Parallel Paths to Realignment

Consolidation in commercial banking offers a glimpse of health care's future

By Jordan Shields, Stephen Morrissette and James Burgdorfer

Payment reform poses a seemingly endless list of complex, interrelated questions. For the trustees and executives responsible for guiding their institutions through this unfamiliar terrain, the best answers to those questions often can be found in another industry.

The commercial banking and hospital fields have much in common. Both are service providers in low-margin, capital-intensive, commercially challenging and technologically complex industries that are among the country's most heavily regulated. Their greatest similarity, however, is the central role that each plays in the community. Both are visible, influential institutions that elicit strong emotional attachment from community members. Additionally, banks and hospitals often share trustees and it is common for bank executives to serve on local hospital boards and for hospital execs to serve on local bank boards.

Despite these commonalities, surprisingly little thought has been given to the parallels between the two industries. Reviewing banking's recent history reveals lessons that can be applied to hospitals.

Patterns of Consolidation

While the commercial banking industry continues to consolidate, it is already significantly more concentrated than the hospital industry. The 10 largest bank holding companies have more than 80 percent of all banking assets. By comparison, the 50 largest hospital systems generate only 25 percent of all hospital industry revenue. By exploring consolidation in the banking industry,

IMAGE BY KEITH NEGLEY/THEISPOT

we can identify patterns that likely will emerge in the formation of larger hospital companies in the coming decade.

Distressed mergers presage strategic mergers: When banks began to consolidate in earnest in the mid-1980s, distressed banks were the first to sell. These weaker organizations were losing ground to better-positioned competitors that were able to make the large investments necessary to modernize their operations and expand.

By the mid-1990s, a shift occurred in the industry. Many distressed banks had sold, but the consolidation trend actually accelerated. Well-positioned banks that had been able to keep up with the capital demands of a changing industry began to recognize that selling or merging represented the best way to improve and expand their platforms. Large, successful organizations increasingly looked for other large, successful organizations with which to merge.

As in the early days of banking consolidation, systems that pursue mergers have been perceived as distressed and needing the resources of a stronger partner. But this perception is changing. Strong, well-positioned organizations with excellent reputations, margins, physician relationships and access to capital are seeking merger opportunities. These organizations recognize the change in the health care environment characterized by commercial and operating complexity and narrow margins.

As with the banking industry, success will be defined by efficiency and the ability to adapt quickly to a new environment. Local companies without scale or regional perspective will have difficulty. Trustees can serve their organizations best by remembering that future success is tied to the provision of high-quality services at competitive rates, not yesterday's independent balance sheet strength.

Consolidation accelerates: Strategic mergers led to larger commercial banking companies, further increasing their strength relative to smaller banks. This manifested itself in several ways, including new information technology platforms like ATMs, lower costs for commodity services and the development of riskier, more specialized services. Larger financial institutions are better able to absorb fixed IT costs. They are also able to devote more resources to the development of new and complex financial products and risk management techniques.

Commercial banks offer a variety of highly standardized, commodity-like services such as credit card lending and mortgage banking. Larger organizations are able to apply their economies of scale to these commodity business lines to expand market share and increase profits. Banks with larger asset pools can take on more volume from any given customer than can smaller banks without increasing their relative risk profiles. Additionally, larger banks are better positioned to develop customized services without any single product materially impacting the risk profile of the organization. For all these reasons, banks became stronger as they grew, leading to a cycle of consolidation.

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A similar trend is emerging in the hospital industry. The operating performance of larger systems is, on average, better than that of smaller ones. In an industry with low operating margins and high fixed costs, this size advantage cannot be overstated. Strong operators have better access to capital, and advantages compound over time. This is playing out as large systems are outpacing their smaller rivals with investments in physician infrastructure, quality improvements and IT.

Despite industry consolidation, room remains for independents: As commercial banks have grown, there have been organizations that have bucked the trend. These banks typically fall into one of three categories:

- those that have entrenched customer bases that have been overlooked by larger organizations;
- those that have structural impediments to merger, for example, credit unions that are willing to trade performance for local control;
- those that have intentionally focused on narrow service lines. These banks may offer a full range of services locally, but are typically national providers of a single, high-margin service.

Industry experts agree that the days are numbered for stand-alone community hospitals offering a full range of acute care services through independent medical staff. However, two types of independent hospitals likely will survive. First, government-owned, safety-net hospitals that receive local tax support will last. Second, certain strong hospitals in exceptional markets may decide to forego scale efficiencies. These organizations largely will be isolated from competition and will enjoy unique medical staff relationships, philanthropic support and demographic attributes that allow them to survive the shift to value-based contracting.

Local service trumps local control: Despite public angst related to banking consolidation, it has been customer-driven. The reasons are multifaceted. First, while corporate

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strategy and structure are determined at headquarters, service and relationships are maintained locally. Therefore, day-to-day interactions with banks change little when their headquarters move elsewhere. Second, as the range of financial services offered by commercial banks has grown, customers have sought these services first from institutions with whom they already have relationships. Third, as banking services have evolved, customers increasingly expect robust online banking functionality. Larger banks are better equipped than local banks to invest heavily in their Internet platforms because they can spread these costs over a larger customer base. While the location of a given bank's headquarters is fodder for cocktail conversation, it appears to have an insignificant impact on sustaining and growing customer relationships.

Like banks, hospitals are a consumer business. Future consolidation is contingent on post-merger integration that improves quality and service for patients and physicians. This notion is supported by several attributes of the hospital business. Some local volunteer boards are ill-equipped to anticipate the demands of a complex and evolving industry. Local input on medical staff issues and planning initiatives is important, but this does not require local ownership; it can be achieved through a subsidiary board structure.

Large companies are generally better able to decentralize authority than stand-alone organizations. For example, banks with limited assets can have a harder time authorizing a large, well-secured loan. Likewise, an independent hospital with inadequate operating rooms or an outdated emergency department may have complete local control but still no ability to adequately fund or quickly approve an attractive capital project. Facilities with the capital and scale to anticipate change and invest in quality outcomes will win the day.

Consolidation Lessons Learned

The experiences of the banking industry hold several possible insights into future hospital consolidation transactions and subsequent integration. The lessons center on standardization, timing and community relationships.

Integration, standardization and centralization: Economies of scale can be realized through standardizing and centralizing activities; this was one of the central tenets of the industrial revolution. Greater standardization can increase quality, improve efficiency and reduce costs.

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The banking industry has wrestled with the proper degree of standardization and centralization for the past 30 years. In the hospital industry, numerous experts and research studies have emphasized the significant benefits that result from evidence-based medicine and the increased use of standardized methods and protocols. The Institute of Medicine found that the United States wastes $130 billion per year on inefficiently delivered services that could be eliminated through standardization.

There will continue to be a role for independent and specialized hospitals that are able to offer unique value propositions that large systems can't provide. However, hospitals should carefully consider the experiences of many small banks. At the start of banking consolidation, simply being local was enough to attract depositors as large companies struggled with integration and merger execution was poor. Eventually, large banks improved service, forcing small banks to find other ways to differentiate themselves.

Timing matters: Change in the number and size of companies in a given industry often results from the interplay of three forces: economy of scale, customer preference and regulation. These forces can act as catalysts that reward scale and efficiency and penalize poorly positioned industry participants. Classically, organizations that are affected but cannot adapt to these forces fail to remain independent. To achieve optimal timing, sellers need to consider these forces.

For hospitals facing thin or negative margins, one obvious lesson from the banking industry is to move early rather than late. While executive teams are trained to be optimistic, it is better to sell a slightly stressed operation than to wait to sell until reaching full financial crisis.

But merging before becoming distressed requires a difficult and candid assessment. The standard for independence should not be survival, but the ability to efficiently offer high-quality services in a changing environment.

External factors are also at play. If either the market demographic or market share declines, value has been lost, regardless of financial circumstance. A healthy institution in a strong market can control its destiny. However, even these institutions must be mindful of their situations. Should their best partner join the hospital across town or shift corporate strategy, even the strongest hospital can find itself eventually merging with a less-than-optimal partner.

Community relations: Because banks and hospitals are important to

their communities, emotions regarding mergers and acquisitions often run high. There are many lessons for hospital trustees. First, be prepared for emotional responses, especially from elected officials, and implement reasonable tactics to address these concerns. Even more so than banking, elected officials view hospitals as quasi-public organizations similar to the institutions they control, such as schools, parks and libraries. Professional public relations advice has become a necessity for a hospital that is considering a merger.

Second, patients and physicians ultimately will refocus on what matters most: clinical outcomes and patient service. If a merger improves these two primary factors, these concerns eventually will dissipate. In the end, patients, employees and physicians are most concerned about good health care, not the hospital's name or sponsorship of the local parade.

Unique Circumstances

Hospitals and banks share many commercial, regulatory and social features, and, yet, they find themselves at opposite extremes in terms of company size and industry concentration. The hospital industry's position as the most fragmented major industry in our economy is even more paradoxical when compared to commercial banking. With poorer access to capital, fewer diversification opportunities and a less-advantageous pricing mechanism than banks, consolidation's appeal to hospitals makes sense. And yet, these anomalies have left many well-intended hospital boards clinging to local control without context, true understanding or accountability.

But despite predictions of rapid consolidation in the hospital business, the change likely will occur over many years and in a halting manner. Much value and opportunity for improvement will be lost in the process. Lessons from banking consolidation — timing, standardization and community relations — have tremendous value.

More fundamentally, future decisions concerning business combinations might benefit from a realistic assessment of the hospital's ownership and governance. Recognizing the unique and challenging roles played by management, boards and owners of hospital companies could add clarity to decision-making. T

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