

The Governance Institute



Go It Alone or Merge Into a Larger System: An Unavoidable Decision

Webinar

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Today's Presenters



Daniel M. Grauman, president & CEO of DGA Partners, has assisted clients including hospitals, contracting organizations and health plans, and other healthcare businesses throughout the nation. His experience includes strategic and business planning; mergers, acquisitions, and affiliations; medical staff development plans; community need and fair market value studies; market and financial feasibility studies for hospitals and healthcare services; and managed care and cost management strategies for providers and purchasers.



Edward A. Kazemek is chairman and CEO of **ACCORD LIMITED**, a Chicago-based firm specializing in healthcare governance, strategy, and management. He has more than 30 years of experience as a management consultant, with an intense concentration on not-for-profit healthcare. His practice is focused on assisting boards, medical groups, and senior executives in the areas of governance assessment/restructuring, board development, strategic planning, and facilitating collaborative arrangements among hospitals, health systems, and physicians.

Webinar Intended Audience

- Those dealing with the question of remaining independent vs. being part of a larger health system
- Standalone hospitals
- Smaller health systems (two to three hospitals)

Topics We'll Cover

1. The board's role and duty concerning the “standalone” question
2. Trends and challenges forcing boards to make this strategic decision (one way or the other)
3. Requirements for remaining independent
4. Models for “partnering” with another health system
5. Decision-making processes to consider

The Board's Legal Obligations

Fiduciary Duty to Provide Effective Oversight –
this requires the board to:

- Ensure ***obedience*** to the hospital's mission and approve strategic direction in support of that mission
- Make ***careful/prudent decisions***
- Remain ***loyal*** to the hospital, above all else

A potential change-of-control situation magnifies the importance of the board's fiduciary duties. The highest level of performance is expected/required

The Essence of Board Work

The decision to remain
independent or to join a larger
health system is the most profound
decision a board—
and only the board—
can make

**How did we get
to this point?**

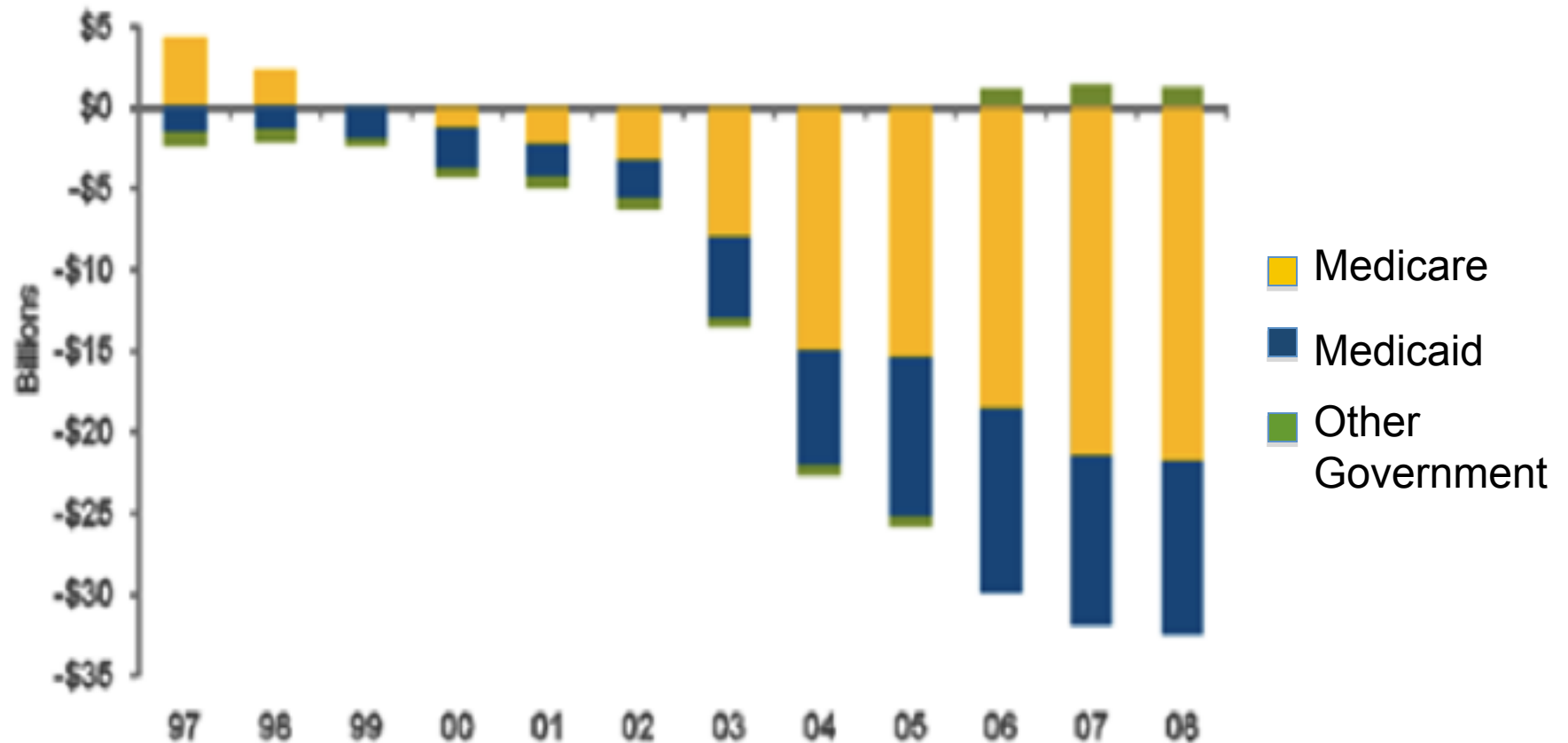
Overall Economic Crisis

- Recession
- Massive credit crisis
- Declining cash reserves
- Decreased investment income
- Loss of savings
- Tighter access to capital
- Increased unemployment
- Elimination of health benefits
- Reduced consumer spending ability

Impact on Healthcare Industry

- Decreased utilization/elective care/volumes
- Decreased employer-sponsored coverage
- Increased Medicaid usage and self-pay
- Lower reimbursement and margins
- Reduced access to capital/higher borrowing costs/
many bond-rating downgrades
- Job cuts
- Reduced services
- **Uptick in mergers, joint operating agreements,
and other collaborative arrangements**

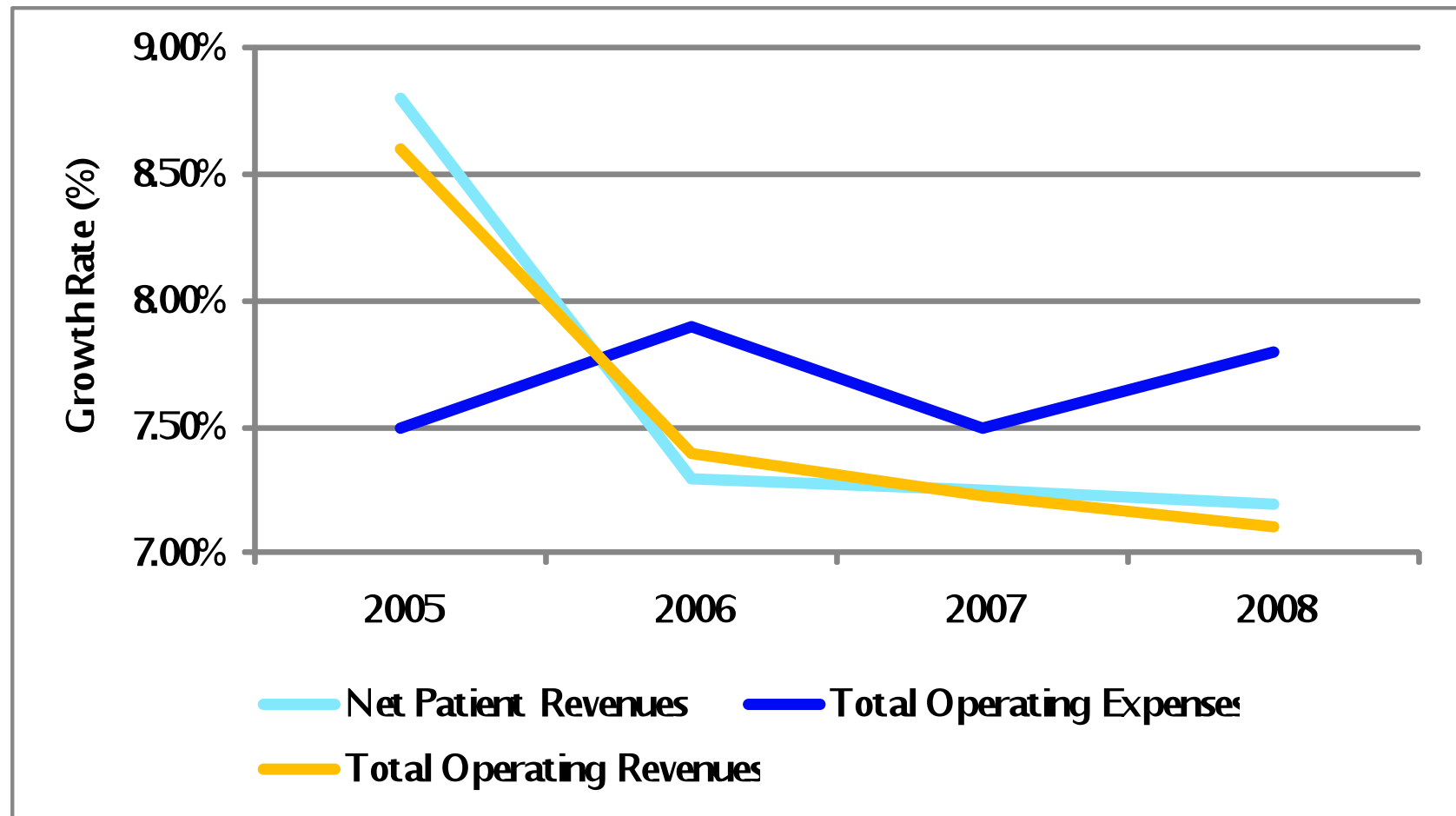
Government Payers Do Not Cover Hospital Costs



Source: Avalere Health analysis of American Hospital Association Annual Survey data, 2008, for community hospitals.

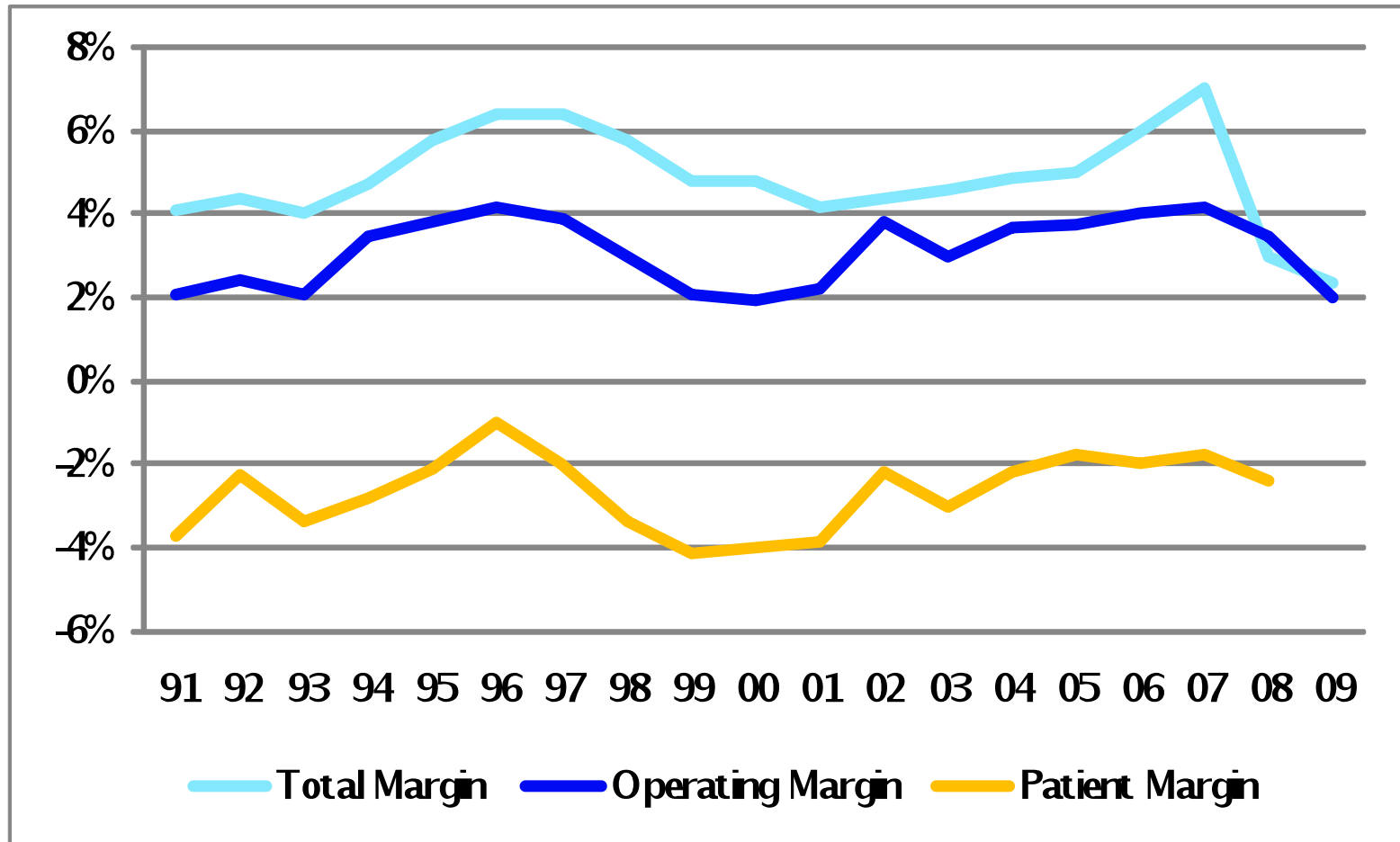
(1) Costs reflect a cap of 1.0 on the cost-to-charge ratio.

Median Expense Growth Outpaces Median Revenue Growth for Third Consecutive Year



Source: Moody's U.S. Public Finance: Not-for-Profit Hospital Medians for Fiscal Year 2008, August 2009

Hospital Profitability on the Decline

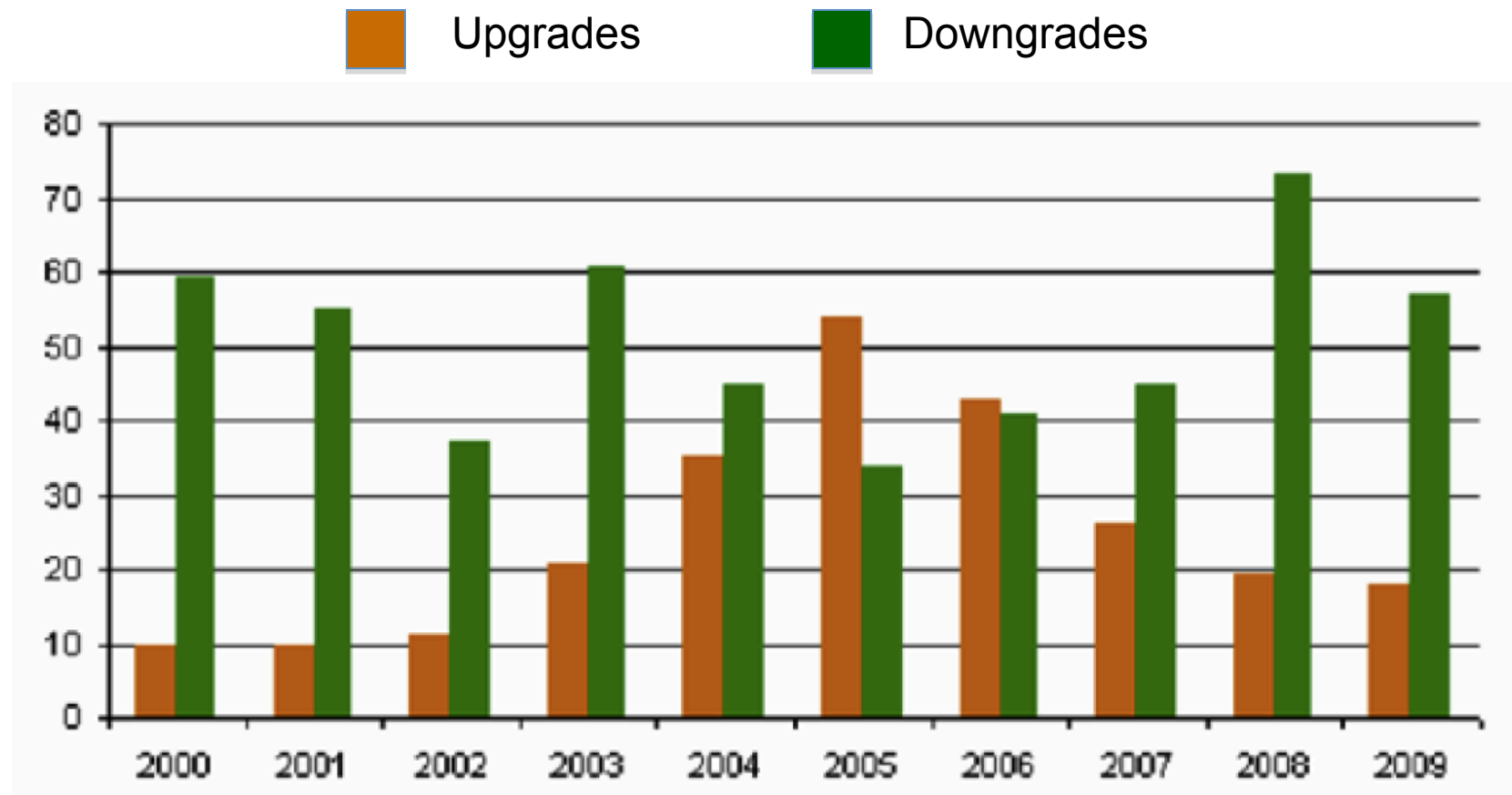


Source: Avalere Health analysis of American Hospital Association Annual Survey data, 2008, for community hospitals.

- 1) Total Hospital Margin is calculated as the difference between total net revenue and total expenses divided by total net revenue.
- 2) Operating Margin is calculated as the difference between operating revenue and total expenses divided by operating revenue.
- 3) Patient Margin is calculated as the difference between net patient revenue and total expenses divided by net patient revenue.

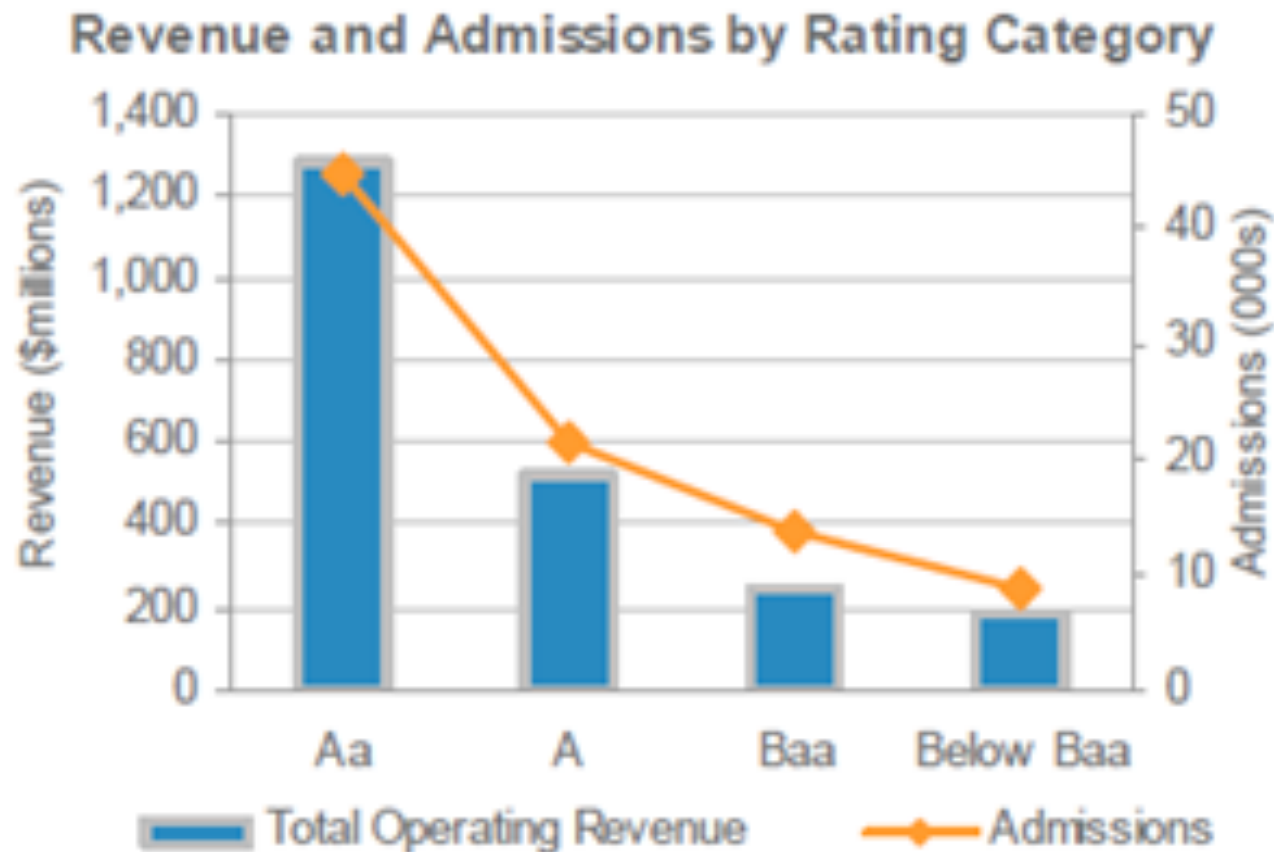
HFMA Key Hospital Financial Statistics and Ratio Medians, December 2009

Bond Downgrades on the Rise



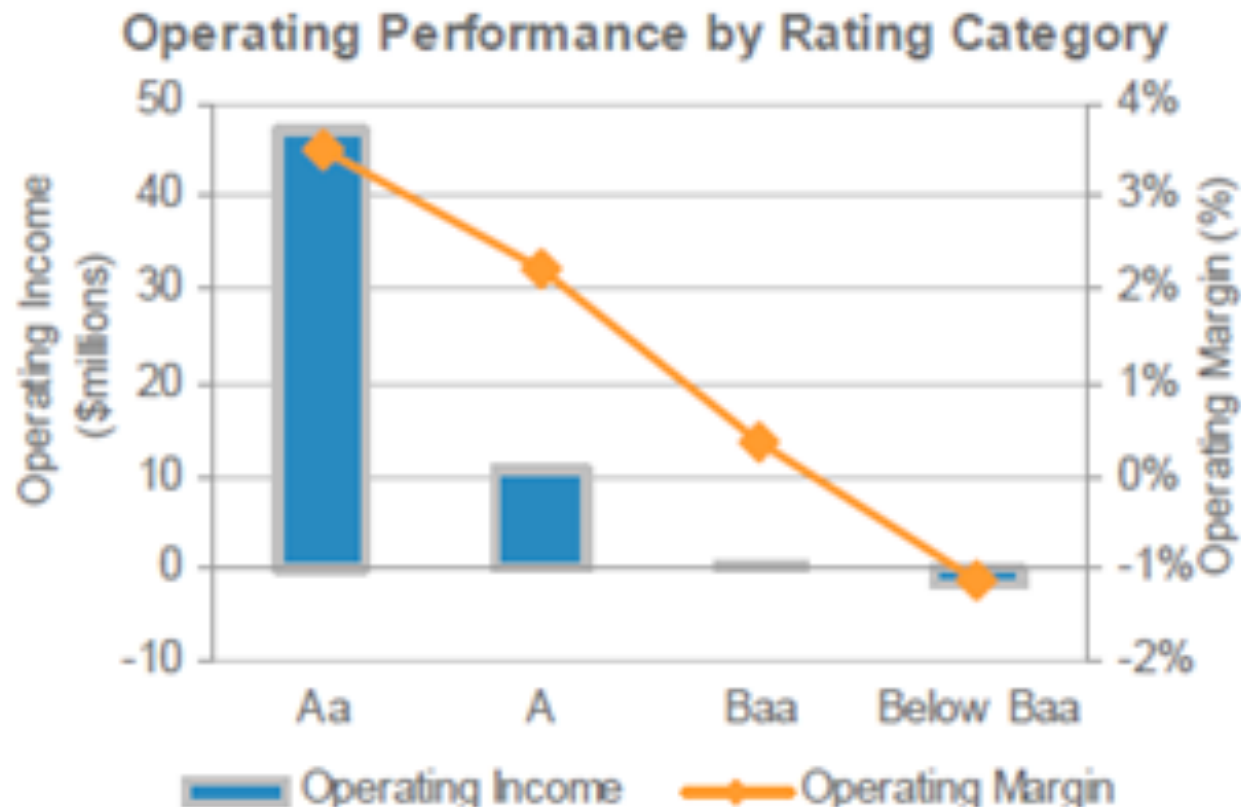
© Standard & Poor's 2010

Credit Markets Favor Large Organizations



Source: Moody's U.S. Public Finance: Not-for-Profit Hospital Medians for Fiscal Year 2008, August 2009

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Source: Moody's U.S. Public Finance: Not-for-Profit Hospital Medians for Fiscal Year 2008, August 2009

Healthcare Reform and Hospitals

- Substantial increase in covered population
- Reduction in Medicare payment rates
- Focus on quality and efficiency of healthcare by linking payment to better quality outcomes
- Shifting Medicare and Medicaid financial risk to providers through:
 - Accountable care organizations (ACOs)
 - Bundled payments
- Commercial insurers likely to follow

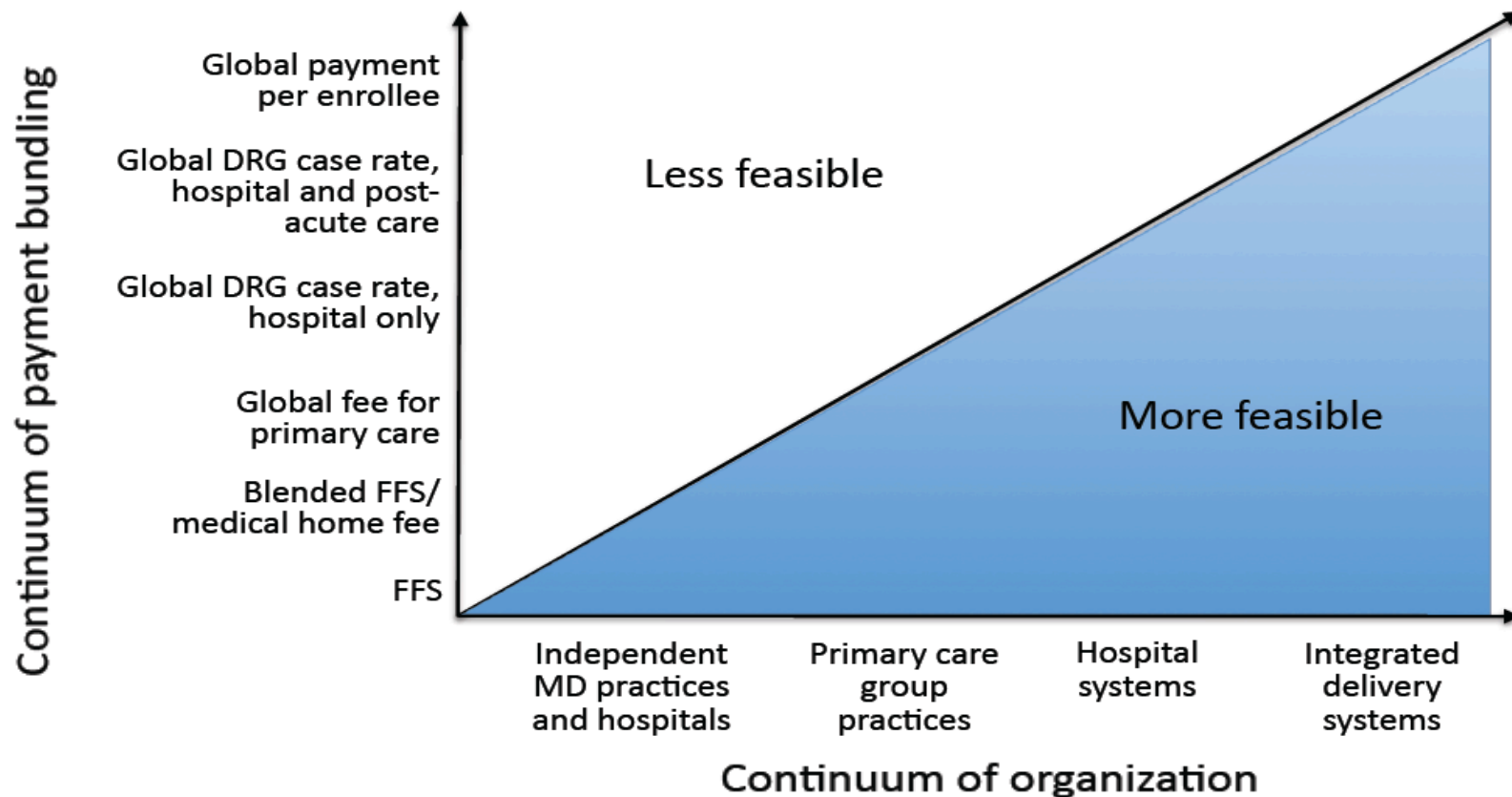
Accountable Care Organizations

- ACOs to be established January 1, 2012
“Medicare’s Shared Savings Program”
- Goals
 - Investment in infrastructure
 - Redesign care process
 - Quality and efficiency
- Medicare Parts A and B
- Serves traditional Medicare beneficiaries

Source: Page 728ff of PPACA

Payment Bundling May Drive Integration

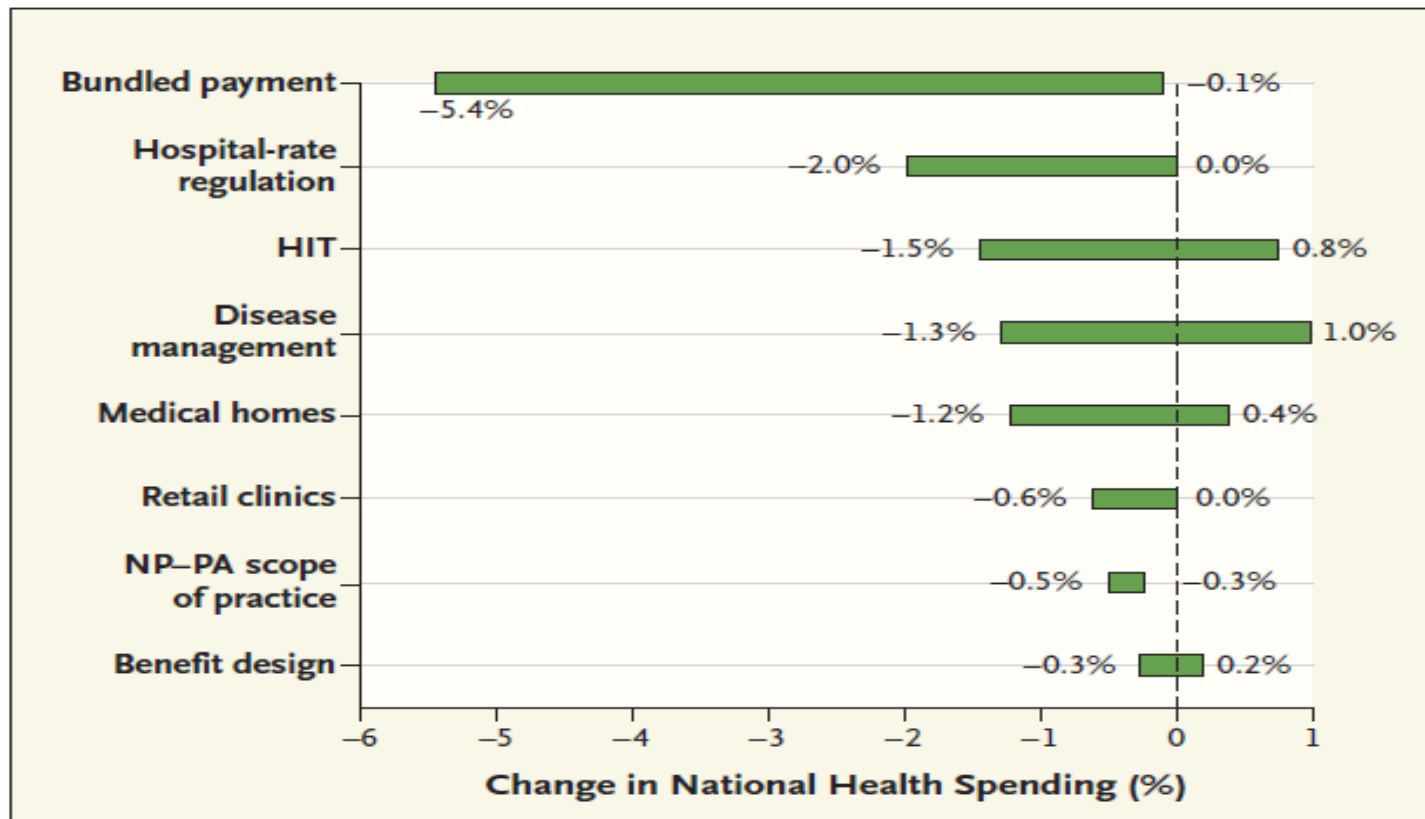
Medicare Payment Framework: Organization and Payment Methods



Notes: DRG is diagnosis-related group. FFS is fee-for-service.

Source: S. Guterman, K. Davis, S. C. Schoenbaum, and A. Shih, "Using Medicare Payment Policy to Transform the Health System: Framework for Improving Performance," *Health Affairs* Web Exclusive (Jan. 27, 2009): w238–w250.

Bundled Payment Anticipated to Save the Most



Estimated Cumulative Percentage Changes in National Health Care Expenditures, 2010 through 2019, Given Implementation of Possible Approaches to Spending Reform.

Source: New England Journal of Medicine, Hussey: Controlling U.S. Health Care Spending, November 2009

Consolidation to Accelerate

- *“Reform will encourage even more consolidation of the industry, as bigger health systems leverage economies of scale and have greater access to credit.”*

Moody's, April 2010

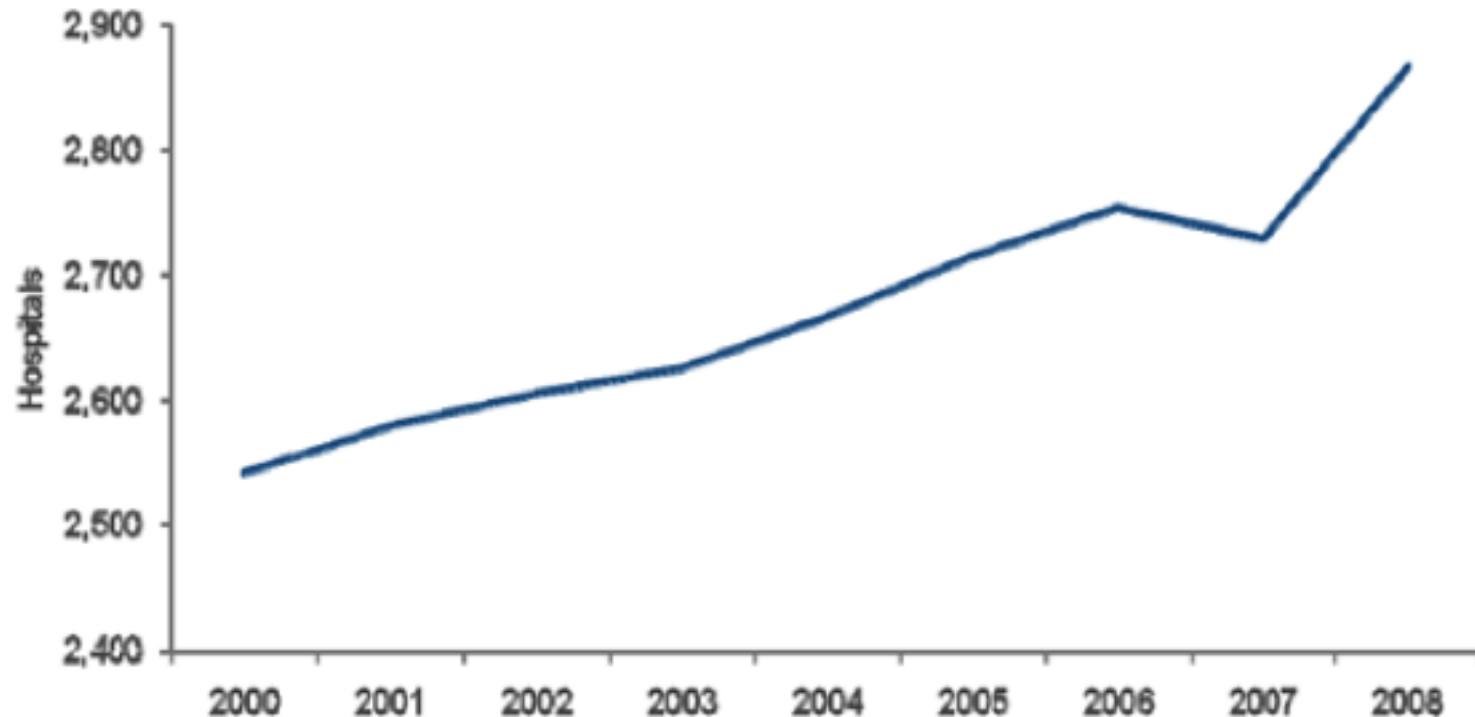
- *“Many not-for-profit hospitals, especially single-site and small hospital systems, may struggle.”*

Moody's, April 2010

- *“Health reform will likely drive hospital consolidation.”*

Fitch, March 2010

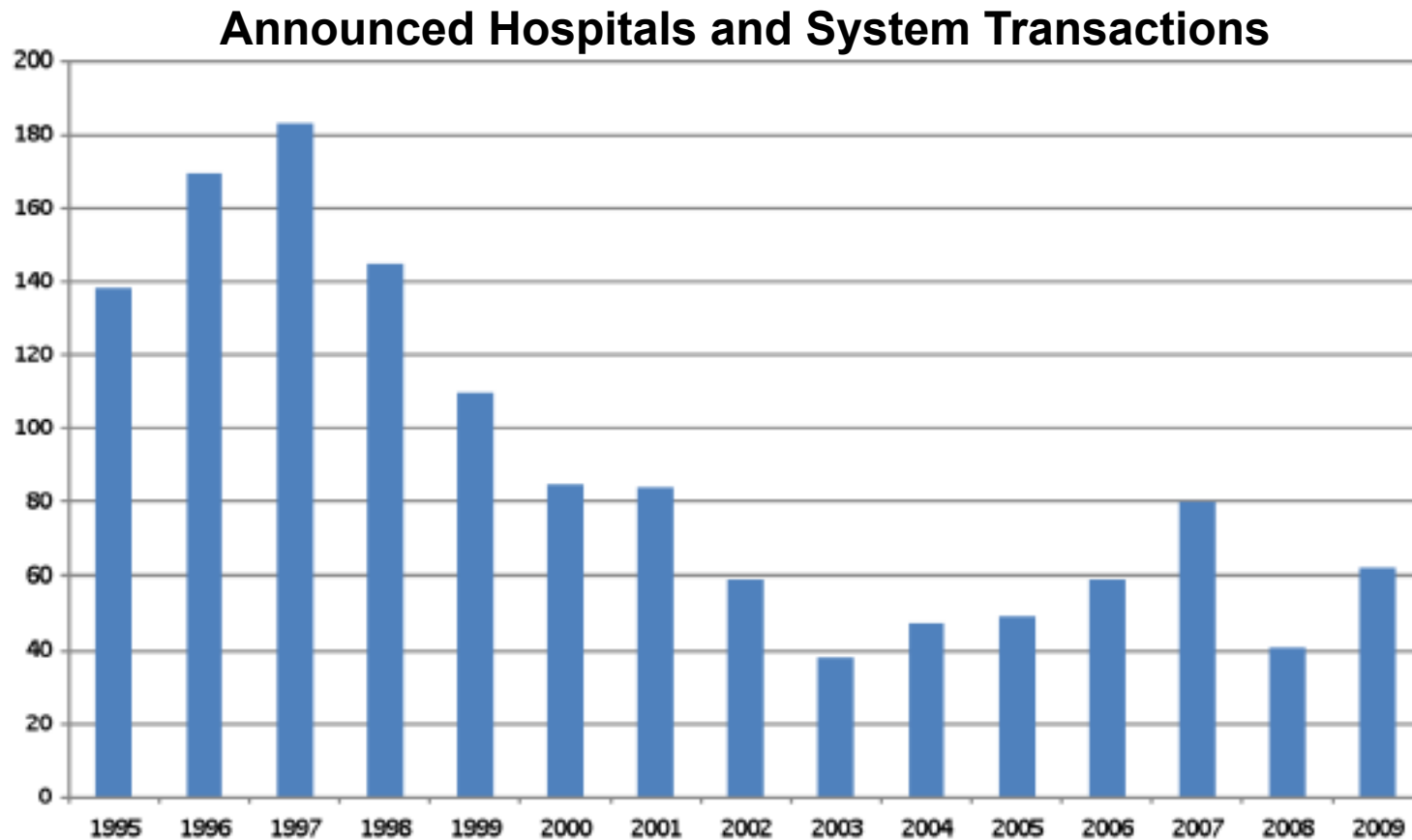
Number of Hospitals in Health Systems⁽¹⁾



Source: Avalere Health analysis of American Hospital Association Annual Survey data, 2008, for community hospitals.

(1) Hospitals that are part of a corporate body that may own and/or manage health provider facilities or health-related subsidiaries as well as non-health-related facilities including freestanding and/or subsidiary corporations.

More Hospital Consolidation Expected



Source: Shattuck Hammond Partners analysis including Irving Levin Associates historical data. Transactions include sales of for-profit hospitals; individual transactions may include multiple hospitals.

Factors Forcing Consolidation

- Capital demands: facilities, technology, and IT
- Impaired access to capital
- Cost of compliance with government audits and requirements
- Increased reimbursement pressures
- Unfunded pension liabilities
- Tax-exemption benefits may diminish
- Economies of scale and increased bargaining power

Moody's/TGI, May 2010

Standalone “Requirements”

- Strong market/competitive position
- Demographics with positive payer mix
- Ability to employ/align with many more physicians
- Proven ability to recruit and retain physicians
- State-of-the art facilities and medical equipment
- Ability to “partner” to provide services

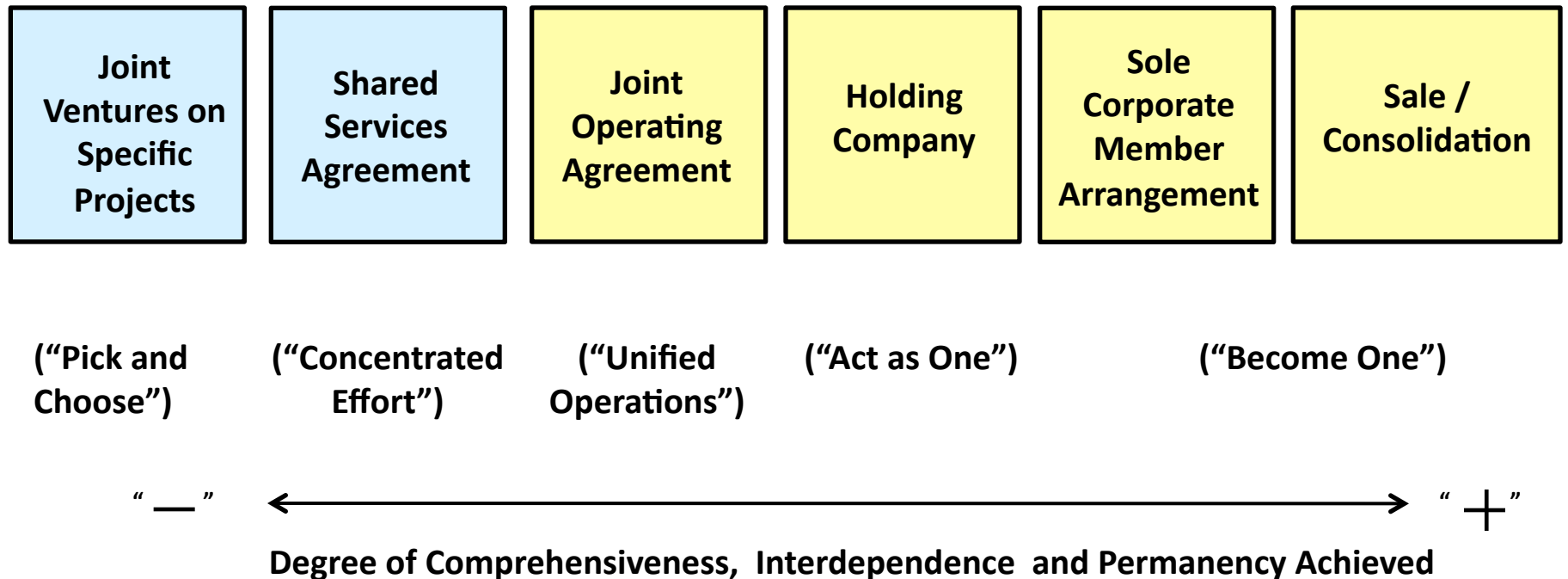
Standalone “Requirements” (cont.)

- Processes to accurately measure and continuously improve clinical quality, patient safety, and service
- Ability to handle bundled payments
- Sophisticated information technology
- Strong operating profitability
- Access to sufficient capital to fund all of the above

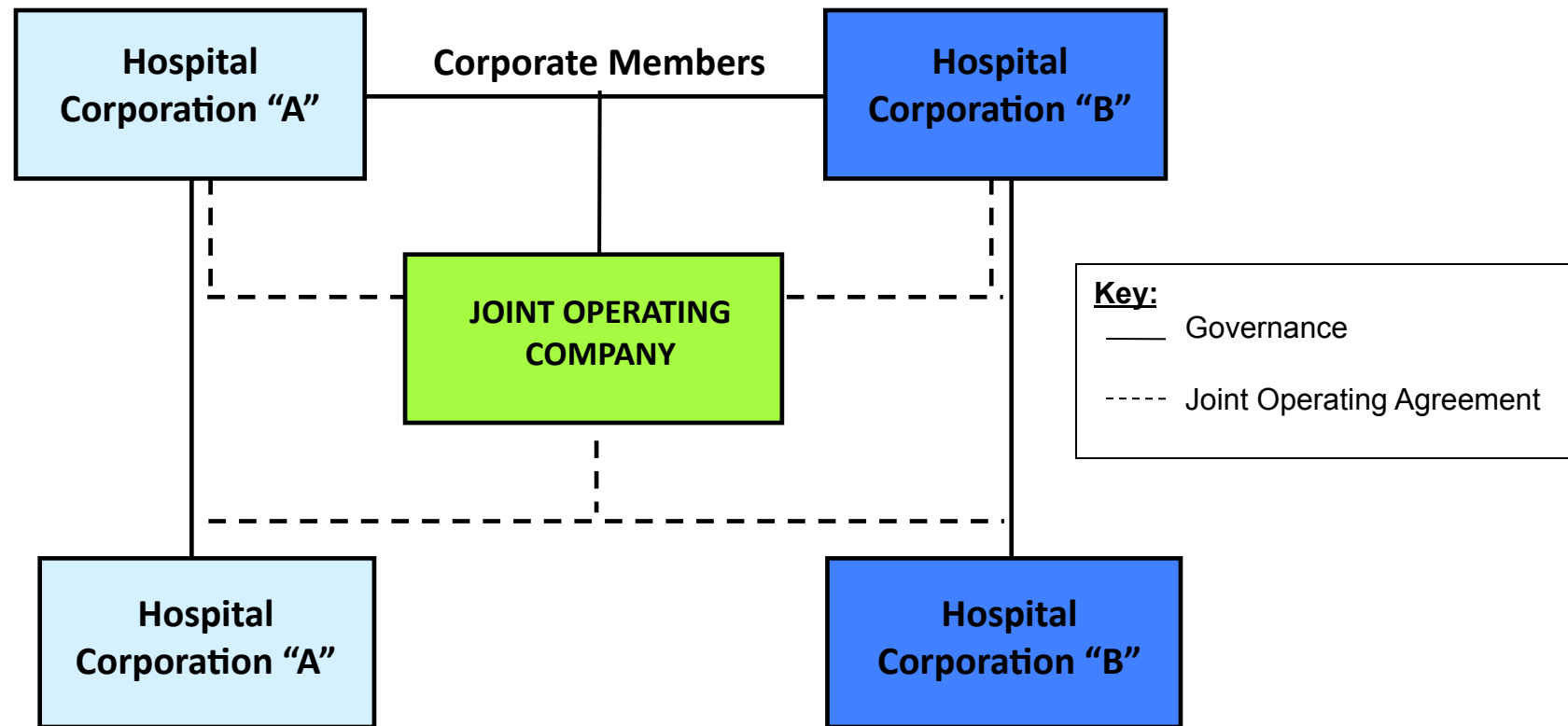
Three Strategic Alternatives

- 1. Remaining independent**
(and developing mutually beneficial relationships with other providers)
- 2. Creating your own integrated system**
(with another hospital(s) as “siblings”)
- 3. Becoming part of an integrated system**
(as a subsidiary in a larger organization)

Partnership Models



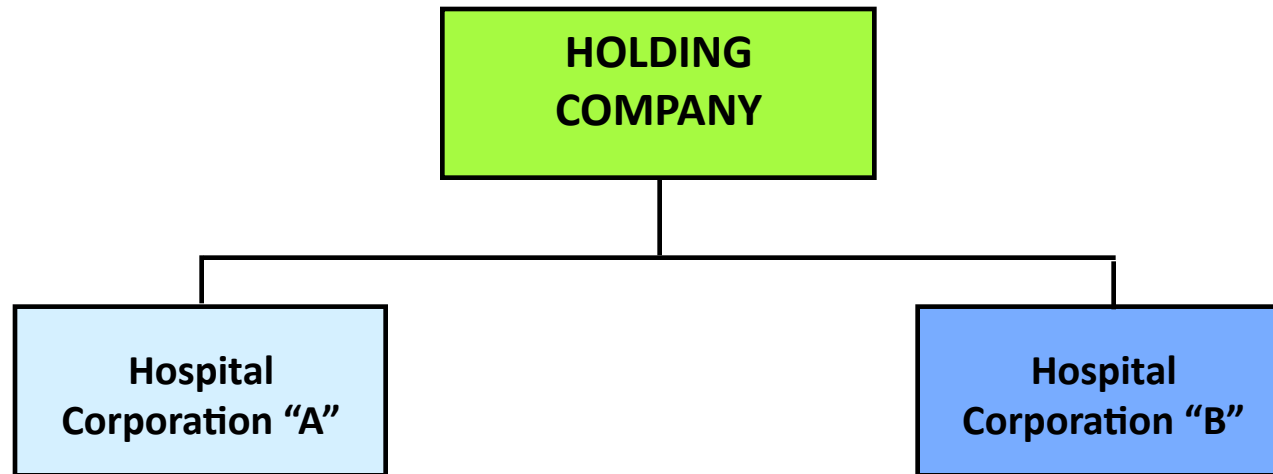
Joint Operating Company Structure “Unified Operations”



- **Description:** Hospital Corporation "A" and Hospital Corporation "B" serve as Members of a corporation that contracts to operate all hospital assets jointly. Ownership of assets and debt obligations remaining in Hospital Corporation "A" and Hospital Corporation "B." Joint Operating Company distributes income according to pre-determined formula.

Holding Company Structure

“Act As One”

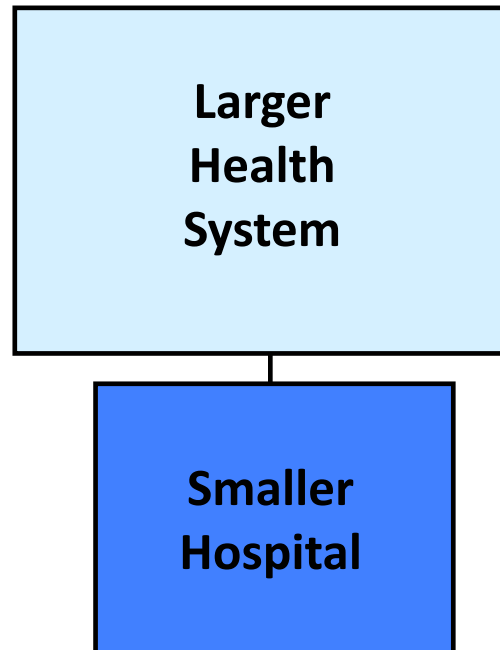


Description: Holding company becomes the sole corporate member of each hospital. The holding company structure:

- Systems may share membership of holding company
- A board consisting of a set number of directors appointed by each hospital
- Sufficient powers over each hospital to direct specified network-wide activities and approve designated institutional activities

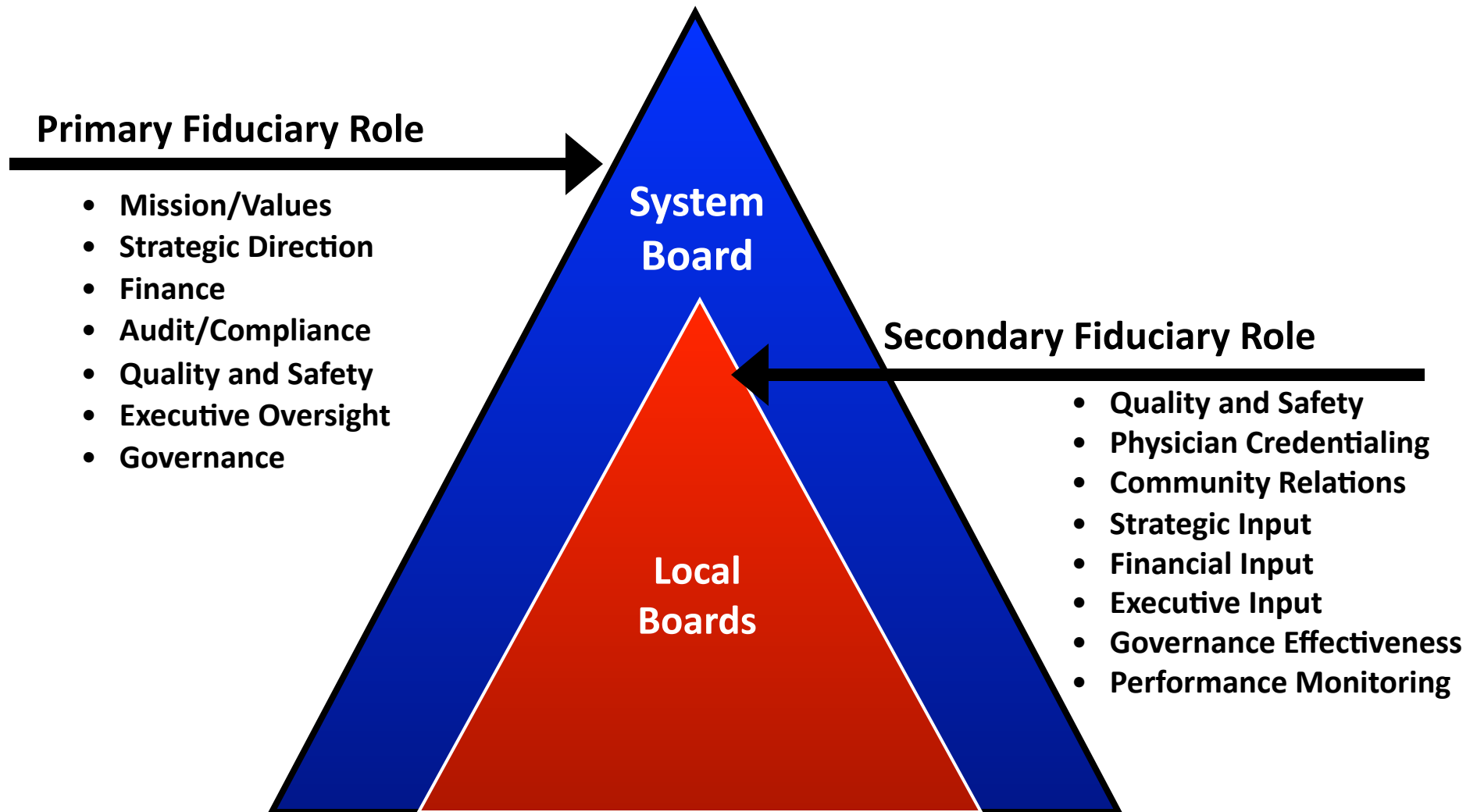
Sole Corporate Member Arrangement

“Become One”



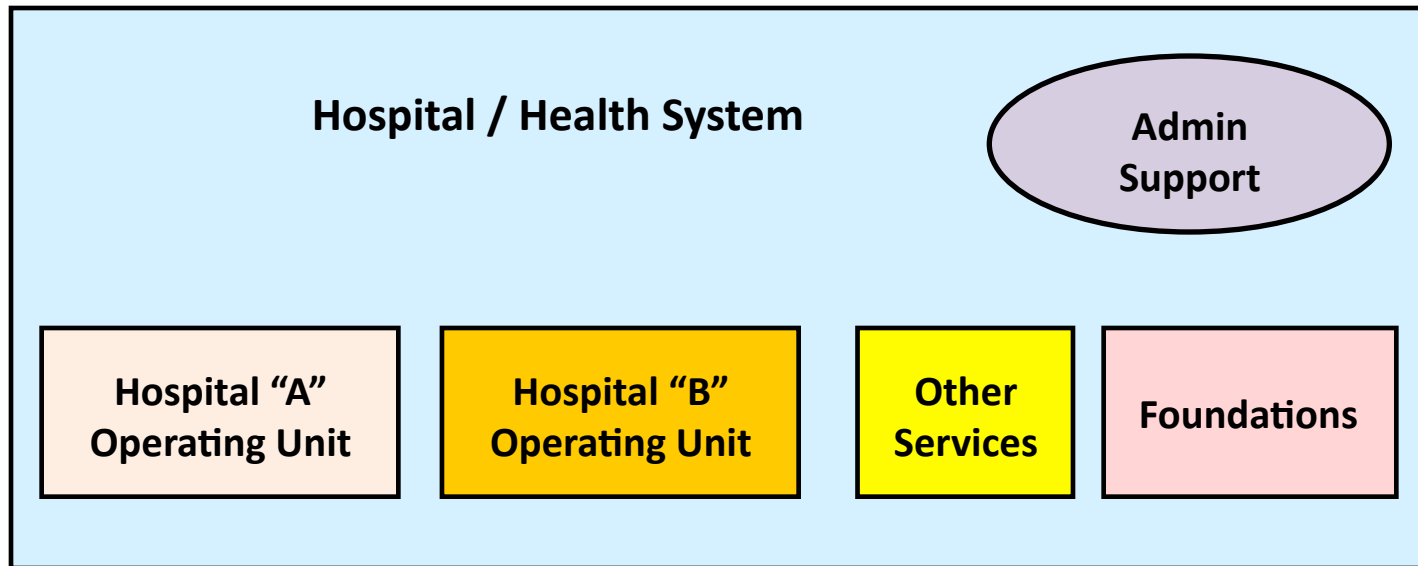
- **Description:** Larger health system becomes the sole corporate member of the smaller hospital with specific “reserved powers” over the “merged” entity. Used by most large health systems.

Sample Shared Governance Model



Sale/Consolidation Structure

“Become One”



- **Description:** Hospital/Health System is the corporate entity with one board and constituent hospitals function as operating units.

“Becoming One” Often Results in Higher Payment Levels

- Many studies
- Results vary widely, mostly show increase
- Specific market and hospital situation has profound effect

Factors That Matter Most:

- Proximity of consolidating hospitals
- Market strength of “acquiring” health system
- Market strength of payers

Key Concerns About “Merging”

- Impact on community/economy
- Losing independence/local control
- Reaction of physicians will vary
- Maintaining inpatient service
- Community reaction will vary and likely be dependent on who the “partner” is
- Employees/unions – mixed reaction likely (positive and negative)

Affiliation Exploration Process

- Engage the full board
- Develop a unified vision of the future
- Create a steering committee of the board
- Determine type of outside assistance required
- Approve an affiliation exploration work plan, schedule, and budget
- Identify methods for involving key stakeholders
- Clarify the potential benefits of/criteria for partnering and identify any “non-negotiables”

Sample Desired Benefits/Criteria

- Improve access to capital
- Ensure long-term financial viability
- Improved managed care contracting
- Enhance quality of care:
 - Additional clinical services
 - Easier referrals/consults
 - Technology access
 - Physician recruitment
 - Medical education
- Gain information technology expertise
- Back office expertise
- Achieve economies of scale
- Enhance reputation

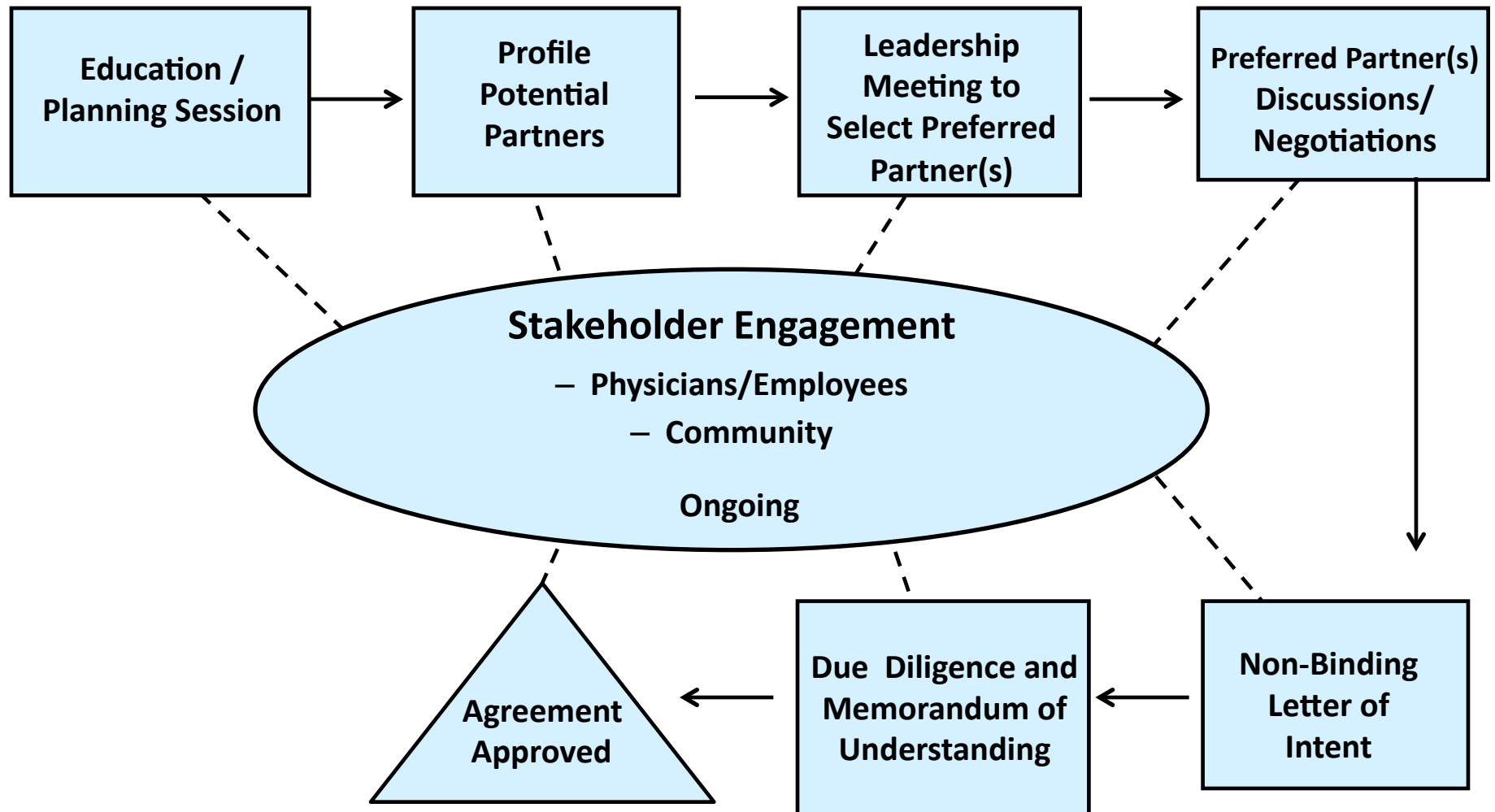
Sample “Non-Negotiables”

- **Total** loss of local control
- Closing inpatient service and ER
- Substantial reduction in services
- Cultural incompatibility

Types of Exploration Approaches

1. Develop a Request for Proposal (RFP) and send to all possible partners.
2. Identify desired partner(s) and proactively reach out to those organizations (only).
3. Use a hybrid approach, in which the RFP is sent to a few, identified organizations.

Sample Exploration Approach



Sample Decision Scoreboard

CRITERIA	System A	System B	System C	System D
CULTURE Style of engagement	3	4	3	2
EXPERIENCE Track record acquiring and integrating community hospitals	4	3	3	2
AUTONOMY	3	4	3	?
FINANCIAL Ability/Desire to provide capital and payer contracting	3	4	2	1
OPERATIONS Support/Integration of back office & IT functions	3	4	4	2
CLINICAL Support seamless, accessible continuum of care	3	4	4	2
MEDICAL STAFF Support development and recruitment	5	5	3	3
LEVEL OF INTEREST	4	5	2	2
BARRIERS	2	5	2	1

Communications Issues

- Agree on a consistent, united flow of information
- Develop a written communications plan and adhere to it faithfully
- Decide how, when, and what to communicate to the community, physicians, employees, volunteers, competitors, and the media
- Set clear expectations, and manage the process carefully

The Board's Role After Today

- Determine whether to continue or intensify this discussion at the board level, and if so, how (e.g., steering committee)
- Integrate this discussion in the strategic planning process
- Set a timeframe for making a decision – one way or the other
- **Provide leadership along with the CEO**



Questions & Discussion



Contact us...

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