McDonnell Investment Management

Mergers and Consolidation: Coping with the Changing Landscape for Health Care

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Consolidation of Health Insurers

The recent King v. Burwell Supreme Court decision (June 2015), which allows federal premium tax subsidies for insurance purchased on all public health insurance exchanges, set off a flurry of consolidation among the large health insurers. Recent activity includes Aetna's $37B purchase of Humana, Centene's $6.3B acquisition of Health Net, and Anthem's $54.2B purchase of Cigna.

The Affordable Care Act (ACA) incentivizes health insurers to cut both administrative and medical costs. By reducing administrative costs, savings drops directly to the bottom line. Cutting medical costs is less direct since 80-85% of premiums have to be spent on medical care. Requirements vary based on the size of the insured group. Larger groups are required to spend 85¢ of every premium dollar on medical care. By decreasing medical costs, insurers can limit premiums, which will attract more members and an additional 15¢ of profit from each premium dollar. That, in turn, improves competitiveness and enhances the insurer's pricing power versus providers. We believe consolidation adds scale and accomplishes these objectives.

Consolidation of Hospitals

Hospitals have been consolidating over the past few years in the face of expected pressures on revenues pursuant to the ACA, as well as broader pressures from Medicare, Medicaid, commercial insurers and the migration from a fee-for-service system to one focused on favorable outcomes and overall population health. Consolidation among health insurers adds another significant impetus for the trend in hospital consolidation to continue as larger combined hospital systems hope to exert market power on health insurers.

The Hospital merger trends that we have observed include:

- Mergers among equals in local or regional markets
- Large systems acquiring small hospitals
- Systems acquiring academic medical centers
- Hospital purchases of health insurance companies and physician practices in order to better coordinate care and manage population health

We generally view mergers, acquisitions and affiliations among not-for-profit hospitals positively since we believe they should result in operating synergies, as well as coordination of care, a higher degree of integration of activities such as purchasing, improved capital access and better bargaining position versus the health insurers. Risks include pressure from regulators that want to ensure that levels of care are maintained and that the costs for services do not rise. Also, certain acquisitions could be dilutive to the acquirer's earnings or expose it to different market risks.

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McDonnell's Research Approach

Our analysis of not-for-profit hospitals includes both top-down and bottom-up approaches.

As we take a top-down approach to analyzing hospitals, we consider both local and national economic trends, as they dictate employment levels and impact health insurance coverage levels, which affect hospital volumes, revenues and margins. We have observed that hospitals in Medicaid expansion states generally are reporting favorable trends in volumes, revenues and lower uncompensated care expenses. It is our practice to continually monitor both state and federal budgetary developments in order to assess the ultimate impact on Medicare and Medicaid.

Our bottom-up analysis considers the hospitals' market shares, service or geographic niches, trends in liquidity, margins, uncompensated care, volumes and the proportion of revenues from Medicare and Medicaid.

Potential Winners/Losers

Hospitals that are likely to succeed in the shifting landscape will be able to manage costs and deliver high quality service in a pressured revenue environment. We believe that strong market shares will lead to pricing power with both health insurers and consumers. Further, we favor hospitals with a history of strong liquidity and margins as well as manageable debt burdens. The ability to offer a continuum of care will be critical in order to stem outmigration, to track and control patient behavior to ensure quality and to better manage and coordinate population health.

Independent or smaller hospitals with lower shares in competitive service areas likely will be challenged to maintain or grow market share in the face of both hospital and health insurer consolidation. As a result, they may face a higher degree of pressure on revenues due to a lack of market power with health insurers and consumers and pressure on volumes as more patients seek care at larger hospital systems. They will also be pressured due to the inability to fully benefit from operating synergies and efficiencies gained from being part of a larger system. Further, weaker hospitals characterized by high rates of poverty and uninsured will be challenged, particularly those in states that do not expand Medicaid, where bad debts are likely to remain elevated due to lower rates of insured and higher uncompensated care.

Hospital consolidations, mergers, acquisitions and affiliations will be especially crucial in competitive markets. Consolidation among hospitals has already been progressing for a number of years due to the need to control costs and manage population health in a stressed revenue environment. The mergers among health insurers will add additional pressure for hospitals to join forces. Therefore, in our view the trend in hospital consolidation will not only continue, but in many cases will be necessary to ensure the viability of not-for-profit hospitals.

McDonnell Investment Management – Portfolio Management & Research Teams