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# Hospital M&A: Beginning of a New Frontier?

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By: **Jake Aygun**

615-613-0215

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# Hospital M&A: Beginning of a New Frontier?



Imagine reading the following headlines five years ago:

- *Six multi-billion dollar NFP-to-NFP health system mergers announced over past 12 months.*
- *Consolidation activity involving large community hospitals and regional health systems doubles.*
- *Only one transaction by a publicly traded FP acquirer not named HCA Healthcare in the calendar year; divestitures by FP increased fourfold.*
- *For the latest year, the number of transactions involving academic medical center ("AMC's") transactions doubled.*

While it may be hard to fathom how quickly the industry has changed, all of these statements are realities of today's hospital mergers and acquisitions ("M&A") landscape. Together, they are contributing to a hospital M&A environment that is very different than past years and warrants considering whether the industry as a whole has entered a new frontier. In order to better understand the realities of the current market, we have identified a number of key themes that are driving the activity occurring between both not-for-profit ("NFP") and for-profit ("FP") health systems.

#1

## The Heightened Pace of Announced Mega Mergers between NFP Health Systems

Lately it seems not a week passes without an announcement that two high profile, well positioned and well capitalized regional or national systems have plans to either engage in exclusive discussions to explore a strategic alliance (signed Letter of Intent - "LOI") or formally announce definitive plans to merge (signed Definitive Agreement). The table below profiles NFP health system mergers announced in the past 12 months whose combined revenue is greater than \$3.5B.



- CHI, the fourth-largest health system in the US, with 104 hospitals in 17 states and \$15.7B in revenue
- Dignity Health, a 39-hospital system in CA, AZ, and NV, with \$11.6B in revenue
- October 2016 announced LOI to merge, with a definitive agreement reached in 2017
- Merged organization will be the largest not-for-profit health system in the US with \$28.4B in revenue



- Palmetto Health, a six-hospital system in Columbia, SC, with \$1.5B in revenue
- Greenville Health System, a seven-hospital system in Greenville, SC, with \$2.0B in revenue
- Entered into LOI in June and definitive agreement reached in November
- Merger of equals



- Beth Israel Deaconess and Lahey Health announced plans to merge in January 2017
- During negotiations, contemplated transaction grew to include three other healthcare organizations (New England Baptist Hospital, Mount Auburn Hospital and Anna Jaques Hospital)
- Massachusetts Department of Public Health approved proposed merger in March 2018
- Combined revenues of organizations would be over \$5B, creating the second largest system in the State



- UNC Healthcare, a ten-hospital system in NC, with \$3.6B in revenue
- Carolinas HealthCare System, a 13-hospital system in Charlotte, NC, with \$5.9B in revenue
- August 2017 announced LOI to create a joint operating company, targeting definitive agreement by the end of Q1 2018



- Aurora Health Care, 15 hospitals in Wisconsin, totaling \$5.0B in revenue
- Advocate Health Care Network, 12 hospitals in Illinois with \$5.5B in revenue
- December 2017 announced plans to merge and completed merger in April 2018
- Creates 10th largest not-for-profit, integrated healthcare system in the United States



- Bon Secours, 20 hospitals in six states, \$3.3B in revenue
- Mercy Health, 23 hospitals in two states, \$4.7B in revenue
- Merger is expected to be completed by the end of calendar year 2018, creating the fifth-largest Catholic provider in US

There is certainly a great deal of debate around the motivations for these mega mergers, but what is certain is the unprecedented degree to which this is now happening. In 2017 alone, there were nine NFP health system mergers where the smaller entity's revenue exceeded \$1B. To provide historical context, this is the equivalent of the total number of deals this size over the previous three years combined.

Given the fluidity in the market and the complexities associated with merging such high-profile organizations, there are still questions as to whether or not all of these announced transactions will cross the goal line to closing. In fact, some of these deals have already been suspended or called off. Six months after announcing their partnership plans, Atrium Health (formerly Carolinas Healthcare System) and UNC Health Care have tabled discussions. Other transactions have closed, but taken longer than expected to move from an LOI to Definitive Agreement to closing, evidencing the complexity (both logistically and politically) of merging such large systems.

Organizations that are mutually aligned on deal terms could still face protracted public/political resistance and/or regulatory hurdles. For example, the well-publicized merger in East Tennessee between Wellmont Health System and Mountain States Health System (now Ballad Health) was finalized in January 2018, almost three years after signing an LOI. Earlier this year, South Carolina lawmakers proposed legislation threatening to force the sale of Greenville Health System, jeopardizing the planned deal with Palmetto Health, before alternative legislation was introduced to potentially clear the path forward. While there clearly remains uncertainty around how many of these mega mergers consummate, the volume of announced partnerships demonstrates that there are fundamental changes in the industry compelling these large organizations to gravitate to other well positioned organizations of similar size.

#2

## NFP-to-NFP deals are becoming larger, and the credit quality of the targets is trending upwards in a meaningful way

In 2017, there were 27 NFP-to-NFP transactions where the target organization had revenue of over \$300M compared to just 13 transactions this size in 2013. This has led to a significant jump in transaction size, which further supports the trend of NFP health systems pursuing larger transactions. This trend appears to be holding strong in 2018 as well.

In February, Navicent Health, a strong AA-rated +\$700MM revenue system based in Macon, Georgia announced plans to merge with North Carolina's largest health system, Atrium Health. This comes on the heels of Houston Healthcare, a +\$250MM revenue system in Warner Robbins, Georgia, announcing exploratory discussions to align with Navicent Health in the fall of 2017. The case of Navicent Health in many ways epitomizes what the NFP M&A industry is witnessing: a firmly entrenched regional system, with a strong credit profile, pivoting from being the acquirer to the acquired. No longer is it simply 'at risk' or financially stressed single site hospitals searching for a financial partner. Today's merger activity includes the full gamut of healthcare providers.

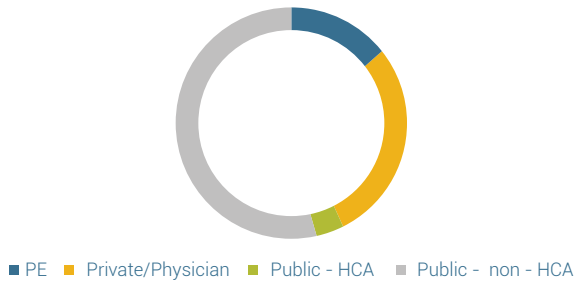
#3

## The composition of active FP acquirers has shifted dramatically from several publicly traded companies to HCA and a group of privately owned hospital companies, and divestitures by FP's are rampant

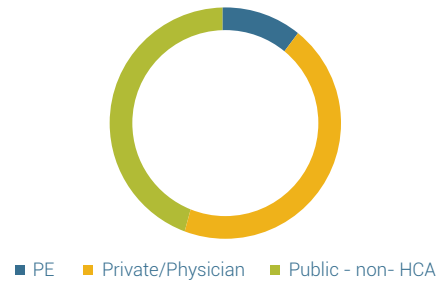
Despite the financial and operational difficulties of many publicly traded FP companies over the last five years, the percentage of announced M&A transactions involving an FP acquirer remained relatively unchanged at 25% from 2013 to 2017. That said, the profile of the active FP systems looked very different in 2013 than it does today. At the start of 2013, there were seven publicly traded FP systems, five had equity market capitalizations of approximately \$2.5B and the other two, Universal Health Services, Inc. ("UHS") and HCA were at \$5B and \$15B, respectively. In 2013, LifePoint Hospitals, Community Health Systems ("CHS") and Tenet Healthcare ("Tenet") were among those systems aggressively acquiring other hospitals. These included Tenet's acquisition of Vanguard and CHS's acquisition of Health Management Associates, Inc. In fact, in 2013 16 of the 28 (or 57%) total FP acquisitions involved publicly traded companies and only one transaction included HCA.

Fast-forward to the end of 2017 and the composition of public healthcare companies looks starkly different. There are now six public companies, of which four have under \$2B in market capitalization, while HCA has nearly doubled in equity market capitalization to over \$32B. In 2017, only 10 of the 31 (or 32%) total FP acquisitions involved publicly traded companies and nine of these included HCA. Recent notable transactions involving HCA include the acquisition of Memorial Health (+\$580MM) in Savannah, Georgia and three Tenet Hospitals in Texas, totaling \$575MM in revenue. HCA's appetite does not appear to be slowing down as evidenced in the March 2018 signing of an LOI to acquire Mission Health System, a \$1.7B revenue and Aa3/AA-/AA- rated system based in Asheville, North Carolina

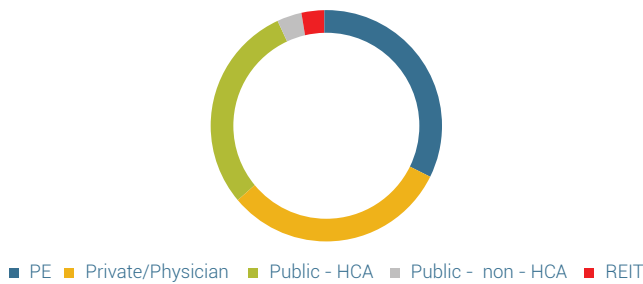
2013 FP Acquirer Profile



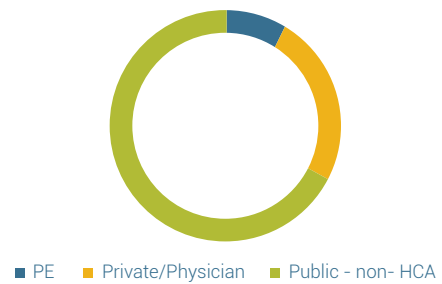
2013 FP Seller Profile



2017 FP Acquirer Profile



2017 FP Seller Profile



Privately held and private equity backed healthcare providers have filled the void left by non-HCA public company acquirers. In 2017, Steward Health Care System, LLC became the largest privately held hospital operator in the United States after acquiring IASIS Healthcare, and in a separate transaction, eight CHS hospitals totaling over \$900MM revenue. Steward now oversees 36 hospitals across ten states with projected annual revenue for 2018 of almost \$8B. Ardent Health Services was another active FP provider in 2017. After being acquired and recapitalized in 2015 by Ventas, Inc. and Equity Group Investments, Ardent has completed several high-profile acquisitions including LHP Hospital Group, St. Francis Health (Topeka, Kansas) in partnership with the University of Kansas Health System, and East Texas Medical Center in partnership with University of Texas. The viability and capacity for acquisitions among the remaining public FP companies has clearly become a major question, especially if HCA continues to flex its size advantage over its FP publicly traded peers and the growth in private equity backed healthcare companies continues. Not only have the non-HCA publicly traded companies pulled back from their pace of acquisition activity, they have been actively selling many of their non-core assets in efforts to try to reposition their overall business strategy, improve near term operating performance and deleverage their strained balance sheets.



In 2017 alone, there were 23 divestitures by the publicly traded FPs compared to only four five years prior. CHS announced nearly 30 hospital divestitures over 12 transactions in 2017. Quorum Health Corporation, which spun off from CHS in May 2016, has already divested or announced planned divestiture of 14 hospitals. As of Q4 2017, Tenet Healthcare announced divestitures in three consecutive quarters after not announcing any divestitures in calendar year 2016. Declining same store performance, deteriorating EBITDA margins and market-by-market challenges are sobering realities that may not offset the effect of divesting underperforming assets. Only time will tell how much further these hospital operators will need to pare down assets in order to right size, but that then raises the question whether they will become acquisition targets for larger and stronger entities or major private equity funds.

#4

## Academic Medical Centers (“AMCs”) and teaching hospitals are as active as ever in M&A and partnership arrangements

Historically, AMCs, relative to traditional hospitals and health system, have been slow to join the wave of strategic partnerships and merger activity. In the 1990s and early 2000s, some AMCs aligned with FP hospital companies and other NFP's largely because of their capacity to access capital and attempts at gaining scale, but generally these partnerships were unique and market specific. However, as AMCs begin to experience greater strain from lower federal funding of graduate medical education and threats to some of its key reimbursement sources such as 340b drug pricing, the pressure for AMCs on profitability is magnified given that AMCs generally run at higher cost levels than other hospitals and health systems. Facing these increased pressures, AMCs have been compelled recently to consider strategic alignments with their nonacademic system partners.

By 2017, a staggering 31% of announced transactions involved AMCs and teaching hospitals, compared to only 16% five years ago. AMCs have been driven by the need to buildout their footprint and ambulatory presence, which has led to a growing wave of more integrated partnerships, mergers and acquisitions. Synergistic partnerships and joint ventures, particularly with FPs, have also gained traction. Examples include a joint venture between University of Central Florida College of Medicine and HCA to build a 100-bed teaching hospital in Central Florida, and the University of Kansas Health System and University of Texas System each announcing joint ventures with Ardent to acquire hospitals in their respective regions. In total, there were six unique synergistic JVs announced in 2017 involving AMCs.

Beyond joint ventures, there have also been a larger number of traditional mergers and acquisitions. One of the most active systems is the University of Pittsburgh Medical Center ("UPMC"), which announced the acquisition of +\$1B PinnacleHealth and three other separate community hospitals transactions in Pennsylvania. More recently, in March 2018, Einstein Healthcare and Jefferson Health announced plans to merge bringing together two of the largest AMCs in the region. In addition, some AMCs have sought to unwind JVs and Joint Operating Agreements ("JOA's") after their existing partnership interests were no longer aligned. After managing OU Medical System hospital facilities under a joint operating agreement with the University Hospitals Authority Trusts since 1998, HCA agreed to terms with the University of Oklahoma UHAT to transfer ownership and management back to both the University and Authority. The University of Louisville assumed operation of University Medical Center in another JOA unwind, effective July 1, 2017. UMC was part of a JOA with KentuckyOne, whose parent company is CHI. In summary, activity among AMCs is prevalent, evolving and showing no signs of slowing down, both in terms of the formation of new alignments as well as changes to existing partnership agreements. AMCs, like all health care providers, cannot afford to take a "wait and see" approach in today's rapidly evolving healthcare environment.

## CONCLUSION

In 2017, there were 118 announced hospital change of control transactions, one of the highest years on record. However, the pace of deal activity itself is not nearly as compelling as the stories behind the industry's transformational themes outlined above. There is a clear market consensus that momentum for rapid M&A activity persists, but it remains unclear how that activity impacts the future construct of healthcare providers and the competitive landscape going forward. Will the latest major wave of mega mergers become the new normal, and will the success or failures of these alignments change the course of future M&A activity? The unique surge in mega mergers creates a push-pull dynamic between whether larger transaction combinations fuel even bigger deals or whether the pace slows as these large-scale organizations assimilate and integrate new members into their system, especially as some systems begin to talk about de-emphasizing inpatient facilities. Could we see the struggling publicly traded FP's find footing in 2018-2019 and stabilize, and does HCA enter a period of acquisition digestion or continue on the acquisition trail? Will AMCs embarking on new partnerships, especially with FPs, prove mutually beneficial and sustainable? These are all big questions in the context of unprecedented circumstances, proving that the trend in M&A within the hospital industry is certainly entering a new frontier.