Financing Acquisitions: Top Strategies for Today's Healthcare Providers

Introduction

Prior to the Affordable Care Act (ACA) in 2010, healthcare provider mergers and acquisitions (M&A) often occurred only when an organization had reached a state of financial crisis. The same cannot be said today, as astute healthcare executives of hospitals and health systems view M&A activity not just as a way to maintain solvency but as a path toward excellence in care delivery—and, of course, adapting to the new environment birthed by reform. Forward-thinking CEOs and CFOs consider a merger or acquisition as a strategic move to accomplish high-level business objectives.

Healthcare M&A activity began heating up in 2012, with the trend continuing into 2016. Experts predict consolidation within the healthcare provider industry will continue for several more years as organizations seek ways to expand their territories, maximize growth opportunities and diversify their payer mixes.

Consolidation has moved beyond the traditional merger or acquisition, however, into alternative partnership structures such as joint ventures and joint operating agreements. This choice of partnership can greatly impact the type of financing an organization should consider to minimize its risk exposure while maximizing capital access. Yet how do savvy healthcare financial officers, CEOs and board members navigate this world of financial options effectively?

This white paper explores the state of M&A activity in the healthcare provider industry, what's driving it and, importantly, the top strategies today's healthcare leaders should use to evaluate their M&A financing options.

Key Takeaways

M&As are viewed as a path toward excellence in care instead of a response to a financial crisis.

Consolidation has moved beyond traditional M&As into more flexible partnerships such as joint ventures and joint operating agreements.

The Affordable Care Act's emphasis on reimbursement tied to value instead of volume changes the playing field for healthcare providers.

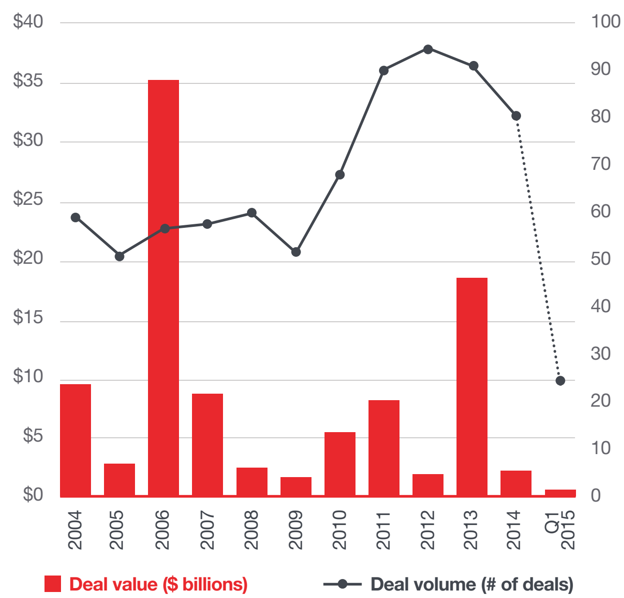
M&A activity rose 19% in the first quarter of 2015 as compared with the same period in 2014.

State of M&A Activity in the Healthcare Provider Industry

The ACA's emphasis on reimbursement tied to value instead of volume has changed the playing field for healthcare providers. Hospitals, systems and other providers realized they could no longer rely on filling their beds to generate revenue. Perceptive providers looked for strategic partners to help them streamline patient processes and influence outcomes to maximize reimbursements. This desire to increase efficiency drove the first wave of healthcare M&A that occurred after passage of the ACA.

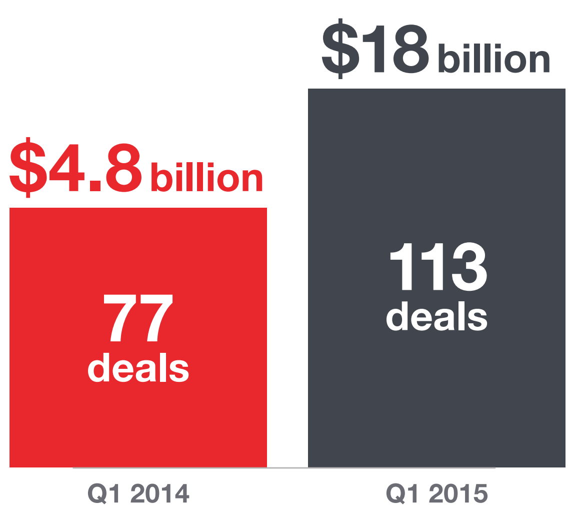
Since that time, M&A activity in the healthcare sector has continued to flourish: 2013 saw a dramatic increase in M&A activities among big players in the industry as providers sought to minimize their risk exposure through growth. And there's no sign that M&A activity in the healthcare provider industry will cool anytime soon. M&A activity rose 19% in the first quarter of 2015 as compared to the same period in 2014. Not only did the number of M&A transactions rise, but the value of these deals skyrocketed, shooting up 92% in Q1 of 2015 over the same quarter the previous year.

Hospitals: M&A Activity



Source: The Health Care M&A Information Source, HealthcareMandA.com

Year-Over-Year Deals for Providers



These numbers may actually understate the level of M&A activity in the hospital sector, because many hospitals have begun undergoing mergers through nontraditional structures such as affiliations and joint ventures that don't require a disclosure of valuations. If this activity were considered, the true nature of M&A among hospitals and their partners might be considerably higher than the hard numbers indicate.

Where is M&A activity going in the foreseeable future? Experts agree deals of all types—traditional acquisitions/mergers and nontraditional partnerships—will continue for at least the next three to five years. In fact, a recent Deloitte survey indicated that 70% of large healthcare companies said they "plan to undertake M&A activity within the next three years." *Mergers & Acquisitions* magazine forecasts healthcare M&A deal volume alone will nearly match M&A volume in all industry sectors through 2015.

What is driving healthcare M&A activity?

The nature of healthcare operations changed radically under the implementation of the ACA. Gone are the days when a hospital or healthcare system could calculate revenue based on volume. Today's provider landscape involves much more risk, with reimbursements dependent on value-based, outcome-driven patient care goals. Many providers undertake a merger, acquisition or partnership to mitigate some of this risk.

Providers seek mergers and acquisitions as a forward-thinking strategy to:

Increase scale	"The rating agencies have been very clear that 'bigger is better' when it comes to credit ratings for healthcare providers," said Zachary Kau, managing director at KeyBanc Capital Markets. "There's a general belief that organizations with large revenue bases are less susceptible to changes in the economy and to changes in reimbursement due to healthcare reform."
Increase payer diversity	Mitigating risk in healthcare requires that reimbursement come from a broad mix of payers. Providers can achieve a healthy payer mix by acquiring a system with a distinctly different payer mix than their own.
Create growth opportunities	Partnerships can enable systems to deliver services to specific demographic groups or geographic areas they don't currently serve. This growth, in turn, fuels the diversity that minimizes risk.
Reduce costs	Merging or acquiring a partner can create sourcing opportunities that reduce costs through volume purchasing.
Lower interest rates	Providers with weaker credit or higher interest cost can realize a reduction in interest paid by partnering with a provider whose credit will allow for borrowing at a lower rate. These partners can then restructure existing debt or obtain lower-cost capital for expansion.
Acquire high-value partners at low cost	"It's still possible to pick up near-distressed, marginal players," says Rob Fuller, attorney at Nelson Hardiman and a former hospital COO. "These partners can bring reduced risk through diversity and scale to an established system."

Key Steps in Acquisition Finance

Shrewd providers proactively address the future health of their organization by looking to M&As to achieve their goals. "I always tell clients, 'You have to be willing to look toward the sun,'" says Patrick Pilch, consulting managing director at BDO New York, a global accounting firm. "It may feel painful at first, but there's a big opportunity to succeed in healthcare today if you have a strong vision of what your organization is going to look like in three to five years."

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Assemble your M&A leadership team

The first step toward a successful merger, acquisition or partnership is to assemble a strong team to lead the organization through the sea change to come. **At a minimum, your team should include:**

Visionary CEO	Your chief executive should be able to communicate the desired outcome of any M&A activity to the entire organization.
Clinical leaders	"Include the most forward-thinking physician or two on your staff in order to understand the pressures M&A activity will exert on their business and how it will affect patients," Fuller suggests. "These doctors can help you work with the clinical staff to determine how you can all pull together to make sure the merger or acquisition serves your mutual patient population."
Chief Financial Officer	Your CFO should keep the team apprised of true costs and revenue throughout the restructuring process, as well as evaluating M&A costs.
Consulting banker	Seek an investment banker with special expertise in healthcare M&A to evaluate all the market subtleties and complex details that need to be nailed down to create a successful transaction. "Choose a banker who listens first," Kau recommends. "A great M&A banker will understand your goals and structure a customized solution tailored to your unique needs."
Legal consultant	An attorney who specializes in healthcare M&A will be a key team member to help your organization understand the ramifications of undertaking various types of restructuring.
Governance committee representatives	Especially for nonprofits, governance committee members will ensure any M&A activity supports the guiding mission of your organization.

Prepare your own house first

Before you go into a merger or acquisition, you should evaluate your financial position to help determine what type of M&A activity will give your organization the biggest benefit. **Take these steps early in the process:**

- **Check your credit.** Many provider organizations undertake M&A to improve their credit, but you should achieve the best credit rating you can on your own first. A strong credit rating can make you more attractive as a partner.
- **Prepare your books.** Get an audited financial statement, as it's the standard for restructuring.
- **Evaluate your capital needs.** Consider your existing capital needs, such as aging facilities that require retrofitting for modern healthcare delivery, and projected future needs, such as expansion into new geographic areas through yet-to-be-built facilities. Also consider what, if any, IT investments you need, such as a fully capable EHR system if you don't already have one.
- **Analyze your market.** What specific M&A activity do you need to engage in to meet your market's future needs? Do you need to scale up? Diversify? Sell out? A keen market analysis will drive your decision making on this key point. Turn to a financial advisor for this type of deep insight.

Traditional and Innovative Options for M&A Financing

Today's healthcare providers enjoy a range of options for M&A financing, but not every option is right for every type of partnership. "The financing options are driven by how closely, or loosely, integrated the hospitals will be after the affiliation," Kau said. "A full asset merger, for example, represents a very tight integration. A joint operating agreement is a looser affiliation. Your financing package should be appropriate to the type of M&A activity you are undertaking." Ultimately, the type of financing you choose should serve your goals by delivering the best value with the least risk. A seasoned healthcare banker will leverage their expertise to tailor a package to your organization's needs.

Traditional financing sources

For organizations seeking a merger or acquisition that involves a high level of integration, traditional funding sources may be the best option. These include:

- **Bonds.** A public issuance of long-term fixed-rate bonds, often tax-exempt for not-for-profit organizations, offers an attractive option to lock in historically low borrowing costs today. However, when issuing long-term fixed-rate bonds, the issuer may be giving up some future flexibility by closely integrating the credits of the two organizations. Undoing these "obligated group" borrowing arrangements down the road may be difficult and costly, which is certainly a trade-off.
- **Direct bank loans.** These may be from a single bank or a group of banks. Bank loans usually provide more flexibility than long-term fixed-rate bonds, as they often must be renewed or refinanced in three to 10 years.

Nontraditional financing sources to consider

If your organization plans for a loose integration with another entity, your goals may be better served with a nontraditional type of financing, including:

- **FHA-242 program.** Available to acute-care hospitals, this government-insured loan program provides capital access to hospital borrowers at attractive rates. Similar to other Federal Housing Administration borrowing programs, the FHA insurance is secured by a mortgage on the hospital's real property. This may be an attractive financing option when organizations with different credit circumstances come together.
- **REITs.** Real estate investment trusts increasingly play a key role in financing healthcare partnerships. REITs can provide hospitals with real-estate-secured lending solutions, which are usually structured as sale-leaseback transactions. The hospital effectively monetizes its ownership interest in a property or building and agrees to lease the facility back from the REIT over a long period of time.

- **Limited put agreements.** In this type of financing, a bank agrees to purchase bonds issued by a provider with a lesser credit profile as long as the partnering entity provides the bank with a "put" in the future. The put agreement often allows the bank to recover the change in the value of the bond during the initial period. This reduces the bank's risk of owning the bond during the initial period and translates into lower borrowing costs for the consolidated organization.

Few healthcare providers go into affiliation discussions debt-free. Debt structure and future financing options are major implications to consider when looking at affiliations. Hospitals should consult a banker or financial advisor to help tailor a credit strategy that meets their needs not just today, but down the road.

How to evaluate your financing options

Even the savviest healthcare CFO probably isn't an expert in M&A financing. To ensure your organization gets the best deal, consult an investment banker or financial advisor that specializes in this type of transaction.

Key questions to ask any prospective banker or financial advisor:

Do you specialize in healthcare M&A?

What volume of transactions has your group advised on within the last year?

Can you handle: exclusive sales, divestitures, tender offers, joint ventures, strategic alliances, recapitalization and restructuring?

Can you advise on middle-market M&A, or do you only work with large organizations?

Ensure everyone has access to the same data and financial recommendations so your organization can move forward at a steady pace.

Keep in mind there's a difference between the timeline for negotiating an affiliation and the timeline for obtaining financing. Financing talks should occur toward the end of the overall negotiation, once the organizations have agreed on:

The main objectives for merging

The growth trajectory for the merged company

The level of risk each partner is willing to take on

Conclusion

The savvy healthcare executive will proactively seek M&A opportunities to maintain a vibrant, profitable organization.

The key considerations to address are:

- In what ways does our organization need to scale in order to stay healthy?
- How do we need to diversify our payer risk?
- How can we increase efficiency through a strategic partnership?
- Where are the growth opportunities in our market that we can leverage through a merger or acquisition?
- What types of M&A financing provide the most advantageous solution to obtaining capital at a low cost with tolerable risk?

As you move forward with strategic M&A activity to enhance growth and patient care delivery, be sure to lean on expert banking professionals to help you obtain the right type of funding to put your organization on the path to success.

Additional resources

Discover how to unlock opportunities for your organization through a merger or acquisition:
www.key.com/corporate/capital-markets/mergers-acquisitions.jsp

Keep tabs on healthcare M&A activity with Modern Healthcare's financial section:
www.modernhealthcare.com/section/mergers-and-acquisitions-finance

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