

## An Open Letter to the Board of Directors of Spectrum Health

June 24, 2021

When I read the recent announcement regarding the proposed merger between Spectrum Health and Beaumont Health, I was stunned. I'll admit it up front, I've never been in favor of this potential merger. During my tenure as Executive Vice President and CFO of Spectrum Health, we discussed possible mergers routinely. In my opinion, a Spectrum Health - Beaumont merger brought nothing new with it. The markets didn't overlap, so there were no significant administrative savings opportunities. The ability of each hospital to grow wasn't enhanced by adding the other to the 'system'. We both took care of similar patients. Each could've focused on better care integration and coordination within their market but they didn't need the other to accomplish that. In short, I never saw how such a merger could improve health, enhance value or make care more affordable. I still don't. I don't believe anything has changed substantively that would cause me to look at the above statements differently than I did many years ago; however, that's not my reason for being stunned.

Back in 1997, when Spectrum Health was created, the merger of Butterworth and Blodgett was controversial, both in the community and with the Federal Trade Commission (who challenged it). Speaking personally, I never thought that merger would happen as it appeared there were just too many forces lining up to stop it. Nevertheless, it did happen, but only after the parties agreed to a Consent Decree with the U.S. District Court, which required the parties to agree to a "Community Commitment" to "assuage any purchaser concerns and to reiterate [the hospitals'] strong conviction that the purpose and intent of the transaction is to reduce costs and to pass those cost savings on to consumers rather than to increase prices or unfairly disadvantage payers". I spent my West Michigan career trying to live up to those words and, admittedly, didn't always succeed. That being said, I was always reassured by the fact that this merger, supported by many key individuals in the business community, would always be a nonprofit organization based in West Michigan. The U.S. Court agreed. In fact, they stated that "the boards of these two hospitals are comprised of prominent community and business leaders whose employees depend on these facilities for services, and who have demonstrated their genuine commitment to serve the greater Grand Rapids community through their governance of the hospitals" was of critical importance to their evaluation of the evidence. That commitment became part of the larger Consent Decree.

Fast forward 24 years to where we find ourselves today, presented with another merger of equals that will take those Spectrum Health trustees and merge them with another group of trustees, outside of West Michigan, outside of the region for which Spectrum Health trustees made their commitment many years ago. Who cares? Why does any of this matter? I can summarize it in five items for you:

1. Governance
2. Transparency
3. Corporate Structure
4. Priority Health – Market value vs. Book value
5. Commitments

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### Governance

The agreement between Spectrum Health and Beaumont Health effectively, after a very short window of time, allows for a 16-person Board, 7 of whom will come from Spectrum Health and seven of whom will come from Beaumont Health. The CEO, who will come from Spectrum Health initially and one new Board member will comprise the rest of the Board. While this structure looks to favor Spectrum Health initially, it would only take the hiring of a Board member more favorable to Beaumont Health and the replacement of the CEO (in favor of Beaumont Health) for Spectrum Health to find itself outvoted 9 to 7 on key issues. Further, the Board Chair will come from Beaumont Health for the next four years. This should be deeply concerning, given what is at stake. Additionally, what if this combined entity merges with another out of state healthcare system in ten years, further diluting the influence of West Michigan board members? Keep that in mind as you read on.

### Transparency

Many years ago, I started publishing Spectrum Health's financial statements, quarterly, on the Spectrum Health website. That practice remains to this day. I did so in the belief that trust couldn't be built without transparency, and trust was key to making the organization successful in the long term. Have you tried to find Beaumont Health's financial statements? I've been looking for the past week and have not located them. If they're out there, they're certainly not easy to find and, no, a few quotes about financials every quarter does not count as "transparency", at least not in my book. Beaumont Health says it has over 300 days of cash on hand yet, they're only rated A1. Do they have a high debt/capitalization ratio that prevents them from having a much larger capital budget? If their operating margins are adequate, and they have plenty of cash, what's the problem? I can suspect what the problem is but, without transparency, I can't know. What will happen with financial transparency going forward?

### Corporate Structure

Consistent with the theme of transparency, go to page 7 of the Spectrum Health consolidated financial statements as of March 31, 2021 (available on the website). Find the "Investments" line and go over to the heading titled "Corporate & Subsidiaries" and you'll see \$2,047,005,000. Why does "Corporate" have \$2 billion and not the hospitals? Because when we put the merger together, there were these things called "Reserved Powers", some of which reserved the power of investing, debt and budget approval to the parent (Corporate), NOT the subsidiaries. While not impacting much because both merging hospitals were six miles apart, it did allow us to make sure that all investments were centrally controlled and managed, which was important because a Chief Financial Officer is also managing the debt side of the balance sheet and the two sides must be managed with one strategy if risks are to be properly mitigated. At the same time, we created a "Master Trust Indenture" (MTI) which included all of the Spectrum Health entities, but not Priority Health. This is necessary so that, when money is borrowed by issuing bonds, the bondholders don't have to worry about how the debt will be collateralized and whether or not they'll be left holding the bag if an entity failed. It's all collateralized by a revenue pledge on ALL of the delivery system entities. In other words, everyone owns the debt, even if it was borrowed for the benefit of only one of the hospitals.

Fast forward to the proposed merger and my governance concerns outlined above. Paragraph 3.a.v. of the Letter of Intent mentions "certain appropriate reserved powers retained by the System Board", which means the current Spectrum Health reserved powers just move out of the

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Spectrum Health Board to the new governing body, wherever that is located. Once the merger is consummated, and a new MTI/obligated group is created (which will look very similar as they are similar throughout large healthcare systems), it will be in the hands of governance to decide where "transformational" capital is spent and where it is drawn from. In other words, debt can be placed on the books of West Michigan while investments EARNED IN West Michigan could be spent in SE Michigan...and vice versa. If this entity should someday merge with other out-of-state entities, West Michigan could find itself investing in healthcare in other states as well, rather than in its own health. How can that possibly be consistent with the U.S. Court's original confidence in the local Board to look out for the interests of local consumers?

### Priority Health – Market value vs. Book value

Priority Health had a book value of \$1.315 billion as of 3/31/2021, the last financial statements publicly available. Per the financial statements, that represented risk-based capital (RBC) of 642%. RBC, per the NAIC, is defined as the minimum amount of capital (equity) appropriate for an insurer to support its overall business operations in consideration of its size and risk profile. So, Priority Health has 6.6 times the equity necessary to cover its risk profile. When I was President & CEO of Priority Health, we moved RBC from @ 250% to 400%. I used to comment that I could run Priority Health all day at 400% RBC. The difference between 400% and the current 642% is @ \$495 million if my math is correct. What happens to that money, given the possible governance scenarios outlined above? Does it get drawn out and spent on hospital renovations in SE Michigan? Could it? Absolutely.

But that \$495 million is just an appetizer. In early March of 2021, Oscar Health, a health insurer with 529,000 members that has yet to be profitable (but counts Alphabet, Inc. as its biggest shareholder at 18%), went public with a valuation of \$9.1 billion. Priority Health, Spectrum's own health insurer (covering all market segments and having a statewide and national network), has decades of earnings reflected in its \$1.315 billion of equity and it has 1,076,000 members as of 3/31/2021. Using Oscar Health as a guide (humor me), Priority Health would have a market value (if sold or taken public) of \$18.5 billion. In other words, the market value of Priority Health (ergo, Spectrum Health) could be as much as \$17.2 billion greater than its current book value. This represents almost 3 times the current book value of ALL of Spectrum Health, half of which immediately accrues to Beaumont Health when the merger of equals occurs. If I admit that the Oscar Health valuations seem absurd and, instead, just use a weighted average valuation/member of the three largest publicly traded plans, United, Anthem and Humana, and applied that valuation/member to Priority Health membership, Priority Health appears to be worth @ \$4.5 billion, still over \$3 billion greater than its book value.

Let's say the new merged entity decides to sell Priority Health. The resulting gain in investments (say, \$3 billion per my estimate above), will be placed at "Corporate" as I mentioned earlier and can be invested anywhere, for any purpose the Board approves. What about West Michigan? Did you give consideration to the people, employers and providers who, as a community, created that \$3 billion of wealth? Perhaps you're thinking it will be a key asset going forward, but I beg to differ. No one in West Michigan, over my 20+ years of service, tried harder than me to make Priority Health integral to reinventing Spectrum Health into a population health company that provided both affordable access to insurance and care, when it was needed. In retrospect, we never graduated from being a hospital. Period. Why would anyone assume that adding Beaumont Health, an organization that sold off its interests in health plans decades ago, would be interested in Priority Health and investing in population health

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initiatives? They wouldn't be...but they'd certainly have interest in the money and they could use Priority Health to dividend themselves whenever the Board saw fit to do so. If access to affordable health insurance is no longer a priority, why would you wait to spin off Priority Health until AFTER the merger, thereby depriving West Michigan of monies well-earned by everyone who took a chance to help this company or, worse yet, keep it but allow it to deteriorate inside this hospital-dominated new entity? In your marketing of the new brand, you trademarked the expression, "For Michigan, By Michigan", but that was not your responsibility, under the Consent Decree, to our region and to the trustees and citizens who came before you. Your responsibility was, and still is, "For West Michigan, By West Michigan". Can you honestly look the citizens of West Michigan in the eye, knowing these facts above, and tell them you're doing everything possible to maintain and enhance the value that they created?

### Commitments

Did you forget, in the Margin Commitment of the Consent Decree, that "the merged entity will target a five year rolling average total margin for the merged system that does not exceed the average of Moody's and Standard & Poor's upper quartile total margins for other health systems nationally"? Did you forget that this margin commitment continues in perpetuity? What happens, then, if Priority Health is sold at a \$3 billion gain...or a \$17 billion gain? What if the gain hits the books (via total margin) right after the merger? Will the \$3 billion be reflected in price decreases to the business community of West Michigan, as required under the Consent Decree, in subsequent years? We all took these commitments seriously and the fact that the announcement of the Spectrum Health - Beaumont Health merger addresses none of these points and, instead, points to consummating this merger in the fall, leads me to believe that you have not considered your existing commitments to your existing community.

### Conclusion and Next Steps

I have no standing in any healthcare system, anywhere. I'm a retiree now in West Michigan who wants to see his grandchildren yield the fruits of the labor of the people who came before them. I'll admit, I don't see any value in this merger. I only see the potential for massive financial loss, both historically and an undetermined amount going forward, to the region that produced all of Spectrum Health. If I could do things over, I'd have created a dividending process to the community through the area community foundations. But that's water over the dam and each generation has to have its opportunity to lead. So be it. I will wish you the best of luck if you go forward; however, I will only wish you the best of luck after the following steps are taken first:

1. *Reduce the RBC of PH* from 642% to @ 400% by dividending @ **\$495 million** to a "Futures Fund" for West Michigan, prior to the new merger, at either the Grand Rapids Community Foundation or a combination of all the community foundations (proportionately) in the market served by Spectrum Health West Michigan, to be used for healthcare, education, community development, business development, the arts and other nonprofit initiatives that invest in this region.
2. *Reduce the excess equity in Spectrum Health's delivery system through a community dividend.* Looking at just the Spectrum Health delivery system (excluding Priority Health), raise the debt/capitalization ratio from 15.6% to 21.9%, a level slightly better

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than the Moody's Aa median of 24.9% while lowering days cash on hand to 250 days on hand, slightly worse than the Moody's Aa median of 264 days cash on hand (we had much poorer ratios for these two 10+ years ago and we were still Aa rated by Moody's). This would result in an additional transfer of **\$690 million** to the "Futures Fund".

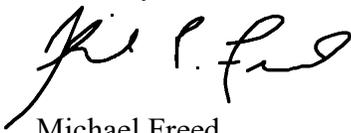
3. *Prepare a plan of divestiture of Priority Health*, whereby its Board can decide to either (a.) continue to function as a stand alone health plan or (b.) sell, or go public, where any future gain on sale (after paying the new merged entity the book value) will be deposited in the "Futures Fund". Assuming a valuation of \$4.5 billion, this would result in a gain of **\$3.2 billion** being deposited in the Futures Fund

Paying this combined **\$4.4 billion** dividend to the West Michigan community, assuming Priority Health was divested, would still leave a Spectrum Health delivery system (with ratios very close to Moody's Aa medians) prepared to merge with Beaumont Health while providing the West Michigan "shareholders" (the community) with the compensation they earned for giving up control of the wealth created here. That wealth would provide West Michigan with a return of the capital it earned so that it may be used for many other regional initiatives, healthcare and non-healthcare alike. What such a dividend will never accomplish, however, is to compensate West Michigan for the loss of control of all future margins, earned in West Michigan, which may be spent elsewhere.

In closing, way back in 2000, Fifth Third Bancorp announced its intent to acquire Old Kent Financial Corp, a bank headquartered in Grand Rapids. Many people were disappointed at the proposed acquisition but, in the end, Fifth Third's offer was a 42% premium over the closing price of the Old Kent shares on the previous day. The shareholders accepted the deal. On behalf of the West Michigan community that has built the Spectrum Health system, where is their compensation for giving up all control of how and where their healthcare dollars will be spent going forward in THIS merger?

I love Spectrum Health. I consider the people who work there as family. I readily admit I don't see a compelling reason for Spectrum Health to merge with anyone. If, as a Board, you insist on pursuing this path, then first execute your fiduciary responsibility to the region that depends on you and provide appropriate compensation to that region before embarking on a new path. When you sign the documents that will permanently change this region, your signature will forever hold you accountable for the repercussions. Please sign carefully.

Sincerely,



Michael Freed