Four Tips for Hospital Merger & Acquisition Success

The current healthcare environment has created one of the most active hospital and health system consolidation markets in decades. This is partially driven by provider responses to the challenges and opportunities created by national and state healthcare reform. Healthcare transactions implicate a vast body of business, patient, physician and legal considerations, complicating the process and leaving many opportunities for missteps.

Here are four tips to help hospitals avoid potential missteps and develop successful transactions.

1. Use strategic considerations to analyze the price tag of an acquisition. According to Thomas Jeffry, a partner in the healthcare and life science practice groups of law firm Arent Fox, the strategic considerations behind an acquisition are crucial for analyzing whether it is worth the price tag. While it can be easy to get caught up in potential positives such a higher market share or greater scale, Mr. Jeffry points out that potential positives are not guaranteed to materialize. If they do, a hospital's bottom line is not always positively affected.

"Increasing market share may not necessarily increase net revenues depending on a variety of factors such as payor mix, cost structure of the acquired entity, need for capital expenditures and debt incurred or assumed," says Mr. Jeffry. "I think [hospitals] always need to do a reality check. How is this going to affect the bottom line post-transaction?"

Issues dealing with payor mix and future capital needs are especially important to address. According to Mr. Jeffry, questions to consider about a potential partner include:

- What is the payor mix?
- Is the payor mix heavily Medicaid or Medicare?
- Does the hospital have a high portion of uncompensated care?
- Does the hospital need a lot of capital expenditures?
- What type of debt does the hospital have?

2. Test market assumptions with input from outside parties. As the Patient Protection and Affordable Care Act unfolds, particularly with the introduction of health exchanges, the market dynamics of healthcare may change and lead to lower leverage to sustain or negotiate higher rates, according to Mr. Jeffry. For this reason, he believes it is particularly important to analyze what assumptions may hold true in the market in a few years.

"It would be a mistake to look at the market today, or last year, and say it will be indicative of what the market will be like in two or four years. As you do transactions, you need to look at what the future holds and put those market assumptions to the test," says Mr. Jeffry.

Mr. Jeffry recommends that hospitals use third parties to test market assumptions, not because they would be incapable of doing so independently, but because third parties deal with a variety of hospitals, communities and transactions. The experience they bring from working in multiple deals may prove valuable to a hospital's transaction process. "If I were a board member, frankly, I would feel more comfortable if I knew some of the financial considerations and assumptions were backed by a third-party study," says Mr. Jeffry.

"I think a lot of individuals believe the healthcare reform act will be a powerful force to negotiate rates and keep costs down. However, if you are a hospital with a high-cost structure, driving costs down may end up being a big problem."

3. Due diligence is more critical than ever. In order for mergers and acquisitions to be successful, executives need to look at the detail of their potential partner. According to Mr. Jeffry, detailed due diligence is more critical than ever.

"Executives need to dig down below the financial statements and understand how the revenue cycle of the participating entities work. They might come in and think they can make a hospital more efficient," says Mr. Jeffry. "However, if state approval is required for the merger, the
approval may be contingent on maintaining a financially losing service line for a period of time."

In this instance, a condition needed to pass the transaction could change the potential financial outcomes. According to Mr. Jeffry, the executives need to have conducted thorough enough due diligence to see where a hospital is losing money in order to decide whether the transaction can absorb any future losses.

4. Consider how the transaction will impact existing relationships with the medical staff. According to Mr. Jeffry, hospitals will need to consider potential impact to relationships with physicians to create successful partnerships that control costs and improve quality. Physician relationship considerations may also help a hospital to handle potential aftermath of a deal. If a transaction merges two different medical staff structures or two medical staffs that are adverse to one another, each hospital's staff could make it difficult to achieve certain efficiencies, which will affect an entire transaction's success.

"Physicians have an impact on referrals to hospitals as well as an impact on quality metrics that hospitals will be reimbursed on in a go-forward basis. They will also have an impact in terms of providing integrated care. I think it is important to look at those relationships both from the acquiring entity and the target entity perspective," says Mr. Jeffry.