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affiliation options for independents

Independent hospitals and medical groups facing pressures to consolidate with larger providers should consider affiliation options beyond the typical merger or acquisition and seek a partner that exhibits complementary strengths to bring greater value to the market.

Continued payment reductions, combined with the capital demands of clinical programs and technology, threaten to eliminate the slim margins under which community hospitals have historically operated and to reduce the income of physicians in independent medical groups. These circumstances have prompted many independent hospitals and medical groups to consider options for mergers and acquisitions to address the

growing importance of scale and scope of services. But many also are concerned about potential loss of autonomy, historical identity, and community focus that may accompany such transactions.

Merging, acquiring, or being acquired are not the only options for independent hospitals and medical groups seeking to overcome the challenges of today's healthcare environment. Other approaches involving affiliation have become attractive alternatives. Whether an organization's affiliation objectives are to better integrate care in the community, eliminate duplicate services and costs, or enable the organization to focus on what it does best rather than trying to be all things to all people, a thorough assessment of the available alternatives and their potential outcomes will ensure the decision is an enlightened one.

Evaluating the Options

Organizations contemplating an affiliation should take steps to define their objectives for such a transaction, thoroughly assess the available options, and identify their preferred strategy and structure. These steps will essentially be the same for any type of affiliation relationship, whether it be a management agreement, joint operating agreement, joint venture, or other approach. (See the sidebar on pages 4-5 for a discussion of affiliation alternatives.)

AT A GLANCE

Many independent hospitals and medical groups are pursuing affiliations with partner organizations to meet the challenges posed by healthcare reform and value-based payments. Before embarking on such a strategy, however, these organizations should:

- > Clearly define their objectives of pursuing an affiliation
- > Assess potential affiliation options
- > Identify a preferred strategy based on evaluation of different affiliation scenarios

Undertaking a disciplined evaluation process also can be instrumental in helping to identify which option is best for the organization. Indeed, the choice of the type of affiliation relationship often is best made only after the potential partners have been evaluated, because the organization's leaders will have a better basis for selecting an approach if they already understand each prospective partner's strengths and weaknesses.

Step 1: Clearly define the objectives of pursuing an affiliation. It is important to start with a clear understanding of your organization's core goals and strategic objectives in partnering with another organization. For example, payment declines might compel an organization to pursue an affiliation as a means to enhance its financial position or gain improved access to capital. Or the organization's objective might be to build a comprehensive delivery network that enables it to respond to the requirements of value-based payment and population health management. It bears emphasizing, based on experience, that the objectives of successful affiliations involve more than simply growing market share. To be successful, the affiliation must bring additional value to the market by increasing the capabilities of each partner. For this reason, you should also consider what kinds of benefits your organization can bring to a potential affiliation.

Step 2: Assess potential affiliations for the organization. With clear objectives in mind and a clear sense of the benefits your organization can offer, you can begin to evaluate available options. This part of the evaluation involves five tasks:

- > Develop evaluation criteria.
- > Create potential affiliate profiles.
- > Assign affiliate ranking.
- > Assess affiliation activity.
- > Perform scenario planning.

The first of these tasks—defining weighted evaluation criteria—allows you to rank potential affiliates based on your organization's vision and goals. For example, if your goals are to enhance your organization's financial position and improve its ability to access capital, your most heavily weighted criteria for choosing a partner

should be the extent to which a prospective partner can help you achieve those goals—with each of these criteria assigned, say, 25 percent of the total weight assigned to all criteria.

The next task requires you to identify affiliation candidates and create profiles to help you better understand their strengths and any obstacles to working together. The profiles should relate to your evaluation criteria but may also assess the affiliation candidates' strategic direction, overall reputation, ability to complement your services and culture, and evident interest in seeking affiliations.

Based on the results of these initial two tasks, it should be possible to rank each potential affiliate based on its ability to support your evaluation criteria. This step might involve developing a scoring system of 1 to 5 for each criterion, where 5 indicates strong support for the criterion and 1 indicates no support. Results for each criterion then could be adjusted to reflect the relative weight of the criterion (e.g., the score might be multiplied by 25 if the weight for the criterion is set at 25 percent and by five if the criterion's weight is 5 percent, etc.).

The fourth task—assessing affiliation activity—involves evaluating the likelihood of other affiliations, mergers, and acquisitions in the local market and the implications to the marketplace and your organization. These transactions can significantly affect the strength and attractiveness of your affiliation candidates as well as have an impact on the forces driving you to consider an affiliation.

The assessment step should conclude with defining a small number of scenarios under a variety of affiliation options and projecting the likely outcome of each. Each scenario should be evaluated both subjectively and objectively. Too often, healthcare organizations “bet the farm” without adequately and objectively assessing the financial consequences of their decision. Hospital leaders should consider the impact under each scenario on the organization's bottom line, credit rating,

and competitive position. Medical groups should understand how their financial viability and future physician compensation are affected under each scenario.

Step 3: Identify your preferred strategy based on each potential scenario. The preferred strategy should be defined by three factors:

- > The level of control or governance you will require or are willing to cede within an integrated organization
- > The organizational, management, and operational structures that will best position the integrated organization for success
- > The specific way that the integration strategy will leverage each partner organization's strengths

Other important considerations are whether it is preferable to proceed with the affiliation immediately or take a wait-and-see approach before determining what steps the organization should take to transition to its long-term vision.

A note of caution: The pressures to improve negotiating strength relative to commercial payers, reduce administrative costs, and provide more comprehensive care to their existing population base often prompt organizations to focus on affiliations, mergers, or acquisitions with their nearest competitors. However, the most successful partnerships tend to be those driven by a vision of enhancing the value the entities bring to their market through complementary strengths and competitive advantages, rather than by a desire for increased size and strength.

Case Study

To illustrate how a community hospital might proceed through such an evaluation process, we offer a case study based on actual experience of a hypothetical organization, which we will call Hometown Hospital.

Hometown Hospital is a midsize community hospital seeking to clarify its future role in the community. The hospital faced a rapidly deteriorating financial position, and it was losing the

battle to align with the community's preferred medical groups and independent physicians.

Based on the organization's current position and discussions with its board of directors, Hometown's leaders identified the following revised long-term goals for the organization:

- > Demonstrate financial strength and operational efficiency through improved access to capital, a strong net income margin, increased days of cash on hand, and a positive contribution margin on all services.
- > Add value to the community ("Be relevant") by developing an area of expertise or a group of services for which the hospital can be the leading provider in the community and by improving the hospital's market position with employers, physicians, and patients.
- > Prepare for a value-based healthcare industry by bolstering physician alignment in areas of expertise, obtaining a comprehensive health IT platform, "owning" the patient care continuum for select services, and achieving a favorable position to partner with key health plans and employers.

Hometown's leaders determined that an affiliation strategy would provide an effective means to achieve these goals.

Evaluation criteria. To assess its affiliation options, Hometown identified six evaluation criteria and gave each a weighting, to total 100 percent:

- > Enhances financial position (25 percent)
- > Improves ability to access capital (25 percent)
- > Bolsters physician alignment and clinical integration (20 percent)
- > Improves market position (15 percent)
- > Promotes operational efficiency (10 percent)
- > Adds value to the community (5 percent)

These criteria reflected Hometown's determination that its most critical need from an affiliation partner was the ability to improve its financial position and gain access to capital.

Potential affiliate profiles. Hometown developed profiles of five regional health systems, two health systems with hospitals in its community,

Affiliation Structures

Organizations considering a strategic partnership have a range of transaction structures from which to choose. The exhibit below plots several affiliation structures based on a comparison of the capital commitment required and the integration/stability achieved. Here is a snapshot of the characteristics of each of these options.

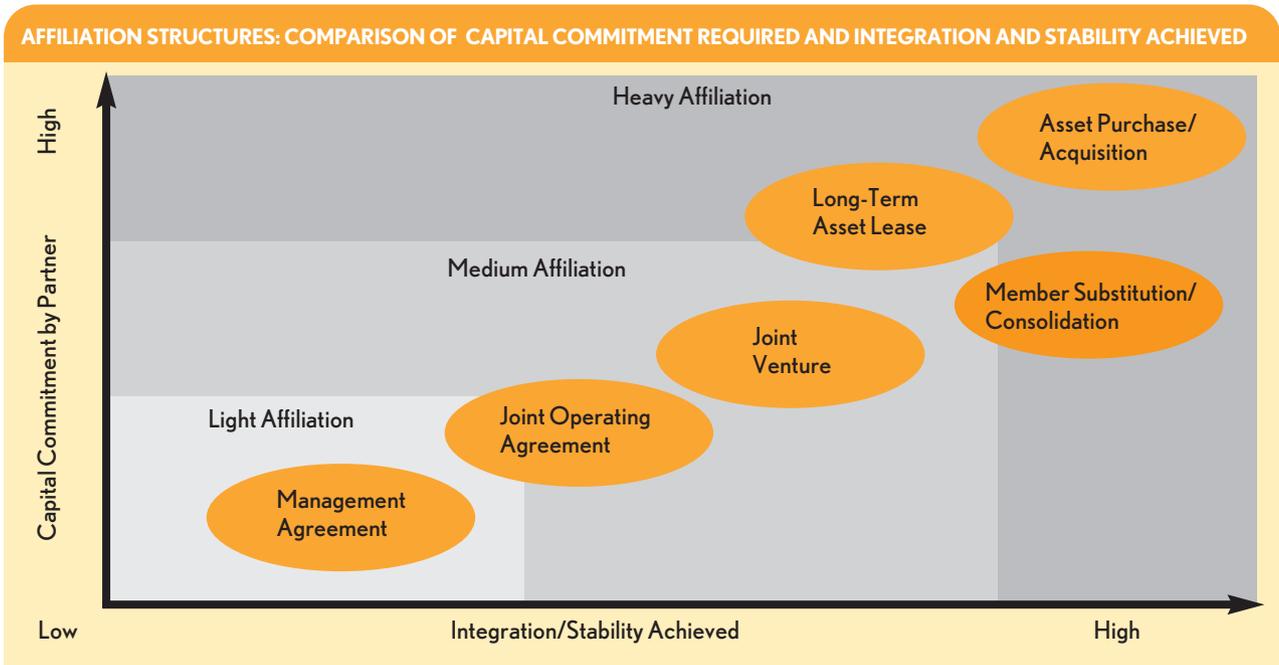
Management agreement. Under a management agreement, the partner-seeking organization elects to outsource day-to-day operations to a third party. The partner-seeking organization enters into a fee-based management agreement with a partner, often a for-profit hospital management company, to manage the operations of the partner-seeking facility. Services provided by the partner under a management agreement vary, but may include:

- > Working capital loan
- > Human resources administration (potentially including employment of hospital staff)
- > Corporate compliance and risk management

- > Managed care contracting
- > Materials management/procurement
- > IT support
- > Billing and collections

A management agreement does not result in realignment of ownership or governance/control. Management fees are often structured as a percentage of the organization’s net revenues (3 to 6 percent).

Joint operating agreement. Joint operating agreements typically bring together two or more organizations to create a jointly governed entity to operate the affiliating organizations. A joint operating company is formed to serve as the operator of both the partner and partner-seeking organizations. The joint operating company is not separately licensed and does not typically employ the affiliating entities’ personnel. Rather, its role is to coordinate strategic decisions regarding operations of the affiliating providers, and it has the power to



approve budgets, loans, strategic plans, managed care participation, asset transfers, and other initiatives. The individual boards of the affiliating providers retain power to determine medical staff appointments, develop budgets, monitor quality of care, and make other day-to-day decisions. Under this approach, balance sheets of the affiliating entities are not consolidated, and the net income and future capital expenditures of the joint operating company are shared between the organizations according to predetermined formulas.

Joint venture. As the name suggests, the joint-venture model involves engaging a strategic partner (typically a for-profit chain) in the development of a new corporate entity that provides services. The for-profit chain contributes cash (and sometimes other hospitals in the same market) to the joint venture; the partner-seeking organization contributes its physical hospital assets and operations in exchange for ownership interest/cash. Not-for-profit organizations typically keep joint-venture ownership interest of only 20 to 30 percent but proportionately higher representation on the joint venture's governing board (50 percent is common). Organizations are often able to negotiate supermajority voting rights over certain operational decisions (e.g., incurring of debt, change of control, and elimination of services). The not-for-profit party generally uses extracted cash to repay tax-exempt debt and liabilities that are not assumed by the joint venture. The for-profit partner manages the joint venture, subject to the joint venture board's oversight, and receives a management fee in return (3 to 6 percent of net revenue).

Member substitution/consolidation. Under a member substitution/consolidation affiliation, the partner-seeking organization amends its articles of incorporation and bylaws so that the partner becomes the sole corporate member, in what generally is a cashless transaction. The partner-seeking organization continues to operate itself subject to certain reserve powers held by the acquirer. This transaction structure is generally the most common form used when both entities are not-for-profit organizations. Governance after

the affiliation is subject to negotiation; however, if the acquirer is substantially larger than the partner-seeking organization, then the acquirer will likely negotiate to have majority governance representation following the transaction.

Long-term asset lease. A long-term asset lease arrangement provides many of the benefits associated with the other structures, while allowing the partner-seeking organization to retain ownership of hospital assets. The parties enter into a long-term lease (e.g., 25-plus years) in which the partner organization receives access to and use of the partner-seeking organization's assets. The partner-seeking organization maintains ownership of its assets throughout the duration of the lease. The partner is responsible for the hospital's revenue and all expenses, including lease payments to the partner-seeking organization, physical plant maintenance, capital expenditures, and medical staff salaries and benefits. Unless the lease is renewed or the hospital is leased to another party, the operational responsibility of the hospital will revert to the partner-seeking organization. The board of the partner organization is often expanded, or a separate oversight/steering committee is established, to enable the partner-seeking organization's board members to continue to maintain a role in determining the direction of the organization.

Asset purchase/acquisition. Under an asset purchase/acquisition, the partner-seeking organization elects to discontinue/reassign all or a portion of its services through the sale of its assets. The partner-seeking organization transfers its assets (and operations) and certain liabilities to the partner in return for a cash payment. The cash payment is used to repay any outstanding liabilities that are not assumed by the partner, which typically include long-term debt and current liabilities. If there are net proceeds remaining after repayment of non-assumed liabilities, the remaining funds are placed in a charitable foundation and can be used to further benefit the community. The partner-seeking organization may be invited to participate in governance on the partner's board and/or local community board.

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and a community hospital in a neighboring community. Important components of the profiles were the degree to which Hometown’s medical staff members were clinically aligned with the potential affiliates and the degree to which the medical staff would welcome an affiliation.

Affiliate ranking. Next, Hometown developed a scoring system to evaluate the ability of potential affiliation partners to meet the evaluation criteria: A score of 5 indicated a criterion would be strongly supported by a potential affiliate, while 4 indicated some support, 3 indicated partial support, 2 indicated minimal support, and 1 indicated no support. Definitions were created for each level of support for each criterion.

For example, for the criterion of the potential partner’s ability to enhance Hometown’s financial position, a potential affiliate was rated as providing strong support (5) if it had a “AA” credit rating with stable or positive outlook, solid financial health

indicators (profitability, solvency, debt coverage ratios, liquidity, payer mix), and extensive foundational resources. An affiliation candidate was rated as providing no support (1) if its characteristics included a credit rating of “BAA” or below, poor financial health indicators (profitability, solvency, debt coverage ratios, liquidity, payer mix), and a lack of foundational resources.

Hometown then ranked each profiled candidate for affiliation. Every potential affiliate received a score of 1 to 5 for each of the six evaluation criteria, with the rationale for the score clearly defined (see the exhibit below).

Affiliation activity. After developing a strong understanding of the affiliation candidates and evaluating their compatibility as potential partners, Hometown considered the potential merger and acquisition activity that could occur in its market and how it might be affected by such transactions. Of the two hospitals in its community, one had joined a regional system in the previous 18 months.

AFFILIATION CANDIDATE RANKINGS										
	Weight	Local Hospital No. 1	Regional System No. 1	Regional System No. 2	Local Hospital No. 2	Regional System No. 3	Regional System No. 4	Regional System No. 5	Neighboring Hospital	
Enhances Financial Position	25%	→	↑	↑	↑	→	↑	→	→	
Improves Ability to Access Capital	25%	↑	→	→	↘	↘	↘	↘	↘	
Bolsters Physician Alignment and Clinical Integration	20%	↗	→	↘	↘	→	↓	↘	↓	
Improves Market Position	15%	↗	→	↘	↗	→	↓	→	↓	
Promotes Operational Efficiency	10%	→	↘	↗	→	↗	→	→	↘	
Adds Value to the Community	5%	↗	→	→	→	→	→	↓	↘	
Total Score		3.9	3.4	3.25	3.2	2.85	2.55	2.4	1.9	
		Strong Candidates			Potential Candidates		Candidates with Limited Potential			
		↑ = 5 ↗ = 4 → = 3 ↘ = 2 ↓ = 1								

Meanwhile, the parent of the other local hospital had recently failed to acquire a hospital within the state because of an antitrust ruling. It was believed that antitrust concerns could limit the immediate options (i.e., prevent a full acquisition) if Hometown selected either of the local hospitals as its preferred affiliation partner. But no likely transactions were anticipated that would prevent Hometown from immediately pursuing an affiliation with any of the potential partners.

Scenario planning. Hometown used scenario planning to assess the likelihood of various changes to its competitive landscape and how it would fare under alternative affiliations. Because of the priority of improving its financial position, Hometown's scenario planning focused on financial projections under a variety of situations with the most likely affiliation candidates. Profit and loss statements as well as the following financial metrics were projected over five years under each scenario and compared with Hometown's debt covenants and medians for various types of hospitals with certain credit ratings:

- > Profitability (EBITDA margin, excess margin, and operating cash flow margin)
- > Liquidity (cash on hand and cash to total debt)
- > Leverage (maximum annual debt service coverage, long-term debt to capitalization, and long-term debt to cash flow)

Scenarios varied by the scope and structure of the affiliations and the affiliation partners. Scenarios included the following.

Clinical/shared serviced affiliation with local hospital No. 1. Under this arrangement, Hometown would reduce its offering of clinical services and focus on select service lines in which its affiliation partner would be willing to reduce its elective cases. Hometown also would purchase certain administrative services from the affiliation partner.

Joint operating agreement with local hospital No. 1. Under this arrangement, Hometown and its affiliation partner would make mutually beneficial service line concessions, share physician networks, and potentially integrate IT platforms.

Full acquisition. Hometown considered the impact of selling to two of the regional health systems.

Other innovative models. Hometown considered how it could serve as a low-cost provider of elective/scheduled services for the accountable care organization of one of the local hospitals and narrow network partnerships with health plans and employers.

Engaging a Prospective Partner

Once you have identified your preferred affiliation strategy and partner, a mutually agreeable design for the affiliation must be developed.

This process will typically involve:

- > Establishing a shared vision for the strategic direction and goals for the affiliation
- > Defining the affiliation's structure and the initiatives that will be pursued under it
- > Estimating the financial and operational impact on each organization
- > Examining transition implications related to the affiliation (e.g., ownership changes and transactions, transfers of assets, service agreements, and physician relationships)
- > Preparing a term sheet that specifies the desired vision, goals, conditions, and guidelines of the affiliation

In many instances, partnering organizations invest relatively little time and effort in designing their affiliation before they enter the agreement. Often, political, strategic, or financial pressures may compel the partnering organizations to "hammer out the details" after entering into an arrangement. This approach may be appropriate in many circumstances. However, in all instances, the partnering organizations should agree to the following core elements of a non-binding letter of intent before entering the agreement.

Guiding principles. Both parties should agree on a shared vision and shared goals to help guide the process.

Key financial terms. Key financial terms define the financial arrangement, any exchange of assets

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that is to take place, and the attendant obligations of both parties. Terms include:

- > Transaction structure
- > Assets/entities to be acquired
- > Consideration and structure of payments
- > Enforceability and exit provisions

Corporate structure. The corporate structure defines the legal entities that will result from any transaction and the relationships among them.

Governance structure. Governance defines the structure, or structures, under which the new entity will set its strategic direction, manage responsibilities, and oversee organizational performance. Governance considerations include:

- > Board composition
- > Board member nomination and appointment process
- > Duration, staggering, and maximum number of terms
- > Authority and responsibility
- > Supermajority provisions
- > Board committees
- > Subordinate governance structures, as applicable

Leadership structure. The leadership structure defines the means of organizing and directing the day-to-day activities of the new entity. It describes the following:

- > The overall operational approach, including consolidated leadership structure versus separate management teams, delegation of authority at the operating-unit level, and centralization of operational support functions (e.g., human resources, IT, accounting, materials management, and billing and accounts receivable)

- > Positions and reporting relationships, including leader titles, roles and responsibilities, and approach used for management performance assessment and accountability

The Time Is Now

Fragmentation has been blamed for many of the ills that plague health care in the United States. Historically, in the United States, going back to the railroads in the late 1800s, fragmented industries have consolidated. Today, leaders of independent community hospitals and medical groups need to ask themselves if they can survive as independents. For many, the answer is no. Yet they also have numerous options. The key is to be proactive and take the steps today to avoid stumbling into a weakened position where the options are few. ●

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