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Acquisition Currencies in Non-Profit Hospital M&A

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This is the first article in a series that Juniper is publishing with The Governance Institute in 2018. We plan to analyze a specific topic that relates to M&A transactions each quarter. For each topic, we will describe how it was addressed in similar transactions in other industries and provide commentary to fit that same topic into conditions in the current healthcare market. An example would be considering the relationship of the macro-credit environment and the for-profit industry's challenges, and highlighting new opportunities this presents to non-profit hospitals.

In December 2017, we suggested that the vast majority of health systems appear to be considering strategic alternatives (i.e., arrangements that result in change of ownership and control).[1] We also noted that the pace, and nature, of change will likely accelerate. Further, M&A strategies (whether via growth or divestiture) at non-profit systems are becoming more offensive, rather than defensive, and are occupying a larger role within overall corporate considerations. These are important considerations because the proportion of business combinations in which the acquirer is a non-profit has increased dramatically in the last eight years. Healthcare reform and the exigent need for scale are the primary causes. Certainly, the travails of investor-owned segment have also contributed to this shift.

Key Board Takeaways

The majority of hospitals and health systems are exploring strategic alternatives involving M&A. As independent hospital boards contemplate forming partnerships, they should:

- Think through what organizations are potential partners for the hospital. Currently, most M&A transactions are occurring between two non-profit partners.
- Consider if an M&A transaction is right for their organization. The market is placing increasing importance on the "value" of these transactions, but that will vary based on several factors, including the hospital's market, structure, and location.
- Ensure the board understands the various "currency" options that are exchanged between parties. These are increasing in number and becoming more creative.
- Look to industries outside of healthcare for M&A best practices. There is significant prescience (30 years' worth) from other industries in the corporate world.

This article focuses on acquisition "currency" in M&A transactions involving non-profit hospitals. We note how health systems will likely "pay" for their newfound acquisition appetite, and review techniques that are being utilized. The potential for an increased pace of change is focusing greater attention on the terms, conditions, and value exchanged (financial and otherwise) in business combinations.

[1] Rex Burgdorfer, "A Year of Change for Community Hospitals," *Hospital Focus*, The Governance Institute, December 2017.

Regulators are placing a heightened emphasis on "fairness" and "thoroughness" in board decision-making processes. Historically, there was a large divide in the approach taken by for-profit companies, non-profit systems, and independent hospitals. Those differences have narrowed substantially.

Note that many "currencies" in non-profit business combinations are non-financial in nature. Below is a list of transaction features to which value is often ascribed by non-profit sellers in M&A transactions:

1. Debt obligations of seller assumed by buyer
2. Capital commitments—typically over a 10-year horizon, including both routine and strategic projects
3. Local input and control retained by seller via board seats on parent board
4. Retention of certain rights by seller over local operations
5. Board composition and mechanisms for local input
6. Creation of enforcement bodies to ensure compliance with terms
7. Mission, vision, and values continued by buyer
8. Commitments to religious or related ethical directives by buyer
9. Retention of existing charity care policies
10. Continued sponsorship and involvement in local community functions
11. Flexibility to use local contractors and vendors, when appropriate
12. Assurance that bequests, gifts, and donations are utilized for original intent
13. Balance sheet housed locally; financial assets not to be swept to buyer
14. Enduring use of name and brand
15. Service lines, accreditation status, and the like, uninterrupted
16. Corporate functions enhanced—recruiting, IT, legal, payer negotiations
17. Employees retained and protected

As with many things, history can provide valuable guidance. In the corporate world, business combination structures and conventions proliferated in the 1980s. This decade came to define many customs in the market for corporate control (e.g., Delaware Law, SEC norms, and shareholder oversight). This historical precedent likely presages near-term considerations for business combinations between non-profit hospital companies. Below we quote points from *The Mergers and Acquisitions Handbook*, which was published in 1987; the slow pace of change in the hospital industry makes these themes equally important today:[2]

- *The means of payment used to effect a merger or acquisition is a critical element of the transaction. It may well determine both the ability to complete the acquisition and the success of the business after the transaction has been accomplished.*
- *The value that can be gained by structuring a transaction that is mutually beneficial to both parties is a primary reason why friendly, negotiated transactions generally are favored over hostile means of gaining control.*
- *Whether the acquirer purchases stock ("membership interests") or assets, purchase accounting methods are required under generally accepted accounting principles (GAAP), and all acquired assets and liabilities must be carried at their market values.*
- *Contingent payments usually are structured so that part of a purchase price is contingent on the target's post-acquisition achievement of certain performance goals. It helps bridge the gap when there is a large difference between the bid price and the asking price for a business, and contingent payments provide an excellent means to keep and motivate former owners of a business during the years immediately following an acquisition.*

[2] W. Peter Slusser and Rory Riggs, "Payment Models and Acquisition Currencies," in *The Mergers and Acquisitions Handbook*, Second Edition, eds. Milton L. Rock, Robert H. Rock, Martin Sikora, 1987.

Most health system boards and managements we work with expect hospital mergers and acquisitions to remain a strategic priority. We hope that descriptions of modern, corporate-derived features aide those considering partnership alternatives and that this information can enhance the nimbleness with which non-profits address various transaction techniques. Significantly, non-profits of all types are beginning to utilize these more advanced M&A tools.

Stay tuned for the following topics to be addressed in future articles:
1. Valuing the troubled hospital
2. Fairness opinions and their role in non-profit M&A
3. Regulatory considerations for hospital combinations

The Governance Institute thanks Rex Burgdorfer, Vice President at Juniper Advisory, for contributing this article. He can be reached at rburgdorfer@juniperadvisory.com.

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