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News, Articles, and Updates

Hospital Joint Ventures between Non-Profit and Investor-Owned Companies: Uses and Future Applications

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A joint venture between Duke University Health System and LifePoint Hospitals, Inc., Duke LifePoint (DLP), recently completed the acquisition of Marquette General Health System (MGHS) in Marquette, Michigan. This combination represents the most significant use of the rapidly evolving *buyer joint venture* (BJV) structure. Most investor-owned hospital companies are currently attempting to form similar arrangements with non-profit partners.

Non-profit companies, both large and small, should consider the significance of these sorts of arrangements as they contemplate the impact of healthcare reform on their businesses. This article explores the practical and market features of BJVs, reviews the objectives of non-profit participants, and considers potential future applications of the structure.

Buyer Joint Ventures

BJVs are arrangements between non-profit and investor-owned hospital companies in which the ownership of existing, newly acquired or newly constructed hospitals is shared. They are simple in concept and structure, varied in commercial application, and complex in organizational design. BJVs will have an important role in the near-term as hospital consolidation accelerates, and could be a precursor of hospital companies in the future.

This structure has evolved from another arrangement between investor-owned and non-profit hospital companies involving hospitals: the whole-hospital joint venture, or *seller joint venture* (SJV). Non-profit and investor-owned hospital companies have entered into more than 30 SJVs over the past 20 years. In these, the non-profit seller retains a minority ownership position and shares in governance.[1] Essentially, SJVs are alternatives to outright sale and represent efforts by non-profit sellers and investor-owned companies to work together to share ownership and governance of the seller's hospital.

These two types of hospital joint ventures are similar in structure; however, the objectives and potential uses of BJVs are broader than those of SJVs. BJVs have been used in several ways, but shared governance of a single hospital, as with SJVs, is not one of them. Fundamentally, BJVs involve a sharing, through joint ownership, of the traditional strengths of each form (i.e., the capital and commercial strengths of the investor-owned company, and the medical and reputational strengths of the non-profit). This structure represents an extension of SJVs in which a broader

[1] This concept is more fully described in Juniper's Governance Institute article: James E. Burgdorfer, "Whole-Hospital Joint Ventures between Non-Profit and For-Profit Companies," E-Briefings, Vol. 7, No. 2, March 2010.

set of objectives are sought. BJVs represent a natural evolution of the hospital industry and a rational response to the economic pressures of healthcare reform. They are for-profit entities and the transactions that create them are "conversions"; however, they often operate under non-profit principles.

BJVs evolved over the past decade, initially as joint arrangements between large non-profits and investor-owned partners to build and own hospitals together. The investor-owned companies that entered into these early arrangements had significant experience with SJVs, and the non-profits were large and focused on preserving their credit ratings. In the past few years, BJVs with broader objectives have been developed, including sharing ownership in hospitals formerly owned by one or both partner(s), and buying non-profit hospitals together.

Despite the variety of their uses, the basic features of BJVs consistently conform to the inherent strengths of each partner. The investor-owned generally provides most, or all, of the required capital and retains a majority ownership interest. It usually has responsibility for day-to-day operations, including administrative functions, capital raising, information technology, and physician recruitment. The non-profit typically oversees medical safety and quality, clinical resources and expertise, programmatic support, branding and reputation, and development of medical specialties and new programs. While non-profits have had several reasons for entering into BJVs, the investor-owned participants view BJVs primarily as a means by which to promote growth of their companies.

Certainly, there are potential drawbacks associated with BJVs. These are new structures; their operating performance has not yet stood the test of time. Developing the level of comfort necessary to enter into these ventures is time-consuming for both parties, and the relationship between them could deteriorate in the future. Non-profits considering selling to BJVs should anticipate a slow and cumbersome transaction process as the partners work through diligence and definitive agreements together.

While early in development and use, these are well-considered and serious undertakings that appear to be successful in practice. Several prominent non-profits have entered into them, and at least two companies have used the structure more than once. The table on the following page identifies the 17 existing and announced BJVs, and is organized according to the objectives being sought by one of the non-profit participants (identified by italics). (Note: several transactions are represented in two of the groupings. These reflect instances where two of the three parties involved were non-profits on different "sides" of the transaction.)

Objectives of Non-Profit Participants in BJVs

The number of BJVs being created has grown quickly during the past several years and their uses have expanded. To date, non-profits have utilized the structure for four purposes, described below.

Existing System Development

Large non-profit systems place great emphasis on maintaining strong credit ratings. Most are also keenly sensitive regarding the need for referrals to tertiary hubs and have a natural desire to control large, multi-hospital systems of care. They have used BJVs in several ways to deal with these conflicting objectives:

- Selling a majority interest in "outlying" community hospitals near their urban hub(s) to a BJV with an investor-owned hospital company
- Contributing hospitals to a BJV into which the investor-owned partner is also contributing hospitals
- Purchasing a minority interest in a network of hospitals previously part of an investor-owned partner

The Shands and INTEGRIS BJVs represent examples of non-profit systems selling a majority interest in their "outlying" hospitals to an investor-owned partner. In separate transactions, both entered into BJVs with Health Management Associates (HMA). Through these arrangements, INTEGRIS and Shands retained the core features of their systems while enhancing their liquidity and minimizing the need for capital investment. Alternatively, Capella and Ascension formed a BJV in which both companies contributed hospitals located in "outlying" communities near Nashville. In another twist, Novant acquired a minority stake in several hospitals near Charlotte from HMA through the creation of a BJV; this venture was subsequently unwound.

The non-profit participant's need to preserve access to capital and maintain and expand referral patterns is central to the creation of these structures. BJVs also allow non-profit management's attention to be refocused onto the larger core hospital(s). In certain instances, BJVs have actually resulted in increased referral volumes from these "outlying" hospitals.

BUYER JOINT VENTURES

	Existing System Development
Shands HealthCare & HMA Gainesville, FL	BJV between HMA and *Shands* acquired three hospitals formerly owned by Shands.
INTEGRIS Health & HMA Oklahoma City, OK	*INTEGRIS* sold majority interest in five hospitals to BJV consisting of HMA and themselves.
Ascension & Capella Nashville, TN	Each partner contributed several hospitals to BJV.
Aurora & IASIS Milwaukee, WI	Proposed BJV between *Aurora* and IASIS, initially to develop cancer center.
Novant & HMA Charlotte, NC	BJV between HMA and *Novant* acquired four hospitals formerly owned by HMA.
	Non-Profits Seeking to Sell
Marquette General & DLP Marquette, MI	*Marquette General* was sold to DLP, BJV between Duke and LifePoint.
Bay Medical & Ascension & LHP Panama City, FL	*Bay Medical* conveyed control by leasing to BJV created by Ascension and LHP.
Community hospitals & DLP NC, VA	DLP purchased (separately) three *independent community hospitals* in NC and VA.
Wilson Jones & LHP & Texas Health Resources Sherman, TX	*Wilson Jones* was sold to BJV between LHP and THR.
	Non-Profits Seeking Growth via Acquisition
Duke Health & LifePoint NC, VA	In separate transactions, DLP purchased three community hospitals near Durham, NC.
Texas Health Resources & LHP Sherman, TX	*THR* and LHP formed BJV to acquire Wilson Jones Medical Center in Sherman, TX.
Tufts Medical Center & Vanguard MA	*Tufts* and Vanguard will attempt to purchase hospitals in the region through BJV.
Ascension & LHP & Bay Medical Panama City, FL	*Ascension* and LHP formed BJV to lease Bay Medical.
	Non-Profits Seeking to Build Hospitals
Ascension (Seton) & Triad Austin, TX	*Ascension* and Triad built hospital near Austin, TX through BJV.
Children's Hospital of Philadelphia & Vanguard San Antonio, TX	*CHOP* and Vanguard propose to build children's hospital in San Antonio via BJV.
Texas Health Resources & Triad Denton, TX	*THR* and Triad formed BJV to build hospital in Denton, TX.
Ascension (Seton) & LHP Austin, TX	LHP and *Ascension* built hospital near Austin, TX through BJV.

Sale of Non-Profit Hospitals

Existing and specially formed BJVs have recently been used to purchase independent non-profit hospitals; the sale of MGHS to DLP is the most prominent example of this. MGHS is a large tertiary care hospital in a rural market that sought a partner to assist with capital requirements and further improve its clinical quality. In the transaction, DLP paid a purchase price sufficient to eliminate all of MGHS's liabilities and create a foundation. Substantial capital investment commitments were also made. DLP made significant pledges regarding physicians, employees, charity care, and local governance. These are all features one would expect in a conventional sale to a for-profit. In addition, however, Duke will provide support with clinical protocols, research, physician and nurse training, and physician recruiting. MGHS saw this combination as the "best of both worlds" as it reviewed several options.

Non-Profit Company Growth

BJVs allow large non-profit systems to be more successful in completing acquisitions. To date, BJVs have made acquisitions within and outside of the non-profit partner's region. For example, DLP announced four acquisitions of community hospitals in North Carolina, Virginia, and Michigan in just two years. In the past, most acquisitions made by non-profits resulted in no value being paid for the equity of the community hospital being acquired. Acquisitions by BJVs, on the other hand, usually result in payment for the target's equity along with commitments to capital expenditures. This increases the non-profit partner's likelihood of success in purchasing hospitals in competitive environments, and with minimal strain on their balance sheet.

Building New Hospitals

Historically, non-profits have (by themselves) constructed new hospitals in growing areas contiguous to their existing hospitals, often challenging their balance sheets and credit ratings. As an alternative, several non-profits have built new hospitals through BJVs with investor-owned partners. These generally resulted in minority ownership positions for the non-profit, however, they greatly eased the impact on the non-profit's credit characteristics without interfering with development of multi-hospital systems of care.

Historical Approaches to Business Combinations

Regardless of the objectives of non-profit participants in BJVs, the structure represents a new, collaborative, and fundamentally different way for investor-owned companies and non-profits to work together. As such, it has important implications for the merger market and its participants. Before considering the future role of BJVs, non-profit and investor-owned hospital companies have historically approached the merger market with different objectives, advantages, and disadvantages.

Non-profit hospital companies have not been acquisitive in the past due to their focus on preservation of debt ratings and local missions. Healthcare reform has changed this and many non-profits now recognize the commercial imperative for larger, more efficient hospital companies. However, large non-profits are experiencing difficulty in contemplating acquisitions, particularly in competitive processes.

Non-profit acquirers are constrained by both internal and external factors. Internally, concern with debt ratings inhibits their willingness to pay sellers for their equity. They lack transaction experience and rarely have personnel fully dedicated to negotiating and executing business combinations. Externally, the federal government is inhibiting consolidation through antitrust enforcement of mergers between neighboring non-profit companies. State governments are flummoxing non-profit buyers as state attorneys general aggressively make transaction agreements available to the public. The likelihood of public disclosure of definitive agreements is causing many non-profit acquirers to be inhibited as they attempt to make acquisitions.

Investor-owned hospital companies have consistently had strong predispositions toward growth through acquisition, primarily because of the requirements of their equity investors. In the 1990s, this manifested itself primarily through intra-sector transactions. Starting in 2000, investor-owned companies turned their acquisition interests toward non-profit companies. Investor-owned companies have certain advantages and disadvantages in completing acquisitions. Access to equity capital provides obvious advantages. As national companies, investor-owned companies are less impacted by federal antitrust enforcement and they are less concerned with the release of transaction details by state attorneys general. They usually have a significant advantage in transaction experience and benefit from staffs that are dedicated to this work.

Alternatively, investor-owned companies frequently encounter negative preconceptions from boards

and management teams of non-profit sellers. These views are slowly declining but remain prevalent. In the past, this has led many non-profits to "give" themselves to large non-profits for little real consideration while rejecting investor-owned suitors. We believe that non-profit sellers will be less willing to do this in the future, particularly in competitive situations.

Future Applications of Buyer Joint Ventures

The hospital industry currently faces greater challenges than at any time in its history. The need to reduce the overall cost of healthcare is likely to result in lower prices, higher operating expenses, and greater volumes for hospitals. The development of larger, more vertically integrated hospital companies is an important part of responding to this challenge. Most investor-owned companies, and many non-profit hospital companies, are actively searching for ways to grow through business combinations.

Along with greater overall M&A activity, we believe there will be a sharp increase in the number of business combinations involving BJVs. They have the potential to quicken the industry's glacial rate of consolidation because they combine the key strengths of each ownership sector. The blurring of historical distinctions in the leadership of the two ownership forms further supports this. Non-profit leaders are now operating hospitals as businesses, and investor-owned leaders are paying more attention to quality and community perception. We anticipate that greater BJV activity will come from two sources:

- Growth in several existing applications of BJVs, particularly non-profit sellers, large non-profits seeking system development, and non-profits seeking growth, as discussed above
- Entering new types of hospital markets, expanding the use of BJVs to urban markets, as described below

To date, BJVs have been utilized in rural and mid-sized markets only. Developing BJVs in urban markets would greatly stimulate growth of the structure. Many urban markets are fragmented and in need of consolidation (e.g., Los Angeles and Chicago). These markets tend to be dominated by non-profits and lack significant investor-owned presence. As a result, they have historically resisted consolidation. The BJV structure represents a means to attract additional suitors to these markets. The infusion of capital from investor-owned companies could also embolden existing non-profits to participate in combinations without fear of damaging their credit ratings.

The combination of capital from investor-owned partners with the quality, safety, and clinical attributes of large non-profits represents an attractive option for urban markets, including suburban and exurban hospitals seeking partners. Many urban non-profits are not prepared to enter into acquisitions by themselves in which meaningful consideration is conveyed. Investor-owned hospital companies are unlikely to enter new urban markets without local system partners or the promise of meaningful market share. BJVs could broaden the market of suitors and foster consolidation by emboldening both of these otherwise recalcitrant merger participants.

We anticipate only modest use of BJVs by non-profit companies other than hospital operators. However, large physician clinics that are seeking to develop significant hospital businesses could utilize this structure successfully.

Conclusion

Consolidation of the hospital industry is likely to be driven by investor-owned and 501(c)(3) companies. On the "buyer" side of transactions, 501(c)(3)s will be increasingly active. On the "seller" side, there will be a significant increase in the number of independent and small system 501(c)(3)s considering sale. As a result, BJVs will increasingly be used by large non-profit systems seeking expansion through acquisition, and non-profits searching for attractive alternatives to selling to investor-owned companies or merging with non-profits for no consideration. Urban markets, in particular, are likely to be the next growth area for BJV activity.

Ultimately, BJVs illustrate the most important and fundamental distinction remaining between investor-owned and non-profit hospital companies: their sources of capital. Differences in management approaches and operating strategies between non-profits and investor-owned companies have narrowed. Without full access to capital, the hospital industry will not be able to consolidate sufficiently to reduce its overall cost to the national economy. Indeed, BJVs might herald a future in which these two ownership forms become one.

The Governance Institute thanks James Burgdorfer, principal at Juniper Advisory, LLC, for contributing this article. He can be reached at JBurgdorfer@JuniperAdvisory.com.