Healthcare Mergers and Acquisitions: Strategies for Consolidation

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Summary • The passage of federal healthcare reform legislation, in combination with other factors, makes it likely that the next few years will be a major period of consolidation for healthcare organizations. This article examines the seven key forces reshaping healthcare delivery—from insurance industry consolidation to cost inflation to the increasing gap between financially strong and struggling providers—and provides advice for organizations on both sides of an acquisition.

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Introduction

Mergers and acquisitions have been a part of the healthcare delivery landscape for the past 50 years. Though they were a rare occurrence until the growth of for-profit hospitals and nursing home chains in the 1970s and 1980s, and then a hot topic with the emergence of physician practice management companies in the 1990s and reactions to possible federal reform in the Clinton era, mergers and acquisitions are now common events.

The level of merger and acquisition activity across all major sectors has been essentially flat for the past seven years, as the data in Exhibit 1 show, reaching a low point in 2009 in the dark days of the recent economic recession. A combination of key forces and factors, intensified by passage of federal healthcare reform legislation in 2010, makes it likely that the next few years will be a major period of consolidation. Eighty-six percent of hospital leaders in a recent survey said they expect increased acute care mergers and acquisitions in 2011 alone (Minich-Pourshadi 2010). What trends and conditions are ushering in a shake-up and restructuring of likely epic dimensions for healthcare delivery?

Key Driving Forces

Seven key forces are reshaping healthcare delivery and will continue to do so in the future (see Exhibit 2).

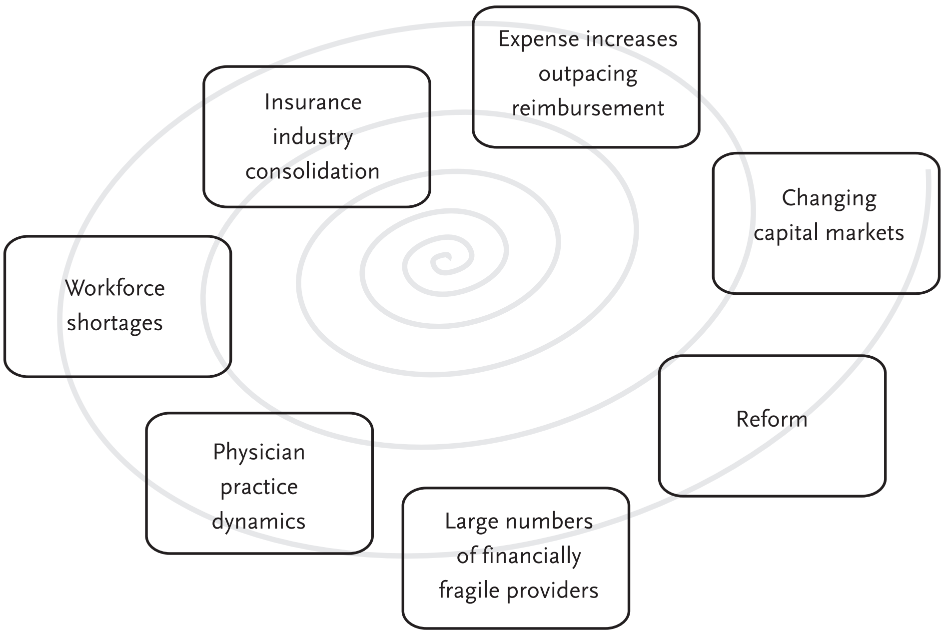
Insurance industry consolidation. Massive restructuring and consolidation of the commercial health insurance industry has transpired, with more change on the horizon. From 1996 to 2009, more than 400 corporate mergers involving health insurers occurred (HCFAN 2009). In 2010, the American Medical Association reported that in 24 of the 43 states examined, the two largest insurers had a combined market share of 70 percent or more. In 2009, just 18 of the 43 states had two insurers with a combined market share of 70 percent or more (AMA 2010). These developments have created a growing imbalance between an insurance industry that is increasingly oligopolistic (with a small number of insurers exerting control) in most markets—often comprising nonlocal large

Exhibit 1: Health Services Consolidations by Year

Sector	2003	2004	2005	2006	2007	2008	2009	2010
Hospitals	38	59	50	56	58	60	52	75
Behavioral	11	20	26	24	13	14	11	7
Home health	25	28	73	55	49	47	42	41
Labs, MRI, dialysis	36	36	39	46	54	41	30	39
Long-term care	103	79	129	145	127	96	75	103
Managed care	29	36	30	28	28	16	15	13
Physician groups	26	34	35	32	41	53	41	60
Rehabilitation	17	10	10	9	16	27	11	12
Other	123	106	136	136	110	123	78	91
Total services	408	408	528	531	496	477	355	441

SOURCE: Irving Levin Associates (2011).

Exhibit 2: Key Industry Forces Driving Provider Consolidation



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national and regional companies—and the still-fragmented providers. In the past few years providers have benefitted from a relatively benign underwriting cycle, but this period appears to be at an end. Insurance companies now have greater leverage in negotiating contracts with providers, and they are using this leverage to minimize rate increases.

Changing capital markets. Capital needs continue to increase because of aging facilities, rapid development of new technology, the growing focus on quality and patient safety, and consumer demands and drivers. However, healthcare organizations are still feeling the effects of the national recession and credit crunch of 2008 and 2009. The overall healthcare provider balance sheet is worsening, and access to debt is increasingly restricted and expensive. To address the national economic and financial environment and their own problems, credit rating agencies have retreated and became much more risk averse. An October 2010 report by Moody's Investors Service indicates that hospital credit rating downgrades are expected to outpace upgrades into 2011. Many hospitals are already undergoing multiple rounds of cost-cutting measures and aggressively attempting to increase efficiencies to offset volume declines; analysts are concerned that hospitals cannot continue to cut their way to growth (Dunn 2010). Larger, geographically dispersed, financially secure providers are likely to be favored under these conditions. As the ability to borrow money is increasingly restricted to the sizable and affluent, the squeeze on healthcare organizations will be severe.

Expense increases that outpace reimbursement. Cost inflation has outpaced

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rate increases for at least the past decade, but that inflation has been offset by better commercial payer rates, volume growth, cost economies, and, until recently, a generally healthy economy. But with the recession and significant unemployment, uncompensated and undercompensated care have escalated, while commercial rates and government reimbursement are now essentially capped. Because of continuing underlying inflationary pressures and diminishing opportunities to pick off the low-hanging fruit and reduce costs (after 10 to 15 years of such efforts), providers face deteriorating financial performance unless they find innovative strategies to offset these dynamics.

The critical question for those who are considering combining forces is, **What could we accomplish together that we cannot do alone?**

Workforce shortages. An aging workforce, rising volumes and staffing needs, and limited supply of staff have created workforce shortages, although shortages in some markets have been moderated by the lingering recession. Unionization efforts have picked up in the last few years, aggravating an already difficult situation. Providers recognize that meaningful supply fixes are slow, expensive, and complex. In the meantime, the market for recruitment of personnel has changed from predominately local to regional/state, national, and, in some cases, international, so the gap between small and large providers' abilities to address workforce shortages continues to grow.

Physician practice dynamics. The central role of physicians in delivery organizations, both their own (medical groups) and others (hospitals and health systems) cannot be overstated. The previously listed dynamics related to general workforce shortages also apply to physicians, even modest but growing unionization. New physicians prefer to seek employment and the security of large groups with more predictable hours, coverage, and time off. This change is a major factor reshaping medical practice organization, with tremendous impact on hospitals and health systems.

Large numbers of financially fragile providers. The forces shaping the healthcare delivery system have created gaps between financially strong and weak providers. These gaps are expected to widen in the next few years, with a disproportionate impact on small organizations, especially inner city and rural providers. Failures and consolidations are inevitable in this environment.

Healthcare reform. If implemented largely as legislated, absent successful judicial challenges, federal healthcare reform will exert formidable pressure and drive fundamental change. Market reform, led by commercial insurers and large employers, is already occurring and will continue regardless of government-mandated reform, but the two together are likely to have a synergistic and greater impact. Reform under any circumstances increases provider risk and favors organizations with scale to weather impending storms.

Benefits and Risks of Consolidation

Environmental conditions are driving large-scale industry consolidation. How should providers best address these challenges and opportunities? While some providers will merge or be acquired only at the last minute to avoid insolvency or the demise of the organization, most will be more proactive, understanding that sweeping changes may be inevitable. Prudent organizations approach this challenge carefully and deliberately as it likely involves the most significant change the organization has ever experienced. Benefits and risks must be carefully weighed against each other. What have organizations been able to achieve historically through consolidation?

The critical question for those considering combining forces is, *What could we accomplish together that we cannot do alone?* This question seems simple, but if the answer is not compelling or the vision is hazy, the answer may not have the strength to carry the potential partners through the rough waters of completing a deal. The vision keeps organizations grounded as they discuss and negotiate the hundreds of particulars of a consolidation over many months. The key attributes of a compelling vision are illustrated in Exhibit 3.

Typically, the vision includes a reference to both organizations' performance improvement and, for not-for-profits, tangible community benefits. Performance improvement can accommodate a range of opportunities, with financial benefits usually top of mind. Related to performance improvement are growth, enhanced competitiveness, and quality improvement. Exhibit 4 presents an example of a recent vision statement for a consolidating organization.

Benefits

The many potential benefits of consolidation can be grouped into seven categories.

Exhibit 3: Vision, or What Could We Accomplish Together That We Cannot Do Alone?

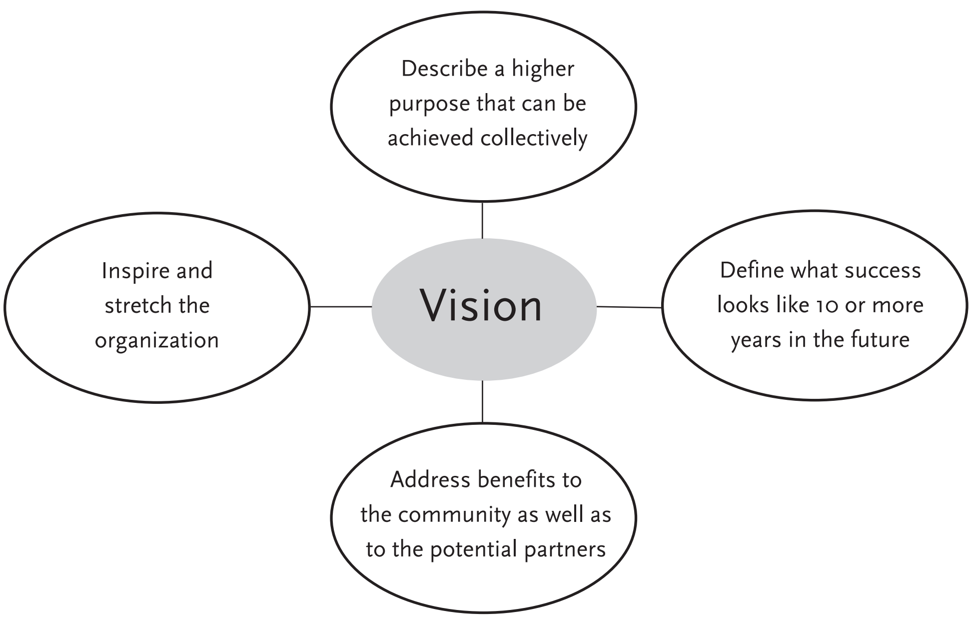

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Exhibit 4: Vision Example—UPMC

University of Pittsburgh Medical Center

Initially, "create a leading-edge healthcare system in western Pennsylvania and play a major role in energizing and transforming the economy in Pittsburgh and throughout the region."

Now, "create a new economic future for western Pennsylvania by . . . exporting excellence nationally and internationally."

SOURCE: University of Pittsburgh Medical Center (2011).

Most of these benefits can be achieved more readily through scale, especially the ability to obtain and support specialized expertise to improve performance.

- **Quality/safety improvement:** These efforts involve sharing best practices and clinical pathway/protocols, implementing expensive technology and software, and collaborating on state-of-the-art and standardized systems and processes to improve care.
- **Improved care for the vulnerable:** These benefits may include funding or developing innovative care delivery models or alternatives to established delivery mechanisms.
- **Capital cost avoidance and access:** Huge potential to avoid duplicative capital investments in both facilities and technology often exists in consolidation, as do opportunities to improve capital access and borrowing terms, especially for the smaller organization.
- **Cost reduction:** This is usually the area most focused on in discussions before the merger or acquisition. Although results historically have been mixed, higher-performing systems are able to achieve a 2 to 5 percent reduction in annual operating expenses off the base of the smaller combining organization (but not necessarily entirely from that organization). In some circumstances, a greater reduction is possible.
- **Access to scarce personnel and expensive technologies:** The new system may be able to attract and afford scarce, specialized, or expensive assets.
- **Expanded services:** A priority nearly equal to cost reduction is to increase the breadth and depth of services through scale opportunities such as adding specialized new staff and technology and extending expertise of one organization to the other.
- **Revenue enhancement:** This benefit is a component of expanded services, but is also obtainable through scale efforts related to billing and collections and, where feasible, managed care contracting.

The smaller organization in a merger or acquisition may desire benefits related to the protection and support afforded by a larger organization, such as greater management depth to deal with the day-to-day and increasingly specialized challenges of operations, and the financial safety net the larger or combined organization may offer.

Risks

An infinite number of risks are inherent in mergers and acquisitions. The major risks that healthcare providers experience can be placed in eight categories.

- **Loss of local control:** This is often organizations' number-one fear in a merger or acquisition. Included in this category is the potential for a large organization to be insensitive to and unresponsive to local needs, the inability to control the destiny of the local organization in the future, and concerns about the loss of power and authority of individuals at the local level.
- **Reduction or elimination of services:** This commonly discussed risk includes concerns that services will be reduced locally or eliminated entirely and about the impact of such moves on the local economy.
- **Reduction, elimination, or redeployment of personnel:** Concern about the future of loyal, important staff or physicians will occur, given the inevitability of change as organizations come together.
- **Unrealistic expectations and goals:** The merger or acquisition may be viewed as a panacea for an organization's ills; leaders may expect too much improvement too quickly or promises may be made to close the deal that cannot be kept.
- **Diseconomies of scale:** Some healthcare organization combinations have proven to be unmanageable, or sometimes just poorly managed, so that the combining organizations' performance is worse than one or both was before.
- **Potential loss of community support:** Philanthropic support and goodwill may diminish given the emotional connections and pride local communities feel for their hospitals.
- **Competitive reaction:** A merger or acquisition is a major, high-profile event that may encourage competitors to exploit new weaknesses or vulnerabilities or otherwise catalyze a significant competitive response.
- **Poor track record in consolidation:** Healthcare organizations' success rate with maximizing the potential benefits of consolidation and minimizing the risks has been mixed, at best, over the years. Caveat emptor—let the buyer beware—is sage advice for organizations contemplating consolidation.

Optimizing the Potential for Success

Healthcare Executive (Squazzo 2010) interviewed four CEOs to get their perspectives on optimizing the potential for success in mergers and acquisitions. The CEOs offered the following key lessons learned and advice:

- Do not lose sight of the ultimate goal, which should relate to mission and community need.
- Keep the patient at the center of discussions about how fragmentation can be reduced and a better delivery system created.
- Blending cultures of the combining organizations is critical to success and quick implementation of the new organization.

- Physician issues and concerns can be significant; successfully addressing them may require extensive discussion and management and innovative approaches.
- Governance and management can be derailers or enablers. Much attention needs to be directed to organizational structures and personalities up front.
- Extensive planning before the deal closes pays big dividends later.

Key Merger or Acquisition Questions

When being acquired or considering acquisition of another provider, organizations need to consider a series of important questions. These are discussed in greater detail in Exhibit 5.

- **Vision:** What can we accomplish together that we could not accomplish independently?
- **Culture:** Can differences in values and organizational behaviors be bridged if we come together?
- **Governance:** Can we balance the parties' egos, desire for control, history, style, personalities, structure, and finances to fashion an overall design, approach, and team?
- **Organizations and operations:** Can we create organizational and operational structures that serve the parties effectively and efficiently?
- **Physician impacts and politics:** Can we show benefit to physicians and navigate often-difficult personal concerns?

Exhibit 5: Planning for Mergers and Acquisitions

Primary Topics

1. Vision
2. Culture
3. Governance
4. Organization and operations
5. Physicians
6. Clinical/quality
7. Finance
8. Legal/regulatory

Secondary Topics

1. Human Resources
   - Staff reductions
   - Unions
   - Pensions
   - Benefits
   - Recruitment and retention
2. Religious
   - Catholic ethical and religious directives
   - Sponsorship
   - "Conversion"/identification
3. Commitments
   - Hospital or other facilities
   - Services
   - Capital
4. Other issues and concerns
   - Leadership opposition
   - Price/financial terms
   - Community
   - Brand recognition/image/name
   - Town/gown
   - Communication/transparency
   - Information technology
   - Facilities
   - Other

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- **Clinical/quality impacts:** Can we grow and improve clinical programs and enhance quality and safety better as partners?
- **Financial benefits:** Can we reduce costs, increase revenue, and improve overall financial performance and position?
- **Secondary issues and concerns:** Can we address human resources, legal/regulatory, religious, and other threshold challenges?

Unlike some business transactions outside the field, mergers and acquisitions in healthcare rarely culminate quickly, nor do they deliver benefits immediately. Particularly in deals involving not-for-profits, merger and acquisition discussions and negotiations typically take 6 to 12 months, and implementation proceeds over a multiyear period (see Exhibit 6). Being mindful of the likelihood that the process will be a marathon, not a sprint, will help healthcare leaders find the endurance and fortitude to manage protracted negotiation and implementation phases.

Exhibit 6: Merger and Acquisition Phases

Phases		Typical Time Frame
1. Premerger planning	⇒	3–6 months
2. Due diligence	⇒	2–4 months
3. Regulatory and special processes (litigation, public notice, sponsor approval, etc.)	⇒	0–*n* months
4. Premerger organization design/implementation	⇒	2–4 months
5. Implementation	⇒	1–3+ years

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Consolidator or Consolidatee?

Leading-edge organizations will see the emerging era of consolidation as a tremendous opportunity to expand their reach and influence and, better yet, extend their quality and brand to other markets not yet served by their organization. Opportunities for consolidators will exceed the time and resources available to pursue them. Some consolidators will be besieged by parties interested in joining their organization and may find themselves continuously reacting to overtures. Others will adopt a proactive posture and identify the markets and entities they want to be part of their system. Regardless of whether a consolidator's orientation is more strategic or opportunistic, it will face two threshold considerations that should be carefully vetted for short- and long-term implications:

1. Should we focus exclusively or primarily on horizontal integration or vertical integration or some blend of the two approaches?
2. Should we focus exclusively or primarily on markets already served, adjacent markets or seek greater geographic spread (regional, statewide, multistate, or national plays)?

Organizations considering joining a system or partnering with others to establish a new system must act while they are relatively strong and still have value; too often healthcare organizations wait until they are close to or on the brink of failure before seeking partners, only to find that the transaction is untenable because time ran out, or to realize too few benefits for their communities because

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the organization had lost its value. Consolidatees should negotiate hard but not unreasonably and should focus on the continuance of their mission, not on the continuance of the facilities they operate.

In all cases of mergers and acquisitions, leadership must be prepared to clearly answer the following questions:

- Are our organizations culturally compatible?
- What are the possible benefits? What can we realistically expect to achieve?
- What are the major obstacles and concerns? How likely is it that they can be overcome?
- For freestanding providers: Can we really continue to serve our community effectively in the future (at least the next three to five years) as an independent organization?

Understanding the inherent challenges in healthcare mergers and acquisitions and the management strategies discussed here will help prepare organizations that see consolidation as an inevitable development. The questions on the table are whether your organization will be at the forefront of consolidation—prepared to initiate and respond to merger and acquisition opportunities—or wait and see what is left after the dust settles. If you want to be at the forefront of change, avoid getting lost in the weeds by referring back to your larger goals and vision often. Do not underestimate how difficult meaningful change is to achieve and be willing to endure short-term turbulence as you move toward long-term viability and success.

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