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What Would You Do?

is a merger the answer?

The Problem

East Memorial Hospital (EMH) and East Suburban Health System (ESHS) are neighboring organizations in the suburbs of a large metropolitan area. Both are concerned that they are not large or strong enough to flourish or possibly even survive over the next five years. Is a merger feasible, and can it create an organization with a bright future?

The Situation

Like many other regions nationally, the metropolitan area in which EMH and ESHS operate is in the early stage of significant change. The provider market is consolidating rapidly on the physician side, with hospitals and health systems right behind. Eighty percent of the primary care physicians in the metropolitan area are now employed by the hospitals and health systems, and specialty groups are also selecting employment at an increasing rate. Although just a few years ago, the market consisted of 55 general hospitals, with 20 in systems and the remaining freestanding, five have closed and more than 30 are in systems now. There are four major systems—three not-for-profit and one for-profit—encompassing 20 of the hospitals and employing about one-third of the area's physicians. The remaining four systems comprise two to three hospitals each. The big systems cover broad geography, the city, and some or all of the adjacent suburban areas, while the small systems are more geographically narrow. All of the large systems are aggressively looking to grow, some outside the metro area.

ESHS is itself the product of two previous mergers, 10 to 15 years ago. As a result of restructuring, ESHS operates two hospitals today, located about 10 miles apart in the eastern suburbs. Both of ESHS's hospitals have somewhat overlapping service areas with EMH. Together the two organizations are, by far, the primary provider in their total service area, with aggregate share of about 55 percent.

Key financial trends and indicators for both organizations appear in the exhibit on page 125. EMH's financials are better than those of ESHS, but neither organization is in a strong position relative to the competition, all of which have had better operating performance and much better balance sheets.

Another important factor is the physician marketplace. EMH and ESHS both rely on their traditional voluntary medical staffs, although bowing to market pressures, each now has some employed physicians—20 at EMH and 50 at ESHS. A number of practices in the service area have been acquired by the big systems, and many of the remaining practices are reportedly on the market. Neither

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organization has a strategy for addressing this critical market dynamic, and both have been surprised by the rapid change in physician interest in employment.

Both organizations have been approached by the big systems, in some cases a few times, with offers to join, but they have always turned down these offers. The CEOs of EMH and ESHS had a chance conversation at a recent meeting and found a lot of common ground. As a result, the CEOs conferred with their board chairs about the possibility of an affiliation, and the four leaders set up a dinner meeting to discuss this option. All agreed that a merger of the two organizations would be more desirable than any of the alternatives, and after each board was briefed, a joint board task force was convened to explore next steps more fully. The task force, on behalf of EMH and ESHS, retained an adviser to guide the organizations through the merger planning process.

FINANCIAL TRENDS: EMH AND ESHS*

	2008		2009		2010	
	EMH	ESHS	EMH	ESHS	EMH	ESHS
Total Operating Revenue	$131,301	$250,780	$140,830	$269,856	$148,592	$281,319
Total Operating Expense	$130,315	$251,371	$136,627	$271,228	$141,474	$282,425
Non-Operating Revenue	$2,517	$6,809	$3,577	$9,081	$5,281	$8,277
Excess Margin	2.6%	2.5%	5.4%	2.8%	8.1%	2.5%
Operating Margin	0.8%	0.2%	3.0%	–0.5%	4.8%	0.4%
Days Cash on Hand	152	149	166	138	193	137
Excess of Revenue over Expense	$3,503	$5,086	$7,781	$6,601	$12,399	$6,208
Total Assets	$122,960	$295,563	$129,984	$302,254	$145,279	$321,025
Return on Assets	2.8%	1.7%	6.0%	2.2%	8.5%	1.9%
Total Current Assets	$31,995	$55,738	$34,801	$52,677	$35,429	$63,423
Total Current Liabilities	$21,642	$47,047	$21,382	$50,508	$22,221	$52,984
Current Ratio	1.5	1.2	1.6	1.0	1.6	1.2
Long-Term Debt	$26,613	$131,817	$24,389	$128,192	$22,048	$122,616
Short-Term Debt	$2,132	$0	$2,225	$0	$2,341	$0
Unrestricted FB	$72,542	$54,964	$81,615	$65,357	$98,045	$80,665
Debt-to-Capitalization	28.4%	70.6%	24.6%	66.2%	19.9%	60.3%
Excess of Revenue over Expense	$3,503	$5,086	$7,781	$6,601	$12,399	$6,208
Depreciation and Amortization	$6,970	$11,600	$6,841	$12,876	$6,952	$14,434
Debt-to-Cash Flow	2.74	7.90	1.82	6.58	1.26	5.94

*Dollars in thousands.

Alternatives Considered

As EMH and ESHS have evaluated the merger, always lurking in the background have been two other options: remain independent or join one of the large systems.

In most regards, the case for the EMH-ESHS merger is a strong one. The two organizations could expect to realize expense reductions of at least 3 percent of their combined budgets, or about $14 million annually. And revenue gains, resulting from new service development and related improvements are also forecast as significant, potentially adding $50 million in net revenue and $10 million in operating margin over the next three years.

A variety of important community benefits also could be realized, including new services, broader/deeper services, and quality improvements. And anticipated reductions in redundant capital expenditures are expected to be significant—potentially avoidable technology and facility investments of about $100 million over the next five years.

Many other joint development opportunities have been identified:

> A common approach and infrastructure for physician employment

> Collaborative recruitment of nursing and other clinical staff

> The potential for extending the primary care residency from ESHS to EMH

> Joint approaches to charity care

> Joint development of an accountable care organization

The one issue that the joint board task force has been unable to resolve is board representation in the new organization. ESHS insists on representation based on revenues, while EMH wants a 50/50 split. The board representatives have suggested that resolution of this issue be deferred to the next phase of planning and have expressed confidence that it could be worked out satisfactorily.

The ESHS-EMH board task force is very positive about the prospects for a merger and recommends that the boards approve proceeding with the merger. Moving forward would involve fleshing out the organizational structure completely, preparation of legal documents and filings, due diligence, and joint business planning. The task force estimates that six months would be needed to complete the merger, and fees for outside advisers would be in the range of $500,000 to $750,000.

If you were a member of the ESHS or EMH board, what would you do?

The Decision

Both boards met on consecutive days to review the case for the merger. On May 2, the ESHS board met and unanimously approved moving forward. On May 3, the EMH board met and things did not go so smoothly. Before the CEO could finish his presentation on the case for merger, a board member interrupted to ask for more information about why ESHS refused to accept a 50/50 split of board representation in the new organization. If this was to be a true partnership, he asked, "Shouldn't the combined organization be governed equally by representatives of ESHS and EMH?" Another board member chimed in to ask whether ESHS considered EMH to be an inferior organization, given their posture on board composition. Task force members attempted to respond to their colleagues' questions and quell their concerns, but things spiraled downhill rapidly. One of the task force members suggested a recess, but this was followed immediately by a motion from another board member to terminate discussions with ESHS. Only 60 percent of the board members voted in favor of the motion, and the merger was killed. ●

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