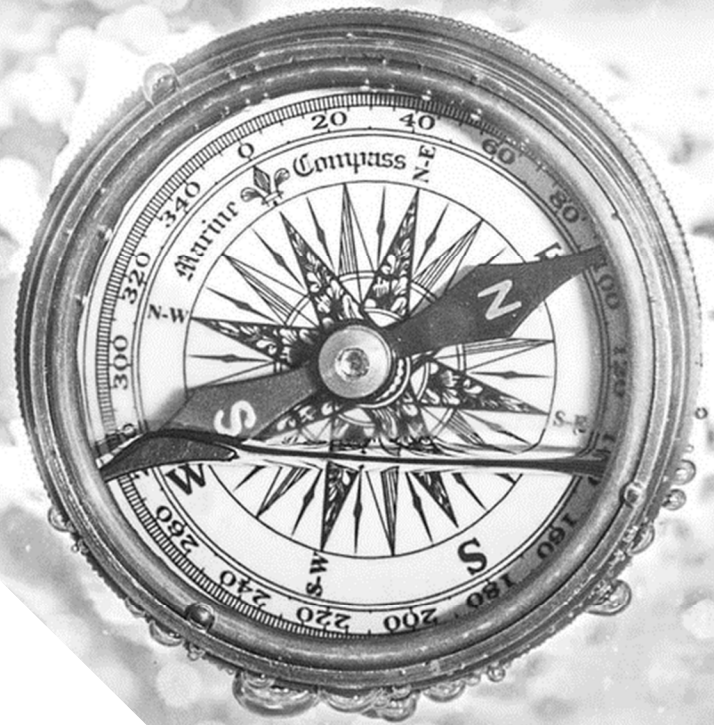


Provider Realignment Post-Pandemic



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May 2020

Introduction

COVID-19 delivered a shock to the U.S. healthcare system that will change it forever. The array of disruptions has been staggering, including:

- Non-essential procedure suspensions
- Global medical supply chain disruptions
- Local, regional, and national equipment shortages
- Market-specific patient volume surges
- An overnight switch to telehealth care delivery

As a result, the U.S. healthcare economy ground to a halt. As we approach a restart, it is important to understand how the effects of the shock—shocks, actually—will impact what was already a changing healthcare industry structure and potential implications for merger and acquisition activity in the provider sector.

Examining Shocks: Why COVID-19 Is So Disruptive to the Healthcare Industry

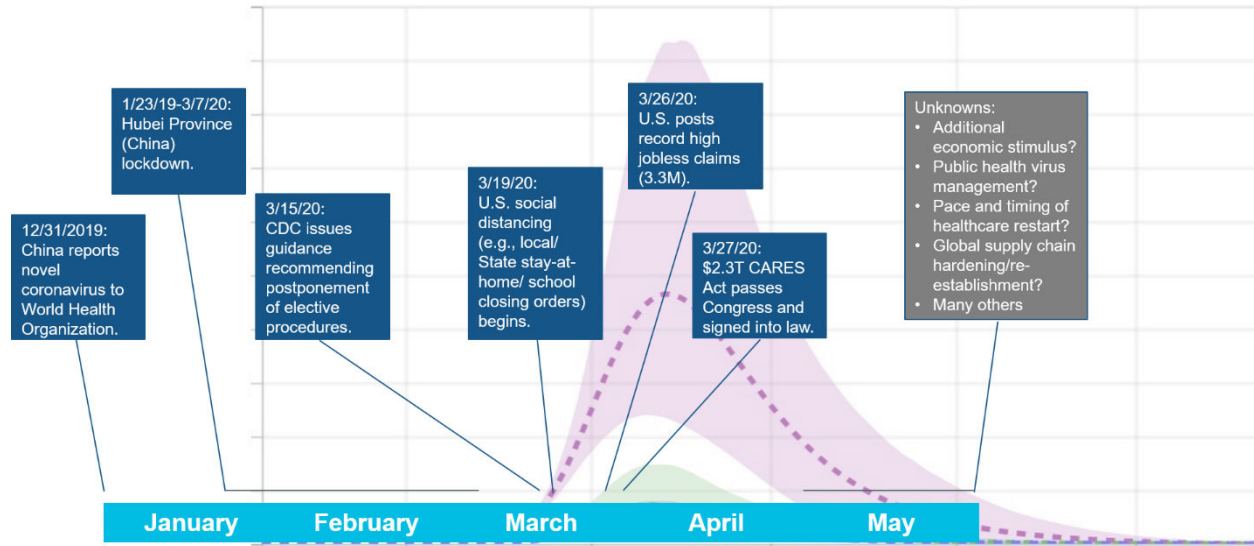
Shocks are not new to modern economies. Most often driven by unforeseen, overlapping macroeconomic factors, they can reverberate globally, impacting multiple industries for varying durations. Conversely, they can be regional/national, and impact single industry sectors.

Exhibit 1: Four Economic Shocks from COVID-19

Type of Shock	Defining Characteristics	Historic Example	COVID-19 Example
Supply	<ul style="list-style-type: none"> • Inputs become scarce, expensive • Supply chain disruption 	<ul style="list-style-type: none"> • OPEC oil embargo 	<ul style="list-style-type: none"> • PPE price spikes, scarcity • Hot spot clinical staff shortages
Demand	<ul style="list-style-type: none"> • Sudden drop in consumer or business spending 	<ul style="list-style-type: none"> • Great Depression 	<ul style="list-style-type: none"> • Elective procedures suspension • Fewer patients seeking care
Financial	<ul style="list-style-type: none"> • Lack of liquidity; frozen credit markets • Falling financial asset values 	<ul style="list-style-type: none"> • 2008–2009 Global Financial Crisis 	<ul style="list-style-type: none"> • 50–70 percent revenue drops; resultant provider balance sheet impairment, capital access challenges
Policy	<ul style="list-style-type: none"> • Unforeseen government policy shifts • Often tied to central banks 	<ul style="list-style-type: none"> • 1997 Asian Currency Crisis 	<ul style="list-style-type: none"> • Shelter-in-place • The CARES Act (and others)

As shown in **Exhibit 1**, the COVID-19 pandemic triggered four economic shocks (supply, demand, financial, and policy) and evolved over an abbreviated timeline, which intensified its impact (see **Exhibit 2**, next page). The timeline indicates the predicted peak in cases and overlays the shocks and various events. At this point, the prospect of a quick recovery remains uncertain.

Exhibit 2: COVID-19 Timeline



Post-Pandemic Provider Realignment

The crisis exposed the high “cost of fragmentation” within the healthcare industry and, we believe, will serve as the seminal event that ushers in an era of greater provider integration and concentration. We anticipate three phases in the industry’s path forward:

- A **turbulent restart** through the remainder of 2020, marked by initially sluggish M&A activity as at-risk providers seeking shelter are courted by cautious buyers assessing their positions and plotting strategies.
- In the ensuing two years, a **shake-out** will follow, characterized by some of the surviving providers and hospitals, risk tolerances battered, seeking safety and security; strong regional systems, insurers, and private equity-backed disruptors will seize the opportunity and be hyper-active in pursuing scale.
- In a final phase, **rise of the titans**, national mega-systems, possessing regional market essentiality, may emerge, dwarfing today’s largest systems. These behemoths would compete directly with scaled, non-traditional, ambulatory-centric networks (e.g., integrated insurance companies) in a marketplace that no longer adheres to traditional delivery vs. financing distinctions. These organizations will vie to deliver on the promise of population health and achieve growth and stability through quality and efficiency.

Hospitals

Hospitals had already experienced a decade of disruptive change pre-pandemic. Post-pandemic circumstances will act as a catalyst to advance the most stubborn of the changes yet to be widely adopted and will drastically accelerate the pace of many others.

Turbulent Restart <i>6–9 months</i>	<ul style="list-style-type: none"> • “Have vs. have not” phenomenon is exacerbated • The financially distressed seek lifelines • Well-capitalized regional systems pursue opportunistic growth • Turnaround-focused, private, for-profit operators enter aggressively • Publicly traded health systems pursue only the most attractive scale opportunities
Industry Shake-Out <i>1–2 years</i>	<ul style="list-style-type: none"> • Some, perhaps many, distressed sellers (especially rural), unable to find geographically proximate buyers, close • Strong sellers seek partners with high quality and operational depth • Regional systems aggressively seek scale consolidation opportunities
Rise of the Titans <i>3+ years</i>	<ul style="list-style-type: none"> • Declining governmental and commercial reimbursement • Large systems leverage scale for clinical and operational advantage and aggressively move to assume insurance risk • A select few integrated national mega-systems (~\$75B+ in net revenue) emerge

Physicians

COVID-19 underscored the inherent risk of small independent and group practice amid economic crises. With high fixed overhead and limited, if any, reserves or credit, some groups failed only days after elective procedures were suspended and well-care visits dried up.

Turbulent Restart <i>6–9 months</i>	<ul style="list-style-type: none"> • Practices reopen; pace of activity ramp-up highly variable • Hospitals and insurance companies that weathered the crisis with capital develop opportunistic physician growth strategies • Private equity active, but at lower multiples; some opportunities lost to strategic buyers
Industry Shake-Out <i>1–2 years</i>	<ul style="list-style-type: none"> • Pre-crisis “physician land rush” escalates, beyond previous levels • Fierce competition for physician services across health systems, insurers, and private equity investors; primary care and procedural subspecialists represent hottest commodities
Rise of the Titans <i>3+ years</i>	<ul style="list-style-type: none"> • Over three-quarters of physicians employed by large group practices, management companies, insurance companies, or hospitals • Private equity investments shift from practice consolidation towards innovation to support operational and clinical efficiencies • Integrated physician enterprises lead health systems toward displacing acute care’s traditional position at center of delivery industry

Non-Acute Providers (Senior Living, Home Health, Behavioral, Other)

Each non-acute sector has faced unique COVID-19 challenges, but their paths out of the pandemic will share similarities shaped by industry forces. Market consolidators will hedge against the cost of fragmentation by building comprehensive well care, sick care, and recovery care networks, while private equity continues to consolidate holdings to eventually exit or, in rare and high-growth situations, take public.

Turbulent Restart 6–9 months	<ul style="list-style-type: none">• Post-acute sector hit hard given fewer hospital discharges• Relatively quiet rebuilding period as businesses stabilize• Some activity with select investor-backed and healthy system buyers
Industry Shake-Out 1–2 years	<ul style="list-style-type: none">• Increasing divide of “have” and “have not” segments within sectors• Sellers will look first for buyers within their sub-industry, then to integrated systems and large insurers; troubled entities will close• Ongoing shift from facility-based providers to lower cost settings
Rise of the Titans 3+ years	<ul style="list-style-type: none">• Increasingly, integrated mega-systems and insurers will add non-acute business lines and compete within these sectors• Select private equity-driven sector roll-ups will achieve scale and be taken public

The Road Ahead

The COVID-19 crisis laid bare the fragility of U.S. healthcare. We paid a heavy price for fragmentation.

Looking forward, boards and executive teams will need to take several actions to keep their organizations relevant and healthy: 1) Evaluate the degree to which local markets are integrating to compete on quality and efficiency; 2) Identify COVID-19 Era competitive differentiators and re-visit strategic plans to incorporate; and 3) Identify partnerships and structures that will leverage differentiation and support the organization’s long-term success.

There will be no *going back* to the industry as it existed, only a *going through* to a stronger, more hardened, and, in some cases and in some geographies, a materially scaled healthcare system. Successfully approaching and navigating such an uncertain future will require healthcare leaders to ask a number of existential questions, including:

- Do we have the financial wherewithal to survive the crisis and a potentially slow recovery?
- Can we articulate a credible path to future practice or system growth?
- Can we continue to successfully compete in a marketplace that advantages integration and scale?

Different organizations will have different answers to these questions. All should proceed based on their answers to them, and others that may be dictated by their markets.

Key Takeaways

COVID-19 will accelerate U.S. healthcare's transformation toward a future characterized by the blurring of traditional lines between care delivery and financing. Integrated, scaled, regional and national organizations that compete aggressively on quality and cost will lead. Increased merger and acquisition activity will be a hallmark of the transition.

To help their organizations navigate these changes, healthcare leaders should:

- Conduct a forthright evaluation of their organization's go-forward strategic and financial position
- Revisit growth plans to determine their continued validity
- Scenario plan to identify key assumptions or market events that could materially impair organizational performance
- Chart a course forward that reflects the realities of operating in a post-COVID-19 world, including partnership models of all stripes

For more information about the impact of the COVID-19 pandemic on provider alignment please contact:



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This article originally appeared in The Governance Institute's journal, BoardRoom Press, June 2020 edition.