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What Would You Do?

should this healthcare system acquire a hospital in an adjacent market?

The Problem

We are the senior leadership team of a medium-sized, growing, successful healthcare system. A small community hospital in an adjacent market, which has been struggling for years, has put itself up for sale. Its financial situation is deteriorating rapidly and, four months into FY07, appears to be on the brink of insolvency unless rescued by another entity. Should we make a bid for it?

The Situation

The community hospital that is for sale is a not-for-profit, 100-bed, medical-surgical facility with a current average daily census of 47. Its annual revenues are approximately $45 million. It is located in its own market about 10-15 miles from other hospitals and systems that surround it, including our healthcare system. All the surrounding hospitals and systems are sizable and are in adequate to good financial health.

The small community hospital is in a semi-rural market at the fringe of two growing suburban regions of other metropolitan areas. Although population growth in the hospital's primary service area is moderate (averaging about 1 percent per year) and its primary service population is only 100,000 residents, the two suburban areas are expected to merge over the next decade; this primary service area could be quickly suburbanized and experience significant growth. The primary service area population is somewhat older than the populations in both adjoining suburban regions and has household median income levels about 20 percent below the rest of the market.

The most recent three years of operating and financial statistics for the small community hospital are shown in the table. In FY07 to date (4 months), the hospital has a cumulative $2 million loss and is rapidly running out of cash.

The medical staff of the hospital consists of 75 active members, about half of whom are family practitioners, general internists, or pediatricians. The medical staff has been at

SMALL COMMUNITY HOSPITAL VITALS

Operating Statistics	FY04	FY05	FY06	Percentage Change
Admissions	3,700	3,500	3,200	(13.5)
Average length of stay	5.7	5.5	5.3	(7.0)
Market share (primary area)	21%	20%	18%	(14.3)
Medicare case-mix index	1.18	1.17	1.16	(1.7)
Emergency visits	20,000	21,000	22,000	10.0
Other outpatient visits (lab, X-ray, etc.)	46,000	47,000	48,000	4.3
Financial Statistics				
Operating revenues	$40,100,000	$41,800,000	$43,200,000	7.7
Operating expenses	$42,000,000	$41,300,000	$43,200,000	2.9
Net operating margin	($1,900,000)	$500,000	$0	100.0
Total margin	($1,800,000)	$700,000	$100,000	105.6
Cash	$8,600,000	$5,000,000	$2,800,000	(67.4)
Reserves/endowment	$700,000	$800,000	$800,000	14.3
Long-term debt	$2,100,000	$1,800,000	$1,500,000	(28.6)
Accounts receivable (days)	60	58	62	3.3
Accounts payable (days)	63	65	67	6.3

its current size for a number of years. The staff is slightly older than the regional average, has a somewhat lower proportion of board-certified/board-eligible members, and is otherwise unremarkable. There is little medical staff overlap with the other hospitals in the region. The medical staff is reportedly supportive of a merger or sale. Also, quality indicators are acceptable and the hospital's image in the community is fair.

However, a few other facts are important in this situation. The hospital's physical plant requires substantial upgrading or replacement. Although the needs are not immediate, they are significant, and a decision will have to be made about what to do with the facilities in the next few years. The clinical equipment is in relatively good condition and is appropriate for a hospital of this type. Not surprisingly, however, IT is rather basic and dated.

Our healthcare system consists of two hospitals with annual revenues of about $500 million and strong recent growth. Revenues have increased more than 10 percent per year since 2000, and the system has a consistently healthy bottom line and a good balance sheet (its debt is "A" rated). The system also has a 22 percent share in the small community hospital's primary service area, and that share has been increasing at a moderate rate. All the competing hospitals and systems are reportedly considering making a bid for the small community hospital. Should we make a bid also?

The Decision

Our analysis of this opportunity resulted in several key positives as well as negatives.

We considered both attempting to operate the small community hospital as an acute care facility and reducing the scope of services to an emergency, outpatient, and primary care facility. Our analysis indicated that although the former option was clearly the current board's and community's preference, the latter would be a feasible alternative.

Nonetheless, we decided not to make an offer for the small community hospital. On balance, the hospital's declining market position and the financial hole it is in outweighed the other considerations. Our healthcare system has been able to grow rapidly, in a financially prudent manner, so we decided it was better off "sticking to its knitting." Regardless of the ultimate outcome in regard to the disposition of the small community hospital, we believe we can make significant inroads in its market with our healthcare system's own primary care and outpatient services strategy.

As it turned out, all the competitors passed on the opportunity to bid on the acquisition, and the small community hospital filed for bankruptcy. Few believe that it will be acquired out of bankruptcy; its patient base is already dissipating. ●

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PROS AND CONS OF ACQUIRING THE SMALL COMMUNITY HOSPITAL

Pros	Cons
Part of the healthcare system's market; good growth prospects	Currently suboptimal demographics, uncertain rate of growth
Successful competitor bid will thwart the system's growth	Need for major capital infusion
Synergy with the healthcare system	Need for major turnaround
The leadership team's belief that it can make the acquisition work	Difficult cultural and operational assimilation