

Multi-State Health Systems: On Their Way at Last

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Five years ago, we wrote an article for The Governance Institute predicting that there would be an increasing number of health system mergers across state lines, creating new multi-state, super-regional systems that would have the benefits of scale, and not just size.¹ We pointed out that there were at that time only about five non-profit, non-Catholic systems formed in that way, and detailed the historical impediments to such developments. The systems we identified as meeting these criteria were Banner Health, Carolinas HealthCare System, Essentia Health, Mayo Clinic Health System, and Sanford Health.

We boldly predicted there would soon be many more cross-border combinations across the country—using the term “soon” advisedly, as change is usually slow in such a fragmented, conservative, and highly regulated industry. There have been few such transactions in this period; however, the conditions are increasingly ripe for these deals. In this article, we describe why this is the case, and double down on our prediction that such combinations will in fact begin to occur—soon.

Thar She Blows! A Textbook Example of This Trend

The recently completed combination of Advocate Health Care of Chicago and Aurora Health Care of Milwaukee is an example of this kind of transaction. They are of almost equal size, serve contiguous geographies, and have complementary areas of expertise. These systems also will gain size, but probably remain below the threshold where size becomes counterproductive.

The combined company will provide others contemplating such tie-ups with a number of criteria to consider when evaluating, negotiating, and structuring similar combinations. The key elements are:

- It is a “good-to-good” combination. The majority of transactions continue to involve a larger, stronger system taking on a smaller individual hospital or system. The “seller” typically has challenges of financial performance, capital access, or cost structure. Both Aurora and Advocate are successful, reasonably large regional systems with good positions in their

markets. It is a more appealing task to make strong organizations stronger than to forge a turn-around of one of the partners.

- The “industrial logic” is strong. The service areas are not only directly contiguous, but are converging economically. As more businesses and residents move out of Illinois into southern Wisconsin, a health system that can cover both areas should find significant growth. In addition, both organizations are committed to physician integration, population health, and risk-bearing, so there is strong strategic alignment.
- They “punted” on just enough social issues. The key impediment to combinations such as this are the social issues of management control and board composition. Many such discussions fail to gain traction over who gets to be CEO and the number of board seats each organization will fill. In this case, the parties agreed to co-CEOs, dual headquarters, equal board seats, and rotating chairmanships. None of these “fudges” is efficient, or long term, but they help to “get the deal done,” which makes business sense.

Why Haven't There Been More?

There are a number of reasons why this multi-state trend has been slower to take off than expected. One, as mentioned above, is simply the nature of the industry: fragmented, conservative, and highly regulated. Many attorneys general remain concerned about the possibility of charitable assets being moved or controlled by an out-of-state entity, and the social issues of management and control remain as potent as ever.

This is in a context of the overall number of transactions being down somewhat from its recent peak in 2015. While activity is still brisk, the individual hospital market is presently tilted toward systems filling out local markets with acquisitions or sellers with financial challenges or capital needs.

There are several reasons that transaction activity has declined among individual hospitals:

- Margins are up. While it is somewhat challenging to identify a large number of

Key Board Takeaways

Boards of healthcare organizations considering multi-state partnerships can take the following steps:

- Assess your own situation to see what you need and what you have to offer. By defining your strengths, needs, and objectives as clearly as possible, you will be in the best position to initiate conversations with others.
- Assess potential partners to get an idea of how well they might meet your needs, and whether their culture might be compatible with yours.
- Determine and quantify the benefits of the combination. If they are significant, and achievable, this will inform the structure and your negotiating approach to the relationship.
- If you identify a potential “good-to-good” partnership, be prepared for an atypical negotiation. Whereas in most transactions it is imperative to agree on many details before closing, in these it may be better to “fudge” some things to finalize the deal.

individual hospitals that are more profitable than they were a few years ago, aggregate figures indicate that the average operating margin of hospitals has increased slightly over the past several years. This is primarily due to reduced bad debt thanks to Medicaid expansion. With less imminent financial distress, individual hospitals are less likely to need to find a partner.

- There are fewer buyers. Consolidation among investor-owned systems as well as Catholic systems have occupied their time and resources, as well as reducing the number of buyers.
- Turnarounds are harder. It is becoming easier and faster for a hospital to fail. Losing a key contract, a sudden change in reimbursement, or similar events have led to discontinuous drops in performance, and systems are increasingly unwilling to take on these situations.
- Many geographic markets have become largely consolidated.

Future Growth of Multi-State Transactions

The patterns above, which tend to depress partnering of individual hospitals, should accelerate the trend of system-to-system consolidation. As mid-size systems seek growth and meaningful scale, the most effective way to achieve this will

1 Barry Sagraves, “Multi-State Non-Profit Health Systems: Why There Are Not More, but Soon Will Be,” E-Briefings, The Governance Institute, September 2013.

be system combinations, and these will include those across state lines.

The overall industry drivers will only intensify. The limits of Medicaid expansion are in sight as funding responsibility shifts back to the states, changes toward population health, and increasing competition from disruptors (e.g., CVS-Aetna, Berkshire/JPMorgan Chase/Amazon) will maintain pressure to reduce costs as well as develop new capabilities and business models. Finally, as individual markets reach a consolidated equilibrium, further growth will have to come from combining with organizations in other, preferably contiguous, markets.

Most of the system mergers to date have arguably been more about size than scale. *Size* connotes the ability to buy in bulk, to centralize some functions and spread overhead. *Scale* adds the ability to operate more effectively as well as efficiently, improving

an organization's ability to execute as the industry changes. This might be by combining skills or relevant markets that provide additional strategic or financial value. A number of studies have indicated that there is significant additional value created by the integration of partners over and above that derived from merely combining.

So, why will there be more multi-state mergers? To paraphrase the bank robber Willie Sutton, that's where the partners are. In many states, either the partners have consolidated or the remaining mergers would face antitrust issues. Thus, the availability of partners and the ability to gain approval will drive systems to look across state lines. The prime markets for this type of activity probably divide into two types: metropolitan areas spanning state lines and rural states where dominant systems either within or contiguous to would find scale benefits in addition to size alone.

Conclusion

Systems looking for significant growth will need to look at a range of transaction strategies. Adding additional hospitals, groups of physicians, and new services will generally be the basis of growth. But they should also consider whether there is a partner a bit further afield that might be able to help them vault to the next level of effectiveness and success.

We believe that the formation of Advocate Aurora Health Care is indicative of a trend that will accelerate in the coming years. There may be a similar opportunity—or competitor—coming to your market, you guessed it, “soon.” ●

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