The Deal Pipeline

[RETURN TO ARTICLE]

Auctions

Share Reprint Save to My Articles

Health scare

By Michael D. Brown Updated 02:25 PM, Jul-27-2012 ET

Almost 40 years after it was built with the help of $100 and $200 donations from area residents, **Hackettstown Regional Medical Center** felt it may be time to enlist some assistance again.

On May 2, HRMC enlisted the help of healthcare investment bank **Cain Brothers & Co. LLC** to explore its options, including a sale or a merger, even though the nonprofit still is well capitalized.

"For a number of years, it was the right decision to stay independent," says HRMC's chairman and former Hackettstown mayor, Michael Lavery. "But after a lot of discussion [the board] decided that now was as good a time as any to try to pair up with another hospital or healthcare provider."

Lavery's words echo what's becoming a national trend involving 501(c)3-level, tax-exempt nonprofit hospitals such as HRMC. Faced with increased patronage, the need to stay technologically advanced and rising expenses at a time during government funding cuts, more nonprofits are joining forces or putting themselves up for sale, and geography isn't a barrier. An Alabama real estate investment trust has acquired several New Jersey hospitals in recent years, while a Tennessee buyer has made inroads into North Carolina, Virginia and Wisconsin, to cite only a few examples.

"[Hospital boards] are getting more sophisticated in getting their futures settled," according to George Bishop, an M&A lawyer at Nashville's Waller Lansden Dortch and Davis LLC who is currently working on at least four active hospital-sale processes. "More nonprofits are reaching the decision to explore a sale or partnership, especially if the company is not able to obtain capital to fund technologies and IT system technology that are necessary to keep them competitive."

New Jersey has been a beehive of activity, and for good reason. According to a March survey of 250 nonprofit organizations, including hospitals, in the state conducted by New Jersey's Center for Non-Profits, 54% had seen a decline in state funds during 2011, while 61% saw increased expenses. Of those nonprofits polled by the center, 73% experienced an increase in demand for services amid the funding declines.

HRMC opened its doors as Hackettstown Community Hospital in 1973, having raised $3 million, an amount that seems quaint in view of today's operational challenges. Besides raising money from residents to erect the hospital on a piece of land then valued at $22,000, the Adventist Church also lobbied to get various state and federal grants.

Nowadays, even with its existing operating agreement with nearby **Hackensack University Medical Center**, HRMC sees the handwriting on the wall. Lavery points east to a Morristown, N.J.-based nonprofit hospital operator, Atlantic Health System Inc., which has increased its financial wherewithal through expansion.

AHS now owns and manages three hospitals only nine miles apart — **Morristown Medical Center** (Morristown); **Overlook Medical Center** (**Summit**); and **Newton Medical Center** (Newton). Among the three facilities, AHS employs roughly 11,000 people and generated revenue of $1.26 billion in the 2010 fiscal year, according to AHS' Nov. 8 Form 990, an annual financial report that 501(c)3 nonprofits are required to file.

Not all New Jersey nonprofit hospitals have been as fortunate or visionary, and that provided an M&A opening in the state for **Medical Properties Trust Inc.**, a Vestavia Hills, Ala.-based real estate investment trust. On March 28, for example, MPT purchased the property assets of Jersey City's bankrupt **Christ Hospital** for $7 million, while its **HUMC Holdco LLC** subsidiary purchased the hospital's operations for $45.27 million, excluding debt. Through HUMC Holdco, MPT has bought other New Jersey facilities, including its $58 million purchase of Bayonne Regional Medical Center on Feb. 23, 2011. The hospital had filed for bankruptcy on April 16, 2007, and had a liquidation plan confirmed two years later. HUMC Holdco on Nov. 4 did pluck **Hoboken University Medical Center** out of court in a $68 million deal. Hoboken University, a 501(c)3-level nonprofit, too, was operated by bankrupt **Hudson Healthcare Inc.** but owned by the city of Hoboken's municipal hospital authority.

The Hoboken University auction was particularly spirited. According to Hudson Healthcare's debtor counsel, Joseph DiPasquale of West Orange, N.J., law firm Trenk, DiPasquale, Webster, Della Fera & Sodano PC, some eight bidders showed interest in HUMC, with equal participation from the nonprofit and for-profit sectors.

DiPasquale believes there remains a large contingency of nonprofits that are unable to compete or fund necessary improvements. When time and resources wear thin, some standalone nonprofit hospitals find themselves at the mercy of a bankruptcy court.

"The bottom line is the not-for-profit hospital model is [all but] dead and not sustainable," he explains. "Once a not-for-profit hospital files for Chapter 11, the state is more inclined to advance charity care payments to prevent the hospital from closing."

But because state and federal governments do not "have the resources or expertise to effectively and efficiently operate a hospital," DiPasquale continues, eventually these hospitals are left to find an outside investor or private-care-facility operator to help keep operations going.

For buyers such as MPT, this circumstance frequently leads to good buying opportunities because many of these hospitals have no choice but to declare bankruptcy. "Based on the for-profit business model and the amount of profits that are being generated, there is tremendous value in the hospitals that are in Chapter 11 [and what they] are selling for," DiPasquale says.

Curiously, while nonbankruptcy auctions involving nonprofit hospitals have produced multiples of revenue in the 0.5 times to 0.9 times range, the use of Section 363 under the U.S. Bankruptcy Code — through which a buyer can buy the assets of a debtor and leave most liabilities behind — involving such entities can actually produce higher deal multiples, sources agree.

Witness the case of Gallatin, Tenn.-based **Sumner Regional Health Systems Inc.**, which filed for Chapter 11 in the U.S. Bankruptcy Court for the Middle District of Tennessee in Nashville on April 30, 2010. **LifePoint Hospitals Inc.**, a Brentwood, Tenn.-based for-profit healthcare provider, served as stalking-horse bidder. According to another Waller Lansden attorney, John Tishler, who represented LifePoint, his client got competition from at least nine other bidders at the auction. It eventually won the auction, paying $154 million, or 1.1 times the hospital's 2009 revenue of $135.8 million. LifePoint then rolled the hospital into a new joint venture, HighPoint Health System, to control Sumner and future hospital acquisitions in the area.

LifePoint CFO Jeff Sherman says expanding a wide range even wider, to 1.1 times revenue, isn't unusual.

"I know it is a fairly large range, but depending on the quality of the hospital and the amount of work the facility needs, the price can vary substantially," Sherman said. "This is how it has been for some time now."

In its most recent deal, announced June 5, LifePoint acquired **Woods Memorial Hospital**, a 72-bed for-profit facility in Etowah, Tenn. Sherman says that LifePoint saw competition from both for-profits and nonprofits during the bidding process. Although terms weren't disclosed and Sherman declined to provide any, based on the company's 2011 revenue of $74.3 million, LifePoint likely paid between $37.5 million and $66 million for the facility.

Another metric used to value hospitals is an Ebitda multiple, says Waller's Bishop. Depending on the geographic location, the level of sophistication of the facilities and the amount of work needed to upgrade the facilities, hospitals are fetching between 5 times and 8 times Ebitda and can sometimes reach higher, he notes.

A good acquirer that uses this metric is Nashville-based for-profit hospital operator **Vanguard Health Systems Inc.**, which has made several acquisitions in the nonprofit sector in recent years. Bishop cites the deal **Vanguard** completed on Dec. 30, 2010, enabling it to acquire substantially all of the assets of the nonprofit **Detroit Medical Center** for approximately $1.2 billion, including $365 million in cash up front. Part of the deal, which was announced in November 2011, requires Vanguard to provide an additional $350 million for routine capital improvements and a further $500 million for "specific capital projects" during the first five years of ownership. The $365 million up-front piece meant Vanguard paid about 3 times **DMC**'s 2010 Ebitda of about $120 million, according to the medical center's 2010 Form 990. For the total $1.2 billion deal, including future payments, DMC is getting a 10 times Ebitda multiple.

Other interesting things are happening in Nashville, too. That's where St. Thomas Health, a nonprofit subsidiary of St. Louis-based Ascension Health, has created the largest nonprofit Catholic healthcare system in the U.S.

One key acquisition St. Thomas made along the way came on April 30, 2011, Bishop says. St. Thomas and for-profit hospital operator **Capella Healthcare Inc.** of **Franklin**, Tenn., created a joint venture designed to own and operate four Capella hospitals in Tennessee. Bishop, who advised Capella on the transaction, says the JV will continue to eye acquisitions using Ascension's capital to expand the breadth of services the network can provide, targeting both for-profits and nonprofits.

"There are a couple of things going on here," says Waller's Tishler, who has provided legal advice on numerous healthcare deals. "As a country, the reimbursement programs for hospitals have become extremely tight as states try to shore up their balance sheets. Even [hospitals] that are relatively healthy right now are looking down the road and seeing a shaky road ahead in terms of funding."

Tishler earlier this year counseled LifePoint on its burst into North Carolina. On Jan. 31, Tishler watched **Duke University Health System Inc.**, an offshoot of **Duke University** in **Durham**, N.C., create **DLP Healthcare LLC**, a for-profit JV with LifePoint. DLP is designed to leverage LifePoint's network of 55 hospitals in 18 states with DUHS's well-regarded research and cardiology program, Tishler says. While LifePoint provides the majority of capital to fund improvements and build the DLP network, DUHS is able to take referrals.

"We had a series of discussions about how we could work more closely together," says LifePoint's Sherman. "[DUHS] didn't want to tie their capital up, but they did want to sign an agreement to help tie up the high-level referrals that most hospitals don't have the facilities or expertise to handle."

Faced with in-state competition from Wake Forest Baptist Medical Center in Winston-Salem and UNC Medical Center in **Chapel Hill**, DUHS "needs to have higher-complexity cases and higher-cost patients to make their model work," Sherman says.

Conversely, he says, DUHS can send its less-intensive cases to other LifePoint hospitals to free space for more critical-condition patients.

Since the deal between Duke and LifePoint was inked, DLP has acquired four hospitals in North Carolina and the surrounding states — **Maria Parham Medical Center** of Henderson, N.C. (Oct. 11); **Person Memorial Hospital** in Roxboro, N.C. (Oct. 3); the North Carolina cardiac catheterization operations of **MedCath Partners LLC**, an affiliate of **MedCath Corp.** (May 5, 2011) and **Twin County Regional Healthcare** of Galax, Va. (April 3, 2011) — and has even expanded to other parts of the country, signing an affiliation agreement with the Marquette General Health System that's associated with Marquette University in Milwaukee on March 6.

Naturally, even while competition to buy hospitals will likely produce heated auctions, the issue regarding the viability of nonprofit hospitals remains, especially because of Medicaid and Medicare funding shifts from year to year, Tishler asserts.

"It's very interesting to watch historically as reimbursement rates and tax benefits have fluctuated so much," he explains. "It's very cyclical and it's also industry-specific. There is a constant tinkering."

For entities such as HRMC that find themselves in a good place financially, the time is right to explore the possibility of a sale, partnership or merger, says Lavery, its chairman, citing the likelihood that public reimbursement could continue to decline.

"We are in a time in the healthcare environment when people are pairing up and affiliating," he says. "You are going to have hospitals that can then utilize a larger network of hospitals and expand their services to compete with the big guys."