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Considerations for Acquiring or Affiliating with Another Hospital

By Tanya K. Hahn
Senior Vice President
Lancaster Pollard
and
Mike Johns
Vice President, Finance Practice
Quorum Health Resources

The economic downturn and resulting restricted access to capital have caused many hospitals to consider a partner or other affiliation strategy. Declining volumes and the deteriorating payer mix are further forcing these discussions – as are the seemingly countless opportunities for capital-rich hospitals to acquire struggling, undervalued hospitals.

Recent healthcare reforms may have a further impact on hospital affiliation. In fact, a recent Moody's report predicts that "as governmental auditing and oversight of revenue are tightened, hospitals will be pressured to operate more efficiently, forcing spending cuts and mergers among smaller hospitals after 2014." Affiliating or acquiring may be the right thing to do, but before taking such a step, there are some considerations for both parties.

From the perspective of the hospital needing a partner, the board must consider a continuum of control. At one end of the spectrum is an affiliation that simply calls for cooperation between the hospitals for mutual benefit, and virtually all control is maintained by the hospital seeking a partner. At the other end of the spectrum is the acquisition of one facility by another, and all control is surrendered to the acquiring facility. In between are management agreements, clinical affiliations, lease transactions, and more formal partnerships with legal and financial commitments by each party.

Consideration should also be given to the benefits provided by the other party.

- If capital needs are driving the decision, then the acquiring facility's balance sheet strength should be evaluated. Will they be able to provide the capital needed for the coming years?
- If expanding the hospital's market is the objective, will the partner provide complementary service lines, a desired brand name and reputation, and a different ability to recruit physicians?

Another consideration is whether the acquiring hospital or system has successfully acquired other facilities. Merging two cultures and achieving synergies are not always easy or successful. Facilities with a successful track record of achieving these objectives are more likely to be successful again.

Debt Factors

Most debt structures have broad provisions for mergers and acquisitions, and they often require bondholder or lender approval prior to such a transaction. Reviewing the debt documentation is a key first step in proceeding with any affiliation/merger discussion.

Hospitals must understand what corporate entity is obligated in the outstanding debt of the hospital being brought in, usually known as the Obligated Group. A debt obligation may be supported by both a hospital and its physician practice group. The merger/affiliation, however, may be desired with the hospital only. Understanding the assets or collateral the hospital owns and the debt it can support without the physician practice group is important to knowing how it might be able to refinance or restructure existing debt. In addition, the acquiring hospital/system may have limitations on its ability to restructure its Obligated Group and must understand current refinancing limitations on its own debt before proceeding with the merger/affiliation.

My Debt is Your Debt

A hospital with outstanding letter-of-credit-enhanced debt may see its debt structure improved by affiliating with a partner that brings a stronger financial position or banking relationship to the table. The LOC may be able to remain in place, saving both hospitals the time and cost of refinancing. Further benefits can be realized if the acquirer has a significant banking relationship with the enhancement provider.

HUD/FHA Section 242 mortgage-insured loans are assumable by acquiring hospitals, with approval from FHA, and they remain nonrecourse to the affiliation/acquiring hospital. The current limitations on transfers are not overly burdensome and should not be viewed as a deterrent to the affiliation/merger. FHA-insured loans can be assumed by either nonprofit or for-profit hospitals.

USDA direct loans may be assumable depending on the acquirer or affiliation partner. USDA financing is limited to nonprofit hospitals that are rural and that cannot access other means of capital. If an affiliation changes any of these features, then the USDA financing would most likely have to be refinanced. If the partner is a similar-sized rural nonprofit, then assuming the debt may be negotiable.

If a hospital is considering a new debt instrument and is also considering a future affiliation/merger, it should proactively consider future flexibility. Potential negative implications of a merger/affiliation can be minimized or eliminated through active management of debt covenants and prepayment requirements within the financing documentation.

Lastly, as organizations consider a merger/affiliation, they must evaluate the impacts of such a transaction on the investment portfolios of each as well as any interest rate mitigation contracts such as swaps, caps or collars on the new combined entities. Often these contracts will also include provisions related to mergers/affiliations, which may impact the ultimate decision and/or timing of the transaction. A comprehensive balance sheet analysis needs to occur along with the evaluation of the debt instruments of both parties.

Mike Johns is vice president, Finance Practice, at Quorum Health Resources. For additional information on QHR's consulting solutions, contact vice president Susan Hassell at (866) 371-4669.

Tanya K. Hahn is a senior vice president at Lancaster Pollard. For information on debt financing for acquisitions or other projects, contact Jason Dopoulos or Anthony Taddey at (310) 458-9180 or visit www.lancasterpollard.com.