ARTICLE

MARKET CONSOLIDATION

Strategic Options for Independent Hospitals and Smaller Health Systems

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Industry Consolidation Trends Continue

The consolidation trend across the US provider landscape has been decades in the making. In the run-up to and in the aftermath of the Affordable Care Act (ACA), some healthcare leaders (and to be honest, a fair number of hired advisers) believed the sky was falling. *If you're not in a system, you better get into one* and *scale matters* are still regular refrains in boardrooms, and it has been common to hear prognostications from industry pundits that a system must have $6 billion to $10 billion in revenue before it has sufficient scale to drive "value"—the golden ring that has proven elusive for even some of the largest health systems, especially from the perspective of managing the total costs of care, improving outcomes, and delivering lower costs to consumers.

According to the American Hospital Association, nearly 70% of US community hospitals are part of the approximately 400 health systems in the country. This represents a sharp increase over the 52% of community hospitals that were part of the estimated 300 health systems in 2000. It is also noteworthy that just over 50% of US health systems have fewer than 5 hospitals, and a similar 50% have fewer than 1,000 beds; it shouldn't be surprising that we also see small systems joining other systems. Further, the 200+ hospitals—mostly rural—that have closed since the year 2000 either never had the chance to join a system or did and still couldn't be saved.

Given the multitude of industry challenges, many of these organizations ask themselves whether there is benefit to being part of something bigger, and many larger systems are waiting suitors—though many larger systems are also critically evaluating their own hospital portfolios for viability and sustainability.

Despite continued focus by the FTC and state regulatory bodies, we expect this consolidation trend will continue. Why? There are multiple consolidation drivers beyond nearly any independent organization's ability to significantly impact its future:

- Reimbursement pressure, broadly
- Declining inpatient utilization rates
- Payers steering cases into ambulatory settings
- Increased prior authorization requirements and high denial rates
- Increasing charity, self-pay, and bad debt
- Workforce shortages across primary care providers, nursing, ancillary, and support areas
- Inflationary pressure on labor costs and supplies
- High costs of employed physician enterprise models
- Weakened balance sheets
- Higher costs of capital and increasing speculation from lenders

Even absent these dynamics, many hospitals and smaller health systems desire the strength of a larger health system to create integrated regional delivery networks and bolster their competitive position. Common objectives include scale-related cost efficiencies across many business and support functions, investment in IT infrastructure, improved access to subspecialists, improved quality through clinical expertise and standardization, and the opportunity to secure the system's expertise and negotiating strength across payer and supply chain contracts.

The degree of success associated with this consolidation trend varies significantly from market to market and system to system. As in all things related to mergers, acquisitions, and partnerships, culture eats strategy every day. Simply put, many deals that see independent hospitals or smaller health systems joining larger systems do not achieve their full potential due to cultural challenges at the leadership and governance level, as well as differing views on strategic, operational, and financial priorities related to the combination.

Clearly, these dynamics should be better vetted during the affiliation partner evaluation process. What also matters is the ability to identify and execute on the integration opportunities. A good number of system transactions stall at the point of execution, often because of insufficient bandwidth or leadership experience to execute, or a failure to appreciate the complexity, timing, or cost associated with getting past "Go." Often the strategy is well understood but the roadmap is not developed enough to enable action. ▶

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Certainly, the pandemic took a significant toll on independent hospitals and small health systems, though even the largest systems were not immune from volume declines and the financial stress stemming from pressure on every aspect of their operations. Some of the largest health systems lost billions in recent years, though at this writing, most have seen a recovery in patient volumes, operating margins, and cash flow. Of course, many stressors continue.

On either side of the industry consolidation topic, it isn't that difficult to find leaders and board members of formerly independent hospitals or small health systems that regret their timing if not the actual decision to join a regional or super-regional system. Similarly, many leaders of regional or super-regional systems reflect that in addition to focusing on back-office and shared-service economies, supply chain, and better payer contracts, higher-impact opportunities remain:

- More significant clinical standardization and care delivery model innovation
- A better-balanced care delivery network across the system's physician enterprise and ambulatory and hospital assets
- Rightsizing clinical services and consolidating sites of delivery where appropriate
- A more advanced business model supported by digital platforms and AI
- Greater consumer engagement
- More impactful community benefit

Indeed, this is the challenging work ahead.

Considerations for Independent Hospitals and Small Regional Systems

ECG believes there is value through system affiliation, but we also appreciate that affiliation is not necessarily the best strategic choice for every organization. Governance and leadership autonomy have great value if the hospital or health system is in an otherwise strong position. Bigger, in itself, does not equate to better, and clinical and market significance—how you act and what you do as a system—matters more than scale.

Independent hospitals and smaller health systems must carefully evaluate their strategic, operational, and financial position and discern when and if they are at the most responsible moment to consider joining a system. For those that have a strong balance sheet or are successfully rebuilding one in the post-pandemic era, there are many avenues for them to play out their strategy. For some, the ability to fulfill their mission, remain in control of their destiny, and achieve an aspirational

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vision is firmly in their grasp—though this will not be the case for all.

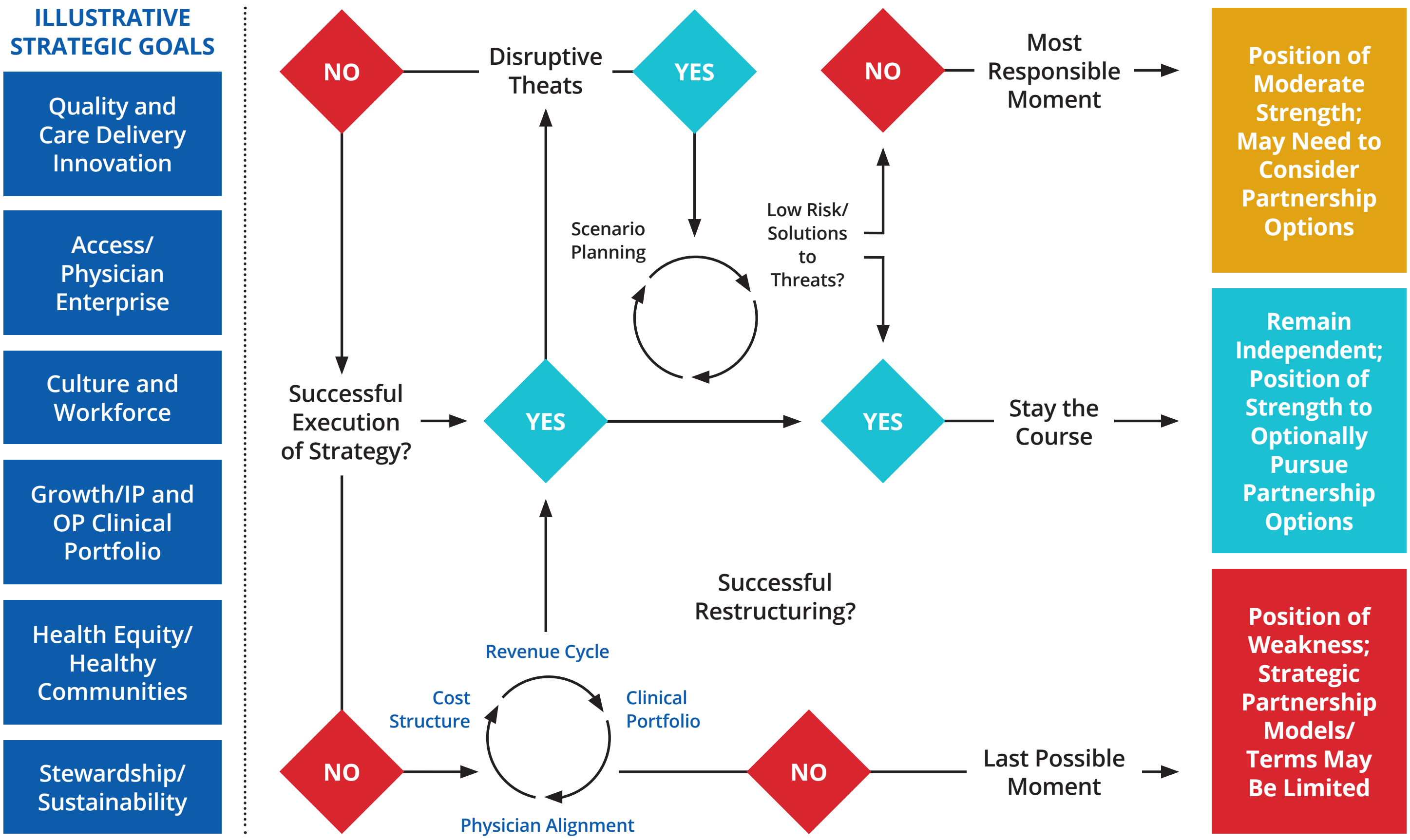
The decision tree for pursuing a partnership, affiliation, or merger/sale is pretty straightforward, provided the organization is starting from a position of strength. **FIGURE 1** illustrates ECG's most responsible moment framework, which assumes the organization already has a clear sense of its strategic goals and supporting initiatives and is executing on that plan. If market dynamics or other factors are impeding successful execution on the organization's plan, a standard order of focused assessments and interventions may be necessary to achieve improvements in areas such as:

- Revenue cycle.
- Revenue and cost structure.
- Productivity and labor.
- Physician alignment, including physician enterprise dynamics.
- Clinical portfolio.
- IT portfolio and cyber concerns.

Other levers may need to be evaluated as well, though these initial assessments will often identify opportunities to right the ship. If not, the organization may be headed toward an inevitable need to find a partner from a position of weakness, or worse, impending bankruptcy—the *last possible moment*.

Similarly, if the organization is making progress on its strategy execution but encountering disruptive market dynamics, it may need to vet various scenarios and adjust its strategy accordingly. This discipline requires an institutional value on strategic thinking and belief that strategy making is continuous and not a static event every three to five years. The scenarios may be based around competitive threats, or often, around strategic interventions taken by the hospital or system itself. ▶

FIGURE 1: ASSESSING THE MOST RESPONSIBLE MOMENT



If the market or competitive threats are considered high risk, even an organization that remains in a position of moderate strength may have reached the most responsible moment to consider partnership options. If the threats are low risk or can be mitigated, the scenario planning process outcome may validate the organization's strategy. It may stay on its current strategic course as an independent organization, in which it case it could still consider various strategic partnership models—but from a position of strength.

Organizations that have decided to pursue a partnership or system affiliation should go through a structured discernment process that evaluates their position across the variables depicted in **FIGURE 2**. High ratings across the variables indicate greater urgency and need for support from a partner. Moderate ratings suggest less urgency, and low ratings indicate a strong ability to remain independent and in a position of control. In the latter situation, a range of affiliation options could be explored that do not require a formal system affiliation through merger or acquisition.

Regional Collaboratives: A Key Strategic Option for Organizations Desiring to Remain Independent

Organizations that have decided to remain independent can still enjoy the benefits of being part of a regional or national health system. Traditional system affiliation models tend to follow a continuum of structural models with progressive degrees of governance, operational, and financial integration, as shown in **FIGURE 3**.

Organizations that want to remain independent may already have various clinical partnerships or even joint ventures with physician groups or other healthcare organizations. Regional collaboratives represent contractual and structural models that the hospital or health system could pursue with like-minded organizations to accomplish a wide range of business objectives, without having to go "all in" as a traditional system affiliation model might dictate. Examples of regional

FIGURE 2: EXAMPLE TRIGGERS THAT MAY SIGNAL A NEED TO EXPLORE OPTIONS

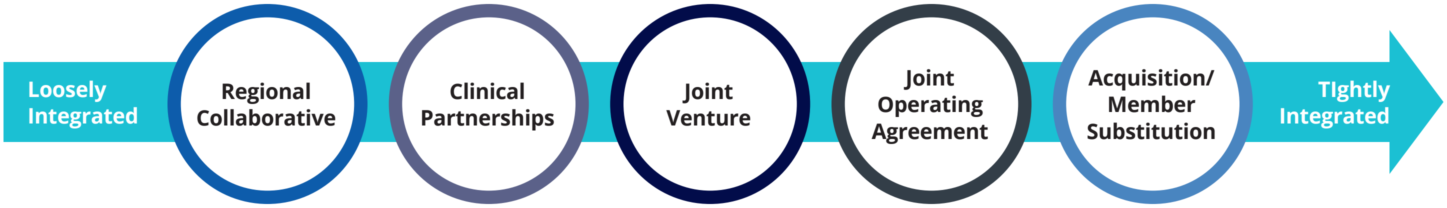
Criterion	A health system will know it has reached the most responsible moment when most of the following variables have "High" ratings:	Rating[1]
Clinical/ Physician	• The health system cannot be competitive regarding quality of care (whether perception and/or reality). • The health system is unable to secure needed programmatic affiliation agreements. • Physician alignment and/or integration challenges are adversely impacting the system's ability to advance its strategy. • Significant gaps exist in key clinical services.	**High, Medium, or Low**
Market Characteristics/ Growth	• Market has unfavorable demographic trends (e.g., declining population, poor payer mix). • Utilization rates are shifting rapidly (e.g., acute care utilization declines, IP to OP shifts accelerate, out-migration). • Despite strategic investment, the health system does not grow its market share. • There is a clear and consistent pattern of market share loss.	**High, Medium, or Low**
Operational	• The health system is unable to realize needed economies of scale to achieve profitability. • HR competitiveness cannot be maintained, and recruitment and retention are difficult. • Labor costs are excessive, and solutions are not within the system's grasp.	**High, Medium, or Low**
Competitive/ Regulatory	• Competitors aggressively move into the service area, targeting the health system's key services. • Competitive dynamics shift (e.g., competitor joins or is acquired by a major system). • The market experiences significant disruptive events (e.g., new entrants, closures). • Significant regulatory changes occur (e.g., elimination of Certificate of Need).	**High, Medium, or Low**
Financial	• Payer contracts are not competitive, and the health system is unable to secure favorable rates/terms. • Short-term performance is acceptable, but financial forecasts appear unfavorable. • Capital is needed, but not available, for a mission-critical project within five years. • There is a high likelihood of not meeting financial obligations over the next three years.	**High, Medium, or Low**

[1] High = does need to pursue strategic partner, Medium = nearing need for strategic partner, Low = does not need to pursue strategic partner.

multi-organization collaborative models include the following:

- **Shared-service initiatives** that build infrastructure or technical expertise to drive economies of scale across certain business functions like revenue cycle, laundry and linen, insurance services (i.e., insurance captive), and biomed equipment maintenance
- **Supply chain initiatives** like group purchasing, regional warehousing and distribution, pharmacy benefit management, and blood products and surgical supplies
- **Workforce initiatives** such as agency nursing and ancillary staffing, and employee benefit management or third-party administration (TPA) services
- **Information technology initiatives** such as regional health information exchange, cybersecurity, and digital health expertise
- **Quality and safety initiatives** such as performance benchmarking, dissemination of clinical best practices and care standards, CMS performance monitoring, and accreditation support
- **Management services organization (MSO) initiatives** that provide services to private physicians and/or health system physician enterprise organizations
- **Population health and value-based care initiatives** such as creation of a regional clinically integrated network (CIN) or accountable care organization (ACO)
- **Venture fund initiatives** that partner with private equity or other innovators to create new businesses,

FIGURE 3: TRADITIONAL STRUCTURAL MODELS OF AFFILIATION



medical devices, pharmaceuticals, or technologies that improve healthcare and may serve as alternative revenue sources

The range of opportunities could extend to nearly every aspect of an organization's business model.

Most regional collaboratives have four to six members and start with a common set of business objectives around pain points that the organizations believe will benefit from scale and shared (or new) expertise. Participating organizations should have some common geographic alignment, though not be direct competitors. Some regional collaboratives span large geographies within a state. Others cross state lines or may even be multi-state. Some, if a specialized healthcare company is an anchor or founding partner, may even be national.

Collaboratives often go by various other names: alliance, network, consortium, partners, etc. They are, however, legal entities structured to meet the shared objectives of the members and should have enough stickiness in contractual terms to warrant at least a three- to five-year commitment.

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Determine Your Path Forward

In times of uncertainty, leaders must still lead. If you are an independent hospital or smaller health system, proactively evaluating your strategic options is a leadership imperative. And strategic agility in defining and acting upon your future may make the difference in your ability to fulfill your mission—or serve someone else's. ■

ABOUT ECG

With knowledge and expertise built over the course of 50-plus years, ECG is a national consulting firm that is redefining healthcare together with its clients. ECG offers a broad range of strategic, financial, operational, and technology-related consulting services. ECG is an industry leader, offering specialized expertise to hospitals, health systems, medical groups, academic medical centers, children's hospitals, ambulatory surgery centers, investors, and payers/health plans. As an affiliated partner of Siemens Healthineers, ECG's subject matter experts have a proven track record of delivering results fueled by top talent and technology.

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