HEALTHCARE

Interested in Acquiring a Hospital?
8 Best Practices to Know About

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Introduction

Hospital and health system acquisitions and mergers have been occurring at an historic pace during the past decade. The number of transactions increased nearly 76 percent since 2007, with growth expected to continue for the next several years.[1] Partnership benefits will depend, in great part, on how thoughtfully and strategically leaders pursue these arrangements.

The axiom "size and scale matter" has become a business truism for good reason. Greater size is equated with economies of scale that generate larger cash flows and easier access to lower-cost capital. Capital access offers health systems protection against current volume shifts, and the ability to invest in needed capabilities and innovations to meet market demands and spur additional growth.

Relevance is just as important as size and scale. As value-driven population healthcare takes hold, the most sought-after health systems will be those that can offer superior quality, access, and patient experience/loyalty at an efficient cost for a continuum of services within a region. The continuum extends from ambulatory and telehealth care to acute and post-acute care.

If health systems are looking to add services or capabilities to become high-performing regional networks (e.g., filling/extending the care continuum, case management, IT infrastructure), it typically is faster to buy than build. An acquisition often can be completed within a year. By comparison, building certain facilities may be a three- to five-year proposition. Certificate-of-need regulations in some states also may limit a health system's ability to build.

While the acquisition process can be relatively swift, it should not be hastened unnecessarily. Health system leaders need to be particularly vigilant about the following eight steps, which are key to finding a partner that is a good strategic match, and ensuring that the two organizations achieve the benefits of integration.

1. Set Goals and Objectives

Setting realistic goals and objectives for an acquisition increases the likelihood that the transaction will progress smoothly and result in a successful partnership.

Health system leaders should be as transparent, clear, and specific as possible about their objectives, and actively manage expectations throughout the partnering process. The goals and objectives likely will start out as broad statements and become more defined and detailed as the acquisition progresses. For example, leaders might begin with a 10,000-foot strategic goal to guide initial discussions about potential partners, such as: "The acquisition will help position our health system to effectively manage population health in specified communities under a value-based care model."

Then at the 1,000-foot view, when health system leaders are drafting a letter of intent with an identified partner, they will need to develop specific objectives to guide the transition and integration, such as: "The combined entity will migrate to one vendor's IT platform within three years."

Finally, at the 100-foot view, they will need to define specific and enforceable legal terms when developing the definitive agreement to finalize the partnership. These will govern the partnership in a manner consistent with the overarching goals and objectives of both parties.

2. Proactively Pursue Partners

Taking time to set parameters for what the health system is looking for in an acquisition partner will help narrow the playing field to the likely best matches. Parameters should be based on the health system's goals and objectives and might include those described in the Sidebar.

Sidebar: Parameters for Identifying Potential Partners

Source: Kaufman, Hall & Associates, LLC

- **Mission and culture:** Leaders will want to ensure that any partner has complementary values
- **Strategic plans:** Leaders will want to consider the critical elements of their organization's strategic plans and how an acquisition would help achieve those goals
- **Location and service area:** A health system may be interested in increasing its regional footprint by acquiring a hospital that extends its traditional service area
- **Size and type of hospital:** System leaders might hope, for instance, to acquire small facilities that could be turned into micro-hospitals that offer emergency, urgent, and limited inpatient care in community settings
- **Services offered:** A health system that wants to grow its post-acute services may be interested in hospitals with long-term acute care or rehabilitation units and facilities
- **Financial position:** A health system with a strong balance sheet and credit rating may be in a position to turn around a hospital that is struggling financially
- **Physician and clinical integration:** Health systems looking to increase insurer network participation and value-based payment arrangements may put a priority on acquiring a hospital with an employed or strongly integrated physician network
- **Needed capabilities:** A health system may be looking to build population health capabilities through the acquisition, such as care management, IT, data analytics, or a health plan
- **History of partnering:** Leaders may want to prioritize any partners they have collaborated with successfully in the past

The number of independent hospitals or health systems that might be interested in partnership opportunities is declining. In recent years, many smaller hospitals merged with larger hospitals or systems. At the same time, however, some health systems and hospital operators have been divesting hospitals. For example, for-profit, Tennessee-based Community Health Systems is well on its way to meeting its goal of divesting 30 hospitals.[2]

Because acquisition opportunities are narrowing and competition for well-positioned hospitals is stiff, health system leaders need to be smart about how they approach and pursue potential partners. Having a skilled advisory team to handle the financial, technical, and legal aspects of the acquisition is critical. The sooner the team is put together, the smoother the process will go. For instance, an expert with significant national experience can identify a list of hospitals/systems that meet the acquisition parameters and priorities, help develop an appropriate acquisition value proposition, and provide access to top decision makers from prospective partners.

The nature of the initial discussions with potential partners will vary, depending on the previous relationship between the parties, the preferences of leaders, and other factors. For instance, the health system CEO might want to begin by directly contacting the hospital CEO. This conversation might be followed by a meeting with key members of the hospital's senior leadership team and external advisors. A brief presentation might provide an overview of the health system's core business attributes and why the organization is seeking a partnership. In other cases, the exploratory process may be more formal and start with the development of a detailed proposal.

A well-designed partnership-exploration process allows for appropriately timed and confidential interactions and meetings between key constituents, including boards, management, and physicians. Whether the approach is formal or informal, exchange of relevant information on both organizations will occur.

3. Evaluate the Strategic Fit

If a health system has had a successful clinical or operational partnership with a hospital in its region, it may make sense to pursue an exclusive negotiation with that single prospect. Otherwise, multiple potential partners should be identified, both obvious and outside-the-box candidates.

Consideration of multiple potential partners as a starting point allows health system leaders to think broadly. Each candidate should be assessed individually and comparatively, based on its potential to help the health system meet the prioritized goals and objectives.

The key elements for ensuring good-fit partnerships include:

- **Strategic position:** The acquisition must be able to improve the health system's ability to meet core goals, such as managing population health. The health system also should consider service line performance and utilization, quality statistics, payer mix, and historical credit analysis
- **Cultural compatibility:** The importance of culture cannot be overemphasized, given that the top reason cited for nearly half of partnership terminations is lack of cultural compatibility[3]
- **Financial considerations and projections:** Baseline financial projections will help the health system understand potential benefits and risks associated with the acquisition. Health system leaders will need details on the amount and timing of any of the potential partner's capital commitments, as well as any debt obligations the system would need to fulfill
- **Governance structure and control:** The two parties need an understanding of the level of control each organization and its physicians expect to have in strategic planning, budgeting, and other issues, as well as whether specific clinical services will be discontinued or enhanced
- **Execution/implementation of operational and strategic changes:** Health system leaders need to estimate the investment of time and money that will be required to integrate with the potential hospital and implement desired changes

While some of the potential strategic and financial synergies can be quantified (e.g., financial projections, service utilization), other factors, such as cultural compatibility, are qualitative in nature. Seeking input from all the members of the organization's leadership team—which should include clinical, financial, and operational leaders, as well as the board—is recommended.

4. Identify the Best Acquisition Structure

When the goal is full integration with an acquired hospital, health systems commonly structure the transaction as either an acquisition (also known as an asset acquisition or stock acquisition) or a merger/membership substitution (also known as a change of corporate membership). Which partnership structure is most appropriate depends in large part on whether the organizations are for-profit or not-for-profit.

Acquisition. Under an asset acquisition, the health system acquires the operational assets of the acquiree in exchange for cash and/or non-monetary commitments. Depending on how the arrangement is negotiated, the acquirer has some flexibility in selecting which of the hospital's debts and liabilities to assume. Typically, at least one entity in an asset acquisition is a for-profit organization. For instance, the recent acquisition of Pennsylvania-based

Crozer-Keystone Health System by for-profit Prospect Medical Holdings, Inc. was structured as an asset acquisition.

In an acquisition, the health system assumes control over the acquired hospital's governance and management. However, the acquired hospital may select an advisory board, which can advise health system leaders about community considerations and selected hospital matters. In addition, the hospital may use any excess proceeds from the sale to fund a not-for-profit foundation to continue the hospital's mission in the community. For instance, Crozer-Keystone became a for-profit health system after being acquired, but it formed a not-for-profit foundation dedicated to improving the health and quality of life of area residents.[4]

Membership substitution. Under these arrangements, the health system becomes the sole corporate parent of the acquired hospital. Instead of paying the hospital a purchase price, the health system makes various financial and nonfinancial commitments to the hospital (e.g., facility investments, assistance in developing an outpatient network). While the hospital cedes governance and management to the health system, the two parties typically negotiate some type of shared decision-making arrangement. The acquired hospital may seek to retain influence over certain types of governance and management decisions.

Membership substitutions are the most common structure used when two not-for-profit organizations want to fully integrate. For instance, four-hospital Susquehanna Health System in central Pennsylvania transferred its membership interest to the much larger UPMC last year. Both health systems are not-for-profit.

UPMC agreed to make an initial $500 million investment in the newly named UPMC Susquehanna, while committing to expand the smaller health system's emergency, cancer, and heart and vascular services; establish a neurosciences center of excellence; improve access to care with an urgent care network; and replace an aging inpatient rehabilitation facility. UPMC Susquehanna's local board of directors remained in place to oversee quality of care, the medical staff, and growth initiatives.[5]

5. Determine a Reasonable Price/Financial Terms Based on Comparative Data

A common mistake that acquiring health systems make is paying too much for a hospital. Understanding the difference between a hospital's value and price is key to avoiding this potentially costly error. Value is what a hospital is estimated to be worth to the buyer. Price is the amount the acquiring health system actually offers to purchase the hospital. Typically, the price is based on recent market prices for similar transactions and may be lower than the estimated value to the buyer, depending on various factors. While not-for-profit transactions often are structured with no actual purchase price, certain financial commitments as part of a transaction will become the implied price in such arrangements.

Extensive, up-to-date pricing from similar healthcare mergers and acquisitions is needed to determine a fair, market-based price or financial terms. Comparable transactions may have occurred in recent years, the same state, or between organizations with similar revenues, margins, and other factors. While information is readily available for transactions of publicly traded healthcare companies, public information is very limited on not-for-profit health system transactions. An acquiring health system should seek proprietary pricing data from an advisor that is active in hospital and health system mergers and acquisitions nationwide.

6. Ensure that Antitrust Regulations Are Not Impediments

The Federal Trade Commission (FTC) has challenged a number of major healthcare mergers in recent years due to concerns about increasingly non-competitive markets as health systems seek to expand across regions and nationally. For example, Advocate Health Care Network and NorthShore University Health System terminated their proposed affiliation agreement after the FTC intervened and won a long legal battle. Even acquisitions between rural hospitals are drawing the FTC's attention.

Given the antitrust environment, health system leaders should be informed early on regarding actionable alternatives for preserving competition post acquisition/merger, and understand the financial analyses regarding the proposed transaction.

Both the Department of Justice and the FTC focus on the Herfindahl-Hirschman Index, which is the measure of market concentration and competition among market participants. At the root of past antitrust interventions is a basic financial analysis that considers the competitive impact on local markets or regions. Health system leaders need transactional expertise—including strategic, financial, and legal input—early on to assess whether a potential transaction may cross an antitrust line, and how to avoid or address any antitrust issues.

Detailed FTC-related work products or analyses sometimes are prepared too late in the process, such as after the strategic and financial go/no-go decisions are made. This may result in suboptimal outcomes.

7. Conduct Early and Thorough Integration Planning

Transaction planning and execution should occur in an overlapping rather than sequential manner. To ensure the effective integration of the hospital and health system, leaders should begin planning for how the organizations will be integrated soon after a letter of intent is signed *(Figure 1).* Transition planning involves many people collaborating across both organizations, and is best started immediately after the parties are allowed to collaborate from a regulatory perspective.

Integration and transition planning should be driven by leadership and based on the financial, operational, strategic, and capital rationales for the acquisition. Laws and regulations regarding what activities can and cannot occur prior to transaction approvals must be followed. Various teams comprised of representatives from both organizations should develop plans for how to achieve specific goals, from combining departments to integrating IT systems. Then, following the issuance of a definitive agreement that finalizes the acquisition, the two partners will be prepared to progress into full implementation mode using the already-developed plans as a roadmap.

8. Be Flexible to Other Partnership Approaches

One final recommendation is to keep an open mind to other partnership approaches. While an acquisition is a common strategy for growth, particularly when full integration is the goal, many other partnership structures are being used successfully in healthcare today, from collaborative network arrangements and management service agreements, to joint ventures and leases *(Figure 2).* By staying flexible about how their organizations achieve partnership goals, health system leaders will be more likely to achieve desired ends.

Figure 1. *Transaction/Transition Planning and Execution*

Source: Kaufman, Hall & Associates, LLC

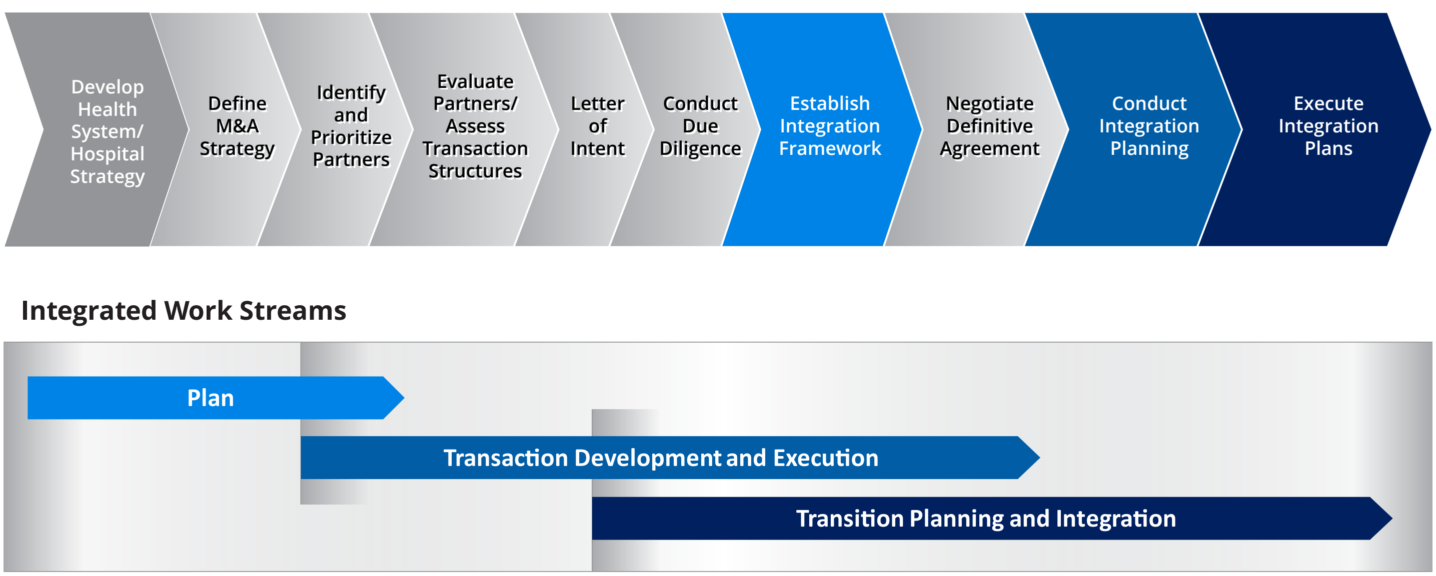

Figure 2. Structures for Cutting-Edge Transactions

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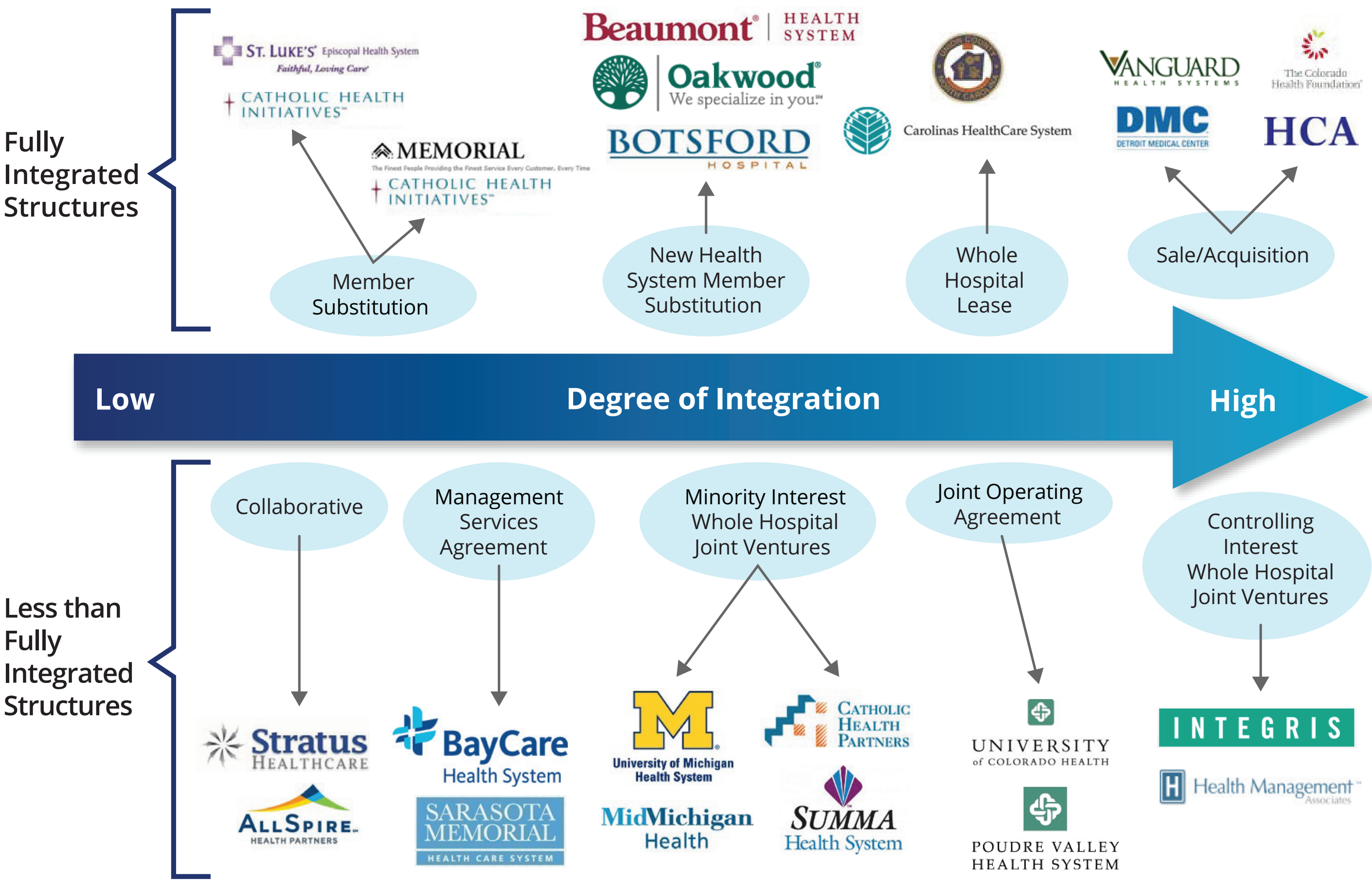
Source: Kaufman, Hall & Associates, LLC



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Mr. Kamholz has been involved in hundreds of healthcare-related M&A transactions and has extensive sell-side and buy-side financial advisory services experience in the following sectors:

- Hospitals and health systems
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Mr. Kamholz has spoken on M&A-related topics at industry forums, including the American College of Healthcare Executives, the American Hospital Association (AHA), the Health Forum/AHA Leadership Summit, and Investment in Merger and Acquisition Opportunities in Healthcare. He has authored white papers and numerous articles published in professional journals, including *Trustee* magazine.

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