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protecting corporate value in affiliation transactions

AT A GLANCE

- Understanding the risks and rewards of affiliations is critical to determining whether the partnership will address specific challenges without compromising organizational goals.
- An analysis of the tension points and potential risks associated with an affiliation also should identify possible strategies for resolution.
- Hospitals can mitigate potential affiliation downsides through a well-run process that follows several key steps.

Hospital leaders are increasingly interested in affiliations, or relationships with other healthcare organizations that do not involve ownership changes. Affiliations can take many forms, including management agreements, clinical affiliations, purchasing cooperatives, and joint operating agreements. But they also pose unique risks. Community hospitals often pursue affiliations rather than mergers or outright sales, for instance, to access the benefits of increased scale without ceding ownership. However, this strategy often can result in a shift of control and transfer of the community hospital's ownership without any reciprocal economic or noneconomic benefit. Clear and consistent affiliation objectives—among other strategies—may enable participants to avoid such risks.

Affiliation Drivers

Organizations pursue affiliations to maintain independence while improving qualitative, operational, or financial performance. The objective of affiliations usually is to maximize near-term control while enhancing integration, scale, quality, capital access, or other benefits associated with partnership. Successful affiliations focus on narrow, clearly identified improvements, allowing organizations to maximize the benefits of affiliation while retaining as much control as possible.

As organizations respond to healthcare reform and the shift toward value-based payment models, affiliations can facilitate the exchange of best practices, reduce costs, and provide access to tools necessary for effective population health

management. Few independent hospitals cover the full continuum of care necessary to succeed under population management. Achieving full integration through an asset sale or merger, however, often is too large of a leap for board members of many stand-alone hospitals. Affiliations offer an alternative approach to fill organizational gaps and better position hospitals in the changing payment and operating environment.

Affiliation Risks

Hospital board members often prefer affiliations to other types of partnerships, such as mergers, because they expect affiliations to be easy to implement, unlikely to fail, and protective of local control. However, affiliations involve significant corporate risk and often damage value. The resulting risk and damage has led industry experts to refer to affiliations as "slow-motion giveaways" and "bear hugs." There are numerous examples of community hospitals that have entered into relatively narrow affiliations only to become fully absorbed into their partner within several years. Boards and management teams can account for the inherent risks of affiliations by developing clear objectives before pursuing affiliations as a way to both evaluate risks and formulate mitigating strategies. When analyzing the key goals and tension points likely in a proposed affiliation, the board and executive team should assess the leading risks associated with the affiliation and identify possible strategies to address those risks. The analysis should examine the following areas.

Stability. Unlike mergers, affiliations are not designed as long-term stable structures. Instead, affiliations trade structural stability for maintenance of organizational control, which creates risk. Successful affiliations require ongoing affinity between partners. Although the organizations may have joined the partnership for different reasons, each should derive ongoing benefits, which can evolve over time but are critical to the partnership's success.

Partnership instability is often considered a benefit due to the misunderstanding that it eases dissolution of the arrangement. However, providers frequently find that unwinding an existing affiliation is more costly and harmful to an organization than continuing the relationship on unfavorable terms. Typical agreements include buy-out provisions that are too expensive for the partnership's smaller provider to execute or that leave the junior partner with untenable financial management or operating gaps. Further, because most partnerships are formed among local organizations with shared markets, dissolving an existing relationship can put one partnering organization at greater risk than the other, such as when physician referral patterns are at stake.

Hospitals that pursue affiliations to solve long-term needs, such as improving their cost structure or branding, face the risk of overreliance on a partner whose interests may change. Smaller partners in affiliations typically risk becoming too reliant on these structures. Then, if either partner decides to exit, the smaller partner is left weakened and worse off financially than it was when it entered the arrangement. Smaller organizations often will surrender to the losing finances of the partnership, or submit to bear hugs, if they find that the organizational cost of exiting the affiliation exceeds the lost value from the slow-motion giveaway.

Realized benefits. Affiliations are designed to promote flexibility and autonomy rather than to maximize outcomes. These relationships, with two separate owners that each have their own agendas, can leave partners arguing over resources and approaches instead of collaborating to optimize care for the community, regardless of the impact to respective bottom lines. For example, partners that share markets may argue over expanding a given service at one location because doing so could reduce volumes at another.

Full integration, which is necessary to maximize the benefits of the partnership and best serve the community, is frequently inhibited by partners that are instead focused on trying to protect their organization. For example, affiliations around purchasing rarely require both partners to standardize their supplies. Instead, partner organizations typically agree on a core set of supplies and then contract separately for others. Although this arrangement is easy to implement and is unlikely to alienate physicians, it also prevents participants from achieving the full savings of a partnership.

Opportunity cost. Hospitals that do not have experience with mergers and acquisitions commonly enter into affiliations without understanding their full range of alternatives. Because partnerships are typically incremental and not episodic, some hospitals pursue affiliations without exploring alternatives or developing a basis of comparison.

For example, a hospital that has identified a need for greater scale, may be tempted to jump immediately to a management contract without any further analysis of options. Although such arrangements allow hospitals to access scale while maintaining local ownership, they also carry an opportunity cost relative to other options. Hospitals that fail to evaluate alternatives, such as a merger, may never know whether another model would have been a better overall business and community decision.

Vetting the range of options available also will promote a better understanding of merits of each option. For instance, management agreements or service-line joint ventures often give the counter party a de facto right of first refusal for purchase. Such provisions are often agreed to without understanding that they can cost the community hundreds of millions of dollars in lost economic value.

Termination. Affiliations are designed to end at some point. The challenge is in knowing how to unwind the affiliation when it no longer meets the needs of both partners. An all-too-common outcome is for the larger organization to absorb the smaller organization at a lower economic and noneconomic sum than the smaller hospital would have garnered prior to the affiliation. To avoid this fate, smaller hospitals should first explore a range of termination options. In addition to documenting the potential benefits of the affiliation, each partner should detail ways they would be better positioned after the affiliation ends. An affiliation entered into without first demonstrating that it will fill a temporary need and leave each partner stronger is unlikely to serve the long-term needs of the organization.

Mitigating the Risks

Affiliations may entail significant risk, but participating organizations can mitigate potential downsides through a well-run affiliation process. The movement toward a partnership should include the following steps.

Establish a basis of comparison. The full range of partnership alternatives should be vetted to define the attributes that are unique to the affiliation. Such comparisons also may identify any potential benefits from other arrangements that an affiliation will force the organization to forgo. A comparison of affiliation alternatives should give the organization an understanding of its market value as well as the economic and noneconomic consideration it could receive from a merger or outright sale. Because an independent hospital is often its community's largest and most important asset, its board should prioritize protection of its value and long-term viability during any decision-making process. The key starting point is assessing the hospital's business value, because that provides a baseline of comparison to evaluate the range of strategic alternatives.

Evaluate the exit. Analyses of the long-term implications of the affiliation should include whether the affiliation will facilitate the hospital's shift with the industry from fee-for-service reimbursement to population health management. Successful hospitals in coming years will take a central role in the patient care continuum and avoid marginalization as so-called cost centers. If hospital leaders intend to use the affiliation as an integration vehicle, then they should acknowledge the likelihood of a slow-motion-giveaway and the expected loss of economic and noneconomic value. If an affiliation will leave either party weaker than when the organization entered it, then it is not the best structure for the hospital.

Pair objectives with structure. Hospital leaders should remember that affiliations typically best fill specific, near-term needs. To meet organizational needs that are expected to persist or other long-term requirements, hospitals should explore alternative structures to affiliations. Alternatives to partnerships and affiliations that sometimes better fit a hospital's goals include building capabilities internally or pursuing joint ventures or full asset merger structures.

Careful Consideration Crucial

Affiliations can bring significant, short-term value. Many organizations have used these structures to fill gaps and improve services while maintaining ownership and local control. But organizations often do not recognize the risks these structures pose. An open and rigorous assessment of both the full range of options and pitfalls of each is crucial as partnership activity accelerates. To mitigate risks of entering into an ill-advised affiliation that can hurt the organization over time, boards and management teams should first fully explore and understand the potential downsides. ●

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