

## **TRENDS IN THE HEALTHCARE INDUSTRY BASED ON OUR RECENT EXPERIENCE – HEALTH SYSTEM CONSOLIDATIONS, MEDICAL PRACTICE MERGERS & ACQUISITIONS – Presented by Foxboro Consulting Group, Inc**

During the past twelve (12) months (2013-2014), we have seen tremendous activity in healthcare provider system consolidations, physician practice acquisitions, as well as large physician group practice mergers. Under pressure to contain costs, while simultaneously delivering higher-quality care, hospitals, health systems, and multi-specialty physician group practices have been consolidating at a feverish pace. What seems to be driving the process are several motivations including the following:

1. OBAMA Care/ the Patient Protection and Affordable Care Act's (PPACA),
2. The Health Insurance Portability and Accountability Act of 1996 (HIPAA) Privacy Regulations,
3. Compliance with STARK Fraud & Abuse & Anti-Kickback laws, as well as compliance with healthcare regulations in general,
4. The higher payroll, compliance & fringe benefit costs of maintaining a qualified, highly trained in-place workforce,
5. Reduction in Medicare third party reimbursement rates,
6. The capital investment required to obtain sophisticated electronic medical records (EMR) systems,
7. The capital investment required to obtain a sophisticated billing system,
8. Third party payers/insurance companies are requiring more data, documentation, notes and copies of x-rays to review, before they process & pay claims, thereby slowing down the cash payments to the medical providers, thereby stressing the providers finances,
9. The reluctance of younger new physicians to buy-in to the equity of existing physician groups (it seems they have high medical school debts and would rather be employed as opposed to take on the added financial responsibilities & obligations of becoming partners or shareholders/owners in the practice),
10. Current owners of the physician group practices are nearing retirement age, and wish to leave all of the above mentioned challenges to the “legal, compliance, insurance company, practice administrator, and regulatory experts,”

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11. Private equity firms and “hedge funds” such as H.I.G. Capital, Cerberus (owned Chrysler Motors), and Bain Capital are now buying whole health care systems (H.I.G. acquired South Bay Mental Health located in Brockton, MA, Cerberus acquired the Caritas Health System in Massachusetts – now known as “Steward Health Care System”, and Prospect Medical Partners (California based firm) acquired CharterCARE Health Partners in Providence, RI) and converting them to for-profit organizations (typically LLCs) that will begin paying the Federal & State governments income tax on profits as well as real estate taxes, and
12. Nonprofit hospitals and health systems in particular will continue to consolidate - Various factors such as the transition to value-based payments, more risk-based contracting and Medicare payment cuts are straining the finances of nonprofit hospitals and health systems in particular. [Standard & Poor's Ratings Services](#), [Fitch Ratings](#) and [Moody's Investors Service](#) have issued negative forecasts for nonprofits in 2014.

As nonprofits seek to stay strong and strategically position themselves in their markets, they will continue to seek out mergers, acquisitions and other types of transactions. They have already been responsible for a considerable chunk of healthcare M&A activity; of the 94 hospital and health system transactions in 2012, 60 percent of them took place among nonprofits. However, it's important to keep in mind that 80 percent of hospitals are nonprofits, meaning they are less active proportionately.

All five hospital sector deals announced in November 2013 involved nonprofit acquirers and targets, reflecting a trend of nonprofit health systems and standalone hospitals joining larger organizations to stay afloat.

In 2012, more than \$143.3 billion in healthcare mergers and acquisitions took place, one of the highest volumes recorded in a decade.

Reimbursement reductions alongside the shift to value-based payments, among other factors, have financially strained smaller hospitals, which have joined forces with larger healthcare organizations in order to survive and thrive. The Patient Protection and Affordable Care Act's call to coordinate care has also motivated providers to come together.

In the past year, numerous hospital and health system deals were announced, including several "mega-mergers" such as Franklin, Tenn.-based Community Health Systems' acquisition of Health Management Associates in Naples, Fla.

This year, as many of the PPACA's major provisions take effect, hospitals and health systems will continue to consolidate. Industry experts predict non-ownership collaborations will rise in popularity, while healthcare leaders become more strategic and selective in deciding who they choose to partner with or acquire, among other trends.

## **Hospitals and Health Systems Employ a Variety of Transaction Models**

As hospitals and health systems take a more [strategic approach](#) to transactions, they can choose to structure deals in a variety of ways depending on their objectives and the internal and external constraints that exist, according to Holly Carnell, JD, an associate at the law firm McGuire Woods.

A transaction can take the form of an asset purchase, which generally involves a for-profit buyer and nonprofit seller. This model limits the buyer's legal obligations as far as historic operations are concerned and typically includes a purchase price and, when acquired by an investor-owned operator, debt being retired or defeased.

"One of the main benefits of the asset purchase model is that you can attempt to partition liabilities as between the buyer and the seller," Mr. Walker says. "The one big potential exception to this is Medicare-related liabilities. These can be more difficult to shed and by default follow the Medicare number, if it is assigned to the buyer. In transactions where a tax-exempt hospital or health system is selling its assets, it is fairly common to establish a charitable trust with all or a portion of the proceeds for the purpose of furthering community health needs."

Increasingly, the healthcare organizations involved in a transaction will adopt a joint venture model, under which a larger hospital and a smaller hospital both hold ownership in a new entity. Although the larger hospital takes a bigger ownership stake, both parties have equal board representation within the new entity.

Finally, hospitals and health systems can also pursue various "alternative" transaction models that fall short of a full merger or sale. One of those structures is a management services agreement, under which a health system usually provides management services to a hospital for a fee. This model has various advantages such as better contracting services for the hospital, but it also has potential downsides such as less success in realizing scale efficiencies.

"There are also quite a few health systems that utilize a joint operating model, where the parties to the combination contractually agree to allocate governance and economic concerns in a specific way without actually moving assets or ownership from one legal entity to another," Mr. Walker says. "The parties are almost fully integrated from an operational, financial and governance perspective, but retain some vestiges of their separate legal existence. This is a flexible structure with lots of potential for customization, but is certainly not uncomplicated from a legal perspective."

## **Hospitals and Health Systems are Increasingly Choosing Non-Ownership Collaborations**

Rather than executing full-on mergers or acquisitions, some prominent healthcare organizations such as the Rochester, Minn.-based Mayo Clinic and the Cleveland Clinic have decided to pursue [non-ownership collaborations](#) and affiliations, allowing smaller hospitals and health systems to retain local control while giving them access to a larger organization's resources and expertise.

Healthcare providers are pursuing non-ownership partnerships more and more in order to reap the benefits of joining forces without going through an actual merger and relinquishing ownership. This trend goes hand-in-hand with organizations becoming more strategic in their transaction decisions; it's also particularly applicable where antitrust concerns exist.

Systems affiliating with local hospitals are learning that ownership is overrated. Knowing and achieving mutual objectives gets both parties more traction than squabbling over who holds the keys.

### **Physician Medical Groups Remain "Hot Commodities" for Health Systems, Hospitals and Public Companies**

Hospital acquisition of medical groups continues to grow, and overall healthcare sector deals involving physician medical groups increased 5.0 % year-over-year to 20 deals in the fourth quarter of 2013. That's also a 33.0% increase from 15 deals announced in the third quarter of 2013.

Foxboro Consulting Group, Inc. has been involved in the valuation of medical practices including the assessment of physician productivity, development of post-transaction physician employment & compensation agreements, structuring acquisition/purchase agreement term sheets, as well as seeking buyers for physician practices.

### **Consolidation Will Give Hospitals and Health Systems More Bargaining Power With Third-Party Payers**

As hospitals continue to join forces, they will gain more bargaining power with health insurers, according to a report from [Moody's Investors Service](#). Since commercial health insurers have already merged to form large entities capable of putting significant pressure on providers, this development will make the balance of power more equal, according to Moody's.

However, a recent report from consulting firm [Alvarez & Marsal](#) stated consolidation will give hospitals unprecedented pricing power and lead to massive inflation. Hospital and health system acquisition of physician practices and other outpatient facilities is of particular concern, since profit margins are higher for outpatient services for commercially insured patients, according to the report. According to the Medicare Payment Advisory Commission, Medicare payments rates for surgeries are 74 percent higher in hospital outpatient departments (HOPDs) than in ambulatory surgery centers.

Overall, the report concluded consolidation could lead to a few providers gaining a stranglehold on hospital inpatient, outpatient diagnostic imaging & laboratory services.

### **Antitrust Enforcement Will Continue To Be a Significant Issue**

Hospitals and health systems executing transactions continue to face antitrust scrutiny from the Federal Trade Commission and state agencies. One high-profile healthcare case involving Boise, Idaho-based St. Luke's Health System's 2012 acquisition of a 40-physician medical group was

decided recently: U.S. District Judge B. Lynn Winmill ruled St. Luke's violated antitrust law when it acquired [Saltzer Medical Group](#) in Nampa, Idaho. St. Luke's was ordered to fully divest itself of the medical group's physicians and assets.

Healthcare organizations lack clear guidance on how to pursue the triple aim (improve the health of populations, enhance the patient experience of care and reduce the costs of care) along with the necessary structural models to achieve it without violating antitrust law.

There are so many different agencies at the federal level and then there are the state agencies. The boundaries for antitrust enforcement have always been a tiny bit vague. The margins on the vagueness now are huge. Organizations are flying blind.

The FTC has expressed more openness to market consolidation where there is a compelling case to increase efficiencies (reduce costs), improve quality and access and where payers are supportive. An example being the CHS acquisition of two hospitals in the Scranton, PA.

### **Hospitals and Health Systems Need to Consider Several Factors to Ensure a Transaction is Successful**

In order to minimize the odds of running into antitrust issues and other problems, healthcare organizations preparing to execute transactions need to consider several factors. For instance, before initiating a transaction, they should ensure their board members are aware of their fiduciary duties under state law. Among other things, board members must carry out a full investigation of relevant details, ensure “*fair market value*” and evaluate alternatives and any competing offers. They must also detect and avoid all conflicts of interests, keep discussions about the transaction confidential and consider the implications the deal will have for the organization's mission.

Although the basic principles are similar, many of these issues vary on a state-by-state basis. Different states have taken different positions on the level and requirements for approval of these transactions.

Hospitals and health systems must also conduct pre-transaction diligence, which includes ensuring its relationships with referring physicians and those physicians' family members don't violate the Stark and Anti-Kickback laws.

Our recommendation is hospitals as a good business practice and regardless of whether they are contemplating a transaction or not, should carefully review all their physician relationships to ensure they are compliant. In addition, what may have been perceived to compliant at one point may no longer be compliant under increasingly stringent regulations.

Finally, healthcare organizations looking to carry out transactions should identify and quantify other key liabilities and concerns such as pension plan obligations, collective bargaining arrangements and real estate leases, which could have provisions that can significantly impact potential deals.

Good advice: Set firm objectives with input from your stakeholders, and then carry them through the request for proposal (RFP), the entire negotiation, and the exact wording of the definitive transaction agreement.

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