

Optimising healthcare transactions: Tactics for success in a complex deal environment

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Abstract The healthcare landscape is increasingly complex, characterised by economic uncertainty, regulatory challenges and rising operational costs. This paper provides a strategic framework for healthcare leaders to navigate this challenging deal environment. Despite economic pressures, merger and acquisition (M&A) activities remain robust, driven by strategic considerations rather than pure expansion motives. Important trends include horizontal and vertical consolidation, innovative joint ventures, strategic partnerships and direct equity investments, all aimed at enhancing operational efficiency, expanding into emerging value pools, and fostering innovation. This paper also delves into the evolving transaction strategies within healthcare systems, highlighting the importance of programmatic capital allocation and structured innovation investments. It outlines the crucial factors for successful execution, such as modernising capital allocation; creating effective governance structures; and building capabilities to test, learn and scale innovations. By leveraging these strategies, healthcare systems can better position themselves for sustainable growth, improve patient outcomes and create value in an increasingly dynamic and competitive market.

KEYWORDS: innovation, M&A, partnerships, strategy, transactions, trends, value-based care

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INTRODUCTION

The calculus of navigating complex healthcare transactions has grown considerably more intricate in the face of a challenging deal environment. Health systems are squeezed by a vice of rising interest rates, economic uncertainty fuelled by Federal Reserve actions and a constantly shifting regulatory terrain. The financial toll of the past two years, with inflation straining budgets and pressuring margins, has further complicated the picture.

This climate, however, has not entirely stifled deal flow. M&A activity in healthcare remains robust, albeit driven by a newfound emphasis on strategic considerations as health systems navigate this landscape of heightened complexity.

Given the aforementioned factors, it is important that industry leaders develop and adhere to robust strategies for navigating an increasingly complex transaction environment and remain

vigilant to shifting, emerging and declining trends and opportunities. While there is no cookie-cutter approach that will yield consistent outcomes, this paper is intended to provide those executives, lawyers, investors, consultants and other professionals with a strategic framework and playbook that can be adapted to specific needs and industry segments and improve value creation from strategic transactions.

LONG-TERM HEALTHCARE TRENDS

Health care in the USA continues to be at an inflection point, marked by several important market trends that are driving material changes in the way health care is delivered, accessed and consumed. Several indicators point towards significant market trends that also indicate a rising wave of disruptive forces that bolster innovation across the healthcare landscape:

- Unsustainable trajectory of costs: At approximately US\$4.5tn, US healthcare

spending represents nearly 20 per cent of the nation’s overall gross domestic product, its share of GDP having almost quadrupled since 1960 (Figure 1).¹

- Labour productivity growth in healthcare lags that of the overall US economy: Between 2001 and 2016, healthcare delivery contributed only 9 per cent of the overall growth of the economy, but 29 per cent of net new jobs. At the same time, workforce challenges, such as those in the field of nursing, were accelerated by the pandemic. This exposed a considerable supply-demand gap, which has resulted in unsustainable growth in staffing and labour costs for health systems.²
- Worsening outcomes: The USA has generally worse population health outcomes than other high-income countries, including lower life expectancy and higher infant and maternal mortality rates, among other variables.³
- Unchecked cost pressures: Accelerating payer focus on curtailing reimbursement rates, growing uninsured and ageing

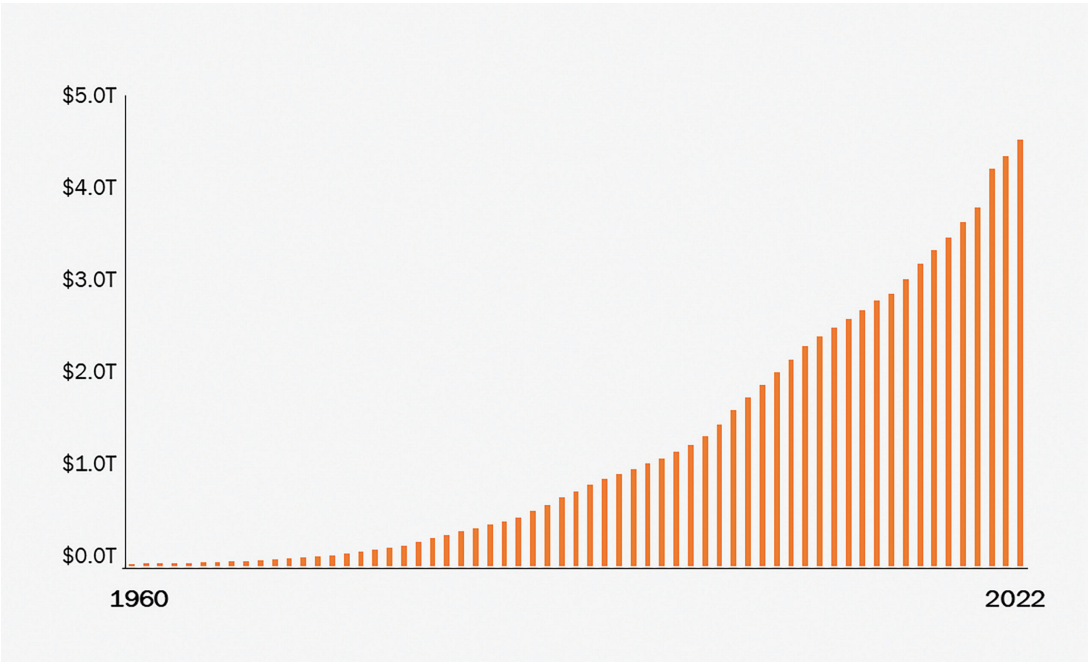


Figure 1 Growth in US Healthcare spend (1960–2022)
Source: Centers for Medicare and Medicaid Services (13th December, 2023) ‘National Healthcare Expenditure Data’, CMS, available at <https://www.cms.gov/data-research/statistics-trends-and-reports/national-health-expenditure-data/historical>.

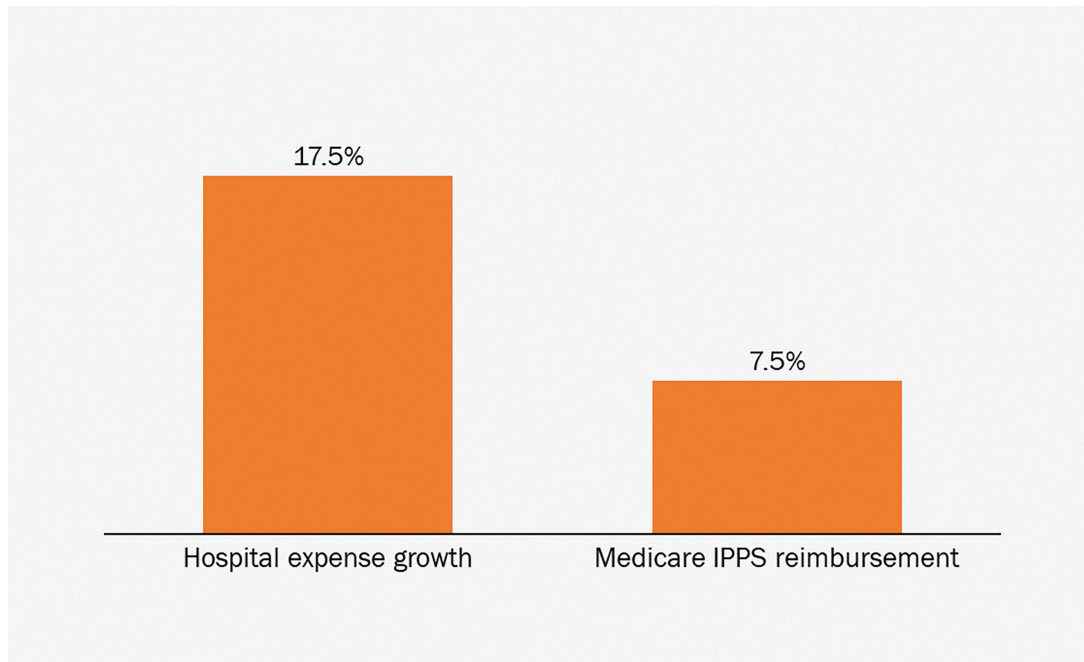


Figure 2 Cumulative hospital expense growth versus Medicare IP prospective payment system reimbursements (2019–2022)

Source: American Hospital Association (2023) 'The Financial Stability of America's Hospitals and Health Systems Is at Risk as the Costs of Caring Continue to Rise'; FY 2020–2022 Inpatient Prospective Payment System Final Rule.

populations and the tightening labour market (post COVID-19) are imposing significant cost pressures on health systems as well as the players across the broader healthcare market (Figure 2).⁴

- New players in healthcare: The ever-changing competitive landscape and ongoing access shifts are creating additional challenges for health systems, with nontraditional players that historically did not play in healthcare delivery — such as payers, technology companies (eg Amazon's acquisition of One Medical, a digital-heavy, access-focused primary care platform) and retailers — investing heavily in the space, with the goal of capturing a wider range of consumer access points and total value.
- Digitisation and consumerism: Digital and analytics adoption is accelerating, with service providers aiming to leverage such platforms to improve clinical outcomes and consumer experience and unlock

efficiencies that will transform how we deliver quality care while ensuring a positive consumer experience.

IMPLICATIONS FOR STRATEGIC FOCUS AREAS FOR HEALTH SYSTEMS

Given these healthcare trends, health systems will need to deliberately lay out essential strategic priorities, with a focus on the following:

- Modernising and turbocharging their essential operations (often in acute care services). Health systems need to further accelerate, regardless of their current starting point, how their essential acute care operations can be reinvigorated by focusing on quality and outcomes (consistently and with low variation by type of service), improving productivity (looking at all opportunities to streamline low value-added work through

automation) and accelerating the adoption of digital technologies that deliver on dramatically improved efficiency, effectiveness and experience.

- Expanding into new, faster-growing value pools (where it makes sense) that are emerging from the shift to value-based care from traditional fee-for-service models. Growth in 'traditional' value pools, notably acute care infrastructure that had historically proven to be attractive investments for health systems, is expected to be outpaced by growth in emerging value pools such as lower-acuity sites of care (eg retail-oriented formats with convenient consumer access points), virtual provider formats and specialty pharmacies. This trend is catalysed by the underlying economics, wherein alternative sites of care have lower costs and earnings before interest, taxes, depreciation and amortisation (EBITDA) margins two to three times higher than the equivalent acute care settings. Similarly, many value-based care delivery players have demonstrated the ability to deliver lower costs and better outcomes as well as realise margins greater than 15 per cent in primary care and specialty models (vs. 8–10 per cent for an equivalent, relatively efficient acute care set-up).

From a purely economic perspective, driving profitable growth demands that health systems focus on diversifying their footprint to play in the emerging, faster-growing value pools and accelerate transition to value-based care, including the adoption of alternative payment models and innovative approaches to better manage the total cost of care. More importantly, as purveyors of delivering health care to communities they serve, health systems need to leverage their essential capabilities along with their brand presence to establish strong positions across established and emerging value pools.

EMERGING TRANSACTION TRENDS IN THIS ENVIRONMENT TO ACCELERATE STRATEGIC EXECUTION

To accelerate the strategic position in their market, health systems continue to leverage inorganic growth levers owing to several benefits driven by efficiencies in capital allocation, realised synergies and speed-to-achieve objectives. Several studies looking at companies that create long-term value show that programmatic capital allocators focused on inorganic growth (vs. *ad hoc* selective or organic investors) generate better long-term value creation.⁵ Although the health system transaction landscape is highly varied and complex, there are six primary archetypes that have increased in popularity in recent years: (a) horizontal consolidation or M&A; (b) joint ventures and strategic partnerships between nonprofit and for-profit entities; (c) structured innovation bets with early-stage companies or investors; (d) corporate carve-outs; (e) health-system consortium plays; and (f) strategic direct equity investments. For each archetype, we provide an overview, recent examples and our outlook.

Horizontal consolidation (i.e., M&A with other health systems) that can support acute/inpatient care

When done right, horizontal scale can help: (a) improve commercial effectiveness by delivering a more differentiated brand for employers, payers, patients and care providers; (b) deliver operational synergies by rationalising capacity, leading to footprint optimisation where appropriate, rationalise support services, create scale in buying and more; (c) create better balance sheets for the whole; and (d) increase the ability to invest, through increased scale, in next-generation capabilities such as in digital or consumer and provider experience.

While there is considerable debate on the extent of realisable synergies through scale

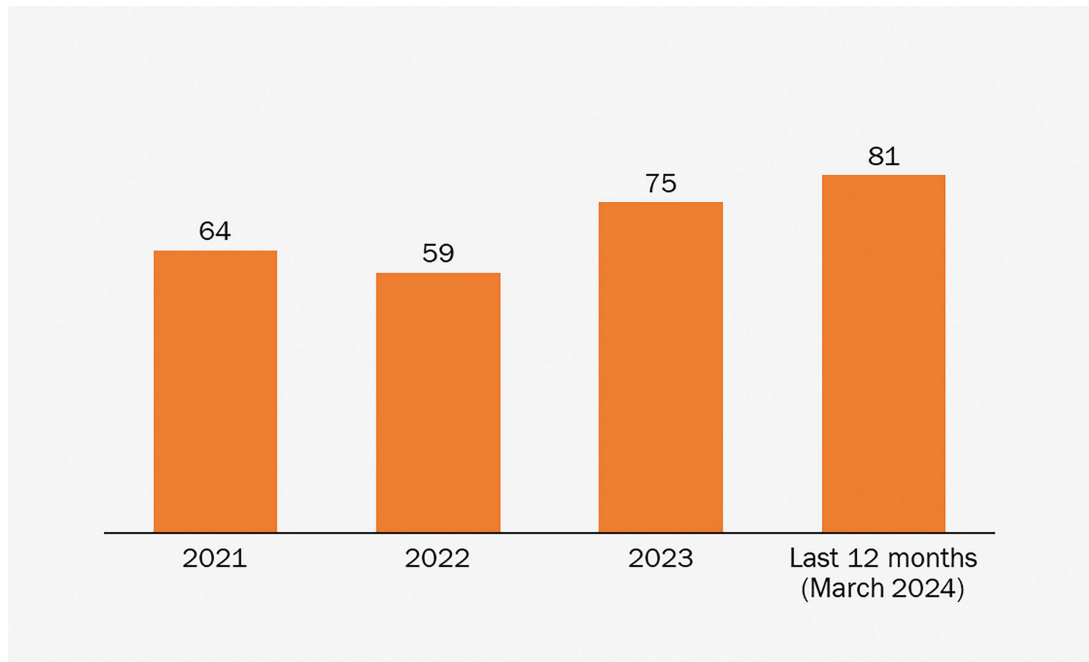


Figure 3 Annual mergers and acquisitions volume trend (2021–2023)

Source: Cain Brothers (1st April, 2024) 'Cain Brothers, Health System Insight'.

which varies in the deal-by-deal context, the opportunity to create effectiveness in capability investments is less debated. With growing margin pressures and the increasing need to double down on capability investments in a largely fragmented care delivery industry, health systems will need to both programmatically and opportunistically evaluate horizontal integration moves (Figure 3).

As Kaufman Hall⁶ and Cain Brothers⁷ have reported, the number of horizontal transactions has continued to increase, and although the average size of the acquired company decreased in 2023 from 2022, it is still ahead of 5- or 10-year averages. The specific trends being seen and expected to continue include the following:

- The nature of large health system M&A activity is expanding in purview from purely organising regional markets to also include cross-market mergers. Recent examples of cross-market M&A include Intermountain Health's

(Utah-based) acquisition of SCL Health (Colorado-based),⁸ Kaiser Foundation Hospitals' (California-based) acquisition of Geisinger Health (Pennsylvania-based)⁹ and Advocate Aurora Health's (Illinois-based) merger with Atrium Health (North Carolina-based).¹⁰ The recent trend in cross-regional transactions, we believe, is a reflection both of increased regulatory scrutiny on local market scale and truly seeking capability synergies (such as in digital, innovation, consumer experience investments) as well as back-office efficiencies (economies of scope and scale, respectively).

- There has been continued M&A activity to develop regional markets such as Novant's efforts in the Carolinas,¹¹ BJC Health System and St. Luke's Health System combination in the Missouri/Kansas region.¹²
- There has been a growth of academic medical centres (AMCs) expanding their teaching, training and research mission to bring care to communities.

Recent examples include UC San Diego's acquisition in southern California,¹³ UCSF's purchase of the CommonSpirit assets in San Francisco,¹⁴ University of Kansas Health system's expansion outside Kansas City¹⁵ and University of Pittsburgh Medical Center's (UPMC's) moves outside greater Pittsburgh.¹⁶

- Many recent horizontal transactions have featured the acquisition of more distressed or low-performing assets. In many cases, challenging economic conditions have prompted entities to either look for a more stable partner or offload assets to shore up the balance of the divesting parent company.

We believe horizontal consolidation will continue in the future as health systems look for new ways to strengthen balance sheets and achieve greater operational efficiency through economies of scale and scope to keep pace or outpace inflationary pressure.

Vertical consolidation outside inpatient care accelerated through joint ventures (JVs) and strategic partnership investments

We expect to see an acceleration in consolidations and in particular JVs and strategic partnerships outside the four walls of the hospital, and we expect to see a continued evolution in the parties engaged in those transactions. We believe this will be driven by revenue and margin diversification trends as more and more lives come under value-based arrangements that will create more pressures on inpatient utilisation. Several examples of continued acceleration can be seen across the board:

- Ambulatory surgical centres (ASCs) were one of the first nonhospital facilities to rely heavily on JVs or strategic partnership structures between ASC operators and established health systems to enable growth, with United Surgical Partners

(USPI) and SCA Health being two of the largest examples,

- Imaging (eg MedQuest),
- Home health (eg AccentCare and LHC Group),
- Behavioural health (eg Acadia Healthcare),
- Urgent care (eg GoHealth and Wellstreet),
- Value-based platforms (eg Wellvana's recent partnership with Advent Health and Agilon's partnership with Maine Health)¹⁷ and
- Emerging partnerships between health plans and health systems (eg Christiana Care and Highmark partnering to launch a Medicare Advantage product).¹⁸

These partnerships are frequently value-accretive for health systems when the counterparties bring operational expertise, differentiated capabilities and speed-to-market tied to a specific service area (such as those outlined previously) that trumps anything the health system could reasonably achieve on its own. Given the revenue and margin intensity of essential acute care operations and hospital-based services, it generally benefits the health system to focus on those aspects of the continuum while allowing a strong partner to deliver value in more distant or detached verticals, particularly those that need to cater to a wide patient base to maximise return.

In any strategic partnership, but particularly in JVs, given the difficulty in unwinding, health systems need to expand their playbook to ensure the system can access upside commensurate with the value they bring, protect the system from significant downside risk and ensure the system has sufficient governance and oversight to enable long-term strategic alignment. Creative structures that optimise the must-have and nice-to-have transaction terms for both parties are emerging and include the following:

- Put or call rights that allow either party to exit the relationship at an

easily determined price (eg discount or premium to fair market value) if performance or counterparty actions fail to deliver on the expectations.

- Criteria for whom the counterparty can and cannot sell to or affiliate with.
- IP and trademark licensing.
- Termination/exit rights are often the biggest challenge in negotiations, especially when dealing with private equity-backed groups since “easy outs” lower the exit multiples for their portfolio companies. Health systems, alternatively, want flexibility to mitigate reputational and financial risks.
- Noncompetition and exclusivity — health systems, while willing to provide some level of exclusivity to JV partners to enhance value creation for the venture, look to narrowly tailor these limitations so as not to impinge on the broad scope of services and solutions that complex integrated delivery systems provide to their communities.
- Change of control — often ties into exit rights, that is, private equity firms do not want restrictions put on whom they can sell to, while health systems do not want to be in a position where a sale happens to a traditional or nontraditional healthcare entity that is not aligned with health systems mission.
- Ownership of the JVs itself — more health systems are willing to take minority positions in certain deals. Nonprofit systems will need to ensure that tax-exempt status is protected but are less concerned about unrelated business income taxation issues if a deal furthers strategies or improves financial performance.
- Governance rights — regardless of ownership splits, parties want to ensure there are decision-making protections at the Board level, for example, if in a minority position, health systems want to have equal board voting rights or supermajority protections on important

decisions such as capital calls, amending governing documents and admitting new investors to the JV.

Structured innovative business-building programmes with early-stage companies or venture capital firms

Given the several pain points and unmet needs in how care is accessed and delivered, there are several opportunities ripe for innovative business building to create differentiated solutions. We believe that health systems are a critical enabler to bring these innovative models to market, given that they are closest to consumers’ needs. Creating and testing these innovative solutions will require experimenting with several concepts with finite failure rates. Therefore, a test-and-learn or lab concept is critical. That said, running at tight operating margins, health systems often lack the R&D budgets that other points in the value chain (eg life sciences, medical products, insurers and technology companies) have. Furthermore, they also often lack the financial models to incentivise and attract entrepreneurial talent to work within their systems to solve these problems.

At the same time, there has been a growing proliferation of venture-backed investments in the sector, resulting in an ecosystem of providers that are already investing in, or that have the willingness to (eg through venture studios) invest in, solutions that tackle these unmet needs from the supply side. As an example, there has been a rapid growth in new businesses that solve the growing community needs in behavioural health, women’s health, paediatrics and value-based care delivery. These companies often lack the local distribution access that health systems have that provides ample opportunities for health systems to partner with these innovative companies in testing models for business building.

Health systems can derive great benefit from establishing a structured, collaborative platform to facilitate structured identification of important pain points and unmet needs and tap into a wide set of companies with innovative solutions to solve these. This type of approach can also make sense for health systems with academic medical partnerships in AMCs given the set of capabilities required. As an example, AMCs can be a helpful accelerant to specific clinical pathways where they may have incumbent capabilities but often find areas (like in digital health models) that are outside their essential remit.

Taking the steps to evaluate and select business-building ideas to drive through an innovation-focused platform may yield great benefits in the long term, including cementing a 'culture of innovation' within the system to help rapidly adapt to ever-changing market dynamics. Over time this can also support more inside-out innovation as well as help accelerate innovation outside smart-growth business building into the full spectrum of clinical, operational and administrative workflows.

One strategy gaining traction involves partnering with promising early-stage companies or even systematically with venture firms that direct several of these innovations. Such partnerships demonstrate a shift towards a more strategic approach by health systems, enabling them to identify and nurture promising healthcare advancements at an early stage. There are a range of affiliation models between health systems and venture firms:

- **Light Affiliation (*Ad hoc* Collaboration):** Health systems engage with venture firms on a case-by-case basis to explore specific opportunities of mutual interest. This offers flexibility but may lack the strategic focus of a long-term relationship.
- **Middle Ground (Consortium Participation):** Health systems join consortia formed by venture firms, such

as the Aegis digital health consortium. This approach provides access to a curated pool of innovations and potential early adoption opportunities. While consortia offer structure, health systems share access with other members and may not have full ownership over the relationship.

- **Deep Affiliation (Acquisition):** Venture firms fully acquire health systems, as exemplified by General Catalyst's buying Summa Health. This model provides the firm with direct control and ownership to create aligned testbeds for innovation but represents a significant shift in the traditional healthcare landscape and potentially shifts health systems' operational and strategic independence. In the General Catalyst/Summa case, this allows the venture firm to leverage the health system to accelerate established proof-of-concept and potentially enables rapidly scaling these innovations solutions for wider adoption within health systems.

This spectrum highlights the range of strategies available to health systems seeking innovation. Choosing the right affiliation model depends on a health system's goals, specific needs and appetite for risk versus ownership and control in the innovation process.

Carve-outs

Health system carve-out transactions are typically based on two different but related factors: (a) creation of industry leading capabilities that warrant broader commercialisation; and (b) shifting strategic priorities (ie evolution of a health system's 'where to play, how to win' philosophy) in terms of geographic or service line focus. As an example of a capability carve-out, consider Providence and its asset Acclara. Providence developed industry leading revenue cycle capabilities and opted to first establish a stand-alone business entity to commercialise that capability and then

sold the entity to R1, which strengthens the balance sheet position in a nonessential functional capability, while continuing to leverage Acclara revenue cycle capabilities via a commercial contract. An example of strategic carve-out includes Community Health Systems divesting several of its assets in West Virginia, Arkansas and Florida,¹⁹ and Tenet's divestments in Southern California and California.²⁰

As health systems invest more heavily in innovation and seek new profit centres, we expect to see both a re-investment such as the foregoing levers as well as finding areas that warrant this type of carve-out transactions. Shifting strategic priorities have driven, and will continue to drive, significant transaction activity tied to geographies or verticals. Larger health systems often enter and exit markets as situations change and priorities evolve.

In the midst of the current market environment, several creative deal structures such as long-term commercial contracts, noncompete arrangements and staggered payment arrangements based on asset performance are being implemented to de-risk the investments.

Consortium plays are emerging as a powerful way for health systems to address industry-wide challenges and create innovative solutions unavailable through traditional channels

Consortia offer an avenue for collaboration across organisations that might otherwise be competitors. Recent examples like Truveta and Civica Rx illustrate the potential of these initiatives. Truveta, a data platform built by a consortium of health systems, seeks to aggregate and analyse vast amounts of patient data, driving insights to improve care and research. Civica Rx, also formed by a health system consortium, tackles the issue of drug shortages and price instability by directly manufacturing generic medications. Consortium plays allow health systems to

pool resources, share expertise and mitigate risk while driving transformative change. These initiatives often revolve around critical business priorities, targeting areas where existing solutions are inadequate or cost prohibitive. By leveraging the collective influence of multiple health systems, consortia can create new companies that directly address shared pain points, potentially disrupting entire segments of the healthcare industry and ultimately improving quality and access to care.

Strategic direct equity investments

Health systems can pursue direct equity investments across thematically aligned focus areas. Health systems that follow this strategy can generate incremental value through preferred access to aligned solutions and services, as well as generate investment alpha on equity investments due to proprietary insights on what works, enabling better underwriting as well as value creation through alignment with essential operations. Moreover, some of these investments can be shepherded by prominent investors with either direct control or considerable influence on strategic direction and operational value creation, thereby allowing health systems to avoid recreating what can be costly portfolio value creation capabilities.

The primary advantages of creating structured avenues for direct equity investments within health systems include: (a) considerable synergies across diligence processes for equity investments and evaluation processes for differentiated companies to partner with for either deeper, strategic relationships or innovative pilots; and (b) alignment in a win-win approach for operating and investment platforms. Further, investing in companies can serve as a conduit to product development on solutions that solve critical customer issues and preferred access to latest thinking and innovations. Beckers calls out 23 health systems with investment arms.²¹ The real number is likely

higher, given that, as an example, Memorial Hermann Health System has invested in over 40 companies in the last three years and was not included in the Beckers list.

FOUNDATIONAL ELEMENTS FOR SUCCESSFUL EXECUTION AND CONCLUSION

Irrespective of the specific priority choices, there are multiple important levers that are becoming critical for health systems to successfully execute on these programmatic inorganic choices:

- Be deliberate about the thematic priorities that health systems pursue, which will vary based on their broader vision and associated strategic considerations. For example, health systems may choose to adopt the path to achieve best-in-class cost efficiencies, or, alternatively, focus on becoming the destination centre of excellence by driving more fundamental innovations in their core, or they may want to expand into value-based health. Whatever the strategic considerations for the health systems are, the inorganic themes of focus must naturally tie to these strategic considerations.
- Modernise the capital allocation approach to achieve diversification by focusing on adjacencies and emerging value pools, thus thinking beyond just 'traditional' capital allocation in a relatively asset-heavy footprint expansion.
- Create a diligence playbook on how to evaluate individual investments, for example, what are the value drivers of the investments? How do we measure differentiation of the company we are evaluating versus other options?
- Build capabilities to test, learn and scale innovations that are addressing important business challenges and pain points where proven solutions do not exist or may not be a good fit for the specific health system.
- Be deliberate on important success metrics on the performance of these

strategic investments (whether equity investments, JVs, M&A or innovation programmes).

- Create internal capabilities to rapidly screen the market and evaluate potential target companies. This is synergistic with the mandate of uncovering strategic investment opportunities in adjacent, growing value pools and new revenue streams.
- Articulate the win-win guiding principles and showstoppers on how to engage and collaborate with partners often backed by venture capital, private equity firms, retailers or payers creating distinctive platforms in several health services segments.
- Develop streamlined governance to evaluate and approve these investments as these opportunities will often be competitive and time sensitive.
- Create a full-potential value creation playbook for smart growth investments and innovation programmes. What does integration look like in the ideal state? What are the essential value drivers and associated strategy for the business? What is the implementation road map to realise these synergies?
- Create a network of internal operational and functional champions whose collaboration and sponsorship are critical to successfully shape and realise the full-potential value from these investments.

In conclusion, as health systems navigate the complexities of healthcare transactions, structured innovation investments emerge as a powerful tool for driving strategic growth and delivering value to patients and communities. By embracing innovation and forging strategic partnerships, health systems can position themselves at the forefront of healthcare transformation, driving improved outcomes and sustainable success in an ever-evolving industry landscape.

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