South Carolina Hospital Association
CFO Forum

Hospital Consolidations
(Mergers and Acquisitions)
What? When? Why?
August 28, 2013
Areas to be Covered

• Why Consolidation?
• Pace of Consolidation
• Drivers of Consolidation
• New Participants in Consolidation
• Appropriate Process for Community Hospitals Considering Consolidation
• Potential Types of Affiliations
• Impact of Affiliations on Credit Ratings
• Current Carolinas Situation
  – North Carolina
  – South Carolina
Desire to Bend the Cost Curve Drives Reform

Median Household Income Compared to Total Health Care Costs

Source: 2011 Milliman Index
Pace of Acquisitions/Mergers Accelerating

Hospitals Acquired/Merged

<table>
<thead>
<tr>
<th>Year</th>
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<td>2002</td>
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Pace of Acquisitions/Mergers Accelerating (Another View)

Center for Healthcare Economies and Policy (AHA)
2013 Pace

• First three weeks of July
  – Approximately two dozen hospital and health system mergers, acquisitions, partnerships, affiliations announced or completed.

• Biggest announcement – Tenet Healthcare Corp. (Dallas) to acquire Vanguard Health System (Nashville)
  – $4.3 billion deal ($1.8 billion cash; $2.5 billion debt assumption)
  – Tenet will
    ◊ have 81 hospitals when finalized (#2 for-profit hospital chain in revenue, #3 in number of hospitals)
    ◊ gain market share in new areas; Chicago, Detroit, San Antonio, Phoenix & New England
    ◊ gain health plans associated with Vanguard
    ◊ Gain market share for its business operations subsidiary, Conifer Health Solutions
Changes in Factors Behind Consolidations

**Historical Factors**
1. **Medicare** reimbursement pressures
2. Increased capital need for **inpatient** facilities
3. Possibility that tax-exemption benefits may **diminish**
4. **Limited access** to capital for lower-rated hospitals
5. Need to **reduce operating expenses**
6. Need to **increase admissions, market share**
7. Need for size & scale to **leverage payers**

**Current Factors**
1. **All payers** creating reimbursement pressures
2. Increased capital need for **O/P facilities & I.T.**
3. Pressure to **justify** tax-exempt status
4. **Costly access** to capital for smaller hospitals
5. Need for **fundamental changes in healthcare delivery**
6. Need to **increase covered lives**
7. Need for size & scale to **gain greater efficiencies**
8. Costly regulatory and compliance changes
9. Riskier debt structures, costly interest rate swaps, onerous bank covenants
10. Need for greater alignment with physicians & payers to create ACO or ACO-like structures
11. Spiraling healthcare costs and insurmountable federal deficit
12. Large unfunded pension liabilities
13. Prolonged economic downturn

Additional Drivers of Integration

- **Additional Historical Drivers**
  - Physician recruitment/retention
  - Management services depth
  - An uncertain future

- **Additional Current Drivers**
  - Value Based Purchasing & other new payment models
  - Population health management
  - Physician shortages, compensation, and changing expectations
  - Don’t be left out of the game
  - Fear of both the known and unknown future
Consolidation Participants

• New players have entered the hospital industry
  – Payers are acquiring hospitals, such as
    ◊ Highmark/West Penn Allegheny
    ◊ Humana/Concentra
    ◊ WellPoint/CareMore
  – Hospitals and payers are affiliating
    ◊ Banner Health Network/Aetna (Arizona)
    ◊ Steward Health Care/Tufts Health Plan (Boston)
  – Private equity firms are acquiring hospitals & systems
    ◊ Have long backed HCA and Vanguard
    ◊ Cerberus – Caritas Christi Health System (Boston-Now Steward Health Care)
    ◊ Oak Hill Capital Partners JV with Ascension Health to acquire distressed Catholic hospitals
Consolidation Participants

• **New players have entered the hospital industry**
  
  – **Joint ventures** between for-profit and not-for-profit hospitals/systems
    
    ◊ Health Management Associates (to be acquired by Community Health Systems)
    ◊ Community Health Systems (Cleveland Clinic)
    ◊ LifePoint (with Duke University Health System)
  
  – **Not-For-Profit Health Systems to bring**
    
    ◊ Clinical quality, safety, physician relations, etc.
  
  – **For-Profit Health Systems to bring**
    
    ◊ Operational efficiencies, supply cost management, revenue cycle management, etc.
Appropriate Process (Not Just Because Everybody’s Doing It)

1. **Hospital Strategic Plan**, stating clear:
   A. Long-Term Goals
   B. Multi-year success strategies
   C. Annual tactics (with subsequent linkage to annual budget)

2. **Then filter against**
   A. What strategies can be accomplished independently
   B. What strategies need external resources

3. **If enough strategies require external resources**
   A. Appoint an Information-Gathering Committee (Board, physicians, admin.)
   B. Identify potential partner hospitals or systems operating in region
   C. Circulate Request for Expression of Interest (RFEI) to potential partners
   D. Execute Non-Disclosure Agreements with interested potential partners
   E. Circulate Request for Proposal (RFP) to interested potential partners
   F. Review proposals & invite on-site presentations
   G. Develop term sheet(s) for most acceptable potential partner(s)
   H. Carry out initial due diligence
   I. Negotiate definitive agreements (binding)
   J. Final Due diligence/Regulatory Approvals
   K. Closing on Affiliation/Transaction
Potential Affiliation Relationship Paradigm

- What are the strategic objectives of the parties?
- What degrees of independence / control are we willing to explore?
- What form of relationship will best allow us to achieve our objectives?
- What barriers need to be considered, and how will they be addressed?

Degree of Economic Alignment/Commitment

Potential Loss of Local Control
Special Member

- Analogous to minority ownership in a for profit situation
- Large system makes investment in small hospital
- Large system treats as equity investment (not a gift or loan)
  → creates alignment of interests
- Large system may treat as “Beneficial Interest” (x% ownership position)
- Large system receives consideration for investment
  - Board seats
  - First right of refusal: clinical relationships, administrative services, conversion to Sole Member
  - Reserved Powers, e.g. issuance of debt, to protect value of investment
- Large system and small hospital able to a) enter into risk contracts together, and b) enter into other contracts together after clinical integration
Role/Control of Corporate Member defined by “reserved powers”
- May be extensive or limited (Sole Member “Heavy” or “Light”)
- Creates ability to consolidate financial reporting = financial alignment

Interests are aligned: economic, quality, strategic

Managed care contracting can be fully integrated

Distinct Entity status = potential separate employer, limits impact on employees
Illustrative Reserved Powers (System Approval Required)

- Issuance of Debt through System
- Changes in Articles/Bylaws which dilute System rights
- Sale of significant assets
- Final appointment of Board members
- Compliance and Audit
- Change in Corporate Members
- Selection/Termination of CEO
- Approval of other affiliations
- Budgetary approval
- Approval of Strategic Plan
- Employment as system, employment policies
- Marketing initiatives
## Sole Member Illustrative Examples

<table>
<thead>
<tr>
<th>West Hospital: Sole Member “Light”</th>
<th>East Hospital: Sole Member “Heavy”</th>
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<tr>
<td>• Remains distinct corporate entity</td>
<td>• Remains distinct corporate entity</td>
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<tr>
<td>• Remains distinct employer</td>
<td>• Employees become system employees</td>
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<td>• Remains distinct medical staff</td>
<td>• One medical staff for system</td>
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<tr>
<td>• Retains local Board, with 2 system Board seats</td>
<td>• One System Board serves as Board for all entities</td>
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<td>• Board appointments follow local nomination process</td>
<td>• System Board members are local Board</td>
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<td>• Budget approvals follow local budget formulation, approved or consolidated basis only</td>
<td>• Top down budget, line item approval</td>
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<tr>
<td>• Strategic plan approval follows local process</td>
<td>• Top down strategic plan</td>
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<td>• CEO appointment: two to hire, one to fire</td>
<td>• CEO appointment: System based</td>
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<td>• Local patient satisfaction and quality management, with System support where requested</td>
<td>• System functions same at all entities</td>
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<td>• Purposeful retention of local culture</td>
<td>• Purposeful application of system culture</td>
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<td>• Local operations retained; system support where requested</td>
<td>• Operations system/corporate based</td>
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Full Asset Merger: Operating Division

- Full asset merger
- No real governing board retained; full control by Large System B
  - May be a local “advisory board” with some delegated powers
- No distinct entity; employees become employed by Large System B
For-Profit Acquisition

- Small hospital is purchased by national/regional for-profit system.
- Transaction typically involves a combination of cash paid to a local entity (such as a Foundation) and agreement to invest capital in local facilities.
- A local advisory Board, with very limited role, may be retained.
- Operating models (financial, staffing, patient satisfaction, quality, employee relations, etc.) are typically those of the for-profit corporation, with limited latitude for variance locally.
Consolidation Models Have Varied Rating Impact

<table>
<thead>
<tr>
<th>Consolidation Model</th>
<th>Credit Positives</th>
<th>Credit Negatives</th>
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<tbody>
<tr>
<td>1. Acquisition of a not-for-profit hospital by a for-profit hospital</td>
<td>100% debt repayment</td>
<td>N/A as rating is withdrawn</td>
</tr>
<tr>
<td>2. Acquisition of a not-for-profit hospital by a larger not-for-profit hospital</td>
<td>100% debt repayment</td>
<td>N/A as rating is withdrawn</td>
</tr>
<tr>
<td>3. Merger between not-for-profit hospitals</td>
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<td>- Scenario 1 - debt remains outstanding for both hospitals with no change in debt security</td>
<td>&gt;Greater synergies as a larger system with critical mass, particularly if in same or adjacent markets</td>
<td>&gt;Hospital may lose local control over strategic direction and expenditures once part of a larger system, more restricted ability to determine capital spending may result in loss of market share</td>
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<td>&gt;Ability to spread costs over a larger enterprise</td>
<td>&gt;Increase demands on finite capital as part of a larger system</td>
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<td>&gt;Greater diversification of cash flows</td>
<td>&gt;Short-term merger difficulties, such as medical staff integration or cultural differences</td>
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<td>&gt;Greater access to capital as a larger enterprise</td>
<td>&gt;Governance issues of legacy hospitals: “us” versus “them” mentality</td>
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<td>&gt;May result in higher rating for both organizations either immediately or over time</td>
<td>&gt;Financial disruptions if financial systems are different, or reserve methodologies are different</td>
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<td>- Scenario 2 – debt is guaranteed by higher-rated hospital</td>
<td>&gt;Upgrade of lower-rated hospital to that of higher-rated hospital if guaranty meets Moody’s methodology and Moody’s determines there is no impact to the guarantor’s rating</td>
<td>&gt;Downgrade may occur if the performance of the lower-rated hospital weakens the credit-worthiness of the higher-rated hospital</td>
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<td>- Scenario 3 – each hospital joins the other’s obligated group</td>
<td>&gt;May result in higher rating for both organizations immediately or over time</td>
<td>&gt;Downgrade may occur for the higher-rated hospitals if the performance of the lower-rated hospital weakens the credit-worthiness</td>
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Scenario 2 – debt is guaranteed by higher-rated hospital
- Scenario 3 – each hospital joins the other’s obligated group
## Consolidation Models Have Varied Rating Impact

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<tr>
<td>4. Affiliation between payer and not-for-profit hospital (no change in debt security)</td>
<td>&gt;Access to larger unrestricted resources&lt;br&gt;Benefits of joining larger enterprise with financial expertise&lt;br&gt;May result in upgrade of hospital’s rating if financial performance improves over the longer term</td>
<td>&gt;Untested strategy for both payer and provider&lt;br&gt;Potential misalignment of focus and resources if mission is unclear and goals conflict, leading to a downgrade</td>
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<td>5. Joint operating companies or agreements</td>
<td>&gt;Nearly the same as full asset merger&lt;br&gt;Upgrade may occur if debt is guaranteed by the larger JOC hospital</td>
<td>&gt;Disruptions may occur if leadership and governance roles are blurred or unclear from the start, multiple boards may create governance issues and inability to execute strategies</td>
</tr>
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<td>6. Joint ventures between not-for-profit hospitals and for-profit hospitals</td>
<td>&gt;Likely the same as an acquisition with 100% debt repayment</td>
<td>&gt;N/A as rating is withdrawn</td>
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<tr>
<td>7. Joint ventures between not-for-profit hospitals and for-profit hospitals to form limited liability company (LLC) for growth strategy</td>
<td>&gt;Increment cash flow; geographic diversification</td>
<td>&gt;Credit implications may be present depending on the strategic and financial linkages of the LLC to the not-for-profit system, such as debt guarantees or potential capital calls; use of system resources</td>
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“New Forces Driving Rise in Not-for-Profit Hospital Consolidation,”
Moody’s Investor Services, March 8, 2012.
Fitch Ratings Comments

“While traditional factors such as economies of scale, access to capital and market share continue to play a role in hospital consolidation, a Fitch survey revealed strategic considerations and preparation for healthcare reform were the primary drivers in 2012 – leading to consolidation activity not seen in over a decade,” said Adam Kates, Director in Fitch’s Public Finance group.

The implementation of new strategies, while potentially positive, introduces execution risk. Hospitals have been taking steps, including strategic partnerships and incremental adoption of new operating models, to mitigate some of the execution risk.

Given the capital resources and managerial expertise new alignment strategies require, the credit-metrics gap between lower rated and higher rated hospitals is expected to continue to widen.

Fitch Ratings, January 23, 2013
Post-Acquisition Performance

• Deloitte’s finding from a review of financial performance of 101 acute care hospital transactions in 2007 & 2008:

  1. National systems appear to be more successful in gaining financial value from M&A deals compared with local and regional chains.
     A. National chains increased margins by 72% from 2007 to 2010.
     B. During same period, local and regional chains increased margins by 11%.

  2. Regional health system acquisitions still hold value, though.
     A. In 2008, the median EBITDA for hospitals acquired by a local or regional chain was -1.8%
     B. By 2010, EBITDA jumped to 5.2%

  3. Successful hospital acquirers, national and regional, showed strong post-deal expense management.

  4. National chain acquisitions generally gained higher volume increases than regional ones (58% vs. 16%).
Status of Consolidation
In the Carolinas
North Carolina Hospitals (as of 8/26/13)

- Fully Independent (15)
- Hospital in Systems (96)
- Independent, but Aligning (4)
- Independent, but Externally Managed (5)
South Carolina Hospitals (as of 8/26/13)

- Independent NFP (20)
- Not-For-Profit Sys (39)
- For-Profit Systems (30)
- State & Federal (12)
South Carolina (Not-for-Profit) Systems

- **Bon Secours St Francis Hlth Sys (2)**
  - St. Francis Downtown (Greenville)
  - St, Francis Eastside (Greenville)

- **Carolinas HealthCare System (10)**
  - AnMed Health Medical Center
  - AnMed Health Rehabilitation Hospital
  - AnMed Health Women’s & Children’s Hospital
  - Bon Secours Saint Francis Hospital (Charleston)
  - Cannon Mem Hosp (Pickens)
  - Carolinas Hospital Marion (Mullins)
  - Roper Berkeley Day Hospital (Charleston)
  - Roper Hospital (Charleston)
  - Roper Hospital North (Charleston)
  - Roper Rehabilitation Hospital (Charleston)

- **McLeod Health (3)**
  - Loris Comm Hosp (Loris)
  - McLeod Reg Med Ctr (Florence)
  - Wilson Medical Center (Darlington)

- **Palmetto Health (5)**
  - Children’s Hosp of Palmetto Health (Columbia)
  - Palmetto Health Baptist (Columbia)
  - Palmetto Health Baptist Easley (Easley)
  - Palmetto Health Baptist Parkridge (Columbia)
  - Palmetto Health Richland (Columbia)

- **Greenville Hospital System (10)**
  - Allen Bennett Memorial Hospital (Greer)
  - Brownell Ctr for Behavioral Health (Greenville)
  - GHS Children’s Hospital (Greenville)
  - Greenville Memorial Hospital (Greenville)
  - Greer Memorial Hosp (Greer)
  - Hillcrest Hospital (Simpsonville)
  - Laurens County HC Sys (Laurens)
  - Marshall I. Pickens Hospital (Greenville)
  - North Greenville LTAC Hospital (Travelers Rest)
  - Roger C. Pierce Rehab Hospital (Greenville)
South Carolina (Not-for-Profit) Systems

- **Novant Health (1)**
  - Upstate Carolina Med Ctr (Gaffney)

- **Shriners Hospitals for Children (1)**
  - Shriners Hospital (Greenville)

- **Sisters of Charity Health System (1)**
  - Providence Hospital (Columbia)

- **Spartanburg Regional HC Sys (3)**
  - B.J. Workman Memorial Hosp. (Spartanburg)
  - Spartanburg Hosp. for Restorative Care (Spartanburg)
  - Spartanburg Regional Med Ctr (Spartanburg)

- **Georgetown Hospital System (2)**
  - Georgetown Mem Hosp (Georgetown)
  - Waccamaw Comm Hosp (Murrells Inlet)

- **Shriners Health System (1)**
  - Greenville Shriners Hosp
South Carolina (For-Profit) Systems

- **Community Health Systems (6)**
  - Chesterfield General Hospital (Cheraw)
  - Marlboro Park Hospital (Bennettsville)
  - Springs Memorial Hospital (Lancaster)
  - Former Triad Hospitals
    - Carolinas Hosp System (Florence)
    - Carolinas Hosp System (Lake City)
    - Mary Black Mem Hosp (Spartanburg)
- **Resurgence Mgmt Co. LLC (1)**
  - Barnwell County Hosp (Barnwell)
- **Trident Health (HCA South Atlantic) (7)**
  - Archdale Med Ctr (Charleston Heights)
  - Daniel Island Med Ctr (Charleston)
  - Colleton Med Ctr (Walterboro)
  - Grand Strand Regional Med Ctr (Myrtle Beach)
  - Monck’s Corner Med Ctr (Monck’s Corner)
  - Summerville Med Ctr (Summerville)
  - Trident Med Ctr (Charleston)
- **Health Management Assoc. (3)**
  - Carolina Pines Regional Hosp (Hartsville)
  - Chester Regional Medical Center (Chester)
  - Upstate Carolina Medical Center (Gaffney)
- **Tenet Healthcare Corporation (4)**
  - Coastal Carolinas Med Ctr (Hardeeville)
  - East Cooper Regional Med Ctr (Mount Pleasant)
  - Hilton Head Hospital (Hilton Head Island)
  - Piedmont Medical Center (Rock Hill)
- **Universal Health Services (9)**
  - Aiken Regional Med Ctr (Aiken)
  - Aurora Pavilion Behav Hlth (Aiken)
  - Carolina Ctr for Behav Hlth (Greer)
  - Lighthouse Care Center (Conway)
  - Palmetto Behav Hlth (Florence)
  - Palmetto Behav Hlth (North Charleston)
  - Palmetto Behav Hlth (Summerville)
  - Three Rivers Behav Hlth (West Columbia)
  - Three Rivers Res Tmt Midlands (W. Columbia)
South Carolina State & Federal Hospitals

- **Medical University of South Carolina (3)**
  - MUSC Children’s Hosp (Charleston)
  - MUSC Medical Center (Charleston)
  - Charleston Mem Hosp (Charleston)

- **SC Dept of Mental Health (5)**
  - Earle E. Morris Jr Alcohol & Drug Addiction Tmt Center (Columbia)
  - G. Weber Bryan Psych Hosp (Columbia)
  - Greenville Mental Hlth Ctr (Greenville)
  - Patrick B. Harris Psych Hosp (Anderson)
  - William S, Hall Psych Inst (Columbia)

- **Military Hospitals (2)**
  - Moncrief Army Comm Hosp (Ft. Jackson)
  - Naval Hosp Beaufort (Beaufort)

- **Veterans Admin. Hospitals (2)**
  - Ralph H. Johnson VA Med Ctr (Charleston)
  - William Jennings Bryan VA Med Ctr (Columbia)
South Carolina Independent Community Hospitals (20)

- Abbeville Area Med Ctr (Abbeville)
- Allendale County Hosp (Fairfax)
- Barnwell County Hosp (Barnwell)
- Beaufort Mem Hosp (Beaufort)
- Clarendon Mem Hosp (Manning)
- Conway Med Ctr (Conway)
- Edgefield County Hosp (Edgefield)
- Fairfield Mem Hosp (Winnsboro)
- Hampton Reg Med Ctr (Varnville)
- Hitchcock Rehab Ctr (Aiken)
- Hope Hospital (Lockhart)
- Kershaw County Med Ctr (Camden)
- Lexington Med Ctr (West Columbia)
- Newberry County Mem Hosp (Newberry)
- Oconee Med Ctr (Seneca)
- Regional Med Ctr of Orangeburg & Calhoun Counties (Orangeburg)
- Self Regional Hosp (Greenwood)
- SpringBrook Behavioral (Travelers Rest)
- Tuomey Regional Med Ctr (Sumter)
- Wallace Thomson Hosp (Union)
- Williamsburg Reg Hosp (Kingstree)

How many will still be independent at this time next year?