

HOSPITAL AFFILIATIONS: A NORTH CAROLINA PERSPECTIVE

By Daniel Carter and Kelly Van Ochten

"We, therefore, the Representatives of the united States of America...do... solemnly publish and declare, That these United Colonies are, and of Right ought to be Free and Independent States; ...and that as Free and Independent States, they have full Power to levy War, conclude Peace, contract Alliances, establish Commerce, and to do all other Acts and Things which Independent States may of right do."

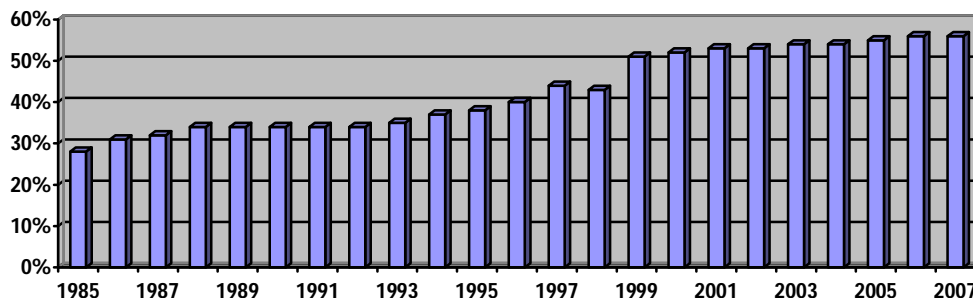
With this Declaration, the United States was established, as a loose affiliation of independent states, each with the power to wage war and conduct commerce on its own. As history accounts, this arrangement did not last even a full decade past the end of the Revolutionary War; the Constitution forming the nation that we recognize today established stronger ties among the states, giving certain powers to a central federal government and leaving more local issues to be governed by the states. So did the states lose their freedom and independence through the Constitution, or did they retain much of their independence while leveraging the size and scale of a federal system to achieve a more successful union?

These same issues are faced by hospital CEOs and board members today. Specifically, for independent, community hospitals considering affiliation, how does hospital leadership ensure that the hospital continues to exist for the benefit of the community it serves, while leveraging the advantages of a larger regional or national system? For many hospitals across North Carolina, affiliation has become a reality, so have those hospitals truly lost their independence? Or have they gained something that they otherwise could not have achieved? More importantly, what lessons can un-affiliated hospitals that may be considering affiliation learn from those that have affiliated?

Trends in Consolidation

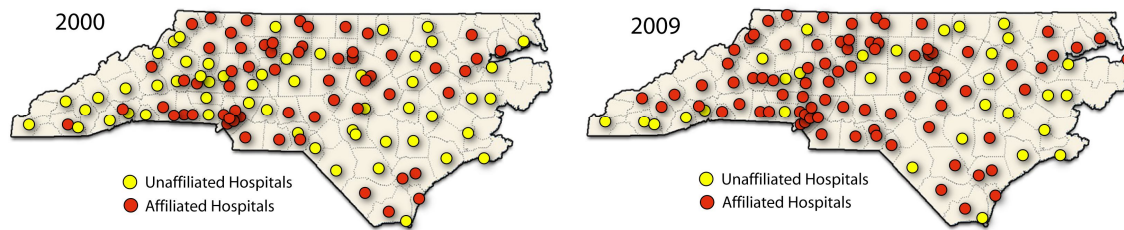
Consolidation, whether through affiliation, merger, or some other form, is prevalent outside the health care industry. While consolidation might seem natural for some industries that are more susceptible to tough economic times, such as airlines and retail chains, it has also become common in industries that typically weather economic downturns fairly well, such as law firms and financial institutions, particularly in the unprecedented economic events of the past 24 months. Even before more recent events, in many parts of the country including North Carolina, hospitals and health care systems have turned to affiliation in order to survive the changing economic climate in the industry. As shown in the following graph, the percentage of U.S. hospitals in a system doubled from 28 percent to 56 percent from 1985 to 2007.

National Percentage of Community Hospitals that are Part of a System



Source: AHA 2009 Statistics

Many North Carolina hospitals are also choosing to align in the current economic climate. As shown in the following maps, the dynamics of the health care market in the state have changed dramatically in a short span of time, with 74 percent of the state's hospitals now part of a larger system.



Source: AHA Guides from 1999-2010 and HPS Research

Drivers

What are the factors that are driving so many hospitals to affiliate? Of course, at a global level, the current economic climate has been straining industries nationwide, and for many hospitals, the recent economic downturn has brought to the forefront many of the issues they've been dealing with for years, such as:

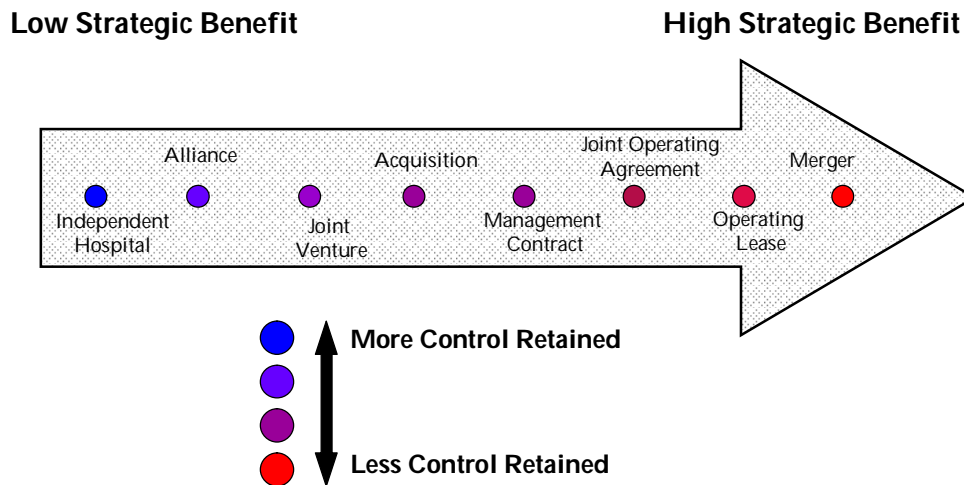
- declining volume;
- narrowing access to capital;
- competition for and with physicians;
- declining reimbursement;
- shrinking profitability;
- changing demographics;
- decreasing leverage with payors; and,
- competitive disadvantage in size and scale.

With the recent enactment of the Patient Protection and Affordable Care Act, independent hospitals may experience increased pressure to affiliate. In their report, *House Approval of Healthcare Reform Signals Sweeping Changes and Mixed Credit Effects*, Moody's Investors Service predicts that hospitals, especially stand-alone community hospitals, "will struggle financially" due to reduced payments and demands for more efficiency, resulting in spending cuts and affiliation or mergers. Mark Pascaris, an assistant Vice President for Moody's states that "[t]here has been more consolidation of managed care and commercial health insurers, thereby giving insurers more leverage in the industry...this may contribute to consolidation among hospitals." (*HealthLeaders Media* report "Hospital Deals are Part of Growing Consolidation Trend Say Analysts," March 2010). In North Carolina, many independent hospitals have concluded that the best way to prepare for the impacts of reform and improve their leverage is through affiliation. During the past five years alone, 19 North Carolina hospitals have chosen to affiliate.

Types of Affiliation

While the word "affiliation" may invoke a knee-jerk reaction in some ardently independent hospital administrators and board members, affiliation does not necessarily require a loss of independence. In general, the more strategic and effective an affiliation structure, the more dependent the relationship; however, it is critical to understand that affiliations and the "systematizing" of health care providers is not a one-size-fits-all scenario. Each provider must weigh its goals and strategy against the strengths and weaknesses of possible organizational structures and potential partners. It is only in the context of the provider's own unique goals and needs that the most effective strategy and partner for affiliation can be

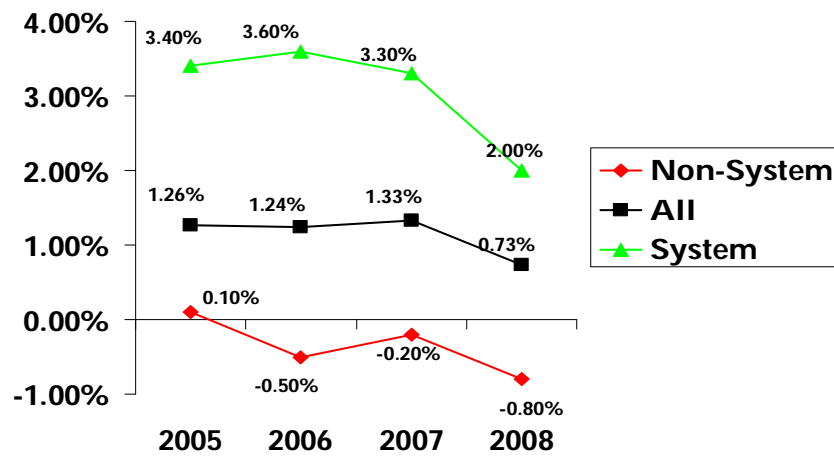
selected. The wide range of collaborative relationships provides virtually all providers with an opportunity to match their particular challenges to an arrangement that can supply the tools to overcome those challenges. The following chart gives some examples of organizational structures and the degree of control that participating organizations can maintain within such structures.



Impact of Affiliation

One of the more obvious reasons for affiliation is the potential financial benefits that it brings to both parties, particularly the independent provider. In North Carolina, hospitals that have affiliated have benefited from increased access to capital, leverage with payors resulting in increased revenue, and cost savings from shared services. The results of these changes are reflected in the operating margins of these facilities. As shown in the chart below, hospitals that are in a system have higher average operating margins than stand-alone hospitals, which have, on average, negative operating margins. Although no one was isolated from the impact of the economy in 2008, on average, system-affiliated facilities were able to sustain profitable operations.

Average Operating Margins for System and Non-System Hospitals in North Carolina



Source: American Hospital Directory, www.ahd.com

Important Questions to Consider

For hospitals that are currently independent or in a loose affiliation structure, several key questions should be discussed among the administration and Board to effectively evaluate the hospital's need to pursue an affiliation strategy, including the following:

- What are the volume, revenue, expense and margin trends of our organization?
- What are we doing to offset any negative trend or to sustain any positive trend? Is it effective?
- Does our organization have the resources to sustain or affect the current trends?
- Do we have the resources to effectively compete for physicians, nurses and allied health personnel?
- What will we do if [insert name of #1 competitor] affiliates with a large system or with another competitor before we do? Will it matter? If so, how much?
- Can we manage the transition to the new health care economic model without a partner?

While these questions alone cannot determine the most effective strategy for your organization, they may provide the insight needed to understand if your organization needs to continue developing its affiliation strategy. They may also help you begin the process of proactively responding to the affiliation trend among hospitals.

HPS and members of its team of professionals have extensive experience with the process, planning, and strategy involved in mergers and acquisitions for health care organizations. If you would like to discuss some of the questions that were posed in this article, or any other questions you may have about affiliation, please contact Daniel Carter at DanielCarter@HealthPlanningSource.com, Dawn Carter at DawnCarter@HealthPlanningSource.com, or Craig Savage at CraigSavage@HealthPlanningSource.com.