The Expanding Range of Strategic Alternatives Available in Hospital System Mergers and Acquisitions

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The business of governing acute care health systems has become increasingly complex in recent years as board governance and industry structure have worked to keep up with the pace of reform and consolidation. The sector has evolved from a largely charitable function to a major industry that comprises 5 percent of the gross domestic product. The acute care health system business is capital intensive, highly regulated and technology driven.

Some industry observers point to the level of ownership fragmentation as a challenge to managing and improving acute care services in the United States. The hospital industry is composed of very small companies compared to similarly sized sectors of the economy. In other industries like managed care, airline, auto and food, beverage and tobacco companies, for example, the 50 largest companies hold market shares in excess of 75 percent. The 50 largest hospital companies together command less than 25 percent market share. The hospital industry has no "large" companies and none have full access to capital like major manufacturing companies have—e.g., commercial paper markets, equity markets, debt markets, synthetic markets, foreign listings, etc.

The passage of the Affordable Care Act and other macroeconomic initiatives are designed, in part, to stimulate the creation of larger health care companies that can deliver higher quality, more cost-effective care. Meaningful consolidation will be challenging and take time. Of the roughly 4,500 total acute care hospitals in the United States, there are more than 2,000 "companies" delivering care. With such fractured ownership, population health as well as standardized, efficient, consistent and coordinated care has been an elusive goal.

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Boards around the country are grappling with these issues and evaluating business combination opportunities more than ever before. Most boards receive a significant volume of input on the general trend of consolidation, but less input on the full range of strategic alternatives that exist and the processes and tactics that can realize the board's desired outcome—typically the long-term security of high-quality, efficient care across a range of desired services for the community.

Significant innovation has occurred in the variety of structures hospitals and health care systems are using to work together. The focus of this article is to describe the structures hospital systems are utilizing in change of ownership transactions, with a focus on the new types of "hybrid" structures that are emerging. These structures include:

- Seller joint ventures
- Buyer joint ventures
- Multi-party joint ventures
- Consolidation transactions
- Membership substitutions
- Asset sales

Descriptions

Seller joint ventures - -

are typically formed between a community hospital and an investor-owned company. The investor-owned company acquires a majority interest in the hospital (usually 60 percent to 80 percent), however, local control is preserved for the community via 50 percent block voting on the joint venture board. Unusual to seller joint ventures, the percentage of ownership does not follow control. Two requirements for a seller joint venture to work are that the selling board must: (1) have a modest level of financial leverage such that selling a 60 percent to 80 percent share of the business is sufficient to retire 100 percent of the liabilities, and (2) have modest future capital needs, as the selling party will be responsible to fund their pro-rata share (20 percent to 40 percent) of capital investments. For example, a hospital that has a large amount of debt in the capital structure and/or a large underfunded defined benefit pension plan may not extract enough proceeds in an 80/20 transaction to fully fund its liabilities at close. Similarly, if a hospital requires significant capital expenditures (e.g., a new patient tower), the resulting foundation may not have enough money left over to prudently co-invest 20 percent in the project.

Buyer joint ventures - -

combine the respective expertise of a clinical partner and an equity-sponsored system. The clinical partner holds a minority of the equity interest (typically 3 percent to 20 percent) and is responsible for overseeing medical safety and quality. The investor-owned partner provides capital (typically 80 percent to 97 percent), operating skill and management capabilities to run the community hospital. These partnerships have been very successful and appealing in recent years. Many consider this one of the more important developments in the hospital industry in the last several decades. Selling boards often view these as "the best of both worlds," accessing scale and community hospital management expertise while also including a partner with a strong reputation for and focus on quality.

The Expanding Range of Strategic Alternatives, continued

Multi-party joint ventures - -

combine the characteristics of the previous two structures, a seller plus a buyer joint venture. This model enables the involvement of a clinical partner, capital infusion and preservation of local control. While complex in execution, it has been implemented in a handful of settings around the United States. Multi-party joint ventures lend themselves to an emerging, but yet to be realized, development in the nonprofit hospital industry: the integrated foundation model. This structure allows community hospitals to utilize the financial proceeds of change-of-control transactions to support research, education, training and other academic functions in a community hospital setting. The promise of access to a share of the annual earnings of the foundation created through the transaction are used to lure a preferred academic partner committed to research, academics, quality and clinical growth at the community hospital.

Consolidation transactions - -

occur when two parties combine to create a new parent company with a self-perpetuating board. This was a popular structure in the 1990's and has seen a revival following the Affordable Care Act. Consolidation transactions created many of the larger national 501(c)(3) systems including Advocate in Chicago, Banner in Phoenix and Sentara in Virginia. Consolidation transactions are difficult to execute. To work, they require two health systems that share a common vision and are similarly sized. It is not unusual for consolidation transaction discussions to unravel over near-term concerns like the identity of the new company's board chair or chief executive officer. Although tricky to complete, when implemented, consolidation transactions have proven to be the genesis of very successful hospital systems.

Membership substitutions - -

are the most common structures between merging nonprofit hospital systems. This structure is analogous to a stock sale transaction in corporate finance. The seller transfers its ownership to the nonprofit acquirer who becomes the new "member." The seller's corporate structure typically remains intact, but ownership and control have shifted to the new parent, which also typically becomes liable for the seller's debts. Membership substitutions have not historically created foundations or included significant economic commitments beyond the assumption of the seller's debt. This has changed, however, and regional nonprofit systems are now among the highest bidders in sale processes. In many cases, systems are now crossing state lines for strategic partnerships, which increases the number of viable partners for boards to consider. Membership substitutions also typically involve forward looking capital

commitments, where the nonprofit acquirer commits to continued investments in the facility and medical staff for an agreed-to period post-closing, as well as forward looking operational commitments.

Asset sales - -

are common between nonprofit sellers and investor-owned acquirers. These are also seen between two nonprofit partners, when the acquiring nonprofit wishes to protect itself from trailing liabilities or quickly fully integrate the acquired facility into its corporate structure. Asset sales typically involve a purchase price, with the seller using its cash and the purchase price to retire its liabilities at close, transferring just its assets to the new owner. Any additional assets, once liabilities have been addressed, typically form a community foundation. Asset sales also typically involve a forward looking capital commitment, where the buyer commits to continued investments in the facility and medical staff for an agreed-to period post-closing.

Conclusion

Maximizing the outcomes of each of these strategic options requires that board members generally understand the purpose and use of each structure, and the factors that influence feasibility, e.g., use of financial leverage, capital expenditure needs, local political environment, etc. Boards equipped with knowledge of these innovative structures will be better able to contend with an increasingly complex operating environment.

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 Megan Rooney and Kristian Werling.