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Health System Growth Strategies: Considerations for Buying vs. Building Assets

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Recent market disruptions in the hospital industry make precise capital planning for growth initiatives important for a health system's overall strategic vision. Finding a balance between service line diversification and expansion, while maintaining sound financial results is crucial when performing a buy vs. build analysis (weighing the pros and cons of building new facilities versus acquiring existing ones). This has become even more meaningful after the COVID-19 pandemic caused a wave of operational challenges for management teams, including patient volume degradation, labor expense escalation, and supply chain disruption. Some organizations have dealt with these issues better than others and have gradually recovered to pre-pandemic financial performance. However, even large, well-capitalized health systems with strong credit ratings have sharpened their focus on making informed decisions around potential transactions while addressing operating pressures.

The buy vs. build analysis is an important consideration in the current M&A environment as there are several reasons why the economics for new construction may prove less favorable. This article highlights some of the main factors driving this to help boards and management teams assess potential acquisitions and whether new campuses or partnerships might be a better path towards growth.

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Construction Risk

The pandemic demonstrated that large shocks to the U.S. economy could occur unexpectedly and have profound impacts on a health system's operations and debt

capacity for new construction. The most significant effects include supply chain disruption and potential construction delays if there are worker shortages or restrictions imposed on the labor force's ability to carry out job responsibilities. While building costs have come down from their March 2022 peak, they are still up roughly 37 percent compared to the pre-pandemic economy, putting a strain on day-to-day operations and the financial feasibility of new development projects.[1]

Furthermore, the high fixed costs associated with hospital organizations make them susceptible to large increases in supply expenses, which also impact the price tag for new construction. Recent data from Gordian indicates that the cost per square foot for hospital projects has risen by more than 6 percent between 2023–2024.[2] Those costs have also escalated more than 20 percent in the last five years. The lingering impacts of the pandemic are driving these increases; supply chain disruption has somewhat subsided, but materials costs are still showing 7–10 percent year-over-year increases.[3] HVAC materials are the largest proportion of the cost per square foot for hospital buildings, which is not surprising given there are significant energy needs for their operations. The financial risk associated with building new facilities is thus pronounced given the uncertainty of another macroeconomic event like the COVID-19 pandemic and the protracted operational issues facing management teams.

The State of the Capital Markets

Expensive capital structures have prompted organizations to revisit the prospect of acquiring existing assets as an alternative to building new ones. As mentioned in an article by Juniper Advisory and McGuireWoods, "Increased borrowing costs could significantly impact the return on investment necessary to justify strategic and major capital projects while diluting operating income."[4] In other words, the financial return for building new facilities is less attainable in today's capital markets. Operators benefitted from over a decade of cheaply priced bond issues and commercial loans to finance new projects, making the payback period manageable for new facilities. Creditor appetite to fund new construction has also dwindled; lenders are generally skittish after recent banking crises and business challenges at hospitals make them hesitant to invest in new construction projects.

To provide some context, in January 2021, the five-year swap rate (a typical benchmark for new construction capital) was roughly 0.50 percent but, by April 2024, increased to 4.37 percent. Keeping credit spreads the same at 2.50 percent, the all-in cost of borrowing in April 2024 was about 6.87 percent, which is over seven times January 2021 levels.[5] Borrowers would thus need to reduce the principal amount of their loan in today's

1 "Producer Price Index by Industry: Building Material and Supplies Dealers," U.S. Bureau of Labor Statistics.
2 Gordian, "Healthcare Construction Costs for 2023," *Building Design + Construction*, April 13, 2023.
3 Sam Giffin, "Hospital Construction Costs Increase," *Health Facilities Management*, January 28, 2024.
4 Adam Davis, et al., "Is your Health System Team Ready for What's Next? A Recession or More Malaise?, Juniper Advisory, August 8, 2023.
5 *Ibid.*

market by about 20 percent to have the same level of debt service as they would under 2021 market conditions, which causes a capital shortfall.[6] This 20 percent gap is often filled with cash contributions (not-for-profit hospitals would most likely explore that option given their excess reserves and inability to issue stock) or from an external equity source, which is a costly and difficult to obtain source of financing for for-profit operators. The combination of higher interest rates and costs of construction has therefore significantly changed capital stack compositions. Borrowers need more proceeds to complete projects due to elevated construction costs, but high interest rates and diminished creditor appetite reduce capital availability. In 2021, capital stacks comprised roughly a 90-10 debt-to-cash and/or investor equity split, but today's market conditions dictate 60-40 or 50-50 splits to finance a project.

Another byproduct of the disruptions created by the pandemic is that capitalization ("cap") rates for hospitals are more volatile than in prior years. The risk profile of hospital investments is elevated due to the uncertainty of a health system's ability to generate adequate operating cash flows to repay investors. Because of this increased risk, the "going-in" cap rate for investors might vary significantly from their exit cap rate, making it difficult to accurately assess the rate of return at the end of the investment period. To compensate for the higher credit risk, lender covenants are stricter and loan-to-value requirements are lower than in previous years.

Land Scarcity and Geographic Premiums

Markets that have strong growth but require additional healthcare services have scarce real estate for new buildings and therefore are built at significant cost premiums. As a result, operators might consider expanding into certain areas to ensure better access to care by acquiring existing assets and reinvesting in them, instead of developing new ones. However, the financial features of such a project could warrant transaction multiples of revenue or EBITDA above typical market medians. The balancing act is therefore to arrive at feasible financial terms that reflect the higher purchase price driven by land scarcity and market desirability, but also ensure the financial benefits outweigh the cost and risk of new construction. Below we discuss recent health system transactions that serve as good examples of the buy vs. build analysis.

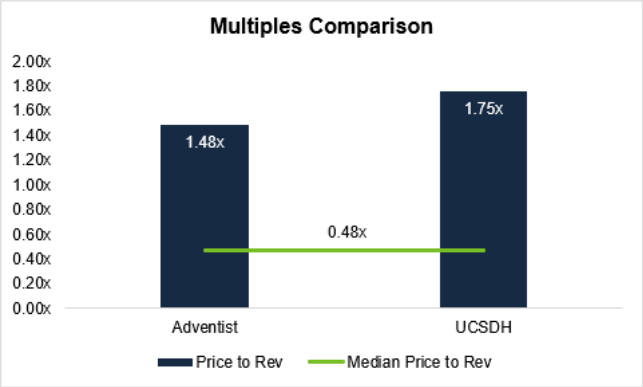
Precedent Transactions

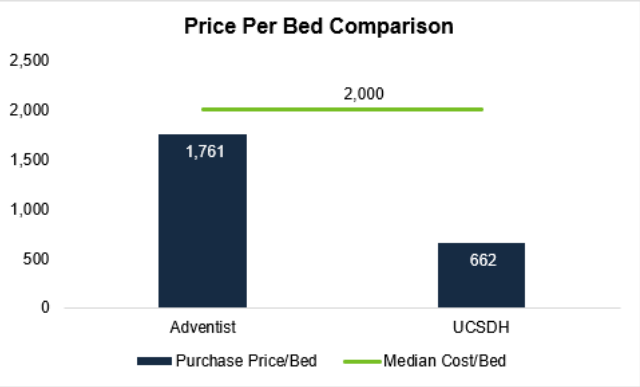
On December 11, 2023, UC San Diego Health (UCSDH) completed the purchase of 302-bed Alvarado Hospital Medical Center (AHMC) from Prime Healthcare. UCSDH's expanding market has robust, increasing healthcare needs, particularly for behavioral

6 Based on Juniper and Blue Owl estimates.

health. The bustling San Diego metro area is also short on bed capacity, which presents a challenge for providers and residents seeking high-quality and accessible care. UCSDH needed to broaden its services with new facilities and add beds at its campuses to meet growing demand, but constructing new campuses would be costly and time intensive. Patty Maysent, CEO of UCSDH, told the *San Diego Union-Tribune* that the $200-million purchase price for the facility is a "massive" cost difference from building a new one. In fact, according to a recent article written by *Scripps in the News*, the cost to build new beds in San Diego is roughly double the national average.[7]

Other similar recent transactions include Novant Health's acquisition of three hospitals from Tenet Healthcare in South Carolina and Adventist Health's purchase of two hospitals from Tenet in California. Like the UCSDH acquisition, Novant and Adventist recognized opportunities to expand in growing areas with strong demand for services, which ultimately drove above-market transaction multiples for each transaction. Below is a visual representation of the UCSDH and Adventist transactions compared to market medians; Novant was not included due to the exceptional nature of the acquiror's purchase price, which we discuss later in this piece.





The two examples above resulted in transaction multiples well above the median revenue multiple over the last five years of 0.48x.[8] However, it typically costs roughly $2 million per bed to build a new hospital in a desirable market, and so Adventist's and UCSDH's recent acquisitions indicate the acquisition prices were at a discount to new construction costs. Simultaneously, divesting companies obtained favorable transaction terms at very high multiples of revenue, indicating the economic terms of the transaction made good sense for all parties. The Novant acquisition is a significant outlier; price to revenue was about 4.35x and cost per bed approximately $8,500, which are well above thresholds shown in the previous charts. Novant's high purchase price was driven by similar market dynamics that existed for the UCSDH and Adventist acquisitions; Hilton Head Hospital, for example, has a unique, desirable location and has sparse real estate to build new facilities,

7 "The High Cost of Building California Hospitals," *Scripps in the News*, April 18, 2023.

8 Scope Research.

prompting high transaction premiums. In addition, the three hospitals were profitable, further driving up the purchase price.

Key Board Takeaways

- **Objective setting for growth:** Board leadership and management should have a clear set of objectives and goals when assessing growth strategies. Clear purpose will help to inform what opportunities exist in the market and prepare key stakeholders to analyze the merits of acquiring or constructing facilities.
- **Navigating operating challenges:** The buy vs. build analysis is more important in today's environment because hospital operations are increasingly challenging. Health systems remain aspirational to broaden their services and increase scale, but deeper diligence is required when assessing opportunities for growth. It is therefore necessary to ensure success for the operations of a system's current physical plant but simultaneously evaluate forward-looking results when integrating or building new facilities.
- **Assessing risk:** Decision making by management teams and board members requires an ongoing assessment of risk. For over a decade, the capital markets offered very favorable interest rates to fund new projects. These low costs of capital were available in a low-inflation environment, making the cost of construction affordable for hospitals. Those days are behind us, which makes these projects more expensive and less attractive, and therefore riskier. Boards need to examine whether the risk of new construction outweighs the price paid for existing facilities. Acquisition premiums, even in very favorable markets, might be worth absorbing versus paying for expensive construction materials, borrowing at high interest rates, and managing project execution risk.

Concluding Thoughts

The importance of assessing buying vs. building is greater now than before the pandemic. Health systems used to aim for a 3 percent operating margin but are more realistically targeting breakeven operations. The 3 percent threshold was the former "golden rule" allowing organizations to generate enough profit to cover debt service, pay vendors, and have some cash leftover for a rainy day or future capital needs. Given many of the adverse factors resulting from the pandemic discussed above, that 3 percent target is much harder to attain. Therefore, lower excess cash flow from operations has prompted organizations

to be more precise when considering new construction versus acquisitions. The cost and lower availability of debt coupled with operating expense escalation in recent years hamper a health system's ability to construct new facilities from their own balance sheets, particularly in dense, growing markets like Southern California and Coastal Carolina. For the foreseeable future, hospitals will continue to grapple with increased rates as long as inflation remains elevated and deal with many lingering operating disruptions from the pandemic. Until these challenges subside, new construction will be less attractive than in previous years. Depending on market conditions, acquisitions paid at outsized multiples might be the more affordable option compared to the price tag for new construction. Management teams and boards will need to have diligent capital plans to properly weigh the pros and cons in a buy vs. build analysis.

TGI thanks Adam Davis, Vice President, Juniper Advisory, for contributing this article. He can be reached at adavis@juniperadvisory.com.