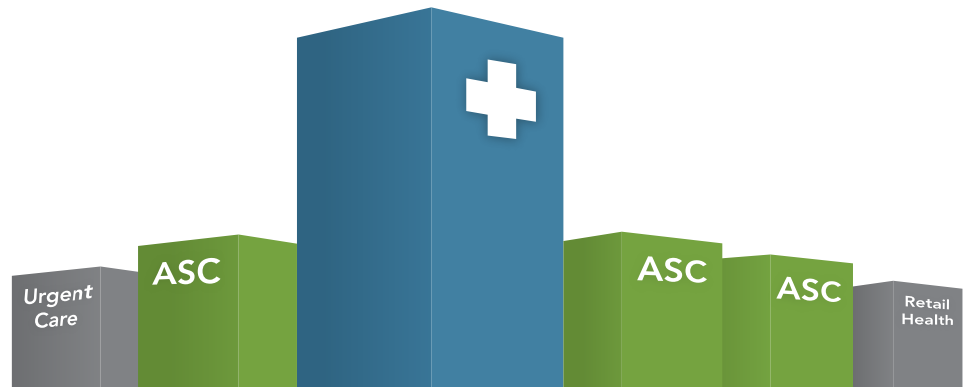


2017



Developing Your Ambulatory Care Network: ASCs Poised to Thrive

A Healthcare Industry Special Report

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Introduction

Hammond Hanlon Camp LLC (“H2C”) specializes in the healthcare services industry, providing trusted strategic and financial advisory services to clients nationwide. As such, the firm monitors a number of healthcare industry sectors, striving to keep clients abreast of trends and opportunities to support their decision making in an increasingly complex operating environment.

This report highlights the Ambulatory Surgery Center sector. It identifies key sector trends, and provides an outlook on future opportunities and considerations for hospitals and health systems. An overview of the sector, including size, composition and key players, is included in the Appendix.

For questions or to discuss the sector with an H2C professional, please see contact information as well as more information about the firm at the end of the report.

Overview

In today's fast-changing healthcare environment, it is critical for healthcare providers to deliver convenient, high-quality care at lower cost. To achieve this goal, a key component of health system strategy will be to continue developing its outpatient and ambulatory network, which includes investing in ambulatory surgery centers (ASCs).

A well-conceived ASC strategy can be a powerful value proposition, helping hospitals recoup lost surgical revenue, extending network access points and supporting population health management strategies. ASCs also contribute to a health system's operational success by improving patient satisfaction, increasing patient referrals and strengthening hospital-physician relationships.

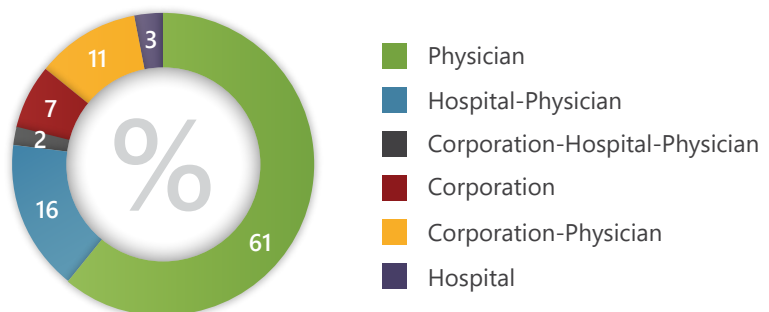
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A well-conceived ASC strategy can be a powerful value proposition.
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Hospitals and health systems have responded to the structural advantage of ASCs by entering into partnerships and joint ventures with physicians and ASC management companies. For ASC physician-owners, partnerships with health systems foster better clinical and financial integration while bringing additional resources to complex, mission-critical tasks like revenue cycle management, regulatory compliance and information technology. Meanwhile, partnerships with ASC management companies offer health systems economies of scale, best practices for operational efficiency, enhanced physician recruitment and provide access to capital.

The overall ASC market remains highly fragmented: multi-facility chains currently operate only about 25-30 percent of the Medicare-approved ASCs in the U.S. Although ASC volume growth has slowed in recent years, the convergence of value-based care, technological advances and an aging population is expected to fuel strong demand in the decades to come. Hospitals that have not already done so should therefore give serious thought to including ASCs as part of a comprehensive, value-based delivery strategy.

Figure 1: ASC Ownership

Source: United Surgical Partners International, VMG Health, Ambulatory Surgery Center Association, Wall Street Equity Research



Ambulatory Surgery Centers: A Cornerstone of Care Delivery

Between the late 1990s and late 2000s, the total number of ASCs nationwide doubled.

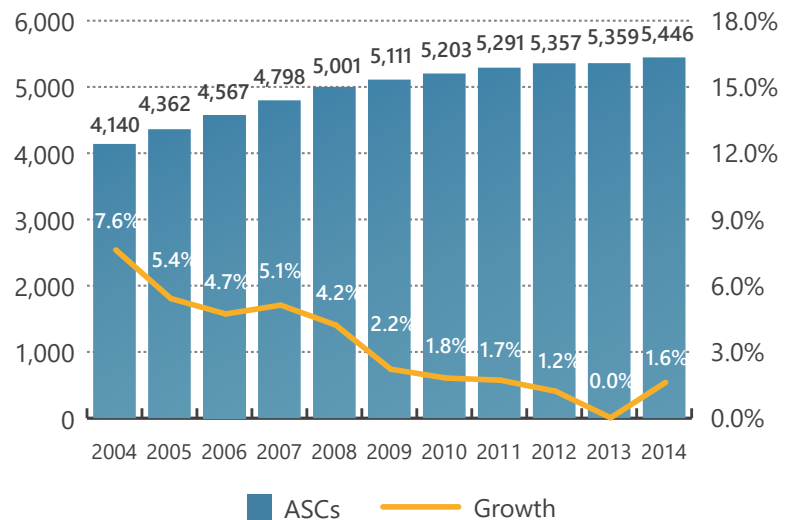
The first ASC was opened in 1970 by two Phoenix physicians seeking a convenient, lower-cost alternative to inpatient surgical services. Beyond enhancing patient satisfaction through easier scheduling, simpler access and faster procedure turnaround, ASC pioneers sought to improve the surgical experience for clinicians.

The elimination or reduction of systemic hospital problems like scheduling delays, limited operating room availability and difficulty obtaining new equipment made ASCs highly attractive for physicians. Opportunities for equity ownership created further appeal.

In 2015, the overall ASC market was estimated at \$27.3 billion. Between the late 1990s and late 2000s, the total number of ASCs nationwide doubled, and today approximately 5,400 single- and multi-specialty ASCs provide about 3,400 different types of Medicare-approved procedures at rates often significantly lower than those paid for equivalent services in the hospital setting. ASC expansion has slowed of late; between 2012 and 2013, new Medicare-certified ASC facilities increased at just 1.1 percent. The recent slowdown of new ASCs reflects a maturing industry and the lingering effects of the Great Recession, which led to the loss of health insurance for many and increased consumer reluctance to pursue elective surgeries.

Figure 2: Medicare Certified ASCs

Source: MedPac



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*The benefits ASCs can produce
... have contributed to a sharp
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surgeries performed in the
inpatient setting.*
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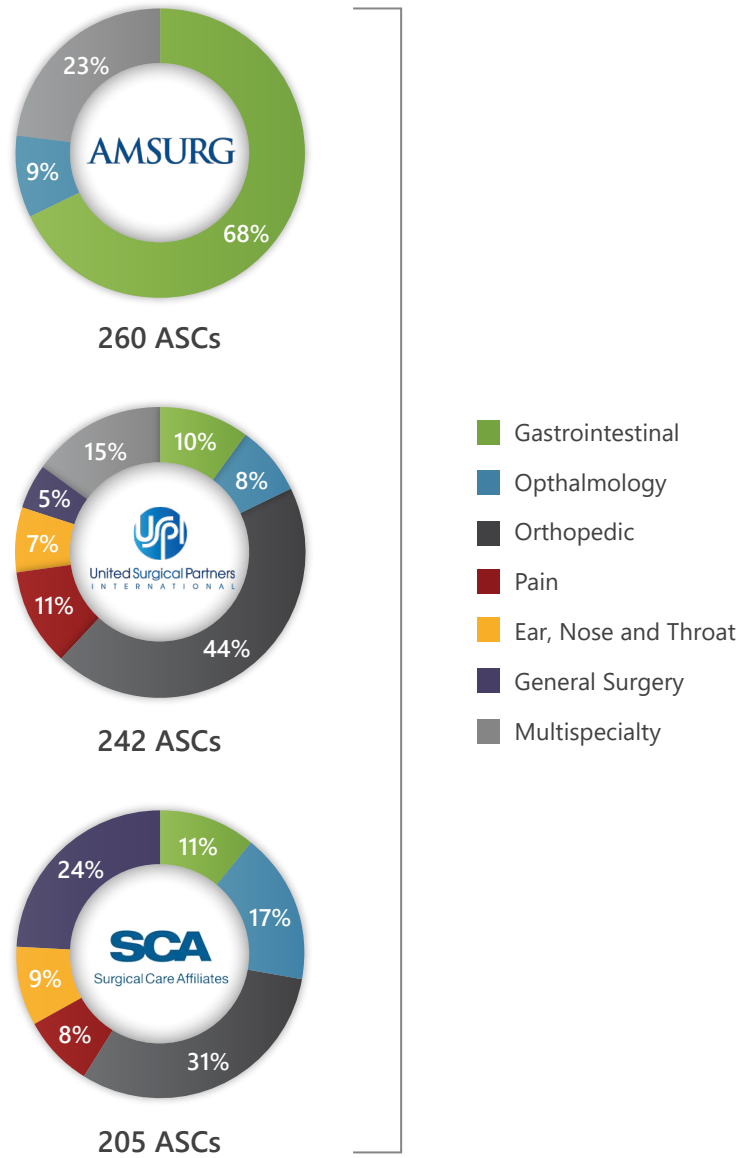
The benefits ASCs can produce for patients, clinicians and payors predictably have contributed to a sharp decline in the percentage of surgeries performed in the inpatient setting. In 1985, inpatient procedures accounted for 85 percent of the approximately 60 million U.S. surgeries conducted that year, while outpatient procedures made up just 15 percent. By 2015, those ratios had nearly reversed, with inpatient surgeries accounting for just 23 percent of procedures and outpatient surgeries representing 77 percent. Over the same period, U.S. surgical volume almost doubled to 110 million procedures. In 2015, total outpatient volume of 85 million procedures was evenly split between hospital outpatient departments (HOPDs) and ASCs, with each controlling about 41 percent. The remaining 18 percent of procedures were performed at other locations (typically physician offices).

Gastroenterology is the most prevalent of major medical specialties offering care through ASCs, with 33 percent of facility capacity. Ophthalmology, pain/neurology, and orthopedics are next with 29 percent, 21 percent, and 8 percent, respectively. From a procedure or volume perspective, ophthalmology is dominant with 30 percent followed by orthopedics next with 15 percent and gastroenterology with 14 percent.

Many of the procedures performed at ASCs are technology-reliant, minimally invasive and diagnostic or preventative in nature. More than 40 percent of all Medicare colonoscopies, for example, are now performed at ASCs, a fact which has helped contribute to a decade-long decline in colorectal cancer mortality.

Figure 3: ASC Ownership • Procedure Mix

Source: Capital IQ, SEC Filings, Company Websites



Source: Capital IQ, SEC Filings, Company Websites

Healthcare Sector Trends Driving ASC Success

Aligning with Healthcare Reform

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ASCs already have shown themselves equal to hospitals in the area of care quality when it comes to lower acuity patients.
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Despite tapering growth, stand-alone surgical centers are ideally positioned to play an important role in the emerging value-based environment by virtue of their experience in delivering high-quality, patient-centered, cost-effective care. Demand should further strengthen by a growing shift of higher-acuity procedures to the outpatient setting, an aging and increasingly cost-sensitive patient population and the expansion of risk-sharing reimbursement models.

ASCs already have shown themselves equal to hospitals in the area of care quality when it comes to lower-acuity patients. A 2015 working paper by health economists Elizabeth Munnich and Stephen Parente found that patients treated in ASCs were less likely to be admitted to a hospital or emergency room in the immediate, post-surgical time-frame than patients who underwent similar procedures in hospital facilities.

An earlier 2014 study by Munnich and Parente analyzed data from more than 50,000 surgical procedures. Among the authors' conclusions: Ambulatory surgery center patients spend 25 percent less time undergoing outpatient surgery than hospital patients.

Separate analysis has found post-surgery infection rates at ASCs are nearly half those of hospitals. Centers for Disease Control and Prevention (CDC) data from 2010 showed that approximately 8.95 hospital patients per 1,000 developed surgical site infections. That compares to an ASC surgical site infection rate of just 4.84 patients per 1000, according to data published in the Journal of the American Medical Association in 2014.

Along with consistent high quality, ASCs generate strong customer satisfaction rates. The Ambulatory Surgery Center Association has reported that 92 percent of patients are satisfied with the care provided in ASCs. Factors influencing the high marks include safe and high-quality service, ease of scheduling, greater personal attention and reduced co-pays due to lower payor ASC reimbursement rates, according to the association.

Cost Containment

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[T]he ability to deliver surgical service for less represents ASCs' most compelling advantage in an era marked by steadily rising healthcare expenses.
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As essential as quality and patient satisfaction are, the ability to deliver surgical services for less represents ASCs' most compelling advantage in an era marked by steadily rising healthcare expenses. ASCs' lower costs reflect their singular focus, lower overhead and more efficient scheduling and staffing, including the absence of any requirement for overnight care capabilities.

In 2014, health economists Munnich and Parente concluded that average costs per procedure at ASCs were \$363 to \$1,000 lower when compared to hospitals. Another study in 2013 by healthcare economists at the University of California at Berkeley found that ASCs saved the Medicare program and its beneficiaries \$7.5 billion during the four-year period ending in 2011, with savings of \$2.3 billion in 2011 alone.

Of the total Medicare reductions, \$6 billion was realized by federal payors, while the remaining \$1.5 billion accrued to beneficiaries. The researchers further determined that ASCs had the potential to save Medicare and its enrollees up to \$57.6 billion over the next decade.

Similar analysis by the Department of Health and Human Services' Office of Inspector General concluded that Medicare would generate savings of \$15 billion between 2012 and 2017 by aligning higher HOPD reimbursements with ASC payment levels for outpatient procedures performed on beneficiaries with low-risk and no-risk clinical needs.

ASC patient out-of-pocket expenses, meanwhile, can be up to 61 percent lower than co-pays for the same procedure at a HOPD, according to a securities report produced by Stephens Inc. Coinsurance for a cataract procedure, for example, is roughly \$195 at an ASC versus \$496 at a HOPD, the Stephens report states.

Technological Advantages

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ASCs historically have been on the leading edge of medical technology.
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ASCs historically have been on the leading edge of medical technology. Contributing factors include engaged physician leadership and flexibility in capitalizing optimal, specialty-specific surgery environments. Reliance on minimally invasive techniques and micro-instruments helps improve ASC care quality by speeding recovery times, reducing infection rates and limiting post-surgical wound management needs.

Today, technological advances are allowing a growing number of complex procedures to shift to the outpatient setting. Among these are partial and total joint replacements as well as pacemaker insertions. Recent Centers for Medicare & Medicaid Services (CMS) approval of nine ASC spine procedure codes — including neck-spine fusion and disc surgery — could create significant new opportunities for orthopedic ASCs.

Positive Demand Trends

The quality and cost advantages ASCs enjoy are matched by equally powerful demographic trends that point to a steady, long-term demand growth. In 2014, an estimated 60 percent of industry revenue was generated from individuals aged 60 and older. Adults age 65 and older represent the single largest market for ASCs, and that population is expected to double in size by 2030, to about 71 million. Additionally, expansion of health insurance coverage provided through the Patient Protection and Affordable Care Act (ACA) should further increase utilization by the 20-to-39-year-old market.

On a separate front, the expansion of high-deductible health plans is forcing consumers to become more cost-conscious with their healthcare expenditures. Between 2010 and 2015, deductibles for all workers rose three times as fast as premiums and about seven times as fast as wages and inflation, according to the 2015 Employer Health Benefits Survey conducted by Kaiser Family Foundation and the Health Research & Educational Trust. This growing financial burden is expected to lead more patients to seek out lower-cost, high-quality providers for elective procedures.

Reimbursement Challenges

Unlike many of their hospital competitors, ASCs enjoy a relatively attractive payor mix that typically averages about 57 percent commercial insurance enrollees. Medicare, in turn, represents about 25 percent of industry revenues. Major differences in the way HOPDs' and ASCs' Medicare payments are calculated have produced wide disparities in the amounts each organization can receive for the same services. But recent regulatory changes are expected to narrow that gap in the future.

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[P]owerful demographic trends . . . point to . . . steady, long-term demand growth.
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[D]ifferences in the way HOPDs' and ASCs' Medicare payments are calculated have produced wide disparities in the amounts each organization can receive for the same services.
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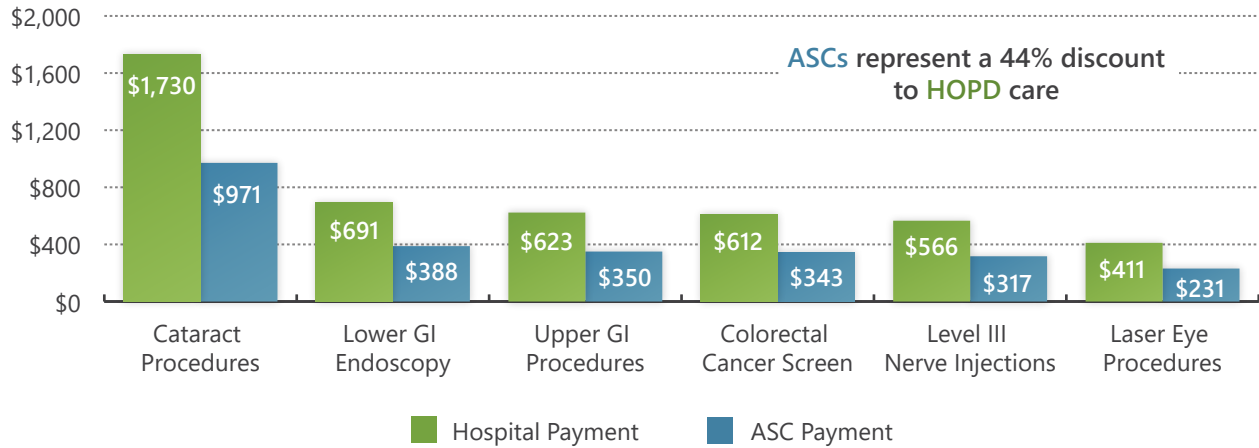
Currently, ASC Medicare reimbursements average just 58 percent of the rates paid to HOPDs for equivalent Medicare services. The differential reflects the facility fee and higher conversion factor HOPDs receive via the Outpatient Prospective Payment System (OPPS). In essence, HOPDs are considered by CMS to be provider-based facilities and paid accordingly.

The Balance Budget Act (BBA) of 2015, however, contained a provision (Section 603) that will prohibit hospitals from collecting higher rates for non-emergency services if the facility is not on or within 250 yards of hospital or health system campus. The provision, which took effect on January 1, 2017, stipulates that new, stand-alone HOPDs will receive lower payments under the Ambulatory Surgery Center Fee (ASCF) schedule or the Medicare Physician Fee Schedule (MPFS).

The so-called "site-neutral" rule applies only to ASC-based HOPDs that began or will begin billing after Nov. 2, 2015. Facilities already operational are grandfathered in and will continue to receive the higher OPPS rates. The rule also will not affect rural health clinics, federally qualified health clinics and stand-alone, designated emergency departments or hospital-based facilities that offer services differing from those of the primary provider.

Figure 4: Medicare Payment Rates to Surgery Centers

Source: MedPac, Wall Street Equity Research



The American Hospital Association (AHA) has argued that higher OPPS reimbursement rates are necessary because of the added regulatory requirements outpatient departments face and the greater capabilities they provide. Legislative efforts are underway to extend the provision's grandfather clause to include ASCs currently under construction. But whether the site-neutral rule will be significantly altered seems questionable, given the multiple estimates showing how much Medicare could save by narrowing the gap between HOPDs and ASC payments.

Hospital ASC Opportunities

ASC Strategies for Hospitals and Health Systems

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ASCs help hospitals and health systems extend patient access and the system network.
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Historically, some hospitals and health systems likely pursued ASC strategies primarily, if not solely, for the purpose of converting the facilities into higher-paying HOPDs. Yet even without this arbitrage opportunity, ASCs can still offer strategic value for acute care providers.

First and foremost, ASCs help hospitals and health systems extend patient access and the hospital or system network. Bringing experienced and operational outpatient surgical capacity on line through an ASC allows hospitals to immediately offer consumers a visible, cost-effective and convenient alternative to hospital-based outpatient surgery.

A broad ambulatory footprint can be essential in establishing a diverse continuum of care capabilities. Combined with primary care and specialist physician offices, urgent or walk-in clinics, acute care hospitals and post-acute capabilities, ASCs help meet population health management needs, including payor network and accountable care requirements. At the same time, partnership arrangements with physicians help foster more effective clinical and financial integration in response to payment bundling and other risk-sharing reimbursement models. Finally, shifting elective procedures to an ASC can free up hospital capacity for higher-acuity, inpatient services.

Adopting an ASC-based surgery strategy clearly can have a negative impact on hospital outpatient revenue. Yet HOPD volume may be flat or declining in any case as payors and consumers increasingly seek out low-cost providers. An ASC agreement creates an opportunity to recapture a portion of that revenue through a vehicle that will likely continue to grow over time. Moreover, an ASC may actually increase hospital referrals, given that a wider physician network will probably send more acute cases for care.

Alliances, Consolidation Continues

At present, approximately 20-25 percent of ASCs have some ownership by a hospital partner. Hospitals are forming alliances with both independent, stand-alone ASCs and national, multi-facility chains. Surgical Care Affiliates, for example, an operator of 179 ASCs, has partnerships with more than 40 health systems. These include well-known organizations like Henry Ford Health System, Sutter Health and MemorialCare, the largest health system in Orange County, Calif. Most major chains have developed similar system relationships.

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In what represents the largest de facto hospital-ASC partnership, Tenet Healthcare in March 2015 entered into a joint venture with United Surgical Partners International (USPI) to combine ASC assets and eventually acquire 100 percent of the company. The new entity retains the USPI brand and is now the largest ASC company in the country with 244 ASC facilities. Tenet operates 79 hospitals in the U.S.

Meanwhile, in January 2017, UnitedHealth's OptumCare agreed to acquire Surgical Care Affiliates for approximately \$2.3 billion in a cash and stock deal. The acquisition substantially expands the healthcare provider footprint of OptumCare and enhances the company's comprehensive ambulatory care services platform, which now includes primary care, urgent care and surgical care services while improving patient experience, quality and cost of care.

Figure 5: Competitive Landscape

Source: Capital IQ, SEC Filings, Company Websites

	Status	Revenue	EBITDA / Margin	No. of Facilities	Comments
	Public (NASDAQ: AMSG)	\$9,369	\$1,375 / 15%	260	<ul style="list-style-type: none"> Envision Healthcare and AMSURG merged on December 1, 2016 creating one of the nation's largest provider networks Owns and operates approximately 260 surgery centers and one surgical hospital in 35 states and DC
	Private	643	190 / 30%	242	<ul style="list-style-type: none"> Owns and operates 242 ASCs and 20+ imaging centers in 29 states, with over one million patients each year Operates two affiliate urgent care brands CareSpot and MedPost Urgent Care
	Public (NASQ: SCAI)	719	168 / 21%	205	<ul style="list-style-type: none"> Operates 205 ASCs and 7 surgical hospitals across 33 states, performing more than 800,000 surgeries and procedures each year Acquisition by Optum Health announced in January 2017
	Public (NYSE: HCA)	41,098	8,091 / 20%	116	<ul style="list-style-type: none"> Largest hospital provider in the country Operates 116 ASCs in 20 states 30+ of HCA's ASC facilities are located in Florida and operate under HCA's SurgiComp division
	Public (NASDAQ: SGRY)	1,079	230 / 21%	99	<ul style="list-style-type: none"> Acquires, develops and manages free-standing ASCs in partnership with physicians Acquired Symbion in June 2014 for \$792 million
	Private Nonprofit	11,936	925 / 8%	34	<ul style="list-style-type: none"> Operates 34 ASCs within the state of California 87% of Sutter's outpatient surgery centers are located in Northern California, with 13% located in Southern California

(1) Figures for USPI only.

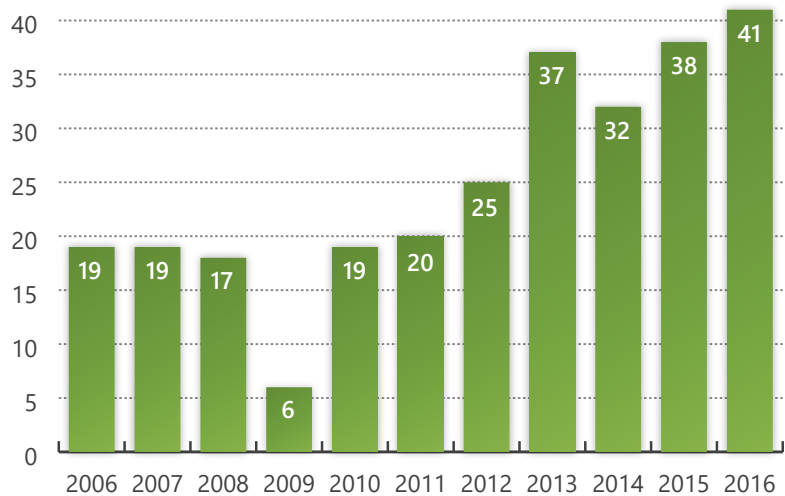
(2) Figures for entire business.

Note: Financials as of latest available period

Like hospitals, management companies also continue to acquire or partner with stand-alone facilities. In 2014, 38 percent of ASC management companies reported between one and five acquisitions, while 24 percent acquired between six and 10 centers.

Figure 6: ASC Mergers & Acquisitions Volume

Source: Capital IQ, Wall Street Research



Joint Venture Models

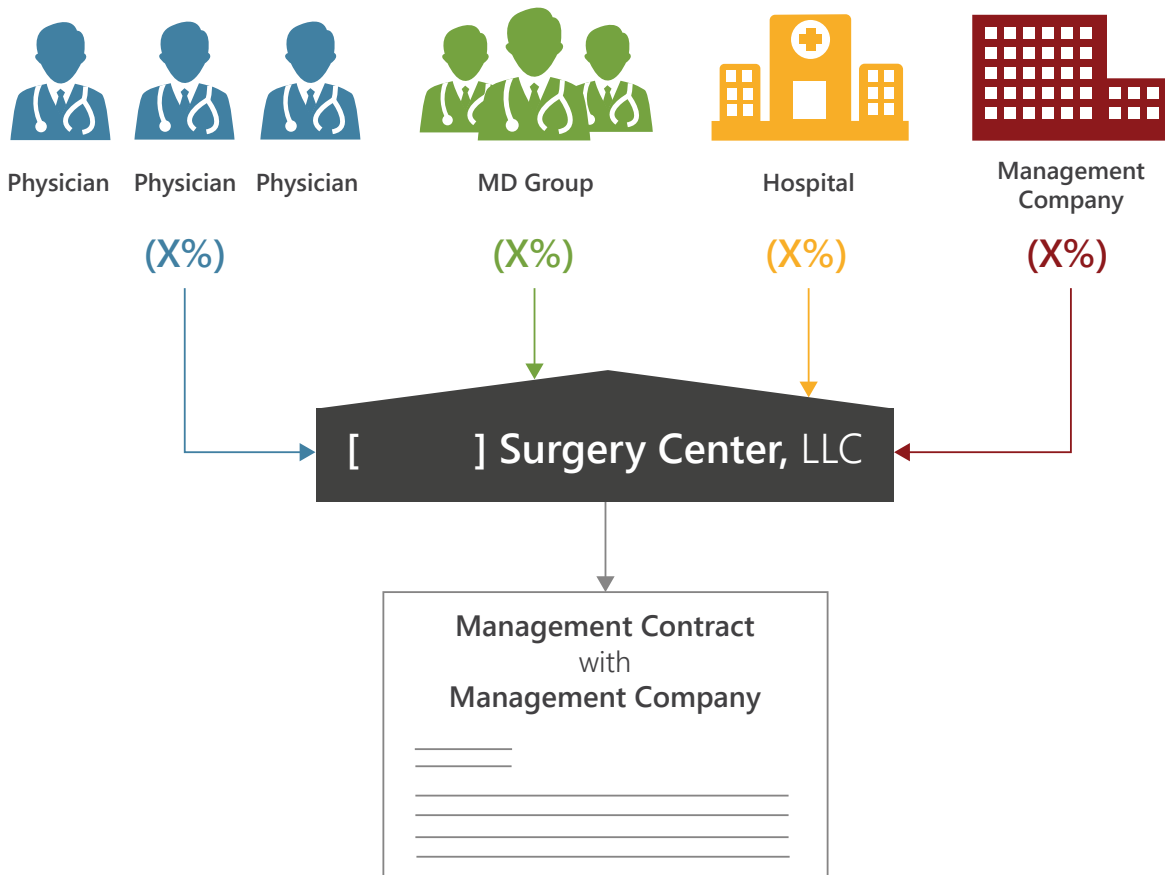
A variety of partnership models are being used by hospitals and systems in agreements with ASCs. Increasingly popular are tri-party partnerships that involve health systems, physicians and national ASC management companies. In bi-party deals between hospitals and physicians, hospitals typically control 51 percent of the ASC and physicians 49 percent. In other instances, hospitals and physicians jointly create a master limited liability corporation, which in turn, controls multiple ASCs. Still another approach is the creation of an ASC management company jointly held by physicians and the hospital.

Partnership Benefits for ASCs

[G]reater clinical and financial integration enables more effective performance by all parties in a value-based, risk-bearing environment.

About 90 percent of all ASCs incorporate some type of physician ownership component, and the positives of hospital alignment for ASC physicians are similar to those that hospitals enjoy. In general terms, greater clinical and financial integration enables more effective performance by all parties in a value-based, risk-bearing environment.

Hospitals also can drive volume to the ASC and thus increase physician income. Additionally, ASCs may gain payor negotiating leverage and higher reimbursement as part of a larger system. ASCs likewise can benefit from hospital or health system support in essential areas like information technologies, compliance and revenue cycle management. As practice management and regulatory compliance become increasingly costly and complex, partnerships offer a critical lifeline that allows physicians to refocus on the provision of care.



Keys to Success

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[M]aintaining a high level of physician ownership is essential.
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Regardless of the partnership approach taken, maintaining a high level of physician ownership is essential, since it helps ensure that physicians remain committed to the organization's success and motivated to perform. Also important are governance agreements that allow physicians to maintain operational control of the facility.

In October 2015, Becker's ASC Review sponsored an industry forum that focused on the business operations of ASCs. Joseph Zasa, a founding partner of ASD Management, an ASC development and management company, offered several suggestions for building healthy hospital-physician partnerships:

- Clarity surrounding ownership and control: A hospital is not automatically entitled to a majority on the board even if the hospital or system owns a majority of the joint venture. The parties should reach a consensus regarding rights of shareholders, ownership eligibility and partner buy-in and buy-out provisions. If the hospital is non-profit, specific controls of the joint venture are required to maintain tax-exempt status.
- Mutual understanding: ASC experts must convey to hospital leaders what they are able to provide and what works in the ASC environment. It is particularly important for hospitals to understand how ASCs differ in areas like staffing, contracts, policies and business office operations.
- Agreement on goals: Be sure to reach a consensus on objectives. An honest, respectful and forthcoming approach by both parties can help make the venture more successful in the long run.
- Reach agreements on moving services: Hospitals should agree to shift appropriate services to the ASC, assuming the moves are attractive to payors, reduce patient out-of-pocket cost and provide a more satisfying patient experience.

Conclusion

Embracing a New Paradigm

The U.S. health system today is in the early stages of a sweeping, historical realignment. Traditional methods of care delivery and reimbursement are giving way to a far more integrated, streamlined and cost-effective approach. Partnerships between long-standing rivals – payors and providers, hospitals and physicians and hospitals and ASCs – are essential to move this transformation forward.

By developing an ASC strategy, hospitals can quickly add the infrastructure they need to provide care in a more patient-friendly and efficient way. Partnering with ASCs that have experience with key elements of value-based care means hospitals do not have to reinvent the wheel in the development of a more effective delivery network. Instead, they are able to focus on coordinating and integrating the entire continuum of care so that patients receive what they need when they need it, and in the most effective way possible.

ASCs are one of the most critical elements of that care continuum. Those hospitals that fail to develop a strategy to incorporate ASCs therefore run the risk of being left behind as America's new healthcare infrastructure takes shape. Those that begin the process of integrating today should reap the benefits in the years to come.

Appendix

Since 2006, the ASC and hospital indices have outperformed the broader market appreciating 200.2% and 165.4%, respectively. Current valuation levels of publicly traded ASC companies have EV/EBITDA multiples between 9.0x and 12.0x outpacing historical figures.

Figure 7: Share Price Appreciation Over Last 10 Years

Source: Capital IQ, SEC Filings, Company Websites

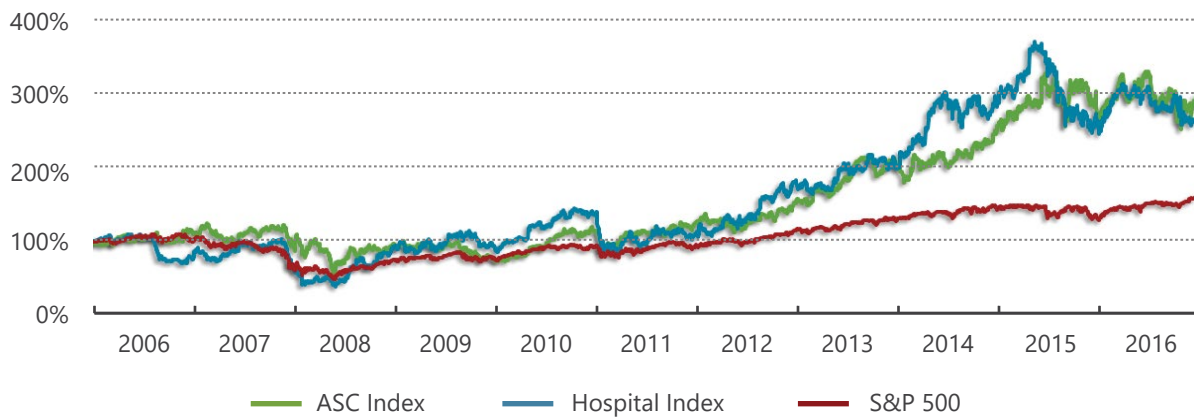
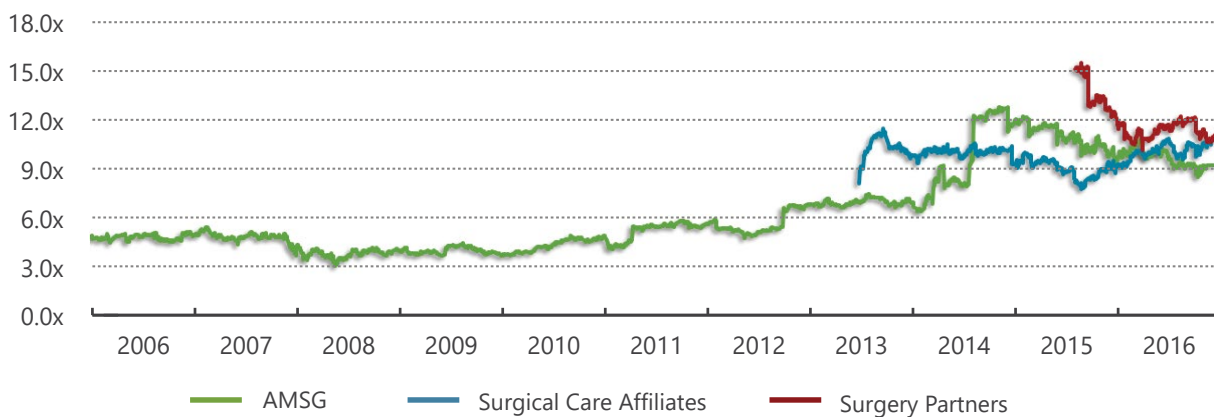


Figure 8: Valuation Levels Over Last 10 Years (Enterprise Value / Last Twelve Months EBITDA)

Source: Capital IQ, SEC Filings, Company Websites



Note: Market data as of Q3, 2016; Hospital Index includes Hospital Corporation of America (HCA), LifePoint (LPNT), Tenet Healthcare (THC) and Universal Health Services (UHS); ASC Index includes AmSurg Corp. (AMSG), Surgical Care Affiliates (SCAI), and Surgery Partners (SGRY).

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³⁴ "ASCs: A Positive Trend in Health Care," Ambulatory Surgery Center Association's Campaign for Advancing Surgical Care," date unknown, <http://www.ascassociation.org/advancingsurgicalcare/aboutascscs/industryoverview/apositivetrendinhealthcare>

³⁵ Mary Rehtoris, "50 things to know about the ambulatory surgery center industry," Becker's ASC Review, July 22, 2015, <http://www.beckersasc.com/asc-turnarounds-ideas-to-improve-performance/50-things-to-know-about-the-ambulatory-surgery-center-industry.html>

³⁶ Darren Lehrich, et al, "Get your partner on: SCAI delivering solid growth with JV strategy," Deutsch Bank Markets Research, April 8, 2015

³⁷ "Tenet, United Surgical Partners International and Welsh Carson to Create the Nation's Largest Ambulatory Surgery Platform," press release, Tenet Healthcare Corp., March 23, 2015 <http://investor.tenethealth.com/press-release/acquisition-and-development/tenet-united-surgical-partners-international-and-welsh-car>

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³⁹ Heather Punke, "7 lessons learned from hospital-ASC partnerships," Becker's ASC Review, Oct. 28, 2015, <http://www.beckersasc.com/asc-transactions-and-valuation-issues/7-lessons-learned-from-hospital-asc-partnerships.html>

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HAMMOND HANLON CAMP LLC (“H2C”) is an independent strategic advisory and investment banking firm with an exclusive focus on healthcare services companies and related organizations. Our commitment to exceed our clients’ expectations begins with senior leadership on every engagement and continues with independent and objective strategic advice. Our belief in the markets and in the power of competition has resulted in loyal clients and long-term relationships.

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