GOVERNANCE THOUGHT LEADERSHIP SERIES

Texas Healthcare Trustees

Mergers and Affiliations 101: Why Hospitals Choose This Path and Key Considerations for Success

Providing education, resources, leadership development to inspire excellence in health care governance.

Merger and affiliation activity in the health care industry has been increasing in recent years and continues at a rapid pace. In 2017, 115 health care entity merger transactions were announced – the highest number in recent history – with Texas being one of the most active states for merger activity. [i] This reflected a 13 percent increase over 2016[ii] and continued an upward trend that is not expected to slow down anytime soon. On the physician front, hospitals acquired 5,000 physician practices between July 2015 and July 2016. [iii]

Changes in reimbursement, regulatory complexity, competition, and the availability of capital have all combined to create an environment that rewards size and scale all along the health care continuum. The lines between for-profit and not-for-profit, provider and payer, physician group and hospital system continue to blur as hospitals seek to merge and affiliate with other entities that will help them deliver high-quality patient care in an economically sustainable manner.

If hospital administrators and board members have not already considered some type of merger, acquisition or affiliation, chances are they will soon. The purpose of this article is to help these decision-makers understand (1) the various types of affiliations that hospitals may consider, (2) the reasons for such affiliations, and (3) the top considerations before pursuing a merger or affiliation.

Types of Affiliations [iv]

Merger, acquisition, affiliation – these terms can mean a lot of different things. In this section, we explore some of the various structures a hospital can use to collaborate with another entity all along the affiliation spectrum.

Clinical Affiliation

A clinical affiliation is an agreement to collaborate on an initiative or to provide a specific service together. This may involve local, regional or national partners. For example, the Mayo Clinic Health Care Network is a nationwide network in which hospitals and health systems enter into non-ownership clinical affiliations with the Mayo Clinic to improve the quality and delivery of care in their regions by taking advantage of Mayo's expertise and gaining access to various Mayo resources.[v] Clinical affiliations also help to align physicians, nurses and other providers across the care continuum, which is important in the era of increased bundled payments and population health initiatives.

Regional Collaborative

A regional collaborative is a flexible structure for partnering on specific initiatives and building the foundation for potential future integration. As the name suggests, these collaboratives usually involve independent entities in a common geographical area. An example of this type of model is the formation of Southwestern Health Resources, in which UT Southwestern Medical Center and Texas Health Resources combined electronic record keeping and coordinated patient care across their facilities in the North Texas area. [vi]

Accountable Care Organization

An Accountable Care Organization, or ACO, is an independent entity owned by constituent organizations and formed for the purpose of entering into risk-based contracts. ACOs resulted from the Affordable Care Act that was passed in 2010, and their purpose is to encourage continuity of care, reduce the cost of care and create shared accountability. Providers in an ACO are jointly accountable for the health of their patients, receiving financial incentives to cooperate and reduce the cost of care by avoiding unnecessary or redundant tests and procedures.

Joint Venture

A joint venture is a short-term or long-term arrangement between unrelated entities to form and operate a common enterprise that pursues a new or existing activity or purpose, while allowing for some level of involvement by all parties in the management or control of the activity. The entities that partner in a joint venture share both the risks and rewards of the activity.

Merger/Acquisition

At the far end of the affiliation scale is a merger, which is the formal purchase of one organization's assets by another, or the combination of two organizations' assets into a single entity. One of the largest hospital mergers in recent history was the combination of Baylor Health Care System and Scott & White Healthcare to form Baylor Scott & White Health in 2013. Just recently, Baylor Scott & White Health and Memorial Hermann Health System have announced their intent to merge, which would create the largest health system in Texas. A definitive agreement for this merger is expected to be completed in 2019 and is yet another indication that merger and acquisition activity in the health care industry is far from over.

Reasons for Affiliations

Hospitals have many reasons to seek additional partners as they continuously explore ways to deliver high quality patient care that also is economically sustainable. Hospital administrators and board members are tasked with achieving this goal in a highly competitive environment of increasing costs, declining reimbursement, and a push by insurers and patients alike to deliver more services in an outpatient setting. When contemplating an affiliation, hospitals typically consider both financial and quality-related factors.

Financial Reasons

Reimbursement

On the revenue side of the equation, hospitals are faced with relatively low reimbursement levels from governmental payers (i.e., Medicare and Medicaid) and declining reimbursement levels from commercial (managed care) payers. One reason to merge or affiliate is to gain leverage when negotiating reimbursement rates for managed care contracts by increasing the geographical service area and/or the market share of providers — and, in turn, the number of patients served by the health system. Potential enhancement of reimbursement rates should not be the only reason to affiliate but is an important consideration that cannot be overlooked.

Volume

As noted previously, hospitals face immense pressure on patient volumes, particularly for inpatient services. An affiliation may help alleviate some of the volume pressure by allowing hospitals to keep lower-acuity outpatient services within their system. Affiliations with ambulatory surgery center, imaging and rehabilitation service providers can provide an avenue for hospitals to maintain access to outpatient revenue streams that will help offset losses due to volume attrition in other areas of the hospital.

Risk Sharing

Vertical affiliations with providers of services that are required before and after an acute episode of hospital care potentially can yield increased reimbursement or reduced penalties by improving outcomes. Programs such as the Hospital Readmissions Reduction Program and the Medicare Bundled Payments for Care Improvement Initiative incentivize providers to work together. For example, affiliations with rehabilitation, home health or hospice providers can allow the hospital to influence the quality of care provided after a patient's discharge from the hospital, improving the hospital's ability to achieve quality incentives (i.e., increased reimbursement) or avoid penalties (such as readmission penalties). As reimbursement is expected to continue shifting from volume to value, increasingly it will become important for hospitals to have partnerships across the care spectrum.

STEPS INVOLVED IN A MERGER

A merger of two entities is a complex process that requires input and coordination among a number of different parties that include the entities' management teams, legal counsel and other advisors. Below are eight steps that are generally a part of most mergers.

1. **Hold initial discussions between interested parties.**
2. **Engage qualified experts (health care attorneys, experienced consultants).**
3. **Conduct preliminary due diligence.**
4. **Develop letter of intent.**
5. **Perform comprehensive due diligence.**
6. **Engage a qualified expert to perform a valuation of the entity to be acquired.**
7. **Negotiate and execute formal agreements.**
8. **Perform post-transaction monitoring.**

Cost Savings

Cost savings are another important reason for affiliations and mergers. With a merger, entities are often able to centralize functions such as information technology, purchasing, administration and human resources in order to eliminate redundancy and achieve economies of scale. Rural facilities may consider affiliating with larger facilities to take advantage of larger group purchasing organizations.[vii] With large physical plants and staff and high supply costs, hospitals and health systems are seeking ways to achieve economies of scale as a way to decrease operating costs. Therefore, the ability to partner with other organizations to leverage their resources and expertise while sharing costs can be a win-win for both entities.

Efficient Use of Resources

A key to a hospital's financial health is the ability to efficiently use resources. Ancillary service operators such as imaging and rehabilitation service providers often have the expertise and experience necessary to efficiently provide these services, while hospitals, with their historic focus on inpatient care, are better served utilizing inpatient space to provide higher margin services. This dynamic has led many acute care hospitals to partner with focused service providers to use their space and resources more efficiently. As noted in a recent report on health care mergers and acquisitions, "Hospitals and health systems looking to free up inpatient resources for services with higher margins have been entering into joint venture relationships with for-profit operators in order to move their inpatient rehabilitation units to freestanding hospitals." [viii]

Access to Capital

Operating a hospital is a capital-intensive endeavor. High-tech radiology and surgical equipment, new technology and expansion demands all drive the need for capital. An affiliation can open up new sources of capital and reduce capital costs for hospitals seeking to meet the needs of their patients, communities, providers and stakeholders.

Quality Reasons

Pay-for-performance, care coordination and population health are some of the quality-related reasons for hospitals to explore affiliation avenues. Patients, commercial payers and the federal government are all demanding quality, which in turn drives affiliation as hospitals seek new ways to be involved along the entire continuum of care. Becoming more vertically integrated by affiliating with physician groups, or horizontally integrated by partnering with another hospital or health system, can potentially improve quality outcomes by fostering clinical standardization and a better continuity of care when all caregivers have access to the same information at the same time.

What to Consider Before Affiliating

Merging or affiliating is a complicated endeavor. Regardless of which affiliation model is pursued, all involve bringing together entities with different perspectives, different cultures and often different goals. Strategic, legal and governance implications also must be considered, along with operational and logistical issues. Five major considerations that must be vetted prior to entering into any affiliation include:

1. What are the goals of the affiliation?
2. Who will champion the initiative?
3. What is the anticipated financial impact of the affiliation?
4. Who will the hospital be doing business with?
5. What will be the impact on stakeholders?

Goals

The first and most obvious thing to consider when deciding whether to pursue an affiliation path is determining the goal the organization is trying to achieve. The first question to answer is, "What are you trying to accomplish?"

Clearly defining a specific set of goals or desired outcomes will help to keep focus when obstacles, questions and detours present themselves throughout the process. Defining the goal may also prevent a transaction from happening if it becomes clear during the vetting process that the intended goal may not be possible. Having a clear objective from the outset will keep everyone focused on the same purpose.

Champion

As with any large project a hospital undertakes, affiliation strategies require a champion to oversee the process. For smaller affiliations, such as a joint venture, the champion may be the business development manager of the entity. Larger, more permanent affiliations, such as a merger, may require a special committee with the CEO as its chair to act as the lead on due diligence and negotiations throughout the lengthy affiliation process.

Regardless of the size and type of affiliation, the project's champion will need to be clearly defined early in the process, along with their specific responsibilities and authority levels. The designated champion should have adequate knowledge of the entity's operational and financial matters in order to make well-informed decisions and understand the implications of such decisions.

Additionally, it is important to have a champion among the physicians who are affiliated with the hospital, either as employees or independent physicians with staff privileges. Ultimately, the physicians are the ones providing services to the hospital system's patients, and they need to understand how the affiliation will impact both them and their patients. Particularly if the objectives of affiliation include quality-related factors, gaining buy-in from physicians will be critical in the success of the affiliation. Similarly, certain cost-cutting measures also require physician buy-in to the extent it impacts practice patterns (such as standardization of supplies). Generally, changes of this nature are most successful when a respected physician champions the cause.

Financial Impact

The financial impact of any decision must be considered, especially when considering a merger or joint venture, as these affiliations can be difficult to unwind. Is the affiliation anticipated to increase volume, increase reimbursement rates or reduce expenses? If an affiliation involves an acquisition of services traditionally provided in a clinic setting, have the implications of becoming part of a hospital system been considered (for example, differences in billing for clinic services versus hospital outpatient department?) Will financial value be created or destroyed? These questions must be answered before proceeding with any type of affiliation.

Business Partner

A significant question to consider is, "Who are you going to be doing business with?" A merger, joint venture or other type of affiliation brings together two entities that each have their own cultures, their own outlooks, and their own way of doing business. These attributes all must be considered before formally joining on any endeavor.

In addition, it is important to understand whether the decision makers in each organization are aligned in their values and goals. An affiliation may make sense on every other dimension, but if the two business partners are out of alignment at a fundamental level, then the likelihood of long-term success is low.

Stakeholder Impact

Hospitals are more than just a business: They are an integral part of our health care delivery system. They have a responsibility to their patients, their patients' families, their staff and the communities they serve. The impact on all of these stakeholders must be taken into account when considering any type of affiliation.

Conclusion

The health care landscape is shifting quickly and going it alone is becoming an increasingly difficult option. As the environment becomes more complex and challenging for hospitals and other health care providers, the likelihood of considering an affiliation or merger with another entity will only increase.

Hospital administrators and board members would be wise to understand the types of potential affiliations that will help their organization achieve its goals, and to remain vigilant in seeking strategic opportunities. However, to achieve the best chance for success, they need to first understand the goals of the organization and ask the right questions before embarking on a path toward affiliation.

[i] KaufmanHall. "2017 in Review: The Year M&A Shook the Healthcare Landscape." 2018.
[ii] Ibid.
[iii] Muchmore, Shannon. "Hospitals acquired 5,000 physician practices in 1-year period." Healthcare Dive, 14 Mar. 2018.
[iv] "The Field Guide to Hospital Partnership and Affiliation Models." Advisory Board, 23 Oct. 2014.
[v] "Building Brands and Networks: What Clinical Affiliations Mean for Providers and the Healthcare Industry." Becker's Hospital Review. 1 May 2014.
[vi] Robinson-Jacobs, Karen. "UT Southwestern, Texas Health Resources form huge health care network." Dallas Morning News 2 Oct. 2015.
[vii] "Executive Roundtable: A High-Level Look at Hospital Affiliations." Becker's Hospital Review. 10 Jul. 2014.
[viii] Meindl, John & Smart, Winston. "VMG's Healthcare M&A Report: 2017 Trends & 2018 Expectations." VMG Health. 2018.

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