

# Hospital Eye Service Transaction to Cut Costs and Boost Revenue

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As hospitals migrate from a revenue base built on patient volume to one based on value and quality outcomes, the pressure to control costs and maximize revenue has escalated. In recent years, many organizations are looking beyond just cost cutting, and instead, are exploring affiliations and partnerships that create economies of scale, conserve precious capital, and spread risk. For example, the number of hospital transactions increased from 55 in 2006 to 91 in 2016, according to *The Health Care M&A Report* published by Irving Levin Associates.

However, large-scale transactions are not the only option for navigating today's healthcare market. Increasingly, hospitals are taking a close look at service lines to determine whether divesting those services, joint venturing with a third-party to provide them, or acquiring a standalone outpatient facility makes financial and strategic sense.

## Urgent Care Leads the Way

Urgent care operations have proven popular targets for recent service line transactions. Health systems have either acquired such locations or have sought partners that can provide services outside the walls of a hospital. By diverting lower acuity patients away from costlier emergency room visits – most notably, uncompensated visits associated with uninsured patients – expanded urgent care services are more

cost effective for health systems. Additionally, for patients with no primary care physician or association with a health system, urgent care centers often serve as a gateway for future health services – helping to expand the system's patient population.

In some instances, health systems have acquired large urgent care service providers and operate them as separate divisions. An example of this is Banner Health, which acquired 32 urgent care centers from Urgent Care Extra in the state of Arizona, completed in November 2016.

## Rehabilitation Joint Ventures Gain Popularity

Rehabilitation medicine is another area piquing the interest of hospitals and service providers. In some communities, rehab operators are acquiring and closing the rehab units of hospitals that compete for these types of patients. Increasingly, however, hospitals and rehabilitation medicine operators are entering into mutually beneficial joint ventures.

Numerous transactions have occurred in which the hospital moves its inpatient rehab medicine services to a facility to be built, owned and operated by a service provider as a separate operating entity. Such an arrangement brings much-needed capital investment, cash or both to a hospital, while allowing it to continue offering a high-quality service the community needs.

These types of considerations prompted CHI Franciscan Health to enter into a joint venture with Kindred Healthcare, a Fortune 500 healthcare services company, to construct and operate a 60-bed inpatient rehabilitation hospital in Tacoma, Washington in July 2016. Under the terms of the agreement, Kindred will manage day-to-day operations of the proposed hospital that is expected to open in the first quarter of 2018. It is interesting to note that CHI Franciscan is a nonprofit, faith-based health system willing to partner with a for-profit enterprise, a trend that is growing.

## Benefits of a Joint Venture

Joint ventures can also offer relief to hospitals coping with limited space. When the service line moves to the third-party's new or existing facility, hospitals can expand higher margin services into the vacated in-house space. In addition, moving the service line out of the hospital may present an opportunity to relocate to an area with a better demographic profile

The value of a specialty service provider's management expertise should not be underestimated. For example, such firms may be experts at managing the many compliance-related issues of their discipline, thereby mitigating risk for the hospital. Where the joint venture calls for sharing of revenue, some hospitals have found that their share, which is typically at or just below 50 percent, often is greater than their historical revenue for the service line, attesting to the bottom-line impact of expert management.

Joint venture governance issues generally can be resolved to the satisfaction of both parties. The typical arrangement is for the hospital to comprise 49 percent of the board of directors. Contracts and joint venture organizational documents can specify that certain major decisions require a supermajority.

It is not surprising then, that hospitals are looking closely at imaging services, emergency departments, psychiatric services, and other specialty service lines as potential joint venture targets.

## How to Assess a Joint Venture Partner

When assessing a prospective joint venture partner, hospitals should consider the following:

- **Governance** — How will the board of directors for the new operating entity be formulated? If the hospital will have 49 percent representation, will the contract allow for a supermajority on major decisions?
- **Community relations** — What effect will the new partnership have on the hospital's relationship with community?
- **Litigation** — Has the prospective partner initiated any litigation or are there lawsuits pending against the organization?
- **Brand identity** — Is the prospective partner well known locally or regionally? How will the partner's reputation affect the hospital's brand?
- **Financial strength** — Does the potential partner have the financial capacity and track record to meet its obligations?
- **Tax status** — Is the partner a for-profit or a not-for-profit operation, and will this be a concern for the hospital board?
- **Culture and values** — How closely aligned are the missions of both entities? If one partner has a religious affiliation, how will that affect the partnership?
- **Unwind provisions** — Should the arrangement prove unsuccessful, how will both parties end the relationship?

## What Joint Venture Partners Seek

Hospitals seeking a service line joint venture should keep in mind a prospective partner's interests. These may include a desire to complement their existing business in order to grow their company, geographic expansion, and the increased buying power of a larger system.

From a hospital's point of view, the potential for cross-selling services and expansion of its service area are important. Occupational medicine

departments, for example, often provide services to company headquarters. These companies may well prefer to continue these relationships at their satellite locations. By partnering with a service provider with a larger footprint, a hospital can offer one-stop shopping to its corporate clients, a decided marketplace advantage. Further, if patients need emergency care after hours, the hospital itself can serve those needs.

As the reality settles in that hospitals cannot always provide all services and remain financially healthy, service line transactions can be a viable alternative. These arrangements can help maintain a certain level of service in the community, thereby aligning with a hospital's mission, and they can contribute to the long-term financial strength of an institution.

## The Service Line Transaction Process

Once a hospital decides to move forward with a service line transaction, the following steps should be taken:

- Obtain a valuation analysis in order to estimate either the hospital's contribution to a joint venture or the potential proceeds of a service line sale.
- Identify potential buyers or joint venture partners for the service line.
- Issue a request for proposal to gauge interest and narrow down the list of potential partners.
- Perform due diligence on remaining partners and schedule management interviews.
- Select a final partner and move forward with a letter of intent.

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