Executive Summary - APPRAISAL REVIEW

Stanford Health Care Advantage

As of Date: March 16, 2020

Report Date: October 23, 2020

Prepared for:
California Department of Managed Health Care

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EXECUTIVE SUMMARY

ENGAGEMENT OVERVIEW AND SCOPE

PYA, P.C. ("PYA") reviewed a valuation analysis ("Analysis") performed by VMG Holdings LLC d/b/a VMG Health ("VMG") of Stanford Health Care Advantage ("SHA" or the "Plan") in conjunction with a review by the California Department of Managed Health Care ("Department" or "DMHC") of the proposed conversion from a nonprofit public benefit corporation to a for profit corporation ("Conversion"). Stanford Health Care ("Stanford"), the Plan's parent and sole member, retained VMG to perform a fair market value analysis of the total invested capital of SHA as of March 16, 2020 and this analysis was documented by VMG in a valuation report dated April 20, 2020 (the "VMG Report")

This Executive Summary documents our procedures and key findings as it relates to our review of the VMG Report.

PROCEDURES

As part of the engagement, PYA's procedures included, but are not limited to, the following.

- Reviewed relevant documents related to the proposed Conversion as provided by the Department, Stanford and VMG.
- Reviewed the VMG Report, specifically, the qualifications of the valuation specialist, and the valuation methodology, valuation calculations, and key assumptions utilized by VMG.
- Held discussions with representatives of DMHC, Stanford and VMG and requested additional documentation and clarifications as it relates to the Conversion and the Analysis.

PYA'S OBSERVATIONS, ANALYSIS AND KEY FINDINGS

VMG was engaged by Stanford to "estimate the Fair Market Value of the Total Invested Capital" of SHA for Management planning purposes. The scope of VMG's Analysis was defined as a "Valuation Engagement" under the Fair Market Value standard.

PYA considered the following relevant historical and projected financial and operating information:

- The Plan had a history of significant operating losses, requiring Stanford's repeated capital contributions through the most recent fiscal year to sustain the Plan's operations.[1]
- Plan membership has not grown sufficiently to improve the medical loss ratio ("MLR") and administrative cost ratio ("ACR") sufficiently for the Medicare Advantage ("MA") Plan to achieve positive earnings on a sustainable basis.
- Additionally, the financial outlook for SHA, including its membership growth, does not reflect anticipated positive earnings in the foreseeable future.
- Despite 18 months of due diligence, deliberations with 12 entities including national MA plans, as well as numerous start-up health plan companies,[2] apart from Essence, no other entity made an offer to acquire the Plan.[3]

PYA reviewed the valuation approaches considered and utilized by VMG.

- Typically, three distinct approaches to value are considered in the valuation of assets and businesses. The Cost Approach is based on the anticipated cost to recreate, replace, or replicate an asset and/or business. The Income Approach is based on the economic benefits anticipated to be derived from the asset and/or business. Finally, the Market Approach is based on transaction data involving similar assets or businesses.
- VMG considered all three approaches but ultimately relied upon the Cost Approach to value the Plan "*as it is the approach most often utilized in situations where the estimated [fair market value] of the entity's identifiable tangible and intangible assets produces a value that is greater than the entity's discounted projected cash flow stream.*"[4] VMG considered the Market Approach but did not rely upon it as it believed that the Plan was "*subscale*" and there was no market transaction data related to a similar-sized entity. Additionally, due to the negative margins, VMG did not believe that the application of the Market Approach was appropriate.

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[1] Consolidated quarterly financial reports for SHA for the period starting May 31, 2018 through February 29, 2019; Consolidated monthly financial reports for SHA for the period starting August 31, 2019 through May 31, 2020.

[2] *Notice of Material Modification to License Application Re: Corporate Conversion*, dated May 2020, Exhibit E-1.

[3] VMG responses related to PYA's questions regarding the VMG Report received on August 18, 2020 and September 8, 2020.

[4] *VMG Report*.

- Additionally, VMG indicated that the absence of any purchase offer for SHA, despite an 18-month process and discussion with 12 participants, was indicative of the "*(lack of) market value"* perceived by potential acquirers of the Plan and its intangible assets.
- VMG's analysis utilizing the Income Approach concluded significant losses each year into perpetuity for the Plan. Utilizing the Cost Approach, *Adjusted Fair Market Value* of the Plan was indicated by VMG to be $5.24 million based on the Plan's tangible net equity ("TNE") as of the Valuation Date. However, as this amount will be subtracted out and potentially be set aside for charitable purposes,[5] the adjusted fair market value of SHA excluding the TNE was calculated as $0.

Based on Stanford management's representation that SHA is likely to sustain financial losses into perpetuity without significant changes to its current operations that can only be enabled by an experienced partner, and that there was an extensive process to identify a suitable acquirer or joint venture partner but that none expressed interest in acquiring the Plan and its assets apart from Essence, **PYA agrees with VMG that neither the Income Approach nor the Market Approach can be utilized reliably to value SHA and that the Cost Approach is the most applicable in the valuation of SHA as of the Valuation Date**.

- PYA relied upon Stanford management's representations as it relates to current and future profitability of the Plan. Given Stanford is not in the business of operating a health plan, and in its current form, and the Plan has required Stanford to consistently fund between $9.5 million and $13.2 million in annual losses between calendar year ("CY") 2017 and CY 2019 and maintain capital to fulfill regulatory requirements (minimum TNE), it is reasonable to expect that a partnership with an experienced managed care organization is necessary to effect profitability.
- Based on PYA's review of the background of VMG and the qualifications of Colin McDermott, PYA believes that VMG has the necessary qualifications to perform the Analysis requested by Stanford.

[5] *Notice of Material Modification to License Application Re: Corporate Conversion*, dated May 2020, Exhibit E-1.

CONCLUSION

Our independent analyses on behalf of DMHC, as described above, identified no material issues related to the VMG Report. VMG's reliance on the Cost Approach is consistent with valuation methodology typical for entities facing similar financial and operational issues. VMG's analysis was predominantly guided by Stanford's representations that the Plan lacks the ability to achieve profitability without the involvement of a more experienced partner. Additionally, the lack of interest from any potential acquirers despite a concerted 18-month process to identify potential partners, and discussions with 12 separate entities, further supported the conclusion that the market did not ascribe greater value to the Plan or its intangible assets.

Matthew Norris
John B. Keny, JD, MBA
Annapoorani Bhat, ASA, M.Soc.Sci., MBA
Robert S. Paskowski, CPA

Signed: W. James Lloyd
W. James Lloyd, CPA/ABV, ASA