Professional Perspective

Strategic Combinations May Be One Antidote for Acute Care Hospitals

Ken Marlow, Wells Beckett, and Dean Balaes, K&L Gates

Bloomberg Law

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Acute care hospitals provide indispensable services to communities across the US, offering a depth and breadth of inpatient care for episodic illnesses, trauma, and surgery, as well as other services. However, these hospitals face significant financial and operational challenges. Such challenges include the rising costs of care, staffing shortages, downward reimbursements, and in some cases, financial distress and even threats of bankruptcy.

The stark reality is that when systems are in the red, fundamental questions arise about the best course of action for the future. Acute care hospitals have faced historic financial challenges since the start of the Covid-19 pandemic. Simply put, hospitals have been spending more money than they make, resulting in reductions in services, bankruptcies, and closures. Indeed, 44% of hospitals were already operating at a loss before suffering the negative impacts of the pandemic.

While the factors influencing the financial viability of acute care hospitals are considerable, they are not insurmountable. This article examines these challenges and explores considerations for health care stakeholders thinking about a potential partnership or other strategic combinations to solve for these problems.

Downward Reimbursements Are Trending

The Medicare Payment Advisory Commission (MedPAC), which acts as an independent advisor to Congress, evaluated payment adequacy and found that Medicare's payments to hospitals were lower than hospitals' costs in aggregate (-8.3%). The existing adjustments are of particular concern when inflation is high, because, unlike other businesses that tend to pass increased costs on to consumers, hospitals largely absorb these costs.

MedPAC predicts that in 2023, margins will remain lower, partly due to the expiration of federal relief funds and spikes in input costs—e.g., inflation and the attrition of medical workers from the sector. For example, from 2019 to 2021, the cost of providing labor has increased by 19.1%—a stark spike when one considers labor costs typically account for 50% of hospitals' total expenses.

These headwinds are raising questions among health care boards of directors and executive leadership teams that are evaluating the best ways to ensure the future health and success of their health systems. Now more than ever, systems are having to grapple with the stark reality that getting these decisions right will be critical to their survival in the future. This environment has resulted in a significant uptick in the number of hospitals and health systems considering strategic arrangements, whether it is from affiliations of service lines and clinically integrated networks or through more fully integrated transactions, such as joint ventures, membership substitutions, or acquisitions.

Financial & Operational Challenges Are Encouraging Strategic Combinations

Once fiercely independent systems are now realizing that the challenges ahead may require a partner to leverage cost reductions, negotiate more favorable business terms with group purchasing organizations (GPOs), increase access to capital, create growth opportunities, and foster other economies of scale and skill. Systems that recognize the challenges and undertake strategic exercises to evaluate the potential opportunities of the health system to seek such benefits of a partner will be better positioned to adapt to inevitable future challenges.

Moreover, it is important that such health systems undertake these exercises and evaluate opportunities when they sit in a position of relative strength rather than to turn a blind eye and likely face further financial deterioration. Most importantly, a potential affiliation or partnership may offer existing systems access to enhanced revenue which will help offset some of the mounting costs and better position the system from challenges by competitors.

For example, many rural acute care hospitals with low patient acuity and dwindling adjustments for outpatient services are very aware that the financial viability of acute care hospitals depends on factors such as patient census, private and government reimbursement rates, and clinician and staff recruitment and retention. These hospitals are not paid enough to cover the costs of providing patient care, and may be served well by cross-market or in-market combinations that allow for offsetting costs, leveraging assets across the health system, and making necessary capital investments.

Health Care Leaders Should Identify the Key Goals for a Potential Combination

When evaluating potential strategic combinations, directors and trustees should consider conducting internal strategic reviews of the organization and determine the organization's key goals with respect to a potential combination. It is imperative for the board members and executive leadership team members to understand the basis for each of the strategic goals and the ranking of same in order of priority.

The outcome of these goals and priorities will shape the attributes required of a potential partner. For example, some of the goals may be geographic footprint and covered lives, level of integration, breadth and quality of services, revenue growth, clinical and quality expertise, and prominence within the individual markets. Additional relevant factors can include short-, mid- and long-term goals to improve plant, equipment and operations, capital access, and to establish a pre-eminent regional or national brand, among others.

Figuring out which goals are the top priorities will further shape which partner has the best characteristics to align with those goals and, in some cases, determine the type of partnership or affiliation best suited for the partners. These strategic reviews should also be viewed as an opportunity to not only rethink and/or renew strategic priorities, but also cultural expectations that encourage positive changes and growth.

Perhaps above all other factors will be the importance of cultural alignment. Without strong cultural alignment, it will be difficult for a health system to achieve its strategic goals. In an effort to maximize the potential for the systems to have a successful dialogue regarding a potential partnership, it is helpful for each of the systems to create opportunities for board to board socialization and executive leadership team to executive leadership team socialization.

In order to help build trust and establish cultural alignment, systems that start early creating opportunities for the board members and executive leadership teams to have an open dialogue with one another will have a stronger foundation as the parties explore what a partnership looks like. Those efforts also give all parties a better sense of how easy or difficult it will be to work together as partners. Moreover, the decision-making for moving forward with a combination strategy will rest with these two groups, so the sooner they start building trust and understanding one another, the more likely they are to consummate the transaction successfully.

Practical Considerations

For health care boards of directors and executive leadership teams who are thinking about strategic combinations to ensure future stability and growth, other practical considerations may be salient here—namely:

- Articulating a clear vision for the merger both before and after the deal closes.
- Assessing whether the financial (and capital) position of the buyer will likely be strengthened.
- Identifying potential system efficiencies a potential merger may bring.
- Assessing what patient-centered growth strategies are possible, especially if an institution has low patient acuity.
- Advancing a plan to the institution's workforce that explains how and why a potential merger will enrich the lives of patients and advance the skills of professionals.
- Investigating who are the appropriate experts to assist with the legal, financial, and regulatory process.
- Calculating whether the merger will likely provide for a decrease in operating expenses.
- Discerning whether a strategic partnership will provide for a competitive advantage.
- Weighing whether cultural alignment between a potential buyer and seller exist.
- Ensuring all appropriate stakeholders support and align with the vision for the merger.

Conclusion

In sum, acute care hospitals urgently require strategies to best position them for the future. Health care costs will continue to rise, labor shortages are endemic, and reduced payments from government and private payors will only tighten in the foreseeable future.

These factors are likely contributing to the rise of strategic combinations with various health systems to remain financially viable. Understanding the factors that enhance or hamper the financial viability of acute care hospitals is essential to ensuring that they immediately remain operational and ultimately grow for the better over time.