The Governance Institute's
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Welcome to The Governance Institute's E-Briefings!

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.

News, Articles, and Updates

Why Are So Many Merger Transactions Failing to Close?

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During the past year, a startlingly-large number of announced merger agreements were terminated. These transaction failures represent a phenomenon that has great significance for many non-profit boards and managements, however, very little notice has been made of them. This article seeks to explore the reasons for these failures and to suggest certain changes in non-profit hospitals' approach to transactions.

By failure, we mean announced merger transactions that are not completed subsequent to the signing of a letter of intent (LOI). The LOI is a short, nonbinding agreement that sets forth the basic business agreement between the principals. It is often accompanied by a public announcement. These agreements are serious undertakings and should only be entered into after both parties have reached agreement on the primary terms, and fully intend to complete the transaction. Well-designed transactions rarely fail to close subsequent to the signing of an LOI. However, we estimate that nearly 25 percent of announced LOIs failed during the past year.

In addition to these failures, the volume of business combination transactions through the first half of 2010 remains unchanged and at the anemic level of the past decade. Taken together, these two factors indicate that the merger market for hospitals is *confused*. Ironically, this confusion is occurring at a time when the hospital industry is the subject of unprecedented speculation regarding the potential for an explosion in the number of business combinations.

Causes of Failure

During the period immediately preceding and following the passage of healthcare reform, hospital leaders gave great consideration to its central economic implication—lower prices and higher costs. Paradoxically, this resulted in the emergence of two new groups of participants in mergers amongst hospitals. Nearly all of the transaction failures of the past 18 months have involved these new participants. In our view, these failures can be traced to two overarching and related factors: new and inexperienced parties to the transactions and poor transaction design.

Over the past decade, most hospital merger transactions involved financially challenged non-profits (for the sake of simplicity, we refer to these as "sellers") entering into change-of-ownership transactions with for-profit companies (similarly, "buyers"). These sellers were typically well-run hospital companies that had experienced difficulty in accessing capital, leading to an obvious need for a partner. At the same time, for-profit buyers had a strong strategic and financial incentive for growth, and considerable experience in completing the acquisition of non-profits. As a result, these motivated sellers and experienced buyers were very successful in completing transactions. Nearly all announced transactions during this period closed successfully. However, the current merger market, with its new participants and high failure rate, greatly differs.

Transaction Participants

Buyers
Historically, regionally prominent 501(c)(3) hospitals and health systems were not acquisitive. Until the past year or so, they rarely expressed interest in considering acquisition opportunities. Logically, this group's mission and capital backing resulted in a focus on its local market. However, healthcare reform has caused many of these large non-profit systems to conclude that greater business scale is critical to future success, and that this can only be accomplished through business combinations.

Nearly all of these newly-acquisitive large non-profit systems are strategically and operationally sophisticated. They lead the industry in understanding the need for consolidation amongst hospitals. However, they are new to the merger and acquisition market and are often inexperienced in their approach to transactions. At Juniper Advisory, LLC, our view is that this group's difficulty in completing transactions relates largely to poor transaction design, as discussed below. In addition, this new group of buyers often seems to not fully appreciate the perspective of the non-profit seller. To be fair, these buyers often must be financially conservative as they consider growth since their only source of capital is the debt market.

Sellers
As mentioned above, during the past decade most non-profit sellers have been motivated by financial issues, usually access to external capital. During this period, most financially strong standalone hospitals and small systems were content to remain independent and only rarely considered the need to be part of larger systems of care. However, with the arrival of healthcare reform, this, too, has changed. A growing number of *proactively*-motivated sellers have perceived the need for scale, but most concluded that they would not be able to lead consolidation (i.e., to be a buyer). These sellers have the strategic insight to consider a transaction, however, their boards often lack the urgency associated with non-profit sellers during the past decade. As a result, they often enter into discussions regarding business combinations with limited resolve.

Design Failure

Well-designed transactions that reach the LOI-stage rarely fail to close. In addition to the presence of new buyers and sellers, we believe the recent high rate of transaction failures is attributable to flawed transaction design. By this, we mean the sequencing of steps in the transaction process. Two factors are of particular importance.

First, in recent press reports, certain sellers implied that they are conducting their due diligence investigation during the period of time between the LOI and the definitive agreement (DA). This is an error, and often leads to difficulty for the seller. The seller's due diligence, which determines whether they are happy with the buyer, should be completed *before* entering into an LOI. Secondly, many buyers indicate that they are focusing on financial issues (e.g., capital expenditure needs) *after* signing the LOI. This, too, is an error. The buyer's due diligence (i.e., between LOI and DA) should be *confirmatory*, not exploratory.

Adding further to the confusion, buyers and sellers are both utilizing euphemisms to describe various aspects of the transactions. Recently, a press release written by a seller upon signing a definitive agreement said, "After almost five months of research and discovery, the partnership is now official." That reflects poor transaction design in at least two ways. The period between an LOI and a DA should not be about "discovery," but rather *confirmation* of information shared before signing the LOI. Also, to refer to an outright sale (*via* asset merger) as a "partnership" obfuscates reality. In another release, upon signing an LOI, the seller noted that they had "signed a nonbinding agreement to study a possible merger scenario." That "study" should have been completed before signing an LOI.

These transaction failures are injurious to both parties. They immediately damage the seller as a result of dashed expectations. Also, the reputation of the buyer *vis-à-vis* future transactions is likely to be impaired. In several recent cases, CEO's have lost their positions over these types of transaction errors.

Conclusion

In order for the hospital industry to be more efficient and to improve its access to capital, larger hospital companies are needed. Logically, many of these companies should be built by large 501(c)(3) organizations and for-profit companies. To be successful, large 501(c)(3) buyers must develop an improved understanding of both transaction design and the perspective of sellers. They need to be more flexible and commercially competitive regarding consideration, structures, and governance. Similarly, proactive non-profit sellers need to become more adept at understanding proper transaction design, and need to carefully adhere to their obligation to the corporation. Ultimately, we believe industry participants should be under no delusion that there will be a quick resolution to this confusion. Consolidation is likely to be slower than many predict.

The Governance Institute thanks James Burgdorfer for contributing this article. He can be reached at JBurgdorfer@JuniperAdvisory.com.