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Transformation and Risk Podcast

Episode 4

Financial Impacts and Challenges Facing the Healthcare Industry

Ethan Crain

Welcome to the Healthcare Transformation and Risk Podcast Series. Here we explore the dynamic world of healthcare transformation and the accompanying risks. Thanks for joining us as we speak with industry experts to uncover the challenges and strategies essential for healthcare systems on their transformation journey.

In this final episode, we'll focus on the financial impacts and challenges facing the healthcare industry. By way of introduction, my name is Ethan Crain. I'm the Northeast Zone healthcare practice leader at Marsh.

And with me are some colleagues, Ruth Kochenderfer, Marsh's national product leader for D&O. Patrick Sartor, US director of healthcare investments at Mercer, and Paul Kibbe, partner in the M&A advisory services at Mercer.

So let's dive in. Ruth, financial transformation is broad and can mean a lot, so what do you mean when we discuss financial transformation in healthcare and perhaps what's driving the transformation?

Ruth Kochenderfer

Ethan, thank you for that introduction and it is absolutely broad and we have limited time in our podcast. It can mean a lot of things. It can mean changing the workforce to include more technology and work more efficiently. It can mean adopting more technology.

I think what we're going to focus on today just because what's going we had to pick was really growth and we're going to even probably focus a little bit more even that on mergers and acquisitions, M&A and healthcare because it is such when we see it (laughs) it can be... I don't want to use a negative word but it could be somewhat disruptive, it often focuses a lot of energy on that particular event for extended period of time, both during the transaction as well as for the same period of time thereafter. So that's what we're going to focus on today.

Ethan Crain

It's a lot without a question, and a lot of our healthcare organizations are dealing with this and it just seems to be front of mine. Thanks for participating. What are the few steps that healthcare organizations are implementing to drive financial transformation?

Ruth Kochenderfer

I'm going to back up a little bit and talk about everything that we're going to once again go to that focus, M&A, but it's reimagining the workforce, creating internal travel nurses much more flexible work arrangement. Using technology to extend workforce capabilities. I have a client who has their senior nurses who may have been considered retirement or who are now kind of virtually overseeing other nurses.

It's really rethinking, being creative, and trying to figure out, "Okay. We can't just keep doing things the same way we've always done them." and continuing on that technology theme, it's using technology and digital health including artificial intelligence. You cannot have (laughs) open up or we do a Google search involving healthcare change without those digital health artificial intelligence coming in.

I think right now we're seeing a lot of exploration in that area along the entire continuum. What do I mean by the entire continuum? From administrative operations to actual provision of care we're seeing. I think it's going to become more and more transformative but I think we're still for a lot of our client still on the exploratory state.

There are certainly things where it's been implemented but I think the real future of that and the real change going to be coming from that is still ahead of us. And, as I promised what we're going to talk about today is consolidation and growth and what are some of the drivers of that consolidation and growth? Why do they have to do it? And then what are some of the challenges and things you should be thinking about when you're considering that?

So consolidation, M&A what can be driving it? Financial challenges, right? We've seen clients who are financially challenged who may be facing insolvency trying to find a solution for continuing to operate. And I think it's even more pivotal in the healthcare space because we're certainly in our rural areas, we have some of the greatest challenges of making sure that care remains available.

So it's consolidation, is what we've seen, you know, that M&A as a solution for some of that. And when I talk about M&A there's many ways you're doing it. I do want to set some parameters. We're talking about vertical M&A, which is basically companies that do the same thing, combining. Let's assume it's the health system acquiring another hospital or a health system acquiring another health system.

All these present different challenges but I do want to just make sure that we have our terminology kind of set. And then there's horizontal. When you have mergers between companies that may provide different services or different parts of the supply chain in the ecosystem, a health insurer provide... acquiring a healthcare provider, right? (laughs)

Usually view it as more of a relationship of, "Hey, you pay for the services." Now you have the payer also being the provider or vice versa. Right? We've seen healthcare providers acquire health insurers or start them up. and then, or something like a health system who decides I'm going to manufacture my own generic drugs. It can be a lot of different things, we're seeing a lot of it. And a very important component of healthcare you really can't not talk about these days is private equity investments. They're a big driver of consolidation as well.

We really see them a lot in the physician space where they may be taking a variety of oncology practices or dental practices across the US and consolidating them under one operating group. So M&A, consolidation, growth can mean a lot, you know, even that means a lot. But what I have to talk about because I am the team product leader is, "Well, what does this mean? What does this transformation mean with respect to potential risks that are out there?"

And it's a lot, right? It can be from the due diligence process to the actual kind of, you know, transaction, to the period after the merger even the act of transformation itself can be a risk because as we've seen over the years, and in particular recently, we have a very active regulatory kind of environment in the United States.

And so if you become the target of the Federal Trade Commission or tax estate attorney general or even, you know, could be a competitor, you may be your major may be challenged and as a result of that, you may not proceed.

There's the risk of even a fail merger, right? Litigation costs, reputation costs even your workforce, right?

During a period of time when you, when there's all this talk of merger employees there could be some unrest. There's concern about, you know, "Well, I have my job going forward?" They may start to be looking for something else.
And even during the summer time period time you may be losing focus on your goals. These are just some of the risks (laughs) that we're setting out. This is such a small little component of, you know, we could spend, you know, an entire podcast just talking about D&O with respect to what we're seeing in in the transformation space. I will get back to it in the end, but I do want my (laughs) fellow colleagues to have a few moments to talk so I will turn it over back to you, Ethan.

Ethan Crain

(laughs) Thanks, Ruth. Right. We agree that we're not going to boil the ocean today but I heard some words that I think are important. there's a lot of pressure on healthcare leaders today, there's a lot of disruption as we talk about this financial and transformation journey, but they're also looking and try to have solutions as they go along in this this transformation.

Patrick, maybe we can talk about the financial, I don't know, harmonization and investment opportunities that drive financial efficiency and some benefit once a mergers perhaps underway?

Patrick Sartor

Yeah. Thanks, Ethan. And I think a good start, starting point for this in any M&A or strategic change in business direction is to talk about the idea of enterprise risk. And we define enterprise risk as the ability for organizations, their ability and their appetite to take investment risk.

And I'm going to define investments specifically around some pools. Of course, the operating unrestricted pool, that strategic pool of capital on the balance sheet is of paramount importance, but also retirement plans and foundation which all are important components of how healthcare leaders think about their investment pools. Beginning with this idea of enterprise risk. We think about it really as a model that is a set of assumptions that goes into a model and really what it incorporates is the proforma of the new organization. And if there's a strategic financial plan as well the assumptions can go in to, to this model.

And what it does is it really tests the newly combined systems operating performance as it pertains to margins and revenue and expense growth specific measures of liquidity, typically measured by days cash on hand. Of course, the return objectives for each pool any associated liabilities like capital deployment for large capital projects, pensions which I'll talk about in a moment as well.

And then really being cognizant of any financial covenants governing the new- newly combined system, and ensuring that the lower bounds of those covenants are not violated. And I think healthcare leaders are always interested in understanding what their peer groups look like and certainly the analysis does think about peer groups from a credit perspective, from a size and business model perspective.
All of those inputs can be put into this enterprise risk model. And at the end of the day what it does, as I said earlier, is it really calibrates the system's ability and appetite to take risks? Then it offers a range of

outcomes that the leadership team and the key stakeholders can agree upon.

Diving down into specific considerations around the operating assets pool, the unrestricted assets, you know the challenge there is, of course, merging different entities, investment philosophies and opinions, their views of risk, their investment objectives, of course. And then stylistically, are they an active investor? Do they prefer maybe more passive investing, index investing, for example?

Their thoughts around US or international exposure. And then one that I think merits special consideration is really private market investing. And that's become a big component of many investors portfolio. They're seeking to invest in asset classes that generate higher returns, but they also come with associated commitments to deploy capital and as you're thinking about capital deployment on a go forward basis, those are, are legally bound in many cases.

Healthcare leaders and management teams need to be cognizant of private market investments and how they might impact decisions going forward. Pivoting to pension plans. Certainly pension plans have legal requirements sometimes times that enforce that they are kept separate and so the separation of those plans there can't be any combination, which can help with efficiency, but there are ways to potentially unify investment strategy by unitizing the individual plans, and then being able to invest with one particular investment strategy so that you can implement more efficiently and you can synthetically bundle the investments together.

Specific to define contribution plans, like 401Ks and 403Bs, I think it's really important to really understand your combined employee population. And, you know, Paul's going to be touching on that in a moment and Ruth touched on that as well, but certainly comparing the different demographics of your employee populations, and then comparing the individual plans design and investment structure and ensuring that you have a best practice in place and that they're benchmarked against similar plans in the industry so that you have competitive benefits.

And then working on that harmonization schedule to ensure that each cohort of employees and participants has equitable benefits across the different plans. And then just wrapping up on foundations. They're obviously separate legal entities so they are kept separate, but what's important from a donor's perspective that sometimes while it's a heavy lift, you need to repaper some of those donor agreements to ensure that on a go forward basis the expectations of those donors are going to be met because sometimes some of those donors have donor advised fund arrangements. There's a menu of investment options that they have within those foundations, and sometimes there's a level of complexity that the combine organization may not want to offer, and so you need to be really cognizant that you don't want to disrupt those donor relationships at the same time providing a structure that's going to be easy to manage.

Finally, the last consideration on the foundation before I turn it back to Ethan is that there is also the ability potentially to unify all those foundations in one custodial relationship that can help with the complexity component of managing many disparate foundations also lower costs across those foundations. So that's an opportunity for systems as they consider mergers and acquisitions. Ethan.

Ethan Crain

Wow. Thanks, Patrick. Gosh. When you were talking about (laughs) enterprise risk, I thought, you know, in my world I think of patient safety and quality of care, so I've just learn a lot from you. So thanks for that.

Uh, so let's get back to this. We've heard some of the finance and risk management impacts that M&A can have on driving transformation or creating financial risk within the healthcare system, but we know that there's another big element that's critical in transformation and that's the people the workforce that must come together to deliver the outcomes defined in any deal thesis.

Paul, what are some ways healthcare organizations are successfully using M&A to transform ways of working?

Paul Kibbe

Yeah. Great. Great question, Ethan. And Patrick and Ruth have already hit on some of the big things that, that healthcare systems and, and healthcare organizations are, are doing to really utilize the transaction to create cost efficiency and optimize the way that they deliver care, but I think that the big thing, right, is the intentionality around how you approach the transaction and how you plan for that integration, right? Healthcare systems especially large non-for-profits are in the business of, of serving patients, as you just alluded to, Ethan, right? Quality of care, patient delivery is on the forefront of what they do day in day out, and we know it's, it's a challenging operating environment, often a lower margin business.

So really kind of being intentional when they make strategic investments like acquisitions is really important. As we think about workforce tend to focus on, on four things. And again, four is not probably comprehensive but as Ruth said earlier, right? We, we want to be targeted here given, given the time we have. So I think really being intentional about the planning around the integration, how do we bring workforces together? What are the opportunities to realize those synergies, create efficiency, and ultimately drive better patient outcomes and better patient experience. Second is understanding the cultures. The ways of working on that the acquiring organization and the organization coming in. And those are, are very different depending on kind of the deal type, right? Ruth mentioned horizontal integration, a system buying a medical group or a hospital. And then you also have... or the vertical, apologies.

You also have the horizontal where you have a system that may be moving into the drug manufacturing or into the insurance space, right? Two very different organizational cultures and ways of working. So being very intentional about that.

The third is talent. Ruth mentioned earlier transforming the workforce. That is on the forefront of the healthcare industry given some of the recent challenges. So really understanding the skills and the needs. And, and then the fourth is really speed and, and managing that change to drive the outcome.

Unpacking those a little bit more. Right? I think the organizations that tend to manage integration really well when it comes to bringing healthcare organizations together are those that are very intentional about how they plan to integrate what resources they have, what resources they need, how do they set up the structure around the workforce elements of integration planning benefits as Patrick just alluded to, compensation roles, responsibility, decision making and, and then culture. How, are we going to intentionally and very rapidly plan for that integration? Because we know delayed integration often creates risk of redundancy, risk of, of patient leakage, right? Not keeping patients within the system. It may impact quality of care and all of that is additional operating expense that the system has to bear. So really being intentional about that integration planning structure, who's accountable for what decision making? And how fast can they move to, to realize those synergies? Around cultures in the way of working. Again, same thing. The leading organizations are looking at that during diligence, right? And, and it's not always quantitative, but it's certainly qualitative.

If we're a large system and we're expanding into a new geography, if it's a rural hospital that we're buying, compensation may be different, how people show up and interact within that hospital may be different. It's a smaller population. And so really understanding what allowed that hospital to operate well in its local community, and what can be utilize to create success when bringing them into a larger system is absolutely important.

So really taking a look at the cultures during integration or during diligence and then carrying it forward into integration planning is a key success factor. The third, right, getting back to talent. And traveling nurses is a good one, right? There's a lot of different clinical challenges right now that health systems are facing as they're hitting a retirement cliff as there's fewer doctors coming into the population. Again, looking back at what is our deal thesis? The healthcare leadership, why are we looking to make this acquisition? Are we expanding service lines? Are we expanding our geographic footprint? Are we looking to,continue to increase the, the, the size of, of our operation? More beds, more access to physicians and, and clinical resources, right?

Really understanding why they're looking to do the deal, and then what does that labor market look like for those clinical roles, for those key administrative roles? So that you can understand as we look to acquire and integrate over a one-year, two-year, three-year, five-year period, are the skills we need to realize what we're trying to do available in that market or are we going to need to find traveling nurses to make sure that we can continue to deliver on what we're looking to do as an integrated system?

Really I think taking a look at the labor market risk, using labor market data, to tie to that model and the value realization in the deal is what leading healthcare organizations are doing. And then speed and change management, right? We know the number one mission is to serve patients to deliver care, right?

And, and clinicians are very focused on that. And so again, that can make change difficult, right? Because the patient is the number one priority, but healthcare leadership realizes we need to move quick. And so in order to do that they need to communicate the value proposition, they need to make sure that the integrated organization feels like it's one, one entity still with the same mission of serving patients, so that again, they can rapidly integrate, mitigate some of that operating expense risk and, and really create a structure that allows them to deliver the highest quality care and continue to maintain that margin they're looking to drive.

A lot of opportunity, it's complex. We see a lot of systems that delay harmonization because they're so focused on the patient and continuing the care delivery and that really creates risk. So the closing point is, if you're doing a deal, that is often a good time to look back at recent acquisitions to say, "Hey, is this the opportunity now to think broader about that harmonization and integration that will allow us to, to continue to drive towards our strategy and our strategic mission?"

Ethan, I'll turn it back over to you.

Ethan Crain

Yeah. Fantastic. There was a lot there, Paul. I'm hearing a lot about speed in which transformation evolves and healthcare leaders having to manage all of this in a challenging marketplace. But we're talking about change. We're talking about risks. We live in the risk world. And so perhaps we can talk about some of the growing or emerging risks that we're seeing from an insurance perspective. Ruth, any thoughts?

Ruth Kochenderfer

Absolutely. I told you would hear from me again. (laughing) so, you know, I'm putting my D&O hat on, but in the D&O world, especially for private not for profit healthcare companies, the absolute biggest risk which is relatively infrequent, which is a good thing, is around competition claims. We loosely refer to them as antitrust but it's a pretty broad swath of claim.

And they could, these are tend to be very, very expensive often tens of millions of dollars. And there is insurance for it, right? So that is our focus, right? (laughs) It, it is the real focus of D&O insurance for our private not for-profit companies.

I will say this that, you know, it's not only around the time of the transaction that you have this risk, we've seen regulators come in several years after a transaction and say, "You have too much market share," or the way you are now negotiating, you know, the pricing or things like that is anti-competitive so it's not just at one kind of frozen point in time, this is the continuing a risk with respect to consolidation.

And I don't want to just focus on D&O, because I think, (laughs) you know, we've got, as Patrick mentioned, right? There's also change with respect to retirement plans and pension plans and that, you know, implicates potential of fiduciary insurance, right? Making sure you get all of that right if, because if you don't, then you can have claims there as well.

And when you're doing this integration, you actually need to integrate everything and that includes your insurance. You have to think about what that means, you have to think about, "Well, if I'm a larger organization going forward, what should a larger organization be purchasing with respect to insurance, right? These are all things that we look at all the time, but you really do need to put some thought into it. And we got Paul, because he has the workforce (laughs) and there's always, you know, there's issues, there's potential claims around that as well, and that where we look at employment practices insurance and we've talked a lot about this about change being fast, you know, there's concerns, it causes stress, it causes disruption.

When you have that in the workforce, right? There's the potential for claims you know, and often at some point in time there may be a reduction in force. It may not be immediately, but it may be afterwards. You don't typically need to of everything and sometimes there is a new role for everyone.

That's potentially a place for potential concern and there are ways that I've seen reductions enforced result in absolutely no claims and I've seen reductions enforced result in a series of claims. How do you handle it well? It often ties back to your culture which is some of the stuff that we've talked about.

And I cannot leave the one that is the biggest kind of concern out there these days, which is cyber. And making sure that you're thinking about your systems. The reality is if you're doing a consolidation, it's very rare from day one that you're going to have all your systems talking to each other that you're going to be on the same platform and deciding how to do that, the time frame for doing that and making sure you're protected during the transition period is just absolutely pivotal. So, yeah.

Ethan Crain

And that-

Ruth Kochenderfer

Just a few mergers. Yeah. (laughs)

Ethan Crain

Yeah. Thanks, Ruth. Yeah. So Ruth, we're talking about consolidating insurance programs and where we're thinking about M&A, we're going to have two of everything. We may have two captive insurance companies. We may have two cyber programs. We may have the same underwriters that have paid the same claim.

There's a lot to consider but there's also something before a deal is happening and that's reps and warranties. It's actually an insurance product that can protect the organization as they're going through or contemplating in M&A. Is there something you can offer from that perspective?

Ruth Kochenderfer

I will keep it very short because it is not my areas of expertise but absolutely. And representations of warranties insurance is really kind of insuring what I call your transaction deal document. It's ensuring the representations and warranties that are actually made in the sale or the merger agreement.

And we have seen a real change in the last few years about reps and warranties, underwriters, being willing to underwrite healthcare deals. When I started as a broker 10 years ago, it was really difficult to get that. That is no longer the case, but it's hard to tell kind of get make sure everyone knows that there has been a real change in appetite but you know, there's a lot of value to representations and warranties.

Insurance, it could help get deals done. Right? It may, it may lower escrow cost so it's not just a question of just transferring risk, it's also, is it a tool that can help you sell this transaction in a better way?

Patrick Sartor

Yeah. And I think Ruth if I just jump in on, on that. I, I think again as the deal making environment continues to get a little bit more competitive, as diligence, timelines are more rapid, maybe access to full information is more limited.

I think that's where we see organizations really looking to lean on that reps and warranty insurance because they want to be able to move fast, they want to be able to move quick but then they want the coverage in case there's something that maybe wasn't necessarily fully understood or shared as, as they went through that process.

So certainly something that we expect to see more need for as the market gets more competitive.

Ethan Crain

Fantastic. Thanks. As we sort of wrap up, we're talking about takeaways for mitigating risk regarding financial transformation. So I'm hearing about thorough due diligence. Uh, we mentioned regulatory compliance. We talked about culture and how that's the integration of cultures is important physician employer retention, our people, our Workforce.

Communication and stakeholder management, the leaders of these organizations and their commitment to making sure that these programs and these deals are going through thoughtfully. Integration planning and post [inaudible 00:28:49] monitoring, right? When the deal is done, that's just the beginning.

And so there's a lot here but I wanted to thank you for your time as that wrap us, wraps up our final episode of the Healthcare Transformation and Risk Podcast Series.

Today we've taken a closer look at the financial impacts facing the healthcare industry. Delving into some of the challenges organizations face and some of the strategies needed for a successful transformation. We hope you found this discussion insightful and that provided a deeper understanding of the complexities and some solutions in this critical area of healthcare.
If you found this episode interesting, please listen to other podcasts in episodes of Transformation and Risk as we explore more facets of healthcare transformation. Thanks so much for listening. Take care.