reported a persistent belief that value-based care will be detrimental to their earnings** (55% believe it will decrease total compensation vs. 10% increase)

QVB6: Do you currently participate in any risk-based alternative payment models with health insurance companies?
QVB2D: For the risk-based payment programs that you are participating in, do you know what types of operational metrics need to be changed to achieve your goals?

Source: McKinsey COVID-19 Physician Survey, 4/5/2021, 3/8/2022

Increasing focus is being placed on select specialties

● ↔ ○

Highly applicable — Not applicable

	Potential theses	Relative importance of levers: Ancillary expansion	Risk enablement	Site of care shifts
Women's health	**Consolidation enables expansion into high-margin ancillary services for OB/GYN** and entry into adjacent specialties	●	◔	◑
GI	Increase procedure facility fees from **ASC ownership**, insourcing service lines, and increasing productivity by employing **staff physician extenders**	●	◔	◑
Dermatology	Value capture from **ancillary service expansion** (e.g., Mohs, pathology)**, use of extenders, and savings in admin cost**	●	◔	◔
Urology	Value capture from **insourcing procedures**, **ASC ownership**, and **improving efficiency**	●	◔	◑
Nephrology	**Provide analytics and care management resources** for late-stage patients, enable contracting with MA payors and in full risk models	◔	●	◕
Ortho	**Ortho ASCs expansion** captures value from episode-based payments and technical revenues; **Provision of ancillary services** drives further upside	◕	◕	◕
Cardiology	**Move catheterizations into ASCs**; additional value from **low-cost site of care** (for VBC)**, staffing extenders,** and adjacent ancillaries	◕	◑	◕
Oncology	Create **integrated ambulatory ecosystem** and pharmacy; drive penetration of growing interest in value-based care	◕	◑	◕

SOURCE: Irving Levin, CMS

Despite enthusiasm from providers, **ASCs have grown at only ~1% p.a. over the past five years**

ASC landscape is still fragmented, with the largest five companies operating <30% of centers

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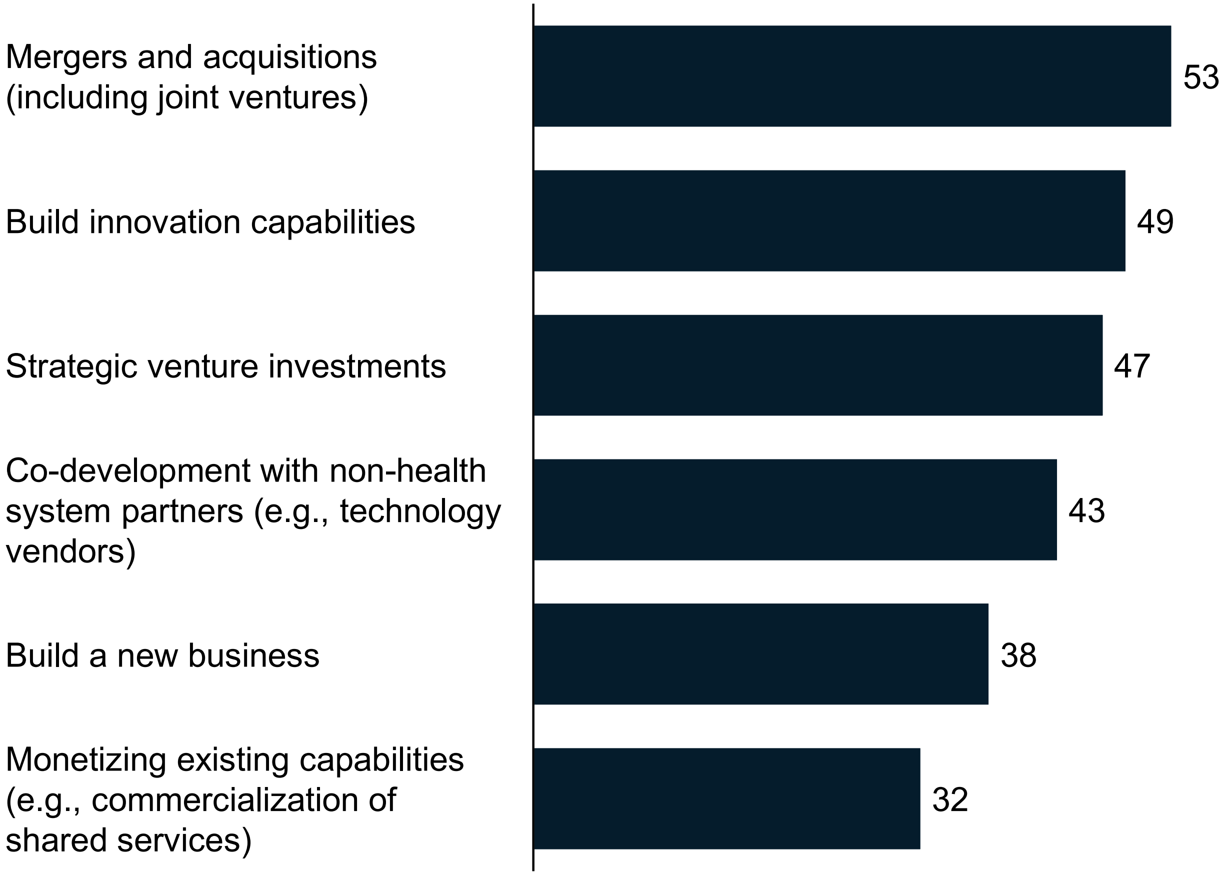
While approaches to diversification vary, most health systems intend to partner with others

Approach to diversification

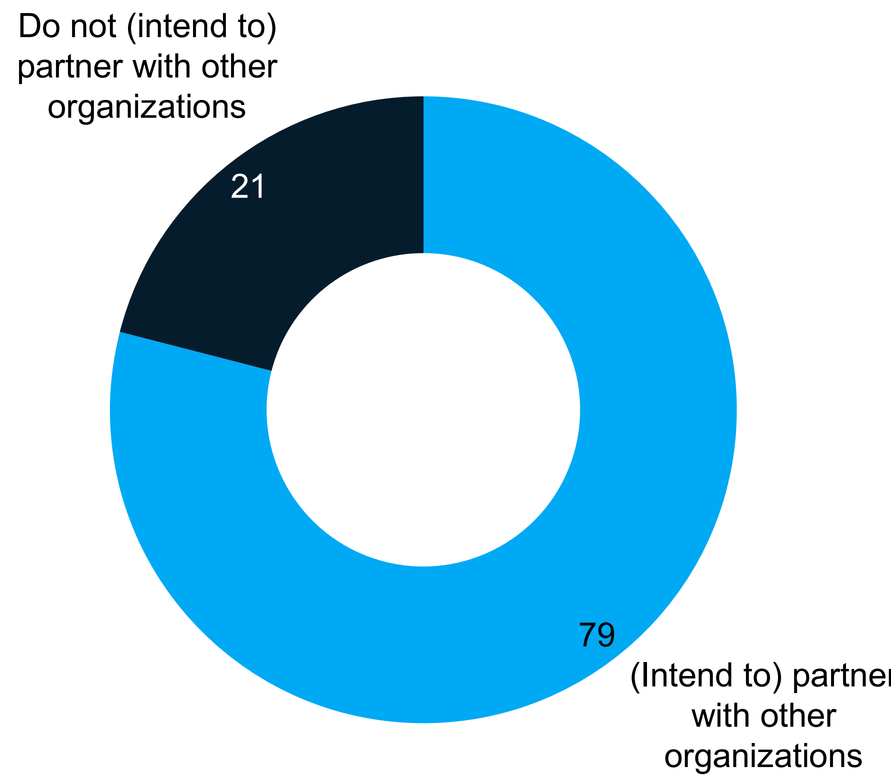
%



Partnership intention

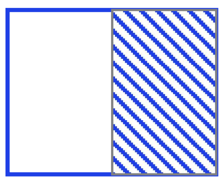
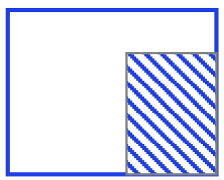
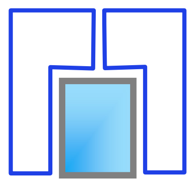
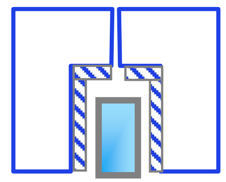
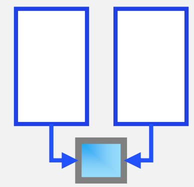
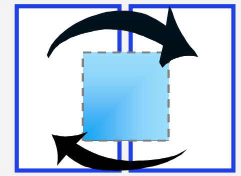
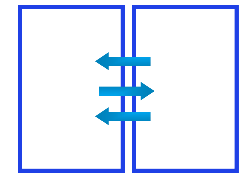
%

Intention to partner with other organizations as a part of diversified revenue strategy %



Source: McKinsey Healthcare Provider CXO Survey on Revenue Diversification (N=53) – April 2022

Health systems have multiple options beyond traditional M&A

Mergers & acquisitions		Partnerships				
		Joint ventures			Alliances	
Large deal M&A	**Programmatic & “tuck-in” M&A**	**Full business joint venture**	**Partial business joint venture**	**“Consortium play” joint venture**	**Strategic alliance with equity holding**	**Contractual alliance**
						
Full combination of two entities, target is >30% acquirer market cap All degrees of operational integration possible	Full acquisition of single asset/ series of smaller, related assets All degrees of operational integration possible	Partner contributions placed into new JV entity Operations led by separate management team	Select resources contributed into a new JV entity Vital other resources remain in parent companies	Parents contribute capital to new entity to jointly purchase asset All previously existing resources remain in parents	Partnership is substantiated with noncontrolling (cross) shareholding	Resources are made available to the partner, but remain inside the parent

← Equity involvement → ← No equity →

← Single new company → ← Separate new company → ← Existing companies →

Examples of scaling healthcare alliances

	Echo Health Ventures 2016	Civica 2018	Truveta 2020
Description	**Born from an alliance between Cambia Health and Mosaic Health**, Echo invests in technology solutions[1]	With 55+ US health systems, **promotes more consistent supply and pricing of generic drug medications**	Coalition of 15+ health systems **co-invested to build a clinical data platform on the cloud**
Why it has been successful	**Pooled capital** to rapidly invest and access deal flow beyond ability of individual organizations	Coalition **offsets high upfront costs with down-the-line savings** on drug procurement, returning greater aggregate value	Data quantity and quality enabled **more attractive commercial agreements** and co-development of new products and solutions

1. Echo Health has since added other systems, including Blue Cross Blue Shield of Tennessee and the USAble Corporation

Source: Company press releases, alliance websites

Successful collaboration models tend to follow a few conditions

- Is there a **substantial enough opportunity** to merit investing time and resources? Would the partnership be **competitively differentiated**?
- Is there **incremental value from scaling inputs via collaboration** beyond what could be achieved standalone?
- Is the capability one that **several (10+) health systems can participate in**, including players in overlapping geographies?
- Does participating in the partnership enable individual systems to improve performance and **avert a high upfront cost and/or scarcity of talent?**
- Does it **minimally impact day-to-day patient care and/or essential workflows?**

Multiple avenues for expanded collaborations

Health plan & DTE offerings

Ability to scale plan capabilities and network relative to solo health system offering

Corporate venture

Access to deal flow and capital, which are critical enablers and help de-risk across portfolio

Clinical education

Reduce startup cost for online program management and curriculum, as well as broader potential for placements

Data and analytics

Co-develop products along with change management capability (clinical and non-clinical)

Are there additional areas that are top-of-mind for consideration?

Key messages

Everyone is grappling with challenging conditions; not-for-profit systems should weigh whether and when to pull levers that for-profits will

Many health systems have yet to pivot capital and focus to high growth areas, with innovation often being driven outside of the non-profit ecosystem

Collaboration models should allow health systems to build capabilities and shape the future direction of healthcare

McKinsey & Company

Questions?

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