Year-End 2016 - Healthcare Merger & Acquisition Trends

PNC Institutional Asset Management’s Healthcare National Practice Group consists of investment professionals who specialize in working with healthcare clients. In this piece, we gather and share relevant industry information of particular interest for healthcare organizations.

**MERGERS AND ACQUISITIONS**

For healthcare organizations, 2016 was a year marked again by consolidation across the industry. For the full year, 939 merger and acquisition related deals, totaling $71.7 billion, were announced. A recent, large example is Ardent Health Services announcing plans to buy LHP Hospital Group, which, according to Institutional Investor, “would create the second-largest private hospital chain in the country.”

A second example is the merger of Providence Health & Services with St. Joseph Health, creating “a nonprofit health and social services system that will serve as the parent organization for more than 100,000 caregivers across seven states.”

A third example is news of merger talks between Dignity Health and Catholic Health Initiatives, who are on a “due diligence fast track to gauge by early 2017 whether they’d be stronger together or better off apart.” The merger, if it were to occur, would result in the “nation’s largest not-for-profit hospital system.”

As organizations ranging from hospitals to labs and long-term care facilities consider the benefits of economies of scale in relation to the inflow of new patients and the operational difficulties of universal insurance coverage, this trend will likely continue, in our opinion.

For organizations that are considering or have completed merger and acquisition activity, an increasingly key concern is the status of retirement plans. The healthcare industry is marked by a cornucopia of diverse retirement plan structures,

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4 “Dignity, CHI would gain scale in merger, but debt issues loom,” by Dave Barkholz, October 2016. Available at: http://www.modernhealthcare.com/article/20161029/MAGAZINE/310299966
making post-merger efforts to consolidate the plans markedly difficult. While the retirement plan liabilities are accounted for on the balance sheet in pre-merger and pre-acquisition due diligence, there is often little consideration given to handling the post-merger or post-acquisition integration of the underlying plans.\(^5\) This can sometimes result in a credit rating downgrade, especially for organizations with defined benefit plans, as retirement plan liabilities on the balance sheet have the potential to fluctuate significantly and can weigh heavily on cash balances.

Another major consideration for merger and acquisition related activity is the potential for the target organization to have a pension plan that is treated as an exempt “church plan” under the Employee Retirement Income Security Act of 1974, as amended (ERISA). Church plans that do not opt-in to ERISA coverage are not subject to ERISA’s minimum funding requirements, nor do they participate in the federal pension insurance program that is administered by the Pension Benefit Guaranty Corporation (PBGC).\(^6\) For target organizations that have underfunded church pension plans, this can create the potential for an outsized liability in an acquisition, especially if the acquirer wishes to close the plan. Furthermore, the underfunded status of church pension plans can lead to employee-initiated litigation. An example of this is a recent federal class action suit filed against Wheaton Franciscan Healthcare and Ascension Health hospital chains, in which the plaintiffs allege, “that among [the] defendants’ shortcomings, defendants have misused the church exemption to underfund the pension by hundreds of millions of dollars and have not informed employees of amendments to the plan.”\(^7\) A second example of litigation stems from the merger of Holy Cross Hospital and Sinai Health Systems in Chicago, in which the lawsuit alleges that, “Holy Cross Hospital transferred plan sponsorship and liabilities to an order of nuns, Sisters of Saint Casimir, the day before completing a merger with Sinai Health System in 2012.”\(^8\) Both examples highlight the necessity for an extra level of due diligence necessary for target organizations with church pension plans, in our opinion.

On the subject of defined benefit plans, Moody’s Investors Service noted a recent trend of nonprofit and public hospitals issuing debt that would be subsequently invested to boost returns or to close plans with underfunded status. The concept behind boosting returns is “spread arbitrage,” where the borrower attempts to earn an investment return in excess of the cost of debt. Furthermore, large organizations are moving to fully fund and close plans in order to have a fixed, foreseeable, cost, as a fixed cost (the debt) is viewed as more favorable than a variable cost (year-to-year pension liabilities). In either case, Moody’s Investors Service concludes that, “pension funding bonds have credit negative elements because by issuing debt a system assumes its assumptions around discount rates, investment returns and rising premiums will pan out.”\(^9\)

In light of this, and given rising pension liabilities and increasing PBGC insurance premiums\(^10\), healthcare organizations are increasingly choosing to freeze or close

\(^5\) Ibid. 2
\(^8\) “Participants sue over church-plan status for Holy Cross Hospital pension fund,” by Hazel Bradford, June 2016. Available at: http://www.pionline.com/article/20160607/ONLINE/160609897/participants-sue-over-church-plan-status-for-holy-cross-hospital-pension-fund
\(^10\) “Premium Rates,” a report by the PBGC. Available at: http://www.pbgc.gov/prac/prem/premium-rates.html
defined benefit plans. According to a recent survey by the NEPC Healthcare Team, 21% have kept plans open, 35% have closed or done a “soft freeze,” and 44% have frozen existing defined benefit plans.\(^\text{11}\) The advantage to a traditional defined benefit plan, relative to a defined contribution plan, is that plan sponsors can take “funding holidays” to reduce the immediate cash draw, which is a short term decision relative to the long term pension liability. This is in contrast to a defined contribution plan structure, where employer contributions may be necessary every year. The major drawback to defined benefit plans is that the liabilities and contribution requirements, balance sheet and income statement line items, respectively, are dynamically based on a number of variables. These variables are included, but not limited to, actuarial assumptions, inflation, and investment returns, which in turn makes them hard to predict with any certainty from year to year. For healthcare organizations on the cusp of a credit rating evaluation, the variability of the liabilities and contributions can sometimes be enough to prevent an upgrade or cause a downgrade. This uncertainty, in our opinion, characterizes the lack of retirement asset planning as a considerable risk.

**Our View**

For organizations considering a merger or acquisition, we strongly advise a pre-merger focus on due diligence related to the retirement program of the target organization. We find it imperative to take note of not just balance sheet liability amounts, but also a deeper look into the actuarial assumptions underpinning the reported liabilities. Furthermore, we recommend determining if and how the target’s plans can be consolidated into the target organization’s existing retirement plan structures. This is especially relevant for target organizations with defined contribution plan structures that are different than what the acquiring organization offers, given that differing defined contribution plan structures don’t often integrate (consolidate) well, if at all.

For organizations that plan to keep defined benefit plans open, we recommend considering a liability hedging strategy for at least some portion, if not all, of the plan assets. Liability hedging strategies can help to reduce the volatility of plan funding status and thus mitigate the potential risk of credit rating downgrades.

A final point is that keeping attractive retirement benefits can lower employee turnover and can both attract and help retain key personnel. Employees are more likely to want to join and less likely to leave an organization that takes care of its workforce both during employment and into retirement.

*For more information, please contact your Investment Advisor.*

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