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HEALTHCARE MANAGEMENT ADVISORS

Intro to M&A Blog Series

Contemplating Your Healthcare Organization's Future in a COVID-19 Environment

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As healthcare organizations brace for financial losses stemming from the coronavirus pandemic, some will have a harder time weathering the storm than others. It's a predicament that could propel some not-for-profit hospitals and health systems into partnerships in 2020 and beyond.

Just months ago, experts thought hospital and health system mergers and acquisitions (M&A) would slow down in 2020. A survey of investment professionals released this past January showed investors expected heavy emphasis on health IT deals and strong interest in behavioral health, home health and hospice care, and post-acute. Hospital M&A generated the least interest.

Now, with hospitals and health systems experiencing double-digit drops in revenue in March and April and some consumers expressing concern over returning to a hospital setting, not-for-profit healthcare leaders are left to consider:

- As restrictions on elective surgeries are lifted, how long will a "return to normal" take?
- What do our utilization and financial projections look like in the next few months and for the remainder of 2020?
- How sensitive are these projections to a shift in consumer sentiment and rising unemployment?
- What does our access to capital look like in the current environment? Do we have enough capital to support our needs in the short term and over the next 18 to 24 months?
- To what extent is our organization vulnerable to competitors (both known and emerging competitors) and disruption during the post-surge phase of recovery?

- How should we adjust our strategy given the current and expected pressures our organization faces?

Careful consideration of these factors and more is critical to assessing an organization's ability to remain independent. It also informs decisions around the type of partnership opportunities to pursue—whether a strategic affiliation, a partial acquisition, or a merger—and enables organizations to approach this process with objectivity and sensitivity.

A CHANGING TIDE

It's important to note that not-for-profit healthcare organizations that have been able to maintain their independence during the consolidation spree we've seen in recent years typically are not the "low-hanging fruit." These are organizations that were in a relatively stronger financial position when the trend toward hospital consolidation first began in 2011—the year after the Affordable Care Act became law—and were able to hang onto their independence even as some of their counterparts looked to M&A for increased leverage with insurers and economies of scale.

In some instances, leaders for these organizations had begun to conclude prior to the coronavirus pandemic that they could benefit financially and competitively from a partnership or affiliation, but because they were not financially distressed, they were in a position to drive transaction structures that were more balanced in terms of autonomy and control.

We began to see transactions that were a little more nuanced, with terms like "co-membership" and "minority interest," where the smaller player still retains important decision making and control over how healthcare is delivered in their communities as well as input into important business and strategic decisions.

But hospitals and health systems are capital-intensive organizations. They must be able to generate sufficient profitability to have cash reserves and secure bonds at lower cost and optimal terms. When an organization's profitability is threatened, its ability to stay current with the latest treatment modalities, fund new initiatives that enhance access to care or care quality, obtain financing for new projects or refinance existing debt is diminished. When independent hospitals or health systems anticipate challenges around capital access, this typically triggers conversations around partnership.

That's why COVID-19 presents such a threat to an organization's ability to remain independent. Loss of revenue from elective procedures has decimated budgets and crippled the outlook for the not-for-profit sector. And while the CARES Act will provide some relief for not-for-profit hospitals and health systems, "It is unlikely to fully compensate the sector for the two main financial challenges facing providers as a result of

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the coronavirus outbreak," Dan Steingart, vice president, Moody's Investors Service, stated in an April 3 report1. "The first is a material decline in revenue and cash flow as profitable elective surgeries, procedures and other services are postponed to preserve resources and avoid spreading the virus. The second is difficulty curbing expenses as surge preparation costs offset any expense reductions from postponed or canceled services."

During the second quarter of 2020, M&A activity among independent, not-for-profit healthcare organizations likely will slow down as the immediate challenges of dealing with the pandemic consume leaders' attention and organizational resources. While healthcare M&A deals that were near completion may close, others are likely to be put on pause, especially as organizations' financial performance is impacted by the pandemic.

However, deal activity is likely to increase later in the year as independent hospitals and health systems struggle with decreased days cash on hand, lower margins, significant hits to their investment portfolios, and other challenges.

A RESOURCE FOR INDEPENDENT HOSPITALS AND SYSTEMS

In the weeks ahead, Veralon will publish a series of blogs to help leaders of not-for-profit hospitals and systems navigate key considerations around independence or partnership in a tumultuous environment. Topics will include:

- Strategically evaluating the choice between independence or partnership
- Understanding your capital needs
- Determining how your organization stacks up against the competition
- Evaluating potential partners
- Exploring affiliation models
- Assessing the fairness of a deal

I welcome your feedback on this and other blogs in the series. Questions? Please share them with me at dgrauman@veralon.com.

Footnote:

1. "Not-for-Profit hospitals – U.S.: Federal Coronavirus Aid Package Provides Modest Relief; Ratings Reflect Support," Moody's Investors Service, April 3, 2020.

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