Picking Teams and Choosing Partners: How Hospital and Health System CFOs are Emerging as Leaders in M&A Strategy

Bank of America Merrill Lynch

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Picking Teams and Choosing Partners

How hospital and health system CFOs are emerging as leaders in M&A strategy

By Molly Gamble

The demands placed on healthcare providers today are sparking a new era of consolidation in the industry. Hospitals and health systems must reduce costs, improve quality and care coordination, and assume risk for patient populations to remain relevant in today's market.

Five years ago, many organizations reacted to these pressures through traditional means: mergers and acquisitions. Now organizations are pursuing new types of relationships — affiliations — which come in various shapes, sizes and intensities. These creative agreements require different skills and capabilities from hospital and health system CFOs. Their worlds hardly revolve around a balance sheet anymore.

When evaluating a potential affiliate or integrating several organizations, CFOs are increasingly taking on a greater leadership role. They are more involved in discussions about clinical quality, patient satisfaction, operations and long-term organizational strategy. The checklist for due diligence has grown longer and more complex.

This e-book, based on survey responses from several financial executives and a roundtable discussion with seven hospital and health system CFOs and M&A experts, discusses the consolidation pressures CFOs are experiencing, the types of affiliations they are entertaining or pursuing, and the traits they want most in a potential partner.

Pressure to consolidate: What are CFOs experiencing?

The number of hospital mergers and acquisitions has steadily increased in recent years. Irving Levin Associates reported 76 hospital mergers and acquisitions announced in 2010, and number of deals announced per year has not dipped below that since. In 2014, the number hit 100. Kaufman, Hall & Associates reported 66 transactions announced between acute-care hospitals in 2010. In 2014, the number increased by 44 percent to 95, and Kaufman Hall noted the deals represented

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an increase in larger, more flexible and less traditional combinations.

In the survey, about half of hospital and health system financial executives said their organization underwent an acquisition, merger or affiliation in the past five years. CFOs' characterizations of consolidation pressures align with the annual statistics: 62 percent said there is greater or significantly greater pressure to partner today compared to 2010. More than a quarter of respondents said the pressure is "overwhelmingly greater."

How does that pressure affect a CFO's typical work week? Most executives (81 percent) said they are approached about a deal — whether by a potential buyer, seller or partner — up to three times a month. Thirteen percent face these types of discussions once a week, and a handful of executives (6 percent) encounter pursuits like this every day.

The phone works both ways, however. Just as many (81 percent) of respondents said they are the ones initiating conversations to buy, sell or partner up to three times a month. Ten percent do so once a week; 6 percent every day.

"It almost feels like it's musical chairs, and the concern is if the music stops, will there be a chair for you to sit in as it relates to some sort of relationship?" said Mark Bogen, Senior Vice president of Finance and CFO of South Nassau Communities Hospital in Oceanside, N.Y.

Different flavors of healthcare M&A

The traditional hospital merger or acquisition is not as common as it was a few years ago. When the wave of consolidation gained momentum, it was largely smaller or underperforming hospitals that "saw the writing on the wall" and merged with a financially healthy parent to survive, says Kerri Schroeder, Specialized Industries Credit Product Executive with Bank of America Merrill Lynch. Some health systems continue to seek out these traditional arrangements: 23 percent survey respondents said their health systems plan to acquire independent hospitals.

But many organizations are pursuing like-minded partners for affiliations, which are more nuanced and permit some degree of independence. Nineteen percent of executives said their systems have built up networks of clinical affiliations, for instance.

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"What we are seeing more and more of, as boards and their management teams make decisions proactively and from a position of strength, they are looking at more creative structures that don't necessarily involve a takeover or merger," said Brent McDonald, Head of Healthcare Strategic Advisory Services with Bank of America Merrill Lynch.

"We're seeing a lot of clients that really don't want to pour more money into their bricks and mortar. They're really doing a lot more from an ambulatory standpoint. They are really catching up to the trend of consumerism, access and positioning themselves to capture lives as a value-based care organization."

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Hospitals have a continuum of affiliation models at their disposal, all of which vary in intensity. Throughout the conversation, three types of affiliations were mentioned several times: joint operating agreements, clinical affiliations and clinically integrated networks.

Joint operating agreement: These are typically accomplished through the formation of a joint operating company, which serves as the parent to two or more affiliating hospitals. JOA affiliations let hospital parties maintain their separate identities and governance structures, but considerable management and financial authority is shifted to the JOC.

Clinical affiliation: When hospitals strike this type of agreement, they collaborate for a certain service and co-brand it. Clinical affiliations may involve local, regional or national partners, and the arrangement can support a mutually beneficial referral exchange.

Clinically integrated networks: Health systems band together to jointly contract with private payers to improve clinical outcomes and care coordination while maintaining their separate identities. These networks, also referred to as "super accountable care organizations," are not designed to salvage financially challenged healthcare organizations.

Diversifying what it means to be a "system"

The M&A playbook grows thicker by the day. There are as several types of affiliation models for hospitals and health systems to choose from, and in addition to this, many CFOs are expanding the strategy to include providers outside of the acute-care realm. The term "hospital system" is becoming less accurate for these sprawling organizations, which aim to include a variety of care settings and capabilities.

"We're seeing a lot of clients that really don't want to pour more money into their bricks and mortar," said Mr. McDonald. "They're really doing a lot more from an ambulatory standpoint.

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Sometimes a diversification strategy not only involves decisions about what you must gain, but what you must lose. Richard Franco, Regional CFO of Presence Health in Chicago, said the 11-hospital system sold one of its hospitals to another organization this year. In its place, the system is looking at ambulatory care, urgent care centers, imaging centers and possibly physician practices for its long-term strategy.

"Being a hospital-based system, we're not overlooking the fact that we may not be the same size of hospitals going forward as we have been in the past," Mr. Franco said.

Jim Dietsche, Executive Vice President and CFO, is facing a similar strategic shift at Green Bay, Wis.-based Bellin Health, an integrated system comprised of two hospitals, a psychiatric center, a network of primary care clinics, retail health clinics, fitness centers, a specialty physician organization and a college for nursing and radiologic sciences. "We started as a hospital, but more and more of our revenue streams come from physician and ambulatory services, and that has made us very successful in our market," said Mr. Dietsche.

Danville, Pa.-based Geisinger Health System has acquired five independent community hospitals in recent years, but Executive Vice President and CFO Kevin Brennan said the organization's growth strategy does not center around acute-care settings.

In addition to its eight hospital campuses, the physician-led system includes a 1,100-member multispecialty group practice two research centers and a health plan with approximately 467,000 members. Forty-five percent of Geisinger's revenue comes from the health plan, and the system is seeking opportunities to leverage its intellectual property, as well.

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How does a system build relevance?

Interestingly, the survey showed CFOs were somewhat divided when asked whether a health system must reach a certain size over the next 10 years to remain viable: 58 percent said yes and 42 percent said no. For those who

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said yes, most (45 percent) were not able to identify the revenue range for that "certain size," while 29 percent said $1 billion to $5 billion, and 19 percent said $5 billion or more.

A system-to-system transaction can shake up an entire market — a dynamic with which Mr. Franco is quite familiar. Presence Health was formed in November 2011 when Chicago-based Resurrection Health Care and Mokena, Ill.-based Provena Health merged. Upon its formation, Presence catapulted itself to become the second largest health system in Illinois behind Downers Grove, Ill.-based Advocate Health Care and the largest Catholic health system in the state.

Now, as regional CFO of the system's northwest Chicago market, Mr. Franco is tasked with sustaining revenue growth while increasing operational efficiencies in a highly competitive and fragmented market.

The pending merger between Advocate and Evanston, Ill.-based NorthShore University Health System — which would place the combined system far ahead of its next rival — is the latest in the Windy City merger frenzy. Chicago-based Northwestern Memorial HealthCare and Winfield-based Cadence closed their affiliation in September 2014. Last June, Hinsdale-based Adventist Midwest Health and Arlington Heights-based Alexian Brothers Health System, part of St. Louis-based Ascension Health, signed a letter of intent to form a joint operating company.

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While many organizations pursue M&A to gain economies of scale, Ms. Schroeder said organizations are also trying

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But relevance is not synonymous with size, at least not to all CFOs. Independence is what sets Brooklyn (N.Y.) Hospital Center apart from others in the market. Two hospitals in Brooklyn recently went under the wing of larger parents — NYU Langone Medical Center and Great Neck, N.Y.-based North Shore-LIJ Health System. Brooklyn Hospital Center took the reverse course of action. The hospital disaffiliated from its academic medical center sponsor this year and struck a new agreement — one involving a lighter degree of alignment —with another AMC.

"There is tremendous opportunity right now in being the very physician-friendly, high-quality, independent community hospital in Brooklyn," said Joseph Guarracino, Senior Vice President and CFO of The Brooklyn Hospital Center. He said independence may not be the long-term strategy for Brooklyn Hospital Center, but it is reasonable in the short-term given the hospital's market.

How CFOs evaluate potential partners today

In the survey, executives' most-cited concern about M&A is the integration of two organizations — namely, making sure the marriage is feasible and fair, including decisions about leadership. Fewer executives cited due diligence and valuation and price as their largest concerns. Nobody identified regulatory and antitrust scrutiny as the No. 1 worry when executing a deal.

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In the conversation, CFOs said they are investing the most time and energy evaluating the following elements of organizations — in addition to their traditional financial responsibilities, of course.

Quality

Clinical quality of care and patient satisfaction is at the top of many CFOs' agendas. "There are very few independent hospitals in our market that remain," said Mr. Dietsche with Bellin Health. "We talk with them, but one of the main things

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Culture

Mr. Dietsche described the culture of an organization as critically important in affiliation discussions. Bellin is part of AboutHealth, a statewide clinically integrated network in Wisconsin that includes eight health systems. The like-minded mission and culture of each member of AboutHealth, Mr. Dietsche said, made the network attractive to Bellin. "Literally all of these health systems that are part of this network have a mantra of the triple-aim mentality. As our performance is based off of that, that culture is very important to be successful."

Governance

Governance has emerged as a top priority to Mr. Brennan as Geisinger executes its M&A strategy, particularly with independent community hospitals. He has found it is critical to determine governance and leadership structures very early on in the discussion, otherwise responsibilities are muddled and lines blurred. "A lot of times, the governance aspects are very important upfront discussion items that a local community board has to come to grips with," he said. "The role of executive management or management in general needs to be clear and understood, or it's bound to cause conflicts."

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Loyalty

Mr. Franco said some may consider loyalty as part of culture, but he makes an extra effort to discuss it explicitly to ensure potential affiliates will act as loyal partners. Retaining patients within the Presence Health network is a critical strategic initiative, and he must ensure referrals and patients will not be sent outside the organization, particularly as it expands into more diverse care settings.

Permanence

A lot of affiliation structures today remind Mr. McDonald of joint operating agreements in the 1990s, which proved fleeting when organizations "could pick up their ball and go home arbitrarily," as he said. That in mind, he stressed permanence as a critical factor for agreements today, meaning the relationship should make sense at least 10 years down the road. "When you are picking teams, these are kind of permanent decisions," he said.

Synergies and mutual benefit

In addition to permanence, CFOs are also concerned about ensuring the relationship is mutually beneficial in the long-term. In the survey, 20 percent of executives said finding a partner with complementary capabilities is a primary driver in their M&A strategy. Ms. Schroeder has seen this come up quite a bit as well. "One of the key questions a lot of our clients seem to ask is not only what does the potential target bring to my organization, but how can I help? What are the competitive advantages or skills my organization brings to the table that will ultimately improve their operation? That overlap, that sort of shared benefit, is really critically important."

The CFO's expanded role

CFOs are now responsible for more than finances when it comes to due diligence and ensuring the potential partner or affiliate is a good fit. This leaves CFOs wearing many different hats and taking on more of a leadership role in M&A strategy and activity. Before, CFOs may have followed the strategy. Now, they are increasingly tasked to set it.

Building a long-term plan is challenging given the fluctuation in markets, much of which is brought on by new consolidation and affiliation agreements. CFOs are greatly invested in patient volume as it flows throughout the region. They must assess retention and determine whether patients are treated in the appropriate care setting, which requires clinical background and understanding. Financial executives are also placing greater emphasis on new metrics, such as unique patient visits, to measure their relevance and penetration in the market.

CFOs must build these strategies while continually evaluating merger or partnership opportunities as they present themselves. As he does so at South Nassau Communities Hospital, Mr. Bogen finds more of his time and focus extends to the operational and clinical sides of the organization. He credits his finance team for having the skill to maintain the focus on financial due diligence as he rolls up his sleeves and gets more involved in discussions about other facets of the organization. "As I say all the time, I spend very little time on finance," he said with a laugh. "I find most of my time is really more operationally and clinically motivated, if you will."

CFOs were still strategic 10 years ago, but Mr. Guarracino said they weren't "the point of the sword." That is, CFOs acted as strategic partners by gathering data and performing due diligence, whereas today they act as strategic leaders. but they were not leading the charge when evaluating merger partners. Today, that's changed.

"I spend a lot of time operationally and on patient satisfaction and quality scores, but also externally in trying to come up with partnerships with IPAs and ACOs, trying to find a win-win between doctor practices and the hospital so we can gain market share and be a partner with the physicians, figure out how to be more important to the community and still engage as a managed care provider," he said.

CFOs are also having new types of conversations with their boards and spending more time educating them, as several executives indicated. "It's challenging for boards to kind of understand all that is coming at an organization," said Mr. Dietsche with Bellin Health. "You have just so many more components to try and navigate your way through this maze, that value-based world." ■

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