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Merged and None the Wiser: What Keeps Hospitals from Gaining Economies of Scale?

By Molly Gamble

Culture makes for a concise culprit.

A merger or acquisition may make great sense on paper, but hospitals often face difficulty in realizing the strategic benefits of the deal.

Two managing partners from Chicago-based Prism Healthcare Partners weighed in with their observations about the risks and obstacles hospitals face in M&A. Combined, Mukesh Gangwal and George Whetsell have decades of experience in healthcare consulting, which has provided them with a range of anecdotes about effective mergers versus those that result in redundancy.

Question: Where do you see some of the benefits of current merger efforts?

George Whetsell: There should be the ability to gain economies of scale, particularly when you have hospitals coming together in a relatively similar geographic location. A lot of regional systems with two to five hospitals have been consolidating and combining general administration, finance, general accounting, payroll, information technology, planning, marketing, supply chain and material management and revenue cycle. It's logical and intuitive.

That said, as hospitals merge, we have seen them struggle to implement those economies of scale. [Hospitals] merge with a great plan, but don't implement all of the things they said they were going to do to gain economies of scale. You can build that out in the plan, but once you merge, the way you get those economies — you have to let people go — which is difficult. There is a real hesitancy to do that.

Q: Why is that? Why is it especially difficult for hospitals or healthcare organizations to lay off employees?

Mukesh Gangwal: Most healthcare — it's still local. They have a large stake in the community they serve. Their boards represent community leaders. This puts inherent pressure to not take action that [negatively] affects people, the community and their reputation. When you combine that with the management depth and strength in healthcare compared to the commercial sector, you see healthcare has always lagged in getting the best and the brightest because of misaligned incentives. Superior performance is not always recognized and rewarded. Also, making tough decisions is not easy for management. There is also a lack of understanding among hospital leadership in how to evaluate the right number and mix of employees or not. They struggle with benchmarks, job content and competitive compensation.

GW: A huge percentage of hospitals are nonprofit and community-based. They are not trying to make huge profits — they are trying to not lose money. There are a lot of social and community service dimensions to their mission. So it's very service-oriented. Letting people go is very counter to the mission and culture of these organizations. Even holding people accountable [is difficult]. Hospitals may transfer somebody to a new job because they are not performing, but they won't fire them. They'll find another spot for them. There's a caring element to the culture, which is a positive thing in many respects, but is a hurdle when it comes to the merger and consolidation strategy.

Q: What are other challenges or risks that come with a merger?

GW: As systems get bigger and gain more hospitals, they often create a corporate office. Functions like planning, marketing, IT, payroll, so on — they basically pull out of hospitals and centralize in a shared support office. There is often a huge amount of unhappiness with the level of service provided by the shared functions. We've been seeing that for years. The formerly individual hospitals give up resources to the shared office and are not happy with the level of support they receive, nor how much of the cost allocation comes back to them.

MG: Size matters. That's the big mantra in healthcare right now. First, a $1 billion organization was big. Then $2.5 billion. Now critical mass is $5 billion or more. Everybody wants to get together to realize some of the benefits, such as [improved] contracting, [reduced] overhead costs, capital opportunities and strategic alignment.

There are financial consultants and others who come up with future projections and scenarios, and all look very rosy. In reality, the merger realization is very hard. The reason is you have two organizations and two cultures. The healthcare industry has never been famous for accepting change. Typically, we see benefits at only 15 percent to 20 percent of the originally projected numbers. We see a very large turnover of executives from the acquired organization. Not only in healthcare, but in general, a large percent of 'acquiree' management leaves in the first 12 months.