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Hospitals and Health Systems: Building Value for the Future Through Integration, Investment and Structured Transformation

Care Integration for the Right Reasons

Over the last decade there have been significant changes in the health care landscape. None has been more profound than the shift to value based payments by both government and private payors. This shift combined with numerous technological advances and new market entrants has radically altered the way in which nearly every hospital and health system delivers health care to the communities they serve.

> **"Perhaps more notable today are private sector actions to expand and accelerate the value-based payment movement and disrupt the status quo. Given the clear signals, health care leaders are focused on gaining scale and/or vertical integration to position themselves favorably for an expansion of value-based care. Unlike past merger efforts to command greater market power, today's consolidation is often more driven by the goal to integrate care delivery and achieve savings."**
>
> – Health Affairs *What to Watch in Health in 2018: Six Key Trends*

Not surprisingly, hospitals and health systems have looked to partner with others through mergers, acquisitions, joint ventures and other arrangements that provide a solid base on which to accept the financial risk inherent in value-based payment arrangements and improve quality and efficiency to compete with a variety of new entrants and emerging transparency initiatives. The goal is to create a continuum of care with closely aligned partners that both retain the essential functions of a hospital and expand on that base to focus on keeping patients healthy, as well as seeing them through the entire recovery process.

> **"Expense growth continues to outpace revenue growth as hospitals face challenges regarding physician hiring, nursing shortages and technology investments. Revenue growth is further challenged by pressures on reimbursement from government entities and commercial insurers looking to boost profits."**
>
> – Moody's Healthcare Quarterly July 2018

To achieve these goals, mergers and acquisitions remain the safest recourse, as decades old regulatory barriers keep hospitals and doctors from working more closely together unless they are under the same ownership umbrella. Numerous special projects, from accountable care organizations to bundled payment experiments, have proven both the value of these closer working arrangements and the need to eliminate these regulatory impediments as every one of these innovative arrangements has required numerous regulatory waivers.

Antitrust Watchdogs Prevent Anticompetitive Mergers

Federal antitrust authorities monitor hospital merger and acquisition activity closely to ensure that health care markets are competitive. When the Federal Trade Commission (FTC) believes a hospital merger threatens competition, the agency has not hesitated to act. Since 2012, the FTC has filed complaints against eight proposed mergers and investigated numerous others.[1]

New care models, like accountable care organizations (ACOs), will continue to attract FTC scrutiny. At the sixth annual Accountable Care Organization Summit, one FTC commissioner noted:[2]

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"We will closely monitor the growing body of empirical work regarding which types of consolidation are most likely to yield consumer benefits. And we will continue to be appropriately aggressive in the very small minority of transactions—whether mergers, joint ventures or ACOs—that may create or enhance market power to the detriment of consumers."

Antitrust oversight of commercial health insurance companies is much more sporadic. Despite blocking two high-profile proposed mergers in 2017, the Department of Justice's Antitrust Division (DOJ) has not moved to alter the trend toward consolidated insurance markets.[3] The American Medical Association found that 73 percent of MSA-level markets were highly concentrated in 2017.[4] For example, a single insurer had at least 50 percent market share in 46 percent of MSA-level markets. Therefore, it is not surprising that a recent article in Health Affairs found that it is concentrations of insurers, not hospitals, which are responsible for premium price increases: Marketplace premiums are 50 percent higher in areas with monopoly insurers.[5]

Moreover, insurers' vertical consolidation has intensified in recent years, which has the real potential to undermine competition by reducing patients' choices and raising out-of-pocket costs. Neither DOJ nor FTC has moved to block insurance companies from combining with other types of health care providers, including physicians and pharmacy benefit managers. For example:

- UnitedHealth Group reported that it employs, partners with, or contracts with 30,000 physicians in 2018, up from 22,000 physicians the year before, and has agreed to acquire DaVita Medical group which employs another 17,000 physicians.[6]
- Given the recent CVS/Aetna merger, the three largest pharmacy benefit managers have come completely under insurance company ownership.[7]

This activity has the potential to reduce competition and lead to higher insurance premiums and retail pharmacy costs among other things.

"The antitrust agencies recognize the need to adapt as new types of transactions appear on the horizon. While the FTC's provider challenges have traditionally focused on competing healthcare providers, and we have not yet brought a vertical provider challenge, we will continue to be on the lookout for other types of health care transactions that may raise antitrust concerns."

– Former FTC Commissioner Julie Brill

Some payers would like to blame hospital mergers for high insurance premiums. But several analyses have found that these mergers typically reduce operating costs and have little bearing on health insurance prices. For example, a study by Charles River Associates found that hospital mergers are associated with a decrease in operating costs of two and a half percent, and noted that these results were inconsistent with other studies that found a direct association between hospital consolidation and the prices paid by commercial managed care organizations.[8]

"While various forms of affiliation are being pursued, many hospital leaders believe, based on their own experiences and observations, that complete mergers and acquisitions are the most effective means for making progress toward meeting the aims of value-based population health."

– Charles River Associates 2017

Moreover, these criticisms typically do not account for other factors that affect insurance premiums, for example cost drivers like demographic change, increased spending in other health care services and the relationship between consumer preference and market power. For example, like firms in every

other sector of our economy, hospitals are not all the same. Some hospitals with high-level or more costly services, like burn or high-level trauma units or other highly specialized care, have higher costs and charge higher prices. These may also be the very hospitals that consumers most want or need to go to when they are seriously ill or badly injured.

Price Growth is at Historic Lows

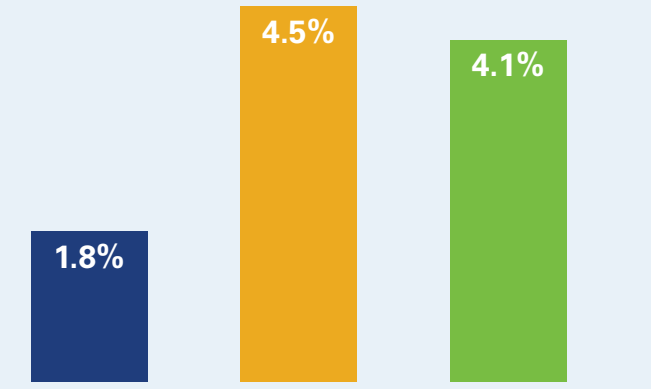
"Sluggish hospital spending continues to restrain growth in overall health spending."

– Altarum 2017

It is not hospital prices that are driving the rise in insurance premiums. Increases in insurance premiums outpaced increases in hospital prices by over two and a half percentage points over the last year. Growth in hospital prices was also outpaced by growth in prescription drug prices last year.

Insurance companies are expected to restrict hospital rates increases even further, according to Moody's.

Percent Change in Premium Levels vs. Change in Hospital Prices, 2017 to 2018



Source: AHA analysis of data from the Kaiser Family Foundation and the Bureau of Economic Analysis. The Kaiser Family Foundation. *Employer Health Benefits Survey*. Data released in 2018. *https://www.kff.org/health-costs/report/2018-employer-health-benefits-survey/*. Bureau of Economic Analysis. PPI Commodity data for Health care services-Hospital inpatient care, seasonally adjusted and PPI industry group data for Pharmaceutical and medicine manufacturing, not seasonally adjusted. Data released in 2018. *https://www.bls.gov/ppi/*.

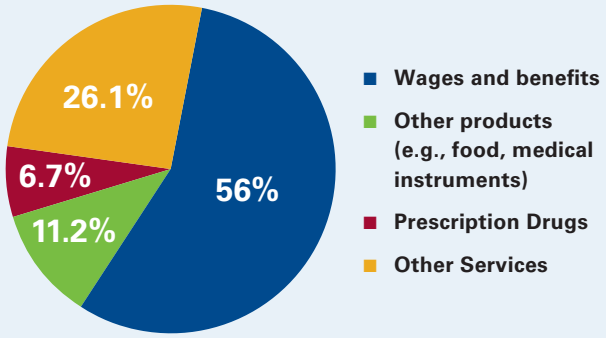
"As health plans place a greater financial burden on patients, bad debt will grow 8%-9%. An aging population will increase hospital reliance on Medicare, which is less profitable than commercial insurance. Government program changes will have mixed effects on reimbursement, while commercial insurers will continue to exert leverage."

– Moody's Outlook December 2018

Unlike other health care sectors, study after study has shown that hospital prices are directly related to the cost of caring for patients. Funds needed to hire and retain doctors, nurses and other medical and support staff with the right qualifications and training are the single largest cost for hospitals.

Over half of hospital costs go to the wages and benefits of caregivers and other staff.

Percent of Hospital Costs by Type of Expense, 2016



Note: Does not include capital.
Source: AHA analysis of Centers for Medicare and Medicaid Services data, using base year 2014 weights.

Hospitals bear additional costs related to the high number of regulatory requirements. Nationally, it is estimated that hospitals, health systems and post-acute care providers spend nearly $39 billion annually on the administrative aspects of regulatory compliance. An average-sized community hospital spends $7.6 million per year, or $1,200 per admission, to support compliance with regulations from just four federal agencies.

Investing in Technology and Upgraded Facilities

Other significant outlays for hospitals and health systems involve IT. Hospitals have made enormous investments in health information technology over the last decade to meet federal standards established in the HITECH Act and the ACA.[9,10] At the same time, hospitals have invested in hardware, software and other technologies as part of broader efforts to improve the quality of care and care delivery.

> **"In addition, nearly 80 percent of surveyed respondents said significant capital investments were made in the acquired organization. Such investments are sometimes needed to ensure patient access to high-quality care…"**
>
> – Deloitte Hospital M&A

> **"Because of their payer mix, these providers [providers who serve a high proportion of Medicaid and uninsured patients] generally have lower operating margins and less access to capital than providers that serve a higher proportion of commercially insured patients."**
>
> – The Medicaid and CHIP Payment and Access Commission June 2015 Report to Congress

Getting and making this new technology work for patients and meeting new and far-reaching government and private-sector requirements (coming from employers and payers) is a major investment for all hospitals. For cash-strapped hospitals, it may be beyond their reach without merging with another hospital that can provide those funds.

For example, hospitals and health systems are embracing telehealth technologies because they offer benefits such as virtual consultations with distant specialists, the ability to perform high-tech monitoring without requiring patients to leave their homes and less expensive and more convenient care options for patients. However, coverage and payment for telehealth services remain major obstacles for providers seeking to improve patient care. Medicare requirements restrict who can receive telehealth services and in what settings (i.e., hospital or physician office) telehealth services can be provided. As a result, Medicare pays for only a small percentage of services. Some hospitals may have difficulty investing in technology given the limitations around providing telehealth services and payment for such services.

Physicians have new and extensive obligations to use electronic health records to report, yet regulatory barriers make that difficult or impossible to do so in collaboration with a hospital without being in its employ.

Essential Capital is in Short Supply

There is no doubt that limited access to capital for IT and other investments essential to providing high-quality care at lower costs is driving mergers.

> **"Lastly, the ability to implement and use new clinical technologies will offer hospitals ways to increase efficiency and lower costs… Hospitals that have the resources and capital to invest in these necessary technologies and evolve with the changing landscape will be successful, while others will struggle."**
>
> –Moody's Healthcare Quarterly July 2018

Credit rating agencies such as Fitch, Standard and Poor's and Moody's anticipate that some not-for-profit hospitals will have difficulty gaining access to capital markets. Modest payment increases from government payers combined with more intense negotiations over rates with commercial payers are expected to limit not-for-profit hospital revenue growth. For many hospitals, particularly those with lower bond ratings, the best and perhaps only strategy to remain viable in their community is merging with another hospital that has the financial resources it lacks.

"The not-for-profit hospital sector continues to experience a rapid pace of M&A activity as hospitals look for ways to manage a more demanding operating environment. The median operating cash flow margin, for example, hit a 10-year low at 8.1% according to our preliminary fiscal 2017 medians data."

– Moody's Healthcare Quarterly July 2018

Need to be Healthy to Provide the Most Value

Quality outcomes, affordability and patient satisfaction are rapidly becoming the touchstones employers, payers, government and, most importantly, patients expect and demand. Meeting these challenges requires reshaping the hospital and health system fields, sometimes through mergers, acquisitions, joint ventures or other innovative relationships. The transformation will require capital investment to build a 21st century continuum of care. When mergers are needed to help financially, geographically or otherwise challenged hospitals avoid "closure, bankruptcy or payment default" or to become stronger and more efficient to meet current challenges and fulfill community needs, that should be a welcome development.

"I believe we can all agree that a key element of positive transformation for our health system must be moving from the system we have used for decades, paying for sickness and procedures to paying for health and outcomes."

– Secretary of Health and Human Services Alex Azar

Keeping Pace with Rapid Technological Innovation to Better Serve Their Communities

The realignment in the hospital field is also fueled by the need to be competitive in a rapidly changing field. More established technology companies, many with capitalization beyond the means of any hospital system, have ambitions to fundamentally disrupt how and where health care is delivered. And there are more new entrants every day. For example, venture capital firms have raised $4.9 billion in the first half of 2018, a 22 percent increase over the previous year.[11]

Powerful established technology companies clearly have ambitions to radically alter how and where health care is delivered. According to market research firm CB Insights, Google is reportedly betting that the future of health care is going to be structured data and artificial intelligence (AI). The company is applying AI to disease detection, new data infrastructure and potentially insurance.[12] In 2017 Google acquired Senosis Health to develop diagnostic tools and treatments for COPD. Senosis has developed technology that will use an existing smartphone microphone as a spirometer to measure lung function, and measure hemoglobin levels with smartphone cameras, a useful tool for detecting anemia.[13]

Likewise, Amazon is among potential industry game changers, where the company is dabbling in efforts to "shake up the experience of care and how it's delivered." Amazon has convened a meeting with experts as the company develops its strategy and builds out its health care business. For example, Amazon has begun acquiring wholesale pharmaceutical distribution licenses in several states, and plans to acquire the online pharmacy PillPack.[14,15] Moreover, Amazon has announced plans to build primary care clinics for its Seattle employees. CNBC reported that Amazon hired Martin Levine, one of the top physicians at an innovative primary care group called Iora health.[16]

Apple also has plans to shake up health care delivery. Tim Cook, Apple's Chief Executive stated unequivocally that "health care is big for Apple's future." For example, Apple markets the Apple Watch as a tool to transform how physicians care for patients, and a tool for patients to manage their health. Ochsner Health System has implemented an initiative that uses heart rate data collected from

patients' Apple watches to make changes to their care plan on an ongoing basis, rather than making changes at periodic appointments.[17] Some market observers believe "Apple has [a] massive advantage over other incumbents in the health care industry like hospitals and pharma: unlike drug companies and hospital groups, Apple doesn't have to chase reimbursements from health insurers. Rather, it can afford to be laser-focused on the patient experience and patient outcomes."[18]

The hospital and health systems fields are leading their own efforts to transform the way in which health care is delivered. For example, more than 40 hospital systems around the nation have established their own centers for innovation focusing both on tools and technology as well as new ideas, workflows and training techniques.[19] All of these developments suggest that hospitals operate in a competitive landscape very different from the landscape of even five years ago and that will continue to transform as more innovations hit the market. This changing landscape makes achieving scale increasingly important in order to remain competitive and deliver value to patients efficiently and effectively.

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