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What Post-COVID Health Provider M&A Could Look Like

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After a sluggish year in 2020 for mergers and acquisitions among hospitals and health systems, 2021 has shown renewed vigor and is poised for considerable transactional activity.

The volume and size of deals in the facility-based health care sector since January suggests that health systems, deal makers and investors have overcome the combination of operational distraction and market uncertainty caused by the coronavirus outbreak and have resumed a secular trend toward regional consolidation and service line extension.

When the COVID-19 pandemic erupted in the U.S. in the first quarter of last year, hospital executives were obligated to shift their focus to a multifaceted operational response to COVID-19, and as a result deprioritized planning for long-term transformation of their business models.

Specifically, many health systems had to contend with a liquidity crunch due to the collapse of elective procedures, while at the same time confronting higher lab supply, and personal protective equipment costs, as well as relentless demands on hospital staff to respond to COVID-19.

The adverse financial impact of the pandemic on health care providers was tempered by a combination of targeted relief under the Coronavirus Aid, Relief and Economic Security Act, Paycheck Protection Program loans and a resumption in many states of nonessential medical procedures in the second quarter of 2020.

However, smaller health systems and independent hospitals that entered the pandemic without substantial liquidity, geographic reach or clinical depth experienced potentially long-term financial and operational adverse impacts as a result of the challenge of responding to COVID-19.

COVID-19 and Returning to Normalcy

Perhaps ironically, in light of these observations, there were fewer announced M&A transactions in this year's first quarter than the corresponding period of 2020.

According to an analysis by Kaufman Hall & Associates, there were 13 announced hospital and health system transactions in this year's first quarter — fewer than half the number in the first quarter of 2020.

And hospital divestitures, both for-profit and nonprofit, dropped from 16 in the first quarter of 2020 to seven in this year's first quarter.

This decline may be explained in part by the fact that closing on an M&A transaction is typically the culmination of months, if not years, of negotiation and planning, and thus the deals announced in the first quarters of both this year and last year reflect the vigor of the M&A market during 2019 and 2020, respectively, and in fact, the first quarter of 2020 had been off to the strongest start in four years.

In perhaps a better metric of relative M&A activity through the pandemic period, according to Kaufman Hall, full-year 2020 M&A transactions numbered 79, down from 92 in 2019.

Interestingly, according to Ponder & Co., the number of transactions involving an independent hospital increased from four in the first quarter of 2020 to nine in this year's first quarter, perhaps reflecting the impact of the pandemic on balance sheets, operational strength and strategic vision.

In addition, the average size of a health system M&A deal has zoomed from roughly $172 million in the first quarter of 2020 to $676 million — the third-highest in the last 10 years — in the same period this year.

With COVID-19 considerations waning, hospitals and health systems will return to strategic transformation initiatives for a number of different reasons.

Health care providers that exited from COVID-19 with strong balance sheets or minimal disruption from the pandemic will be positioned to capitalize on opportunities created by divestitures by other organizations. These providers may also be sought as merger partners by other well-capitalized acquirers.

Health systems will likely be considering transactions that offer opportunities for regional concentration — as opposed to building a national or multiregional network — as the impact of responding to the COVID-19 pandemic has reinforced the thesis that regionalization improves the value of those services where higher volumes are associated with better quality.

In a similar vein, health systems may well look to enter new markets and offer new services that expand their continuum of care such as urgent care retail networks, while disposing of noncore assets such as skilled nursing, home health, labs and post-acute care facilities, through either outright sales or partnerships with specialty service providers to ensure patients have access to the continuum of services.

Following that theme, the key differentiator among health care providers will be the ability to identify core business strengths in order to build resiliency in the face of industry disruption and market shifts.

With the goal to improve quality of care while taking advantage of economies of scale, large nonprofit hospital providers will look to consolidation and partnerships for revenue diversification and geographic expansion opportunities, in large part because it is anticipated that a greater proportion of reimbursement will come from lower-rate government programs.

The aging population exacerbates this trend as the baby boomers shift to Medicare and there is an increase of consumers moving to Medicaid coverage due to the fallout from the COVID-19 pandemic.

These same large health systems will use consolidation to increase top-line revenue, net income and unit profitability, while adding clinical and technological resources to draw patients for complex, high-revenue procedures and build up capabilities in nonhospital settings that are operated by nontraditional providers.

The pandemic has proven to be a catalyst for hospital systems to strengthen intellectual capital resources to be nimbler and to respond to different modes of providing care more efficiently, including implementing telehealth, developing new clinical protocols and rebuilding supply chains.

Antitrust Enforcement Trend Shows No Sign of Slowing

Antitrust enforcement in the health care sector has shown no signs of slowing in recent years, even against the backdrop of the COVID-19 pandemic. The Federal Trade Commission has continued to challenge horizontal mergers of health care providers that the agency believes may lessen competition

In February 2020, however, the FTC faced a setback when its challenge to a proposed merger between two Philadelphia-based hospitals, Thomas Jefferson University and Albert Einstein Healthcare Network, was rejected in federal court on the grounds that the agency failed to support its narrowly drawn geographic market.

Nonetheless, the FTC remains active in challenging mergers with one other active case to prevent a health care provider merger in Bergen County, New Jersey — Hackensack Meridian Health Inc. and Englewood Healthcare Foundation — and one acquisition in December 2020 in Memphis, Tennessee, by Le Bonheur Healthcare of two St. Francis hospitals, that was abandoned after the FTC challenged it.

In June 2020, the FTC and U.S. Department of Justice issued new vertical merger guidelines that cover combinations between companies in different segments of the supply chain.

The guidelines were updated to modernize the FTC and DOJ's methodologies for evaluating vertical mergers and focus on identifying ways that a vertical merger may (1) raise rivals' costs or allow a combined entity to foreclose its rivals, (2) allow access to competitively sensitive information, or (3) otherwise enable coordinated interactions among competitors.

The FTC's recent challenges of hospital mergers and revised vertical merger guidelines will be significant as health care providers evaluate potential combinations.

In addition, Congress is beginning to turn its focus to consolidation in the health care industry and on May 19 held a hearing on hospital consolidation. It is still too early, however, to assess what, if any, impact congressional interest will have on enforcement policy.

Antitrust enforcers and private litigants have increasingly focused investigations and litigations on alleged wage-fixing and no-poach agreements among competitors in the health care arena.

In December 2020, the DOJ, which has responsibility for criminal enforcement of the antitrust laws, filed its first criminal charges relating to wage fixing in health care when it charged Neeraj Jindal, the owner of a therapist staffing company, with engaging in a conspiracy to suppress wages of physical therapists

and physical therapist assistants who provide home health care.

In January this year, the DOJ criminally indicted Surgical Care Affiliates, a corporate owner of surgical facilities, alleging that it agreed with two unnamed health care companies not to solicit each other's senior-level employees, i.e., a no-poach arrangement.

DOJ officials have forecast in various public speeches that the agency intends to aggressively pursue wage-fixing and no-poach agreements.

Plaintiffs lawyers representing current or former employees have likewise challenged such agreements and have filed follow-on civil litigation after DOJ's January indictment.

We anticipate that this activity will continue and that investigating these potential risks will be increasingly significant as part of any diligence for a combination or an acquisition.

Finally, the Biden administration has the potential to reshape the FTC's leadership, which could eventually impact the agency's enforcement priorities in health care. On Jan. 29, Joseph Simons, a Republican appointee and former chair of the FTC, resigned. Rohit Chopra, a Democratic appointee, has been nominated to the Consumer Financial Protection Bureau, although it is unclear when he will leave the FTC.

On June 15, Lina Khan, an academic who was appointed by President Joe Biden and who has been critical of Big Tech, was confirmed as the third Democratic FTC commissioner. In a move that seen as something of a surprise, Biden appointed Khan as chair of the FTC shortly after her confirmation.

It is too early to tell how Khan will approach health care given her recent confirmation. Biden will have additional opportunities to appoint up to two new commissioners when Chopra steps down and when Commissioner Rebecca Kelly Slaughter's term expires in 2022.

New appointees with a focus on health care could have a meaningful impact on the agency's approach toward the health care industry.

Anticipated Uptick in Bankruptcy Filings

After three consecutive years of significant increases in health care industry Chapter 11 filings — in particular those related to facility-based care, health care industry filings declined in 2020 as compared to the prior year. In 2020, hospital filings fell by roughly half, year over year, and bankruptcies of skilled nursing facility operators dropped by 81%.

This downward trend in filings can be attributed to COVID-19-related government aid to avoid hospital and nursing home closures in the middle of a global pandemic. Nonetheless, as the impact of the pandemic stabilizes, these stop-gap measures may be inadequate to bridge the significant loss of revenue engendered by people choosing to forgo or delay elective procedures and by a decline in enrollment in nursing home care.

A dearth of elective surgeries, typically more profitable than COVID-19 treatments, might be compounded by anticipated state and local government budgetary constraints that would result in slower Medicaid and Medicare payments rendering the health care stimulus payments made this year insufficient to avert a financial crisis for many facility-based care facilities.

In the coming year, these COVID-19-related pressures, combined with existing prepandemic uncertainty surrounding the Affordable Care Act and general competitive and operational challenges, are likely to cause an increase in bankruptcy filings, restructurings, and bankruptcy sales of facility-based health care facilities, unless a facility is so critical to a community that local governments have no choice but to step in to avoid a closure.

As an alternative, companies can consider an out-of-court restructuring, which can include converting facilities in exchange for re-tenanting or sales, cash payment and debt reduction from lessees, and other out-of-court solutions.

Looking Ahead

2021 may prove to be a busy year on the health care front.

It is anticipated that hospitals and hospital systems, which have weathered the COVID-19 storm, will resort to the M&A market for a variety of reasons.

Some of the health care providers will be in a position to capitalize on divestitures of other organizations, while other health care systems will be interested in increasing market share and to diversify, in terms of both geography and service lines, in part to remain competitive and to ensure that patients have the full continuum of services.

Some providers may look to consolidation and partnerships for revenue diversification and geographic expansion opportunities, in large part because it is anticipated that a greater proportion of reimbursement will come from lower-rate government programs.

In addition, the pandemic has served as a catalyst for hospital systems to strengthen intellectual capital resources, primarily in the form of consolidation or acquisition, in order to provide care more efficiently, while providing consumers more access points and flexibility, including implementing telehealth, developing new clinical protocols, and rebuilding supply chains.

From an antitrust perspective, continued scrutiny by the FTC is expected as revised vertical merger guidelines are implemented, which will require a thorough investigation of potential risks as part of any diligence for a combination or an acquisition.

Furthermore, new appointees to the FTC with a focus on health care could have a meaningful impact on the agency's approach toward the health care industry.

Finally, a reversal of the decline in hospital and hospital system bankruptcy filings witnessed in 2020 are anticipated. COVID-19-related pressures, combined with existing prepandemic uncertainty surrounding the Affordable Care Act and general competitive and operational challenges, are likely to cause an increase in bankruptcy filings, restructurings, out-of-court restructurings and bankruptcy sales, leading to potential opportunities for health care providers in a position to capitalize on divestitures.

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