Maximizing Success of Hospital M&As:

Strategies to Ensure Long-Term Value

White Paper

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Abstract: In today's marketplace and with healthcare organizations, in general, all transactions do not automatically lead to success, regardless of how success is defined. And even the realization of short-term objectives does not guarantee long-term value will come from the deal.

So how does an organization's board, management team, and key stakeholders ultimately ensure their deal targets will result in long-term value creation? It is true that even the best plans, roadmaps, outside experts, and financial resources can still result in missing the projected targets for that deal strategy. However, we can look at some of the trends from various deals that have taken place in the current marketplace, and assess the key characteristics that resulted in success versus failure.

Key Words: consolidation, mergers and acquisitions, M&A, hospital and physician transactions, alignment, joint ventures, strength in numbers, volume to value, fair market value, value, scope vs. scale

Introduction

Consolidation among healthcare provider organizations, including hospitals and physician-owned entities, has continued to increase over the last ten years. The specific structures, valuations, and overall strategies for integration related to transactions involving hospitals and other healthcare provider entities has changed as the volume rises. Hospitals have been engaging in various types of mergers and acquisitions (M&A) throughout multiple economic cycles that have ultimately comprised numerous waves of consolidation.

During the 1990s, we saw an influx of transactions between physicians and hospitals, where these two unique market players pursued mergers and other various joint ventures. The majority of these arrangements ultimately proved to be negative experiences for both sides, with most of them eventually unraveling, leaving behind the baggage that continues to impact the dynamic between hospitals and physicians today.

We are again witnessing the consolidation of hospitals and physician-owned entities through a variety of joint ventures and alignment structures, mainly driven by the broader trends in healthcare reform and value shifts in the economic model associated with the delivery process. Meanwhile, consolidation among hospitals and health systems also continues to increase through traditional M&A, as well as alternative deal strategies and structures. And regardless of how the deals are done, most healthcare M&A transactions focus on allowing these organizations to achieve objectives relating to strength in numbers and shifting from volume to value.

In this paper, we will discuss some of the key factors that can result in a transaction yielding long-term value and success.

Understanding the Financial Drivers

One issue that always remains as a constant question (and sometimes elusive target) for any discussion around amalgamation through deal strategies and partnerships is how the parties involved achieve their value targets under a proposed transaction. Just how do partners participating in a deal achieve long-term success after it is complete?

The financial drivers involved in a transaction between healthcare provider organizations—regardless of size—often can be rather unique. First, the process of determining and negotiating a deal's valuation and economic terms differs from most agreements, because it is necessary to adhere to specific fair market value guidelines. As a result, transactions involving such organizations often have a minimal range of movement regarding the financial consideration. Advisors regularly talk about deal comparables and market multiples; however, these valuation parameters have a narrow range and frequently even less movement, compared to other markets and industries.

Another key point when considering the financial impact is the value driver that ultimately makes a buyer interested in doing a deal. This question brings up perhaps one of the most complicated factors of healthcare M&A transactions and has been this way over the years and throughout market ups and downs. Most people would think that if a health system—particularly a not-for-profit system with a role as a major community or market stakeholder—would be able to tell you relatively quickly the value they hope to achieve from a transaction where they're spending hundreds of millions of dollars.

Unfortunately, this insight is not always the case, and likely this scenario is more common than the alternative, where relevant stakeholders can clearly define and understand the answers. In fact, in many past hospital deals, the assumption would primarily entail the parties getting together and having an idea that teaming up through a merger or one party selling to the other would result in making great strides for the organizations, their patients, and the communities as a whole. However, it was unlikely that the expected value would include putting any real numbers to the source of the value. And for some deals, the mere hope that "one-good-plus-one-good-equaled-one- great" was the driver behind these deals.

Success—in spite of ourselves

Due to the nature of some healthcare organizations and the particular market dynamics in which they operate, some deals that entailed less than optimal value drivers and other key strategies ultimately turned out okay over time. Many of the organizations or partnerships that emerged out of such deal scenarios grew and achieved marked success going forward. And, during certain periods of change within the healthcare industry, *value* was still achievable, despite the unintended issues that would challenge most consolidation strategies. Whether it was timing and particular market dynamics or the good fortune of making the right deal at the right time, the success that has come out of some periods of consolidation, and almost-inevitable result would benefit most stakeholders, regardless of their shortcomings and poor planning efforts.

However, good fortune and inevitable success despite contrarian efforts is not the norm and rarely continues for long periods. The result of many deals among healthcare organizations was a failure and/or significant hardship for the entities left behind post-transaction. Rather, many well-planned deals failed to deliver the intended or anticipated long-term, to the shock and surprise of many people within the industry that such deals were not as successful as they thought or hoped they would be.

Types of Transactions: Scope vs. Scale

Without delving too deeply in the nuance and complexity of transaction types, most transactions fall into one of two over-arching categories: 1) Scale; and, 2) Scope. And keeping with the simplicity theme here, scale transactions can generally be summed up as deals where the primary focus of the parties is to achieve growth through increasing components of their respective businesses (i.e., services, products, geographies, etc.) where the parties are already involved to some degree. Consider scale as simply expanding in size to do more of what the organization is already doing. Scale strategies, on the other hand, are deals where the focus is targeting expansion into new business areas, such as gaining new services and/or product lines, expanding geographic reach, etc. And, while these two general types of transactions are not always mutually exclusive, most healthcare deals can typically be categorized into one of these two buckets.

Value—the Elusive Target

In today's healthcare marketplace and the current wave of consolidation among various healthcare organizations regardless of size, scope, or financial investment involved, *value* is more elusive than ever, and achieving value from such deals is increasingly difficult for all stakeholders involved. Just defining a value target for a deal can be challenging enough for many healthcare organizations, particularly those larger health systems that tend to grasp tightly to the traditional dynamics that were in past cycles. But even if you can peg specific value targets of a deal and strategic objectives that are tied to defined growth and financial projections post-transaction, setting objectives and achieving them in a way that results in long-term growth and value creation for the organization is an entirely different matter.

Then what's missing in between setting these targets and seeing them through to reality? Is it the lack of a plan, or "roadmap" as it were? Are the expectations going into a deal and driving the value targets unrealistic or improperly influenced and misunderstood? Perhaps there were external market variables that negatively impacted our targets, but which were unforeseeable, and this ultimately resulted in missing those targets or other unintended consequences on the long-term value justification. Yes, yes, and yes—all of these factors, or a combination of them (and others), are likely reasons for the failure of deals in today's marketplace to deliver long-term value.

So how does an organization pursuing a transaction work to limit the risk of failure or missing its value targets? Begin with identifying the value targets. If you are unable to do that, then take a step back in the process and make sure to address and define the value targets. How else can you ever expect for a complex investment or M&A transaction to deliver the value that you expect if no one in the organizations—both buyers and sellers—can articulate these core points?

Planning—the Obvious Component

The planning process, though seemingly obvious, is the piece that is most often ignored or overlooked by organizations engaging in some transaction. But this "roadmap" ideally will result in a chart to walk your organization(s) from today where the parties are two separate entities, through a five-plus-year (or as designated) period when a clear value has been achieved and as the organizations continue to build that value model.

The strategic roadmap that spans from the beginning to beyond a deal's completion, there will be smaller parts of the larger map that assist in implementing vital segments of the overall process. For instance, there's the deal itself, which is a crucial but relatively small piece of the over-arching picture. Then there's integration, also one of the most critical components, though often missed entirely. But the key to the strategic roadmap is ensuring the effective implementation of each of these parts, and just as important, that the management of them allows for value to be delivered and transferred, streamlined and seamlessly, throughout the entire process. Think of the roadmap strategy as ultimately guiding you to an elusive and well-guarded treasure. However, to arrive at the final "X" marking the spot, an organization and its leaders first will have to complete individual series of tasks and challenges, reaching one goal before proceeding to another.

Once a sufficient and comprehensive roadmap plan is in place, the rest is execution. Though seemingly straightforward on the surface, the implementation entails some uncertainty and potential for confusion, as you inevitably encounter many pitfalls, landmines, and traps along the way. As such, you must be prepared to negotiate such obstacles, some of which comes through the planning process; however, there will be parts that are outside an organization's or team's range of expertise.

There are some key critical success factors that all leaders should consider before pursuing a transaction, regardless of a deal's size, scale, or scope, and regardless of the role they happen to play in a particular transaction scenario. We will outline some of these factors and evaluate several of the optimal strategies that leaders within healthcare organizations can consider when pursuing a deal.

- Defining and achieving long-term value from transactions
- Key components of successful transactions
- Deal processes and structures
- Role and value of advisors in the transaction process

Defining and Achieving Long-Term Value

As stated earlier, doing deals within the healthcare industry and among healthcare provider organizations was nothing new before 2008. Through the multiple waves of consolidation in healthcare services, most transactions were relatively simple and straightforward regarding the value opportunities and overall targets for the stakeholders involved in these deals. For many transactions involving healthcare organizations, regardless of size or scale, it was not overly difficult to understand the rationale behind the deals, and few barriers prevented their success.

No longer can healthcare services organizations assume a deal will generate long-term value, however, simply because it appears to make sense on the surface. Moreover, these organizations and their leaders also must gain a better understanding of what it even means to achieve long-term value from a transaction. Meaning, just because two parties complete a deal does not automatically imply that short-term success will ultimately result in generating value for the organizations involved and their stakeholders over time.

A long-term value will inevitably entail something different for each organization, and their leaders must determine what "value" means for their stakeholders. The concept of value depends on numerous variables and is relative to an organization's situation and individual context. Further, *value* can take on very different characteristics when contrasting value in a short-term context versus what it looks like to achieve long-term value for a given enterprise. Value does not always equate to financial or economic metrics, nor can it always be restricted to conventional valuation methodologies, particularly for healthcare services organizations. Typically, these entities must consider a broad range of factors that most traditional enterprises in other industries and sectors simply do not have to consider.

Components of Successful Transactions

The critical components of a successful M&A transaction between two entities in the healthcare industry encompass the following steps and subsequent stages:

- Importance of strategy development and planning
- Comprehensive due diligence
- Managing deal as process and addressing all pieces strategically
- Investment – not just acquiring an asset
- Role and value of advisors

Strategy and Planning

- Why strategy and planning are necessary
- Set targets and form a roadmap
- Gather support and get all stakeholders on board
- Establish governance and set roles and responsibilities

Comprehensive Due Diligence

Once the strategy is developed, and the plan is in place, the next step is to conduct a comprehensive due diligence review of the entities involved. The due diligence activities encompass the following aspects of review:

- Comprehensive review – operational, financial, clinical, legal/regulatory
- Purpose of confirmatory due diligence
- Planning for seamless transition into integration
- Key players, expertise, and roles
- Process and strategies
- Achieving objectives/targets, measuring success, and determining readiness

It is essential to recognize that your M&A deal is not just the act of acquiring an asset. Rather, it is a major investment for your organization. It calls for focus and planning and the involvement of financial professionals and advisors.

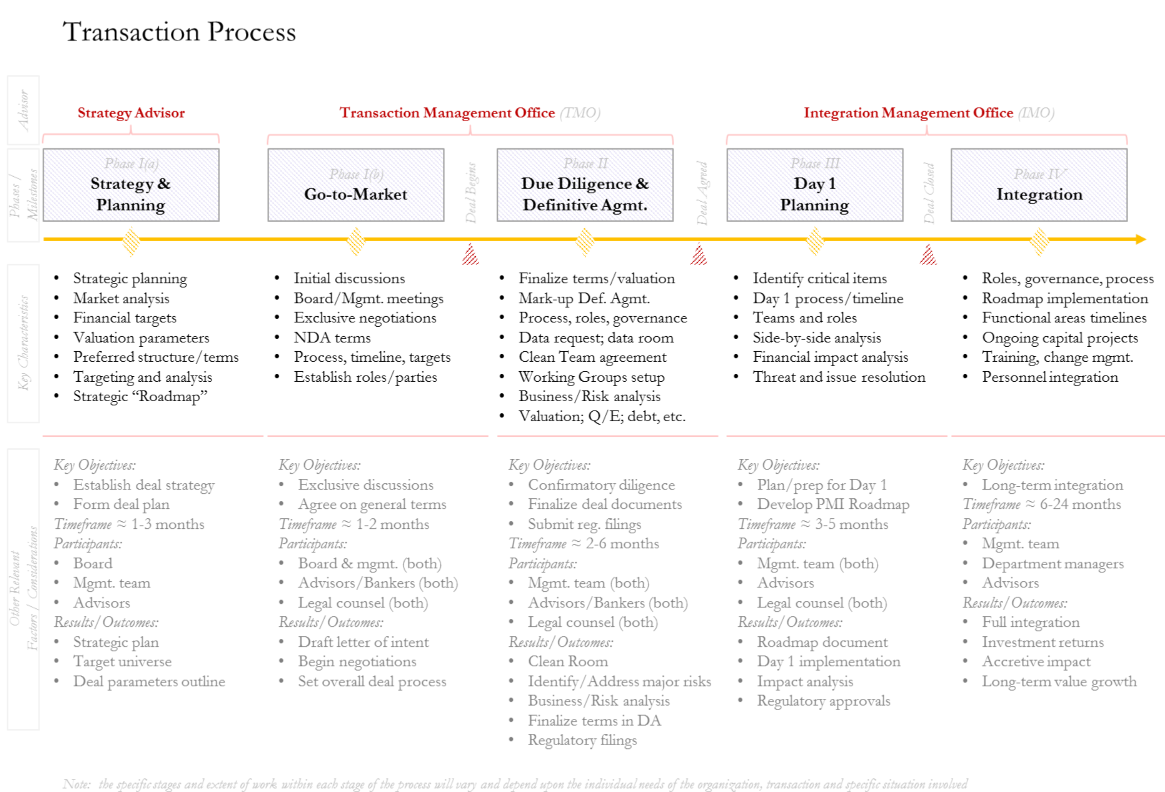
Deal Process and Structures

Other actions include managing the deal as a process and addressing all of the pieces strategically. The list of strategy and planning activities of this stage, briefly, are as follows:

- Internal review; strategic planning
- Market analysis
- Financial targets and projections; valuation parameters
- Planning preferred structures and terms; set limits/thresholds
- Targeting and analysis

Figure 1, below, illustrates the complication process of a transaction.

Figure 1. Transaction Process



The Value and Role of Advisors

The complications and time investment in working through the M&A transaction process can be simplified by using outside advisors with experience in conducting M&A transactions. The following section elaborates on the role and value of advisors.

- Part of the overall investment (cost/benefit analysis)
- Critical in mitigating risk
- Greater likelihood of overall, long-term success/value
- Independent perspective

Once a sufficient and comprehensive roadmap plan is in place, the rest is execution. Though this process may seem relatively straightforward on the surface, the execution stage entails lots of uncertainty and potential for confusion, particularly as you will inevitably encounter many pitfalls, landmines, and traps along the way. As such, you must be prepared to negotiate the obstacles, some of which comes through the planning process. However, there will always be parts that are outside an organization's or team's range of expertise.

Tapping into the Right Experience

The challenge in the complications of M&A ventures is where outside advisors come in, to provide technical expertise and knowledge from experience in specific areas or through the deal process as a whole. The know-how typically will come from a combination of deep domain expertise in relevant areas (i.e., healthcare finance, valuation metrics, quantitative analytics, market research, etc.) and experience executing similar transactions that have been successful (and perhaps failures that result in sometimes even more valuable lessons) elsewhere in the marketplace.

Using an advisor to help navigate through the deal process is not a requirement or absolute necessity. However, it can be difficult for an organization to maneuver through a process that is highly specialized and nuanced, and in which most management team members do not have specialized experience. A characteristic of successful deals is the use of quality outside advisors where specialized experience is needed. Moreover, engaging an advisor to guide your organization through the deal and value creation strategy process ultimately allows management to focus on their primary job responsibilities, which in turn contributes to an organization's overall strategic value, operational efficiency, and growth.

There are many ways an advisor can help your organization through a transaction process. Investment bankers specializing in M&A advisory often are valuable resources in an M&A transaction. However, their role typically will be limited to the parts that specifically focus on structuring and executing the deal, and perhaps arranging financial products, such as credit facilities and other instruments implemented in the deal. Bankers are restricted to give advice about the financial or valuation components of a deal, as well as coordinating the various deal process steps. However, usually, this is coordination at a high level and does not involve getting into the details of an organization's strategic targets, value measurements, and other critical pieces that come into play when trying to achieve long-term value from a specific deal strategy.

You can engage an advisory group for transaction services that can serve as the overall coordinator of the deal process, and which will play a substantial role in the due diligence phase of this process. Due diligence is a critical piece, particularly when looking at deals as the buyer. Being the buyer can ultimately take shape in many different ways, whether it's purchasing an equity stake in a joint venture enterprise, or acquiring another hospital in which the majority of the deal's financial consideration, i.e., value, comes through absorbing debt and/or making capital commitments. Constructing the financial model for this transaction will entail diverse inputs for these different types of structures; however, the overall process remains the same across all deal efforts. It eventually boils down to an investment being made by one party to join in a strategy with another entity, after which the newly merged entities or the joined efforts in this particular venture will continue forward under a combined approach with unique value and growth targets over some defined period.

Other types of advisors that can be of value throughout the transaction process and an organization's overall strategic effort are those consultants that can get involved in specific pieces of the process. The work of these advisors will be to provide very specific and often technical expertise within a defined component of a deal. Appointees can include a valuation advisor who assists an organization on the financial modeling and calculations of a deal's or organization's value. Other consultants will provide specialized technical analysis and advice in specific areas of due diligence and/or the integration process. Additional specialized experts may be involved to assist in the major functional areas, such as HR due diligence and payroll consolidation, or IT/IS systems and infrastructure integration. Some consultants may be engaged merely to offer answers on executive compensation or to conduct analysis on an organization's employed physician network and related strategies.

There are many different types of advisors available to provide assistance to an organization through the strategic deal process, and there are many various structures for engaging consultants in this kind of scenario. However, it is critical to understand that no consultant, lawyer, or otherwise magic bullet will automatically deliver a result of success by just engaging them and paying their fees. There is no level of experience and/or domain expertise within a particular technical area that will deliver value from a deal if such efforts are not in conjunction with very intentional and proactive strategic planning on behalf of the organization driving the transaction strategy and overall effort.

CONCLUSION AND SUMMARY

In today's marketplace and with healthcare organizations, in general, all transactions do not automatically lead to success, regardless of how success is defined. And even the realization of short-term objectives does not guarantee long-term value will come from the deal.

So how does an organization's board, management team, and key stakeholders ultimately ensure their deal targets will result in long-term value creation? It is true that even the best plans, roadmaps, outside experts, and financial resources can still result in missing the projected targets for that deal strategy. In this paper, we have reviewed some of the trends from various deals that have taken place in the current marketplace, and assessed the key characteristics that resulted in success versus failure.