How the right M&A can help hospital CEOs cure shrinking margins

Building a better working world

US hospitals face significant margin challenges, driven by an ever-increasing cost of care and high pressure to reduce reimbursement for those care costs. By contrast, payers are largely concentrated, and those same payers are also competing directly with providers as they extend across the value chain. The whole industry is looking for breakthrough innovation that can disrupt these dynamics and create a healthier, more innovative system of care delivery. In this environment, hospital M&A has an important role to play.

Only 34% of health care executives say they expect to actively pursue M&A in the next 12 months, down from 60% a year earlier, according to the latest EY Capital Confidence Barometer. But CEOs might want to rethink M&A intentions now to improve their hospitals' long-term growth outlook. Several factors could support M&A in 2021 and beyond, including low interest rates, vertical integration between payers and providers and the need for hospital systems to scale to compete.

We offer some suggestions for assessing specific needs, calibrating investment appetite, and deciding which M&A options are right for their organization.

Margins under pressure

Hospital margins have been shrinking over the past several years. The average operating margin fell to 0.3% in 2019 from 1.8% in 2015.[1]

Drivers of margin pressure stem from rising labor and other operating costs and the increasing negotiating strength of managed care players. As hospitals shift care to lower-cost, outpatient settings (which is good for patients and our overall health economy), their individual margins often suffer. Hospitals also face new potential pricing pressures after being forced publicly to disclose their rates for the first time in 2021, a move intended to enable easier comparison shopping by patients and payers.

COVID-19, meanwhile, resulted in the delay or wholesale cancellation of elective procedures across a range of categories and caused patients to forego many regular health screenings altogether. This loss in volume, resulting in unexpected unrealized revenue, played out as hospitals also faced a slew of pandemic related costs. And the pandemic's effects linger, with hospital revenue in 2021 expected to decline by at least $53 billion, according a study commissioned by the American Hospital Association.[2]

1 *National Hospital Flash Report.* nationalhospitalflashreport_jan.-2021_final.pdf, www.kaufmanhall.com.
2 "Hospital Revenue Likely Will Fall $53B In 2021 — And That's The Low Estimate," https://khn.org/morning-breakout/hospital-revenue-likely-will-fall-53b-in-2021-and-thats-the-low-estimate, February 2021.

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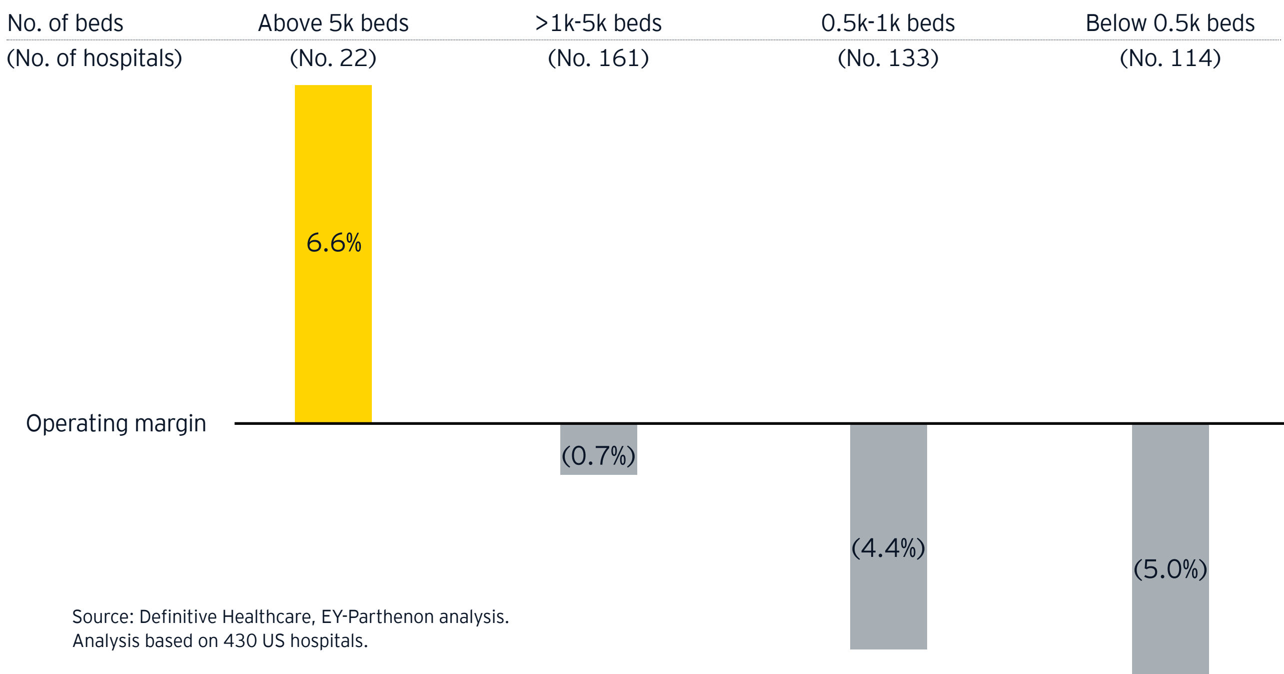
At the same time, hospitals are responding to changing patient dynamics and the increasing demand to serve patients at home or in other settings, increasingly enabled through a digital experience. The pandemic accelerated an already growing trend of patients seeking more outpatient care. Ultimately, meeting patient needs in their daily, at-home lives, and pushing further into wellness (away from sick care) tend to be commonly accepted elements of a solution to the ever-growing burden of national health expenditures on the overall US economy. In the short term, however, these moves come at the expense of our nation's hospitals, which still derive economic stability from volumes through their doors.

These margin pressures and shifting care dynamics all suggest that a return to pre-pandemic M&A activity will likely follow. Prior to the pandemic, hospital M&A had been on an upswing, with the number of hospitals combining in deals rising from about 230 in 2017 to about 350 in 2019, according to Irving Levin Associates. That number fell to about 150 in 2020, the lowest level in a decade.

Ratcheting up M&A is an option to lower costs and increase margins (see Figure 1) through economies of scale, capture broader patient volumes, enhance coordination of care delivery across the care continuum, and develop sustainable reimbursement solutions with managed care and corporate payers.

Only the largest hospitals, with operating margins averaging 6.6%, have comparable margins to the largest US payers (which ranged from 5.0% to 8.1% in 2019). The rest of hospitals actually had negative operating margins in 2019.

Figure 1: Larger hospitals have better margins



Source: Definitive Healthcare, EY-Parthenon analysis.
Analysis based on 430 US hospitals.

Operating margins tend to be higher in larger hospitals

Payers consolidate, while also competing with hospitals

Gaining the strength of scale could be even more important for hospitals as payers consolidate (giving them more pricing power).

The level of payer consolidation varies widely by market, though an American Medical Association study showed that in 2019, 74% of the combined HMO, PPO, POS and exchange markets were highly concentrated. Other data has shown that high payer concentration is associated with lower hospital prices.

Payers, especially large commercial entities, are also increasingly entering care delivery themselves through acquisitions, competing with traditional providers. UnitedHealthcare's OptumCare is now one of the largest physician networks[3] in the US, with care delivery available in most states. And Humana is continuing to move into the space with its planned acquisition of home care and hospice provider Kindred at Home, which Humana said will help it "more quickly implement and scale the value-based models and clinical innovation it has designed, focusing on total cost of care and delivering outcomes and value beyond what is possible in a traditional, fee for service model."[4]

But health care is a highly local industry. Dynamics will differ by geographic footprint and different systems may require a different type of partner, so it is essential to understand what different deal types may deliver.

In the long run, convergence of the industry may be critical to enable the US to break away from the "pay for volumes" paradigm. In the meantime, health systems and payers can work together to find solutions that can work for sustainable economics today and bridge to tomorrow. Hospital M&A will likely play an important role as health systems (1) extend beyond the hospital to develop more effective solutions for care and wellness that the payer community should value; (2) increase their presence in provider-sponsored health plans to manage risk more effectively; and (3) invest, together with payers, in innovative solutions such as tech and analytics that can accelerate transformation toward new models of care.

3 Source: Optum Care Programs for Agents & Their Clients
4 "Humana Announces Agreement to Acquire Remaining 60 Percent Interest in Kindred at Home Accelerating Integration of the Nation, `Largest Home Health Provider into Humana' Payer Agnostic Healthcare Services Platform," *Business Wire*, www.businesswire.com/news/home/20210427006057/en/.

Examine your own financial health and the market environment

It is incumbent upon hospital executives to take several steps to determine if M&A is a viable option and to examine what types of deals might be most advantageous for growing in a consolidating health care environment. Doing so can enable them to identify what the goal of an acquisition may be: growth to invest in new areas or capabilities, improve brand strength, compete amid industry convergence, scale to improve payment negotiations, or a combination of the above.

1. **Conduct a financial checkup.** Determine the organization's current financial health and its ability to access capital and debt. This information can allow the CEO and CFO to determine how much firepower exists to consider M&A.

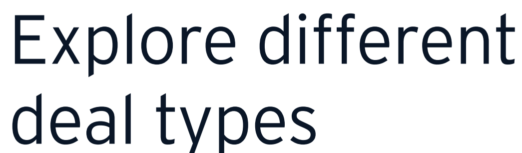
2. **Examine the competitive dynamics.** Assess trends in the competitive landscape within the organization's market. Characterize whether there is evidence of meaningful patient movement to peers or outpatient competition.

3. **Review reimbursement dynamics.** Examine how reimbursement rates have trended in the relevant service area and how they are poised to trend with potential payer consolidation.

4. **Consider demographic changes.** Review the demographic outlook in the service area and explore whether service area expansion can be pursued to access broader groups of patients across service lines.

5. **Address outpatient migration.** Determine whether there is patient demand for areas of care or care settings where the organization does not currently operate at scale.

6. **Look for M&A target opportunities.** Explore whether there are struggling systems or other care delivery models that could represent an under-valued opportunistic M&A opportunity.



Explore different deal types

Of the health care executives that expect to pursue M&A in the next 12 months, 64% say they are focusing on bolt-on acquisitions.[5] A bolt-on could be the right type of acquisition if it allows a hospital system to address skill sets such as digital care or gives patients more treatment options or locations. A more transformative deal may have its own benefits, allowing for healthier margins, heightened capacity fungibility, and other financial benefits. Perhaps most importantly, owning more resources along the care continuum and being able to provide the spectrum of services a patient might need gives a provider oversight across the patient's care, which can lead to better quality of care.

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Consolidation of hospital peers or systems may reduce costs by increasing scale. Such deals can reduce operating expenses at the acquired hospital by about 2%, according to an AMA study.[6] Substantial savings can also be realized in fixed costs, including in pharmacy and laboratory operations, group purchasing, IT and back office processes. These deals can also enhance clinical quality by facilitating the updating or standardizing of clinical operations across the combined system.

M&A with payers to construct provider-sponsored health plans (PSHPs) offer health delivery organizations the opportunity to capture the full dollar of patient care costs, enable revenue diversification, and provide an opportunity for systems to pursue value-based care models. Savings can also be realized by combining system and health plan functions like tech support and human resources. Meanwhile, deals with PSHPs can allow health systems to understand patient utilization patterns and outcomes, which helps in managing population risk long-term. Plan benefits can also be better tailored to specific, local communities in the service area.

M&A with an academic medical center can allow a health system to increase its scale and improve its regional brand presence as a provider of world-class, innovative care. It can also improve financial, clinical and operational performance of health systems by reducing costs, diversifying revenue sources to include teaching and research proceeds and increasing quality of care. Health systems may also be able to increase their referral network and expand speciality services to their patients, while also entering into advanced research (e.g., clinical trials) and medical education (for physicians and other allied professionals).

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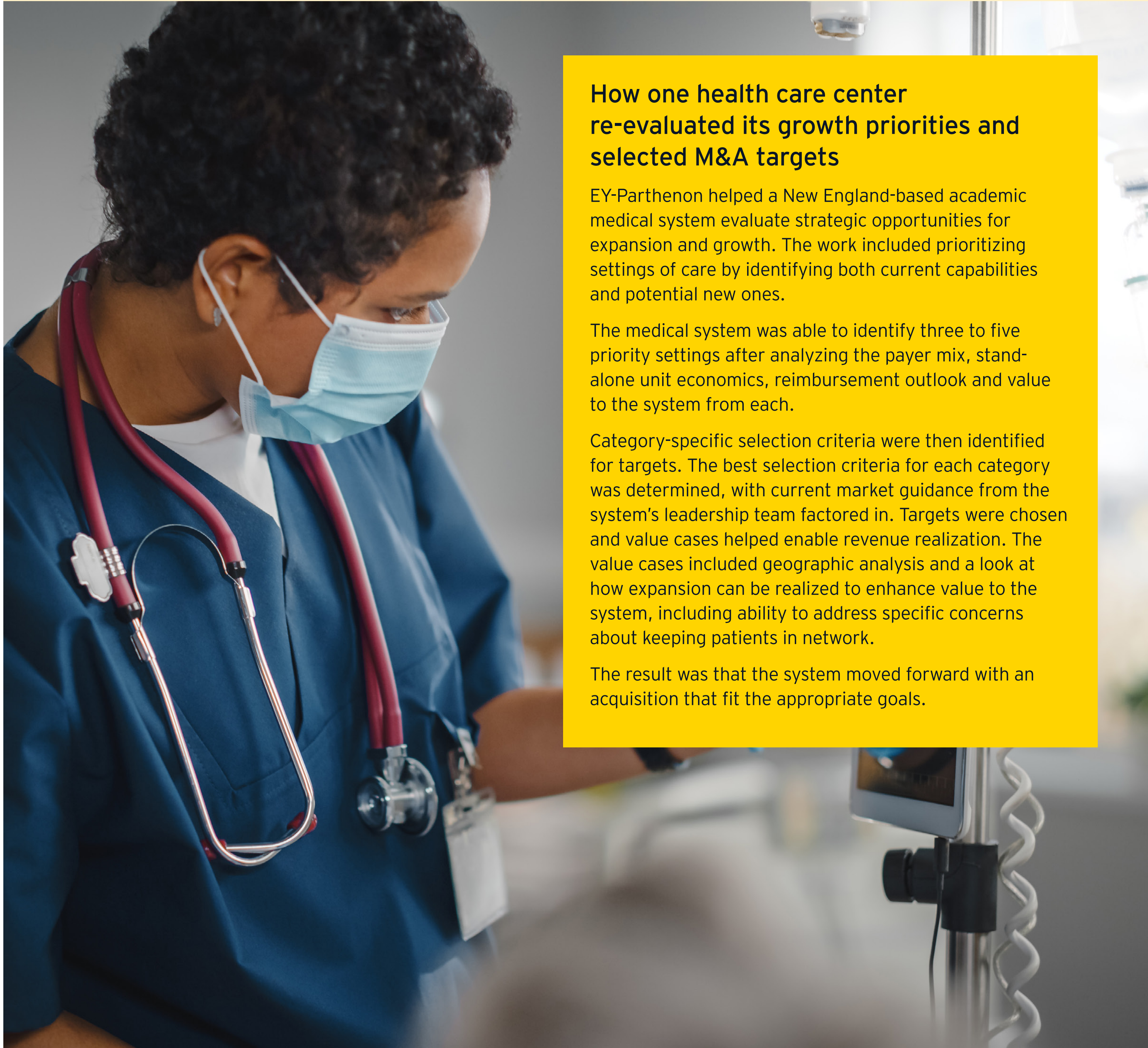
5 *EY Global Capital Confidence Barometer,* 2021
6 "Charles River Associates Report Hospital Merger Benefits," AHA, www.aha.org, accessed 4 September 2019

M&A to acquire technology can help speed the development of new capabilities, such as artificial intelligence, data analysis and automation, that can improve both patient outcomes and hospital operational excellence.

M&A to expand across the care continuum also can improve patient outcomes by offering primary care, home health, rehab, post-acute and sub-acute care coordinated under one organization across the value chain.



How one health care center re-evaluated its growth priorities and selected M&A targets

EY-Parthenon helped a New England-based academic medical system evaluate strategic opportunities for expansion and growth. The work included prioritizing settings of care by identifying both current capabilities and potential new ones.

The medical system was able to identify three to five priority settings after analyzing the payer mix, stand-alone unit economics, reimbursement outlook and value to the system from each.

Category-specific selection criteria were then identified for targets. The best selection criteria for each category was determined, with current market guidance from the system's leadership team factored in. Targets were chosen and value cases helped enable revenue realization. The value cases included geographic analysis and a look at how expansion can be realized to enhance value to the system, including ability to address specific concerns about keeping patients in network.

The result was that the system moved forward with an acquisition that fit the appropriate goals.

Summary

Many hospitals can benefit from M&A as they simultaneously try to offer patients different access to care, try to increase their negotiating ability with consolidated payers, and deal with new competitors from outside of traditional provider networks.

But M&A is not a one-size-fits-all solution. Hospital executives need to decide what they want to get out of a deal and which types of M&A will help them realize those strategic goals.

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