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capitalizing hidden values from hospital assets

Monetizing noncore assets can be a source of capital for hospitals.

AT A GLANCE

- > Benefits from selling noncore assets include generating capital and freeing up management resources.
- > Monetization transaction structures include sale, partnership, and strategic affiliation.
- > A hospital that engages in such a transaction needs to ensure that the purchaser or joint venture partner will maintain the hospital's high standards of care and ethical principles.

Today's operating environment demands that hospitals—whether or not they enjoy a strong capital position—evaluate all potential sources of capital. Most tax-exempt hospital operators have four primary sources of funding:

- > Income from operations
- > Income from investments
- > Philanthropy
- > Tax-exempt debt

For safety-net providers, government subsidies may also be a significant source of capital. What is common among not-for-profit hospitals is a severely constrained ability to access sufficient capital to fund necessary investments in plant and operations. The current healthcare landscape presents clear pressures on operating and non-operating cash flows, and borrowing at all credit levels has become more restrictive and expensive for all but the highest rated hospital operators.

The good news is that alternatives exist for increasing liquidity and accessing capital by capturing hidden values trapped in many hospitals' noncore assets and lines of business. Generating capital through sale, joint venture, or other form of asset "monetization" is emerging as a significant source of new capital for many hospital operators. Beyond the financial benefits, these transactions can also have significant strategic benefits.

Candidates for Noncore Asset Monetization

What a given hospital might consider to be a non-core asset or business and, therefore, a candidate for a monetization transaction will vary depending on how the level of operational integration, legal characteristics, and overall operating philosophy mesh with core hospital operations.

Assets and businesses that are frequently considered to be noncore and potential monetization candidates include the following:

- > Affiliated hospitals in noncore markets or with significant, sustained operating losses
- > Ambulatory surgery centers
- > Behavioral health facilities and operations
- > Diagnostic imaging centers
- > Dialysis centers
- > Home health agencies
- > Hospice facilities
- > Laboratories
- > Managed care organizations
- > Medical transportation services
- > Medical office buildings
- > Physician practice management infrastructure
- > Specialty programs such as wound care, diabetes management, occupational medicine, and wellness
- > Rehabilitation facilities
- > Senior health and housing, including skilled nursing, assisted living, and dementia services
- > Wellness and fitness centers

The relative attractiveness of monetizing any of these assets and operations will depend on three primary considerations:

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- > The strategic implication to the organization of selling an operating activity or asset
- > The potential capital to be generated from a monetization transaction
- > The impact of the transaction on financial statements and credit profile

Hospitals should not consider monetization of noncore assets purely from a financial impact standpoint. The strategic benefit or disadvantage of selling an operation should be the first consideration that goes into any evaluation of a monetization opportunity.

Why Assets and Business Lines Are Classified as Noncore

A hospital might have many reasons for classifying an asset or business line as noncore. A primary reason is financial and often relates to lack of economies of scale and a resulting high, non-competitive cost structure. A laboratory serving a small- to medium-sized hospital or system, for example, may not have enough volume to generate low per accession and test costs, and attracting skilled technicians and pathologists can often be difficult.

The allocation process for scarce capital resources is often another contributing factor. Following the lab example, a hospital might be more compelled to allocate capital to upgrading operating rooms or clinical information technologies than it would to purchasing of state-of-the-art laboratory equipment. Hence, a business line such as the laboratory may become starved for capital and orphaned within the hospital. Selling or joint venturing with an independent lab company can solve issues like these and generate substantial capital for redeployment in core acute care assets.

Another important reason for an asset or business to be considered noncore is that hospitals recognize that, in some cases, third parties (or third parties in the form of joint venture entities in which the hospital continues to participate) can operate businesses more efficiently and profitably without degrading quality.

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Not-for-profit and for-profit organizations that specialize in operating senior living facilities, for example, can often bring lower cost structures to these businesses, because personnel policies and salaries and benefits packages do not need to match the levels often necessary for hospitals to attract and retain staff or meet collective bargaining arrangements. A third party also can apply different benchmarking to the business. In addition, focused operators often have more expertise to better manage operational and development risks.

Clinical expertise is also a key factor in concluding whether a service line is core or noncore. For example, specialty operators of freestanding rehabilitation facilities or even units within hospitals are typically able to demonstrate better clinical outcomes at lower costs than general acute care hospitals operating these units on their own.

After years of excess bed capacity in several markets, many hospitals are beginning to encounter significant capacity constraints. By selling or joint venturing noncore operations such as skilled nursing and rehabilitation units, hospitals can free up hospital bed capacity for more profitable use. Similarly, by joint venturing with outpatient surgery companies, hospitals can free up operating room capacity to accommodate higher intensity inpatient procedures.

Benefits from Capturing Hidden Values in Noncore Assets

Capital generation and unlocked management resources are the two most obvious benefits to a hospital that sells a noncore asset or business line or enters into a joint venture partnership relating

to a noncore asset or business line. Assessing the comparative impact from both a balance sheet and income statement perspective is fundamental to any assessment of a monetization opportunity. Cash proceeds from a full or partial sale transaction can augment balance sheet strength through additional cash reserves, which is particularly important to credit rating agencies, or be redeployed into core acute care hospital operations for higher and better uses.

Freeing up management resources used to operate the sold or joint ventured business, while perhaps somewhat difficult to quantify, is another benefit. The ability to focus on key operations and challenges, without being distracted by marginal assets and businesses, is often a significant bonus for overburdened management teams.

Hospitals engaged in monetization transactions can typically retain referral business from the new operator of the joint venture, and the methods to achieve these referrals can usually be addressed in the transaction documents. If a hospital completes a joint venture transaction or otherwise retains an equity interest in the sold business, the hospital will benefit by participating in future earnings distributions from the business. Due to the operating efficiencies and expertise of companies focused on a specific sector, such as ambulatory surgery or home health, the income and cash flow generated from partial ownership can often be greater than the income generated under 100 percent hospital ownership.

Important strategic benefits can also be derived that are in addition to the usual financial and unlocked management resources benefits. For instance, Caritas Christi Health Care in Massachusetts announced in an Aug. 18, 2009, news release that it sold its outreach laboratory business to Quest Diagnostics. In addition to cash proceeds generated by the sale, Caritas Christi said that it would gain access to Quest's information technologies and be able to use Quest's online ordering and results-reporting systems to update its medical records. Caritas Christi also said that Quest will collaborate with it on a secure

information exchange among the system's hospitals, network physicians, and affiliated physicians.

Transaction Structures

There are three general types of monetization transactions: sale, partnership, and strategic affiliation.

Sale. A 100 percent sale is the most obvious alternative. The hospital sells the asset or business line to a new operator in return for consideration, generally cash, and the new owner takes over. Depending on what is sold, the hospital can retain significant contractual commitments to protect its strategic interests. For example, in most medical office building (MOB) transactions, the hospital will retain ownership of the land underneath the MOB and enter into a ground lease with the building's buyer. The terms of the ground lease often include controls on the buyer, such as what kind of tenant can rent space within the building (e.g., a physician on the hospital's medical staff), and in that manner, the hospital can continue to protect the core reason for owning an MOB.

In cases such as home health, hospice, or rehabilitation where the operation is part of the continuum of care, purchasers are usually willing to provide the hospital with long-term contracts to render the acquired services to the hospital's discharged patients at favorable rates and with specific service and quality commitments built into the agreements. These types of arrangements allow the hospital to preserve the strategic value from the sold operation while benefiting from the monetization. To further preserve the hospital's interests, some buyers are willing to structure repurchase rights under certain circumstances and at predefined valuations.

Partnership. Partnerships and joint ventures with unrelated parties and related parties, such as physicians, can have a multitude of variations. The ultimate legal and operating structures will depend on answers to key strategic questions such as the following:

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- > What will be the ownership interests of the parties? 50 percent/50 percent? Minority? Majority?
- > How much capital will be necessary?
- > How will the venture be financed?
- > What are the clinical objectives of the venture?
- > What is the business case for the venture?
- > How will the venture be reimbursed?
- > How will the venture be managed?
- > How will the venture be governed?
- > How will the venture be taxed?
- > What impact, if any, will it have on the hospital's tax-exempt status?
- > Will there be a "halo" effect that will produce additional volume for the hospital?
- > What is the impact on corporate allocations?
- > How will competitors react?
- > What is the exit strategy or strategies for the parties?

Joint ventures can be structured in many ways depending on the objectives of the parties.

Common objectives include:

- > Accessing proven management expertise
- > Enhancing hospital referrals and patient catchment areas
- > Boosting the growth rate of the business and/or increasing market share and geographic scope beyond what one party can accomplish on its own
- > Generating capital for the business

If the objective of the joint venture is to attract capital to support the operation, a common transaction structure is for the hospital to contribute the operation at its fair market value and the joint venture partner to contribute cash equal to the value of the operation contributed by hospital. The joint venture partner then usually obtains a contract for management of the joint venture.

Strategic affiliation. Strategic affiliations through the use of management contracts can also have lots of variations. Hospitals can use contracted management to provide patient care services instead of employing a manager directly as a salaried employee. Support departments such as security and dietary have a long-standing history

of using this kind of contracted management service. Outpatient services such as ambulatory surgery, wound care, and wellness centers are often conducted through management contract arrangements.

Avoiding Pitfalls

Pitfalls in monetization transactions, particularly those involving clinical operations, primarily relate to the acquiring company or partner. The hospital needs to be assured that the purchaser or joint venture partner can and will maintain the hospital's high standards of care and ethical principles. No hospital can afford to have its reputation diminished by a subsequent owner and operator. The hospital will also need to be assured that strong community ties can be maintained. Further, it is critical that the hospital maintain and enhance strong physician relationships and continue to cultivate business referral sources. Another consideration is that the hospital's employees involved in the sold or partnered business be treated fairly during the transition and after the transaction closes.

Another set of pitfalls involves technical legal aspects relating to transaction structures and terms, particularly if the transaction involves physicians. In cases involving physicians, transaction terms need to comply with a complex set of laws and regulations designed to prevent physicians from overusing the services of a facility in which the physician has a financial interest. And in all cases, tax-exempt organizations must avoid benefiting private persons and businesses while fulfilling their charitable purposes.

Monetization Process Steps

Before entering into a monetization transaction, hospitals and health systems should take several steps to evaluate whether the decision would benefit the organization.

Inventory noncore assets and businesses. As a first step in evaluating monetization alternatives, the hospital should assess what operations are potentially noncore in relation to its strategy and mission. This step starts with an assessment of the

business line's strategic importance and impact on the hospital core operations and mission.

A second part of the decision process should include a comparison of key performance benchmarks against industry standards. If the hospital's benchmarks generally tend to fall below the industry's (i.e., the hospital performs worse than the industry average), the hospital may be more inclined to include the business in the noncore category or at least recognize that the business might perform better under a different ownership and/or management structure.

The third part of inventorying noncore assets and businesses is to estimate an asset's value, which will help to assess the financial impact of a monetization transaction.

Consider values. A number of different methods can be used to determine the potential value of a noncore asset. The clearest, but most resource-intensive way is to solicit offers from potential buyers. Absent actually marketing a noncore asset, other proxies for determining potential value include assessing values of publicly traded companies focused on a specific sector and values associated with completed transactions. In some cases, it may be advisable to engage an adviser familiar with doing merger and acquisition transactions in the subject sector. Such an adviser can pinpoint value better and gauge potential third-party interest based on experience and understanding of specific facts and circumstances.

Identify potential candidates. In virtually all hospital-related sectors, multiple companies will be seeking to participate in a monetization transaction. Sometimes, as in the senior living and home health sectors, there will be both not-for-profit and for-profit participants. The more participants in a given sector, the more likely it is that an interested transaction party or parties can be identified.

Solicit interest and proposals. Assuming the hospital decides to move forward with a monetization, it (or its adviser) should prepare a memorandum

that describes the opportunity surrounding the subject asset or business line, with its positive impacts and any potential negative impacts, and distribute it to potentially interested parties. Enough information should be included in the memorandum so that an interested party can make a realistic assessment of the degree of its interest and be in a position to put forth a good-faith preliminary proposal. Confidential information can be managed in such a way that it is shared only when a potential buyer has been identified.

Decide. With one or more proposals in hand that indicate the broad outlines of transaction terms and valuation, hospital management and board members will be able to make a determination about whether to proceed with the monetization transaction.

Capture Hidden Values

The primary sources of liquidity and cash flow generation for hospitals and health systems are constrained, and the environment for funding capital expenditures is often difficult. As a result, many hospitals and health systems should consider capturing hidden values contained in noncore hospital service lines and assets through monetization transactions that can result in significant financial, operational, and strategic benefits. ●

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