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Announced Quarterly Hospital M&A Volume is the Lowest in Nearly 10 Years

Market Perspectives - 2019

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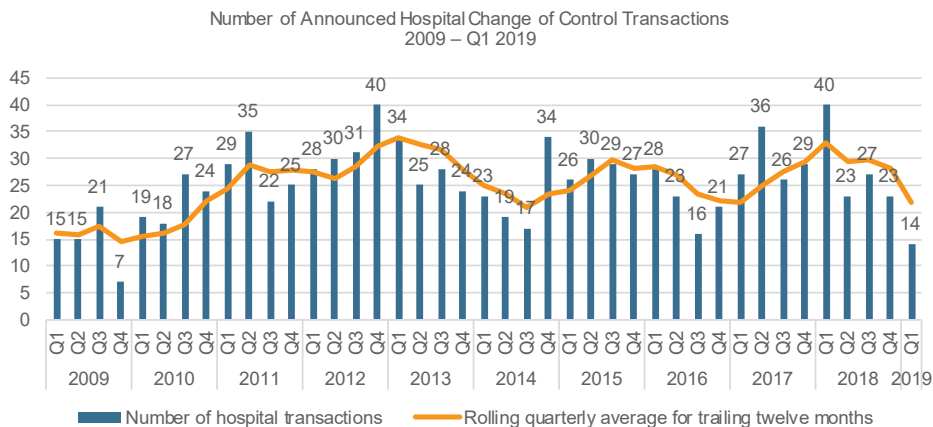
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The first quarter of 2019 exhibited the lowest quarterly volume of announced acute care hospital transactions since the fourth quarter of 2009. It also marked the first quarter since the third quarter of 2016 that had less than 20 announced transactions.



#1 What is Driving the Reduced Transaction Volume?

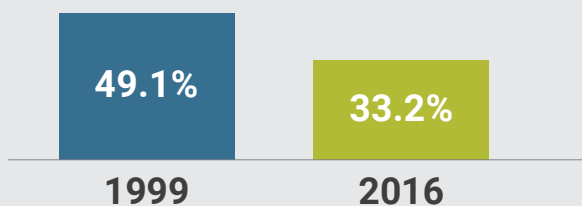
One major driver of the slowdown is the reduced pace of for-profit divestitures after the frenetic selloff during 2017 and 2018. CHS announced 24 separate transactions in 2017 and 2018, while Tenet and LifePoint combined to announce another dozen divestitures over the same period. QHC, which was spun off from CHS in 2016 with 38 hospitals, announced the divestiture of 14 hospitals (over nine transactions) in 2017 and 2018. Over the last several quarters the for-profit divestiture pace has slowed as they have sold their most isolated and disparate assets. We foresee continued for-profit divestitures as these systems further evaluate and reposition their portfolios, but at a slower pace with less urgency.

Another factor contributing to the decline in announced transactions is the ‘natural pause’ that occurs following a period of acquisitions in which the consolidators take the necessary time to digest and integrate their new acquisitions. Tackling the demands of integration, while simultaneously addressing the nationwide decline in inpatient utilization trends, consolidators are questioning the need to continue to acquire small community hospitals. Furthermore, the number of non-rural struggling hospitals that need to seek a partner has diminished after a decade of rampant M&A activity (Exhibit 2).

Additionally, the pool of potential partners for these struggling hospitals to join has shrunk as consolidation completed over the last decade has reduced their options. The increasing rate of rural hospital closures also indicates the options for these hospitals are shrinking. Meanwhile, healthy independent small-to-mid-sized systems are carefully considering all strategic options available – organic growth, acquisitions, or partner. With the changing healthcare delivery landscape, the impetus for growth still exists, but these systems are balancing the need to act with the need for judicious action.

Exhibit 2
Trendwatch Chartbook 2018.
American Hospital Association.
2018. Washington, DC

Hospitals Not in Health Systems (%)



#2 **Is Hospital M&A Over?**

We do not view the reduced volume of the first quarter 2019 to be a harbinger of the end of hospital M&A. First, the drivers of consolidation have not changed. The need to consistently grow at a rate that exceeds persistent expense inflation, reimbursement challenges, technology and capital needs, and the need to adapt to uncertain value-based payer models continue to pressure hospitals and systems of all sizes. Scale is critical in helping address these challenges although regional relevance is also essential. Second, the ability of many healthy small-to-medium sized health systems to ‘play Switzerland’ is getting more and more challenging as regional systems draw closer. Third, we find that the level of strategic discussions among systems has not relented at all—discussions related to both looser affiliations as well as change of control transactions. In certain major markets, significant mergers are under consideration that will have implications for the other providers in those markets and will likely result in further consolidation.

Furthermore, we forecast for-profit divestitures to remain high even if not at 2017 and 2018 levels. Both CHS and QHC have assets in their divestiture pipeline, evidenced through their earnings calls and by both companies' announced divestitures in Q1 2019. Additionally, LifePoint's merger with RCCH could result in divestitures as the portfolio is reviewed under private equity ownership.

Although the shift to providing care in an outpatient setting is a real and growing trend, healthcare systems are heavily anchored in inpatient care and the bonds community hospitals form with those they serve. Hospitals and regional additions will still be needed as the base of a health system's footprint. Another major focus for 2019 through 2020 we expect to see is not-for-profit systems operating more like systems rather than confederations, and likely divesting assets as portfolios are fine-tuned following the recent wave of mega-mergers.

#3 What are the Implications?

The reduced volume of M&A transactions is indicative of a shift to more thoughtful, slow and highly-disciplined processes. As more and more healthy systems partner with each other, creativity will be needed to structure these alignments in a way that appeals to two healthy systems, not simply a takeover. Many health systems are seeking ways to be proactive in their consideration of strategic options and to identify and approach strategically valuable assets, instead of being reactive to opportunities when they are presented to them. Systems are seeking external growth, but also have to evaluate their own partnering options on a regular basis, as regional opportunities and threats cannot be ignored.

So what should management teams, boards, and their other constituents do differently? The answer is that the same discipline and strategic thinking are required as they have implemented for the past five years. A dip in announced M&A activity does not mean the end of consolidation or that the reasons for consolidation are no longer relevant. Health systems must continue to aggressively pursue multiple paths at once:

- Assess their strategic position and ability to remain independent in a disciplined manner at least once a year
- Continue vigorous pursuit of organic growth strategies
- Pursue proactive outreach and discussions with systems that could be future partners
- Consider and study strategic system alignments that are short of change of control
- Closely monitor the strategic moves of competitors and new market entrants