Politics, Interest Rates, FTC Slow Hospital M&A

Hospital M&A Slightly Slows in the Third Quarter of 2016 But a Later Uptick is Expected

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Hospitals continue to lead in the total volume of healthcare transactions and also in mega deals, according to a new mergers and acquisitions (M&A) report. However, such deals slowed in the latest quarter.

The third quarter PwC deals report found U.S. hospital M&A activity was slightly down in the third quarter. However, Thad Kresho, leader of U.S. Health Services Deals for PwC expected no continued slowdown because many of the underlying issues driving consolidation remain.

Some issues affecting M&A relate to the presidential elections and market hesitation over the Federal Reserve raising interest rates.

"Players are wondering whether Obamacare will be repealed and how that might impact everything," Kresho said in an interview.

Kresho also blamed recent merger skittishness on antitrust scrutiny from the Federal Trade Commission into high profile hospital mergers.

"If you're the dealmaker, you're wondering what's going on and that gives pause," Kresho said.

The latest report indicated to the M&A specialist that hospital finance executives to whom no one is talking about strategic affiliations, joint ventures or mergers, may be the target, not the buyer.

"If you or your hospital aren't having these conversations, be concerned," said Kresho. "The hospitals subsector was the most active in terms of deal value, accounting for approximately 42 percent of health services transactions in Q3 2016," the PwC report noted.

Hospitals and health systems continue to expand their circle of care by acquiring more physician practices and growing market share through ambulatory surgery centers, urgent care centers and freestanding emergency departments (EDs), Kresho said.

"While the numbers may seem down a little, there's a lot happening and many of these conversations are done behind the scenes," Kresho said.

Kresho conceded that there remains uncertainly in capital markets, even with low interest rates.

"The big, strong players can still borrow, but lenders are a little pickier than they have been historically," Kresho said. "They've become more sophisticated in figuring out how these new reimbursement models work."

More Stagnation Findings

The latest M&A report by consulting firm Kaufman, Hall & Associates found 77 hospital transactions in the first three quarters of 2016, compared to 78 during the same period in 2015.

There was geographic merger concentration in New York and Pennsylvania, Kit Kamholz, managing director for Kaufman Hall, said in an interview.

“These states are not seeing a lot of population growth and are faced with over bedding and overcapacity issues, which are leading to more consolidation activity,” said Kamholz.

Additionally, 40 percent of hospital transactions during the quarter were among for-profit providers. That was an increase over the 20 to 25 percent of mergers that typically involve for-profit hospitals.

“More of the sellers are investor-owned and tend to sell to for-profit buyers,” Kamholz said. “We’re also seeing more distressed organizations experiencing higher levels of distress and those tend to go to for- profit organizations.”

Investor-owned giants like Community Health Systems, Quorum Health, and Tenet Healthcare are overleveraged and entering a selling mode, Kamholz said.

Another change is in the increasingly dynamic academic medical center (AMC) sector, which had eight transactions so far in 2016.

“By and large, they have been way behind successful regional health systems in developing networks and are now just catching up,” Kamholz said. “Typically, they are the highest-cost providers and are attempting to support research and academic, as well as clinical missions. Years ago AMCs were the mecca of healthcare. Many will be around for years, but the most successful will also join other healthcare organizations and become part of broader networks, rather than remaining stand-alone AMCs.”

Market Drivers

Gregory Hagood, senior managing director and head of overall M&A and healthcare practice for SOLIC Capital Advisors, an investment bank, has seen an acceleration of hospital consolidation. Most recently, that trend was characterized by two types of deals: regional consolidation, in which a large anchor health system buys up multiple hospitals around it, and mergers relating to bankrupt hospitals.

“We’re seeing the strong merging with the strong and really distressed hospitals merging with whomever they can,” Hagood said in an interview. “There’s a number of small community hospitals, often rural, and critical access hospitals struggling now and filing for bankruptcy or closing.”

In some cases, the distressed hospitals close and their owners reopen as primary care, urgent care or long term care centers or freestanding EDs, Hagood said.

The Affordable Care Act and its focus on quality performance are impacting at-risk hospitals, Hagood said.

“After years of seeing bonuses for implementing electronic medical records and adopting quality measures, now we’re seeing hospitals paying penalties,” Hagood said.

For-profit hospitals, collectively, are paring their portfolios as they face a challenging reimbursement outlook.

"Inpatient volumes are declining; we're seeing accelerated closure trends," Hagood said. "So people are cautious on taking on turnaround assets and investing in costly inpatient infrastructure. Shifting demographics is causing many rural hospital closings, even relative to 10 years ago. The population is moving out of those communities leaving behind the poor and elderly to sustain a modern hospital with diminished resources. Investments in technology also are forcing a move from small, older rural hospitals to bigger regional hospitals."

Hagood predicted that telemedicine will play a more disruptive force in hospitals over next three to five years.

For-profit hospitals face continued volume growth challenges and cost containment issues, according to a recent Moody's Investors Service report. Besides traditional mergers, Moody's sees different forms of strategic alignments, such as clinical affiliations or joint ventures that move hospitals closer to serving their patients' needs.

Dean Diaz, senior vice president of the corporate finance group for Moody's Investors Service, said high deductible insurance policies are making more individuals responsible for greater portions of their care costs and preventing some from accessing care.

"We're also starting to see a return to wage pressures on the cost side as hospitals employ more physicians, driving up wage costs," Diaz said in an interview. "Some hospitals are strategically targeting as many points of care as possible, planning for a time when bundled payments or capitation become the standard."

Few of the small market hospital closing are investor owned because there is rarely a lack of buyers, Diaz said.

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