Volume 17, No. 6 • November 2020

E-Briefings

New research and expert opinions in the area of hospital and health system governance.

What Has COVID-19 Meant for Affiliations and Partnerships?

By Jeff Sommer, Managing Director, and Clare Kelley, Consultant, Stroudwater Associates

Huge operating losses, ongoing operational challenges, and a "new normal" have called into question the rationale of some planned mergers. What can the healthcare industry learn from cancelled mergers, renegotiated affiliations, and partnerships that have been consummated during the pandemic? How can health system leaders utilize these events to gain a fresh perspective on existing and potential partnerships and ensure that organizational objectives are being met?

Pre-COVID-19

In late 2019, the credit rating agencies predicted a positive outlook for the hospital sector in 2020. Per Moody's, NFP hospitals' operating cash flow was expected to improve between 2–3 percent in 2020.[1] The projected growth in operating cash flow was due in part to the highest Medicare reimbursement rate increases in many years, an expected delay in payment cuts to Disproportionate Share Hospitals until late 2020, increases in commercial health plan rates in the low single digits, and tighter expense controls. While Stroudwater felt that these short-term trends were valid, the longer-term outlook was concerning as many "headwinds" for the industry are structural and recurring. Without COVID-19 on the radar screen, partnership activity continued along trends that had been at work for several years including selective buyers and rural hospital closures and bankruptcies.

Post-COVID-19

In March 2020, with the effects of COVID-19 ramping up, S&P and Moody's voiced concern that the coronavirus outbreak was "accentuating cash flow constraints." Primary drivers of cash flow hit by the pandemic were the cancellation of profitable elective procedures, material reductions in service volumes, and higher operating

Key Board Takeaways: Lessons from the Last Three Years

- **Know your strategic value.** If you want to attract a quality partner and a quality set of contractual terms, you must have a compelling strategic value proposition. Key drivers of value included in the proposition are cash flow, covered lives, clinical quality, referral patterns, and geographic coherence.
- **Strategic alignment is critical.** Enduring strategic value to partners is essential to weather the storm and create an enduring partnership.
- **Know the unique rural value proposition.** If you are a rural health system or a system exploring rural affiliation options, make sure your advisor can vet and model the value proposition of rural operations and unique revenue opportunities so you get the fullest benefit of the unique designations available in the rural sphere. Rural healthcare may be the most misunderstood and undervalued portion of our healthcare delivery system today.
- **Know the strengths and weakness of your partner.** The strength of your partner matters. Does your partner have the liquidity, operational excellence, and clinical resources to deliver? Do their strengths offset your constraints and needs? Does the partnership agreement speak to those opportunities?

1 Deirdre Fulton, "Moody's Upgrades 2020 Outlook for Non-Profit Healthcare Sector to Stable," *Healthcare Finance News*, December 16, 2019.

THE GOVERNANCE INSTITUTE

A SERVICE OF nrc HEALTH

costs associated with new COVID-19 operating protocols. The duration, location, and severity of COVID-19 disruptions will determine the extent of the impact on health systems over the next several months to years. On March 25th, Moody's changed its 2020 outlook for the industry to negative.[2]

The uncertainty and very serious short-term impacts on health systems made selective buyers pump the breaks and in some cases, re-think planned mergers and partnerships. As of October, *Becker's Hospital Review* highlighted five mergers that have been called off:[3]

- Michigan: Advocate Aurora and Beaumont Health
- California: Ventura County Medical Center and Dignity Health
- Ohio: Beaumont and Summa Health
- Illinois: Advocate Trinity Hospital, Mercy Hospital and Medical Center, South Shore Hospital, and Bernard Hospital
- New Jersey: Geisinger and AtlantiCare

Affiliation and Partnering Fundamentals

Stroudwater has advised several clients on pending affiliations over the last 12 months, none of which have been cancelled. In one instance, a buyer sought to renegotiate terms and won some limited concessions, but in every instance the planned affiliations are proceeding. Forging a durable partnership requires that each prospective partner have a compelling value proposition for the partnership. Simply focusing on getting the highest purchase price does not ensure that the strategic, operational, and financial rationale is sound and durable. Carefully vetting prospective partners, evaluating potential deal structures, and crafting enforceable deal terms are essential. A strategically sound partnership will do the following for participants:

- Address critical operating and strategic risks
- Mitigate partner risk
- Address gaps in capabilities
- Enhance both participants' strategic and market position

If one of the parties to a prospective partnership does not understand the strategic value of its affiliate, it is too easy for the partnership to be abandoned or unwound when circumstances change. For example, many of our affiliation clients are small or mid-size hospitals and health systems serving rural communities and regions. Many organizations view rural hospitals as "the juice not being worth the squeeze." These larger organizations often do not appreciate the unique value that rural operations can bring to a larger health system, including:

- System overhead cost-allocation to rural affiliates receiving cost-based reimbursement
- Rural affiliates having access to 340B-associated funding
- Unique clinic designation opportunities, including uncapped cost-based reimbursement, that can be replicated system-wide with the rural affiliate as the sponsor

Stroudwater advised a rural health system in its search for a partner in the months leading up to the pandemic. The initial frontrunner had many of the attributes our client sought in a partner, including high- quality clinical and operating resources, scale, and financial strength. During the process, we communicated our clients' rural value proposition, including the opportunities described above, to prospective partners. Several understood how they could leverage these attributes within their systems and made proposals that reflected this value proposition. Unfortunately, our client's pre-affiliation frontrunner would not, or could not, grasp the value that the prospective affiliate would have brought to their system. Our client selected a competing proposal from a different system. Despite the impacts of COVID-19 on our client and its preferred partner, the affiliation remains on track without a pandemic-related hiccup.

Applying What We Have Learned to Existing Affiliations and Partnerships

For existing partnerships, now is an excellent time to evaluate these assets as a portfolio. Some key considerations include:

- **Renewal risk**
  - Be aware of pending renewal options.
  - How is the partnership performing and how might it be improved?
  - Does your partner intend to renew?

Forging a durable partnership requires that each prospective partner have a compelling value proposition for the partnership.

2 Suzie R. Desai and Kenneth T. Gacka, "Not-For-Profit Acute Care Sector Outlook Revised to Negative Reflecting Possible Prolonged COVID-19 Impact," *S&P Global*, March 25, 2020.

3 A. Ellison, "5 Hospital Mergers Called Off This Year," *Becker's Hospital Review*, October 13, 2020.

- Do you want to renew?
- What other options exist?

- **Be proactive! Ensure you have time to evaluate your options and the performance of your existing partner.**
  - Understand notice provisions and plan accordingly.
  - Evaluate your partner's performance.
  - Evaluate your options—do you have a credible alternative if necessary?
  - What strategic, operational, and clinical considerations should inform your decision-making?
- **Do you have the leverage to renegotiate?**
  - Leverage often begins and ends with credible alternatives.
- **What capabilities and vulnerabilities have COVID-19 revealed about your partner and the partnership? How has COVID-19:**
  - Changed your needs, opportunities, and constraints?
  - Changed your risk profile?
  - Revealed the strengths and weaknesses of your partner?
  - Revealed the pros and cons of the partnership?

Applying What We Have Learned to Prospective Partnerships

- How has COVID-19 changed your needs, opportunities, and constraints?
  - What vulnerabilities and opportunities have been revealed?
- How has COVID-19 changed your risk profile?
  - What new priorities should inform your partnering decisions?
- Has COVID-19 revealed previously hidden strengths and weaknesses of your partner?
  - How did prospective partners respond to COVID-19?
- What was their approach to working with affiliates during COVID-19 and how does that match your needs?
  - What is their track record at their affiliates?
- Does your prospective partner understand your value proposition?
  - Can you effectively describe your value proposition to potential partners?
  - What can you do to enhance your value proposition?

Warren Buffet said it well: "Only when the tide goes out do you discover who has been swimming naked." This advice applies to partnerships as well. Doing the homework up front is the best way to make sure that neither your partner nor your organization are caught in a compromising position when the tide goes out.

The Governance Institute thanks Jeff Sommer, Managing Director, and Clare Kelley, Consultant, Stroudwater Associates for contributing this article. Jeff can be reached at jsommer@stroudwater.com and Clare can be reached at ckelley@stroudwater.com.