THE GOVERNANCE INSTITUTE

A SERVICE OF nrc HEALTH

Hospital Focus

FEBRUARY 2024

The Outlook for Independent Hospitals: Key Insights for Leaders

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While the healthcare industry overall has suffered from the COVID-19 pandemic and its aftermath, smaller, independent hospitals and systems (independents) have been hit particularly hard.

Many of these hospitals had modest liquidity going into the pandemic, which proved to be insufficient to offset continuing weak operating results, forcing them to defer capital investment and spend down unrestricted cash and investments. Credit ratings have been downgraded as a result, making it more costly, if not impossible, to access capital in the recent unfavorable capital markets environment.

Many governing boards and management teams thus have determined it necessary to look at strategic options—mergers, divestitures, or affiliations—to ensure the continuation of their community healthcare missions. Unfortunately, many have found that their options are more limited than they hoped, and the terms that can be achieved are less favorable than they could have expected pre-pandemic.

Mergers and Acquisitions Trends—Acute Care Hospitals

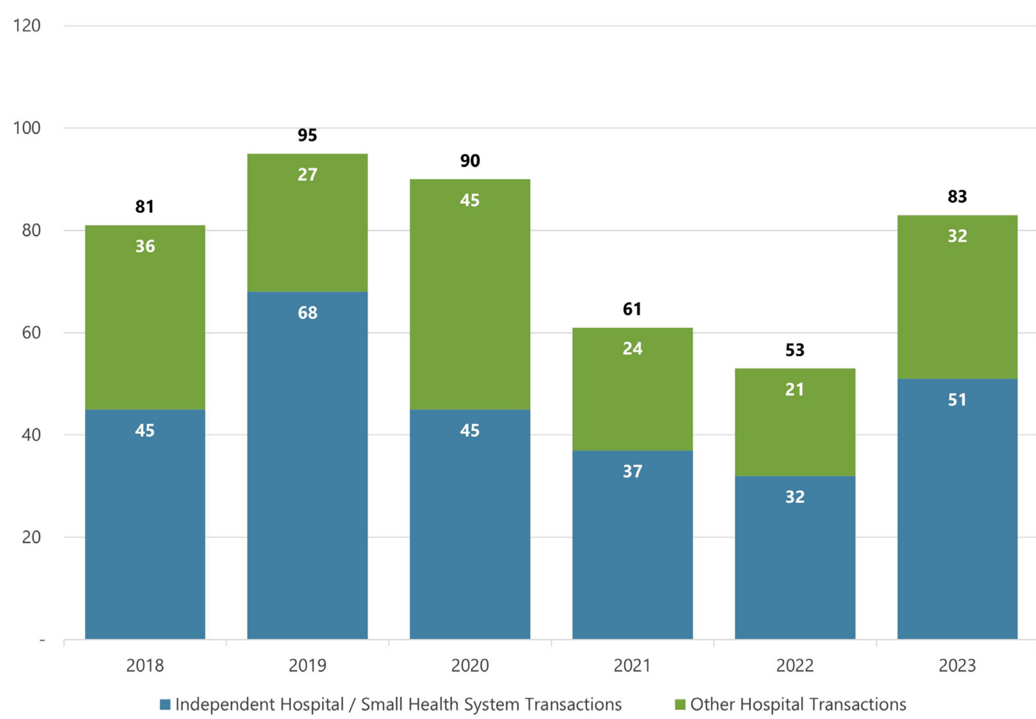
Prior to the pandemic, anticipated benefits of scale drove consistently high mergers and acquisitions volume both regionally and nationally. Independent hospitals often had an array of potential partners from which to choose and, if other objectives were met, operating losses by the independents did not discourage acquirers. Competition allowed independent hospitals to secure significant commitments—both strategic and financial—and their leaders to retain meaningful governance roles.

Credit Outlook: Acute Healthcare Sector

Moody's Investors Service revised its outlook to stable in November 2023, followed in December by negative and deteriorating outlooks by S&P Global Ratings and Fitch Ratings, respectively.

While credit analysts expect some cash flow improvement in 2024, they cite continuing labor pressures, other inflationary expenses, deferred capital, and lower unrestricted liquidity, among other factors, as the basis for their outlooks.

Volume in 2023 returned to pre-pandemic levels, but the transaction environment changed. Larger systems now face their own financial challenges with no clear path back to pre-pandemic profitability, and liquidity reduced by substantial operating losses and unfavorable capital markets. In addition, a more restrictive antitrust environment at the federal level and heightened concern from states about rising healthcare costs discourage acquirers from participating in sale processes. As a result, the universe of interested partners has narrowed, fair market valuations have declined, and other terms are less favorable. This is not expected to change in the near term as independents increasingly seek partners that can secure their futures, while potential buyers continue to exhibit caution.



As M&A volume overall returned to pre-pandemic averages in 2023, independent hospital transactions represented just over 60 percent of all announced acute care transactions, in line with historical averages.

A more detailed analysis of the numbers reveals several interesting trends related to **independent hospital** transactions:

- Academic medical centers (AMCs) were buyers in 24 percent of announced transactions, down from 31 percent in 2022 but continuing a trend of community hospital acquisitions as AMCs look to expand capacity in lower cost settings and spread overhead across a larger base.
- Regional health systems with strong balance sheets took advantage of opportunities to bring smaller, often distressed market participants and rural providers into their systems on favorable terms.
- Purchases of hospitals in backruptcy or after hospitals had closed represented an increasing number of transactions, helping to reduce buyers' upfront cash expenditures and avoid the assumption of liabilities.
- A significant number of announced transactions were called off after buyers completed due diligence.

What Attributes of Independent Hospitals Attract Buyers?

Despite the challenges facing independent hospitals seeking partners, the data above clearly indicates that deals are getting done. Leaders may question whether there are common characteristics among those that were successful in finding partners: H2C has found that many of the drivers of strong credit ratings among independents are the same ones that differentiate a hospital in an M&A process, and these are often non-financial characteristics.

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H2C conducted an analysis of independent hospitals in 2022 to determine which characteristics were the most predictive of financial strength, using credit ratings as a proxy. Attempting to answer the question: "Can independent hospitals remain independent?" H2C used Moody's Investors Service' database for operating and financial information and other sources of data for demographic and socioeconomic market characteristics, to identify and compare the 10 highest-rated and the 10 lowest-rated independent hospitals across the country. When several of the top and bottom ratings were the same, H2C used detailed data to rank them within the category.

Unsurprisingly, the profiles of the highest-rated hospitals reflected:

1. Leading market share with limited competition

2. Lower population with higher income levels than average
3. A commercial payer mix of 30 percent or greater
4. Solid cash flow margins to fund growth and provide a financial cushion
5. Lower average age of plant
6. Strong liquidity profile and moderate leverage

Defining Independent Hospitals

For the purposes of our analysis, H2C Securities Inc. (H2C) adopted Moody's credit rating criteria that defines independent hospitals as hospitals with less than $750 million in operating revenue and health systems as hospitals or systems with greater than $750 million in operating revenue. H2C acknowledges there are independents that have more revenue and health systems that have less revenue than these thresholds.

Since H2C's original analysis in 2022, the group of bottom-rated independents has changed more than the top. With most in financial distress, several hospitals came off the list as a result of M&A transactions, bankruptcy filings, and closings. Some found buyers after filing for bankruptcy or closing, although the terms of the transactions were much less favorable to the hospitals or their communities. As indicated by the following examples, favorable market position and service area characteristics served to offset weak or distressed financial positions and debt covenant violations. Virtually all the hospitals were located in service areas that were adjacent to the acquirers/partners:

- **Butler Health (PA)**, rated Baa3, merged with Excela Health (PA). Butler Health had leading market share in a consolidating broader market, strong relationships with service area payers and providers, a three-year trend of operating losses, and moderate debt with positive cash-to-debt ratio.
- **Capital Region Medical Center (MO)**, rated Ba1, was acquired by the University of Missouri Health System. It had a longstanding affiliation with the health system, strong outpatient services footprint, favorable service area characteristics, negative operating and cash flow margins, and low liquidity relative to debt.
- **Mercy Iowa City (IA)**, rated B1 and downgraded to Caa1 during the M&A process, was acquired in bankruptcy by University of Iowa Hospitals and Clinics. Mercy Iowa City had a strong brand reputation and was the only community hospital option within a broad radius. It also had a multi-year trend of operating losses compounded by a failed EMR implementation, volumes never recovering to

pre-pandemic levels, and a costly and oversized facility requring significant capital expenditures.

- **Southeast Health (MO)**, rated Ba1, was acquired by Mercy (MO). It struggled over recent years but improved after restructuring. It had a good market position with service line expansion opportunities, negative operating margin and minimal cash flow, and high leverage and low liquidity, producing a negative cash-to-debt ratio.
- **Yakima Valley (WA)**, rated Ba1, was acquired by MultiCare Health System (WA). The hospital had a leading market position as the sole community provider following closure of its competitor, was the only Level III NICU in service area, and had below average cash flow margins and low leverage but also modest liquidity to invest in growth.

Considerations for Hospital Leadership

Based on these factors and the outlook for the industry, the messages for hospital boards and senior leaders contemplating future direction are clear:

- If leaders have been hoping to climb out of the downward spiral caused by the pandemic, it is time to honestly assess whether the hospital can return to profitability and liquidity levels sufficient to rebuild essential capital and continue to fulfill your mission. Further, it is unlikely that distressed hospitals can "borrow" their way back given the impact of a much higher cost of capital.
- Characteristics that drive strong credit ratings and financial performance will also determine the hospital's attractiveness to partners. Operating losses can be absorbed, but only if other fundamentals are strong: payer mix, market share, market growth, geographic adjacency, high-quality providers and services, sufficient working capital, and manageable levels of leverage. While it is impossible to change certain characteristics, they may be overcome by other factors.
- It is important to consider the hospital's position as options are considered and expectations are established—and well before commencing any marketing process. Tradeoffs may be necessary. For example, upfront cash may be less important than commitments to expand services and/or fund growth in the hospital's community. Acquirers are more reluctant to commit to maintaining services, retaining all employees, etc., as they require flexibility to improve operating performance. Future capital commitments are more often tied to financial performance and powers reserved to the selling entity are more limited. In today's environment, it is necessary to prioritize what is most important to your community going forward.
- **Do not wait too long**. With great concern for their communities and their best intentions applied, leaders often view giving up independence as a sign of failure.

"Lower-rated entities will have a difficult 2024 without meaningful partnerships or significantly improved labor conditions."

—S&P Global Ratings, "Historical Peak of Negative Outlooks Signals Challenges Remain for U.S. Not-for-Profit Acute Health Care Providers," December 6, 2023.

> Certainly, there are hospitals that possess all of the attributes discussed above that will continue to thrive as independents. However, given the unique challenges of today's healthcare industry, many others will not, and it is important to accept this reality before financial resources are substantially depleted. Pursuing a partnership while still in a relative position of strength and articulating the attributes of the hospital as perceived by potential acquirers will only increase the hospital's options, enhance the terms that can be achieved, and very likely serve the mission better than the hospital will be able to do independently.

The Governance Institute thanks Victoria Poindexter, Managing Director, and Michael *J. Tierney, Executive Director, H2C, for contributing this article. They can be reached at vpoindexter@h2c.com and mtierney@h2c.com.*