Non-Profit Boards and the Merger Market: Preparation, Organization, and Approach

This article is Part 2 of our series on the hospital merger market. Part 1 (October, 2007) discussed hospital industry dynamics that have led to many of the change-of-control ("merger market") transactions in this decade and encouraged non-profit boards to be more proactive in their use of this market.

Two Views: For-Profit vs. Non-Profit

Few, if any, large industries have two major groups with such widely divergent views and approaches to the merger market as the hospital industry. For-profit and non-profit systems approach change-of-control dynamics and transactions in entirely different ways. For-profits view the merger market as an ongoing component of their business; non-profits often approach it in an *ad hoc* manner. This latter view can compromise mission and business interests of the non-profit. *This is particularly true in the current environment, which favors non-profit buyers.* Historically, non-profit boards have focused on operating and local-market issues. Today, however, many non-profits recognize that they are operating in an industry where:

- Change is occurring to the structure of the industry and the complexity of the business has increased dramatically.
- Both for-profit and non-profit companies are participating in this change, but often with different approaches.
- For-profit companies have had a stronger business case for growth, which has resulted in greater use of the merger market.

The difference in perspectives between the two groups is dramatic, but should narrow in the future. Most for-profit companies:

- Seek *growth*
- Are organized to both create and react to opportunities quickly
- Understand the procedural nuances of transactions
- Have small boards with national representation and perspective

Whereas, most non-profit systems:

- Seek strong *credit profiles*
- Are often unprepared to address the merger market
- Often lack experience with the procedural nuances of transactions
- Have larger boards comprised of local leaders

Regardless of whether responding to overtures from for-profit suitors or attempting to grow via acquisition or merger, non-profit boards and CEOs would benefit from reconsidering their approach to the merger market. This is particularly true in light of current conditions that favor non-profit buyers—the credit market crisis and operating environment have caused many for-profits to temporarily reduce their growth objectives.

Outcomes

The merger market holds two meaningful outcomes for non-profit systems—growth of the business and mission, and outright sale and alteration of the mission:

- **Growth:** strong non-profits are currently seeking to secure their futures by developing greater business scale. Much of this growth will, by necessity, result from merger market transactions in the form of acquisitions or mergers. In so doing, these non-profits will often be confronted with competition from for-profit purchasers of hospitals.
- **Foundation:** this occurs when communities seek to "monetize" their investment in the hospital business. In a *conversion,* or sale to a for-profit, the board is electing to exit hospital ownership and enter the healthcare foundation business. This is often accompanied by an objective of greater capital investment in the hospital. For example, the sale of Health Midwest to HCA in 2003 resulted in a commitment of $500 million in capital improvements to the health system and created an $800 million healthcare foundation from the net proceeds of the sale.

Alternatively, affiliations and other non-change-of-control arrangements have less obvious outcomes and a higher rate of failure. These approaches often amount to "feel good" exercises, which consume great amounts of time, result in little benefit, and forestall needed change.

Preparation

Regardless of whether a non-profit system is contemplating growth, a foundation model, or neither, non-profits would be well advised to undertake and document a thoughtful review of their financial and business situation and available strategic financial alternatives—from both a business and legal view. This sort of review has become standard practice for those non-profit systems experiencing financial challenge. Unfortunately, most rarely consider such an effort unless faced with immediate difficulty. As a result, many system boards are consumed with operating detail and local issues, and do not understand the potential impact of external trends on their mission and business.

A comprehensive review of the organization's business, financial, and market circumstance provides a solid basis for developing a meaningful understanding of strategic options—in terms of both operating and ownership alternatives. This sort of approach is central to good decision making and defending against external criticism of any resultant transaction. The review can be done internally or with external assistance. In our experience, every non-profit board should be equipped with knowledge of their value and access to capital, along with an understanding of the impact of structural change, and whether financial challenges are situational or systemic.

Organization

Non-profit systems trail for-profits in being organized to best take advantage of merger market opportunities:

- **Management:** for-profits typically have a development function with dedicated employees. Non-profits often do not, and most relegate this task to a part-time effort by the CFO. While the need for a development department may vary, it is essential that someone within the organization be held accountable for strategy.
- **Boards:** non-profit boards are often large and multi-focused. In our experience, it is best to leave most merger market matters to a stand-

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ing committee—executive, strategic planning—that reports to the full board. Too often, these are created only to react to events; they should be permanent features with a distinct focus on strategy.

Approach

Non-profit management and boards should adjust their approach to the merger market, particularly when attempting to use it to achieve growth. Part of the challenge is organizational, but a shift in approach is often needed. We would suggest that non-profit boards consider the following:

- When looking to the merger market for growth, accept competitive processes as both a business reality and a necessity for sellers. Occasionally, non-profit management teams and boards eschew participation in competitive for-sale processes, even when the target holds strategic importance. These types of processes have become a necessity for sellers in order to satisfy state attorneys general and other critics.
- Taking a more commercial approach to the merger market is essential for future success. As Juniper manages for-sale processes, we are routinely struck by the difficulty non-profits experience in assembling indications of interest in competitive processes. Often, this is as simple as overcoming a tendency to overanalyze at the beginning. Most competitive process include very adequate time for full due diligence—but later in the transaction. At the outset, much detail can be postponed, without being disingenuous, through the use of contingencies. We also often see a lack of understanding of the steps of a transaction and their interrelationships. Boards would be well advised to review this with outside bankers or counsel.

Current merger market conditions favor non-profit consolidators; this is an opportune time for non-profits to achieve strategic objectives. In order to take advantage of this opportunity, non-profit boards and management should reorient their approach to the merger market.

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