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A Pivotal Moment for Health System Partnership

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2023 could be a turning point in financial performance for not-for-profit hospitals and health systems, one rating agency predicts—but can these organizations afford to go it alone? What to consider in evaluating opportunities for partnership and crafting the right deal.

Healthcare merger-and-acquisition (M&A) deal volume slumped to its second-lowest level since 2000 (see Exhibit 1). But while experts expect a slow start to M&A activity in 2023, partnerships among not-for-profit hospitals and health systems likely will be key to success.

As healthcare organizations navigate the financial aftermath of the pandemic, workforce shortages, and an inflationary environment, we'll likely see more hospital and health system deals out of necessity. 2022 was "one of the worst financial years on record" for hospitals, according to a Fitch ratings analyst, who expects "a very bumpy 2023" for hospitals and systems. Most not-for-profit health systems ended the year with depressed margins and will continue to face financial challenges stemming from high labor and supply chain costs through 2023, as well as uncertainty in the financial markets. It's a situation that S&P says could take years for hospitals to recover from, financially.

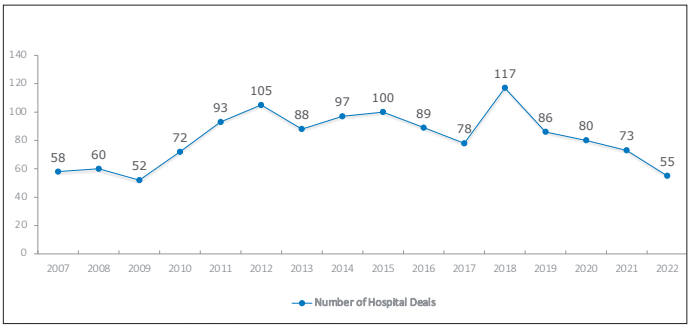

Exhibit 1. Trends in Hospital and Health System M&A

Source: Irving Levin Associates and AHA TrendWatch Chartbook and Modern Healthcare Transactions database.

In this environment, once again, not-for-profit hospitals and health systems must consider: Can we afford to go it alone? If not, how can we ensure that a *partnership*—whether in the form of a merger, acquisition or affiliation—is the right fit?

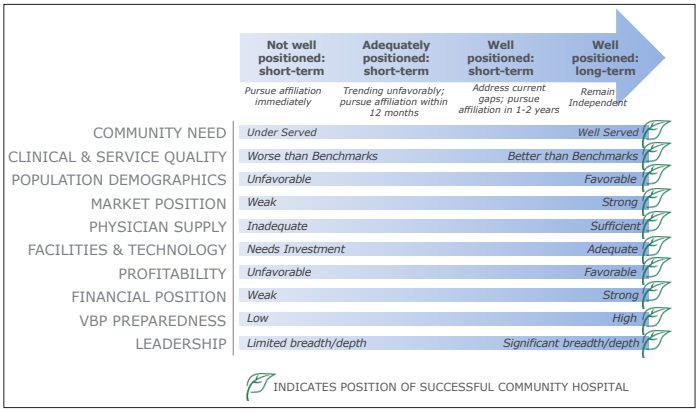

Exhibit 2. Assessing Your Hospital's Ability to Maintain Independence

The stakes are high. Larger organizations may have a path for getting performance back on track—but smaller, weaker organizations may not (see Exhibit 2). Organizations that are in a position to acquire another hospital or system will be much more rigorous in evaluating potential partners. And, the type of partnership model selected could significantly impact success. For instance, the looser the affiliation, the happier a formerly independent entity might be, but the lesser the financial benefit an organization could expect. Additionally, success involves more than what is seen on paper. It's also highly dependent on cultural fit.

Here are three major questions leaders and their advisers should consider.

What does our organization want?

Increasing financial pressures necessitate a proactive approach in determining not just whether an organization can remain independent, but also the benefits the hospital or health system should seek to gain from affiliation. These may include:

- **Access to capital**, which is crucial for material plant investments, growth-based strategies, technology and innovation—including digital innovation.
- **Clinical program development**, such as those geared toward target populations and conditions that affect a significant number of an organization's community and patients, and the ability to fill physician and care access gaps.
- **Access to economies of scale** and enhanced positioning in discussions with healthcare purchasers and vendors—providing a source of cost efficiency and improved margin performance.
- **Positioning for risk-based contracting**, including the ability to succeed in risk-baked arrangements, which requires access to population scale, specialized management expertise, a data analytics competency and infrastructure.
- **Improved geographic coverage and service mix**, helping to optimize market share—especially important as the payer market continues to consolidate and exert payment pressure.
- **Physician recruitment and retention capabilities**, especially at a time when well-funded physician aggregators, payers and retailers are aggressively competing for providers.
- **The ability to close gaps in senior-level knowledge due to resignations or retirements**, such as in areas like IT.
- **Bolstered liquidity position and reduced cost of capital**, vital to an organization's ability to weather the financial aftershocks of COVID-19 and inflation.

From there, organizations must prioritize the benefits that are most important to them. This will help focus discussions and negotiations with the potential partner organization.

It's not only important to understand what you want, however. You also need to know what you're bringing to the table. Understanding how your organization would stack up in the eyes of a potential partner is an essential part of this process, as it gives leaders a clear view of whether they can get what they need—and to what extent. Guiding considerations include the following:

- **Understand financial current and estimated future financial performance and position.** While nearly all hospitals and health systems are operating significantly below pre-pandemic levels, some are in a worse position than others. Ideally, starting the conversation around partnership should begin early, when the organization is still in a financial position sufficient to attract multiple potential partners. However, even if the financial picture is unfavorable today, being able to speak to a runway to financial stability and having concrete, quantifiable improvement initiatives underway will help a partner fully appreciate and understand the long-term value and risk profile of the partnership.
- **Size up the organization's capital needs.** Think about the capital requirements not just in the immediate aftermath of COVID-19, but also long term. For example, does the organization have the technological resources to provide remote care in the home for an aging senior population? Does it have the IT infrastructure to support data interoperability, which is delayed for now, but coming soon? Which capital projects should be fast-tracked to maintain market share, and which can be delayed—and for how long?
- **Gauge the organization's strategic weaknesses.** It's important to understand a hospital's areas of vulnerability as seen through a potential partner's eyes. For example, if the hospital's orthopedic group were to cut ties with the hospital to work with a competitor, where would that leave the organization in terms of elective surgery and diagnostic imaging revenue? What would it take to attract a new orthopedic group to your hospital—and how much of a capital infusion would be needed to support a return to service?
- **Contemplate what success would look like from a partner's point of view.** Success isn't solely defined by an organization's financial standing, but also by factors such as competitive positioning, market share, payment rates, and physician and patient satisfaction. For example, if your hospital were to lose two points in market share, how would this affect your balance sheet? If a new competitor were to enter the market, how would payer contracting rates be impacted? The key is to know the hospital's strengths and weaknesses at least as well as—and preferably better than—a potential partner.

When partnership is the desired approach, what type of partnership is the best fit? How attractive is this option to a potential partner?

Affiliations come in various forms, each with distinct advantages, disadvantages and considerations. It's important to consider the implications of each affiliation model to identify which forms might be optimal and—just as important—rule out any model that a healthcare organization is not willing to consider.

- **Determining the right model depends on the goals for affiliation**. There will be some aspects of an affiliation that the organization views as must-haves. Depending on the situation, these must-haves could be a subset of the benefits expected from an affiliation. For example, if an organization is highly leveraged, access to capital may be a requirement for any partnership. Must-haves do not need to be limited to benefits; they may also include cultural compatibility, assurances that current clinical services are maintained for the local community, or a guaranteed level of autonomy.

  Generally, the greater the desired financial impact, the greater the need to function as a single entity and the greater the financial risk borne by the partnering organization—which comes

with a proportionate loss of control to the partnering organization. Identifying the right balance of financial benefit and control is often one of the key tradeoffs for an organization seeking and evaluating potential partnerships.

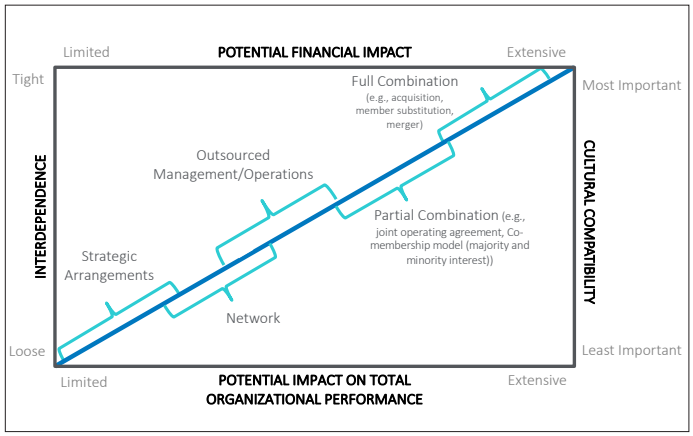

Exhibit 3. Understanding the Potential Implications of Affiliation Models

As shown in Exhibit 3, there are a range of partnership models, which traditionally include:

Strategic arrangements: Two or more organizations—even competitors—may collaborate to meet a clinical or business need together while remaining independent. Examples include targeted clinical affiliations between regional academic medical centers (AMCs) and community hospitals. Generally, financial impact is low for these types of affiliations. .

Network model: Formally (i.e., via a separate organization) centralizes various corporate services, such as purchasing, between organizations—typically in a common geographic area—to gain benefits of centralization and economies of scale through a collaborative network model without changing the ownership or governance of participants. Another version of a network model is networks focused on jointly pursuing population health and value/risk-based reimbursement strategies, like accountable care organizations and clinically integrated networks. While there is more potential for material financial benefit, the organizations are still independent and thus are not able to take advantage of many of the financial benefits of greater interdependence.

Outsourced management/operations: A contractual arrangement in which a healthcare provider organization agrees to manage another hospital without any change of control. This can be a springboard to tighter affiliation.

Long-term lease: This model is used when constraints on transfer of ownership hinder a more complete form of integration, often for district/municipally owned organizations.

Partial combination: Examples of partial combination or partial change of control models are described below. There is significant variation in the degree of financial impact and degree of retained independence afforded by these models, because each arrangement has its own flavor (e.g., majority vs. minority, reserved powers).

- **Joint ventures**: These are shared equity ownership arrangements and thus relevant to for-profit organizations and subsidiaries. As such, this structure is not a common model for the horizontal hospital and health system M&A universe. However, hospitals and health systems often pursue joint ventures for vertical areas of M&A activity, such as in the ambulatory surgery center space, with hospitals often sharing ownership in for-profit ambulatory surgery centers with surgeons.
- **Co-membership arrangements**: These partnerships are the not-for-profit version of a joint venture, with customized governance provisions that are unique to the transaction. A recent example of a majority interest co-membership arrangement took place in 2021, when Atlantic Health System became the majority (51%) member of CentraState Healthcare System via a comembership agreement.
- **Joint operating agreements (JOA):** Sometimes called a "virtual merger," under these agreements, effectively only the profit and loss statement is merged, while balance sheets remain separate. The degree of separateness inherent in this structure, however, makes governance, strategy, and capital finances difficult to coordinate, manage, and prioritize, which has led to mixed results with this model.

Full combination: Full combination models carry the largest potential financial impact, as the organizations begin to operate as a single entity, allowing access to the full scale benefits of affiliation. Examples of full combination models include:

- **Corporate member substitution:** Under this approach, typically the larger hospital or system assumes responsibility for the smaller hospital's balance sheet and becomes its sole corporate member. The system then has the authority to appoint the board for the previously independent hospital as well as certain key reserved powers. While there is no "purchase price" in this type of arrangement, financial commitments are often made, leading to strategic and operational integration. This option has the greatest appeal to boards that remain committed to retaining not-for-profit status for philosophical reasons and that wish to keep an active hand in the governance of the institution.
- **Merger:** In a merger consolidation, two organizations combine via the formation of a new, third organization. The new organization becomes the legal entity that replaces both separate entities. In the not-for-profit world, the new entity becomes the sole corporate member of both consolidating organizations.
- **Acquisition:** In an acquisition, the acquiring entity fully takes over the other party. The other party no longer retains a separate identity and becomes fully consolidated into the acquiring organization. Typically, a purchase price is paid to the seller. This model is the common full combination model for transactions involving for-profit selling entity(ies).

An organization's ability to influence the type of model depends on its attractiveness to a potential suitor. This is especially true at a time when dealmakers are likely to apply more rigorous scrutiny in evaluating candidates for partnership.

Who are the potential partners we should consider?

Being proactive in the affiliation process is essential. Organizations should not sit back and hope the optimal partner will seek them out to explore an affiliation. Leadership teams need to develop a list of potential partners from which they can initiate preliminary affiliation discussions. There are many considerations that can help refine this list:

- Are there organizations with which the hospital or health system has had beneficial partnerships in the past?
- Are there organizations that have been successful consolidators in the local or regional market?
- Is the hospital or health system willing to consider a for-profit partner? What about private equity?
- Are there organizations with which the organization believes it shares a common vision or compatible culture?

The first steps of a significant partnership process should ultimately be determined by the board, based on recommendations from the management team. The board should strive to reach consensus on as many of these considerations as possible. The answers to the questions noted above will ultimately drive the type of process that is adopted.

Hospitals may choose to negotiate with one or two preferred partners or embark on a more traditional M&A process involving the development of a request for an indication of interest and/or a more detailed proposal RFP) that will be sent to prospective partners. If and when this point is reached, the thoughtful and proactive consideration, analysis, and discussions about the organization's wants and needs that led up to this stage will serve your organization well when the time comes to evaluate the proposals received and select the best course of action.

Potential Affiliation Partner/Partnership Scorecard – Illustrative				
Criteria for Evaluating Partners	Potential Partner 1	Potential Partner 2	Potential Partner 3	Potential Partner 4
Culture	3	4	3	2
Partnership Experience – Track record in acquiring and integrating community hospitals	4	3	3	2
Preserved Autonomy – Does the partnership structure provide for desired degree of retained autonomy?	3	4	3	2
Financial Ability/desire to provide capital and payer contracting	3	4	2	1
Operations Support/integration of back office & IT	3	4	4	2
Clinical Support seamless, accessible continuum of care	3	4	4	2
Medical Staff Support development & Recruitment	5	5	3	3
Level of Interest	4	5	2	2
Ease of Integration – Are the barriers to integration relatively moderate or heavy?	2	5	2	1
Scale: 1 – Highly Unfavorable; 5 – Highly Favorable				

Exhibit 4. A Scorecard for Evaluating Prospects for Affiliation

You can't always get what you want … but you can get what you need.

Sometimes, the pressure to complete the deal can interfere with the need to make sure the relationship is being pursued for the right reasons. After all, not-for-profit hospital systems—especially independents—are more aware than ever of their weaknesses and vulnerabilities in a post-COVID world. But there are ways to protect the organization's interests for the long-term. Key actions include the following:

Conduct a financial gut check before moving forward with a deal. Developing a robust understanding of the financial implications of the partnership can, to an extent, be even more important than due diligence. Indeed, for boards, it is their fiduciary duty to understand the comprehensive impact of a transaction before moving forward. This consists of:

- **Quantifying financial and operating risks identified during due diligence—and understanding the future implications.** And assessing whether any findings suggest key deal terms need to be revisited prior to close.
- **Testing the impact of capital commitments.** Here, a *fairness opinion*—which assesses the reasonableness of the price for both parties and the terms of the transaction, including capital commitments—is essential. It will help, even force, leaders to determine: Are the areas of proposed investment appropriate, or should they be revisited?
- **Working with counterparts to identify post-transaction areas of opportunity.** This sets the foundation for realistic, tangible opportunities to be included in the prospective financials. While most synergies are not realized in the first year, there should be a list of low-hanging fruit opportunities that can be implemented in the first three to six months after the deal closes.
- **Pressure-testing assumptions.** This information will help manage risk and uncertainty more effectively.

Evaluate whether the deal is a fair deal. Here, it's important to consider: Can you identify the value the organization will receive from the transaction. A financially fair transaction does not have to represent the highest or best price. It should, however, represent a price that falls within the range of reasonable values identified. A formal fairness analysis should clearly identify and explain the valuation approaches used in the analysis with all supporting financial details. It should include a review and analysis of proposed terms of the deal; an explanation of the adjustments and reconciliations that were made in arriving at the valuation; and the sources of information used, including interviews with key hospital leaders and other constituents. It should also incorporate an analysis of the "value" of nonfinancial terms of the deal.

Don't forget culture fit. Just as chemistry between two individuals is one sign of whether a relationship is meant to be, connecting the similarities and differences between the mission, vision, and values of two healthcare organizations is crucial to determining whether the organizations are compatible for partnership.

When the organizations' purpose and aspirations are highly aligned, the potential for seamless integration increases—and that's good for patients and employees. When stark differences exist, organizations could find that a match that looks good on paper doesn't translate to agreements around decision-making processes, communication approaches, or management styles. If these differences aren't resolved to mutual satisfaction, one or both partners could end up feeling as though they've made the wrong choice.

Taking the time to carefully evaluate the synergies that exist between the organization and a potential partner as well as the potential for long-term value—for the hospital or health system and those it serves—can mean the difference between a healthy, long-term commitment and a relationship that starts strong, but fizzles shortly after it has begun.

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3 Caroline Hudson, *For nonprofit health systems, 2023 could be the turning point*, Crain's Chicago Bus. (Jan. 12, 2023), https://www.chicagobusiness.com/health-care/fitch-ratings-says-nonprofit-health-systems-see-improvement-2023.

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