Modern Healthcare

Dealmaking Stayed Hot in 2018, With a Focus on Physician Practices

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Stop me if you've heard this one: Consolidation was a trend that dominated healthcare over the past year.

Consolidation is hardly a new phenomenon, but the pace at which it's happening, the types of buyers and their targets all morphed in interesting ways in 2018.

Hospital consolidation, which continued at high levels, has almost lost its ability to surprise, especially given the sheer size of deals like the merger between Catholic Health Initiatives and Dignity Health, a deal expected before year-end that would create the nation's largest not-for-profit hospital company by revenue.

But the degree to which profitable physician practices are being gobbled up by a number of different buyers has been quite the spectacle.

This year, buyers hungry for acquisitions paid particular attention to specialty practices in such areas as orthopedics, cardiology, dermatology, gastroenterology and dentistry. Primary care is in strong demand, too.

As far as who is buying practices, it's a three-way race between the old hats—health systems—plus private equity firms and, a relatively new entrant: payers. UnitedHealth Group's OptumCare has been particularly aggressive about buying physician practices as part of its strategy to get as close to consumers as possible. But Centene Corp., Humana and Anthem are adopting a similar strategy as they work to control spending.

Private equity investors and payers may have the upper hand. Health systems are known to struggle when it comes to integrating practices into their operations, and often aren't willing to make the capital investments physicians demand, said Matt Caine, a managing director with SOLIC Capital. Groups like Optum, by contrast, are more inclined to support physicians' instincts. "I think their strategy is one that's quite remarkable relative to what's going on in the industry today," Caine said.

Physician practice acquisitions take on a number of forms. Carole Streicher, a partner with KPMG who leads its healthcare and life sciences deal advisory practice, said that sometimes different practice areas with one or two physicians are rolled up into groups with 50 or 100 different physicians.

The difference that Streicher has observed in recent acquisitions is a real focus on value creation. "What we're seeing is finance folks dive into 'How can we now create one plus one equals three?' " she said. "It's really the optimization of that business and how that can create better cash flow for the business overall."

Declining margins

Hospital margins continued to plummet in 2018, even as balance sheets remain stronger than ever. Martin Arrick, a managing director in S&P Global's U.S. public finance division, said health systems continued to depend heavily on non-operating income throughout the year, and non-operating margins exceeded that of operating margins.

“Normally it's the other way around,” he said. “That points to a dependence on non-operating income.”

That proved to be a thorn in the sides of some systems in 2018 when the stock market failed to deliver to the degree it did in 2017, a banner year. Oakland, Calif.-based Kaiser Permanente's net non-operating income fell 52% in the third quarter of 2018 year-over-year mostly due to the volatile equities market, but an executive told Modern Healthcare the system does not plan to change its investment strategy.

Arrick said S&P isn't likely to downgrade a system because of poor investment performance if its operating performance remains stable.

Even hospitals that are still seeing strong investment gains kept capital spending modest this year, according to a November report from Fitch ratings. One-quarter of hospitals had AA- ratings at the time of the report, up from 17% at the same time in 2017, mostly because Fitch's new rating criteria bumped hospitals up. Meanwhile, fewer hospitals were rated BBB+ or below.

Providers placed strong emphasis during the year on bringing in technology to centralize and standardize back-office tasks, said Tracey Coyne, a senior manager in Crowe's healthcare performance division. With that, teams were able to use those tools to analyze their operations from a broader perspective.

The year also saw providers' continued—albeit slow—march toward value-based care. There weren't any huge moves; more like providers gradually positioning themselves to take on risk, whether in the form of insurance contracts or through bundled payments, said Joe Fifer, CEO of the Healthcare Financial Management Association.

“There wasn't a big aha moment,” he said. “But I'm seeing steady preparation and the actuality of taking on more risk,” he said.

Fifer agreed providers are hesitant about the move toward value-based care given its potential to cut into their revenue. “It's human nature to be hesitant and quite honestly, it's human nature to gravitate toward something that's familiar,” he said. On a broader scale, it's healthy for providers to look at such arrangements strategically and analytically to understand how they'll work, Fifer said.

The year also saw a heavy emphasis on data analytics. Providers are investing more and more into being able to harness and analyze data to better understand their finances and operations. It's also been an important component in the evolution toward value-based care.

In some ways, 2018 saw examples of breaking from the traditional merger and acquisition strategies of the past as a way to rise above the disruption that's dogging the industry. Case in point: the merger between pharmacy chain CVS Health and health insurer Aetna to create a $70 billion company whose leaders say will reinvent healthcare for Americans. The new company, which promises cheaper, integrated healthcare, could deliver stiff competition for providers.

Another interesting move was not-for-profit health system ProMedica's purchase of the nursing home provider HCR ManorCare for $1.4 billion through a complex deal that required the conversion of HCR's for-profit facilities into not-for-profit assets. The combined entity includes 13 hospitals; health plans; assisted-living and memory-care facilities; skilled-nursing and rehabilitation centers; and hospice and home health services.

“They've got this huge initiative to get into the long-term care space and have really fundamentally changed the nature of their organization,” Arrick said.

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