

63%

of healthcare executives say their financial objective for their M&A activity is to improve leverage with payers.

INTELLIGENCE REPORT

JULY/AUGUST 2023

WHAT'S DRIVING M&A?



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THE MOST CHALLENGING OPERATING ENVIRONMENT IN AT LEAST A QUARTER CENTURY WILL DRIVE HEALTHCARE M&A

With the need for increased pricing power and scale due to the inflationary carnage of 2022–23, healthcare M&A activity is poised to accelerate. For the first time since immediately following the Balanced Budget Act of 1997, which curtailed governmental reimbursement, significant numbers of providers lost money on an operating basis. Many providers, driven by inflationary pressure on labor, which included unprecedented contract labor cost, experienced double digit percentage growth in operating expenses. To make matters more challenging, providers were not able to offset operational weakness with investment portfolio returns given the decline in debt and equity markets during this period.

Healthcare providers that issued debt to finance capital expenditures experienced bond covenant breaches with frequency not seen since the financial crisis of 2008–2009. Most of the breaches were due to debt service coverage insufficiency as earnings fell short of annual or maximum debt service as prescribed in debt documents. Even many providers who were able to generate debt service coverage compliance were left unable to finance current capital needs due to limited room under their respective debt document additional debt tests.

Amid the backdrop of this difficult operating environment, the survey results are understandable:

- 75% of respondents strongly or slightly agree that economic uncertainty is driving M&A plans
- Two leading drivers are: 1. Increased pricing power (65%) 2. Improved margins (53%)
- Two leading financial objectives are: 1. increased market share (67%) 2. Enhanced payor leverage (63%)

We note that the largest health insurers, which remain significantly larger than the largest providers, generally experienced strong revenue growth rates and profitability in direct contrast to most providers. As a result, providers are rational to pursue strategic initiatives that increase provider pricing power as a strategy to pass on inflationary costs to payors and consumers, which remain stubbornly high in the healthcare sector even as we see clear evidence of declining inflationary pressure in the rest of the economy.

With respect to M&A planning, BofA would recommend the following:

- **Increased pricing power is critical in and after an inflationary period environment:** if a provider cannot pass on the cost of inflationary pressure on a dollar-for-dollar basis to its managed care payors, then the provider should seek increased pricing power from a merger or acquisition. History holds important lessons: many organizations across many sectors were able to realize recovery and improved financial performance in the inflationary 1980s.
 - **If you can't beat them, join them.** Given recent health insurance revenue growth rates and profitability, a health insurance company acquisition can make long term financial sense for many providers.
 - **Health systems should consider alternatives to the current and prevailing employed physician model.** In a highly challenging operating environment, physician subsidies that follow most health system acquisitions of physician groups may be currently unaffordable. Considering alternatives that better align the financial incentives of providers and their practitioners, which may include joint venture arrangements, may be advisable.



Mike Quinn
Head of Healthcare
Strategic Advisory Services,
Managing Director
Bank of America

WHAT'S DRIVING M&A?

Not so long ago, providers could claim that health-care mergers and acquisitions would save consumers money, improve care, and streamline services by eliminating redundancies.

Over the past few years, however, a number of studies—and a growing sophistication in media coverage—have shown that most of these claims are not panning out, and that bigger is not always better for care quality, convenience, or cost, for patients.

Earlier this year, a Harvard Medical School study in *JAMA Network* examined 580 health systems and found that physician services delivered within health systems cost as much as 26% more when compared with independent doctors, and that system-based hospital services cost 31% more, on average, compared with independent hospitals, while care quality improved only marginally.

“One of the key arguments for hospital mergers and practice acquisition was that health systems would

deliver better-value care for patients,” says study lead author Nancy Beaulieu, a research associate in the Department of Health Care Policy in the Blavatnik Institute at Harvard Medical School. “This study provides the most comprehensive evidence yet that this isn’t happening.”

The federal government has also taken notice. The U.S. Department of Justice and the Federal Trade Commission are aggressively scrutinizing and challenging healthcare

M&A, noting that they often create monopolies in their service areas that are designed to improve negotiating leverage with payers, with consumers ultimately footing the bill.

After shutting down several high-profile mergers in mid-2022, FTC Bureau of Competition Director Holly Vedova warned “this should be a lesson learned to hospital systems all over the country and their counsel: the FTC will not hesitate to take action in enforcing the antitrust laws to protect healthcare consumers who are faced with unlawful hospital consolidation.”

And yet healthcare M&A continues, further concentrating the hospital and physician services sectors.

What is driving these M&A? Randy Davis, vice president and CIO at CGH Medical Center in Sterling, Illinois, 115 miles due west of Chicago, believes he has the answer. Davis also serves as adviser for this HealthLeaders Intelligence Report.



John Commins

Research Editor
HealthLeaders

ANALYSIS AND SURVEY RESULTS

“I’ve been around long enough to know that it comes back to the one universal rule of life in a capitalist country: Follow the money,” Davis tells HealthLeaders. “M&A is driven first and foremost by money, and that usually means a lack of it. Hospitals and group practice leaders know a gravy train when they see it, and they seldom will give up that seat unless they’re forced to.”

“It starts with a hospital’s inability to attract quality physicians across a breadth of specialties that can generate the procedural and ancillary revenue that forms the backbone of a successful hospital,” Davis continues, noting that Illinois is down to 17 independent hospitals.

Figure 1 | The uncertainty of the economy is affecting our organization’s M&A plans.

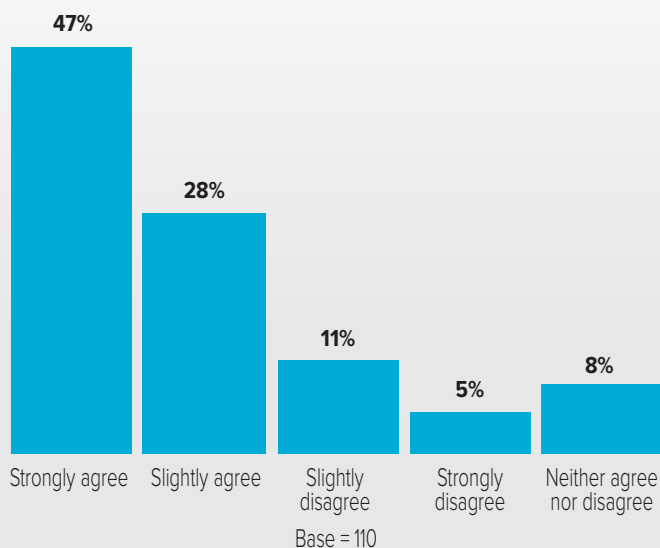
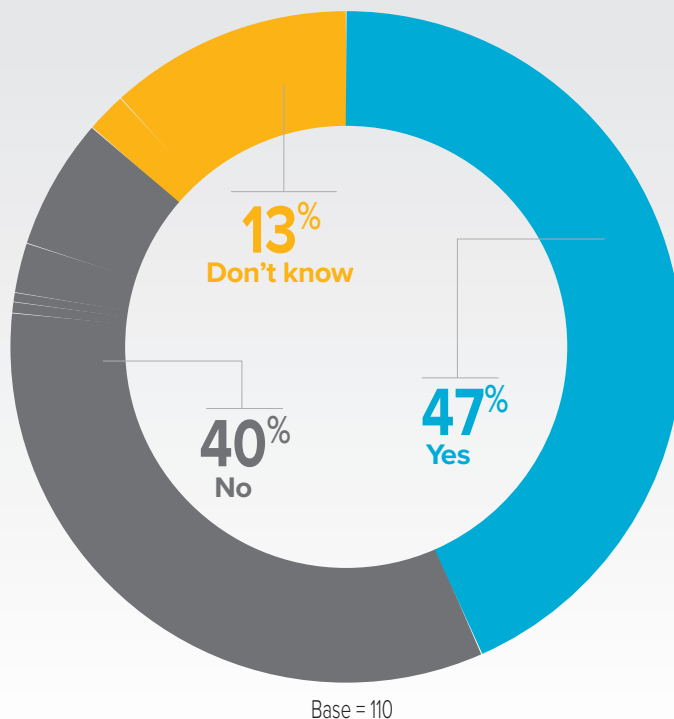


Figure 2 | Given the regulatory climate, are state and federal regulations affecting your M&A plans?



“If you start losing those physicians, whether it be to retirement or other reasons, that’s the beginning of their downfall,” he says. “Hospitals are money-losing entities surrounded by the money-train of lab, imaging, CT, cath labs, GI labs, and a few other procedural departments. If you want to kill a local hospital, give patients lower-cost alternatives for those services—surgery centers, imaging centers, etc.—and those hospitals quickly become a target for M&A.”

In the latest HealthLeaders Mergers, Acquisitions, and Partnerships survey, a hefty majority (75%) of respondents agree (47% strongly agree, 28% slightly agree) with the

ANALYSIS AND SURVEY RESULTS

Figure 3 | What result(s) do healthcare M&As deliver?

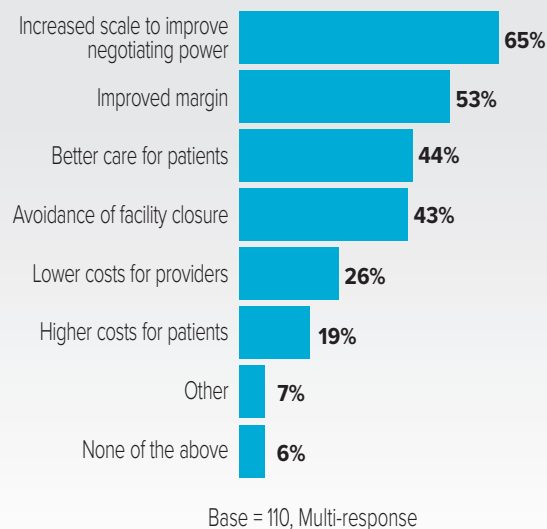
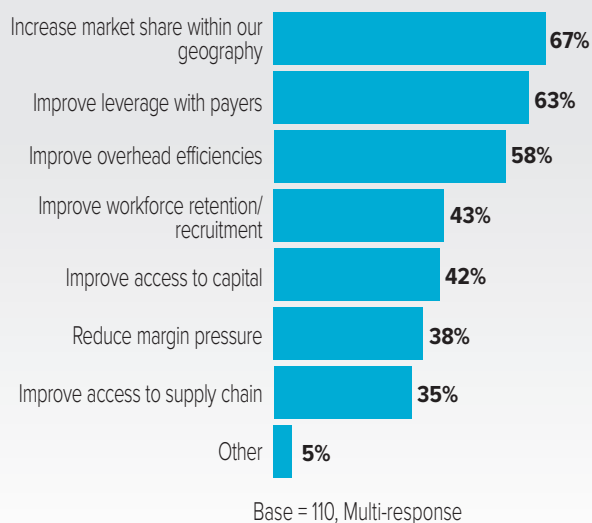


Figure 4 | What are the financial objectives of your M&A?



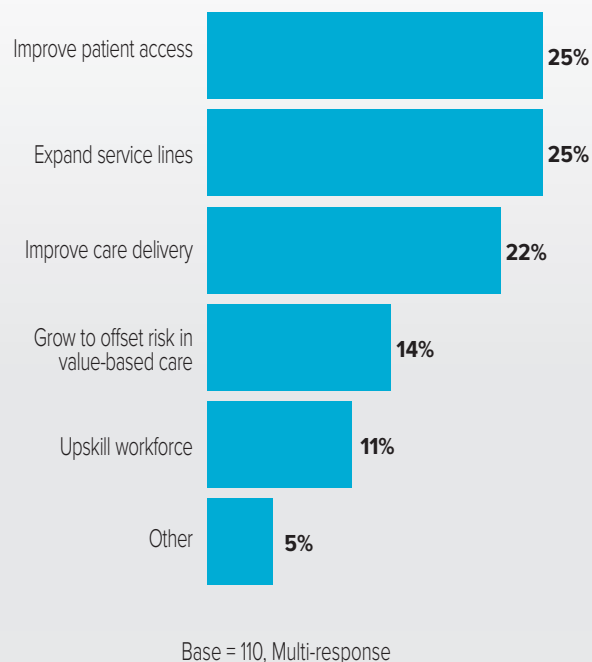
premise that economic uncertainty was affecting their M&A plans (Figure 1). Davis shrugs those numbers off.

“If a hospital can’t recruit physicians, they’re not going to blame it on themselves. They blame it on the economy. So, the ‘uncertainty of the economy’, I look at that as a phrase where you let an awful lot of people off the hook,” Davis says.

When asked if the adverse regulatory climate was affecting their M&A plans, nearly half (47%) say yes (Figure 2).

“From the perspective of a successful M&A plan, I would wholeheartedly agree with that,” Davis says. “But from the perspective of, ‘Is it driving M&A?’ No, not at all. The regulatory climate does not, in and of itself, push M&A because those regulations are a given.”

Figure 5 | What are the care delivery objectives of your M&A?



ANALYSIS AND SURVEY RESULTS

Almost two-thirds (65%) of respondents say their primary reason for M&A is to increase leverage with payers (Figure 3).

“Before people would try to hide behind the skirts of some other reasons. Now, they’re fessing up and admitting that their primary motivation is and always has been to follow the money,” Davis says.

In Davis’ opinion, “M&A does not provide better care for patients. Does it avoid a facility closure? Yeah, if you’re talking about not putting a chain on the doors. But if they take away labor and delivery, from your wife’s perspective that’s shutting down your hospital.”

When respondents were asked about the financial objectives of their M&A (Figure 4), the top response was to

Figure 6 | Describe the nature of your most recent M&A

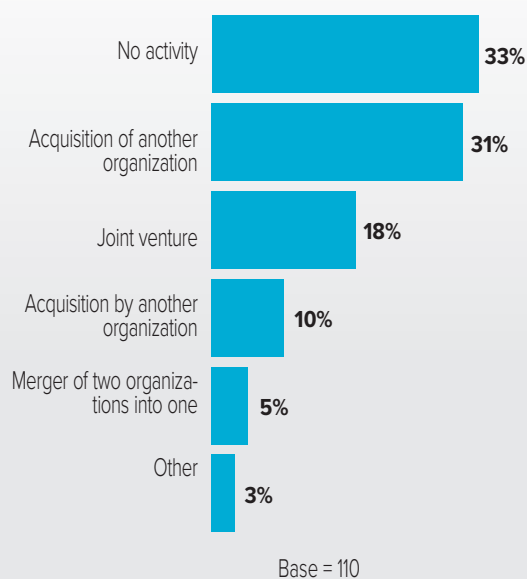
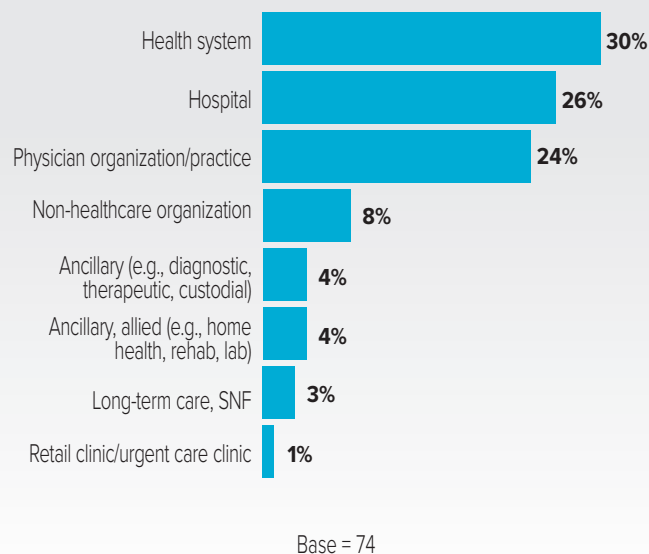


Figure 7 | What entity was involved in your M&A?



increase market share in their service area (67%) or improve leverage with payers (63%).

Davis dismisses the other reasons, including improving overhead efficiencies (58%) and improving recruiting and retention (43%).

“What are the financial objectives of your M&A?” He says for the entity that’s been acquired, it’s to save the hospital.

“Improve leverage with payers (63%)?” Absolutely, but that should be 100%,” he says.

“[The M&A] may or may not improve workforce retention (43%),” Davis says. He says if your hospital gets acquired, you may lose departments or the acquiring organization may bring in its own team.

ANALYSIS AND SURVEY RESULTS

Figure 8 | Describe how your M&A affected revenue and margins.

	Increased	Remained the same	Decreased	Don't know
Net patient revenue	51%	18%	9%	22%
Operating margins	28%	31%	24%	16%

Base = 74, Of those involved in M&A activity

Figure 9 | How were care costs affected in each setting after your M&A?

	Cost of providing care increased	Cost of providing care decreased	Cost of providing care remained the same	Don't know
Inpatient	19%	18%	27%	36%
Outpatient/ambulatory	19%	23%	36%	22%
Virtual care	18%	16%	30%	36%

Base = 74, Of those involved in M&A activity

Year over year (YOY) results from HealthLeaders' 2022 M&A survey showed that when respondents were asked about the nature of their most recent M&A, the top answer was "no activity," which jumped from 25% in 2022 to 33% in 2023, which might be a sign of the times (Figure 6). But "acquisition of another organization" responses jumped from 22% to 31% YOY, respectively, showing that when there was activity, acquisition was first choice versus being acquired. Joint ventures are also on the decline with respondents saying these happened 18% in 2023, versus 25% in 2022.

Health systems and hospitals were the top entities involved in respondents' recent M&A activity (health systems increased from 30% in 2023 versus 19% in 2022, and hospitals jumped up to 26% from last year's 16% (Figure 7). Physician organizations moved down two percentage points from 26% last year to 24% this year.

Yet more than half (54%) of respondents say their next target for M&A will be physician practices (Figure 11).

"No surprises there," Davis says. "They'll be integrated with the hospital and all they'll have to do is participate in provider billing. Yesterday you could charge \$110 for an office visit and today you can charge \$140. Physician acquisitions are in many cases driven by the reality of provider-based billing."

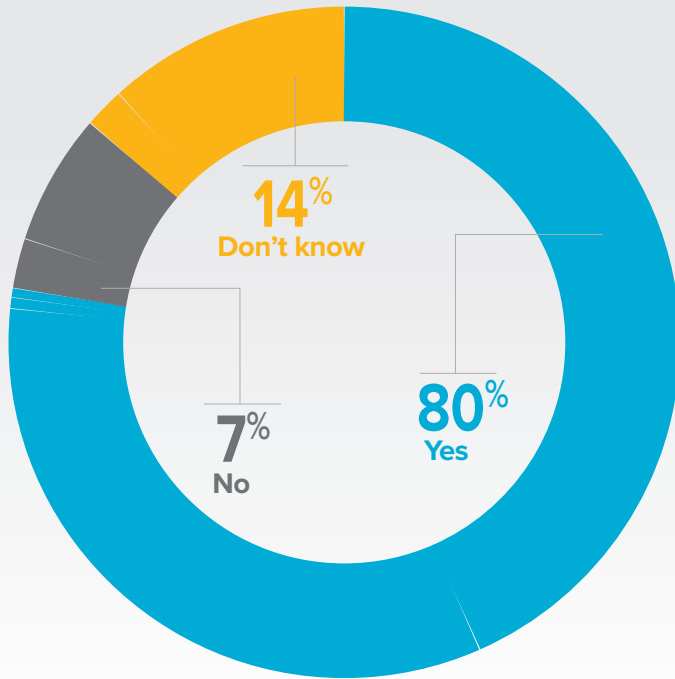
Despite M&A outlooks and climate, 80% of respondents say that, in retrospect, they'd do it again (Figure 10).

For the acquired hospital, Davis says, that's no surprise because their only other option likely was closure.

Sixty-five percent of respondents say they expect their M&A to increase over the next three years (Figure 13), which Davis says "tells me that there are still lots of physicians available."

ANALYSIS AND SURVEY RESULTS

Figure 10 | Looking back, would you participate in M&A again?



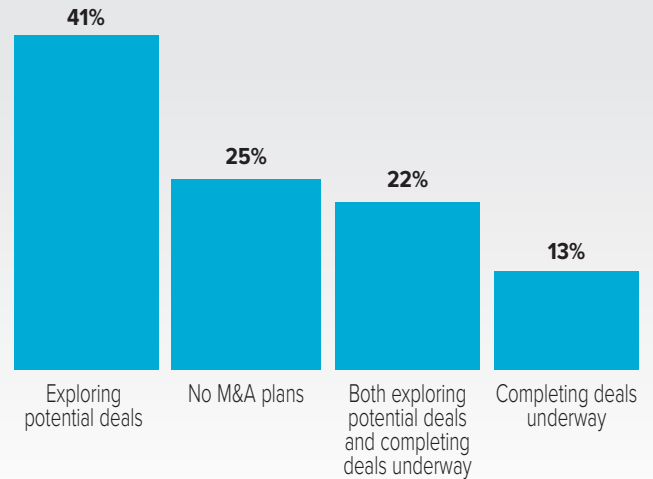
Base = 74, Of those involved in M&A activity

“Because the majority of M&A taking place goes directly to physician practices,” he says, “that consolidation of physician practices will continue until there’s nobody else to buy.”

Davis says the dollar value of the deals (Figure 14) validates his belief that physician practices are a ripe target for acquisition.

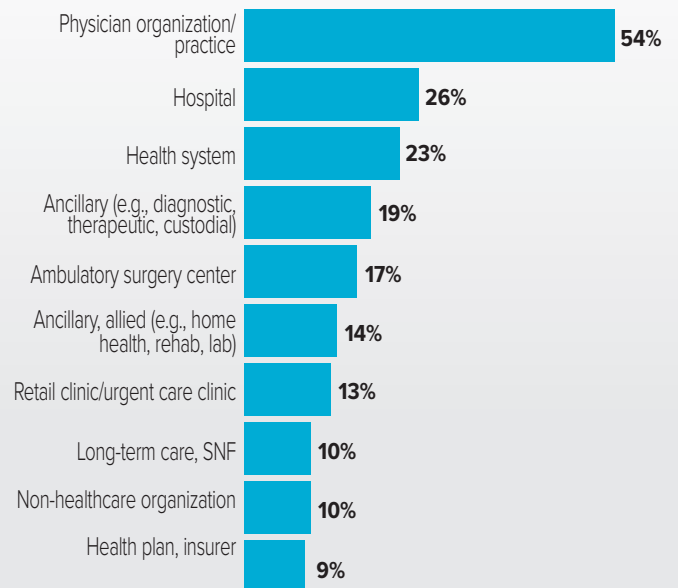
“Really large acquisitions of \$100 million plus means they’re going after the smaller hospitals,” he says. “Anything less than that and you’re talking about a large physician practice, which is again consistent with the overall target that

Figure 11 | The uncertainty of the economy is affecting our organization’s M&A plans.



Base = 110

Figure 12 | What entities will you pursue through M&A within the next year?



Base = 69 | Multi-response, Of respondents exploring potential deals

ANALYSIS AND SURVEY RESULTS

was indicated by the previous question about going after physician-focused practices. There aren't many practices that are worth \$100 million or more. So, the small numbers that are going after the big-dollar acquisitions are the larger hospitals with their eyes on the community hospitals in their service area."

The bottom line is the bottom line, Davis says, and when you follow the money, a lot of responses from the survey make sense.

John Commins is a senior editor for HealthLeaders. He can be contacted at jcommins@healthleadersmedia.com.

Figure 13 | Within the next three years, do you expect your M&A to:

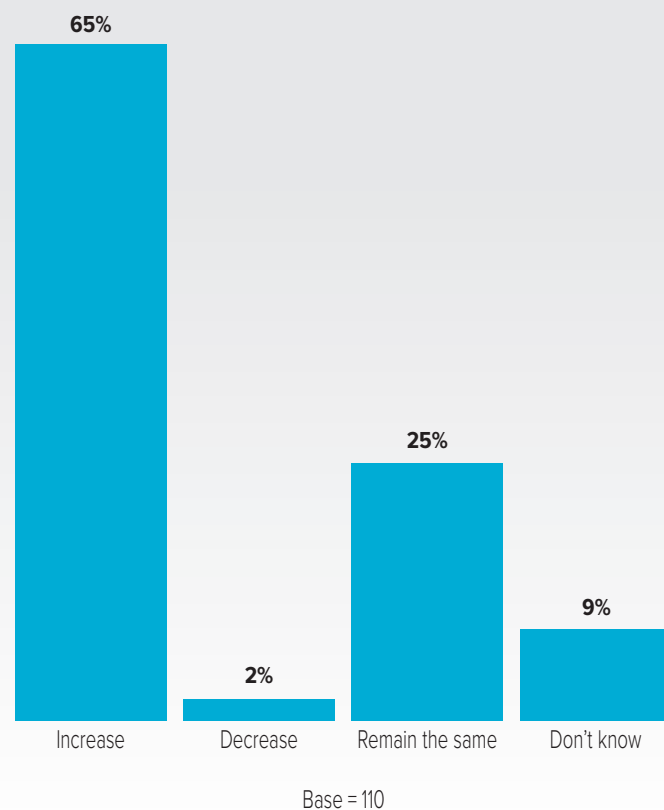
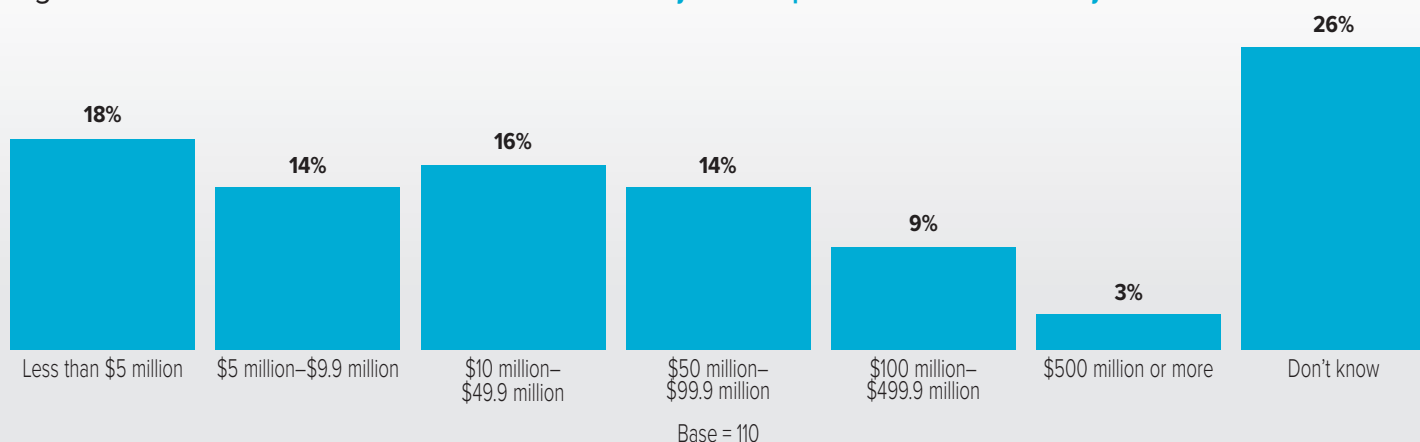


Figure 14 | Estimate the total dollar value of the M&A that you will explore within the next three years.



METHODOLOGY

The HealthLeaders 2023 Mergers, Acquisitions, & Partnerships Survey was conducted by the HealthLeaders Intelligence Unit, powered by the HealthLeaders Council. It is part of a series of thought leadership studies. In April 2023, an online survey was sent to the HealthLeaders Council and select members of the HealthLeaders audience at healthcare provider organizations. A total of 110 completed surveys are included in the analysis. The margin of error for a base of 110 is +/- 9.3% at the 95% confidence interval. Survey results do not always add to 100% due to rounding.

What Healthcare Leaders Are Saying

Here are selected comments from leaders on how they will demonstrate lower consumer costs with M&A.

“We will be able to negotiate better rates with insurance plans. In turn, we can pass savings on to our patients.”

—CEO/President at a large health system

“Outsourcing.”

—Chief nursing information officer at a medium hospital

“Lower costs through increased use of technology.”

—CEO/President at a small hospital

“Using the Medicare value-based program showing lower total cost of care”

—CEO/President at a small physician organization

“Consolidating service lines and reducing provider costs in smaller markets. Transitioning with medical practices to shift to outpatient cost structures vs. HOPD.”

—CEO/President at a large hospital

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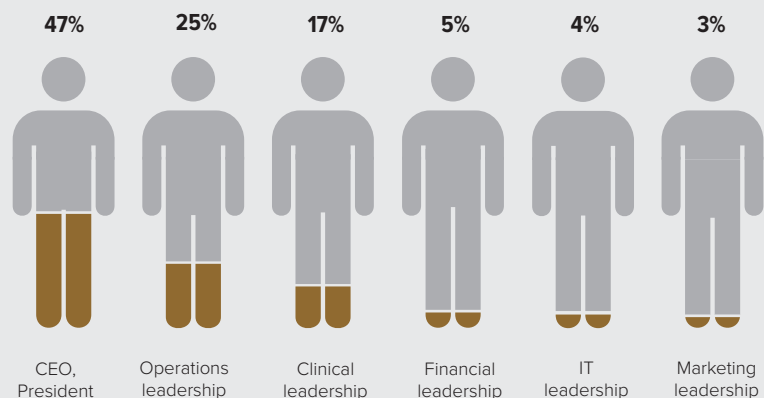
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RESPONDENT PROFILE

TITLE

Base = 110



CEO, PRESIDENT

- > CEO, President
- > Chief Executive Administrator
- > Chief Administrative Officer
- > Board Member
- > Executive Director
- > Managing Director
- > Partner

OPERATIONS LEADERSHIP

- > Chief Operations Officer
- > Chief Strategy Officer
- > Chief Compliance Officer
- > Chief Purchasing Officer
- > VP/Director Operations Administration
- > VP/Director of Compliance
- > Chief Human Resources Officer
- > VP/Director HR/People
- > VP/Director Supply Chain/Purchasing

FINANCIAL LEADERSHIP

- > Chief Financial Officer
- > VP/Director Finance
- > VP/Director Patient Financial Services
- > VP/Director Revenue Cycle
- > VP/Director Managed Care
- > VP/Director Reimbursement
- > VP/Director HIM

CLINICAL LEADERSHIP

- > Chief Medical Officer
- > Chief Nursing Officer
- > Chief of Medical Specialty or Service Line
- > VP/Director of Medical Specialty or Service Line
- > VP/Director of Nursing
- > Chief Population Health Officer
- > Chief Quality Officer
- > Medical Director
- > VP/Director Ambulatory Services
- > VP/Director Clinical Services
- > VP/Director Quality
- > VP/Director Patient Safety
- > VP/Director Postacute Services
- > VP/Director Behavioral Services
- > VP/Director Medical Affairs/Physician Management
- > VP/Director Population Health
- > VP/Director Case Management
- > VP/Director Patient Engagement, Experience

MARKETING LEADERSHIP

- > Chief Marketing Officer
- > VP/Director Marketing
- > VP/Director Business Development/Sales

IT LEADERSHIP

- > Chief Information Technology Officer
- > Chief Information Officer
- > Chief Technology Officer
- > Chief Medical Information Officer
- > Chief Nursing Information Officer
- > VP/Director IT/Technology
- > VP/Director Informatics/Analytics
- > VP/Director Data Security

TYPE OF ORGANIZATION

Base = 110

Physician organization (MSO/IPA/PHO/clinic)	36%
Health system (IDN/IDS)	24%
Hospital	22%
Ancillary services provider (diagnostic/therapeutic/custodial)	12%
Ambulatory surgical center	2%
Convenient care/retail clinic (including retail pharmacies with clinics)	2%
Urgent care center	2%
Payer/health plan/insurer (HMO/PPO/MCO/PBM)	1%

NUMBER OF PHYSICIANS

Base = 110

1–9	12%
10–49	21%
50+	65%
N/A	2%

NUMBER OF BEDS

Base = 110

1–199	45%
200–499	14%
500+	18%
Do not have a standard number of beds	24%

PROFIT STATUS

Base = 110

Nonprofit	52%
For-profit	48%

NET PATIENT REVENUE

Base = 110

\$1 billion or more (large)	15%
\$250 million–\$999.99 million (medium)	15%
\$249.9 million or less (small)	55%
None of above	16%

RURAL STATUS

Base = 110

Yes	29%
No	71%

RESPONDENT REGIONS

