Health Care Futures Direct: COVID-19's Impact on Healthcare M&A 2020, June 2020

The COVID-19 pandemic has threatened the sustainability of many hospitals and health systems in the United States. Since March, hospital finances have rapidly deteriorated as a consequence of cancellations of profitable deferrable cases, such as surgeries, procedures and office visits, combined with an influx of expensive, complex and unpredictable COVID-19 cases. Revenue declines coupled with rising expenses are causing hospitals to burn through liquidity in excess of $50 billion per month nationwide, according to the American Hospital Association. For many non-profit hospitals, which tend to carry sizable investment portfolios that are important to financial stability, these issues are compounded by ongoing stock market volatility that has weakened balance sheets during this initial wave of COVID-19.

Smaller, independent community and rural hospitals have been disproportionately impacted by the financial burden of COVID-19, and have far less potential to recover from this crisis compared to larger health systems with more expansive and diverse resources and deeper balance sheets. Over the next 12-18 months, we expect to see a material increase in acquisition and similar opportunities related to financially distressed and challenged hospitals, in addition to an uptick in hospital closures. Factors driving acquisitions and closures are only being exacerbated by the COVID-19 emergency, including:

- Lack of balance sheet depth and limited access to capital
- Inability to invest sufficiently in information systems, comprehensive provider networks, facilities, medical equipment and pension funding
- Lack of sufficient return on aligned provider investments
- Expense growth outpacing revenue growth
- Payer mix degradation
- Lack of "investment grade" operating performance discipline

In addition to these factors, we expect that special reimbursement and cost savings programs such as 340B, HOPD pricing, Critical Access Hospital and Sole Community Hospital status, and state fee programs, which many operators depend upon to remain viable and were under increased scrutiny pre-COVID-19, will be under even greater risk of funding/program cuts. While bailout and advance payment programs have been helpful, they have proven to be insufficient to enable those living on the edge to stay afloat. More challenging, it is hard to imagine that continued dependence on the previously mentioned special dispensation programs at a time when state and federal budgets are being severely compromised, will be available in current capacities.

The continued independence and viability of U.S. hospitals and health systems post-pandemic is in jeopardy. While States are emerging from provider restrictions on deferrable cases, it is clear that returning to past operating levels will not happen quickly, nor will it be easy. This continued incremental stress will force providers, especially those that are financially vulnerable, to rethink the feasibility of continuing to remain independent and the need for greater vertical and/or horizontal integration. While new and unexpected inter- and intra-state relationships are emerging to assure coordinated and cooperative access to essential health care services in response to heightened COVID-19 related needs, it is not expected that such cooperation will look to address more foundational financial performance vulnerabilities. We expect that this pandemic (there will be more) is but the beginning of inevitable change for financially at-risk providers.

Health Care Futures believes that the COVID-19 crisis will, at a minimum, expose challenged assets, both free standing as well as those that are part of larger health systems. We expect that this situation will result in a number of dynamics that hospitals and health systems will need to be prepared to address including, but not limited to:

1. **Distressed assets:** The impact of the COVID-19 situation in terms of extended operating losses is proving to be significant, particularly on freestanding and sole community providers, which are more likely to be ill-equipped to weather major economic downturns. For many that are not affiliated with larger health systems, cash depletion, provider losses and lack of access to system resources is threatening organizational viability. We expect that those in this situation, regardless of health system affiliation, will need to openly address the question of “what’s next” in order to strengthen the organization’s ability to serve its communities and promote its Mission.

2. **Practice fragmentation:** Several community hospitals and health systems across the country continue to depend upon independent physician practice structures (both single and multi-specialty) for critical physician coverage. Similar to hospitals, independent provider practices have been challenged by state restrictions on non-emergent and deferable cases, but appear less able to withstand practice downturns due to lack of cash balances. Practice viability is increasingly being challenged, and fragmentation is a common and more frequent outcome. This presents strategic imperatives and opportunities for hospitals and health systems to provide support to independent practices and protect access to these needed provider resources.

3. **Revisit of payer-provider relationships**: There is a reason that fully aligned payer/provider organizations such as Kaiser and Geisinger are used as catch phrases for truly integrated health care coverage and delivery, and what could be when structures and incentives are truly aligned. Increasingly, the traditional lines between payers and providers are blurring (e.g., UHC, Aetna) and may serve as a vehicle to stabilize independent and strategically important providers through focused partnering initiatives.

4. **Upswing of private-public ventures with virtual joint economics:** Increasingly, service line and programmatic joint venture opportunities are being explored with up-stream partners to facilitate the addition of capital-intensive technology and support physician services by providers with more limited means. Creative joint venture and investment relationship structures provide opportunities for smaller providers to expand service offerings and leverage up-stream relationships for strategic advantages and distributed economic risk.

5. **Strategic affiliation among “strong-er” organizations**: We expect that more strongly positioned, smaller health systems and independent hospitals will continue to explore options to achieve improved functionality, financial performance and financial security through relationships with organizations that bring scale efficiencies and functional depth. The COVID-19 emergency has underscored the pace at which organizational and economic instability can occur. Smaller health systems and hospitals may be advantaged by exploring affiliation opportunities while they’re able to negotiate from a position of strength, as opposed to after positioning is weakened and options become more limited. Strategic affiliations continue to warrant serious consideration when a strong and compelling business rationale exists.

Implications

Health Care Futures believes that timing is critical as the rate of volume recapture appears to be taking longer than expected, in turn drawing down cash reserves and organizational financial viability and value. For smaller, independent providers with limited means, this situation is particularly acute. This is a critical consideration in potential up-stream transactions. At the same time, larger health systems must weigh their ability to preserve operating and balance sheet strength, while considering options for both proactive and opportunistic strategic growth. In either case, critical assessment of financial strength and depth, and valuing affiliation opportunities are essential to securing strategic positioning. Working with a trusted and objective third party can help to advance these efforts expeditiously, especially at a time like this when organizational resources are stretched thin.

How we can help

The Health Care Futures senior team of advisors has facilitated numerous mergers, acquisitions and other affiliations between health care organizations with a principal focus on hospital-hospital, health system-hospital and medical group-hospital transactions. For organizations in the early stages of considering a partnership, development of an initial Strategic Business Options Assessment is often helpful in objectively assessing the business case for alignment in general. This Assessment is designed to build the qualitative and quantitative fact case required for Boards and management to be confident in a decision to remain independent, or a decision to pursue a strategic partnership with another organization, and if so, who.

In addition, Health Care Futures has extensive experience working with organizations seeking to acquire other health care organizations and smartly enhance their strategic positioning and relevance. Health Care Futures has led numerous joint engagements, where we assist all parties to a potential transaction to evaluate the business case, and, as applicable, to develop the key terms for alignment. Health Care Futures continues to be a leading resource for this service nationally. We would welcome the opportunity to discuss our experiences and thoughts with you.

If you have questions or would like additional information, please contact your regular Health Care Futures advisor, or:

Bob Kaufman, Partner
O: (952) 641-4321
C: (612) 889-8461
b.kaufman@healthcarefutures.com

Edward McGrath, Partner
O: (630) 467-1700 x102
C: (847) 910-0564
e.mcgrath@healthcarefutures.com