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Partnerships, Mergers, and Acquisitions Can Provide Benefits to Certain Hospitals and Communities

A report by Kaufman Hall prepared at the request of the American Hospital Association

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Introduction

Hospitals and health systems face many pressures to increase the scale of their operations

Demographic and economic forces are increasing the percentage of patients who are beneficiaries of Medicare or Medicaid. Because these programs pay below hospitals' cost of care, hospitals must seek efficiencies of scale to drive down costs and minimize their losses. Larger organizations also can spread fixed costs across a greater number of facilities, lowering per unit costs of care.

Hospitals and health systems are assuming risk under value-based payment programs designed to drive down the total cost of care. Assumption of risk requires a patient population large enough to diversify risk and absorb the impact of high-risk, high-acuity patients.

The ongoing movement of care from inpatient to outpatient settings has opened healthcare to a new class of competitors who do not bear the high costs of providing acute-care services. These new competitors include major national retail chains and tech giants, whose scale and financial resources dwarf those of even the largest health systems. Health systems must increase scale to access capital on competitive terms. Moreover, scale helps health systems attract the intellectual talent necessary to innovate in competitive outpatient services, while maintaining access to—and enhancing the quality of—the acute-care services that they exclusively provide to their communities.

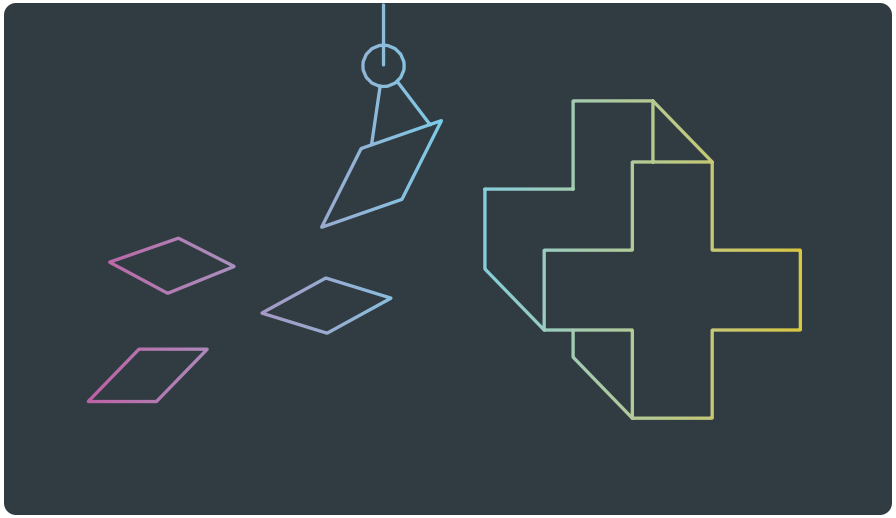
To help mitigate these challenges, hospitals are considering a range of partnership, merger, and acquisition possibilities to gain new capabilities, realize new efficiencies, and spread costs over a larger organization. As illustrated in the spectrum of opportunities on p. 7, hospitals considering these possibilities may pursue less integrated affiliations and partnerships or more highly integrated mergers and acquisitions.

The COVID-19 pandemic has had a devastating financial impact on hospitals and health systems. Prior to the pandemic, about 25% of hospitals had negative operating margins. At the beginning of 2021, almost one year after the pandemic took hold in the U.S., half of hospitals had negative margins, the result of significant volume declines and increased pandemic-related costs.

Legislative and regulatory change could create new financial pressures on hospitals. These changes include site-neutral payment policy proposals, efforts to limit discounts under the 340B Drug Pricing Program, and scheduled Medicaid Disproportionate Share Hospital (DSH) and Medicare sequester payment cuts.

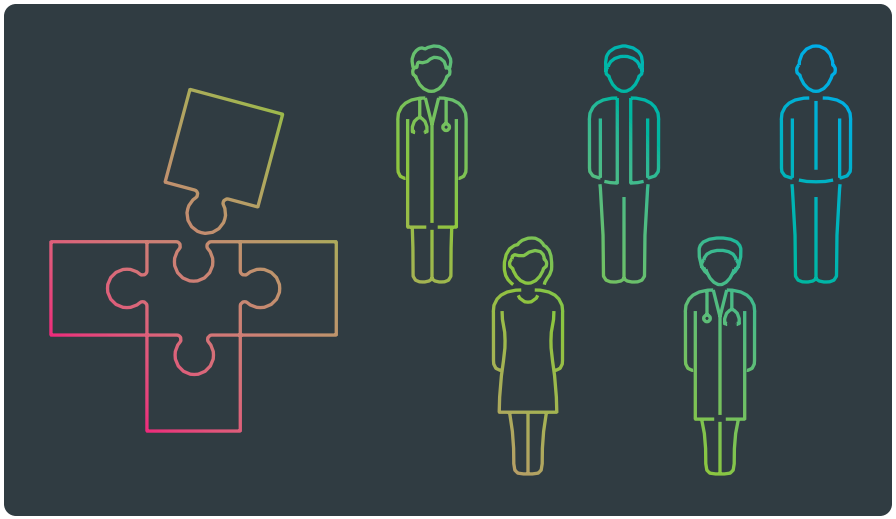
The impact of these forces has transformed healthcare

- As of July 26, 2021, the Cecil G. Sheps Center for Health Services Research at the University of North Carolina reports that 138 rural hospitals have closed since 2010. A new record was set in 2020, with 19 rural hospital closures, driven by low patient volumes, heavy reliance on Medicare and Medicaid payments, and new financial pressures resulting from the pandemic.
- An analysis of AHA and Kaufman Hall data suggests that almost 40% of hospitals may be financially challenged or distressed prior to an M&A transaction.



For some hospitals, partnerships, mergers, and acquisition are a necessary response to these forces and have provided many benefits to patients and communities

- They have saved certain hospitals from closure—even some of the most financially distressed organizations—preserving and often enhancing patient access to care
- They have given health systems the scale needed to:
  - Provide resources to support consumer-centric strategies that enhance the patient experience of care
  - Engage in partnerships with health plans and large employers to improve the accessibility and affordability of care
  - Obtain capital at an affordable cost to make investments in care delivery advances, technology, and population health infrastructure
- They have assisted in efforts to reduce costs while enhancing the quality of patient care



Integration models reflect hospitals' and health systems' strategic goals

Horizontal integration models between hospitals and health systems can range from looser affiliations to full acquisitions. Strategic goals of horizontal integration include:

- Increasing geographic coverage within a market to offer sufficient breadth of access to potential insurer or employer partners seeking new health plan options for their members or employees
- Bringing specialty services or management capabilities to hospitals in new markets, which expands access to healthcare services and enhances operational efficiencies
- Combining systems with complementary capabilities that can enhance care delivery, manage alternative payment model risk, or improve operations across the combined entities

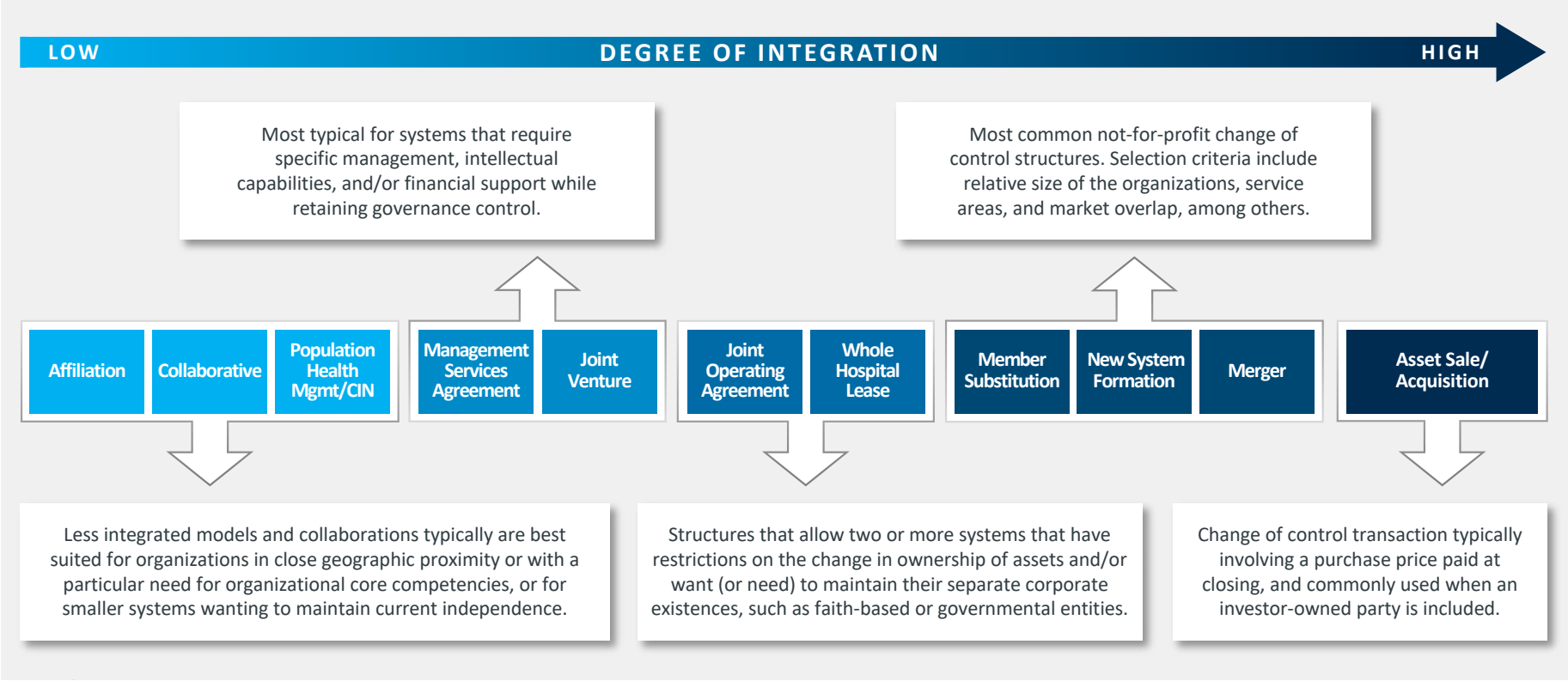
Vertical integration models between hospitals and health systems and other providers (e.g., physician groups, post-acute care facilities, behavioral health services) can also range from affiliations to acquisitions. Strategic goals of vertical integration include:

- Expanding patient access to services across the care continuum
- Building care networks to coordinate patient care under risk-bearing value-based payment models

The degree of integration is determined by a range of factors

A hospital that lacks strong management capabilities in behavioral health, for example, may enter a joint venture partnership with a skilled behavioral health operator.

A merger or acquisition may be more appropriate for a financially distressed hospital that requires major capital investment and management oversight from the acquiring hospital.



Source: Kaufman, Hall & Associates, LLC

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Benefits of Partnerships, Mergers & Acquisitions

Acquisitions of financially struggling hospitals can help preserve access to care

- Kaufman Hall analyzed data on 463 transactions between 2015 and 2019 (some transactions included more than one hospital). Among the 463 transactions, we conducted additional analyses with data from 266 hospitals acquired between 2015 and 2019 that were included in the AHA Annual Survey data.
- Approximately 20% of hospitals (92 total) in Kaufman Hall's database of 463 transactions between 2015 and 2019 cited financial distress as a key driver for the transaction. Some of these distressed hospitals had struggled financially for several years preceding the merger, but others saw rapid and significant declines in performance that triggered a decision to merge.
  - More than one-third of the hospitals citing financial distress (31 of 92) had declared bankruptcy, a clear sign of imminent closure.
  - The 31 transactions involving bankrupt organizations included 34 hospitals in total; only 6 of these hospitals have subsequently closed. **More than 80% were saved from bankruptcy** and remain operational today.
- In the additional analyses of 266 hospitals, **almost 40% (104) were financially challenged, cited financial distress, or both**. Financially challenged hospitals were defined as those having an operating margin at or below -2.0% for at least two of the three years prior to acquisition (including the year of acquisition). By comparison, median operating margins for hospitals rated by Moody's Investors Service ranged between 1.7% and 3.4% for fiscal years 2015–2019.*
  - Of the 104 hospitals identified above, 88 were financially challenged and an additional 16 were hospitals that cited financial distress at the time of acquisition.

*Moody's Investors Service: *Medians—Financial Performance Showed Stability Before Pandemic.* Sector Profile: Not-for-Profit and Public Healthcare – US. Sept. 9, 2020.

Acquired hospitals benefit from capital investment and improvements to better serve their communities

Many of the hospitals saved from bankruptcy have seen significant post-acquisition enhancements. For example:

Central Iowa Healthcare (IA), was acquired by UnityPoint and renamed UnityPoint Health – Marshalltown. Construction on a $38.4 million expansion facility has begun and is scheduled to be completed in 2022.

Oconee Regional Medical Center (GA), was acquired by Navicent and is now named Atrium Health Navicent Baldwin. More than $10 million has been invested in the medical center and it has a new nursing partnership program with Georgia College.

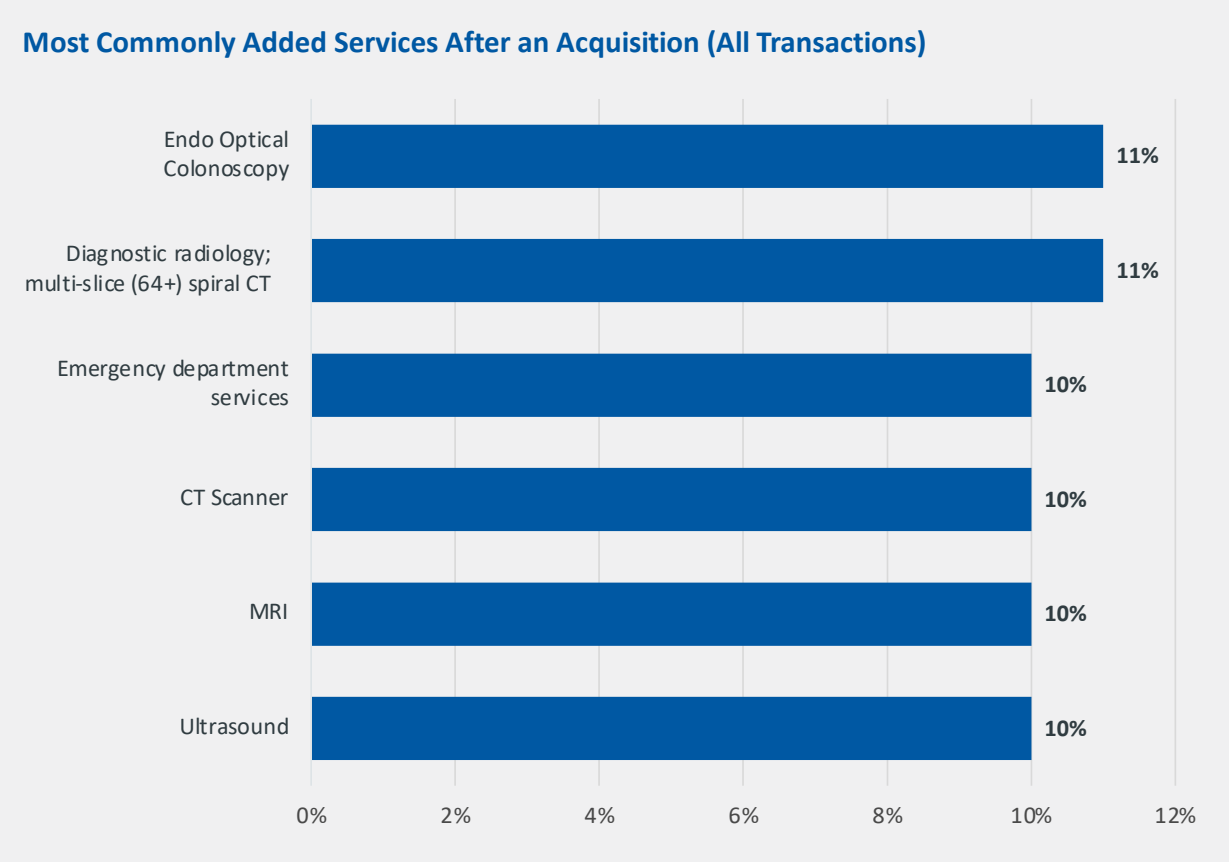
Morehead Memorial (NC), was acquired by UNC Health Care and renamed UNC Rockingham Health Care. At the time of closing, UNC pledged a $20 million capital investment over three years after the acquisition; most recently, the hospital acquired a $3.8 million linear accelerator for its cancer center.

Fayette Regional (IN), was acquired by Reid Health and renamed Reid Health Connersville. In the year following the transaction, it saw post-transaction improvements including:

- Complete transformation of the emergency department and the hiring of five permanent, certified emergency department physicians
- Restoration of outpatient lab, radiology, cardiopulmonary rehabilitation, and occupational therapy services
- Addition of new specialty services outreach in oncology and podiatry

Acquired hospitals are often able to offer expanded services

- Across all transactions, almost **4 in 10** (38%) of acquired hospitals added one or more services post-acquisition
- **Almost half** of hospitals acquired by an academic medical center (46%) added one or more services
- Patients at hospitals acquired by academic medical centers or large health systems also gain improved access to tertiary and quaternary services



Sources: AHA Annual Survey, 2016–2019; Kaufman Hall proprietary database on merger & acquisition activity, 2015–2019. Analysis focused on 46 services across major service areas, including behavioral health, cardiology & cardiac services, chronic disease/pain & wound management, diagnostics, emergency and trauma care, geriatric & palliative services, home health, neurology, oncology, and women's health.

Mergers and acquisitions can improve the cost and quality of patient care

A report by Charles River Associates for the AHA, updated in August 2021, found a **3.3% reduction in annual operating expenses** at acquired hospitals. A 2017 study in the *Journal of Health Economics* found an even more significant **average cost savings of 4%–7%** at acquired hospitals in the years following an acquisition.

The Charles River report found that **revenue per admission** at acquired hospitals **declined a statistically significant 3.7%** relative to non-merging hospitals, suggesting that cost savings are passed on to patients and health plans. The report also found statistically significant improvements in readmission and quality outcome metrics.

Finally, a recent study of rural hospital mergers and acquisitions, published by *JAMA Network Open* in September 2021, found significant reductions in mortality for a number of common conditions—including acute myocardial infarction, heart failure, acute stroke, and pneumonia—among patients at rural hospitals that had merged or been acquired. The authors concluded that "these findings suggest that rural hospital mergers were associated with quality improvement."

Larger health systems often have resources to pursue consumer-centric strategies and enhance the patient experience

Kaufman Hall surveys hospitals and health systems across the nation, and scores them based on four aspects of consumerism: access, experience, pricing, and infrastructure.

Based on scores, organizations are assigned to four tiers, with Tier 1 being the "best in class" overall ranking.

In our most recent survey, **almost 90%** of the organizations in Tier 1 (15 of 17) **had revenues in excess of $1 billion**, as did 74% (40 of 54) of the Tier 2 organizations.

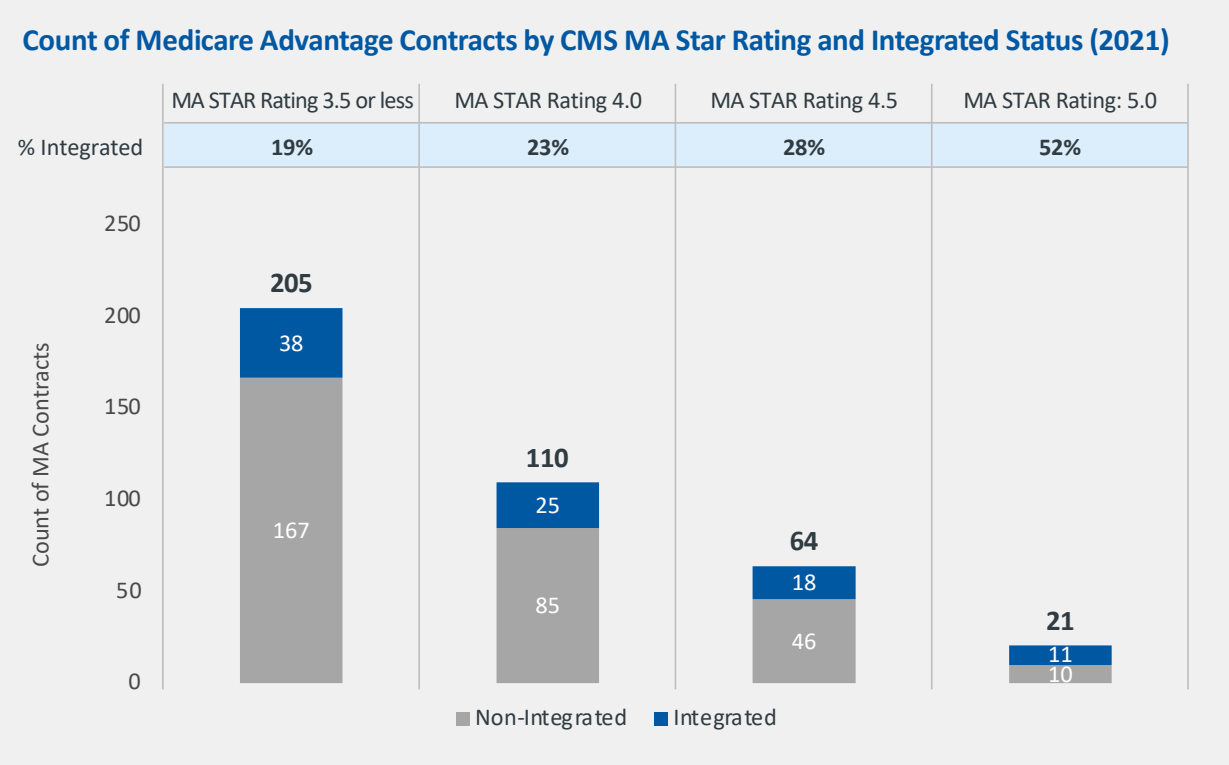
Ranking of Systems' Performance by Size (Annual Net Patient Service Revenues)

Overall Tier	$1B+	Under $1B	Grand Total
1	15	2	17
2	40	14	54
3	48	38	86
4	23	42	65
Grand Total	**126**	**96**	**222**

Source: Kaufman Hall, survey data for 2019 *State of Consumerism* report.

Integrated systems rank highly for excellence in services provided to Medicare beneficiaries under Medicare Advantage contracts

- Integrated systems represent an increasing percentage of Medicare Advantage (MA) contracts with CMS MA Star Ratings above 3.5.*
- The CMS MA Star ratings measure the quality of health and drug services provided under MA contracts to Medicare beneficiaries.
- In 2021, **integrated systems made up more than half (11 of 21) of the MA contracts awarded the highest 5-star rating,** although they represented just one quarter of all MA contracts.



Note: Excludes Medicare Advantage contracts not given an Overall Star rating by CMS.

Sources: CMS 2021 Star Ratings Data Table (published October 2020); CMS MA Monthly Enrollment by Plan Report, Apr. 2020; Decision Resources Group, Managed Market Surveyor, 2020; Parent organization websites. Kaufman, Hall & Associates, LLC

*MA Star Ratings are distinct from the star ratings used to compare hospitals on CMS's Hospital Compare website.

Large integrated systems are attractive partners for health plans seeking collaborations to make healthcare more affordable

- Consumers experience the cost of healthcare primarily through health plan premiums, deductibles, and copayments.
- Some health systems are creating their own health plans to further integrate care and coverage; other health systems are partnering with health plans to economically align their interests in the service of the consumer.
- A health system partner must bring sufficient network and economic scale to the partnership to achieve meaningful, quantifiable results within the health plan's member population.
- **Network scale** requires sufficient breadth, depth, and access to participate in alternative payment models, and requires both horizontal and vertical integration:
  - The network's geographic ***breadth*** increases its ability to pursue population-based models for large employers (i.e., public employers or large, regionally based corporations)
  - The network's ***depth*** in primary care services increases its ability to manage costs across the care continuum
  - The network's ***access*** to secondary, tertiary, and quaternary services increases it ability to control costs for procedural services
- **Economic scale** is a key enabler of success in alternative payment models. Greater economic scale increases:
  - The health system's **tolerance for risk**, which allows an alternative payment model to be big enough to be meaningful to the health plan and its members (or employers and their employees)
  - The health system's **ability to invest in capabilities** required for success in a value-based environment, which may or may not be revenue generating
- **17% of acquired hospitals** that provided data for the 2019 AHA Annual Survey reported a significant partnership with an insurance company or health plan, up from 13% in 2018.

Scale improves access to capital markets and the cost of capital needed for critical investments in care delivery and population health

- Credit-rating agencies—including Moody's Investors Service, Fitch Ratings, and S&P Global—assign ratings of health systems' creditworthiness that determine access to and cost of capital.
- Access to low-cost capital is critical to fund investments in care delivery advances, technology, and population health infrastructure that improve patient outcomes.
- Aaa is the highest rating Moody's assigns. Because of the challenges inherent in healthcare, no health system carries an Aaa rating. Within the Aa category (considered "high grade" by Moody's) only one health system in the country has the highest Aa1 rating.
- Scale is an important factor in determining an organization's credit rating. Of the 36 hospitals rated Aa3 by Moody's, **none have annual revenues below $1 billion**. One-third have annual revenues of $5 billion or more.

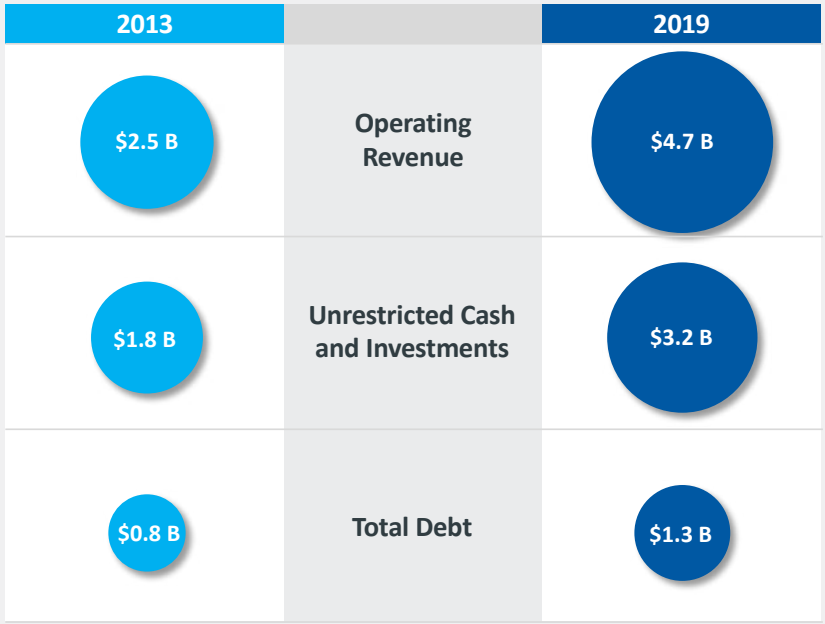
Metric	Moody's Aa3 Rated Systems [1]			
	All	<$5B	$5-$10B	>$10B
Number of Systems	36	24	7	5
Median Days Cash on Hand	284 Days	303 Days	260 Days	245 Days
Median Unrestricted Cash to Debt	168%	178%	161%	137%
Median Operating Margin	2.4%	2.3%	2.9%	3.4%
Median Op. Cash Flow Margin	7.6%	7.3%	8.5%	9.6%
Median MADS Coverage	5.4x	5.7x	5.4x	4.4x

Source: Kaufman Hall analysis of Moody's Municipal Financial Ratio Analysis (MFRA) database, using most recently available full fiscal year data in the database. Excludes systems that have not been updated since 2018 or earlier.

The scale requirements for high-grade ratings keep climbing

- Across all of Moody's "Aa" high-grade rating groups (Aa1, Aa2, and Aa3), **median operating revenue has almost doubled** from 2013 to 2019. Similar median increases are seen in unrestricted cash and investments held by the system and total debt carried by the system.
- Medians are not determinative of an individual health system's rating, but they reflect actual rating outcomes and serve as guides for organizations seeking to improve their credit rating.
- Highly rated health systems **attract more investor interest** and can **access capital at a lower cost** than lower-rated organizations.

"Aa" Category Moody's Rating Universe for Not-for-Profit Hospitals; 2013 vs. 2019 Medians



Sources: Kaufman Hall analysis, based on Moody's Investors Service, *Revenue Growth and Cash Flow Margins Hit All-Time Lows in 2013 US Not-for-Profit Hospital Medians* (Aug. 27, 2014) and *Medians – Financial Performance Showed Stability Before Pandemic* (Sept. 9, 2020).

Final observations

- Partnerships, mergers, and acquisitions have been an essential tool as hospitals and health systems adapt to a rapidly changing environment. Increased scale has enabled hospitals to:
  - Enhance the patient experience by investing in consumer-centric strategies that improve access to and convenience of care
  - Enter value-based partnerships with insurance companies and health plans to improve affordability of care for consumers
  - Obtain the funds needed for investments in capital improvements, innovation, and intellectual capital at favorable rates, helping to ensure the most efficient use of resources
- For acquired hospitals, partnerships, mergers, and acquisitions enable:
  - Financial stabilization to preserve access to care in local communities
  - Expansion of services and access to capital needed for facility improvements and enhancements in the quality and safety of care delivery

Although not necessarily the right choice for all hospitals, partnerships, mergers, and acquisitions have been an essential tool for adapting to a changing environment. Hospitals will need continued flexibility to seek partners as they work to recover from the pandemic's impacts on their staff, operations, and financial health.

- Patients and communities are the ultimate beneficiaries of these efforts.
- The COVID-19 pandemic has dramatically illustrated the indispensable role that hospitals play in their communities. Hospitals will need continued flexibility to seek partners as they work to recover from the pandemic's impacts on their staff, operations, and financial health.

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