Developing a Hospital Transaction Strategy and Process

by **Rex Burgdorfer and Jordan Shields, Juniper Advisory**
and **John Callahan, Megan Rooney, and Kristian Werling, McDermott Will & Emery**

Pursuing a transaction is among the most significant actions that a hospital board and management team can undertake in the life of an institution. It also is the riskiest. Economic and non-economic stakes are high, including preserving the hospital's mission and charitable objectives, safeguarding access to care, ensuring quality and protecting employees. A well-run merger process maximizes board objectives and avoids critical missteps.

This article identifies key components of an effective transaction process. Successful organizations start with their mission and clearly articulated medium and long-term objectives. They then complete a comprehensive options assessment, identifying the full range of strategic financial alternatives. By pursuing an organized transaction process, organizations can devote attention to pursuing alternatives best suited to fulfill their mission and meet their objectives.

Developing Objectives

The first step for a non-profit hospital board considering any hospital transaction is to clearly articulate its charitable objectives and goals for a potential transaction. Not only does this process help focus the board, it can be critical for approval of the transaction. In many states, hospital transactions are subject to state attorney general or other regulatory approval, and the hospital will be required to demonstrate that at every step of the process the organization's charitable objectives and goals guided decision-making.

To help articulate specific charitable objectives, management, often with the help of an outside advisor, can assess the needs of the market. This typically entails a review of market demographics, growth trends, referral patterns, and other market characteristics. Second, organizational offerings are matched against the needs of the market. If there is a gap between market demand and organizational offerings, filling that gap often rises to an organizational objective. These gaps can be both qualitative and quantitative. For example, improving poor population health outcomes could be a qualitative objective, while improving quality metrics or adding a service could be quantitative objectives.

When boards fail to clearly articulate objectives and hold themselves to the pursuit of those objectives, organizations find themselves chasing short-term solutions to systemic problems. This manifests itself with hospitals that define "independence" as an organizational goal without tying it to any of their articulated objectives. The result is hospitals that accept poor quality or deteriorating financial positions as a condition of a changing healthcare environment instead of dispassionately assessing how to ensure access to efficiently-delivered, high-quality services for the community.

It is rare for an objective to have a predetermined solution. Instead, an organization's objectives typically allow for a range of strategies and tactics. It is a mistake to jump to a given partner or structure at this stage, and the organization should undertake a thoughtful assessment of its full range of strategic financial alternatives through a carefully structured options assessment.

Options Assessment

Boards are best able to assess their situations and choose the optimal path for their organizations when they simultaneously consider the full range of strategic alternatives available. To do this, Boards should complete a situation review considering the internal factors that will impact future success, as well as the external choices available to them. Internal factors include strategic position within primary and secondary service areas, forecasted operating and financial performance, solvency analyses, access to capital and an assessment of business value. This exercise reviews the organization's qualitative and quantitative gaps and identifies structures to meet those gaps.

The situation review should consider non-recurring market-centric issues as well as recurring hospital-centric issues. Market-centric issues include the structure of the healthcare industry and how that structure is changing. These market forces are then considered within the context of the hospital to assess business value, debt capacity, expected changes to reimbursement and other financial and operational shifts to which the hospital will need to respond. Hospital-centric items include the organization's financial condition, physical plant condition, competitor activity, physician relations and strategic position. The situation review should also consider activity within the regional market and assess how that activity will impact the hospital's ability to meet its objectives.

At this point in the process, it is important for boards to begin consulting with experienced antitrust counsel. Antitrust counsel is important for two key reasons. First, the board should be educated about the "do's and don'ts" of antitrust laws prior to beginning to discuss and document consolidation options. Even in early-stage strategic discussions, board, management and their advisors should avoid definitive statements about the ability to assert pricing power or market domination of certain types of procedures or patients. Second, boards and management should consider how the Federal Trade Commission and state antitrust regulators will view a potential combination. Boards should consider how managed care organizations might react and what efficiencies should be obtained from a potential combination. Furthermore, if a hospital is experiencing severe financial difficulties, antitrust counsel should be consulted to determine how financial data would be presented to the FTC to justify certain transactions. In some cases, informed antitrust advice also will allow a board to consider whether transactions with certain partners will be more difficult to execute from an antitrust perspective than others.

This situation review feeds into a formal options assessment. Within the context of the hospital's situation and objectives, the board should review the full range of alternatives available. This includes all of the alternatives available that do not include a transaction, like a contractual or branding

affiliation with a larger system, divesting non-core assets, entering into a joint operating agreement or participating in an accountable care organization. The range also includes alternatives like a seller-joint venture or a long-term lease. A seller joint venture allows the hospital to sell a portion of the business, but maintain some governance input. A long-term lease maintains ownership, but transfers operational control for an upfront payment. Alternatives like a consolidation, where two hospital companies come together to form a new jointly governed system, should also be considered. Finally, alternatives that include a full change of ownership and control should be evaluated. These include a merger with another nonprofit system or an outright sale, typically to an investor owned company or a buyer joint venture.

A broad scope of discussions can help demonstrate that the board considered all options to fulfill the charitable mission of the organization.

It is important for the board to keep an open mind throughout the options assessment. This process is designed to be exploratory and to uncover the full range of available alternatives. A common mistake of organizations that carefully develop their objectives but do not pursue a structured options assessment is that they bounce from one narrow tactic to the next. Instead of stepping back and evaluating their situation within the broad context of the market, they will pursue one-off fixes designed to fill a single gap without addressing their long-term strategic and financial positions.

Designing a Process

If the options assessment recommends the exploration of partnership structures, a controlled competitive process should be considered to solicit interest from the market. This process should be specific to the hospital and will vary based on local dynamics, but should include the following components:

Gradual and comparative

The process should allow for thinking to evolve as more is learned about potential market options. Instead of attempting to solve for the best outcome upfront and in a vacuum with limited real-time market input, decision making should be iterative and allow for the priorities of the hospital's objectives to change over time as actionable alternatives are explored and vetted.

Scope of discussions

Unless there is a specific reason to exclude a particular partner or structural alternative from discussions, the process should be inclusive of all reasonable alternatives. A broad scope can help to demonstrate that the board considered all options to fulfill the charitable mission of the organization. Even if a given partner or structure does not ultimately prove to be the organization's best match, its offer may identify attractive alternatives that would not otherwise have been considered.

Timing

The timeline for the process should be designed to the organization's benefit. A detailed timeline, minimizing risks inherent to the process, should be developed before embarking on a process. If a situation arises mid-process that compels a deviation from the timeline, care should be taken to balance the risks and benefits related to that deviation.

Strategic options committee

Establishing a board committee to oversee the process can help to provide consistent input, improve oversight and increase responsiveness. The strategic options committee should regularly report to the full board and, when the time is right, the full board and management should have ample opportunity to screen finalists in person for cultural, physician, operating and vision fit. It is the role of the board's advisors to manage the process, ensuring the effective use of the committee's, management's and board's time.

Competition

In many situations, competition can help organizations maximize economic and non-economic value. This can be helpful in demonstrating to state regulators that maximum value was obtained for the assets of the non-profit. As important as ultimate regulatory approval, a well-run controlled competitive process also ensures the board that it has selected the option that best meets its objectives.

Conclusion

Successfully executed transactions can appear deceptively simple from the outside. In fact, they are highly complex orchestrations, taking place in challenging operating and regulatory environments. The economic and non-economic ramifications for hospitals and the communities they serve cannot be overstated.

By following carefully designed processes, boards and management can mitigate transaction risks and maximize value. Successful transactions begin with the development of clearly articulated objectives that support the hospital's charitable mission. By considering the full range of structures and partners, hospital boards achieve the basis of comparison necessary to choose the alternative that best meets their objectives.

Juniper Advisory is an independent investment banking firm dedicated to providing its hospital industry clients with M&A and other strategic financial advice. McDermott Will & Emery is a global law firm with internationally recognized corporate and health practices. Juniper bankers Rex Burgdorfer and Jordan Shields co-authored this article with McDermott Will & Emery attorneys John Callahan, Megan Rooney, and Kristian Werling.