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HEALTHCARE MANAGEMENT ADVISORS

Blog Series: No. 3 - Taking a Look at a Deal in Depth

Anatomy of a Deal: The Art of Negotiating a Deal in Healthcare M&A

Daniel M. Grauman, Managing Director & CEO **Scott Stuecher**, Manager

So you've made it through the request for proposals (RFP) process, an ordeal that can amount to a great deal of (usually digital) paperwork and a series of check-the-box demands, with little, if any, one-to-one discussion with the issuer. Now comes the interesting part: discussions between the healthcare organization that is seeking a partner, and two or three carefully chosen suitors.

In our previous posts in this series, we described the factors that have led Independent Hospital X (IHX), a fictional independent hospital inspired by real events, to seek a partner. We've also shared the reasons why Regional Health System (RHS), a not-for-profit system, might benefit from a partnership with IHX—namely, to prevent a competitor from taking over, which could threaten RHS's strategic ambitions and long-term future success.

Now, IHX and RHS must explore: What might partnership look like, and what will both sides need to give up in order to agree to a transaction? The endpoint of this process: execution of a letter of intent.

DIGGING INTO THE DETAILS

As we mentioned in our first post, before the pandemic emerged, some independent hospitals were able to avoid partnership because their financial position remained strong. These hospitals still had the clinical expertise to support key service lines, and they provided value for their communities. But the pandemic created a financial event for hospitals that stretched independents' ability to survive. In this environment, access to scale as well as modern technologies and specialty support become even more crucial.

Independent hospitals are more aware than ever of their weaknesses and vulnerabilities in a post-COVID world. Their goal is to protect the viability of their community asset and residents' ability to access most, if not all, of their care locally. Many organizations also have a strong interest in maintaining some level of local control. Even during the pandemic, we're seeing a move toward more balanced governance in healthcare mergers and acquisitions (M&A). These include *co-membership models*, the not-for-profit version of say, a 60-40 deal, with customized governance provisions that are unique to the transaction.

Capital commitments, whereby an organization commits to specific capital improvements for up to five to 10 years following a transaction, became increasingly common prior to the pandemic. For independent hospitals that enter negotiations from a relative position of strength, whether due to its operating position or interest from multiple competitors, capital commitments remain a highly desired M&A outcome.

The question is: What is each side willing to give up to secure a partnership?

For example, coming out of the RFP process, RHS anticipated that IHX would require a significant capital commitment in exchange for control of the organization. However, once discussions begin, it quickly becomes apparent that shared control tops IHX's priorities for partnership. While the hospital also desires a capital commitment, hospital leaders are willing to lower their expectations regarding the size of a capital commitment for a voice in the hospital's future.

DEMYSTIFYING THE MOTIVATIONS FOR PARTNERSHIP

By understanding the motivations of each party, organizations that wish to explore partnership become better positioned to determine the right model for partnership. They also gain the insight needed to design deal terms that offer important benefits for both sides, creating a sense of a "win-win" for each party. The spirit of collaboration that results from these discussions sets the stage for a stronger partnership once the transaction is final and the true work—operating the new entity—begins.

At the end of discussions, IHX gained the ability to:

- Set its own budget;
- Play a significant role in determining strategy;
- Agree on the selection of a new CEO; and
- Have a representative on the larger health system's board.

Meanwhile, RHS was able to lower the capital commitment it had envisioned making at the start of this process while securing an asset in an attractive, affluent community with strong potential for growth. Ultimately, RHS came to the negotiating table with an important commodity in successful partnerships: flexibility.

But the deal isn't over yet. Next comes due diligence. Find out more in our next blog in this series.