

Remain Independent or Join a System?



Over the past two years, the number of independent hospitals joining systems through full asset mergers has rapidly increased. According to Irving Levin Associates, the number of transactions is on track to top 100 deals in 2011, up from only 52 in 2009.ⁱ Moreover, these transactions do not include numerous affiliations. Add to that an increase in non-traditional deals including increased interest by private equity groups making outright acquisitions of independent hospitals and small systems.ⁱⁱ For the well-financed, the current market represents a buyer's opportunity. For small systems and independent hospitals, there is often significant concern about taking on the future alone.

Many needs are driving the desire to join systems, including infrastructure to manage future payment models, access to capital, potential for cost efficiencies, increased market access, expertise managing a continuum, and programmatic and physician growth.

However, giving up community-based governance to join a broader system is not something most community hospitals enter into without much deliberation and consideration. Typically, hospital leadership discusses the contrasting futures of remaining independent or joining a system.

Achieving Success as an Independent Hospital

If an organization decides to remain independent, its future success depends on eight factors (see Exhibit 1). Some factors offer a very strong strategic advantage, some can be significantly influenced by management action, while others are of lower impact on the future success of the independent hospital.

Geography. Both geographic coverage and long distances to other competitors offer a strong advantage to the independent hospitals that enjoy them. While location is difficult to influence, geographic coverage can be improved with careful planning and physician partnerships.

Physician Alignment. Aligning physicians under the three elements of the physician-hospital alignment triangle— economics, clinical activity and purpose— is the key to strong physician relationships. Because physicians influence all parts of the continuum’s growth and effectiveness, strong physician alignment is the number one indicator of success as an independent hospital. Moreover, physician alignment is an element that can be developed by the hospital.

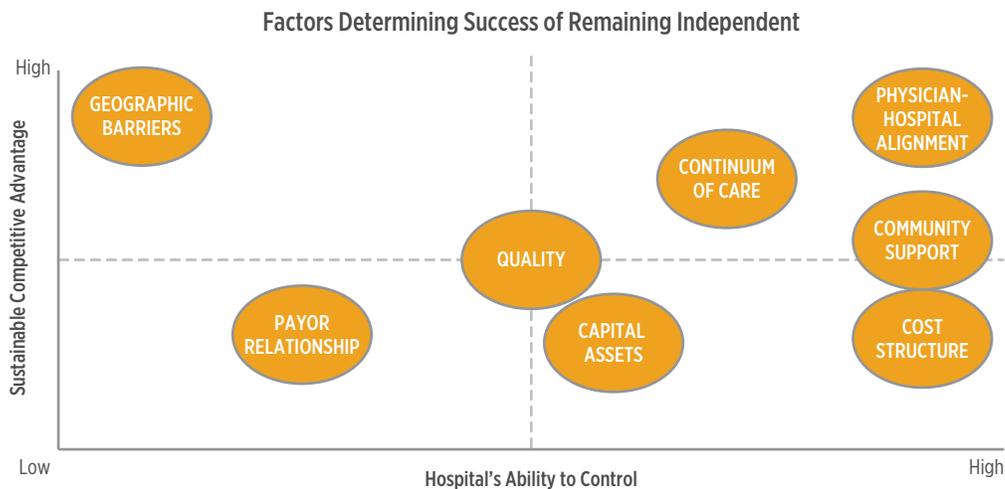
Payor Relationship. The payor mix of various communities plays a large part in determining the financial resources available to hospitals. Markets with large concentrations of

payors or high percentages of lower-reimbursing payors have a large risk and low margin for error. Additionally, hospitals that have not developed the relationships and infrastructure necessary to manage risk-based payments or even bundled payments are facing significant challenges in the future payment environment.

Cost and Revenue Structure. Those that have dramatically reduced overhead and, through partnerships, have leveraged economies of scale outside their organizations, strengthened their financial position and thereby their ability to remain independent. Moreover, systems will not offer as much by way of cost savings to these organizations, reducing the value of joining a system.

High-Quality Inputs, Processes and Outcomes. Providing high-quality care is nearly fully within the hospital’s sphere of influence. Hospital leadership’s role in defining the quality signature of the organization will be of increasing importance in a more transparent world. Moreover, creating a high-quality signature in the market can be difficult for competitors to emulate, as it requires coordination and cooperation with various stakeholders, especially physicians.

EXHIBIT 1



Capital Asset Base. Organizations that have not advanced their facilities and technologies, or those that have a poor balance sheet position, are likely to face challenges if they remain independent. The future environment will demand financial flexibility.

Community Support. Strong commitment by the community to maintaining independence can be influenced by the value provided by the hospital and can create a strong advantage to remaining independent. Communities with strong ties will reduce opportunities for competition from physicians or outside organizations and can in some cases support the success of the independent organization directly through tax revenues or philanthropy.

Managing a Continuum. Being an integral part of the continuum of care has always been important for hospitals' continued success. With increasing emphasis on population health, the ability to lead and manage the continuum of care provides a strong, durable competitive advantage beyond simply providing only the acute care, hospital component. Organizations that have developed an effective and cohesive continuum of care have a strong competitive advantage over other organizations in the market.

Independent hospitals positioned strongly in each of these eight areas are likely well positioned to remain independent. Moreover, the value of joining a system is much less than if an organization is in a weak position on any of these factors. Leaders of independent hospitals should carefully analyze their position and create strategies to strengthen each factor that can be influenced.

By combining and strengthening these elements, organizations that desire to remain independent can do so for the foreseeable future. Those that do not have enough of the elements to successfully remain independent should consider other options.

Achieving Success When Joining a System

Those that have made a decision to join a system have two sets of challenges. The first is to maximize the organization's value to a system such that the independent hospital is in the strongest bargaining position. To that end, the elements that must be maximized to remain successful as an independent hospital are also the things to do to maximize an independent hospital's value to a system. The second challenge is how to pick a partner.

In some cases, picking a partner is straightforward. For instance, in the Upper Midwest, a hospital that joined a large regional system did so because nearly the entire medical staff supporting the hospital was already employed by the system. There were no other realistic options.

In other cases, however, the organization must determine the criteria for selecting the right system partner. The criteria fall into at least five major categories:

Mission, Vision, Values and Culture. Joining a system with a significantly different mission, vision, values or culture is a difficult proposition. The first step must be to realistically assess the difference in values. This is especially true when a non-profit considers a for-profit partner. The statement, "culture trumps strategy," should be carefully considered.

Governance. The governance consideration fundamentally is often a question of reserve powers. However, the real discussion should be about how a locally based, managed and governed institution will remain in touch with the local populations' needs. Systems today are moving toward a much more centralized model in response to industry pressures. Nevertheless, the independent hospital must consider how, within the increasingly centralized system, future decision-making structures will ensure the needs of the local population are met. This will often be through the remaining structures of the local board.

Management and Structures. As mentioned above, systems are rapidly consolidating decision-making. As such, a clear understanding of the role and structure of local management must be considered in seeking a partner. Will the local management team be able to lead initiatives for the local community, or is its future role one of implementing and managing decisions from the system office? Considerations include the reporting relationships of various departments (such as finance, purchasing and IT), physician relationships (private and employed), staff relations, clinical service line reporting relationships, and strategic and capital planning.

Clinical and Continuum. A key reason for the increase in system growth is the focus on population health models and the changing health care delivery paradigm that many independent hospitals feel ill-prepared to handle. As such, careful investigation of the potential system partner's positioning within the continuum, relationships with physicians, and expertise at organizing and providing value across the care continuum should be a major focus.

Finances. Finances tends to be the central focus of many partnership and merger discussions. Organizations joining a system generally work to secure the best financial payouts possible for the community and/or commitments of capital investment into the local health care delivery system. However, unlike just a few years ago, the regular commitments of a "replacement hospital" have diminished. Instead, the focus tends to be on upgrades to inpatient facilities coupled with investments in physician, ambulatory and other parts of the health care continuum.

Additionally, strong consideration should be given to the system's ability to streamline processes, especially back-office processes that are sensitive to scale economies. More value must be created to offset the overhead assignments from corporate offices that are a reality of every system.

Conclusion

Macroeconomic and regulatory changes have shifted the competitive landscape for independent hospitals and health care systems. Responding appropriately to these changes will strengthen independent hospitals that choose to remain independent and create better options for joining a system for those that choose to partner. ❖

- i Irving Levin Associates, www.levinassociates.com
- ii Recent examples include: Cerberus Capital Management's acquisition of Caritas Christi Health Care; Ascension Health's partnership with Oak Hill Capital Partners; Leonard Green and Partner's acquisition of Prospect Medical Holdings; and Warburg Pincus' acquisition of Coffee Health Group

KURT SALMON

Kurt Salmon is the premier management consulting firm for today's leading hospitals and health systems. We work closely with our clients to create tailored solutions for their strategic and finance, facility development and performance, operational and information technology needs.

CONTACT

Jeff Hoffman
650.616.7200
jeff.hoffman@kurtsalmon.com

www.kurtsalmon.com