



DIXON HUGHES GOODMAN LLP

DHG Healthcare

**WHAT HOSPITAL EXECUTIVES SHOULD BE  
CONSIDERING IN**

*Hospital Mergers and Acquisitions*

**WINTER 2013**



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# Executive Summary

Organizations that provide healthcare in the United States – both hospitals and physicians – have experienced seismic shifts in the last 20 years from the advent of managed care to the Patient Protection and Affordable Care Act. One of the more significant industry trends today involves hospital consolidation to create larger hospital systems with broader service reach and economies of scale to combat growing strategic, economic and regulatory pressures.

This research white paper, *What Hospital Executives Should be Considering in Hospital M&A*, seeks to address the increased prevalence of mergers, acquisitions and other types of consolidation by exploring several burning questions:

- How prevalent are hospital consolidation transactions today?
- How have transactions been regulated to maintain appropriate market competition and avoid for antitrust violations?
- What is different about transactions today compared to those of prior healthcare reform eras?
- What are the five questions hospital executives should be asking, relative to consolidation?
- If alignment with another hospital/system is on the horizon, what process can organizations use to navigate the transaction successfully?

Many hospitals and health systems are pursuing alignment with other hospitals, and this movement to consolidation is likely to continue in the near term. In fact, only 13% of hospitals surveyed in 2012 intend to maintain independence from alignment with other hospitals or systems.<sup>1</sup> For the other 87%, alignment is at least a consideration in their strategic plans.

<sup>1</sup>Strafford presentation that contains data from: Media Intelligence, M&A: Hospitals Take Hold, January 2012

## Introduction

Acute care hospital consolidation is among the most significant healthcare trends today. Increasing margin pressure from government and commercial payors and escalating intensity of competition for healthcare dollars indicate that acute care mergers and acquisitions will happen with greater frequency and complexity in the near future.

How did hospital consolidation become such a burning issue in healthcare? And how will healthcare executives successfully maneuver industry consolidation as a buyer, seller or target? What process should hospitals follow when considering and executing transactions? To be successful in the healthcare industry today, executives should know the answers and ramifications to these questions to determine an appropriate proactive strategy to maximize success (whether independent or aligned) in an era of consolidation.

## Background

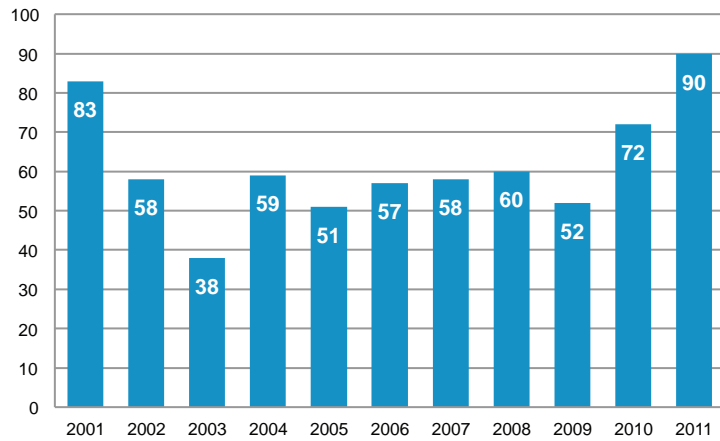
Acute care hospital mergers and acquisitions take many different forms; the scope of models which hospitals are using to align is broad and growing. Organizations are using both traditional methods to consolidate (mergers, joint ventures, etc.) as well as more creative structures (joint operating agreements, clinical affiliations, etc.) Throughout this research, all partnership methods will be referenced collectively as “transactions.”

Many hospitals cite their reason for entering a transaction as 1) seeking economies of scale, 2) drawing on a partner’s unique clinical or managerial strengths or 3) gaining geographic strength to better serve patient and community need.

The following visual provides an overview of the types of transactions occurring in the market today.

AFFILIATIONS	JOINT VENTURE	JOINT OPERATING AGREEMENT	MERGER	ACQUISITION
<ul style="list-style-type: none"> <li>• Most flexible form of consolidation, though option of a weak vs. strong affiliation exists</li> <li>• Utilized to increase footprint, gain economy of scale, create referrals, supplement an already successful set of services, exchange best practices</li> <li>• Do not necessarily change management or governance</li> </ul>	<ul style="list-style-type: none"> <li>• A mildly flexible arrangement</li> <li>• Used to create something new (limited inpatient or outpatient activity, service, purpose) that may be overwhelming to do solo</li> <li>• Shared governance between two hospitals</li> <li>• Contains some form of profit/risk sharing.</li> </ul>	<ul style="list-style-type: none"> <li>• Virtual Mergers, where assets may separate but services are coordinated</li> <li>• New overarching governing board is created but hospitals maintain independent boards as well</li> <li>• May borrow for capital investments as one organization</li> <li>• Similar to a joint venture, but larger. Extends past just a specific service or activity</li> </ul>	<ul style="list-style-type: none"> <li>• Mutual decision of two companies to combine</li> <li>• Leadership may be a combination of the two hospitals or from an outside source</li> <li>• Hospital’s absorb each other’s assets and debts</li> <li>• Goal is to increase economy of scale, improve quality, increase market share</li> </ul>	<ul style="list-style-type: none"> <li>• Purchase of one hospital by another</li> <li>• Usually smaller acquired by larger, but not always</li> <li>• Goals: increase market share, footprint, acquire additional services, financial stability</li> <li>• Hospitals may continue to function semi-independently or make transformational changes to match buying hospital</li> </ul>

**Fig1 NUMBER OF ANNOUNCED HOSPITAL CONSOLIDATIONS BY YEAR: 2001-2011**



Source: Irving Levin Associates, Inc. (2012). *The Health Care Acquisition Report: Eighteenth Edition.*

### Example of FTC Wins

- OSF & Rockford
- ProMedica & St. Luke's

## How Prevalent Are Transactions Today?

The pace of hospital consolidation has been relatively inconsistent in the last decade. **(See Fig. 1)** Many observers believe that the increased prevalence of consolidations experienced in 2010 and 2011 (72 and 90 respectively) represent a material increase in overall transaction activity, correlated in part to hospital preparation for reform provisions of the Patient Protection and Affordable Care Act (PPACA.)<sup>2</sup>

Billions of dollars are spent annually on transactional costs and capital expenses related to hospital consolidations. Annual hospital transaction costs peaked in 2010 at \$10.3 billion, excluding 2006 in which the HCA/Columbia transaction accounted for \$31.6 billion of the year's total \$34.7 billion.<sup>3</sup> Given the increased pace of hospital transactions and their significant economic impact, healthcare leaders should be prepared for the strategic opportunities created by possible transactions in their surrounding markets.

## How Are Transactions Regulated?

Government agencies (principally the Federal Trade Commission) provide guidance to consolidation transactions. The Federal Trade Commission (FTC) and financial lenders oversee significant hospital transactions to ensure competition and compliance with bond covenants, respectively. While the FTC's regulatory oversight of hospital consolidation activity decreased for about a decade, in 2008 it began to use retroactive data to demonstrate that a hospital affiliation could

### Example of Potential FTC Loss

- Palmyra & Phoebe

<sup>2</sup> Source: Irving Levin Associates, Inc. (2012). *The Health Care Acquisition Report: Eighteenth Edition.*

<sup>3</sup> Source: Irving Levin Associates, Inc. (2012). *The Health Care Acquisition Report: Eighteenth Edition.*

be considered anticompetitive. Using this approach, the FTC has increased its scrutiny with relative success at preventing or unwinding what it considers anticompetitive healthcare practices.

Recent examples of FTC success in blocking or unwinding hospital mergers include OSF Healthcare and Rockford Health System in Illinois, ProMedica Health System and St. Luke's Hospital in Ohio and potentially Palmyra Park Hospital and Phoebe Putney Health System in Georgia. Hospitals and their advisors should understand regulations and case history as they consider transactions, avoiding the pitfalls that have befallen other hospitals.

OSF and Rockford spent two years challenging the FTC's claim that the transaction was anticompetitive. In April 2012, OSF announced it would abandon its attempt to acquire Rockford.<sup>4</sup>

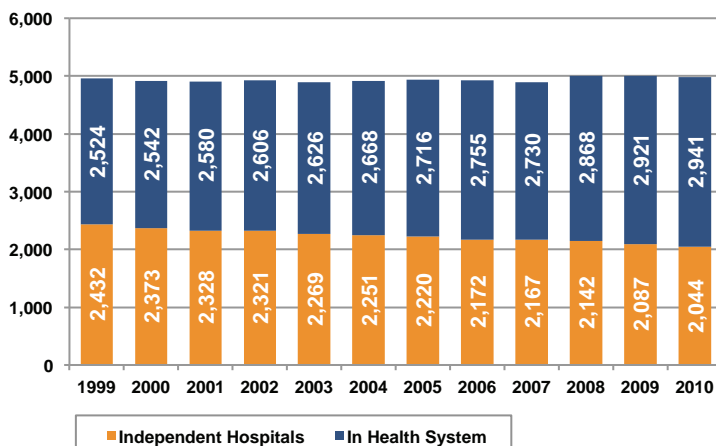
ProMedica and St. Luke's consolidated in 2010, but the FTC successfully claimed that the partnership would require insurance companies to pay more and increase patient premiums; in December 2011 an administrative judge upheld the FTC's decision that the hospitals' behavior was anticompetitive. In March 2012 the hospitals appealed to the FTC unsuccessfully and the FTC's order to unwind the transaction was sustained. The hospitals are still appealing the decision to the Federal Circuit Court of Appeals.<sup>5</sup>

On February 19, 2013, the Supreme Court ruled unanimously to overturn the lower courts' decision to allow the acquisition of Palmyra Medical Center by Phoebe Putney Memorial Hospital for \$195 million. The FTC had challenged the transaction citing that the hospital combination would have created a local monopoly, leading to higher healthcare costs for insurers and patients. The court challenge focused on whether or not federal antitrust laws applied when the acquiring party was a local government entity; the court ruled that yes, the laws do apply because the State of Georgia had not clearly authorized the hospital board to engage in anticompetitive conduct. Phoebe Putney Memorial Hospital has stated that it is going to review the decision closely.<sup>6</sup>

## What is Different About Transactions Today?

Research indicates that many hospital leaders believe hospital consolidation is necessary in order to do more with less.<sup>7</sup> In addition to the increase in hospital mergers, other forms of hospital transactions are also increasing. According to American Hospital Association data, while the number of hospitals has only marginally increased since 1999 (up less than 1%), the number of hospitals affiliated with a system has increased 16% (2,524 to 2,941). **(See Fig. 2)** This means that while the number of hospitals is not growing, the number of health system affiliations is rising, highlighting the trend of existing hospitals to consolidate in some way within the healthcare system.

**Fig. 2 NUMBER OF US INDEPENDENT HOSPITALS AND HOSPITALS IN HEALTH SYSTEMS: 1999-2010**



Source: Avalere Health. (2010). Analysis of American Hospital Association Annual Survey Data for Community Hospitals.

<sup>4</sup>Source: FTC. (April 2012). *OSF Healthcare System Abandons Plan to Purchase Rockford in Light of FTC Lawsuit; FTC Dismisses its Complaint Seeking to Block the Transaction.*

<sup>5</sup>Source: Turner, K. (2012). ProMedica, FTC gear up for next legal battle. *ToledoBlade.com.*

<sup>6</sup>Source: Kendall, B. (February 19, 2013). *FTC Gets More Muscle in Policing Hospital Mergers.*

<sup>7</sup>Source: The New York Times. (April 2012). *Regulator Orders Hospitals to Undo a Merger in Ohio.* *The New York Times.*

<sup>8</sup>Source: Strafford presentation. (2012). In M. Intelligence, *M&A: Hospitals Take Hold.*

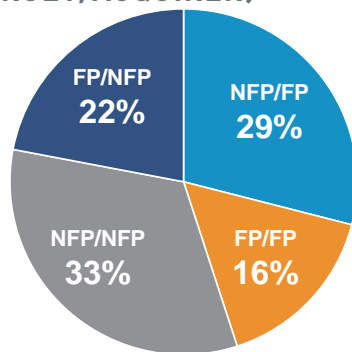
Moreover, research shows that 78% of hospitals are either exploring possible hospital consolidation transactions or are in the midst of a transaction with another organization already; only 13% have a strategy to maintain complete independence.<sup>8</sup>

**High Failure Rate.** In 2011 alone, 25% of potential hospital mergers did not materialize in a transaction (when the potential merger is signified by signed letters of intent to align.) Previously that rate was close to 5%.

There are two reasons for this increase in potential mergers. First, there are significantly more inexperienced buyers and sellers attempting to consolidate. Second, many hospitals are not doing the appropriate financial, cultural and operational due diligence before signing a Letter of Intent (LOI).<sup>9</sup> Rather than postponing due diligence, hospitals should be engaging in more detailed research earlier, confirming their compatibility (or lack thereof) with a potential partner. Experienced hospitals and their advisors engage in more thorough and diligent processes from beginning to end.<sup>10</sup>

A signed LOI that does not conclude in a hospital transaction is not necessarily a negative outcome. Determining that hospitals are not suitable matches for one another before consolidation is an appropriate end; far better than entering an ill-fitted transaction. Common understanding for the transaction rationale can mitigate the negative outcomes of a failed LOI.

**Fig. 3 NOT-FOR-PROFIT & FOR-PROFIT TRANSACTIONS 2001-2011 (TARGET/ACQUIRER)**



Source: Irving Levin Associates, Inc. (2012). *The Health Care Acquisition Report: Eighteenth Edition.*

## What Five Questions Hospital Executives Should Be Asking?

To best understand what is happening with hospital transactions currently, there are five questions that hospital executives should be asking.

- 1. What is the pace of M&A activity in my market?** Healthcare is a local enterprise and the dynamics of any market's hospital transactions will affect the entirety of that market. The size of the market players, the prevalence of for-profit (FP) hospitals and the type or scope of previous market transactions lends important perspective to healthcare executives. As previously stated, the FTC is increasing its focus on identifying hospital mergers that foster anticompetitive practices regionally. It is important to understand how a potential transaction may affect market competition. Nationally, not-for-profit (NFP) hospitals represent 78% of the hospital market since 2001. During that time frame, for-profit hospitals (or systems) have been involved in 67% of all transactions. **(See Fig. 3)** Understanding how the increase in for-profit activity may affect a hospital service area allows executives to more adequately forecast possible transaction scenarios for the local market.

<sup>9</sup> Source: Thomas Brown, K. W. Current Trends in Hospital Mergers and Acquisitions. HFMA.

<sup>10</sup> Source: Burgdorfer, James. (January 2011). Why Are So Many Merger Transactions Failing to Close. *The Governance Institute.*

“This economy is making higher quality hospitals... more willing to partner or merge.”

## 2. Why are not-for-profit hospitals considering for-profit partners?

For-profit hospitals offer the financial expertise and access to capital that many not-for-profit hospitals need in today's economy. Research has shown that larger healthcare organizations benefit from more favorable bond ratings and lower borrowing costs.<sup>11</sup> With decreased revenue, increased quality expectations and increased costs for maintaining technological advances, not-for-profit hospitals are not just open to consolidation, many are seeking consolidation. As one leader in a for-profit hospital's M&A office said, “this economy is making higher quality hospitals, [hospitals and health systems] that are run well but in need of financial help, more willing to partner or merge. This is a new trend; previously those seeking to be acquired had lower quality measures and represented greater financial risk. That is not the case right now.”<sup>12</sup> This is also demonstrated by the increased occurrence of small and mid-sized hospitals issuing Requests For Proposal (RFPs) to potential hospital partners. These hospitals are attempting to position themselves to attract more advantageous suitors. This trend is expected to continue at least through 2013.<sup>13</sup>

- ## 3. If my organization is an acquisition target, how can leadership improve the hospital's negotiating position?
- Too often, organizations begin considering a transaction when urgency peaks. A “burning platform” creates a strong need for change and also creates a poor negotiating position for a hospital seeking consolidation.<sup>14</sup> Organizations that begin considering their options before they experience a burning platform will have better options and a greater likelihood of success.

As stated previously, many hospitals are actually beginning to seek partners themselves by soliciting RFPs. If an organization has firmly decided to seek a partner, there are three action steps to improve the organization's value:

- **Solidify relationships with physicians through formal alignment initiatives.** Whether through management agreements (i.e. co-management, medical directorships) or clinical initiatives (i.e. bundled payments, clinical integration) hospitals with strong, legally appropriate ties to their medical staffs offer more predictable future cash flow and are thereby more attractive to potential buyers.
- **Reduce Accounts Receivable (A/R) balance.** This financial measure is an oft cited proxy of a hospital's credibility with payors, its prevalence of bad debt and the organization's overall financial position. Carrying a small A/R balance suggests that a hospital can convert work into cash quickly, thereby mitigating reliance on short-term debt.
- **Demonstrate the hospital's quality and efficiency.** One of Michael Porter's Five Forces<sup>15</sup> is “payor power to influence the market.” In healthcare, commercial and government payors have tremendous power, and the way they are exerting that power is by financially rewarding those with good quality and efficiency (measured by CMS Core Measures, HCAHPS and Value-Based Purchasing requirements.) The winning organizations have stronger top-line net revenue and better margins, thereby increasing their negotiating position with potential partners.

<sup>11</sup> Source: Cynthia Keller, J. S. (2012). U.S. Not-For-Profit Health Care System Ratios: Stability in 2011 Gives Providers A Firm Foundation to Face Industry Changes. *S&P*.

<sup>12</sup> Source: Interview (2012, September 7).

<sup>13</sup> Source: Hospital M&A; An Outlook 2012: 5 Key Trends. (December 2012). Health Strategies & Solutions.

<sup>14</sup> Source: Kotter, J. (1996). *Leading Change*. Harvard Business Review Press.

<sup>15</sup> Source: Porter, M. (2008). The Five Competitive Forces That Shape Strategy. *Harvard Business Review*.



**4. How can I put together the correct “A-Team” for any transaction?** Transactions of any kind require specific skills to ensure a successful outcome. Therefore identifying the correct action team is an important step. Members should include, but are not limited to: a consultant to act as project manager, a strong legal presence and a capable banking or financial expert.. This team can work together as a strong driving force within the transaction, serving as the “A-team” that helps the process along without being burdened with creating the change.

- **Utilize a strong consultant as a project manager.** The project management component provides an objective task manager to complete the necessary steps in a timely manner. As the changes begin to occur, often times it appears overwhelming to those within the change. Identifying a project manager that is separate from the transformations allows the process to continue to happen as planned.
- **Understand the complicated legal challenges.** Understanding the complicated legal adjustments that a transaction creates is imperative and must be addressed by a trusted and knowledgeable attorney. Entering into transaction conversations without identifying and confronting these challenges is both dangerous and short-sighted.
- **Maintain a strong financial presence.** With bond ratings, possible funding source changes (NFP vs. FP) and revenue cycle shifts, identifying a financial expert could mitigate financial mistakes and set the organization up for future success.

**5. What are the key characteristics of successful M&A transactions?**

Motivations for partnership can vary widely from purely financial to exclusively strategic, with an infinite number of possibilities between the two extremes. Nevertheless, successful transactions maintain some similar characteristics:

- **Facilitate mutual understanding of a transaction’s value.** Without proper leadership support, the partnership may struggle to achieve its operational and financial objectives. Timing can be everything: one executive described a 10-year courtship between two hospitals considering a transaction. The consolidation could not occur until both hospitals’ leadership teams and boards of directors were ready. According to this executive, this transaction has been successful due mostly to the combined leadership efforts.
- **Research your own organization.** Significant time should be spent truly understanding your organization’s position in the market and what that organization could gain from a partner. In his book *Good to Great*, Jim Collins calls this “Confronting the Brutal Facts.” Successful organizations fully understand the strengths and liabilities they would bring to a partnership.

- **Conduct due diligence on potential partners.** Presumably, one of the reasons for the high LOI failure rate is that organizations have rushed into signing the LOI before conducting all appropriate research. Even though some hospitals feel pressure to consolidate quickly, taking the time to ensure that your potential partner is compatible will save time and considerable cost in the future.
- **Act rationally, not desperately.** Instead of waiting until your organization is engulfed in a burning platform, make a decision to look for partners while you have a strong market position. This will allow the decision to be made based on a rational plan and objectives. A CEO told his business strategy executive, “I pay your salary to keep me out of the bad deals, and your bonus to get me good deals.” Staying out of a bad deal is just as important – if not more so – than entering a good deal.
- **Acknowledge culture.** According to recent survey respondents, just under half of all terminated transactions cited culture as the primary reason. This can be especially true if the transaction combines traditionally culturally different organizations (i.e. for-profit and not-for-profit, faith-based and non-faith-based). Understand how the cultures of the two organizations will interact, both positively and negatively. Even if the cultures are dissimilar, being prepared for the challenges to come will increase the likelihood of success.

## What Process Can Organizations Follow to Navigate the Transaction?

The healthcare industry is volatile, demanding change without a clear future. Organizations who consolidate successfully follow proven, detailed methodologies. Success is largely a derivative of disciplined planning and disciplined action.

One example of a disciplined process is outlined below. The method follows a three-phased approach of **Discover, Design, Deploy**.

### Discover

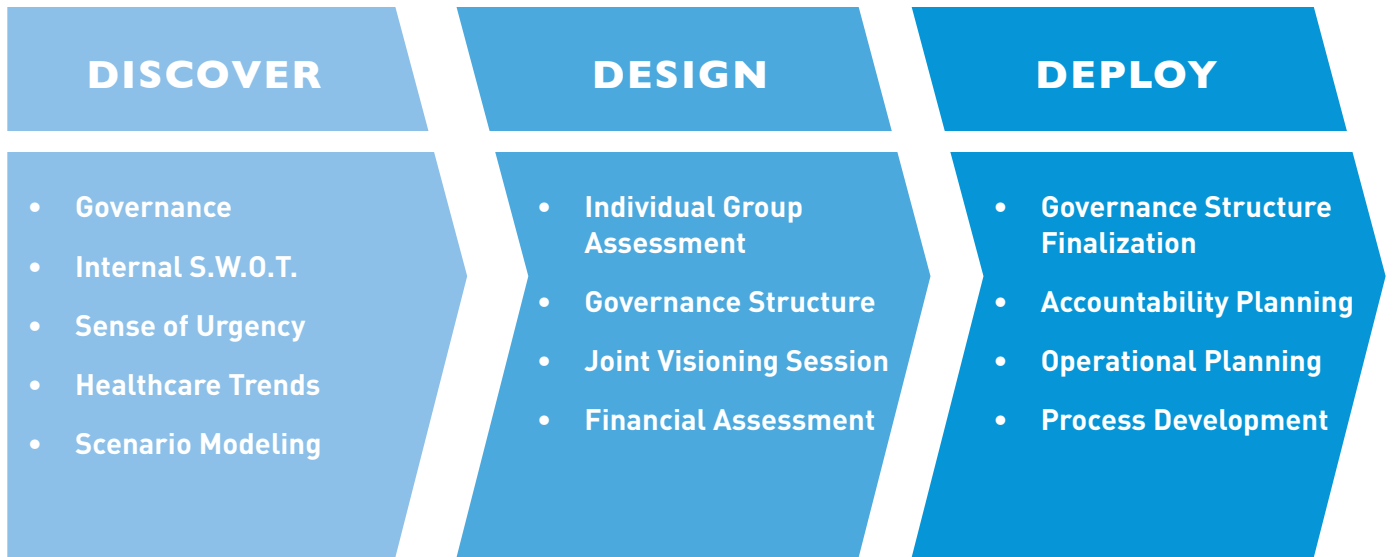
As a transaction becomes more likely (signified by greater urgency and/or a signed Letter of Intent), organizations should begin the Discover phase. This involves self-reflection, preliminary due diligence, identification of financial and cultural barriers and scenario modeling to pinpoint the organization’s options. As the tasks associated with the Discover phase are completed, administrators and board members will determine whether or not to proceed with the transaction. If the answer is yes, the process continues to the Design phase.

### Design

This second phase is focused on assessing how an identified partner(s) fits with another organization. Efforts should be directed toward identifying potential governance structures of the new entity, preparing financial projections and understanding the organizations’ shared vision for the future. If the new governance structure and financial opportunity are sufficient for all parties and the joint vision meets all parties’ expectations, the process continues to the Deploy phase.

### Deploy

Having understood the current and future states of the proposed transaction, the Deploy phase tangibly sets the agreement in motion. Establishing the new entity and its governance structure, accountability planning, operational planning and process development are the centerpieces of the Deploy phase. As these tasks are completed, the transaction commences.



## Conclusion

The healthcare market is experiencing unprecedented change. Strategic, economic and regulatory pressures are causing hospitals and health systems to consider their options related to integration and consolidation. The pace of transactions is accelerating and is expected to remain strong. Regulatory scrutiny is tightening and the number of blocked transactions is unusually high. More potential consolidations are reaching the LOI stage but do not result in a final transaction. Consolidation is a viable alternative for many providers. Hospital executives should follow a disciplined process to **Discover** the value of consolidation, **Design** the parameters of a potential transaction and, if appropriate, **Deploy** resources to consummate a mutually beneficial transaction.



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