PREDICTING SUCCESSFUL HOSPITAL MERGERS AND ACQUISITIONS

A Financial and Marketing Analytical Tool

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Analytical Tool

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Chapter 1

What This Book Will Do for You: Introduction

This book is designed as a tool that hospital and hospital system executives can use to determine the potential success of a merger or acquisition within the nonfederal hospital sector. We did not examine other types of mergers involving hospitals, such as long-term care facilities or physician groups. Particular emphasis needs to be given to the effect of managed care in future merger analysis.

We believe that there are three factors that must be considered when reviewing a prospective merger or acquisition: (1) the financial viability of the new unit; (2) the positive or negative effects on the marketing efforts of this entity; and (3) its potential for increased operational success and efficiency. Each element is analyzed and reviewed with regard to its relation to the others.

We have analyzed data on all mergers and acquisitions of California hospitals between 1982 and 1992. There was a total of 29 mergers during that period. (Note: Data on mergers within the Kaiser system were not available.) We first analyzed the data to determine *which* hospitals were potential candidates for mergers.

Data from five years prior and up to three years after merger or acquisition are compared. We also attempted to compare these hospitals with hospitals of similar revenue, size, and type of location that had not merged or acquired another hospital.

From this data we attempted to develop a model that would predict a merger candidate. We found seven significant financial variables that would discriminate between merger candidates and nontargeted hospitals.

We found that the model was successful in predicting merger or acquisition targets. The success rate varied from 55 percent to 93 percent. The variance of the results was due to the age of the data. That is, predictions based on data from five years before a merger were less accurate while data from one year before a merger permitted extremely accurate predictions.

We determined seven significant financial variables from one year prior to the merger or acquisition for the buying hospital and the new organization. Examining these seven variables, we concluded that the new organization was negatively impacted by the merger or acquisition. However, these variables could not predict the success or failure of the new organization.

Still, we attempted to predict the potential for success of the new organizations with this model. We found that our analysis of financial data alone, *based on a single financial ratio*, could predict failure with a high degree of accuracy and success with less precision.

Thus, we see two potential conclusions from this work. First, that if the executives studying the potential merger or acquisition reviewed these variables, they would have a fairly good idea whether or not the new organization would be better or worse off financially than the old organization initiating the transaction. Second, we can conclude that these mergers are taking place because of nonfinancial factors that *offset the negative financial impact in the long run*. If not, then these very talented and intelligent executives made bad decisions for their organizations. To conclude, we review what has happened with as many of these mergers and acquisitions as possible.

MERGERS AND ACQUISITIONS AS A GROWTH STRATEGY

There are four possibilities for growth as seen in Figure 1.1: market penetration, market development, product/service development, and diversification. A review of the definitions of these terms, as stated in one of the popular marketing textbooks, will aid our discussion.

Market penetration is trying to increase sales of a firm's present products in its present markets—probably through a more aggressive marketing mix. The firm may try to increase the customers' rate of use or attract competitors' customers or current nonusers. For ex-

FIGURE 1.1. Four Possibilities for Growth

	Present Products	**New Products**
Present markets	Market penetration	Product development
New markets	Market development	Diversification

Source: E. Jerome McCarthy and William D. Perreault Jr., *Basic Marketing,* 10th edition. Homewood, IL: Irwin, p. 66.

ample, Coca-Cola has increased advertising to encourage people to take a morning Coke break instead of a coffee break and to switch from Diet Pepsi to Diet Coke.

New promotion appeals alone may not be effective. A firm may need to add more stores in present areas for greater customer convenience. Short-term price cuts or coupon offers may help. For example, AT&T has increased advertising and offered special discounts to encourage customers to choose AT&T over other long-distance telephone services.

Obviously, effective planning is aided by a real understanding of why some people are buying now and what will motivate them to shift brands, buy more, begin purchasing, or resume buying.

Market development is trying to increase sales by selling present products in new markets. This may only involve advertising in different media to reach new target customers. Or it may mean adding channels of distribution or new stores in new areas. For example, McDonald's is reaching new customers by opening outlets in airports, office buildings, zoos, casinos, hospitals, and military bases. And the franchise is rapidly expanding into international markets with outlets in places such as Brazil, Hong Kong, and Australia.

Market development may also involve a search for new uses for a product, as when Lipton provides recipes that indicate how to use its dry soup mixes to make party dips.

Product development is offering new or improved products for present markets. Here, the firm should know the market's needs; it may see ways of adding or modifying product features, creating several quality levels, or adding more types or sizes to better satisfy them. Computer software firms such as Microsoft boost sales by introducing new versions of popular programs. Microsoft has also developed other types of new products for its customers. It now sells computer books and even computer hardware.

Diversification is moving into totally different lines of business—which may include entirely unfamiliar products, markets, or even levels in the production-marketing system. Until recently, Sony was strictly a producer of electronic equipment. With its purchase of CBS records, it has expanded into producing music—and it is considering other moves that will take it further yet from its traditional business.[1]

Mergers or acquisitions may be used within each of these strategies. For example, by acquiring a hospital within your current market, you may increase market share to help customers, such as HMOs, identify your organization as the one that they want to do business with.

By adding hospitals in a market that you have not entered, you have the opportunity to develop that market for your brand. Often, expansion into new markets is accomplished by buying "fire sale" units and restoring them to health. Of course, this can be accomplished in your current markets or in new markets.

An acute care hospital organization that buys long-term care, rehabilitation, and/or psychiatric units is moving into product development strategy. To differentiate this strategy from diversification, you can see that the additions listed in the definition are still within the provision of hospital-type care. Acquiring a drug wholesaler would be more akin to diversification.

While the correct nomenclature is not important, the concept that an organization can increase sales and improve revenues through the acquisition of or merger with other organizations is important. Because few new markets are available for hospitals and because competition is increasing, the merger and/or acquisition route may be the only one available for organizations that want to grow.

We want to caution you about one facet of using an acquisition strategy to capture market share. That is, there are regulatory restrictions that must be considered. We will review the current published opinions. However, only legal counsel can give you a definitive answer.

MERGERS AND ACQUISITIONS AS A DEFENSIVE STRATEGY

Another organization seems to be interested in a market that you have had your eye on for some time. You do not see its value within your current strategic plan. However, you do have plans for it in the future. By acquiring a unit within this market you can forestall the move that your competition seems to want to make.

There is danger in this strategy. You may find that your acquisition costs are only the first installment that you will have to pay. If the new market needs development, you may find that it will take years for the unit to break even.

To Succeed, Both Financial and Marketing Aspects Must Be Considered

To remain competitive and efficient in the current managed care environment, hospitals and other health service institutions must continually reassess their market positions. This may mean eliminating or otherwise modifying services to cut costs.

The other option is to increase revenues. If it is possible to acquire a new unit that permits economies of scale or offers other incentives, it is wiser—in the long run—to attempt to build up an organization instead of trying to downsize since there are limits to the savings that you can obtain as your system or hospital shrinks.

Operational Aspects Affect the Success of a Merger or Acquisition

All too often a unit may look ideal for acquisition or merger only to find that the financial and marketing elements were fine but that there were operational aspects that were not considered.

The merger of medical staffs has caused problems in even the smoothest transition. A warning sign of potential trouble is when the two units to be merged are geographically close together. This may indicate that the staffs chose not to work cooperatively because of job insecurity.

Redundant employees need to be released with a minimum of trauma. If one hospital is unionized and the other is not, you can expect some difficult problems. Finding a method to retain the best employees—without raising issues such as age discrimination—will take much of your time. Of course, the differences between the utility of the physical plants will also be of major concern.

Differing corporate cultures and community images may become apparent. You will see that caution is essential when analyzing the factors and applying cost/benefit ratios to them.

Quality is an important factor that may be affected by the formation of a new entity. We will discuss operational quality and customer service quality. Quality goes beyond numbers and it goes below the surface. Quality is not merely what people will accept, nor is a set of statistical norms that can be reported to the Board on a quarterly basis.

In discussing what level of quality you need to achieve to compete in the managed care environment, we also discuss centers of excellence. We believe that managed care organizations will contract only with true regional centers that offer unique services at a level of quality acceptable to knowledgeable consumers. "Me Too" centers may actually cost you money if they are included in your capitation payment. We also discuss nonmanaged centers that can be very profitable and attract patients.

REFERENCE NOTE

1. E. Jerome McCarthy and William D. Perreault Jr., *Basic Marketing*, 10th edition, Homewood, IL: Irwin, 1990, 65-67.