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## **Industry Trends—Not Policy Uncertainty—Driving Hospital M&A**

### ***Antitrust Enforcement in Recent Years has had an Impact on Hospital Consideration of M&A Deals, According to Industry Advisers***

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Despite policy uncertainty, hospital mergers and acquisitions (M&A) continue because of underlying market trends, industry analysts say.

As of the end of the third quarter, hospitals and health systems have completed 87 transactions in 2017, putting them on pace to exceed the 2016 total of 102 deals, according to a Kaufman Hall analysis.

Twenty-nine transactions were announced in the third quarter of 2017, down slightly from 31 in the second quarter, the consulting company found.

The quarterly count of Irving Levin was somewhat lower, with 15 hospital acquisitions identified, compared with 22 in the previous quarter.

The deal volume is continuing despite high-profile federal policy uncertainty stemming from proposed Republican legislation to overhaul the Affordable Care Act and regulatory changes by the Centers for Medicare & Medicaid Services.

Thad Kresho, U.S. Health Services Deals leader for PwC, said policy uncertainty has spurred more due diligence and some caution in hospital deals.

“But the activity levels in the market, the chatter, and the deals we’re working on haven’t seen any real change in their activity levels in a downward perspective,” Kresho said in an interview.

**Federal policy uncertainty has made “everyone on the margin more cautious” in M&A deals, said Greg Hagood, senior managing director for SOLIC Capital Advisors.**

**“That has a much bigger impact on the payer side, if you’re putting together health plans or insurance providers,” Hagood said in an interview.**

**Instead, Hagood sees the ongoing M&A surge as driven by a dynamic similar to that which the retail industry experienced previously. The resulting landscape would include large regional hospitals but fewer small community hospitals.**

The share of deals involving community hospitals dropped in the latest Kaufman Hall data, but that was mainly due to a sharp increase in the number of transactions involving very large hospital systems.

Anu Singh, managing director for Kaufman Hall, said policy uncertainty is impacting some activity. But ultimately federal payment levels are only decreasing, regardless of proposed changes.

“Some of those you can just count on as industry trends or changes in the competitive dynamics within the industry that are not going to be reversed,” Singh said. “Our clients are being a little bit more holistic in their view of what’s happening in the industry and not using reform or industry change or other factors as the driver. When it’s done right, it’s in consideration of a multitude of factors.”

### **Antitrust Impact**

Another factor that has impacted hospital consideration of M&A deals is antitrust activity.

Following a string of federal antitrust suits in recent years, a recent executive order from President Donald Trump also sought to limit “excessive consolidation.”

Singh said he has seen an increase in federal scrutiny of hospital system mergers recently.

“It’s curious to me because it seems a little contrary to what the policy decisions are and contrary to what I see as the necessary tools to success for health systems in the future—size and scale is going to become important, managing populations that are wider and more diverse is going to become important,” Singh said. “The FTC [Federal Trade Commission] is running counter to that.”

**A string of high-profile victories by the FTC against proposed hospital mergers in recent years has left entities much more likely to walk away if they have indications that a proposed deal will draw antitrust scrutiny, Hagood said.**

Industry advisers are closely watching the case of a proposed merger between nearby health systems in southern Virginia and Tennessee (Mountain States Health Alliance and Wellmont Health System) to see whether state support is sufficient to clear federal scrutiny.

Singh expects the hospital industry generally to respond to FTC opposition by relying more on “alternative transaction models,” avoiding deals with health systems in adjacent markets, and focusing M&A efforts outside the inpatient setting—including deals with physician practices, insurers, and post-acute care providers.

“The FTC seems less concerned about what organizations do when there is a gap between” their markets, Singh said.

Kaufman Hall is seeing an increase in “creative affiliations,” meaning partnerships that use nontraditional models to achieve strategic goals in response to emerging market factors. More hospitals are looking at such affiliations or joint ventures, as well as use of state “certificate of public advantage” laws to shield their deals from FTC scrutiny, said Lisl Dunlop, a partner at Manatt. As many as 20 states have such statutes that shield hospital deals from federal antitrust laws in favor of a review by the state’s Department of Health.

“At this point, if you are a hospital thinking about doing a deal in a region where there really isn’t a lot of alternative acute care competition or there is a lot of aggregation in a particular service line, the FTC is a serious concern,” Dunlop said.

However, Singh doesn’t expect FTC scrutiny to reduce the overall numbers of hospital deals or collaborations.

## Other Challenges

Some industry advisers said they have seen evidence that the finances of acquired hospitals can suffer in the immediate aftermath of M&A, as found in a recent analysis by HFMA and Deloitte.

Kresho said such financial struggles can come from increased levels of hospital bad debt that in turn stems from the increased prevalence of high-deductible health plans and self-pay. But costs also are driven by increasing competition for clinicians in a tight job market, as well as compensation costs following a historic industrywide hiring spree.

Controlling costs through “head-count reductions” often is difficult for hospitals to follow through on post-merger because such entities are frequently the largest employer in their community and are concerned about the public-relations impact of layoffs, said Kresho.

Kresho said hospitals can overcome some of those challenges by developing very prescriptive cost-control plans well before transactions are closed.

## Future Directions

**Not yet clear in the hospital M&A data is the coming impact of trends such as a shift of large-scale investors away from inpatient hospitals and toward community-based providers, and an increased reluctance by regional hospitals to buy independent hospitals, according to Hagood.**

**“A lot of community hospitals are beginning to not be on the verge of bankruptcy, but really struggle financially in terms of generating enough net cash flow to reinvest in their infrastructure,” Hagood said. “And when they’re starting to reach out, they’re not getting a lot of interest.”**

**Hagood expects M&A data to emerge in 2018 illustrating the struggle of community hospitals, which he has seen anecdotally.**

Singh said the data for the smallest category of hospitals—those with revenue of less than \$100 million—has bounced up and down in recent years, but no clear trend has emerged.

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