The Advisory Board Company | Health Care Advisory Board

RESEARCH BRIEFING

M&A—To What End?

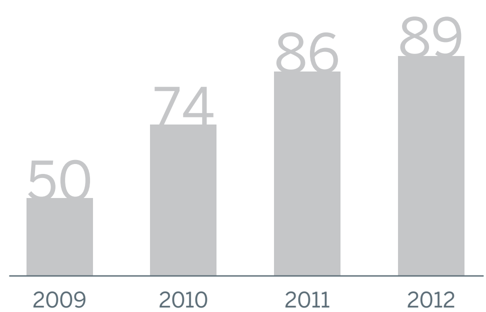
Five Characteristics of Intentional Corporate Strategy

We are in the midst of the most significant period of **provider consolidation** in the last 30 years.

Hospitals, physician practices, and integrated health systems have seen periodic flurries of deal-making in the past, but rarely has the American health care provider sector experienced such sustained increases in mergers and acquisitions (M&A) activity as it has in recent years.

Over the last four years, the number of announced hospital and health system M&A transactions has almost doubled—a tally that grows even more if you include deals that failed before they were concluded. Add this to massive shifts toward physician practice acquisition and employment, and the recent consolidation becomes even more remarkable.

Number of Closed Hospital Transactions



88% of provider executives plan to pursue M&A within the next 12 months

The consolidation trend may be only just beginning. Interviews with hospital and health system executives, as well as our own analyses, suggest that hospital and health system M&A activity will continue to accelerate in 2014. Our findings square with a recent GE Capital survey of provider executives: 88% plan to pursue a merger or acquisition within the next 12 months.

However, executives must proceed with caution. We see a fundamental shift in the value associated with M&A that should change the way leaders vet prospective partners and the upside expectations they communicate to internal and external stakeholders.

Success in the market will no longer be derived from higher prices.

Over the past few years, many health care providers have been pursuing mergers and acquisitions in an effort to consolidate their competitive position in local markets, securing richer referral streams, and acquiring greater price leverage. But these benefits of scale are increasingly hard to come by as the health care industry evolves and matures.

Still, we see boards and management teams, from the smallest private practices and community hospitals to the largest for-profit chains, continuing to narrowly focus on scale as the primary motivation for M&A. They are asking each other, and asking us: "How big is big enough?"

But these days, "How big is big enough?" is a worthy but insufficient question. Size alone, and size's legacy benefits, will not be enough for health systems to grow profitably in the emerging environment.

Emerging limitations to traditional benefits of scale in health care industry

Consolidating Market Position	Hospital markets in 75% of all MSAs already “highly concentrated” by FTC/DOJ guidelines	Heightened scrutiny on physician employment, particularly specialty practice acquisitions
Locking Up Referral Streams	Fewer physicians remain unaffiliated	Network “leakage” from scheduling inefficiency and limited evidence of patient benefit
Increasing Price Leverage with Private Insurers	Shrinking population of commercially insured patients	Purchasers refusing price increases, punishing high-cost providers with transparency tools

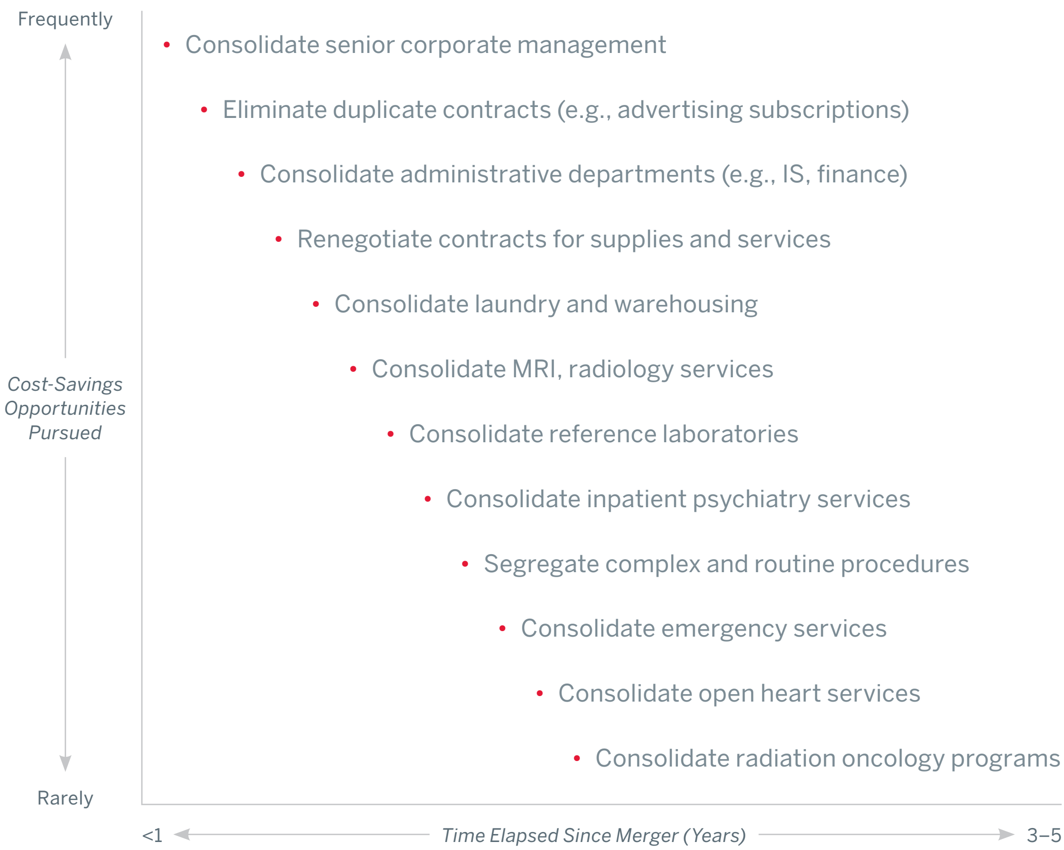
It has been difficult—and rare—for health systems to get significant economies of scale from M&A.

That's not to say that size is unimportant—far from it. Economies of scale do continue to exist in the health care provider industry, but to capture them, health systems need to maintain a relentless focus on cost savings and make numerous difficult operational decisions—ambitions that often dissolve in the face of institutional inertia, pressure from stakeholders, and the sheer magnitude of the task.

So executives ought to view deals that promise significant cost savings, immediately or even over the long haul, with an abundance of skepticism.

Few networks even attempt to pursue full range of cost savings

Cost-Savings Opportunities Pursued



Defensive deals remain sometimes unavoidable, but they are particularly risky.

In many recent cases, provider consolidation has really been a way to play defense. With new market entrants and expanding regional competitors threatening traditional volumes, many health care providers feel compelled to merge with another organization for financial stability.

Moreover, many institutions fear getting shut out of future deals by staying on the sidelines. In an active M&A environment, they worry that if they don't make a deal, their competitors will, and they will no longer have the option to acquire assets, competencies, or revenue streams down the road.

These are rational concerns, and valid reasons to pursue consolidation. However, the urgency associated with defensive M&A often means that executives proceed too rapidly, without evaluating all options or completing the planning necessary to integrate successfully.

And even if the transaction was the best possible strategic decision at the time, the consolidation and its aftermath will inevitably distract key executives at a time when the margin for error in strategy and operations remains razor-thin.

"I spent the last three months negotiating with myself to acquire a medical group that has done business with us for 15 years. There's no celebration dinner after you close a deal where the only clear outcome is that we are guaranteeing the income of our 'partners.'"

Health system CEO in the Southwest

"We're stronger than ever, but with every satellite clinic our competitors open I feel a little less bullish. Honestly, we're better than they are clinically, but that won't matter when they unleash their war chest. So we're shopping for a regional partner who can help us level the playing field financially without diluting what makes us great."

Health system CEO in the Upper Midwest

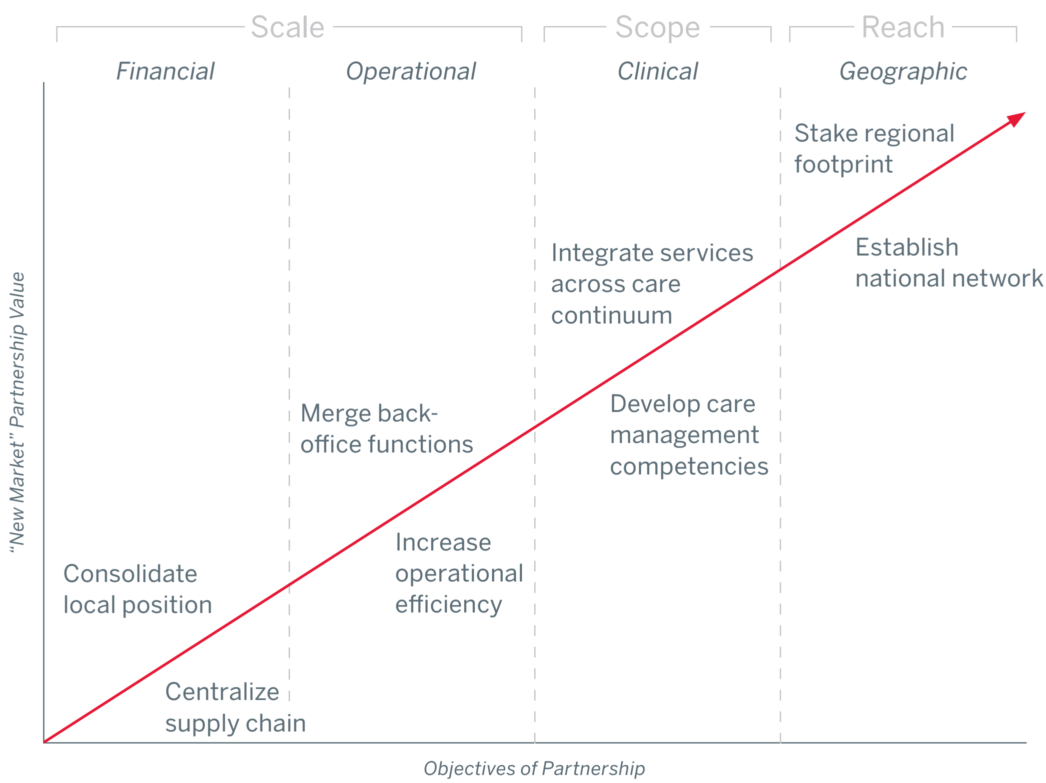
Increasingly, health systems see M&A as a way to gain scope and reach, not just scale.

Over the past few years, we have seen more and more health systems considering mergers, acquisitions, and affiliations that complement or extend their capabilities or geographies, not just their overall size. For example, we've seen organizations merging to get access to health plan capabilities, population health management assets, or even marketing prowess.

This is a natural evolution for provider strategy, since the entire hospital and health systems industry needs to become proficient at population health and cross-continuum management, among other important transformations. And all signs suggest that this trend will continue.

The caution to bear in mind, though, is that the returns on these "scope and reach" deals can take longer to realize than simpler "scale" mergers. It's hard enough to get two similar organizations to work together; it's much harder to integrate two organizations with fundamentally different orientations or operational domains.

Priorities of acquisitive health systems



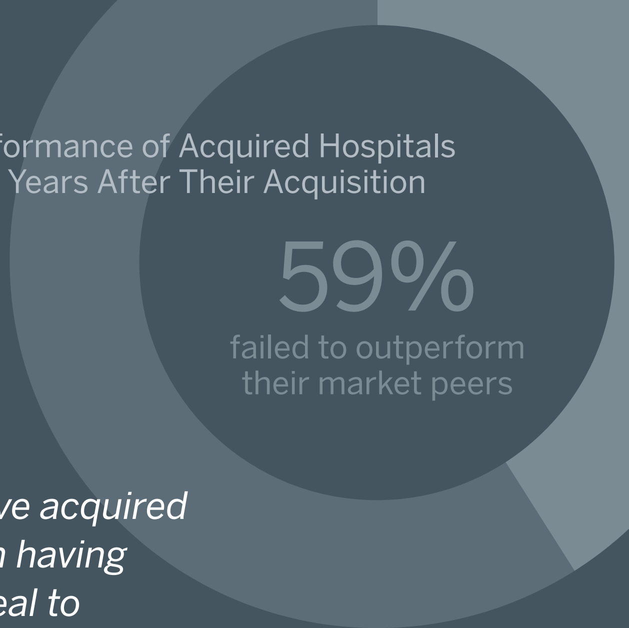
No matter what their intent, ill-conceived mergers and acquisitions end poorly.

Many studies of M&A both inside and outside of health care show that a majority of deals fail to create value, and what's more, far too many actually destroy value.

According to a recent Booz and Company review, about one in five hospitals start to lose money within two years of the transaction.

There is also a huge opportunity cost: CEOs from some of the most acquisitive health systems over the last few years report that they spend a disproportionate share of their time distracted by operational crises rather than pursuing new growth opportunities.

Performance of Acquired Hospitals
Two Years After Their Acquisition



> *"Disturbingly, about one in five acquired hospitals actually went from having positive margins before a deal to negative margins two years after a deal."*

Booz & Company

> *"The one thing my board took away from this retreat is that building a 'super-regional' footprint across 2012 has bought us a massive turnaround project for 2014. Sure we kept our competition at bay, but now we're fixing last year's mistakes instead of going after new opportunities with real upside."*

Health system CEO in the Mid-South

Successful deals result from intentional, not reactive, corporate strategy.

The health systems that are most successful in M&A are committed to intentional corporate strategy. They judge the value of potential affiliations, mergers, and acquisitions based on how they help deliver a better product to patients and purchasers—not how effectively they insulate the system from competition.

Five characteristics of Intentional Corporate Strategy:

1 Clarity of purpose

Intentional corporate strategy starts with a well-formed and clearly articulated organizational purpose.

2 Professionally managed pipeline

The M&A function should be an organized, routine process, not an episodic activity.

3 Transactional discipline

Not finding the right deals? Try cutting out the noise.

4 Scientific approach to cultural fit

Map cultural affinities and possible contradictions in parallel to financial due diligence.

5 Integration as core competency

When a deal closes, you should start executing the integration plan, not planning it.

1 Clarity of purpose

Intentional corporate strategy starts with a well-formed and clearly articulated organizational purpose.

This purpose provides a framework for assessing the organization's distinctive strengths and gaps.

It's up to the CEO to instill that purpose. Leaders of exceptional organizations in any industry ensure their statements of purpose and vision reflect clear choices about two things:

- **Who** the enterprise means to serve
- **How** the employees of the enterprise fulfill the enterprise's distinctive promise

TOYOTA

PURPOSE:

A manufacturer of a diverse lineup of vehicles all over the globe, well-known for its management philosophy and the world's first mass-market hybrids.

VISION

"[Leading] the way to the future of mobility, enriching lives with the safest and most responsible ways of moving people. Through our commitment to quality, constant innovation, and respect for the planet, we aim to exceed expectations."

RALPH LAUREN

A leader in the design, marketing, and distribution of premium lifestyle products in four categories: apparel, home, accessories, and fragrances.

"[Providing] quality products, creating worlds, and inviting people to take part in our dream. We were the innovators of lifestyle advertisements... and the first to create stores that encourage customers to participate in this lifestyle."

MAYO CLINIC

A nonprofit worldwide leader in medical care, research and education...joined by common systems and a philosophy of "the needs of the patient come first."

"To inspire hope, and contribute to health and well-being by providing the best care to every patient through integrated clinical practice, education, and research."

In other words, define the product you are trying to build...

Consumer-Oriented Ambulatory Network

- Maintains extensive network of outpatient care sites
- Offers convenient primary care, diagnostic, procedural services at competitive prices

Financially Integrated Delivery System

- Assumes full risk by offering health plan to subscribers
- Unifies care financing and delivery into single coordinated care enterprise

Best-in-Class Acute Care Destination

- Consistently delivers efficient, effective acute care episodes
- Ensures reliable coordination, communication, data sharing across the care continuum

Full-Service Population Health Manager

- Assumes delegated risk from payers and/or employers
- Prioritizes care management, coordination to limit avoidable demand

...and identify who must choose your product and what they want.

Commercial Payers

- Resisting further premium increases
- Building network for health insurance exchange products

Population Health Managers

- ACOs growing in number and reach
- Providers re-evaluating existing referral relationships

Activist Employers

- Increasingly becoming self-funded
- Bearing full accountability for employee costs

Clinical Shoppers

- Increasing number of patients enrolled in high-deductible health plans
- Growing public availability of provider cost and quality data

2 Professionally managed pipeline

The M&A function should be an organized, routine process, not an episodic activity.

M&A can't be treated as anyone's hobby, especially the CEO. Organizations that effectively source potential transactions that further the organization's strategy invest in dedicated leadership for the M&A function. Properly organized and directed, these teams are the execution arm for the tactics (M&A, JVs, affiliations, etc.) that serve to further the CEO's strategic vision.

Selling the value of your system is a full-time job. M&A directors need to stay attuned to opportunities in the market, gather better information than their counterparts at other systems, continuously "sell" organizations on the upside of working with their enterprise, and advocate specific actions urgently when justified.

High-Performance M&A Function

- **Source** opportunities proactively
- **Screen** pre-vetted targets
- **Conduct** due diligence
- **Execute** transactions
- **Formalize** integration process

Five key characteristics of successful M&A teams

1 **Explicit governance structure**

Management and reporting structures clearly delineated, decision makers understand scope of their oversight and when they need to step in.

2 **Well-defined framework for assessing potential targets**

M&A team uses consistent set of metrics and guidelines to objectively and quickly assess each potential acquisition.

3 **Rigorous approach to risk assessment**

Areas of financial and cultural uncertainty rigorously assessed and quantified during due diligence process; results ultimately used to inform deal structure, post-deal planning.

4 **Continuous reporting and audit process**

Clear standards set out for M&A reporting and benchmarking; team incentives ultimately tied to short- and long-term value creation.

5 **Hardwired process for knowledge retention**

Lessons and best practices learned throughout M&A projects are recorded and packaged into knowledge assets that can be leveraged during future deal-making.

3 Transactional discipline

Not finding the right deals? Try cutting out the noise.

There is a simple, disciplined approach to separate worthy opportunities from distractions: combine benchmarks for strategic relevance, financial return, and cultural fit with a limited set of intangible "non-negotiables" that automatically kill any deal.

Key Criteria for Potential Mergers or Acquisitions

1. Would partnering with this organization advance our long-term strategy and help us build a better product?
2. Does this organization meet established financial benchmarks?
3. Does this institution meet criteria for cultural alignment?

There are two other things to keep in mind when focusing on transactional discipline:

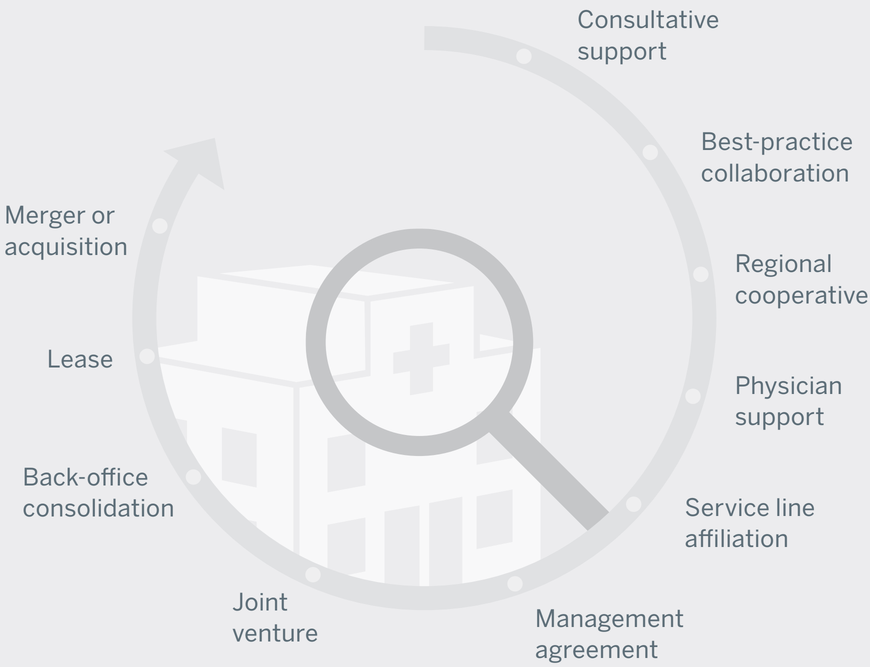
Speed. Be quick, but don't hurry.

Speed is an important measure of performance for the M&A function in two ways:

- When deals pass your filters, you must move through procedures expeditiously to overcome push-back from conservative factions within your organization.
- You want to kill non-conforming deals quickly to avoid wasting time.

Expansive view of options. Remember that M&A is not the only tool in your arsenal.

We don't live in the ideal world of pro formas and NPV models, so sometimes the numbers tell you one thing (it's a go) and your instincts another (maybe, but not right now). This is when you need to remember your range of options for partnerships.



4 Scientific approach to cultural fit

Map cultural affinities and possible contradictions in parallel to financial due diligence.

Executives are instinctively aware that cultural compatibility matters, but most fail to realize the true importance of actually assessing cultural fit and sometimes rely too heavily on personal interactions with counterparts.

You need to engage in the same information gathering and cultural analysis as you do on financial due diligence. That includes identifying cultural affinity and gaps by gathering data from executives, community board members, medical staff leadership and independent practices, competitors in the marketplace, management, and line staff.

Gather concrete metrics to quantitatively compare compatibility

5 Integration as a core competency

When a deal closes, you should start executing the integration plan, not planning it.

Even the most intelligently sourced transaction will fail if you don't effectively integrate the organizations. Great M&A functions are made or broken by the quality of integration execution.

The most successful organizations begin building an integration team and drafting a post-merger action plan during the due diligence period and, in many cases, before a letter of intent has even been issued.

Case Study

GE Capital replicates flexible yet robust integration process for each acquisition

Pre-acquisition:

This stage includes due diligence, negotiation and announcement, and deal close. Due diligence staff, including representatives from finance, business development, human resources, and information systems, in addition to company executives, achieve the following:

- Develop communication strategy to address audience, timing, mode, and message
- Perform preliminary cultural assessment to identify potential barriers to successful integration and assess the capabilities of potential leaders
- Select an integration manager to oversee the integration process full-time

Strategy formulation:

This stage includes the launch of the integration process, the acquisition integration workout, and strategy formulation. Senior-level management allocate resources and take the following immediate actions:

- Introduce integration manager
- Conduct orientation and planning sessions to jointly develop a 100-day integration plan
- Acclimate new GE leadership to business culture
- Determine accountability for integration process
- Visibly involve senior management

Integration:

The integration manager and executives oversee integration and course assessment and adjustment.

- Employ integration program and adapt integration processes according to feedback
- Utilize results of cross-cultural analysis to hold session with management, develop six-month plan for closing cultural divides
- Begin short-term management exchange

Post-integration:

This stage includes long-term refinements and value realization.

- Continue to develop common practices introduced during integration phase
- Continue long-term management exchanges
- Conduct corporate management education
- Audit integration process

Want to learn more?

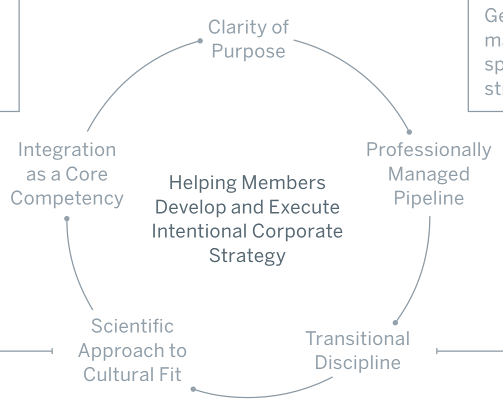
Build Your Blueprint for Corporate Strategy

Executing intentional corporate strategy is a marathon, not a sprint. Whether you are beginning to consider your options, or working on integration, the Health Care Advisory Board has the resources to help both buyers and sellers develop an intentional and intelligent corporate strategy, proactively source suitable acquisition targets or buyers, and manage a successful and value-creating integration.

Executive Strategy Workout
Onsite Intensive
Outline clear goals for your organization and internal communication strategy in multi-part, one-on-one CEO working sessions.

Best-in-Class Integration Planning
Executive Briefing
Capture returns on your investment with an action plan that begins at the outset of formal discussions and extends through the first 12 to 24 months post-merger or acquisition.

Best-in-Class Governance and Structure for the M&A Function
Executive Briefing
View profiles of successful approaches from inside and outside the health care industry. Get an inside look at decision-making structures, operational span of control, and sourcing strategies.



Key Determinants of Cultural Affinity Checklist
Decision Guide
Find out if your potential partner is a "true fit" before you commit. Measure cultural affinities and differences with our interview guides, key stakeholder mapping, and crosswalks.

Partnerships and Affiliations Diagnostic
Decision Guide
Arm your executive team, board members, and physician leaders with a clear framework and tools to weigh different alignment models along a spectrum from affiliation to M&A.

See these resources and more at advisory.com/corporatestrategy

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Sources:

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Health Care Advisory Board interviews and analysis.

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