The mandates of the Affordable Care Act (ACA) have caused hospital and health system leaders to regroup over the last several years as they try to determine the best ways to steer their organizations through the upheaval. Despite the challenges resulting from so much change, many leaders view this time as an opportunity to expand into new markets and strengthen clinical, operational, or financial competencies by merging, acquiring, or in some way affiliating with other healthcare entities.

Overall, healthcare merger and acquisition activity has surged in 2015, increasing 78 percent from a year ago, according to data released in July from Thomson Reuters. The value of such deals reached $395.8 billion, surpassing the record $392.4 billion set in 2014. Although pharmaceutical companies accounted for nearly half of the deals, healthcare providers made up 32 percent.

The success of healthcare mergers, acquisitions, and other affiliations is predicated in part on available capital. The need for, and sources of, funding are considerations present throughout the process. Other considerations include choosing a partner, evaluating an arrangement’s capital needs, selecting an integration model, finding the right money source, and financing the deal.

With these considerations in mind, this HFMA Action Brief, sponsored by KeyBank, offers several strategies that health system leaders have used to assess and manage capital needs for their growing networks.

**Consider Options that Reflect Strategic Goals**

To ensure a merger or acquisition is worth the capital outlay, an organization must first appreciate the reasons behind the potential affiliation and determine how the arrangement will fit in the organization’s overall strategic goals. In other words, what benefit is the entity seeking from the relationship? Does the organization want to beef up its acute care services? Expand its primary care operations? Introduce a new service line? Move into auxiliary services, such as laboratory or imaging facilities?

A number of larger organizations are beginning to shift their strategy away from strictly hospital acquisition and toward arrangements involving ambulatory care. For example, Banner Health of Phoenix, which operates 29 hospitals, recently acquired three acute care entities, including the University of Arizona Health Network in Tucson. Those investments were made in pursuit of larger strategic goals, primarily entering new markets. Now, however, the health system is shifting its growth strategy to the ambulatory side. “We’re intentionally reducing the pace of our acute care investments and refocusing more on digital tools and ambulatory healthcare delivery because capabilities in those areas will be key to future success in a marketplace that will increasingly be governed by consumer choice,” says Dennis Dahlen, senior vice president and CFO for Banner Health. “We believe we have enough hospital capacity in our network, and I suspect that’s true for most healthcare providers that are acute care-based.”

While part of Banner’s strategy includes acquiring smaller to mid-size physician practices, the organization is also evaluating opportunities with imaging, urgent care, and ambulatory surgical centers, Dahlen says.

North Shore-LIJ Health System (NS-LIJ) in Great Neck, N.Y.—a 17-hospital system with facilities in the New York metropolitan area and Westchester, Nassau, and Suffolk counties—also takes an acute/non-acute care approach to its growth strategy. NS-LIJ looks for turnaround opportunities with capital-poor community hospitals that can benefit from NS-LIJ’s governance, centralized services, and technology. “Sometimes, they’re not in the best financial position, and that’s why they’re looking for a partner,” says Bob Shapiro, CFO of NS-LIJ. “We lead them, but we help them get to where they should be.”
When considering ambulatory services, the strategy reverses: NS-LIJ looks for partners with expertise in non-acute care to build its strengths beyond the inpatient setting. The organization’s goal is to establish a presence in new markets and build the brand, while also reducing acute care costs per unit by scaling expenses across the network of hospitals.

“That’s a strategy that we’ve stuck with so far, and it works for us,” says Shapiro.

Like Banner Health and NS-LIJ, SCL Health in Broomfield, Colo.—an eight-hospital system with coverage in Colorado, Montana, and Kansas—is shoring up its ambulatory presence, although it has not closed the doors on the acute care world. SCL Health is building four community hospitals, referred to in Colorado as micro hospitals, in the Denver metro area. The organization is also starting to strengthen its expertise outside of acute care and now owns a home health agency in Denver. SCL Health also recently entered into a joint venture with Touchstone Imaging Dry Creek in Englewood, Colo., to own and operate seven freestanding imaging centers throughout the state. “Many of our growth strategies currently are moving away from the acute care hospital and more toward population health—meeting the needs of the populations that we serve,” says Mark Wilkinson, SCL Health vice president and treasurer.

Along with the care setting, Wilkinson says location is another key criterion for strategic growth. SCL Health has transitioned two hospitals in Kansas and one hospital in California to other health systems in recent years to better meet the healthcare needs of the respective communities. Earlier this year, SCL Health signed a letter of intent to affiliate with Brighton Community Hospital Association (doing business as Platte Valley Medical Center), an 81-bed hospital in Brighton, Colo. “Acquisitions need to be in an area that makes sense from a market standpoint as well as geographically,” Wilkinson says. “As a result, we have established joint ventures and affiliations in regions such as the Denver area where SCL Health already has an established history of serving the community.”

**Think Beyond Acquisitions**

Although acquisition is still a viable growth strategy for many healthcare organizations, other configurations may fit better with current healthcare dynamics, such as the shift in care from acute to non-acute settings. There seems to be an industry trend in this direction. Rather than traditional mergers and acquisitions, healthcare organizations are entering into more non binding configurations, such as partnerships, collaborations, and joint ventures, according to a report published in February by consulting firm PwC. Furthermore, an HFMA Value Project report on acquisition and affiliation strategies indicates that an effective way to gain market share is to meet care purchasers’ demand for high-quality, convenient access, and competitive prices. As a result, organizations are seeking a range of partners and partnership opportunities to meet these needs, often pursuing several options simultaneously. Such non-traditional configurations may help reduce increasing risks to payment by coordinating treatment along the care continuum—a requirement if healthcare providers are to meet quality standards touted by the ACA.

Indeed, much of SCL Health’s recent expansion has been through joint ventures and similar affiliations. “Joint ventures allow a health system to grow without the need to invest the amount of capital that may have historically been needed in growth strategies,” says Wilkinson. “Such models can be a way to enter a market without having to build or invest in an acute care hospital. Partnering with another entity to leverage knowledge and management skills while decreasing the capital investment and sharing the financial responsibility is common in health care.” An example is SCL Health’s previously mentioned project involving community hospitals. These will be built as part of a joint venture with Emerus Holdings, a Woodland, Texas-based healthcare organization.

Much of the decision on how to structure an affiliation depends on the needs and desires of both sides. “There may be instances when one or both parties are not interested in merging,” continues Wilkinson. “However, they may be open to doing some sort of joint venture or partnership that’s not a full acquisition. Every healthcare transaction is different, and organizations must understand each participant’s goals and needs before moving forward.”

In some cases, certain entities lend themselves to particular arrangements. For example, Banner Health typically acquires physician practices because this structure helps preserve the patient-provider relationship. Other targets, such as ambulatory surgery or imaging centers, will most likely be crafted as joint ventures, in which the participating organizations share ownership and management.

“The value of acquiring new physicians truly manifests itself in a fully integrated medical group, because these enterprises create interconnections between providers so patients can experience seamless care,” says Banner’s Dahlen. “If the entity can
be highly coordinated, leveraging existing consumer tools—whether it’s patient portals or online scheduling—across the enterprise, we can deliver on that consumer experience. In the ambulatory surgery and imaging space, however, it’s less about a relationship and more about a service. A patient needs something, he or she gets it, and the experience is over. This lends itself to a more itinerant relationship. We also recognize that certain subject matter expertise is necessary for running these types of facilities, and we don’t necessarily have that skill set present in our health system.”

Non-acquisition deals frequently require less capital, which means an organization can redirect more money to invest in improvements to clinical services, staffing, and infrastructure for the new enterprise. “We would generally prefer non-acquisition arrangements, rather than leaving cash/capital behind, or in the hands of somebody else,” says Dahlen. “We’d rather redirect it into making the newly-formed organization stronger. As such, these arrangements are much more aligned with our financial plan.”

Assess Future Capital Needs

Once an organization targets a potential partner and determines a possible arrangement, it should perform due diligence, including a comprehensive balance sheet and operation statement review. Moreover, the entity should spend time forecasting the capital requirements associated with the prospective connection. This forecast should include not just how much capital will be required to acquire or in some way integrate with the other organization, but an assessment of future capital needs in the key areas of services, staffing, and technology.

Non-acquisition affiliations may require less financial capital than those in which one side takes on the assets and liabilities of the other. In joint ventures, for instance, both sides may bring financial capital to the deal, or instead, one side may bring expertise and/or brand capital.

For NS-LIJ, the capital required for acquisitions and joint ventures is about the same.

With its acquisitions, the organization does not actually buy a hospital, but provides capital in the form of staffing, services, and technological infrastructure to boost the hospital’s financial performance through cost savings and increased revenue. NS-LIJ sets up its business model at the hospital, replacing the governance board with its own and centralizing services, such as revenue cycle management. There is no limit on the investment amount the health system is willing to make. Instead, the organization reviews each opportunity on a case-by-case basis.

“The first order of business is determining why the hospital is losing money,” says NS-LIJ’s Shapiro. “Is it poor management, poor payer mix, or something else? We then gauge how much capital will be required to improve the hospital versus the risk involved in turning the facility around. For one hospital, a $10 million investment may look viable; for another that same amount may not. A couple determining factors are payer mix and potential viability. For instance, a hospital may have too many competitors, meaning that reaching a positive cash flow would be too challenging.”

NS-LIJ’s due diligence process for outpatient joint ventures is similar to what occurs on the acute care acquisition side. The organization determines what each partner can contribute in terms of capital and expertise. “We’re doing the critical review,” Shapiro says. “It’s just a matter of sharing the up- and downsides with a partner.”

Review All Capital Options

When it comes to securing capital for large-scale initiatives such as mergers, acquisitions, and joint ventures, many organizations would agree that the optimal money source is in-house. NS-LIJ, SCL Health, and Banner Health all have benefitted from strong market share and cost savings generated from business models that include centralized administrative and operational services, such as revenue cycle. This has generated revenue for the three organizations, which they use to finance growth.

“We’ve engineered out a lot of inefficiency by centralizing and regionalizing core functions, transactional support activities, and business services,” says Banner’s Dahlen. “For the last several years, Banner Health has achieved operating EBITDA margins of between 13 and 14 percent and maintains a debt-to-capitalization ratio of below 40 percent. So far, that’s been sufficient for our expansion needs.”

About half of the financing for NS-LIJ’s deals comes from operating capital. In some cases, the organization has been able to use the cost savings and new revenues generated by improvements made to acquired hospitals to bring in other organizations.

“We take our own generated capital, and we turn around the places so they stop consuming money that they don’t have, turn their bottom line into a positive, and then that creates cash and debt capacity that they didn’t have access to before,” NS-LIJ’s Shapiro says.

Historically, healthcare organizations have used tax-exempt bonds to finance brick-and-mortar investments. Banner Health, for example, will use tax-exempt
bonds to fund its recent acquisitions, which include Payson Regional Medical Center in Payson, Ariz., and Casa Grande Regional Medical Center in Casa Grande, Ariz.

However, less traditional arrangements, such as joint ventures, do not qualify for tax-exempt financing. For example, the financing for a joint venture with an imaging center that is not classified as a not-for-profit organization is subject to taxes.

“Hospitals cannot use tax-exempt bonds as much as in the past because much of what hospital systems are doing is not tax-exempt eligible,” SCL Health’s Wilkinson says. “In place of tax-exempt bonds, healthcare organizations are often using taxable bonds, which do not have some of the private business use restrictions—allowing for more flexibility with a growth strategy.”

Organizations may choose to use taxable bond financing to fund transactions that fulfill an organization’s goals for population health management. “The reality is that in the future, healthcare growth will be less brick-and-mortar arrangements and more joint ventures, such as with home health, ambulatory surgery, and imaging centers,” continues Wilkinson. “These may not meet the requirements to be financed with tax-exempt bonds, but you need to meet the healthcare needs of the community and carry out the mission of the organization.”

NS-LIJ also uses tax-exempt and taxable bonds when investing. “We don’t borrow every year—more like every two to four years—but when we do it’s a large number, such as for brick-and-mortar projects,” says Shapiro. “In the last few years as interest rates have fallen, we have also turned to another financing option: private capital sources. The private placement allows us to get some additional capital that we use to invest in some of the urgent care centers and other ambulatory initiatives.”

Dahlen says Banner Health has also used private capital, albeit infrequently, and considers the option when planning to finance a deal using outside capital. “Size is definitely a factor,” he says “Securing private loans would be suitable for deals in the hundreds of thousands as opposed to millions of dollars. For larger amounts you definitely want to seek a more stable funding source.”

All in all, having strong margins and cash flow creates a solid foundation, but recognizing and reviewing all options for sourcing capital is key to effective financing.

Understanding Capital Needs

Today’s healthcare leaders face a multitude of challenges beyond providing the best care possible for their patient populations. For many, forming affiliations has become necessary to provide comprehensive, cost-effective care. Having a full understanding of how capital plays into the decision-making process for these arrangements is critical to achieving success. Organizations should enter into any relationship with their eyes open, having investigated whether the association makes sense, is affordable and meets the organization’s capital constraints.

Endnotes