Non-Profit Hospital Boards and the Merger Market

During this decade, non-profit boards have been confronted increasingly with the potential for merger and change-of-control ("merger market") transactions. There has been a dramatic increase in the need for non-profit organizations to consider macroeconomic industry conditions and the resultant role of the merger market. Hospital and health system boards of directors must be proactive and take into account their business and financial circumstances in relationship to this phenomenon. This article explores the industry dynamics that have contributed to this trend and notes an emerging view that may contribute to future merger transactions.

Economic Setting

There are multiple economic factors altering the structure of the hospital industry. This structural change and its underlying causes—including industry consolidation and shift in ownership—is not well understood, and driven by these factors:

- Nearly 40 percent of all non-profit hospital companies are experiencing some form of financial difficulty, often accompanied by a decline in debt ratings and diminished access to capital.
- The capital markets' response to the hospital industry's circumstance has been polarized:
  - Access to *debt markets* has become more difficult due to concerns about the credit characteristics of borrowers.
  - The *equity markets* are optimistic about the hospital business and are investing in its growth potential.
- Private equity firms are investing enormous amounts of capital in the hospital industry, backing experienced management teams in creating new business entities (e.g., Signature and Capella) and completing financial transactions (e.g., HCA's leveraged buyout). Their objective is to purchase non-profit hospitals and convert them to for-profit.
- Well-capitalized non-profit hospital systems have been seeking to secure their futures through targeted transactions involving the merger market.

Defense versus Offense

Nearly all sale transactions completed by non-profit hospitals since the late 1990s have been based on defensive considerations. Ultimately, this orientation results from the difficulty associated with governing entities in an extraordinarily fragmented industry.

It can be difficult to anticipate and respond to operating and financial problems and trends. It is even more challenging to identify problems resulting from the larger changes to the structure of the healthcare industry. It often takes years of financial difficulty before boards are willing to consider the merger market. Indeed, non-profit boards' responses to financial problems follow a discernible pattern:

- Focus on operating and financial problems happens only after violations of financial covenants occur.
- Operating consultants are then retained, usually resulting in expense reduction and a refocused organization.
- Non-core assets are frequently sold.
- A decision to close or sell the hospital might be made.
- During this process, mission and "value" usually dissipate.

However, important changes are occurring in board decision making at certain health systems, as some of the most foresighted non-profits have become concerned about industry changes. The following developments are responsible for this new approach:

- The IRS, Congress, and state attorneys general are challenging non-profit status, executive salaries, and property tax exemptions.
- Structural change and business complexity are causing boards to consider the need for larger operating scale.
- There is increased emphasis on physicians' ability to participate in economics through joint ventures.

As a result, boards of leading organizations are becoming proactive. Boards can and should use the merger market as an offensive tool to ensure their system's future success.

Future Board Action

We encourage boards to recognize structural change and other macroeconomic trends, and proactively consider the merger market in their planning. Ideally, decisions regarding operating and ownership alternatives should be based upon an organized understanding of a hospital's business circumstance and changes to the structure of the industry. Depending on the situation, this could be considered in either of two contexts:

- If a health system is experiencing poor financial results, including lack of access to capital, the board should determine whether the fundamental issue is operational or systemic. If systemic, early consideration might be given to a sale or merger.
- If a system has experienced strong financial results, the board might consider the likelihood of continued success given changes to the structure of the industry. Potentially, it might consider whether the merger market could be used to forestall future problems such as insufficient scale.

Historically, non-profit hospitals and health systems have focused on operating and other microeconomic issues and have considered the merger market only after experiencing financial trouble for several years. As a result, mission and value are often eroded. Today, however, the boards of some of the most successful systems are carefully considering the impact of fundamental changes in the structure of the hospital industry and are becoming more offensive in their thinking about the merger market. We suggest that boards consider the merger market in a proactive way, regardless of their circumstance.

The Governance Institute thanks James Burgdorfer, principal and a founder of Juniper Advisory, for contributing this article. In a future article, he will discuss specific procedural and organizational recommendations related to the use of the merger market by non-profit hospital systems. Juniper Advisory specializes in advising non-profit health systems on merger market transactions and other elements of corporate strategy. Mr. Burgdorfer can be reached at (312) 506-3009 or jburgdorfer@juniperadvisory.com.