Hospitals' Acquisition Targets Diversify to Include Complementary Services

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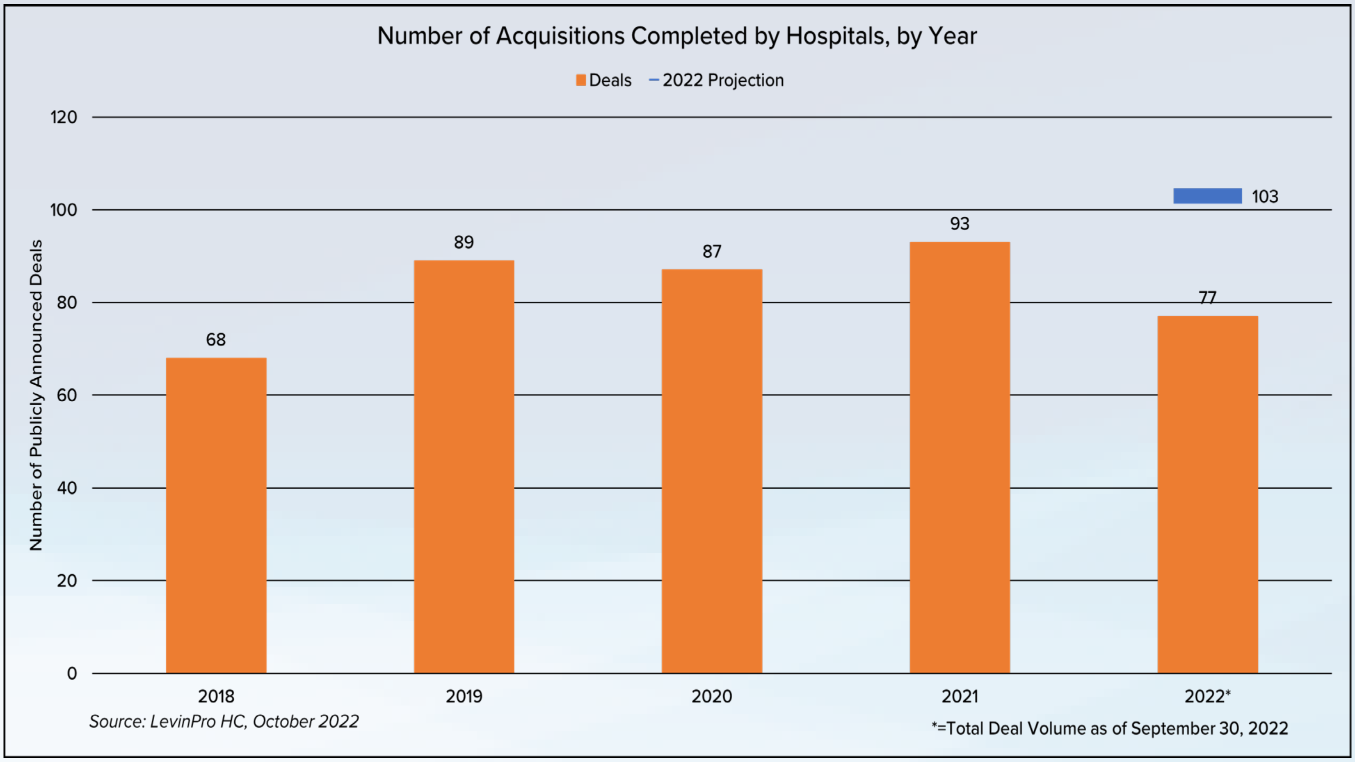
Introduction

Hospitals have continued to accelerate their acquisition strategies, and transaction totals are set to break the record set in 2021. According to the LevinPro HC database, based on publicly disclosed deals across the healthcare spectrum, 77 acquisitions were made by hospitals during the first nine months of 2022, putting the total on pace to reach 103 by the end of the year. That would be a record. This compares to the 93 transactions from 2021, and the amount has generally trended upward since 2018, when the total numbered 68 transactions. The activity was followed by 89 deals executed by hospitals in 2019 and a slight dip to 87 in 2020.

However, current macroeconomic conditions, including the ongoing increase in interest rates, may slow the momentum. These transactions include acquisitions of other hospitals, physician medical groups, home health agencies and other service providers. This trend has grown as hospitals increasingly employ different strategies to increase profit margins and better serve their patients. Patients who are no longer hospitalized while undergoing frequently provided procedures can be treated in lower-acuity settings such as ambulatory surgery centers that a local hospital owns.



Source: LevinPro HC, October 2022

Recovery times after many acute episodes are also diminishing, meaning patients can convalesce in lower-cost settings like skilled nursing facilities or at home. Partnering with or acquiring these businesses allows the hospital to "own" the patient through the continuum of care. Follow-up visits by a patient can also contribute to a hospital's bottom line when a hospital also owns physician practices. Plus, a hospital can complement this strategy by freeing its acute-care beds for additional patients requiring a higher level of care.

"CRAZY PACE"

"In the last two years, those of us who work in health care have worked harder and longer than we've ever worked in our careers," said Bobby Guy, a shareholder and healthcare mergers and acquisitions attorney at Kansas City, Missouri-based **Polsinelli**. "It's been a crazy pace for healthcare consultants, healthcare investment bankers and healthcare lawyers."

Rather than acquiring complementary facilities, one significant system in New England decided to pursue additional hospitals and their ancillary businesses. **Yale New Haven Health**, one of the largest health systems in Connecticut, finalized an agreement in October to acquire the operations of a set of hospitals from Los Angeles-based **Prospect Medical Holdings, Inc.** Another deal announced in October was by Ontario, California-based **Prime Healthcare Services, Inc.**, which acquired nine general acute care hospitals and two related medical offices in four states from **Medical Properties Trust, Inc.** for $360 million.

And there were several similar-sized mergers and acquisitions announced during the year. In the first nine months of 2022, hospitals and health systems purchased 97 hospital facilities. In 2021, 149 hospital facilities were purchased, and in 2020, there were 131 facilities acquired.

LONG-TERM STRATEGY

Pursuing a long-term acquisition strategy has been the goal of the not-for-profit C**olumbus Community Hospital** in Columbus, Nebraska, which has a population of just over 24,000. It began in 2009 when Michael Hansen became the hospital's president and CEO.

"Columbus is kind of a mid-sized community hospital and back then the board had a vision of becoming more of a regional referral center and that was my challenge over the last 13 years," Hansen said. "There were a lot of gaps back then in terms of programs and services."

Hansen went to work filling those gaps in 2012 with the first of six acquisitions that continued through December 2021. The deals for the 50-bed acute care facility included:

- Columbus Orthopedic & Sports Medicine Clinic on May 1, 2012
- Columbus Otolaryngology Clinic on May 1, 2017
- Columbus General Surgery Clinic on May 1, 2018
- North Central Radiology on October 1, 2018
- Columbus Surgery Center on June 1, 2021
- Columbus Cancer Care on December 1, 2021

"When we acquired the **Columbus Surgery Center**, that was strategically to prevent somebody else from coming into town and building an [ambulatory surgery center] that would be competitive against us," Hansen said. "We employ all our surgeons now, and we didn't want somebody from the outside coming in and building a surgery center in our community."

The numbers provide the best evidence regarding the success of the growth strategy.

“That’s been the approach strategically, to grow all the service lines,” Hansen said. “In 2009, I think we were about a $40 million gross revenue operation back then. We’re at about $260 million now. We just continue to grow. That’s been the strategy and it has worked very well.”

Hansen’s operation has more than 900 employees and could serve as a model for other rural health systems facing falling revenue and patient days.

“NO LONG-TERM DEBT”

“Our bottom line has been growing at double digits for the last 13 years that I’ve been here, and we didn’t even have a blip during the COVID-19 pandemic,” Hansen said. “We’re probably in the top 5% of hospitals financially. We have no long-term debt. I retired our debt in 2012 and everything that we’ve done in terms of operations and all the construction projects that we’ve done have been with cash from operations.”

That is impressive, and managing costs is a priority for Hansen. The absence of long-term debt is an advantage for Columbus Community Hospital in the current interest-rate environment. But this could be difficult for other hospitals to replicate.

Labor issues have received significant coverage from various news outlets, including staffing shortages and healthcare providers’ wage demands, which have been an ongoing challenge for hospitals.In October, **Mayo Clinic** in Rochester, Minnesota, increased pay by 6% for some workers, representing its most significant across-the-board increase in 20 years. The change impacted 64,500 workers within the five-state health system, but with inflation above 8%, it may not be enough.

More than 2,000 nurses and other workers at **Temple University Hospital** in Philadelphia voted to authorize a strike on October 13 after failing to reach a deal on new contracts.

KaufmanHall reported that two-thirds of executives in a survey said staffing shortages led to their facilities operating below total capacity over the past year.

“You have to look at your expenses,” Hansen said. “Your [full-time employees] are your greatest expense. For most organizations, it’s 50% to 60% of your expenses. As we grew and as we acquired different practices, I looked at [full-time employees’ expense] as a percentage of net operating revenue and I tried to keep that statistic very stable through our growth. It’s something that I constantly look at.”

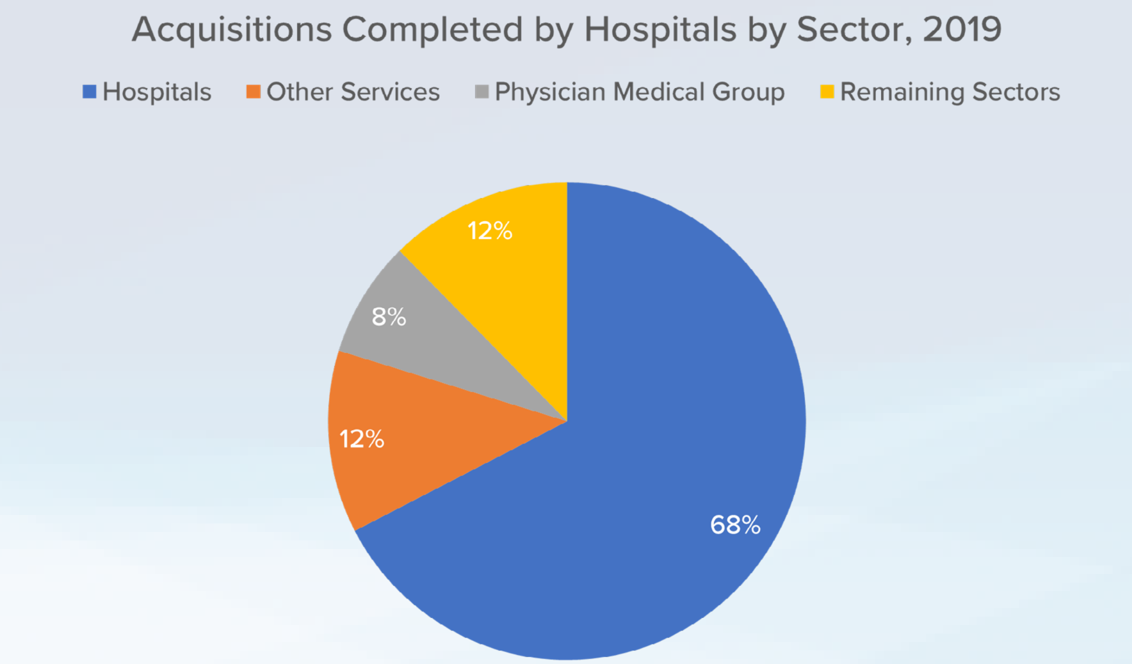
COST CONTAINMENT

Hospital executives must understand that for an acquisition strategy to increase profitability and competitiveness, costs must be contained throughout the process to guarantee that increasing expenses will not erode profits.

Rather than move at a breakneck pace that could become overwhelming, Hansen's acquisitions have been spread out over a decade. The strategy used by Columbus Community Hospital mirrors a trend in recent years that has shown hospitals moving away from simply acquiring other hospitals in favor of complementary services.

"Two-thirds of the time we're advising a large independent or a small system ... seeking a larger partner," said Rex Burgdorfer, a partner at **Juniper Advisory** in Chicago. "They believe there are skills and resources in the realm of quality and safety that could be improved upon if they were part of a larger organization. Academic medical centers have awoken to believe that they need to have a lower-cost community setting as part of their network."

The statistics reflect hospitals' diversification strategy. Of the 68 deals made by hospitals in 2018, 46 of them were for other hospitals, accounting for 67.6% of the total. The percentage dipped the following year as the 89 deals in 2019 included 60 hospital transactions, falling to approximately 67.4%. In 2020, the deal total of 87 had 52 hospital transactions, with a drop to 59.8%. The number fell below 50% for the first time in recent years in 2021. The record-high 93 deals included 44 hospital transactions, accounting for 47.3%.



Source: LevinPro HC, October 2022

"ARMS RACE"

"We're seeing hospitals go away in the United States at a rate of somewhere between 15 and 30 shutting down a year," Guy said. "That may accelerate at some point. You had approximately 5,000 [hospitals] in the U.S. about 20 years ago. That has dropped by several hundred and will continue dropping. We have an arms race going on to see who can capture more market share fast."

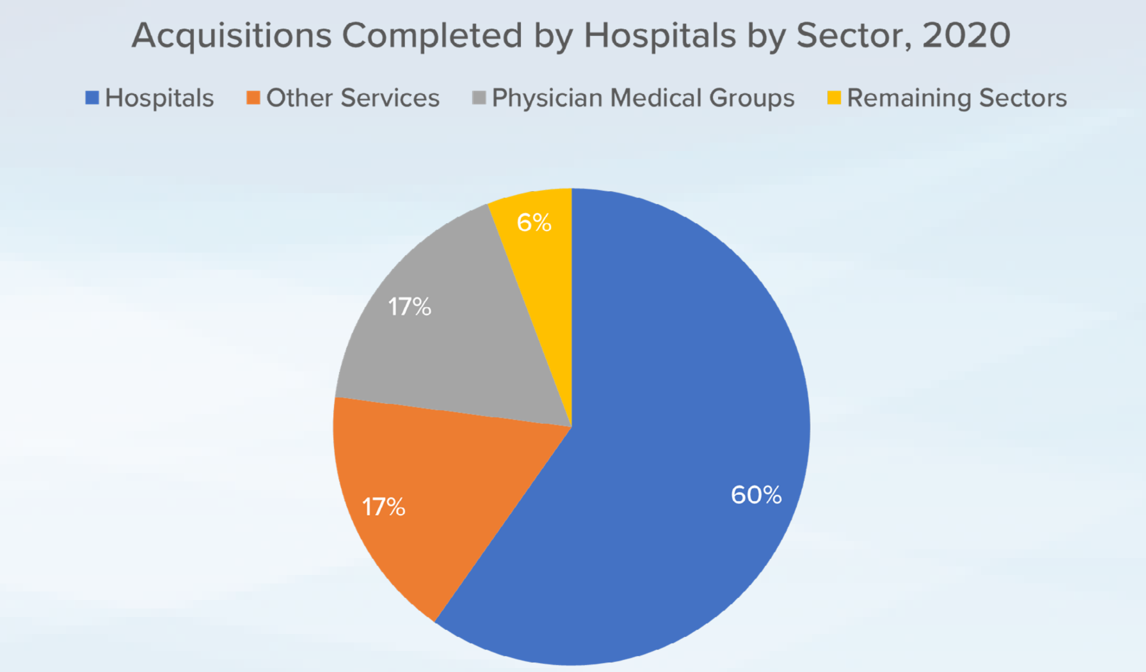
A report from the **American Hospital Association** cited numerous factors behind 136 rural hospital closures between 2010 and 2021 and a record 19 closures in 2020. The report cited low reimbursement rates, staffing shortages, low patient volumes and regulatory issues, as well as rising costs for labor, drugs, supplies and equipment as factors driving closures. Through the first nine months of 2022, the 77 transactions with hospitals as the acquirer included 33 Hospital deals, representing 43% of the total.

“Hospitals used to have very binary options at their disposal,” Burgdorfer said. “They could dig in their heels and try to get more efficient and effective on their own. Or they could roll over and be [acquired] by the big health system down the road. The good news is in today’s environment there has been significant innovation between those extremes in the structure of deals that are occurring today.”

Another trend emerged during the same five-year period.

Acquisition strategies employed by hospitals have shifted toward Other Services, a catch-all sector in the LevinPro HC database that includes health clinics, infusion services, medical documentation services, medical office buildings and medical transportation services. Also included are services provided by locations such as ambulatory surgery centers and urgent care facilities.

“Hospitals for years have been buying other hospitals and building hospital networks,” Guy said. “What’s changed in the last few years is that they are now buying much more diversified groups of assets. But what we’ve really been doing is watching the disaggregation of hospitals. Services that used to have to be provided in hospitals have been moved out into lower-acuity settings. You have renal [care]. You have surgery centers. And you have imaging centers moving a lot of services out of hospitals.”



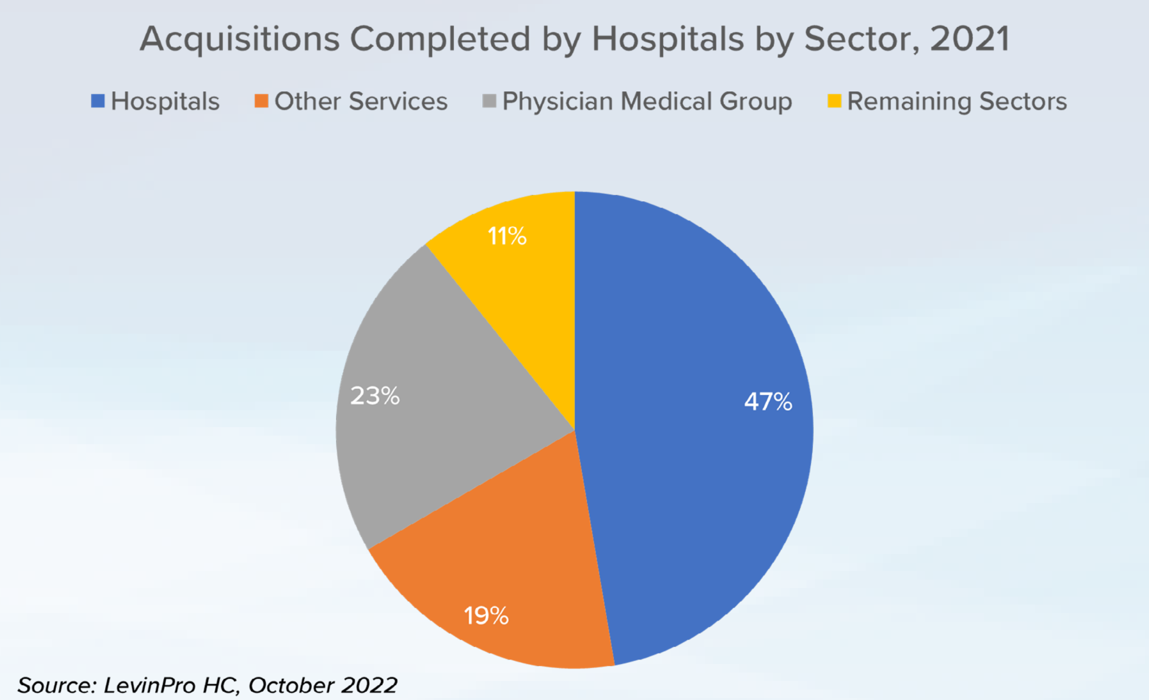
Source: LevinPro HC, October 2022

Other Services accounted for four acquisitions made by hospitals in 2018 out of the total of 68 deals, accounting for only 6%. In 2019, Other Services deals reached 11 out of 89, accelerating to 12% of transactions. Other Services acquisitions made by hospitals in 2020 amounted to 15 out of the deal total of 87, or 17%. In 2021, Other Services transactions made by hospitals reached 18 out of the total of 93 deals, amounting to 19%. Through the first nine months of 2022, Other Services accounted for 20 of the 77 acquisitions made by hospitals, or 26%, and for various reasons, we believe that to be on the low end of the real acquisition activity. Acquisitions made by hospitals of facilities and businesses that fall within the Other Services sector provide an opportunity to take control of related operations that offer a chance to add to the bottom line.

"A GOOD SURGICAL PRACTICE"

"A good surgical practice can generate anywhere from $5 million to $15 million a year in profit if you run it the right way," Hansen said.

The trend has been somewhat inconsistent regarding physician medical groups acquired by hospitals. The incentive for hospitals to acquire PMGs is connected to the concept of "owning" the patient. This can also be accomplished by adding doctors to the staff. The dollars spent for care don't end when patients are discharged. Instead, the hospital system can continue providing care and collecting payments from patients' insurance companies when hospital-owned PMGs offer follow-up care and treatment.



Source: LevinPro HC, October 2022

Hospitals picked up 11 PMGs in 2018 out of 68 acquisitions, accounting for 16% of the total. The numbers dipped in 2019 as seven PMG deals were recorded by hospital acquirers, amounting to 8% of the total. The numbers increased in 2020, with 15 PMGs acquired by hospitals within the 87 total deals posted for 17%. Another increase was generated last year when 21 PMGs were picked up by hospitals from the transaction total of 93, representing 23%. The trend has weakened slightly in 2022, with 13 PMGs acquired by hospitals during the first nine months of the year from 77 deals representing only 17%.

Hospitals have had to compete with private equity firms in acquiring PMGs. During the first nine months of 2022, private equity firms or their portfolio companies announced 319 transactions in the PMG sector. This is compared with 231 transactions during the same period in 2021 and 89 deals in the first nine months of 2020.

"[PMG deals are] evidence of health systems emphasizing the continuum of care and having access to the patient across the service lines and that continuum," said Matt Caine, the managing director of **SOLIC Capital Advisors** in Atlanta. "It's been less about just buying up and aggregating hospitals and being much more strategic with respect to deployment of capital and the acquisition of home health and hospice, physician practices, ambulatory surgery centers and telehealth services. There is less emphasis on the old hub and spoke strategy of buying hospitals in the region. I don't see that going away, but there is more emphasis on gaining access to patients across the care continuum."

2022 has produced numerous headwinds that hospitals face as they look to provide care amid an increasingly competitive healthcare environment.

"WALL STREET SMACKDOWN"

Those headwinds, and the hospitals' performance post-COVID, generated a harsh reaction from Wall Street when stocks of hospital operators plunged on October 21 after investors were disappointed by earnings reports from **Tenet Healthcare Corp.** and **HCA Healthcare Inc.** The group experienced a loss of more than $5 billion in market value. Tenet, which is based in Dallas, operates 65 hospitals and more than 450 healthcare facilities. HCA Healthcare includes 182 hospitals and more than 2,300 sites of care in 20 states and the U.K.

Reports stated that hospitals had been impacted by a reduction in COVID patients and the direction of non-COVID procedure volumes. According to the **Cain Brothers** *Health Systems Insights* released on October 24, margins will continue to experience "significant downward pressure" at the investment and operational levels.

"Decreased cash positions from covering losses and repayments of Medicare advance payments from COVID stimulus, combined with rising interest rates, are driving hospitals, health systems and provider organizations to reevaluate their strategic alternatives in search of a more financially sustainable future," the report stated. "As affiliations become more complicated, pressure on management and boards increases and antitrust regulators become more active, the path to identification and execution of successful transactions is more challenging."

The report added that regional affiliations could make sense as standalone hospitals, smaller health systems and sub-scale regional affiliates of national systems seek stability.

Pipeline Health System notified its vendors on October 6 that it filed for Chapter 11 bankruptcy protection. **Bain & Company'**s *Frontline of Healthcare* survey showed that a quarter of U.S. clinicians are considering switching careers, and a third are considering changing employers. Burnout, inadequate staffing and a lack of resources are cited as reasons behind the numbers.

KaufmanHall's *National Hospital Flash Report* in September stated that its median year-to-date Operating Margin Index was -0.3% through August.

Memorable headlines have included:

- Dwindling federal COVID relief funds, how will health systems cope?
- Kaiser, union reach deal to end 10-week mental health strike
- St. Luke's Health System to close 2 hospitals
- Hospital finances need "intensive care"
- Atlanta Medical Center shutters ED; emergency response times soar

"HUGE EXPENSE SPIKES"

Commenting on the challenging operating environment, the October 4 issue of **Cain Brothers'** *Industry Insights* cited labor force concerns, the staffing shortage driving "huge expense spikes during the first half of 2022," as well as inflationary pressures, the end of government-supplied pandemic relief and pressure from private companies seeking to disrupt the established acute care model. Despite the headwinds, including the macroeconomic trend of rising interest rates, Matt Caine forecasts an increase in hospital-related M&A activity in 2023.

"I would probably have to say, maybe, a 10% to 15% increase [in deal volume]," Matt Caine said. "There are those willing and interested to transact. There's going to be an increase in activity driven by the need to transact among many smaller hospitals."

"PRESSURE ON MARGINS"

"Establishing the right partnership goals and determining the optimal governance structure are critical pieces that should be considered before signing up for an affiliation," the October 24 Cain Brothers' *Health Systems Insights* report stated. "As market forces continue to put pressure on margins, health systems are increasingly encouraged to find ways to diversify their revenue base in a mission-consistent manner. While we often showcase ancillary business lines as a prime opportunity for health systems to achieve such diversification, venture investments in mission-consistent companies have increasingly taken center stage for health systems looking to diversify."

The report's bottom line regarding the outlook for the future: "Given the challenges the hospital industry is facing, we believe that M&A activity will continue." And with distress comes opportunity (which should mean lower valuations). It may be a matter of survival.