Introduction | The Merger and Acquisition Path to Consolidation

This is the INTRODUCTION from HealthLeaders Media Breakthroughs: Hospital Merger and Acquisition Strategies

In collaboration with PRICEWATERHOUSECOOPERS
The Merger and Acquisition Path to Consolidation

Hospitals and health systems have been through upward cycles of merger and acquisition activity before, but always when there was a change in the underlying business fundamentals of the industry that made getting bigger a more rewarding option. When health plans started to get the upper hand in contracting two decades ago, hospitals and health systems merged to bring a heftier threat to the bargaining table. Hospitals eagerly purchased physician practices, and sold them just as quickly, in the rush toward integration in the late 1990s.
The fundamental reasons behind a hospital system’s desire to grow big remain as strong as ever—the need to spread fixed costs for technology and administration over a larger revenue base, strengthen weaknesses in market penetration, and add key service lines and physicians. Added to that imperative is a new set of directives pushing hospitals and health systems to begin to assemble the pieces they will need for a business built on value and not volume. If, as the predictions portend, hospitals and physicians will be compensated by bundled payments for episodes of care, be put in the hub of medical homes, or carry the risk and accountability for care, then that is incentive enough for some to buy now and get paid later.

Adding to the dynamic are physicians in large and small groups. Once emboldened to strike out on their own by reduced costs of technology and favorable payer rates that rewarded them for their independence, physicians are now saddled by investment demands for more information technology and have seen their rates for office procedures fall to the earth. Those primary and specialty physicians seeking shelter at the hospital may find hospitals being very selective. Terms will be largely dictated by the hospitals and built around a flexibility of options not necessarily exclusive to full employment.

For those health systems that are large and getting larger, the push to merge and acquire is to build a foundation for the coming healthcare business climate. Paul Wiles, CEO of North Carolina–based Novant Health, with 12 hospitals and more than 3,000 beds in four states, predicts that hospitals “are in a long-term stress period.”

“It will take very different strategies to be successful,” Wiles says. “We’re all going to be working on trying to achieve superior outcomes, and do it in a more affordable way than we had in the past. Integration, size, and scale matter. Somebody’s going to disagree with me, but for my purposes scale matters, and it gives you a better chance of succeeding in distressed times than not doing it that way.”

Own or rent

If there is one primary philosophical split that will separate even those health systems that are growing, it will be in the question of whether to purchase those assets they need to deliver a broader continuum of services or to partner with groups or companies already expert in noncore services. Michael Dowling, president and CEO of North Shore-LIJ Health System, is not only adding hospital bed space—for example, with the 2010 merger with Lenox Hill Hospital in Manhattan—but is purchasing a healthcare continuum shopping bag of items ranging from home health to a new medical school. “I believe very, very strongly that the biggest challenge going forward is figuring out a way how to change the delivery of care so that the care is not more care than the patient needs, and it’s coordinated with great quality and service,” Dowling says. “You have to have all pieces of the delivery system working together or that statement is impossible.”

Novant’s Wiles says his system has adopted a philosophy to concentrate on areas of care “where physicians are integral and intimate to the process.” Novant does not want to capitalize a home health or long-term care business, so it will instead “find partners to work with that we can get comfortable with to deliver a high-quality, efficient product.”
Bayhealth, Inc., a small hospital system that was formed in 1997 to merge two Delaware competitors, has eschewed the ownership growth model since the organization’s initial merger that brought together Milford Memorial Hospital and Kent General Hospital. Instead, its leadership team has focused on adding prestigious clinical and business affiliation agreements with a world-class academic medical center in the University of Pennsylvania Medical Center.

Through partnerships in cancer, heart, and other clinical service lines, the system’s leadership feels it has bolstered its status locally as a place for complex care that boasts the clinical expertise of the largest big-city hospital.

“That’s what makes it different than affiliations that sometimes take place between institutions that are very similar, but don’t really bring a lot of different stuff to the table,” says Dennis Klima, then president at Kent General and now president of Bayhealth. “In our case, we were looking for certain things from Penn, and they were looking for certain things from us. That created the win-win opportunity. On top of that, we were convinced the cultures blended well.”

New growth

Traditional hospital merger activity that grows market share in a health system’s primary area is still a driver, but with a more selective view than just a grab for beds. Chances are the targets for acquisition are losing money and may have suffered years of physician defection and poor infrastructure investment, says Dowling. “They may have infrastructure that is so bad that you’d never be able to fully fix it, so you’ve got to be strategic on this. It’s not just saying, ‘Well, here is a stand-alone hospital, I’m going to go after it.’ We’ve never done that.”

* 2009–2011 market basket figures are forecasted
Source: Centers for Medicare and Medicaid Services (CMS)—Market Basket Data; CMS 1406-F FFY 2010 Final Rule (pg. 379)
Baylor Health Care System has a hybrid approach that blends “green field” builds in key areas of the 10-county Dallas-Fort Worth metroplex with selective inpatient hospital bed acquisition and an aggressive ambulatory strategy. For Baylor, growth is the key to keep up with projected population booms that could double the area population in the next 15 years, says CEO Joel Allison. “It’s not just about playing in that space just because we want to go bigger,” Allison says. “We want to be the best and we want to be able to meet the needs of communities and serve all areas of our metroplex.”

Novant’s Wiles is convinced that growth offers his organization many benefits along the patient care spectrum, not just economies of scale, which are generally the most often cited reasons for a merger or acquisition. “Growth enhances our ability to be a high-performing organization,” he says. “We learn from new people coming in. It’s not growth for growth’s sake.” Growth, says Wiles, at least for Novant, is at the heart of improving patient outcomes. Novant has defined “superior outcomes” as achieving the goal of recording at least 75% of CMS quality indicators at or above the 90th percentile in Novant hospitals. “The core is superior outcomes, and we think the growth part is a method or a tool to attain superior outcomes,” he says.

### The physician

In the rush to lock up key physicians, many hospitals may look to the security and comfort of full employment or practice acquisition as a way to secure the long-term commitment and guarantee physician participation on system quality initiatives. For Baylor, employment is just one option of many that are offered, says Michael Taylor, Baylor’s senior vice president of operations.

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Paul Wiles, CEO, Novant Health

“Physicians aren’t any different than the rest of us in that they prefer choice,” he says, which could include employment, joint ventures, partnerships, or leadership arrangements. But once in the fold, physicians, regardless of their structure with the health system, “have the responsibility to meet the quality criteria and participate actively in what we call the ‘service excellence, patient satisfaction’ perspective.”

Bayhealth’s ability to attract clinical expertise has been bolstered by its 1997 merger and its aggressive partnership efforts. Klima says the merger allowed Bayhealth to garner the critical mass to be comfortable offering more sophisticated services, “like cardiac surgery and cardiac cath services that were above and beyond what we otherwise could have done.”
In the second quarter of 2010, for example, 111 healthcare provider M&A deals were announced; this is a 26% increase in deal activity over the same period in 2009, according to the most recent quarterly healthcare M&A report from Irving Levin Associates. As health reform was working its way through Congress, the industry saw a huge surge in activity coming from the hospital sector.

Both waves of consolidation were sparked, in part, by health reform. While President Clinton’s health reform proposals were unsuccessful, the threat of passage did change the market. Hospitals and health plans sought significant and rapid growth through M&A to bulk up their negotiating clout with each other. Many of the moves were defensive and some failed to live up to promised efficiency gains, leaving a bitter taste for stakeholders. The experience offers lessons for today’s organizations.

But don’t count on the next round of consolidations to be a repeat of the past. Healthcare organizations now realize they can take a more
Introduction | The Driving Force Behind the Next Wave of Healthcare M&A

A strategic approach to M&A decision-making and view it as a key part of their growth strategy. While segments of the new health reform law are prompting them to look at broader and deeper integration, their actions are also guided by a desire to preserve their mission of care to patients and communities served, balancing their need to cut costs with efforts to improve quality and access.

Though many of the provisions of health reform don’t take effect until 2014, healthcare organizations already are developing new business models in anticipation of the changes ahead. A recent Mergermarket survey of healthcare investors found that a large majority of respondents (83%) believe health reform will trigger consolidation among both healthcare providers and payers and 75% expect it will trigger consolidation among healthcare services companies, particularly technology-focused healthcare firms including electronic medical record companies.²

Hospitals need to make massive capital investments in new medical and information technology. They need to expand or upgrade existing facilities to meet growing demand, comply with more stringent regulatory requirements, and differentiate themselves through services, quality measures, and customer satisfaction. It’s becoming increasingly apparent that hospitals need to do more with less, and that success will

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PHYSICIANS INVOLVED IN Mergers and Acquisitions (Cumulative) 2007-2010

Source: Irving Levin Associates
Introduction | The Driving Force Behind the Next Wave of Healthcare M&A

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BETWEEN THE LINES

75% of healthcare investors expect it will trigger consolidation among healthcare services companies, particularly technology-focused healthcare firms.

require a higher level of collaboration, which, for many, involves a strategic merger or acquisition.

We are talking with many hospitals that want to align with hospitals or health systems of equal or greater financial strength. They may be seeking a partner more advanced in IT infrastructure or one that can fill a service line gap. They may have opportunity to strengthen their presence locally or to expand their geographic footprint regionally, nationally, or internationally.

Increasingly, hospitals are looking beyond the hospital sector for partners in other health sectors or among emerging new market participants as they begin positioning themselves for the breadth and scale needed to be an accountable care organization.

Organizations should approach mergers, acquisitions, and divestitures cautiously, negotiate carefully, and develop integration or exit plans proactively.

The details are numerous and extremely complex: balancing capital needs, governance structures, and cultures; performing the appropriate financial, tax, human resources, systems, and operational due diligence; and completing the necessary regulatory filing requirements.

Healthcare organizations need to begin by weighing their options for how they will continue to fulfill their mission of care five or 10 years from now. Assess up front whether a particular merger, acquisition, or divestiture is financially, operationally, and culturally advantageous to the organization and the community. If a deal makes sense, recognize that mutually advantageous dealmaking in today’s environment

7 STRATEGIES FOR SUCCESSFUL DEALMAKING

1. Manage diligence and integration in lockstep: An integrated process for due diligence and integration can help a healthcare system better identify issues and opportunities.

2. Envision and plan for Day One: Focus on operational details for the newly combined organization and establish executive leadership both for the deal itself and for the organization going forward. This includes defining the span of control, responsibility and accountability, and reporting relationships.

3. Aspire to excellence in deal communications: How health systems communicate about a deal, both internally and externally, matters. Plans should include the deal announcement, integration process, and people plans.

4. Prioritize initiatives for maximum impact: Focus on projects that either generate incremental revenue or drive down cost.

5. Establish an integration management office: Develop rigorous program management and realistic timelines under a central governance structure and a methodology driving the integration.

6. Execute quickly and methodically: Health systems should consider all areas touched by the transformation and engage the various stakeholders such as physicians, human resources, finance, information technology, operations, and legal.

7. Put people issues first: People should understand where they fit, what they are being asked to do, and how their work is associated with the value they provide every day.
requires increased due diligence by both buyer and seller and simultaneous attention to integrate operations.

The first 100 days of integration are the most crucial, and planning a comprehensive integration strategy well in advance of Legal Day One is key, with consideration given to questions such as:

- What will the combined organization look like?
- What will its governance and leadership structure be?
- How will the overall integration strategy impact each functional area?
- Who will be the transitional leaders of each functional work stream?
- Are the right resources in the right places to support integration planning and execution?
- How will the overall integration strategy translate into operational details?
- What will be the one-time and run-rate costs, and what synergy assumptions are built into the deal model?
- When and where will the early synergy opportunities be found?

At the same time, the organization's strategic leadership must pay particular attention in answering these important questions:

- What are the 20% of mission-critical actions that will drive 80% of the value in the new organization?
- Who are the people focused on those critical areas?
- Do they understand their roles and responsibilities?

In all business combinations, effective and timely communications with key stakeholders is of utmost importance. This ongoing dialogue is imperative in healthcare, a business that touches people when they are most vulnerable. A patient's point of contact to the organization, whether it is with a doctor, nurse, billing staffer, cafeteria worker, or housekeeper, should not be negatively affected by lack of communication during a merger or acquisition. Mergers and acquisitions should be part of every provider's growth strategy. However, healthcare organizations must proceed with caution and have a disciplined deal process, an experienced transaction team, a robust due diligence process, and a well-thought integration and communications plan.

Steven Elek III, Partner, Health Industries Transaction Services, PricewaterhouseCoopers

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