DECEMBER 2007

STRATEGY CHALLENGE

Alan M. Zuckerman

hfm
healthcare financial management association www.hfma.org

healthcare financial management

What Would You Do?
should this successful integrated system divest one of its business units?

The Problem
Midwest Integrated Health is experiencing intensifying competitive pressures and declining financial performance in its regional pharmacy business. Midwest's management team has solicited offers to purchase the business from three vendors and believes a sale is in the best interest of Midwest Integrated Health. The board is reviewing management's report and recommendations, including the bids of the three vendors. What should the board do?

The Situation
Midwest Integrated Health is a highly successful, growing, not-for-profit integrated delivery system operating in a small urban area in mid-America. The system has had six straight years of outstanding performance, with revenues increasing from $225 million to $375 million and total margins averaging 12 percent per year. As a result, the system has an exceptional balance sheet, including $400 million in reserves and very little debt. Financial forecasts for the next five years, including ability to fund capital needs, are excellent.

In addition to its flagship hospital, Midwest has a foundation and four related business lines:
> Midwest Regional Pharmacy (multi-outlet retail pharmacy operation)
> Midwest Medical Supply (provider of medical equipment and supplies to the general public and hospital patients)
> Midwest Extended Care (operator of a 230-bed nursing home and 175-unit retirement center)
> Midwest Ventures (for-profit company that operates an ambulance service, a day care center, and two ambulatory surgery centers, and manages 30 physician practices)

The hospital represents about 35 percent of overall assets and 75 percent of total revenues, but the related business lines have been solid performers and nearly all members of the leadership team agree that good synergy exists among those lines.

Nonetheless, the management team has been increasingly concerned about the future viability of its pharmacy unit. Historically this entity has been a stellar performer, but its performance is slipping, and growing competitive pressures are emerging. Growth in prescriptions filled was up 18 percent in 2001-02 but has decreased every year since, with 2005-06 growth only 1.5 percent. Market share in the region reached a high of 41 percent in 2005 and decreased for the first time in 2006. With significant expansion of national competitors locally in 2006-07, share is expected to drop dramatically in 2007. The unit is still profitable, but profitability is projected to decline beginning in 2007. Management has summarized the current situation as follows:
> Revenue growth is slowing dramatically.
> Scripts will be flat for 2007 at best.
> Some evidence of margin compression exists.
> Walgreens has embarked on a rapid regional expansion plan.

As a result of growing concerns about this business unit, management solicited proposals from companies interested in acquiring Midwest Regional Pharmacy. Three bidders responded to management's solicitation, and discussions and negotiations have been proceeding for months with two of the three bidders. Midwest's management team believes it has a fair offer from both bidders and that the $24.5 million offer and the terms and conditions agreed to with one of the companies is especially attractive.

Midwest's management team recommends selling the pharmacy unit to the preferred bidder and

The hospital represents about 35 percent of overall assets and 75 percent of total revenues, but the related business lines have been solid performers.

has summarized its case in a report to the board. The highlights from the hold-versus-sell analysis, shown in the sidebar, were presented to the board.

Midwest's management team's conclusion is that the rationale to divest the pharmacy business is stronger today. The competitive environment is likely to intensify, and the downside scenario envisioned by Midwest could be significantly worse than anticipated. Given that the current bids fairly and fully valued the pharmacy unit, the management team wants to proceed to cash out while the unit was at near peak asset value.
If you were in Midwest Integrated Health's position, what would you do?

The Decision

The board of Midwest Integrated Health agrees with most of the management team's analysis. However, it differs on the important issue of the value of the pharmacy unit as a core holding of Midwest. The board's discussion on this point highlights two issues: Midwest Regional Pharmacy's synergy with other business units, and its central role through many highly visible distribution points throughout the area. The board's conclusion is that the pharmacy unit is indeed a core holding.

The board also has challenged management to come up with an alternative use for the cash proceeds from a sale that would be as beneficial to Midwest as the investment in the pharmacy unit. Especially in light of the magnitude of Midwest's current reserves, merely liquidating what even management has conceded is likely to continue to be a profitable business to add to Midwest's bank account is not viewed as being in the community's best interest.

Therefore, the board's decision is to reject the recommendation to sell and charged management with vigorously defending Midwest Regional Pharmacy's position in the market. ●

Alan M. Zuckerman, FACHE, FAAHC, is president, Health Strategies & Solutions, Inc., Philadelphia (azuckerman@hss-inc.com).

HIGHLIGHTS: HOLD-VERSUS-SELL ANALYSIS OF MIDWEST REGIONAL PHARMACY

Reasons to Hold

- Midwest Regional Pharmacy is a significant contributor of operating profits to Midwest Integrated Health. In FY06, the positive income statement impact was about $1.7 million and the pharmacy unit absorbed about $2 million in corporate overhead.
- Historical trends have been attractive, with a five-year (2001-06) compound annual growth rate of 15 percent. Midwest Regional Pharmacy commands a sizeable market share of about 40 percent.
- Midwest Regional Pharmacy extends the Midwest brand and reach in markets served by the organization.

Reasons to Sell

- Significant capital and management resources will be needed to remain competitive and hold existing market share as Midwest's "natural" market matures. Weakening economic conditions in the pharmacy business are predicted for Midwest's service area, with payment pressures emerging as drugs become a larger component of overall healthcare spending and increasing costs are incurred due to the chronic pharmacist shortage.
- Financial performance is already showing some signs of weakness. Growth has fallen dramatically, with trends suggesting further declines in FY07. Gross margins fell 0.5 percent in FY06 due to the impact of the Medicare drug benefit shifting the mix from cash to Medicare. Further erosion of margins is expected over the next few years, while operating costs and capital costs are increasing.
- An increasingly competitive landscape is emerging. The loss of dominant local health plan exclusivity will invite aggressive competitors, while accelerating encroachment of mail order and other competing distribution methods is expected. Walgreens, with its extended channels of mail order and specialty drug distribution, is opening three stores in the next 12 to 24 months in Midwest's service area. Market share erosion will occur. Each 1 percent in share for the pharmacy unit is equal to roughly $1 million in annual revenues and $200,000 in pretax profits.
- The pharmacy unit is not a core holding for Midwest Integrated Health and its assets may be better deployed elsewhere. Financial markets are likely to support a sale. In addition, the timing for a sale is excellent. An active transaction environment is in place and Midwest Regional Pharmacy has performed well over the past several years.