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 have looked beyond cost cutting toward affiliations and partnerships that create economies of scale, conserve precious capital, and spread risk. For example, the number of hospital transactions increased from 59 in 2004 to 79 in 2014, 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 and occupational health services have proven popular targets for recent service line transactions. Health systems have either acquired such locations or sought partners who will provide the services off site. Occupational health, in particular, can pose problems for hospitals because work-related injuries and illnesses often take years to litigate, creating high accounts receivable days and increased bad debt. In some instances, health systems have acquired large occupational and urgent care service providers and operated them as separate divisions. This is the case with Dignity Health, the San Francisco-based non-profit hospital system, which in August 2012 acquired U.S. Healthworks, Inc., the largest independent operator of occupational medicine and urgent care centers in the United States, that now operates through a wholly-owned, for-profit subsidiary of Dignity Health.
THOUGHT LEADERSHIP

HOSPITALS EYE SERVICE LINE TRANSACTIONS TO CUT COSTS AND BOOST REVENUE

REHABILITATION JOINT VENTURES GAIN POPULARITY

Rehabilitation medicine is another area piquing the interest of hospitals and service providers alike. In some communities, rehab operators are acquiring and closing the rehab units of hospitals that currently 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 the University of Wisconsin Hospital and Clinics to enter into a joint venture with Centerre Healthcare Corporation, a national inpatient acute rehabilitation services provider, in August 2013. Under the terms of the agreement, Centerre will construct and operate a free-standing, 50-bed inpatient rehab hospital on UW Health’s planned new campus in Madison, WI. It is interesting to note that UW Health is a non-profit, academic center willing to partner with a profit-making enterprise, a trend that is growing.

THE 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%, 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

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?
Hospitals are looking closely at imaging services, emergency departments, psychiatric services, and other specialty service lines as potential joint venture targets.

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 that hospitals cannot provide all services and remain financially healthy comes into sharp focus during these unsettled times, 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.

49% 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.

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.

Transaction advisory consultants can assist with many aspects of a service line transaction.

ABOUT THE AUTHORS
Shane Goss, Managing Director
Shane Goss has extensive experience providing valuations for mergers and acquisitions, corporate compliance and financial reporting, and serves as a financial consultant to healthcare companies. Shane can be reached at 312-880-3456 or sgoss@huronconsultinggroup.com.

Karen Kole, Manager
Karen Kole provides fair market valuations and financial advisory engagements exclusively for healthcare entities; with a majority of time spent on merger and acquisition advisory. Karen can be reached at 312-880-3457 or kkole@huronconsultinggroup.com.

huronconsultinggroup.com

© 2016 Huron Consulting Group Inc. All Rights Reserved. Huron is a management consulting firm and not a CPA firm, and does not provide attest services, audits, or other engagements in accordance with standards established by the AICPA or auditing standards promulgated by the Public Company Accounting Oversight Board (“PCAOB”). Huron is not a law firm; it does not offer, and is not authorized to provide, legal advice or counseling in any jurisdiction.