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This newsletter is designed to inform you about new research and expert opinions in the area of hospital and health system governance, as well as to update you on services and events at The Governance Institute. Please note that you are receiving this newsletter because you are a Governance Institute member or expressed interest at one of our conferences.

The Rise of the Hospital Joint Venture

By Barry Sagraves, Juniper Advisory, and Ken Marlow, Waller

This article is the first in a series examining the advantages of joint ventures, the process of developing a joint venture, and expected trends related to these transactions.

Since the enactment of the Affordable Care Act in 2010, more and more hospitals and health systems have entered into some sort of affiliation, whether through acquisition, membership substitution, joint venture, or clinical affiliation. This trend is a result of the mounting pressures hospitals and health systems face in the current healthcare environment. Yet, fundamental change in the makeup of the hospital market also paves way for innovation, which includes new ways that organizations may partner to confront these challenges. The joint venture structure is one such innovation.

For those hospitals and health systems that are financially sound and have sufficient capital, entering into an affiliation allows them to best position themselves for future success—to thrive rather than just survive. Evaluating strategic alternatives from a position of strength allows the board of a hospital or health system to take its future into its own hands and identify affiliation partners that complement and enhance its operations, capitalization, compliance, and quality functions. Exploring a range of joint venture alternatives has been found by many systems to be a "best of both worlds" approach—combining the installed market presence and reputation of a non-profit system with the scale, access to capital, and management expertise of an investor-owned company.

Most hospital and health system boards are aware of the trend of consolidation; however, many fail to appreciate the full range of strategic alternatives that may exist (including the joint venture structure) and the processes and tactics that can identify and realize the board's desired outcomes. This article is the first in a series in which we will examine 1) the potential advantages of joint ventures; 2) how to go about the process of exploring a joint venture, including selecting a joint venture partner; and 3) expected trends and future developments with joint ventures.

Challenges Posed by Industry Changes	Emerging Opportunities
• Reimbursement cuts year over year • Increasing costs and expenses for information technology in connection with electronic health records, meaningful use, and collection of data for quality metrics comparison, all key elements of successfully managing population health • The requirement for effective compliance programs and, in the event of noncompliance, being subjected to repayments, penalties, and other sanctions • Increasing challenges in financing capital expenditures, and continuing or increasing pension funding challenges	• Vertical integration, where health systems may vie to "control the premium dollar" rather than being a price taker from insurance companies • New ways of developing and sharing clinical protocols to reduce variation in outcomes and improve quality • Make capital investment decisions on a regional basis, across all elements of the health system

Advantages of Joint Ventures

Hospitals and health systems are looking to joint ventures for a number of reasons, many that are common but others that may be unique to potential partners. Some of the most common factors are:

- **Governance**: One of the key areas that many boards find attractive about joint ventures is that the current organization remains an owner and is directly involved in the governance of the venture. While gaining access to increased capital and opportunities, the local board remains very much "at the table" in managing the organization. There is, however, no standard model among potential partners, and both the legal structure and the day-to-day realities of decision making must be carefully explored and negotiated.
- **Investment potential**: A second potential advantage in a typical non-profit/investor-owned joint venture is that the non-profit corporation retains an equity stake in the business, which it will expect to increase in value over time. In addition, as a charitable organization, it will be able to diversify its holdings with the sale of an interest in its current business, reducing its overall portfolio risk.
- **Access to capital**: The capital needs of a hospital or health system are extraordinary. A hospital that enters into a joint venture has the benefit of additional sources of capital. A financially healthy partner can share the burden of capital investments, whether for working capital, routine, or strategic capital projects. Even with a fairly healthy financial position, many organizations find themselves facing limits to their debt capacity or significantly underfunded pension plans. These liabilities can often be eliminated as part of the joint venture transaction.
- **Enhancement of quality**: In the evolving healthcare environment, the hospitals that provide the best quality of care will be rewarded, while those that do not meet the requisite standards will face consequences. Specifically, the Affordable Care Act includes a value-based purchasing program, which rewards hospitals that exceed quality measures and penalizes underperformers with payment cuts. Partners that have a history and reputation of clinical and quality excellence, as well as access to highly specialized medical services, will provide the assistance to ensure not only that patients are receiving the best quality of care, but also that, as a result, the hospital is rewarded financially for providing excellent care.
- **Physician recruitment, retention, and alignment**: Another way a joint venture can strengthen a hospital or health system is through physician recruitment and retention. Partners that have strong physician networks and a proven ability to attract and retain physicians will continue to be critically important to the success of a hospital. Partners that can provide resources to aid physicians and caregivers in skills development and career plan development of staff at all levels of the organization will be attractive to hospitals. In addition, investments in a significant infrastructure of recruiting, the sourcing of specialists and practice management experts, and support for promoting practices and retaining quality physicians will be instrumental in ensuring success. A final, psychological point cannot be underestimated: physicians, particularly in an employment situation, want to "join a winner" that can offer them the potential for a secure professional and financial future.
- **Efficiencies and bargaining leverage**: With the implementation of the Affordable Care Act, the cost of doing business has increased, while reimbursement has decreased. This has placed increased pressure on hospitals and health systems to find efficiencies and engage in cost-cutting efforts. Through joint ventures, healthcare organizations can find synergies in various aspects of the operations, such as back office, management, and administrative functions. They also may have more leverage in negotiations with suppliers and payers. In addition, the larger scale may provide for better terms with respect to health and welfare benefits, as well as insurance policies.
- **Continuation and expansion of services**: The continuation and expansion of healthcare services is critical to the success of hospitals and health systems. A joint venture with a strong partner can solidify the ability of the organization to provide existing services and in many cases provide additional specialty services that are not currently offered at the hospital. With the addition of a joint venture partner, the hospital also may be better positioned to offer additional ancillary services, such as diagnostic, laboratory, and pharmacy services. By ensuring the continuation and expansion of services, the patient is more likely to seek care within the local community.

A Glossary of Hospital and Health System Transaction Structures

Below are the key structures seen in recent partnerships announced by hospitals and health systems:

- **Seller joint venture**: Seller joint ventures (SJVs) are typically, but not always, formed between a community hospital and an investor-owned company. The investor-owned company acquires a majority interest in the hospital (usually 60–80 percent). However, local control is preserved for the community via 50 percent hospital representation on the joint venture board. In these arrangements, the hospital gains access to needed capital while maintaining a collaborative culture, and the investor reaps returns if and when the hospital partner grows its market share. *Example: LHP Hospital Group's joint venture with Porteneuf Medical Center in Idaho.*
- **Buyer joint venture**: Buyer joint ventures (BJVs) combine the respective expertise of a clinical partner or a system with a regional presence with an investor-owned system. The clinical partner holds a minority of the equity interest (typically 3–20 percent) and is responsible for overseeing medical safety and quality or providing regional services. The investor-owned partner provides capital (typically 80–97 percent), management capabilities, and economies of scale to run the community hospital. These partnerships have been very successful and appealing in recent years. Together, the BJV goes out to acquire hospitals and health systems. *Example: Duke LifePoint's joint venture that acquired Conemaugh Health System in Pennsylvania.*
- **Shelf joint venture**: In order to be ready to compete effectively for acquisition opportunities, it may be advisable to structure the BJV before there is an actual target available. Typically a letter of intent is signed between the prospective joint venture partners, which is then made binding simultaneously with the closing of the acquisition. A shelf joint venture is a strategy for forming a partnership in advance of a partnership opportunity.
- **Consolidation transaction**: A consolidation occurs when two parties combine to create a new parent company with a self-perpetuating board. Consolidation transactions are difficult to execute but typically double the size of the individual partners, quickly achieving scale. This was a very popular structure in the 1990s and has seen a revival post-health reform. *Examples: Advocate Health Care in Chicago, Banner Health in Phoenix, and Sentara Healthcare in Virginia.*
- **Membership substitution**: A membership substitution is the most common structure between merging non-profit hospital systems. The seller transfers its membership to the non-profit acquirer, which becomes the new "owner." The structure is used in non-profit transactions where the seller wants its corporate structure to remain intact post-closing, or the buyer wants to assume, rather than retire, the liabilities. *Example: Meriter Health System joining UnityPoint Health.*
- **Asset sale**: The typical structure for an investor-owned acquisition of a non-profit. The buyer acquires the assets (working capital, fixed assets, intangibles) and excludes most liabilities, which the seller then retires. Remaining funds are used to establish a local community foundation that can be used for various charitable purposes, including promotion of healthcare in the community. *Examples: Sale of Marquette General Health System to Duke LifePoint and sale of Guthrie Medical Center to Mercy Health.*

Note: For a more in-depth look at the various structures, see Jordan Shields and Rex Burgdorfer, "The Expanding Range of Strategic Alternatives in Hospital System Mergers and Acquisitions," *BoardRoom Press* Special Section, Vol. 25, No. 4, The Governance Institute, August 2014.

Conclusion

Hospitals and health systems across the nation are faced with challenges unlike ever before. We have provided here a brief overview of the advantages that many hospitals are finding in joint ventures and other affiliations. In our next articles, we will further discuss how a hospital board should go about developing a joint venture and other models, the trends we're seeing, and what we predict to occur in the months and years to come.

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