The Governance Institute's
E-Briefings

Volume 8, No. 4, July 2011

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This newsletter is designed to inform you about new research and expert opinions in the area of hospital and health system governance, as well as to update you on services and events at The Governance Institute. Please note that you are receiving this newsletter because you are a Governance Institute member or expressed interest at one of our conferences.

News, Articles, and Updates

Consolidation Transactions: Will They Make a Comeback?

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The recent combination of two suburban Chicago hospitals represents the reappearance of a transaction structure that has been rarely used since the 1990s. Central DuPage Hospital and Delnor Hospital have combined via a consolidation transaction, each becoming part of a newly created parent company. This transaction is similar to many business combinations that occurred in the late-1980s and 1990s. In fact, nearly half of the 40 largest 501(c)(3) systems, and most of the large Catholic systems, resulted from these sorts of arrangements. These include such well-known companies as Advocate Health Care, Aurora Health Care, Banner Health, BJC HealthCare, Iowa Health, North Shore-Long Island Jewish Health System, Sentara Healthcare, Spectrum Health, Texas Health Resources, and UPMC.

This article explores consolidation transactions in an effort to consider the role they might play in the current merger market. Characteristics of hospital companies that entered into these kinds of combinations in the past are also reviewed, along with their corporate development subsequent to the consolidation transaction. We also describe the business objectives and social and economic circumstances that caused the parties to select this transaction form. These transactions, and their possible reappearance, are an important element in the discussion regarding the need for larger companies in the hospital industry. Their potential use should be considered in the context of the major issues surrounding industry consolidation.

Consolidation Transactions

A consolidation transaction is a business combination in which two or more unrelated entities agree to form a new parent company. Subsequent to the transaction, the new parent owns the assets and assumes the liabilities of the former individual companies. Unlike most other legal forms, neither party succeeds the other. Instead, the parties agree to become part of a jointly held new company.

In the past, these have typically been cashless exchanges between non-profits in the same market—often competitors in urban areas. They are sometimes called "new holding company" transactions; we will refer to them here as "consolidation" transactions. These can be easily confused with "mergers" by casual observers. However, a merger is a transaction in which one party overtakes the other—both ownership and control change, and the overtaking party either becomes the parent of the other, via a member substitution, or the other party ceases to exist, via an asset purchase.

Industry Consolidation

The potential reappearance of consolidation transactions should be considered in the context of the need for industry consolidation and the formation of larger companies. Many factors point toward the need for the industry to consolidate into a more rational structure. Healthcare costs have reached the point of crippling the U.S. economy. Even prominent periodicals, including *The Economist* and *The New Yorker*, that have historically paid little attention to the economic impact of the fragmented hospital industry have recently described the role that small hospital companies play in the healthcare crisis. Ultimately, controlling the increase in healthcare expenditures is the key to getting the nation's fiscal house in order.

A significant body of research supports the view that large, multi-hospital companies are more efficient than small hospital companies. Large systems understand that healthcare reform creates the need for greater scale in order to lower the cost of capital, improve access to physicians, strengthen management breadth and expertise, and allow sharing of medical best practices. Despite this, and broad acceptance of the notion that scale improves clinical and financial performance, many small and mid-sized hospital companies continue to resist change. We believe that this is largely due to the long-held, and still pervasive, focus on local issues and control.

There was an increase in the number of hospital merger transactions during the second half of 2010 and first half of 2011; however, meaningful consolidation remains elusive. Several factors account for this: the number of transactions remains small in relation to the total number of hospital companies and their average size is very small, between one and two hospitals. Also, many proposed transactions are failing to close, and others are being completed at a snail's pace. Transactions involving non-profit hospitals often take more than 18 months to complete. This compares to much larger transactions in the corporate world that are often completed in less than six months.

Participants, Features, and Limitations

As discussed, consolidation transactions are cashless combinations in which a new entity assumes the assets and liabilities of the individual companies that existed prior to the combination. They differ from most other business combinations in that neither participant overtakes the other. Other arrangements result in one party surviving and the other being subsumed or eviscerated.

In addition to these unique structural features, consolidation transactions are usually accompanied by certain common social features. They were actively used during the 1990s as a response to the onset of managed care—a powerful external factor. The shared concern felt by many boards regarding this challenge contributed significantly to the large number of these transactions. Also, the boards of participants in these transactions tended to be more geographically diverse than those of most 501(c)(3)s and, often, their board's motivations and objectives extended beyond local issues. At a certain level, these boards also shared a preference for outcomes devoid of winners and losers.

The initial composition of the newly consolidated entity's board is often determined by the relative economics of the two parties. Occasionally, however, equal representation, without regard to differences in value, is granted to both sides. Subsequently, boards are either self-perpetuating or each constituency continues to nominate its proportionate share of the board. The former is obviously most beneficial to future governance because it obviates the fractionalization that can occur with other formats. This approach, however, certainly requires the broadest and most enlightened perspective by both boards and, probably, a healthy dose of ecumenicalism.

Most of the companies created by these transactions have been successful in their markets and many are regional leaders. At inception, most were combinations involving two mid-sized hospital systems in the same metropolitan area. Exceptions to this include at least one transaction in which two geographically disparate systems combined. Most of the resultant multi-hospital systems experienced a very similar pattern of corporate development subsequent to formation. Similar to most 501(c)(3)s, they were not acquisitive until healthcare reform seemed likely. Typically, these companies made very few acquisitions during the first decade or so following the combination. Now, however, many of them are considering the merits of growth and are likely to become acquisitive.

Conclusion

Many 501(c)(3)s began revisiting the merger market in 2008, largely due to the specter of healthcare reform and the economic crisis. A small number of these companies have begun to complete small acquisitions. With these newly proactive systems entering the market for corporate control, we believe that the application and popularity of consolidation transactions will return, but on a limited basis. We expect to see more system-to-system consolidations as mid-sized organizations recognize the benefits of substantially increased scale. Thus far, there have been only a few interstate transactions; however, we anticipate that this will change and a meaningful number of consolidation transactions will include combinations of 501(c)(3) systems in different metropolitan markets. Even though these transactions are likely to be limited in number, their benefit to the overall healthcare delivery system could be substantial. Their cashless nature should be most welcomed by a capital-starved industry. Also, these sorts of combinations can be accomplished on a larger scale and at a quicker pace than most merger arrangements.

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