

# ACQUIRE, GROW ORGANICALLY, OR MERGE?

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The Critical Question For Healthy Independent  
Hospitals And Regional Health Systems To  
Answer In 2019

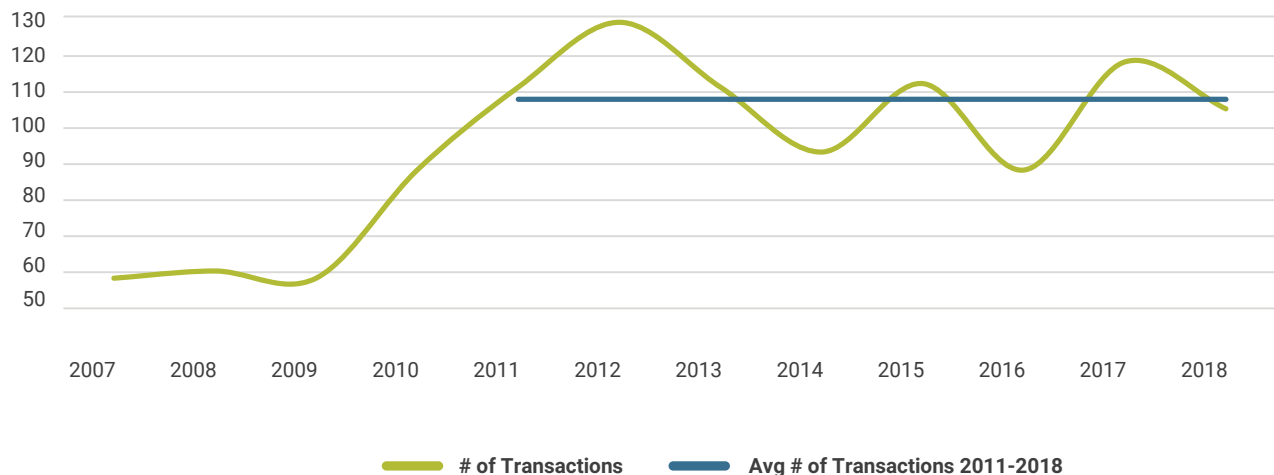
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Over the past decade, many independent hospitals and health systems have merged with larger, stronger credit quality systems. Announced hospital M&A activity increased from 58 transactions in 2009 to 111 in 2011 and has averaged over 100 per year since that time. While some of these transactions were the result of financial distress, others were accomplished for more strategic or practical reasons.



While the proliferation of consolidation is not a new theme, there is a lull in the amount of activity in the second half of 2018 with announced hospital M&A activity decreasing in the last six months of 2018 versus the same period in 2017. Based on conversation with our clients and other providers, this is due in part to the remaining healthy independent hospitals and regional health systems assessing the landscape. The pressing matter is which path will independent hospitals and regional health systems choose in 2019: acquire, grow organically or merge?

The key challenges facing our clients and driving this introspection are consistent:

- Modest volume growth in 2017-2018 with a significant impact to operating margin
- A need to identify new growth strategies to offset the steady increase in expenses
- The desire to expand ambulatory footprint
- Continued employed physician group losses
- The need to pursue population health at the proper pace
- A pursuit of lighter affiliations in lieu of full integration

With the industry facing so many pressures, it is clear that even the healthy independent hospitals and regional health systems will need to address these challenges. What remains to be seen is how they will be able to address them without the resources of the mega systems?

#1

## ACQUIRE?

### INDEPENDENT HOSPITALS AND REGIONAL HEALTH SYSTEMS REMAIN THE LARGEST GROUP OF ACQUIRERS

Despite the headlines captured by mega-mergers of not-for-profit (“NFP”) healthcare systems, independent hospitals and regional health systems (\$200 million to \$2.5 billion in net revenue) have been the most active group of acquirers of hospitals in 2018. Many of these providers are acquiring hospitals for the first time or for the first time in many years, emerging as formidable competitors to the larger systems and for-profits. In fact, continuing a five-year trend, in 2018, small to mid-size health systems and large independent hospitals accounted for nearly half (48%) of announced NFP acquisition transactions.

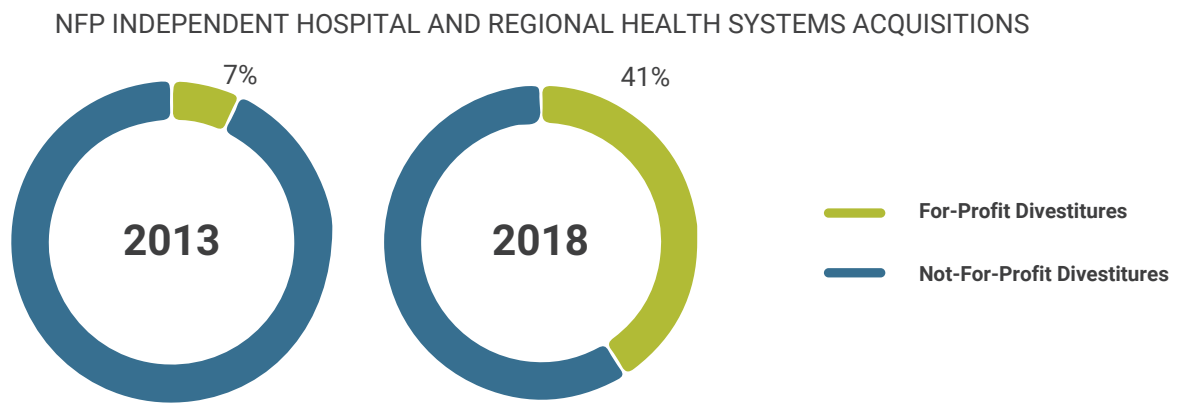
#### 2018 Announced Transactions

Revenue Category	% of NFP Acquirers
> \$2.5 billion	46%
\$200 million-\$2.5 billion	48%
< \$200 million	6%

Digging a bit deeper into the acquisition activity over the past year, for-profit health systems, with the notable exception of HCA, all but ceased acquisition activity of NFP hospitals and health systems in 2018. In the five-year period between 2013-2017, for-profit operators averaged more than 16 transactions per year with NFP hospitals and health systems. Through November 2018, only four such transactions were recorded. HCA's acquisition of Mission Health in Asheville, NC represents the only publicly-traded for-profit health system acquisition of a NFP health system for the year.

In fact, most for-profit systems are in the opposite mode, divesting assets in an attempt to de-lever their balance sheets. Given the landscape, the independent hospitals and regional health systems have become the most likely acquirers of for-profit divestitures as well as others seeking partners, making up 41% of acquisitions in 2018. (A figure that has increased from 7% in 2013.) At the same time, many large not-for-profit systems have focused on mega-mergers, with announcements from Advocate-Aurora, CHI-Dignity Health, Baylor Scott & White-Memorial Hermann, and Mercy Health-Bon Secours. These mega systems seem to be thinking about scale on a completely different level than independent hospitals and regional health systems, and often ignoring the opportunities afforded by the acquisition of individual hospitals. The focus of the mega-mergers is often on non-contiguous acquisitions that offer large initial foot-holds into new geographical markets. Single hospital acquisitions often just don't 'fit the bill'.

These trends create a tremendous opportunity for independent hospitals and regional health systems to enhance regional relevance and market share through the acquisition of smaller hospitals.



## Not All Scale is Created Equal

Regional relevance is the everyday battle for our mid-size provider client base. Many clients wrestle with the question of "How big is big enough?" A \$200 million independent hospital may think a \$500 million regional system is the right size, while a \$2 billion system thinks \$5 billion in net revenue is the goal. While there is little doubt that scale is extremely important, not all scale is created equal. Size relative to market opportunity and the ability to create regional relevance are of the utmost importance to weathering industry headwinds.

The need for regional relevance is evidenced by recent activity by for-profit systems. As mentioned previously, for-profit acquisition activity flourished between 2009 and 2015 to build overall scale, accounting for 30% of the total acquisition volume. Many of these transactions include portfolios of community hospitals that were outside existing markets and/or not market share leaders in competitive markets. As a result, the fallout for some of these for-profit hospital companies has been to cease new acquisition activity since 2017 and instead to divest a significant portion of their portfolios to de-lever their balance sheets.

What can one learn from the rapid growth and resulting fallout experienced by some of the for-profit operators? When considering an acquisition, the answer is to focus on building scale to expand regional relevance and for new markets, evaluating a target's market share. As seen with many of our clients and the market activity over the past 12 months, acquiring the in-region and adjacent for-profit hospitals being shed by large for-profit operators has been an effective means to building relevant scale as seen in the following examples.

- MUSC (SC) acquiring CHS's four remaining South Carolina hospitals
- Baptist Memorial Health Care (TN) acquiring McKenzie Regional Hospital from QHC
- Baptist Health Systems (AR) acquiring Sparks Health System from CHS
- St. Luke's Hospital (MO) acquiring Des Peres Hospital from Tenet
- Health West Tennessee Health (TN) acquiring three hospitals from LifePoint Health

Over the past decade, the industry has evolved away from systems with hospitals in disparate markets with varying levels of market relevance, to the most successful healthcare providers being market leaders and regionally relevant. Therefore, when assessing "how big is big enough?" regional relevance is of equal importance as size and scale. The result is:

- Top line growth
- Extended geographical reach
- Enhanced regional relevance
- Added scale and concentration of covered lives for value-based healthcare models
- Defensive move against larger out-of-market competitors
- Addition of new physician specialties or depth; expand or become a regional referral center
- Ability to spread fixed costs across large revenue base to offset expense inflation

# Integration of Acquisitions is Not Easy

As many of our clients have pointed out, hospital acquisitions are not easy. A considerable number of providers are first-time or infrequent acquirers. Transactions require substantial focus and can strain even the most well-run organizations, especially when health systems already have a full plate of organic growth initiatives. As a result, this group must be aware of the risks involved with acquisitions including:

- Significant management time commitment
- Near to medium-term pressure on balance sheet due to purchase price, debt assumed, and capital commitments
- Pressure on consolidated operating margin as targets are often underperforming with losses growing in the months leading up to closing
- Post-transaction integration is time intensive and critical for success
- Financial performance of the target can get even worse post-transaction before it gets better as needed changes are made
- Industry's shift to outpatient services may call into question the need for acquiring hospitals
- Rating agency scrutiny of acquisitions may pressure bond rating due to financial pressures and integration concerns; delivery of the business case is critical

While these risks are not insurmountable, Ponder urges its clients who acquire hospitals to evaluate the investment over a three-to-five year period. There may be near-term moves that can provide a small-to-medium sized lift to margins, often related to specific expense line items or to enhancing payor strategies, but the real benefit of acquisitions is the long-term value of combined strategic growth. This strategic growth takes significant management resources, financial commitments, and time, but for those who pick the right acquisitions and the required time and resources, it can strengthen the organization over the long run.

## #2

# GROW ORGANICALLY? THE NEVER-ENDING FOCUS

Regardless of external growth, independent hospitals and regional health systems realize organic growth is essential to remaining relevant. A lack of top line growth with increasing expenses has a dramatic effect. Even modest revenue pressure can significantly dampen the bottom line; therefore, organic growth is critical. If a system with a 3% operating margin does not grow revenue for a year, while expenses continue to grow at 3%, the operating margin drops dramatically from 3% to zero. Thus, maintaining status quo is unsustainable. Given the pace of wage growth, increasing pharmaceutical costs and employee benefits, hospital executives need to grow revenue significantly each year just to keep pace. Therefore, this theme and the potential responses by our clients are very consistent:

- Expand the ambulatory footprint, organically or through in-market partnerships
- Optimize the employed physician group, filling gaps where needed and assessing effectiveness of existing providers
- Consider (or expand) creative approaches to value-based payment models
- Extend the current footprint, ideally without upsetting the balance with neighboring competitors
- Address post-acute needs and continuum of care often through partnerships of select groups of providers
- Consider partnerships of all sorts to diversify revenue streams

Organic growth is critical regardless of whether providers acquire or not.



## BE ACQUIRED? STAY ON THE LOOKOUT

While focused on growth, the independent hospitals and regional health systems are also wise to keep a lookout for opportunities with larger systems. Board members and management often view keeping in touch with these bigger systems as part of their fiduciary duty. Often the strong desire is to stay independent, but if healthcare headwinds grow meaningfully stronger or competitors become more aggressive, independent hospitals and regional health systems want to be aware of their strategic options. Many have taken or are considering lighter affiliations with their large system neighbors. These lighter partnerships range from service line affiliations, to sharing corporate services, to developing clinically integrated networks, to broader regional collaborations. These relationships are ways to gain incremental benefits of volume or margin and to assess the relationship before fully committing to an integrated structure. However, independent hospitals and regional health systems need to recognize that lighter partnerships may not satisfy the larger system partner in the long term, and a number of these collaborations have dissolved over time as the participants seek additional lift and benefits via more integrated relationships.

## Characteristics of Healthy Independent Hospitals and Regional Health Systems

In considering the need to pursue more integrated structures, such as the need to merge, Ponder stresses to its clients that the question comes down to whether or not the independent hospitals and regional health systems can best carry out their mission and meet their strategic goals on a standalone basis or by partnering with another system. The question is not whether bigger is better or can we achieve \$5 billion in scale, but rather can we meet the health needs of our community we serve?

In considering this question, we have found that there are common characteristics of those who remain independent and thrive. Not all of these characteristics are required, but the more characteristics that describe the system, the better:



- Differentiated market position, isolated service area or lack of serious competition
- History of proactive reinvestment in capital assets and strategic expansion
- Strong balance sheet (high liquidity and low leverage)
- Geographically distributed care system / patient acquisition strategy
- Strong physician alignment and integration (especially primary care)
- Strong demographics, payor mix
- High quality service lines (clinical and care delivery/service)
- Consistently higher profitability (EBITDA margins in excess of 9%)
- Key, meaningful strategic alliances
- Common/integrated information systems and structure to effectively manage total cost of care and population health
- Willingness to innovate (creative partnerships) and assume risk
- Strong administrative and physician leadership

Again, not all of these are needed, but healthy independent hospitals and regional health systems should regularly assess where they stand in terms of each of these characteristics. Ponder stresses to its clients the need to develop a scorecard and revisit it at least annually.

## CONCLUSION

Hospital M&A activity has been consistent and robust for most of the past decade. However, the softness in the market in the second half of 2018 begs the question of whether this is a theme or an anomaly. We believe that a major factor of the slowdown is that many more challenged independent hospitals and small health systems have already been forced to find partners. The remaining independent hospitals and regional health systems are healthier as a group and are now pausing to assess their options—organic growth, acquisitions, mergers, or a combination of these. It is essential that independent hospitals and regional health systems (1) be disciplined with their acquisition strategy, (2) choose a select, but not overwhelming, number of organic growth strategies and (3) be cognizant of their own options with larger partners. All of these paths must be pursued concurrently while analyzing their position in terms of the characteristics of healthy systems outlined above. At the end of the day, consolidation is likely to continue, but the ultimate pace of consolidation will be dictated by the trajectory of industry challenges related to volume constraints, reimbursement pressure, and pace of the transition to value-based care. Systems are wise to continue to evaluate their role in the market, their potential options, and how future changes may change both of those.