FEATURE STORY

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a new tool for system building

Hybrid deals are enabling unlikely partners to come together in developing strategies for care delivery and population management.

AT A GLANCE

- A *hybrid deal* is an innovative type of joint venture between for-profit and not-for-profit entities designed for the purpose of improving healthcare delivery in a mutually accretive manner.
- Not-for-profit health systems, in particular, find hybrid deals attractive because these systems typically take a minority stake in the venture, requiring significantly less capital investment from not-for-profits than an outright acquisition.
- Hybrid deals allow not-for-profits to preserve capital for other needs while often maintaining some level of governance.

Hybrid deals—an emerging partnership model between for-profits and not-for-profits—are evolving from the surge in merger-and-acquisition activity in the healthcare industry in recent years. They are an innovative type of joint venture that are enabling new types of partners to come together in ways that would have been unheard of just a few years ago to overcome financial and regulatory hurdles that many in-market mergers present.

It is common for not-for-profit hospitals to have opportunities for growth. However, growth requires capital, and many not-for-profit hospitals are simply surviving day to day—able to meet routine capital needs, but unable to make significant strategic capital expenditures, let alone grow through acquisition (see the top exhibit on page 2). In today's challenging economic environment, not-for-profit hospital executives are wondering where growth capital will come from. They are testing partnerships formed through hybrid deals to determine whether such partnerships provide a plausible way to overcome these challenges and improve value for purchasers and consumers.

Origins of This Transaction Model

During the last wave of hospital consolidation, which occurred in the late 1990s to mid-2000s, many deals were driven by financial objectives resulting in tight transaction structures. For instance, according to the American College of Radiology, reduced payments from managed care and Medicare put significant pressure on clinical revenues at academic medical centers (AMCs), resulting in a flurry of mergers between AMCs and community hospitals, such as that between Methodist Hospital and Indiana University Health in Indianapolis in 1997.

MEDIANS BY CATEGORY: FREESTANDING HOSPITALS AND SINGLE-STATE HEALTHCARE SYSTEMS, FY11

	Moody's Rating		
	Aa	**A**	**Baa**
Beds	998	439	276
Admissions	57,451	23,161	15,474
Total Operating Revenue*	$1,909,552	$585,080	$351,783
Operating Cash Flow*	$194,373	58,333	$28,801
Less Debt Service*	($33,811)	($17,358)	($11,796)
Less Routine Capital Expenditures*	($134,742)	($37,193)	($19,589)
Free Cash Flows*	**$25,820**	**$3,782**	**$2,584**

* Dollars in thousands.

A-rated and Baa-rated hospitals and health systems have virtually no available funds to invest in strategic capital.

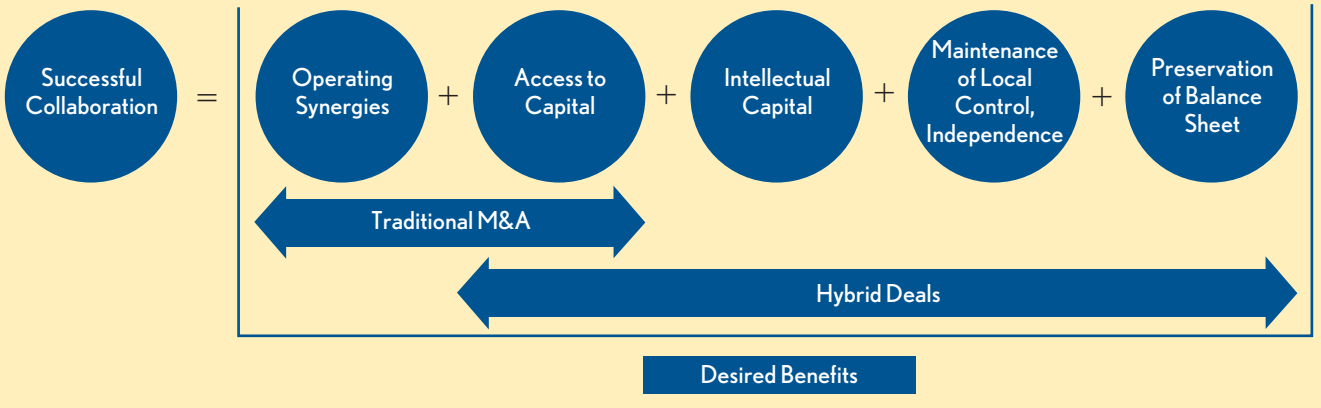
Since 2010, scale advantages have helped fuel another wave of traditional mergers and acquisitions. Many of the respective objectives of hybrid deals and traditional mergers and acquisitions overlap, including preservation of mission. Thus, hybrid deals and traditional merger-and-acquisition activity are not mutually exclusive, nor is the "strange bedfellows" element of hybrid deals limited to joint-venture structures.

"What's more important to these systems than the details of these transactions is whether the honor of the system and the quality of the name brand and reputation can be maintained through this relationship," says Pete Lawson, executive vice president of development, Health Management Associates, Inc. (HMA), in Naples, Fla.

As performance improvement opportunities have proven more elusive, hybrids have become more prevalent in the current wave of partnerships and have been uniquely fueled by demand for growth beyond the core (e.g., new services, new markets) without relinquishing control or "starving" the balance sheet.

The hybrid model has come to define the current wave of hospital consolidation; however, a precursor to the hybrid model can be found in traditional ambulatory surgery center (ASC) joint ventures that grew in popularity in the 1990s. For

DISTINGUISHING HYBRIDS FROM TRADITIONAL MERGERS AND ACQUISITIONS (M&A)



POTENTIAL ADVANTAGES AND DISADVANTAGES OF HYBRIDS

	Potential Advantages	Potential Disadvantages
Community	> Maintain services to community and some board representation > Capital for "community foundation" and tax benefits > Expand service offerings	> Negative reaction from community > Mission incompatibility > Relinquish some control
Strategic	> Funding for strategic geographic and care continuum opportunities > Membership in a larger network > Defense against competitive threats > Brand accretion	> Negative reaction from competitors > Brand dilution
Clinical and Quality	> Access to clinical protocols and playbooks > Funding for programmatic growth initiatives > Incentive for good physicians to stay in community > Quality accretion	> Negative reaction from medical staff > Quality dilution
Financial and Operational	> Access to capital without starving balance sheet or preempting maintenance of capital expenditures	> Potentially higher cost of capital > Potentially limited cost reduction opportunities > Timing of "exit strategy"
Legal and Regulatory	> Less regulation than traditional mergers and acquisitions	> Loss of tax-exempt status > State/attorney general review > Certificate-of-need implications > Negative reaction from union(s)

example, several management companies offer expertise in developing and managing for-profit ASC joint ventures in conjunction with local hospitals (often not-for-profits) and physician organizations. Unlike physician-hospital joint ventures of ancillary businesses, the hybrid model supports deals surrounding entire hospitals and/or health systems.

Consider three models that, while different from each other, offer similar potential advantages and disadvantages from the point of view of not-for-profit health systems. The unique arrangement between Duke University's AMC and publicly traded LifePoint brings together two seemingly incongruous organizations that are finding creative ways to mutually benefit from their competencies. Similar in concept, but with a different level of integration and market strategy, is Ascension Health Care Network (AHCN), the joint venture formed by Ascension Health System, the largest Catholic health system in the country, and Oak Hill Capital Partners, a private equity firm. In a different approach, HMA enters into various markets as a for-profit operator of acute care hospitals that then affiliates with one or more not-for-profits in these markets.

Features of HMA's hybrid models. As of April 1, 2013, HMA has entered into 12 hybrid models, beginning with a partnership with Orlando Health in 2006. The structures of these models are virtually the same and meet IRS guidelines to retain the not-for-profit hospitals' tax-exempt status:

> Each entity shares equal governance regardless of ownership structure (usually a 10-member board).

Interest in hybrid activity is building, and it's noteworthy that this increased interest is occurring at a time when most people would say that utilization is heading downward and payment is pressured.

> HMA is always the majority owner—often owning 60 to 80 percent.
> A limited liability company (LLC) is set up in the state in which the not-for-profit hospital resides and pays taxes.
> The existing charity care policy of the not-for-profit hospital is adopted.
> All employees are brought on board with the same salaries, benefits, and tenure.
> The not-for-profit hospital's name remains unchanged.
> Existing assets and operations of the not-for-profit hospital are contributed into the LLC.
> The same Medicare provider number is used.
> The not-for-profit hospital is valued as if it is being acquired.
> The not-for-profit hospital purchases its ownership at closing, effectively becoming the owner of a new company (the LLC).
> Acquisition proceeds are used to pay off bonds, and any excess is put into a tax-exempt foundation.
> HMA manages the new organization.

In many instances, other hospitals in the not-for-profit system continue to exist, particularly in the case of teaching hospitals. For example, a couple of Shands Healthcare's teaching hospitals are not part of the Shands/HMA partnership model. In models such as the Shands/HMA partnership, the strengthening of the community hospitals as a result of entering into a hybrid model has caused the unaffiliated teaching hospitals to see an increase in tertiary referrals. In the first full year after the Shands deal, the associated-but-unaffiliated teaching hospitals experienced a double-digit increase in admissions, which was largely a product of what the hybrid model was able to accomplish at the community hospital level. These accomplishments included, for example, the addition of robotic surgery and a new intensive care unit and the recruitment of new physicians—initiatives that Shands may not have accomplished on its own, given the capital needs of the teaching hospitals that may have taken priority over the capital needs of the community hospitals the system owned. The three Shands hospitals that entered into the hybrid were losing millions per year. Three years later, those same hospitals earn millions per year on their minority ownership, plus tertiary referrals are now coming back to Shands' teaching hospitals at much greater volumes, according to Lawson of HMA.

An Increasingly Prevalent Option for Partnership

For-profits generally share the same reasons for participating in hybrids; only the markets are different. Nearly every hospital transaction faces intense scrutiny from the Federal Trade Commission (FTC), such that local buyers are not always the answer for an independent hospital looking for a suitor. The fact that hybrids involve partnerships between not-for-profit hospitals and suitors from outside the not-for-profits' markets, thereby circumventing increased regulatory scrutiny, is a significant deal driver.

More notable than which for-profits are entering into these deals is which for-profits are choosing *not* to do so. Hospital Corporation of America (HCA) showed interest in hybrid models in the late 1990s through joint ventures in Colorado, Louisiana, and Texas, but has since bought out its partner in Colorado. Community Health Systems inherited a couple of hybrid deals through the acquisition of Triad Hospitals in 2007. HCA and Community Health Systems are the two largest for-profit health systems in the United States, with nearly 300 hospitals combined; however, they have not been active in the hybrid market in the current merger-and-acquisition cycle. (Community's recent alliance with Cleveland Clinic does not involve any exchange-of-

ownership stakes.) It is an open question whether such large, deep-pocketed organizations with access to public markets and related growth mandates might again consider engaging in hybrid discussions, effectively fueling an already active market.

LHP Hospital Group, Capella Healthcare, and other for-profit organizations have taken the plunge of partnering with not-for-profit health systems on a market-by-market basis. In August 2012, IASIS Healthcare, based in Franklin, Tenn., and Aurora Health Care of Milwaukee formed a joint venture in southern Wisconsin, while Vanguard Health Systems, based in Nashville, Tenn., and Tufts Medical Center, Boston, formed a joint venture in Boston. These organizations are the latest entrants into an increasingly active market. In the aggregate, analysis of publicly available deal announcements from 2008 to 2012 discloses that at least seven for-profits have completed a minimum of 20 hybrid deals involving more than 40 hospitals.

Distilling the Mutually Accretive Aspects

Not-for-profit health systems find these hybrid deals attractive because they typically allow for these organizations to take a minority stake in the venture, which requires a significantly smaller capital investment than would an outright acquisition. The hybrid deal also allows the not-for-profit health system to preserve capital for other needs while often maintaining a material level of governance.

With today's ever-evolving IT platforms and physician integration models, hospitals have mounting capital pressures. From building IT infrastructure to increasing ambulatory capacity and pursuing meaningful physician alignment strategies—not simply funding annual depreciation—hospital strategic capital is often oversubscribed. Within most not-for-profit systems, capital is committed to maintaining existing assets and is not available for acquisitions. "For us, the issue that comes through all of this is access to capital," says Travis Froehlich, Seton Healthcare Family's chief strategy officer, regarding Seton's recent deal with LHP Hospital Group. (See examples of this and other recent hybrid deals in the exhibit on page 6.)

Conversely, for-profits are attracted to the hybrid model because it allows both new avenues for growth not otherwise available and the opportunity to help meet the needs of local communities, particularly in situations where the local not-for-profit partner is facing a negative bottom line. Many independent hospitals desire to become part of a larger system, but many not-for-profit systems do not have the capital to be the consolidator.

"We are entering competitive markets where our interest is in not-for-profits that could take a leadership role in being the first or second health

Hybrid Deals Are Not Unique to Health Care

Parallels to the healthcare industry's recent experiences with hybrid deals can be drawn from other industries that have experienced similar not-for-profit/for-profit unions. For instance, in 2004, the city of Chicago awarded a maintenance and operations contract for the Chicago Skyway, an eight-mile, six-lane toll road and bridge, to Cintra-Macquarie, a foreign infrastructure banking consortium. Years of underfunding of maintenance and repairs to America's infrastructure, coupled with state and local budget constraints, have resulted in public-private partnerships across various segments of the transportation industry.

Highways, airports, and urban transit at large have all benefited from the infusion of private capital to infrastructure projects that are in dire need of financial resources, but whose state and local government owners have no available funds to invest. Raising taxes has limited benefit, and the federal government is scaling back on funding. Is a mass transit system's oversaturation of bus routes relative to the population it serves akin to a hospital's excess bed capacity?

Would the Chicago Transit Authority benefit from a private owner that designs services and makes investments around its travelers to turn a profit in much the same way that the Chicago Skyway has? This is not to say that not-for-profit hospitals have designed their facilities around unneeded services; rather, it is a question of whether hospitals that are designed around their inpatient business will increasingly find the need for significant financial resources to redesign their services to reflect the new world of broader patient access and fewer patient overnights at a time when capital for new projects is scarce.

EXAMPLES OF RECENT HYBRID DEALS, INCLUDING GOALS AND STRUCTURE

Not-for-Profit Partner	For-Profit Partner	Key Goals	Structure
› INTEGRIS Health System, Oklahoma City › 2011 revenue: $1.4 billion	› Health Management Associates (HMA), Naples, Fla. › 2011 revenue: $5.8 billion	› INTEGRIS sought to raise capital for struggling hospitals. › HMA's goal is to leverage expertise to turn around "sweet spot" hospitals.	› HMA acquired an 80 percent stake in five of INTEGRIS' rural community hospitals. › HMA is the day-to-day operator. › INTEGRIS retains its brand.
› Seton Health System (Ascension Health), Austin, Texas › Ten acute care hospitals	› LHP Hospital Group, Plano, Texas › Six hospitals in four states	› Seton sought to build a new hospital in a strategic location. › LHP's goal is to provide capital.	› LHP owns an 80 percent interest. › Board representation is 50/50. › The hospital is recognized as a Catholic facility. › Seton retains the brand.
› Marquette General Health System, Marquette, Mich. › 2011 revenue: $300 million	› Duke Lifepoint Healthcare (DLP), Durham, N.C. › Four hospitals in three states	› Marquette sought access to clinical and operational resources. › DLP's goal is to provide capital and advances in quality.	› DLP acquired Marquette for $483 million, including $350 million in capital commitments and a $23 million donation to Marquette's foundation.

system in that regional market," says Molly O'Neill, senior vice president and chief business development officer for Ascension Health Care Network, based in St. Louis. "In several markets where we've advanced to the next round of the decision process, those first hospitals become just that: first hospitals. In the six months following a hybrid deal, we typically pursue three or four other hospitals in the region that we could link together, both Catholic and non-Catholic, so that our presence in the market will matter—whether to payers or employers or to the market as a whole, by creating the necessary scale to make the hospitals a hub of patient care activity."

In years past, distressed hospitals have been the largest class of hospitals seeking affiliation. In the current market, however, many well-performing hospitals are actively seeking partners now, while in a position of strength, rather than five to 10 years down the road, when a more fiscally challenging environment is likely to be a limiting factor. As a result, there is an abundance of strong assets on the market, with even more buyers than sellers. The result: High prices are fueling the need for well-capitalized partners.

Based on current hospital transaction activity, a hospital with financial performance similar to that of Moody's Baa median could command more than $100 million in capital investment from a for-profit partner in exchange for greater than 50 percent ownership in the new LLC, other valuation drivers notwithstanding. What this means to the not-for-profit hospital is that at the time of the transaction, a new corporate entity (usually an LLC) is established, and each partner holds an interest in the new LLC, which is a taxable for-profit company. The not-for-profit usually uses its portion of the proceeds to pay down debt, invest in its foundation, or invest in other hospitals within its not-for-profit system.

Of course, price is not the only determining factor in today's deals, whose purpose is, at the core, to ensure long-term sustainability. "What we're seeing is that price is important, but understanding the market investments that need to be made and how to drive physician alignment, how to build an ambulatory network, how to strengthen existing service lines, and how to create partnerships with other health systems across the continuum is what makes a strong partner," says O'Neill of Ascension

Health Care Network. "It's not just about fixing revenue cycle and supply chain and hoping that's enough to turn things around."

Will Hybrids Rewrite the Formula for Financial Sustainability?

As hospitals are expected to play a larger role in managing population health, we are likely to see multiple for-profit partners across different asset types within the same not-for-profit system. "We may pursue joint ventures in parts of the continuum because we don't have the same level of expertise as other organizations might in areas such as home care or long-term acute care," says Froehlich of Seton Healthcare Family, which has a joint venture with Kindred Rehabilitation Hospitals, based in Central Texas, for inpatient rehabilitation and long-term acute care and an ASC joint venture with United Surgical Partners International of Chicago. "We're trying to decide how much investment we need in home care or nursing home care, and whether we should buy this service or joint venture it." Tax status is not driving the conversation as it so often does in traditional mergers and acquisitions.

Many markets are ripe for a hybrid deal, and hybrids will be a major tool for system building, as not-for-profits will increasingly seek joint ventures for major assets. Hybrid deals may make the most sense for not-for-profit systems and for their communities to ensure long-term sustainability in a time of uncertain sources of cash. Not-for-profit hospitals across the country are currently considering hybrid deals as a viable strategy.

An example is an AMC that wishes to develop an integrated delivery system across a broad region within its state. To do so effectively, the AMC seeks a preferred organizational partner that shares a similar vision, but also can provide capital and "accountable care" capabilities and resources. Through a strategic review of potential partners, the only candidates that remain are for-profits, primarily because of the significant capital needs the system faces. More and more, larger regional health systems are questioning whether a hybrid model is the optimal avenue given the current environment. "These health systems first have to figure out whether they need inpatient beds. Then, they're going to have to look at their capital needs, where they want to put their capital, and whether they want to pursue a project themselves or seek a joint venture," says Froehlich of Seton Healthcare.

Interest in hybrid activity is building, and it's noteworthy that this increased interest is occurring at a time when most people would say that utilization, at least from an inpatient perspective, is heading downward and payment is pressured. What could derail this momentum?

"If people do not understand the healthcare enterprise beyond just a hospital play, the hybrid model will not be sustainable," says O'Neill of Ascension Health Care Network. "There should be a balanced portfolio with ambulatory, physician practice, and provider risk generating a large component of revenues. As an industry, we need to look at the hospital as one component of care delivery and take a longer view. Part of due diligence means considering whether there are other opportunities in the market."

Perhaps avoiding derailment hinges on the for-profit partner achieving the returns it expects on the capital it puts at risk. ●

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