Healthcare Merger Mania Drives Not-for-Profit Hospital and Health System Consolidation

By James LeBuhn
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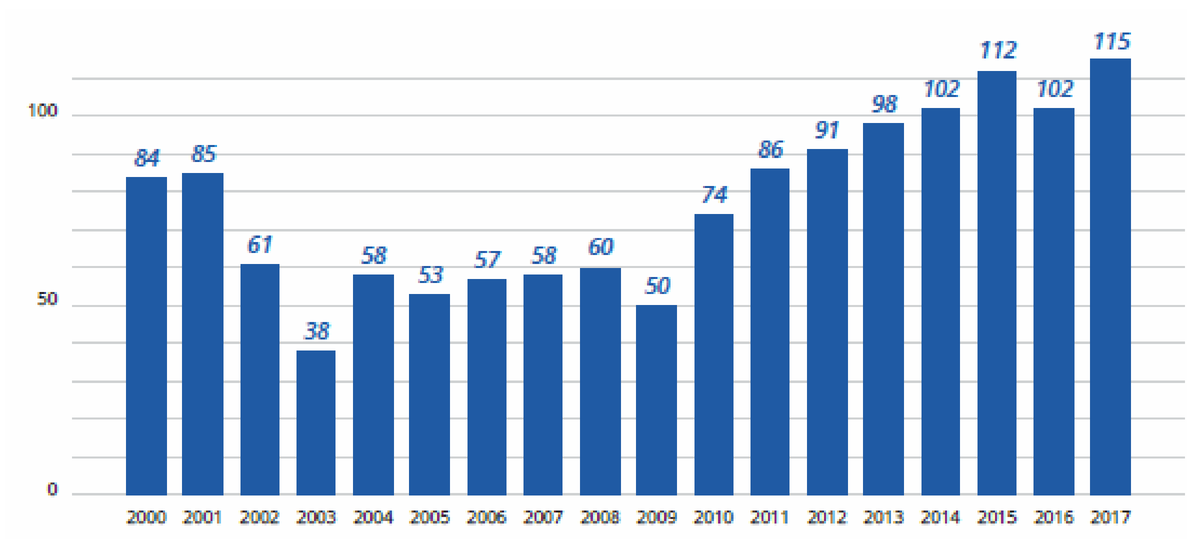
In March, Cigna announced plans to acquire Express Scripts for $67 billion after its planned merger with Anthem was blocked by the US Department of Justice. CVS and Aetna have agreed to a $69 billion merger less than a year after Aetna and Humana called off their proposed merger. Meanwhile, United Health's Optum unit has been acquiring physician practices, urgent care centers and ambulatory surgery centers in 35 key U.S. markets. In total, Optum-owned physician groups comprise about 30,000 physicians across the U.S.(1)

The consolidation trend among health insurers, pharmacy benefit managers and retail healthcare operators is also playing out among not-for-profit (NFP) hospitals and healthcare providers. According to Kaufman Hall, there were 115 announced merger and acquisition transactions involving a not-for-profit hospital or health system in 2017, the highest number in recent history.(2)

Hospital and Health System M&A Activity, 2000-2017



Source: Kaufman Hall

Historically, mergers and acquisitions in the NFP healthcare sector were driven by financial need or distress. However, since the passage of the Affordable Care Act (ACA) in 2010, "strategic" considerations have become the key driver in the growth of provider mergers, alignments and affiliations. Among the key changes in the ACA legislation was a reduction in the rate of increase in hospital reimbursement under Medicare and a movement away from reimbursement based on volume to reimbursement based on outcomes. Thus, the legislation incentivized hospitals and health systems to operate more efficiently and provide rewards to those organizations that could reduce the overall utilization of healthcare service of a given population.

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Similar to other consolidating industries (e.g. interstate banking in the 80's and 90's), NFP managements and boards are pursuing "strategic" mergers and acquisitions to realize increased economies of scales, (in non-clinical shared services such as information technology, billing, insurance and supply chain), reduce clinical variation and improve outcomes, capture a larger patient population and enhance contracting leverage vis-a-vis consolidating managed care providers. While the trend of smaller stand-alone community hospitals being acquired by a larger system remains robust, the merger of larger, highly rated systems has been a newer development over the last 12-24 months. Some of the more noteworthy mergers (announced or completed) in the NFP sector include the merger of Advocate Health (IL) and Aurora Health (WI), with combined revenues of $11 billion; the proposed merger of Dignity Health (CA) and Catholic Health Initiatives (CO), with combined revenues of $27 billion; and the announced merger of Mercy Health (OH) and Bon Secours (MD), with combined revenues of $8 billion.

Conclusion

We remain constructive on the NFP hospital and healthcare sector despite an increasingly challenging operating environment. While operating margins are expected to be compressed in 2018 and beyond, the strong liquidity positions and improving balance sheets of many investment grade hospitals serve to mitigate the expected compression in profitability. We view the consolidation among NFP hospitals and health systems as a positive credit development for selective investors in tax-exempt healthcare bonds. The acquired hospital typically gets access to lower cost capital as well as the operational benefits of more efficient shared service and supply costs. Similarly, the acquiring system gains greater scale and wider geographic coverage (as well as the net assets) at a lower cost than building a new hospital and/or outpatient network. While an acquisition may be dilutive to financial performance in the near-term, more often than not, the realization of the forthcoming strategic benefits and the economies of scale of the merger may enhance the credit profile of the combined entity and reward investors over the longer term.

Sources:

1) Moody's Investor Service "Hospitals Face New Threat from Health Insurers' Disruptive Growth Strategies," Feb. 21, 2018
2) Kaufman Hall "2017 in Review: The Year M&A Shook the Healthcare Landscape," 2018