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Current Trends in Hospital Transactions

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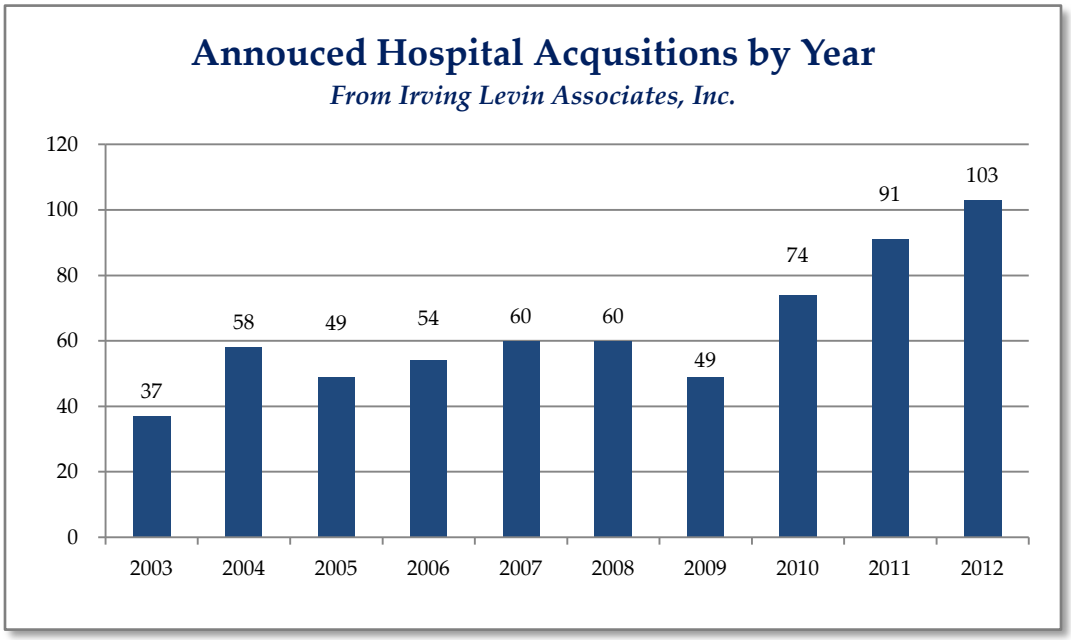
Introduction

Since the passage of the Patient Protection and Affordable Care Act ("PPACA") of 2010, HAI has observed a significant increase in hospital acquisitions. Smaller community-based hospitals are the typical target of this trend due to a variety of factors, including: additional costs associated with meeting various regulatory requirements, pervasive and costly capital improvements, and funding acquisitions for outpatient service lines. Regional or national health systems, who offer the benefits of cost savings through economies of scale and access to capital, have been the typical acquirers. In addition to acquisitions, other transaction activity observed by HAI has increased, including: joint ventures, co-branding, intangible asset purchase or licensing, and service arrangements. Transaction activity observed by HAI involves general acute care, specialty, and physician-owned hospitals within both the for-profit and not-for-profit spaces. The following is a discussion of these trends and the key valuation considerations for hospital transactions, due diligence, and financial reporting.

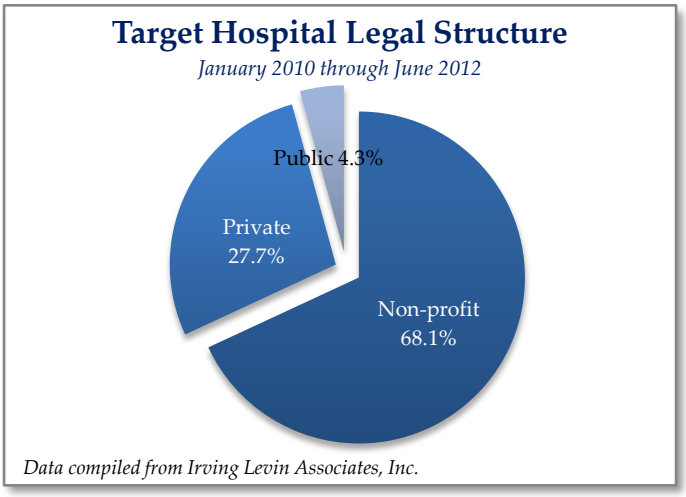
Announced Hospital Acquisitions – Trends

The following graph illustrates the number of announced hospital acquisitions by year as outlined in Irving Levin Associates' merger and acquisition database. Hospital acquisition activity remained fairly stable until 2010, with Irving Levin Associates' database reporting approximately 40 to 60 announced acquisitions per year. Since the passage of PPACA in early 2010, reported acquisition activity has increased to over 100 transactions announced in 2012, an increase of roughly 70 percent. While the Irving Levin Associates' database only represents a portion of the acquisitions that have occurred across the country, HAI notes the relative year-over-year changes are consistent with observations of the market as a whole.

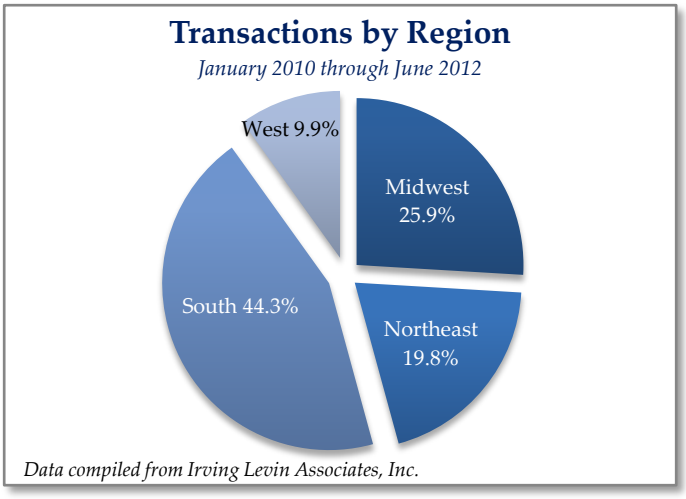


Current Trends in Hospital Transactions

Of the transactions over the past two and a half years, approximately 70 percent of the target hospitals were not-for-profit entities and 30 percent of the target hospitals were for-profit entities (*i.e.*, both private and publicly traded entities). A number of the "private" transactions included participation by private equity funds either directly (platform investments) or indirectly (add-on investments), including well-known groups such as The Carlyle Group and Cerberus Capital Management. The adjacent pie chart outlines the aforementioned aggregate distribution among entity types from transactions announced between January 2010 and June 2012.



Due to regulatory, demographic, and health-related factors, the transactions reported by Irving Levin Associates are concentrated in the Southern region of the United States as illustrated in the adjacent pie chart. Geographical considerations have a significant impact on valuation due to the varying population demographics and health economics that impact entities on a state-by-state or even city-by-city basis.



Announced Hospital Acquisitions – Valuation Commentary

Transaction data from the past two and a half years that HAI analyzed indicates a wide range in the size and profitability of the hospitals acquired. Hospitals included in the transaction data range in size from 10 to 16,000 licensed beds, with revenue ranging from $3.1 million to $3.3 billion and earnings before interest, taxes, depreciation, and amortization ("EBITDA") margins ranging from under 1 percent to slightly over 40 percent. Caution and care should be used when interpreting the data for valuation purposes. For example, the target hospital that generated an EBITDA margin of 40.2 percent happens to be a physician-owned hospital that focuses heavily on outpatient surgery cases. This transaction is not all that comparable to a general acute care hospital that may generate revenue across a wider spectrum of outpatient and inpatient services, and is certain to generate a significantly lower EBITDA margin. Valuation analysts attempting to derive valuation multiples from this data should be mindful of these nuances, and adjust the selection of comparables accordingly.

The following table further outlines the aforementioned target hospital statistics across the 214 announced hospital acquisitions between January 1, 2010 and June 30, 2012.

Target Hospital Statistics for 2010 through 2012

	Beds	Revenue	EBITDA	EBITDA %	Price / Revenue	Price / EBITDA
Min	10	$ 3,100,000	$ 139,000	0.4%	0.02x	1.74x
25th	61	$ 43,800,000	$ 4,100,000	5.0%	0.44x	6.71x
Median	160	$ 98,100,000	$ 10,200,000	7.5%	0.62x	9.80x
75th	276	$ 206,300,000	$ 19,300,000	12.7%	0.94x	15.29x
Max	16,000	$ 3,300,000,000	$ 205,000,000	40.2%	1.58x	52.67x

**2012 transactions through June 30* *Data compiled from Irving Levin Associates, Inc.*

Over the historical period analyzed, price-to-revenue multiples have ranged from less than 0.10x for small, financially distressed community hospitals to as much as 1.80x for surgical hospitals being purchased by private equity funds. Price-to-EBITDA multiples are also dispersed across a wide range over the historical period analyzed, with many of the higher price-to-EBITDA multiples resulting from distressed transactions that are based on the cost of acquired assets and prospective profitability after restructuring. It is important to note that the reported "price" differs from transaction to transaction, with "price" representing equity, invested capital (*i.e.*, equity plus debt), or some other undefined "price" metric. This highlights the importance of valuation analysts carefully selecting transactions that are appropriate for comparison to a subject hospital and making appropriate adjustments to the valuation multiples.

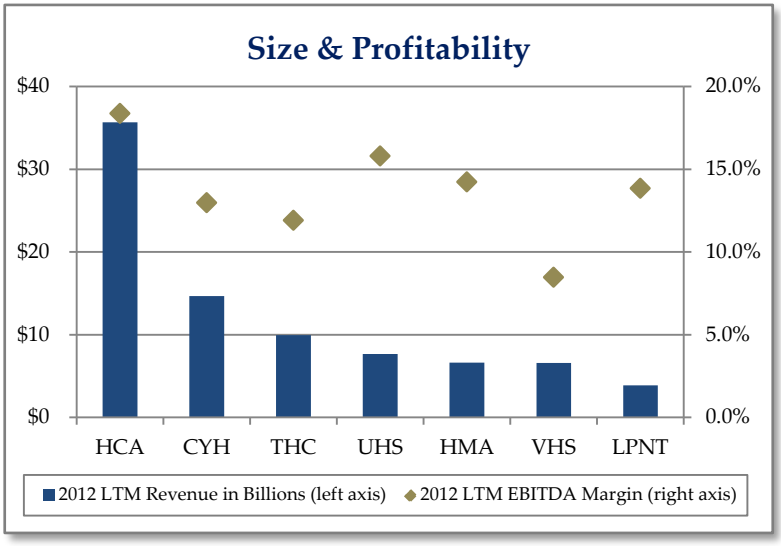
Publicly Traded Hospitals – Valuation Commentary

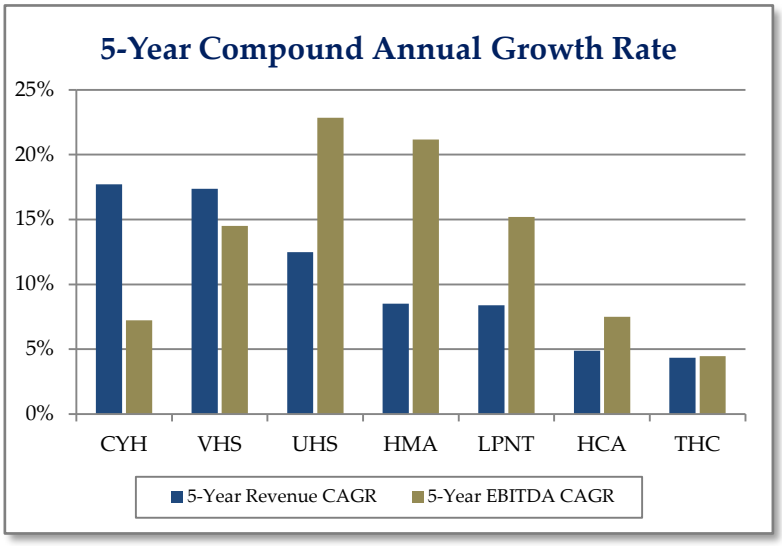
Valuation guidance can also be gleaned from share prices of publicly traded hospitals, including: HCA Holdings, Inc. (NYSE: HCA), Community Health Systems, Inc. (NYSE: CYH), Tenet Healthcare Corp. (NYSE: THC), Universal Health Services Inc. (NYSE: UHS), Health Management Associates Inc. (NYSE: HMA), Vanguard Health Systems Inc. (NYSE: VHS), and LifePoint Hospitals Inc. (NasdaqGS: LPNT). There are a few other publicly traded hospital systems which operate in state-specific markets, such as Integrated Healthcare Holdings Inc. (OTC: IHCH) and SunLink Health Systems Inc. (NYSE: SSY), but these companies are thinly traded and are typically not relied on for valuation analyses.

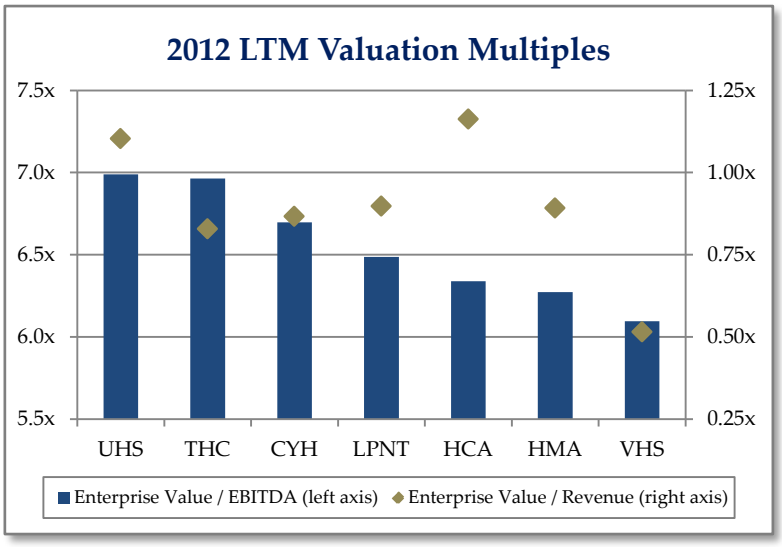
Current Trends in Hospital Transactions

When using publicly traded companies as comparables under the market approach to valuation, it is very important to consider adjustments to the multiple to reflect differences in size, profitability, growth, diversification, geography, access to capital, etc. Given the acquisition activity that has occurred over the past few years, it is important to understand the level of growth and profitability that relates to organic versus acquired growth, and to what degree these growth rates and levels of profitability are sustainable on a go-forward basis. The level of sustainability is tied, in part, to the availability of capital to continue the acquisition trend. The adjacent graphs compare the size, profitability, and growth of the seven aforementioned publicly traded hospital systems.

As shown in the third adjacent graph on this page, the total enterprise value-to-EBITDA multiples for the publicly traded hospitals fall within a very tight band, generally ranging from 6.0x to 7.0x. Total enterprise value-to-revenue multiples for the publicly traded hospital systems are dispersed across a wider range, from a low of 0.5x to a high of 1.2x. The dispersion is the result of varying EBITDA margins for the publicly traded hospital systems, as total enterprise value-to-revenue multiples tend to be highly correlated with EBITDA margins. Thus, the use of a simple linear regression model to aid in selecting an appropriate total enterprise value-to-revenue multiple is a common practice in business enterprise valuation.







Physician-Owned Hospitals – Trends

Section 6001 of PPACA placed a moratorium on the development of new physician-owned hospitals and limited existing physician-owned hospitals from future expansion beyond 2010. In spite of this challenging regulatory environment, HAI has observed increased transaction activity for physician-owned hospitals in 2012 and continues to observe increases into 2013. In fact, Physician Hospitals of America indicated there have been 33 transactions over the past 24 months in which physicians have completely divested their ownership. These transactions have further consolidated the physician-owned hospital market down to 240 hospitals as of the date of this paper.

This transaction activity has been driven by a few key factors, namely the constraints with additional physician syndication, the evolution of the relationship between a minority shareholder (*i.e.*, management company) and the controlling physician owners, the desire to align with a larger corporate partner to assist with negotiating payor and expense contracts, and the acquisition or alignment of physician investors' professional practices by competing health systems.

Physician-Owned Hospitals – Valuation Commentary

When valuing physician owned-hospitals, it is important to understand the constraints caused by PPACA, such as limits on the aggregate physician ownership, the number of operating and procedure rooms, and the number of licensed beds. Despite these limitations, physician-owned hospitals are able to expand certain outpatient service lines, such as diagnostic imaging and pathological laboratory services, as well as expand the number of observation beds to the extent there are constraints on bed capacity. Administrators of physician-owned hospitals have adapted to maximize the utilization of space, operating rooms, and licensed beds through altering business hours and staffing models. These nuances necessitate that the appraiser develop more detailed projections, which give specific consideration to each service line within the hospital. Failure to do so could result in a significant misspecification of value.

Other Considerations

Intangible Assets

Transactional activity is not always operationally focused, and HAI has observed an increase in transactions focused on the underlying intangible assets of a hospital, including: licenses, certificates of need, trade names, and know-how. These intangible assets may serve as the focus in an outright purchase, and are also frequently licensed or used as a contribution to a joint venture. Utilizing a well-known and respected hospital name, having access to experienced and sub-specialized medical personnel, and relying on proven management procedures could result in less patient leakage, increased services offered to patients, increased revenues, and a more efficient operating structure for a subject hospital.

Due Diligence

In addition to business enterprise valuations and fairness opinions, there is significant due diligence required for hospital transactions. This includes, but is not limited to, audit, tax, information technology system integration, operations, and compliance. Each of these diligence activities has the potential to disrupt a transaction, but perhaps the most important is compliance. Compliance issues identified in the due diligence process, especially those related to the fair market value and commercial reasonableness of existing contractual arrangements with referring physicians, introduce additional challenges and complications for parties focused on finalizing a transaction. Depending on the transaction structure, acquirers are concerned with successor liabilities that could be inherently acquired. These liabilities are associated with coding practices, physician employment agreements, professional service agreements with physicians, and other sorts of compensation and service relationships. It is advisable that the acquirer hire an independent healthcare valuation company to review and opine on the various aforementioned coding practices and compensation agreements.

Financial Reporting

After a business combination has occurred, there are certain financial reporting requirements under Accounting Standards Codification ("ASC") 805 and ASC 958. While these financial reporting requirements have always been a point of consideration with for-profit entities, ASC 958 was issued in 2009 (effective in 2010) and requires not-for-profit entities to follow financial reporting guidance for business combinations in conformity with for-profit entities under ASC 805. Under these standards, the acquired tangible and intangible assets, as well as any assumed liabilities, must be allocated to the acquirer's balance sheet at fair value as of the date of the combination. It is important to note that the definition of fair value may result in valuation considerations not consistent with the regulatory definition of fair *market* value, and in certain instances material differences in these values may exist. These differences are primarily related to the concept of "market participant" adjustments, which include reasonable operational and financial adjustments that can be realized by a hypothetical pool of investors, absent buyer-specific synergies. Common market participant adjustments include improved commercial payor contracting, the addition of certain patient services, reduced medical supplies and durable medical equipment costs, and improvements to staff utilization. Material differences in market participant adjustments can be particularly true for tax-exempt and/or struggling hospitals.

Tax-exempt business combinations involve community or religiously affiliated hospitals, and in many instances these entities are acquisition targets due to poor, moderate, or stagnate financial performance. Acquisitions of tax-exempt hospitals may be structured to include the assumption of debt held by the target hospital, the establishment of an endowment to benefit a community or religious affiliate of the target hospital, and a commitment to a certain level of capital improvements at the target hospital over a specified period of time. In these instances the purchase consideration may be limited to the fair value of the assumed liabilities, which could result in a bargain purchase.

Bargain purchases result when the fair value of the acquired assets is greater than the purchase consideration (*i.e.*, cash paid plus liabilities assumed). This difference is recorded as a gain on the income statement, with the gain ultimately increasing book net assets on the balance sheet. This is a positive signal to the bond markets, as it indicates the financial strength of the acquirer has improved as a result of the acquisition. This can lead to an acquirer realizing healthier financial ratios relative to static bond covenants, higher borrowing capacity, more flexible lending terms, and lower borrowing costs on a go-forward basis. Financial reporting requirements for business combinations can be complicated; it is recommended the acquirer have frequent discussions throughout the valuation process with their external auditors and valuation experts to navigate these requirements.

Summary

Hospital transactions are becoming more frequent, larger, and involve more complex structures. Regardless of the driving force or type of hospital transaction, it is more important than ever to understand the opportunities and risks that a transaction may present. Whether looking to acquire a hospital or enter into a joint venture or other alignment, hospital management must be prudent in selecting advisors who are well versed in the various structural, legal, and valuation issues which are present in these transactions.

If you have any questions about current or future business enterprise valuations, intellectual property valuations, due diligence, or financial reporting for business combinations, please contact Nicholas Janiga at ***(303) 688-0700*** *or* ***njaniga@hcfmv.com****. To learn more about HealthCare Appraisers, please visit our Web site at* ***www.HealthCareAppraisers.com****.*