

Health Care Industry Valuation Insights

ARE HOSPITAL ACQUISITION PRICES GOING UP? THE RESULTS OF A WILLAMETTE MANAGEMENT ASSOCIATES ACQUISITION PRICING ANALYSIS

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There has been recent debate in the health care industry journals as to whether hospital pricing multiples are increasing or decreasing. This article presents the results of a study of empirical data regarding recent hospital acquisition transactions. This article also discusses the factors that have affected the recent trend in hospital acquisition prices.

INTRODUCTION

Recently, a number of health care journal articles have discussed the direction of prices regarding hospital acquisitions. Not surprisingly, opinions vary with regard to the direction of hospital acquisition prices.

One complication regarding this current debate is the lack of analysis of empirical data regarding hospital acquisition transactions. To fill this void, we performed an analysis of hospital acquisitions that occurred during the years 2000 through 2004. The objective of this analysis is to identify what trends, if any, are manifested in the data.

This article discusses some of the underlying trends that have affected the economics of the hospital industry over the last five years. And, this article reviews various transactional data in order to address the question: "Are hospital acquisition prices going up?"

A HOSPITAL IS A HOSPITAL—NOT

The environment within which a hospital operates has a significant impact on its market value. This statement is true for several reasons:

1. The size of the market has a bearing on the services that a hospital can provide. Typically, hospitals in very small markets do not serve a population sufficient in size to support many specialty services. And, these specialty services are often among the most lucrative.
2. The local payor mix can have a substantial impact on profitability. Markets with a high percentage of patients that are insured by programs such as Medicaid and SCHIPS (State Children's Health Insurance Program)

tend to yield lower average reimbursement rates, and hence have lower profit potential.

3. Different buyers look for different types of opportunities. Therefore, the competition to buy a given hospital will depend on the nature of the hospital. Buyers seek to attain leading market share in a given market. Some of the rationales for this fact include:
 - a. A number of hospital companies look for hospitals in markets that are large enough to support lucrative specialty programs, but small enough to allow one hospital to be the sole or dominant provider.
 - b. Other buyers seek to achieve market power by acquiring multiple facilities in larger metropolitan markets.
 - c. A third group of buyers seeks hospitals in small rural markets where they are assured of being the sole provider, albeit with lower margin potential.

Therefore, the desirability of a given hospital, and hence its value, is influenced by the size and the degree of fragmentation of its local market. It follows that average acquisition prices in any given year may be influenced by the mix of the local markets in which the acquired hospitals operate.

NOT-FOR-PROFIT ACQUIRERS AND FOR-PROFIT ACQUIRERS

While the hospital industry is dominated by not-for-profit companies, for-profit companies acquire a disproportionate percentage of the hospitals that are sold each year.

Companies such as Community Health Systems, LifePoint Hospitals, Triad, and Health Management Associates have announced that acquisitions are key components to their business strategy.

While for-profit companies own only about 15 percent of the nation's hospitals, they are the buyers in at least half of all transactions in most years. Similarly, in most years, for-profit companies represent less than half of the sellers.

A notable exception occurred in 2004 when Tenet, suffering repercussions from its recent legal and financial problems, was the seller in 13 transactions (representing approximately 25 percent of the total number of transactions identified).

The following Exhibits 1 and 2 present the hospital acquisition transaction activity levels of (1) for-profit buyers and sellers as compared to (2) not-for-profit buyers and sellers.

Exhibit 1 indicates that not-for-profit buyers substantially reduced their acquisition activity in 2002 and did not manifest any significant increase in acquisition activity until 2004. Exhibit 2 indicates that, as sellers, both groups have reduced their activity since 2001.

However, the for-profit sellers presented an up-tick in activity in 2004, largely due to the Tenet divestitures. Other for-profit companies, such Universal Health Systems, Triad, and Community Health Systems, engaged in some portfolio pruning by selling hospitals (1) that were under-performing or (2) that did not provide a good fit with the company's operating strategy.

THE IMPACT OF INDUSTRY PROFITABILITY ON HOSPITAL ACQUISITION VOLUME

The reasons behind the overall decline in hospital purchase/sale transaction activity are not clear. However, the reasons may be related to a decline in the general level of industry profitability. Exhibit 3 presents the operating profit margins for five, large publicly traded hospital companies from 2000 through 2004.

In general, these companies exhibited declining profit margins over the past four years. This decline was influenced, at least in part, by higher levels of bad debt resulting from (1) increasing numbers of uninsured patients and (2) greater degrees of cost shifting by employer-sponsored health plans. Another factor for this decline in profitability was the higher labor costs due to a general shortage (1) of nurses and (2) of other skilled health care workers.

Not-for-profit hospitals generally have lower profit margins than their for-profit counterparts. Therefore, not-for-profit hospitals would tend to feel the impact of a change in margins more acutely. In that case, a change in margins would have a disproportionately large effect on the not-for-profit hospital's ability to raise capital to make acquisitions. In fact, reports by several of the for-profit hospital companies state that one of the primary motivations for not-for-profit entities to sell their hospitals is a lack of capital to support their missions.

Data from the *National Hospital Indicator Survey* published by the Medicare Payment Advisory Commission (MedPAC) show that overall Medicare margins declined from 10.2 percent in 1997 to 1.7 percent in 2002. MedPAC

Exhibit 1
Number of Hospital Acquisitions
By Type of Buyer
For the Period 2000 to 2004

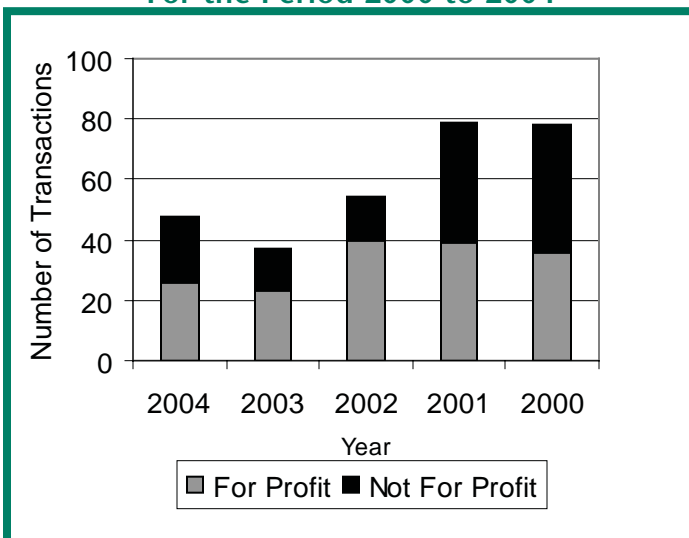


Exhibit 2
Number of Hospital Acquisitions
By Type of Seller
For the Period 2000 to 2004

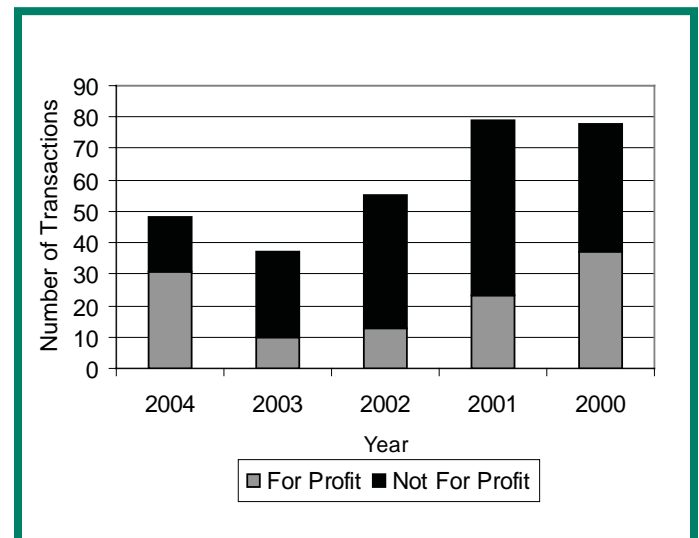
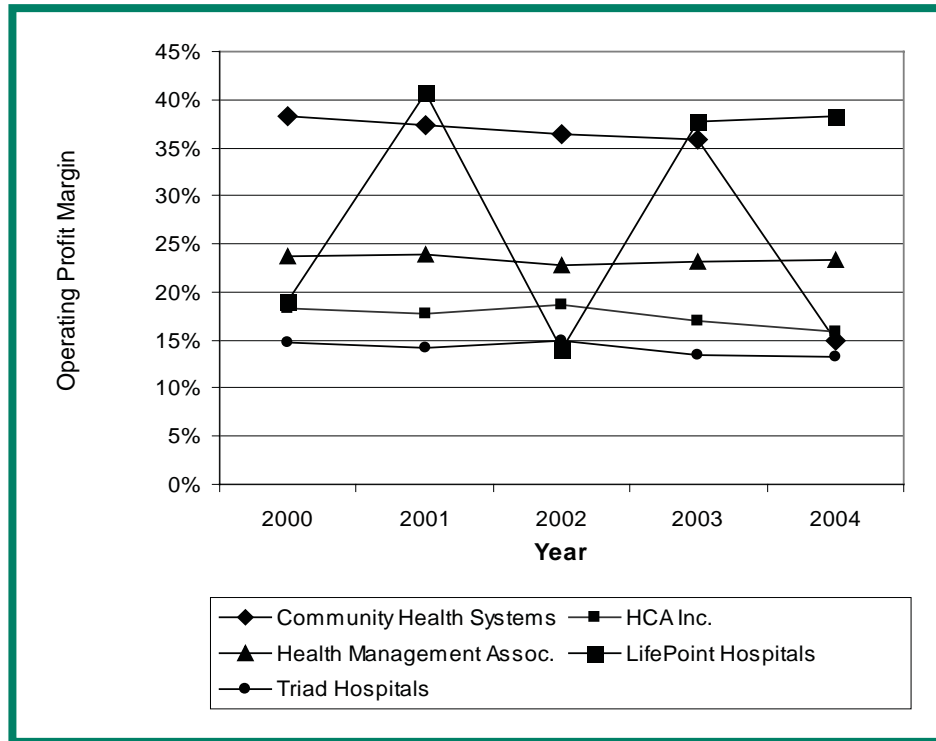


Exhibit 3
Hospital Operating Margins
for Publicly Traded Hospital Corporations



also reported that hospital margins from all payors declined from 6.2 percent in 1997 to 3.5 percent in 2001, with the largest decrease (1.9 percent) occurring in 1998. However, while hospital payment-to-cost ratios for private payers declined from 117.6 in 1997 to 112.3 in 1999, these ratios increased each subsequent year to 115.6 in 2002.

These data suggest that while significant cost shifting between Medicare and private health plans may have occurred between 2000 through 2002, overall profitability still deteriorated. As a result, hospitals have become increasingly dependent on private payors for their profits. And, hospitals are at increased risk from a turn in the insurance underwriting cycle that would curtail the growth in private reimbursements rates enjoyed in recent years.

A “survey of surveys” published by the Healthcare Financial Management Association indicates that hospital profit margins improved modestly in 2003 and 2004. Solucient reported that the median operating margin increased from 3.8 percent in 2002 to 4.1 percent in 2003, based on surveys of 751 and 779 hospitals, respectively.

Four out of five surveys of 2003 and 2004 data indicated that margins improved in 2004, with increases ranging from 0.1 percent to 1.3 percent of revenues. The exception is two surveys published by INGENIX, which included data from roughly 1,800 hospitals. These two surveys indicated that margins decreased from 1.14 percent in 2003 to 0.69 percent on 2004.

In addition, a recent report by Standard & Poor’s indicates that the medians of key financial indicators (1) for stand-alone facilities and (2) for not-for-profit health systems improved in the first half of 2005. Improvements were shown in a number of indicators, including (1) days’ cash on hand, (2) debt service coverage, (3) days in accounts receivable, and (4) excess margin.

Overall, these surveys indicate that industry profitability improved somewhat over the last two years. This conclusion is consistent with (1) a decrease in transaction activity and (2) an increase in acquisitions by not-for-profit companies.

The apparent conflicts in the data between (1) the five for-profit hospital companies and (2) the broader surveys do not necessarily provide divergent views of the fundamental economics of the industry. Rather, these conflicts may point to an increased focus on efficiency on the part of the not-for-profit sector.

The differences in the profit margins exhibited by the five publicly traded hospital companies versus those indicated by the industry surveys are striking. One likely explanation for the relatively superior profit margins reported by for-profit hospital companies is that managers of investor-owned companies are incentivized to maximize profitability and thus efficiency. However, this incentive has generally not been the case for the managers of not-for-profit hospitals.

However, an increasingly challenging fiscal environment may be forcing not-for-profit operators to improve efficiencies in order to survive. Accordingly, the improvement in financial results indicated by the industry surveys may well be just a matter of the not-for-profit sector closing the efficiency gap with the for-profit sector.

On the for-profit side, there seems to be no shrinkage in the number of acquisitive companies. And, acquisition capital seems to be readily available, both from the public markets and from private equity funds. One possible explanation for their declining acquisition activity is that the for-profit companies are maintaining a more disciplined approach to acquisitions, considering only those candidates that closely fit their operating strategies.

Alternatively, given the up-tick in acquisitions by not-for-profits entities in 2004, it may be that access to capital (from both internal and external sources) for the not-for-profit sector is improving. This improvement reduces the impetus for hospital sales to the for-profit sector.

HOSPITAL TRANSACTION PRICING

If the decline in transaction volume is a result of lower demand (i.e. more selective acquisition strategies), then, intuitively, one would expect prices to decrease, all other factors being equal. If the decline in transaction volume is the result of fewer properties becoming available for sale, then one would expect transaction prices to increase.

In order to determine if there has been a change in hospital pricing over the last four years, we examined transaction data for 2000 through 2004 as published by Irving Levin Associates in the quarterly *The Health Care M&A Report*. This publication lists announced transactions each quarter.

Among the data provided are: (1) the target and buyer, (2) the target's revenue and number of beds, (3) the target's income tax status (i.e. for-profit or not-for-profit), and (4) if available, the target's profits, the transaction price, and information concerning the terms of the transaction.

From these published data, we analyzed all transactions that met the following criteria:

1. the target hospital was a general, short-term acute care hospital;
2. the transaction purchase price was disclosed; and
3. the target hospital revenue was disclosed or readily obtainable.

Several very large transactions were eliminated as being not reflective of typical valuations for standalone hospitals or small groups of hospitals. The transactions we eliminated included: the LifePoint Hospitals' \$1.7 billion acquisition

of Province Healthcare Company in 2004, The Blackstone Group \$1.75 billion acquisition of a 66 percent interest in Vanguard Health Systems in 2004, the Texas Pacific Group \$1.4 billion acquisition of Iasis Healthcare Corporation in 2004, the HCA, Inc. \$1.125 billion acquisition of Health Midwest in 2002, and the Triad Hospitals \$2.4 billion acquisition of Quorum Health Group in 2000.

As presented in Exhibit 4, these transaction selection criteria yielded the following numbers of transactions for each year reviewed:

Exhibit 4
Selected Sample Size of
Guideline Hospital Purchase Transactions
For the Period 2000-2004

Year	Number of Purchase Transactions Analyzed
2004	20
2003	25
2002	32
2001	37
2000	37

Given the relatively small sample size, we made no attempt to categorize the target hospitals based on the characteristics of their respective markets. In order to develop a means for determining relative pricing, we calculated a price-to-revenue multiple for each transaction.

In the vast majority of cases, the target hospital earnings were not disclosed or the target's earnings were negative. In addition, reports from several active acquirers indicate that these companies often buy hospitals that are not efficiently managed. The pricing of such acquisitions is often based on pro forma financial results, rather than on historical financial results.

Without access to the buyers' pro forma financial data, "relevant" price-to-earnings multiples cannot be calculated. Accordingly, price-to-earnings data would not represent a meaningful measure of relative acquisition pricing.

As presented in Exhibit 5, the data exhibited the following price-to-revenue multiples for each year:

Exhibit 5
Selected Hospital Acquisition Transactions
Price-to-Revenue Acquisition Pricing Multiples
For the Period 2000-2004

Year	2004	2003	2002	2001	2000
Price-to-Revenue Multiples:					
Mean	0.65	0.71	0.79	0.66	0.62
Median	0.50	0.46	0.56	0.63	0.42
High	2.22	2.25	1.88	2.84	2.58
Low	0.00	0.25	0.00	(0.07)	0.05

These data indicate that hospital acquisition pricing is widely divergent from transaction to transaction. Examining the median and mean transaction prices indicates that hospital acquisition prices have been flat, at best, over the last several years. And, likely, hospital acquisition prices have actually declined.

A note of caution in interpreting these data is in order. This is because of the variability in pricing and the lack of ability to adjust the results for factors such as: (1) the character of the local market and (2) the physical condition of the target facilities. However, a downward trend in pricing would be consistent with the declining margins exhibited by the five publicly traded hospital companies referenced above.

As a final test, we segregated the acquisition transactions in each year based on the profit status of the buyer. We performed this analysis to determine if there is evidence that not-for-profit companies pay more or less than for-profit companies for hospital acquisitions.

Experience indicates that not-for-profit hospitals prefer to sell to other not-for-profit hospitals in order to maintain the community-based mission of the seller. If a not-for-profit buyer cannot be located, then the seller turns to the for-profit sector. This is because the for-profit sector is the next best alternative for ensuring the continued availability of local health care services.

This perceived bias in favor of not-for-profit buyers could result in a less competitive sales process for the hospital being sold. And, this bias could result in a lower price. This is true if both buyer and seller are not-for-profit.

If the seller is a for-profit entity, then a not-for-profit buyer would compete with any other interested parties. Presumably, the price paid would be unaffected by the tax status of the buyer. However, the proportion of not-for-profit buyers has increased over the past two years. And, this shift could result in a downward effect on average hospital acquisition prices.

Exhibit 6 presents average price-to-revenue pricing multiples for the selected hospital acquisitions grouped by type of buyer.

The data presented in Exhibit 6 indicate that for-profit companies paid higher pricing multiples in some years, and not-for-profits companies paid higher pricing multiples in other years. Collectively, however, these data do not support the premise that acquisitions by not-for-profit buyers would have a downward influence on average hospital acquisition pricing multiples.

SUMMARY AND CONCLUSION

A review of selected hospital acquisition data (reflecting hospital purchase activity over the past five years) indicates several pricing factors that may have exerted a negative impact on hospital acquisition pricing.

Based on the conclusions of our analysis, these primary factors include the following:

1. Hospital acquisition transaction volume has declined since 2000. While acquisition transaction volume did increase in 2004, this was largely due to the Tenet divestiture program that resulted from the company's fiscal and legal problems.
2. For-profit companies are the buyers in well over half of hospital acquisition transactions in most years; and, these for-profit companies have experienced declining profit margins.
3. Cost shifting between Medicare and other payors (i.e., decreasing profit margins from Medicare and increasing profit margins from private payors) appears to have increased over the last several years; this cost shifting has put profit margins at greater risk.

Exhibit 6
For-Profit and Not-For-Profit Buyers
Analysis of Hospital Acquisition Price-to-Revenue Pricing Multiples
For the Period 2000-2004

Type of Buyer		2004	2003	2002	2001	2000
For-profit	Number of transactions	10	17	25	27	20
	Median pricing multiple	0.59	0.45	0.71	0.62	0.47
	Mean pricing multiple	0.67	0.72	0.84	0.59	0.62
Not-for-profit	Number of transactions	10	8	7	10	17
	Median pricing multiple	0.41	0.65	0.54	0.77	0.42
	Mean pricing multiple	0.63	0.67	0.63	0.85	0.62

Some other factors would tend to support higher hospital acquisition prices. In particular, despite the decrease in profit margins among for-profit companies, there are indications that overall industry profitability is slightly improving. This factor would tend to reduce the total supply of hospitals that are available for purchase.

Our review of the hospital transaction data indicates that the negative factors are outweighing the positive factors. Consequently, hospital valuations appear to be declining over time. The mean and median price-to-revenue multiples generally have decreased since 2002.

This conclusion implies that the market has responded to the deteriorating profit potential by reducing the hospital acquisition prices it is willing to pay. Based on our analysis of empirical transactional data, the answer to the fundamental question of this discussion, "Are hospital prices going up?" appears to be "No."

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We are pleased to announce that

Trey Stevens

has been named the director
of our suburban Washington, D.C., office.



Trey specializes in business valuation services (for purposes of fairness and other transaction opinions, ESOPs, gift and estate taxation, merger & acquisition pricing, S corporation conversion, buy/sell agreements, and purchase price allocation) and in litigation support/expert witness services (for purposes of family law, intellectual property infringement, breach of contract disputes and other commercial litigation claims, dissenting shareholder rights, shareholder oppression, condemnation and eminent domain, and taxation disputes).

Prior to joining the firm, Trey was a director of the RSM McGladrey, Inc., national valuation services practice.

Trey holds a BA degree in economics from Northwestern University and an MBA degree in finance from the University of Michigan. He is a certified business appraiser (CBA) and an accredited senior appraiser (ASA) in the business valuation discipline.

Trey frequently lectures on business valuation issues for accounting, taxation, legal, and other professional organizations. And, he has testified as an expert valuation witness in various federal and state courts.