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55%
of executives who are planning an M&A within the next year say that physician practices are their top target.

INTELLIGENCE REPORT

JULY/AUGUST 2022

M&A INCENTIVES REMAIN CONSTANT IN A SHIFTING HEALTHCARE LANDSCAPE

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RISING TO THE CHALLENGE OF THE INFLATIONARY ENVIRONMENT

Healthcare providers, stressed by the inflationary environment with surging labor expense, are forced to revisit strategic growth plans

With the impact of the COVID-19 pandemic receding, the stress of surging labor expense, especially for nursing, as well as other inflationary pressures are taking center stage in the healthcare provider landscape. With inflation running at 8.6% currently, its highest level in four decades, many providers are experiencing substantial financial operating stress. The largest pressure point for most has been the absolute need to utilize a significant amount of agency nurse staffing at materially higher hourly rates, which has pressured financial performance for providers across the country. The growth in labor and other expenses is especially painful when considering that supplemental governmental funding related to the pandemic has dried up and many providers are in the middle of repaying their CMS advance payments.

On the positive side of the equation, volumes have largely returned to pre-pandemic levels, but for many providers, the return to more normal utilization has not offset the rising cost of labor, supplies, and debt capital, which has increased significantly for both taxable and tax-exempt execution during the first half of 2022 as we have observed material capital flight from fixed income funds driven by inflationary pressure. To make matters worse, healthcare providers could not rely on strong equity market returns in the first half of 2022 that boosted balance sheet liquidity for many in 2021.

Mike Quinn
Head of Healthcare Strategic Advisory Services, Managing Director
Bank of America

After a pause, M&A volume will grow as a strategy to offset the challenging operating landscape

Given this stressful operating environment, it is not surprising that 73% of respondents expect the dollar value of their respective organizations' M&A activity to increase in the next three years. It's also not surprising that the respondents' leading five financial objectives from planned strategic growth were as follows:

- Increase market share within our geography
- Improve financial stability
- Expand geographic footprint
- Improve position for payer negotiations
- Improve operational cost efficiencies

Whether it's fee-for-service or value-based reimbursement, it's going to be critical that providers have the requisite leverage with insurance payers to be able to offset some of the inflationary pressure on the expense side of their income statements with significantly more favorable payer contracts in upcoming negotiations. This need will clearly drive an increase in M&A activity as will the need to improve scale and efficiency as a strategy to mitigate recent alarming growth in labor expense. As noted last year, the provider response to the COVID pandemic was exemplary. We fully anticipate that providers will rise to the challenge of this historic inflationary environment and that strategic partnerships will play a critical role in an appropriate response for many.

PANDEMIC CHAOS HASN'T DETERRED HEALTHCARE M&A

Even after two-plus years of pandemic and the chaos it's created—a sputtering economy, a looming recession, and a regulatory crackdown—there isn't any reason why healthcare mergers and acquisitions (M&A) should be decelerating.

And for the most part, these deals are still going through.

That's because the underlying motivations haven't changed; mainly, providers still want to consolidate to leverage a bigger footprint with payers, which will prove especially critical as the nation's healthcare delivery system transitions—however glacially—to value-based care.

John Commins
Senior Editor
HealthLeaders

Seventy-three percent of respondents to the 2022 HealthLeaders *Mergers, Acquisitions, & Partnerships Survey* say the primary result of consolidation (Figure 2) is better bargaining power for providers.

Hospital M&A was down in 2021, but the deals during that year involved bigger health systems generating almost twice as much revenue when compared to M&A in 2020, according to a Kaufman Hall report.

And while hospital M&A may be slowing somewhat, there appears to be no slowdown in the acquisition of physician practices and other ancillary and highly profitable services.

Michael Abrams, MA, managing partner at Numerof & Associates, tells HealthLeaders that much of the M&A activity this year will be driven by "plenty of private equity and corporate capital out there looking for assets to buy across all these sub-sectors."

"In '22, we expect to see continued interest by payers and private equity in all of these sub-sectors of healthcare delivery," Abrams says.

Lawrence Epstein, CEO of Pediatric Urology Associates, a New York City–based physician practice with 17 providers at 15 offices in New York, New Jersey, and Connecticut, warns that healthcare M&A could falter if private equity loses interest.

"If they do, M&A is going to fall off a cliff," he says. "They're the ones who are driving a lot of this, and if they don't get the returns they want or they're not going to get their cash back, then this is going to go away as fast as it accelerated."

M&A activity

Respondents to the HealthLeaders survey are upbeat, with 71% (Figure 12) of those who are exploring potential deals saying they expect their level of M&A activity to increase

within the next three years, while 18% say they expect their activity to remain the same. Only 6% anticipate a decrease in M&A activity.

Further, 73% of respondents say they expect the dollar value of their M&A activity to increase in the next three years (Figure 13), with 25% of respondents estimating their next deal will be valued between $10 million and $49.9 million (Figure 14).

Regulations and M&A strategies

These projections of robust M&A activity come as state and federal prosecutors are cracking down on healthcare sector consolidations. This spring, the threat of Federal Trade Commission antitrust lawsuits prompted several health systems to scuttle their consolidation plans.

Figure 1 | **Given the regulatory climate, are state and federal regulations affecting your M&A strategies?**

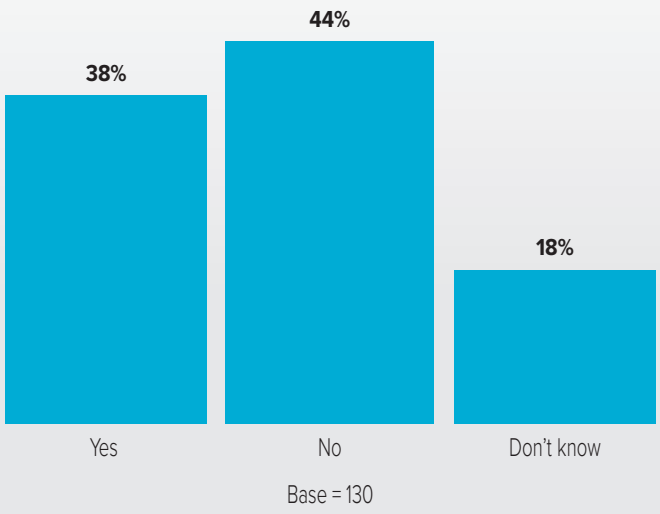
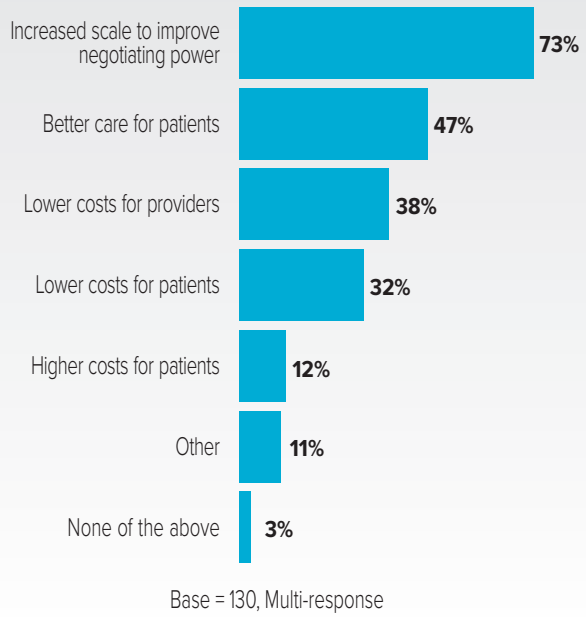


Figure 2 | **What result(s) do healthcare M&As usually deliver?**

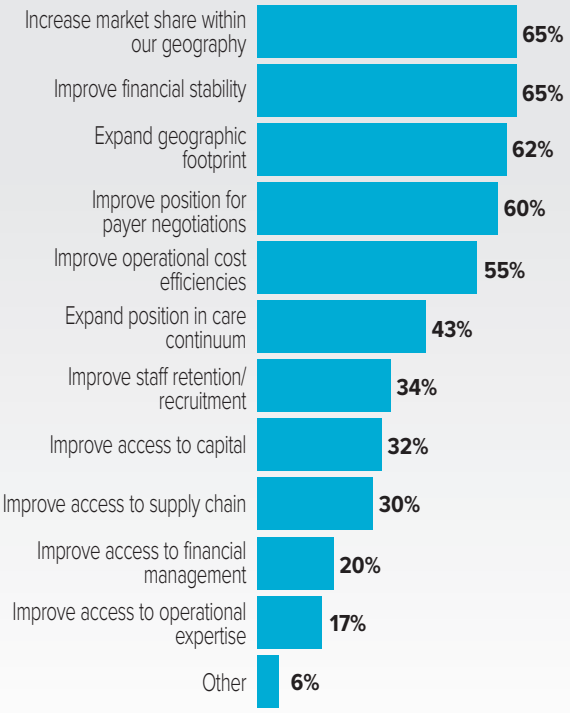


But respondents to the HealthLeaders survey do not appear to be overly concerned when asked if the newly enhanced scrutiny of healthcare M&A by state and federal regulators is affecting their consolidation plans. More than one-third (38%) say "yes," 44% say "no," and 18% say they "don't know" (Figure 1).

Epstein says that the regulatory crackdown could be more intimidating for physician practices than health systems in part because physician practices often don't have the experience and expertise to deal with the intricacies of M&A.

"The health systems, on the other hand, know how to comply with the regulations that get through it, and they're trying to take advantage of that," he says.

Figure 3 | **What are the financial objectives of your M&A planning or activity?**



Base = 130, Multi-response

Epstein says that disconnect exists because payers and providers are still negotiating under a fee-for-service system and haven't been forced to do the scutwork required to make value-based care profitable.

"Most other industries have been focused on either growth or efficiency, and that has squeezed profits, but both the payer side and the provider side haven't done that," he says. "And now you see the end result when the patient mix goes to unprofitable services, like long-term inpatient days, instead of quick surgeries and high-end imaging and other treatments."

He observes, "Some hospitals just can't survive. They get gobbled up or close because they can't cut costs."

Financial objectives

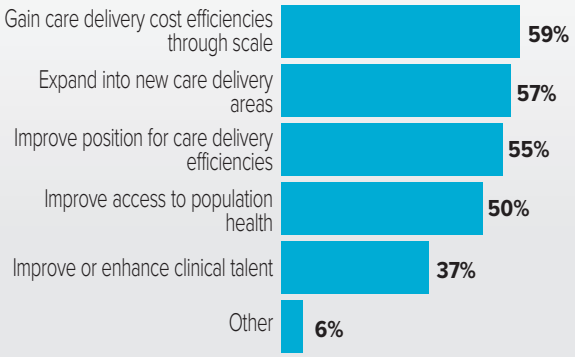
When asked what they expect from their own M&A (Figure 3), respondents cite strengthening their market share

Epstein believes the push for partners is in part generational, with providers under 40 "pretty much indoctrinated that they can't beat the insurance companies, and so they want to join up with someone who can keep the fight going."

M&A results

In what appears to be a disconnect, however, nearly one-third (32%) of respondents say that M&A results in lower costs for patients (Figure 2)—despite scant evidence to qualify that statement, especially as payers raise premiums to cover negotiated costs.

Figure 4 | **What are the care delivery objectives of your M&A planning or activity?**



Base = 130, Multi-response

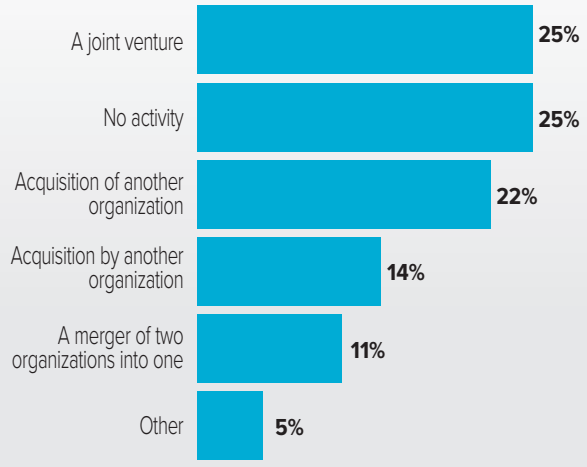
and improving their financial stability (both cited by 65%), expanding their geographic footprint (62%), and improving their negotiating power with payers (60%).

Epstein says these responses make sense for physician practices because they often don't have the capital to make the investments they need to take advantage of growth opportunities, and so they look for partnerships with deep-pocketed investors.

As for care delivery objectives in their own M&A, more than half of respondents (Figure 4) say consolidation would improve cost and care efficiencies and allow them to expand into other subspecialties.

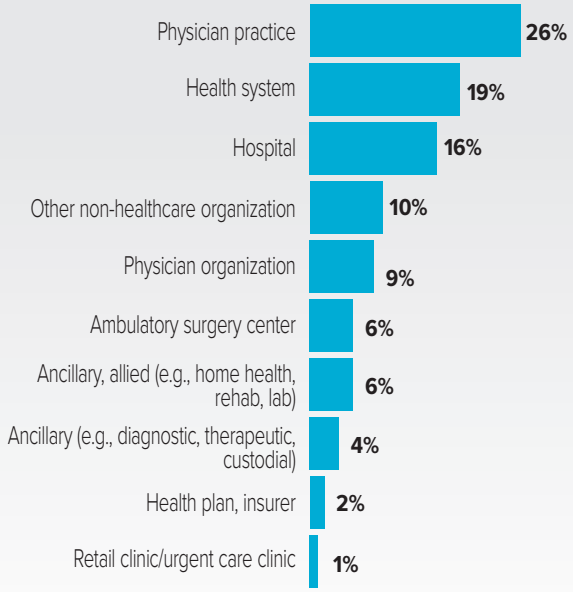
"They don't address what the customer would get out of this in terms of value," Epstein says, "because all sides don't really know what value their customers want, except that they want to be well and not be sick."

Figure 5 | **Describe the nature of your most recent M&A activity.**



Base = 130

Figure 6 | **What kind of entity was involved in your most recent M&A activity?**



Base = 98, Of those involved in recent M&A activity

Entities involved in M&A

Physician practices (Figure 6) represented 26% of the most recent M&A activity for respondents, and Epstein says that's not surprising.

"Providers do everything because they write all the orders and they're the ones who know where everything's buried," he says. "And if nurses were more independent, or there were nurse practitioner networks, you'd find that they'd merge them up. But they're mostly system-based or group-based or employees and not owners."

Figure 7 | **Describe how your most recent M&A activity affected revenue and margins.**

	Increased	Remained the same	Decreased	Don't know
Net patient revenue	54%	22%	5%	18%
Operating margins	42%	24%	13%	20%

Base = 98, Of those involved in recent M&A activity

Figure 8 | **How were care costs affected in each of the following settings after your most recent M&A activity?**

	Cost of providing care increased	Cost of providing care decreased	Cost of providing care remained the same	Don't know
Inpatient	10%	19%	33%	38%
Outpatient/ambulatory	13%	35%	33%	19%
Virtual care	8%	18%	35%	39%

Base = 98, Of those involved in recent M&A activity

"The other thing is that you could buy a physician practice on the cheap," he says. "You don't have to spend a lot of money on the acquisition itself because there's not much there that you would have to do. The ones that overpay usually end up paying a price for overpaying for the group."

Financial effects

When asked to describe the financial effect of their most recent M&A (Figure 7), most respondents saw net patient revenues (54%) and operating margins (42%) improve, with about one-quarter of respondents saying those metrics remained the same post-merger.

"That's because they're able to negotiate better prices, and there are some efficiencies you can wring out with mergers: moving services around, recertifying beds for synergistic services," Epstein says.

"Home health services and durable medical equipment grew tremendously in the last two mergers I did and absorbed a lot of business that way," he says.

Cost of care, by settings

More than half of respondents (Figure 8) said their care costs either dropped or remained the same in the inpatient (52%), outpatient/ambulatory (68%), and virtual (53%) settings, which Epstein says offers validity to claims that M&A can reduce care costs.

"[Some healthcare systems], for example, know what the dollar is being spent on, and as long as they know what asset they're buying and what services they're getting out of it, they can squeeze efficiency and do better," he says.

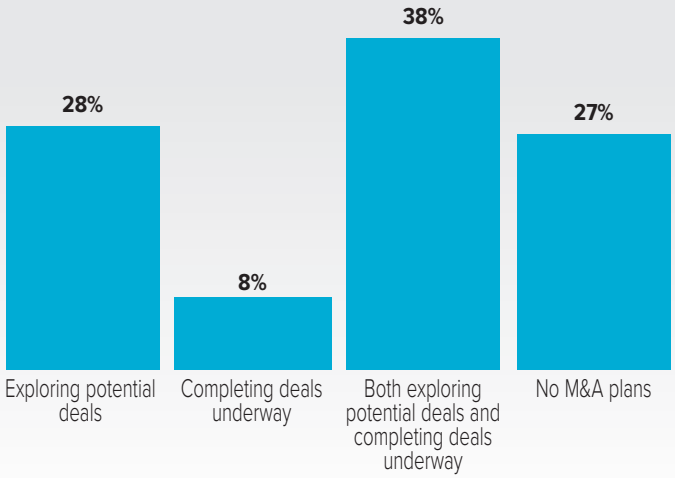
However, that is not the case with all M&A, Epstein says.

"With my two mergers, I saw my cost balloon, not go down, because you've added another enterprise of overhead on a physician practice that never existed before," he says. "So, from a budget standpoint, the budget ballooned. That's why

the play for a lot of these M&A was if you had an ancillary service that you could split-bill, that's how you made money."

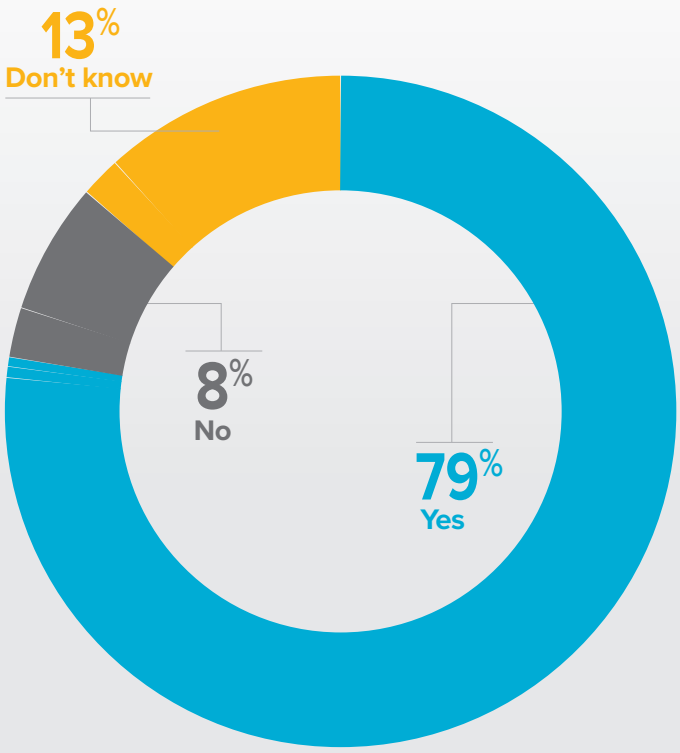
"I ran a pulmonary intensivist practice with a large outpatient service. We had a good amount of spirometry pulmonary function testing. We bundled payment and our costs were lower to the payer," Epstein says. "But when we went to the health system, they [split-billed] the provider fee and the tech fee and it went up 10 times. Who ended up paying the cost? The patients on the commercial side because Medicare wouldn't."

Figure 10 | **Describe your M&A plans for the next 12–18 months.**



Base = 130

Figure 9 | **Looking back, would you participate in your most recent M&A activity again?**



Base = 98, Of those involved in recent M&A activity

There doesn't appear to be a lot of buyer's remorse with consolidation. When asked if they would do their most recent M&A again (Figure 9), 79% of respondents say they would. Only 8% say they wouldn't.

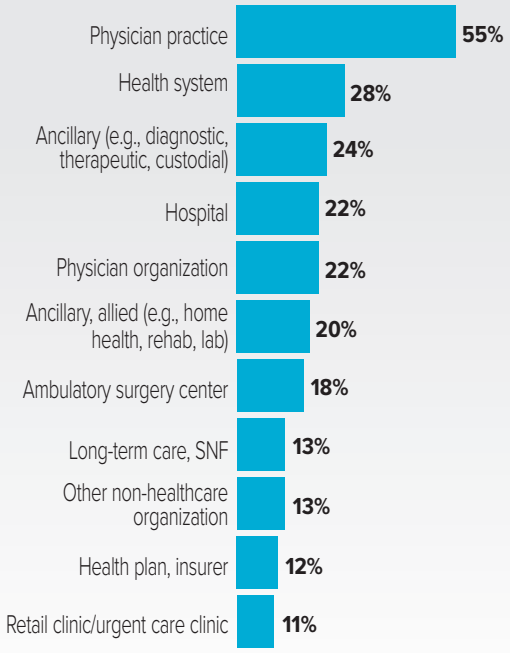
Epstein says that single-digit minority is made up of providers "who value their autonomy and they don't know how to get beyond it. So, they just fight against it, but they don't succeed."

M&A activity, next 12–18 months

Likewise, 73% of respondents (Figure 10) say they're either exploring M&A (28%), completing deals already underway (8%), or both (38%), while 27% say they have no M&A plans.

Epstein believes healthcare providers should always be thinking about M&A.

Figure 11 | **What entities will you pursue through M&A within the next year?**



Base = 85, Multi-response, Of respondents exploring potential deals

"You've got to keep talking. You got to keep looking. Unless you're growing organically and you're able to keep up with your costs, you need to find alternatives that will help you," he says.

"I'm still talking to private equity even though we've been struck down two or three times. In my business, because all the capital washes out at the end of the year, we need to find partnerships," he says. "I've had to invest in digital engagement, not cheap for a practice our size, just to compete, forgetting everything else. Everybody around us, their front door has been digitized. If I don't, they'll go somewhere else."

Types of orgs pursued

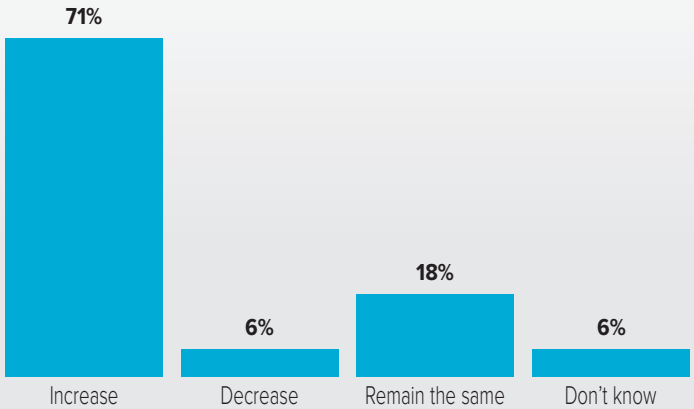
Physician practices (55%) are the top target for those planning an M&A within the next year (Figure 11), with health systems coming in a distant second at 28%.

Epstein says physician practices are attractive targets, in part, because they're under the radar of state and federal antitrust regulators.

"Nobody controls that much of a market share. It's rare in a particular metropolitan area, which is what they look at," he says. "That's why Optum has been able to continue to gobble up practices in geographies that still have a lot of providers because they're not gobbling up whole markets."

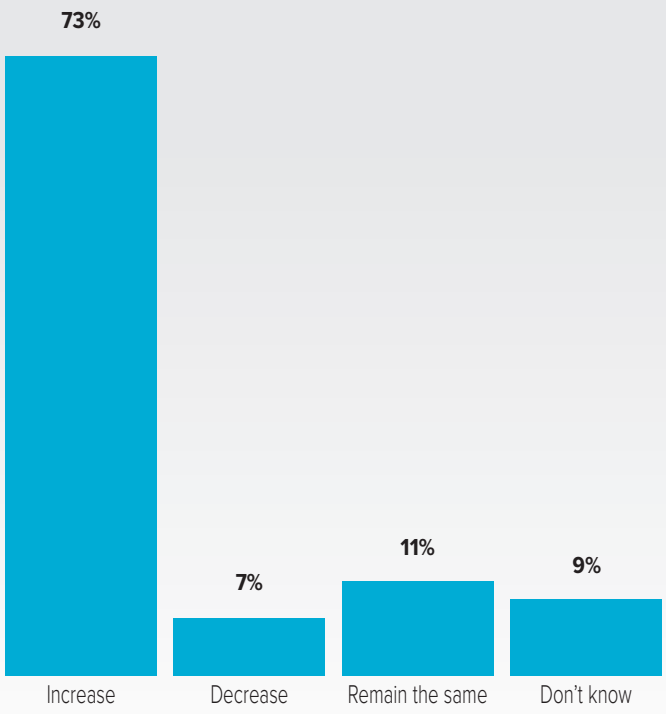
"They don't have to worry about that part of it per se unless they go into a smaller metro area where there's only one spine group in town and they've already merged

Figure 12 | **Within the next three years, do you expect your M&A activity to:**



Base = 85, Of respondents exploring potential deals

Figure 13 | **Within the next three years, do you expect the dollar value of your M&A activity to:**



Base = 85, Of respondents exploring potential deals

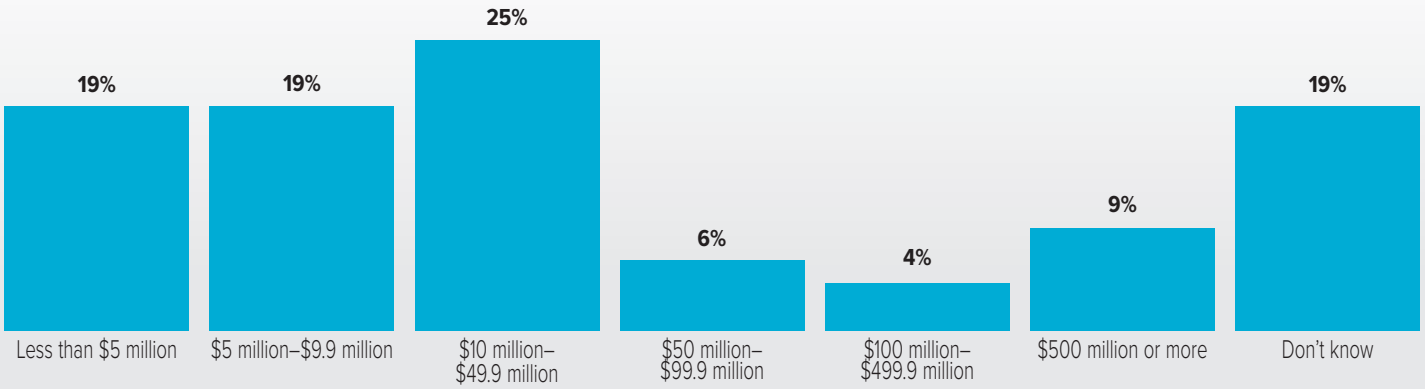
with everybody themselves," he says. "But when the health system goes and buys [them, that's] when the scrutiny might be raised a little bit, especially if the ASCs or MRI centers get gobbled up as part of the merger."

Despite the relative lack of regulatory oversight, Epstein says that physician practice acquisitions can give providers the same leverage with payers that health systems strive for.

"If the group is big enough, they can control the market," he says. "Horizon [Blue Cross Blue Shield of New Jersey)] has done some innovation projects, working with one or two musculoskeletal groups because they controlled enough of the market share in a six-county area, so that they could experiment with cost and value."

John Commins is a senior editor for HealthLeaders. He can be contacted at jcommins@healthleadersmedia.com.

Figure 14 | **Estimate the total dollar value of the M&A activity that you will explore within the next three years.**



Base = 85, Of respondents exploring potential deals

METHODOLOGY

The HealthLeaders 2022 *Mergers, Acquisitions, & Partnerships Survey* was conducted by the HealthLeaders Intelligence Unit, powered by the HealthLeaders Council. It is part of a series of thought leadership studies. In April 2022, an online survey was sent to the HealthLeaders Council and select members of the HealthLeaders audience at healthcare provider organizations. A total of 130 completed surveys are included in the analysis. The margin of error for a base of 130 is +/- 8.6% at the 95% confidence interval. Survey results do not always add to 100% due to rounding.

What Healthcare Leaders Are Saying

Here are selected comments from leaders who share how they expect M&A to be different after the pandemic subsides.

"With the cost of [nurse] travelers hitting all organizations so hard, I can see more M&A happening out of necessity to continue to operate. I fear smaller hospitals will face deep challenges that may hamper their existence."

—VP/director of operations at a small hospital

"There will be many more M&As due to the rising cost of inflation. It's difficult for smaller companies to stay in business."

—CEO at a small physician organization

"There will be fewer major players in the industry, and we will see more smaller, independent hospitals and health systems absorbed into these major systems."

—Chief strategy officer at a medium health system

"Support staff shortages should improve. The pandemic has made it easier to pick up struggling practices."

—COO at a medium physician organization

"A surge in population will cause larger systems to reach out to outlying facilities to expand the primary service area to garner this population to use the system services."

—CFO at a small hospital

About the HealthLeaders Intelligence Unit

The HealthLeaders Intelligence Unit, a division of HealthLeaders, is the premier source for executive healthcare business research. It provides analysis and forecasts through digital platforms, print publications, custom reports, white papers, conferences, roundtables, peer networking opportunities, and presentations for senior management.

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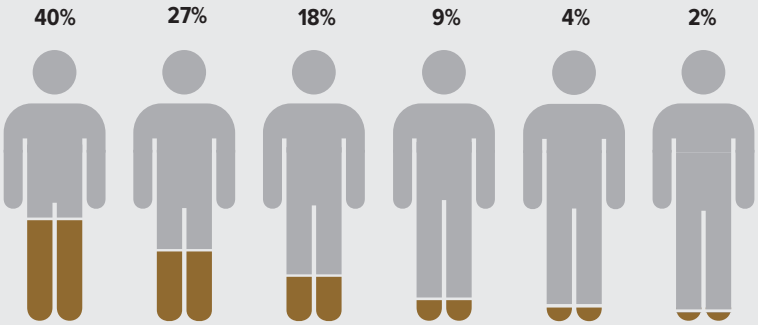
RESPONDENT PROFILE

TITLE

Base = 130



CEO, PRESIDENT

- CEO, President
- Chief Executive Administrator
- Chief Administrative Officer
- Board Member
- Executive Director
- Managing Director
- Partner

OPERATIONS LEADERSHIP

- Chief Operations Officer
- Chief Strategy Officer
- Chief Compliance Officer
- Chief Purchasing Officer
- VP/Director Operations Administration
- VP/Director of Compliance
- Chief Human Resources Officer
- VP/Director HR/People
- VP/Director Supply Chain/Purchasing

FINANCIAL LEADERSHIP

- Chief Financial Officer
- VP/Director Finance
- VP/Director Patient Financial Services
- VP/Director Revenue Cycle
- VP/Director Managed Care
- VP/Director Reimbursement
- VP/Director HIM

CLINICAL LEADERSHIP

- Chief Medical Officer
- Chief Nursing Officer
- Chief of Medical Specialty or Service Line
- VP/Director of Medical Specialty or Service Line
- VP/Director of Nursing
- Chief Population Health Officer
- Chief Quality Officer
- Medical Director
- VP/Director Ambulatory Services
- VP/Director Clinical Services
- VP/Director Quality
- VP/Director Patient Safety
- VP/Director Postacute Services
- VP/Director Behavioral Services
- VP/Director Medical Affairs/ Physician Management
- VP/Director Population Health
- VP/Director Case Management
- VP/Director Patient Engagement, Experience

MARKETING LEADERSHIP

- Chief Marketing Officer
- VP/Director Marketing
- VP/Director Business Development/Sales

IT LEADERSHIP

- Chief Information Technology Officer
- Chief Information Officer
- Chief Technology Officer
- Chief Medical Information Officer
- Chief Nursing Information Officer
- VP/Director IT/Technology
- VP/Director Informatics/Analytics
- VP/Director Data Security

TYPE OF ORGANIZATION

Base = 130

Physician organization (MSO/IPA/PHO/clinic)	**32%**
Hospital	**28%**
Health system (IDN/IDS)	**26%**
Ancillary services provider (diagnostic/therapeutic/custodial)	**6%**
Urgent care center	**2%**
Payer/health plan/insurer (HMO/PPO/MCO/PBM)	**2%**
Ambulatory surgical center	**2%**
Convenient care/retail clinic (including retail pharmacies with clinics)	**2%**
Third-party administrator, pharmacy benefits manager	**1%**

NUMBER OF PHYSICIANS

Base = 130

1–9	**12%**
10–49	**16%**
50+	**72%**
N/A	**1%**

NUMBER OF BEDS

Base = 130

1–199	**25%**
200–499	**13%**
500+	**23%**
Do not have a standard number of beds	**38%**

PROFIT STATUS

Base = 130

Nonprofit	**62%**
For-profit	**38%**

NET PATIENT REVENUE

Base = 130

$1 billion or more (large)	**19%**
$250 million–$999.99 million (medium)	**13%**
$249.9 million or less (small)	**58%**
None of above	**9%**

RESPONDENT REGIONS