VERTICAL INTEGRATION WILL TEST HEALTH SYSTEMS’ VULNERABILITIES
A recent flurry of vertical integration deal activity reflects a clear strategy – regardless of the entity involved – to control or influence patient encounter points across the entire continuum of care delivery.

Vertical integration is defined as the combination of two or more stages of production normally operated by separate companies within one company. Horizontal consolidation, by comparison, occurs when a company acquires another firm that offers similar products or services, thus increasing the buyer’s market footprint while simultaneously decreasing competition.

In healthcare, a vertically integrated system can offer a broad range of different patient care and support services. For example, hospitals can buy physician groups or health systems can form drug companies. For the purposes of this report, we’ve narrowed our scope to highlight the new market trend of vertical integration deals and what it means for care delivery.

**KEY TAKEAWAYS**

- Vertical integration in the healthcare industry is not new, but large M&As have put a renewed focus on the activity.
- Payers and retail pharmacies are driving new vertical integration deals which will affect health systems’ partnership, referral and top-of-funnel strategies.
- Health systems must find a way to evolve beyond their fragmented legacy care delivery models. This will involve partnering with untraditional allies to create regional hubs which bring value to consumers and build patient loyalty.
- Watch for both health systems and non-healthcare entities to continue to partner, acquire or integrate in the future. These deals will look to grab dollars from health providers’ revenue margins. Know your vulnerabilities.
THE CURRENT STATE OF VERTICAL INTEGRATION

Vertical integration is currently a hot topic and could mark a new era in healthcare industry transformation, but it’s not a new strategy. Geisinger and UPMC, for example, both introduced health plans into the market in the 1980s and 1990s, respectively.

Payers and retail pharmacies have been front and center in the recent wave of vertical integration deals. These players have been inspired by the rising costs of healthcare — hospital prices increased by 42% between 2007 and 2014 — and tasked themselves with driving down the cost of care by pushing patients to lower-cost care settings. These moves are not only being made to boost their own profits but also to gain larger market share to better compete and strengthen their negotiating position with providers.

The recent vertical integration moves listed below exhibit the diverse industry partnerships that can be achieved.
INDUSTRY IMPLICATIONS

Make no mistake, vertical integration is testing and exposing providers’ vulnerabilities. While the payer and retail pharmacy vertical deals have a lot to do with owning more of the U.S. drug supply chain, they will also erode providers’ margins by impacting their referrals and top-of-funnel strategies. In reality, insurers would prefer people not visit the hospital, so these deals seek to prevent high-cost, unnecessary hospital admissions.

The healthcare funnel refers to a continuum of services and points of entry where patients engage with caregivers. At the top of the funnel sit primary care, urgent care, retail clinics and wellness programs. The bottom of the funnel includes tertiary and quaternary care services.

With retail pharmacies offering lower-cost, convenient care options and services, individuals are willing to seek care in these locations over more expensive hospital settings. While these patient encounters may not be blockbuster moneymakers for hospitals and health systems, their numbers add up. As a result, hospitals and health systems are facing pressure on volumes and profit margins.

In addition to lost revenue, a referral stream for more expensive care services is narrowing as insurers push patients to providers in lower-cost care settings, who will then refer patients to their preferred network, if and when appropriate. With payers and retail pharmacies controlling more care service market share and referrals to in-network caregivers, health systems will be forced to think about their affiliated partnerships and ambulatory strategies to assess their top-of-funnel and referral opportunities.
NEW YORK IMPLICATIONS

Vertical integration is not simply on the horizon for HANYS members, it's happening right now. Northwell, Montefiore and Mount Sinai are all aggressively pursuing deals to achieve larger size and scale while outpatient care settings/options are increasing in New York state:10

- NewYork-Presbyterian and NYU Langone Health are among many providers in New York that have made strategic investments and focused on ambulatory care.
- There are at least 23 CVS MinuteClinics in New York City, plus hundreds of CVS pharmacy locations in the state.
- Health insurer Oscar launched a primary care clinic in Brooklyn and offers Doctor on Call appointments 24/7 through their app or website.
- OptumCare operates under ProHEALTH Care in New York state, offering urgent care for adults and children 365 days a year.

Not all vertical integration efforts result in immediate success. For instance, while Montefiore and Mount Sinai both operate insurance plans, NYP divested its health plan SelectHealth in 2012, and Northwell announced in 2017 it would shut down its insurance operation.

Much like providers across the U.S., New York providers that are not proactively re-evaluating care delivery and business models and/or searching for opportunities and beneficial partnerships can expect a negative impact on their bottom lines.
CVS Health shocked many in late 2017 when it announced it would acquire Aetna in a nearly $70 billion deal. At the time, the companies stated the deal would “remake the consumer healthcare experience” by combining CVS’ local clinic presence and Aetna’s analytics. In May, CVS CMO Troy Brennan shared that CVS wants to “complement, not compete, with primary care” while outlining three target groups:

- Patients with five common chronic diseases (diabetes, hypertension, hyperlipidemia, asthma and depression).
- Patients who disproportionately contribute a large share of total healthcare costs.
- Patients transitioning from a hospital who need readmissions prevention attention.

To support these initiatives, Brennan said CVS Health would explore four major categories: intervention coordination at CVS Pharmacy and MinuteClinics; health monitoring and data collection in patients’ homes; patient outreach via digital tools; and connectivity with primary care providers to assist with preventive care.

The merger could affect health systems as it would compete in the population health and retail pharmacy strategies spaces. If Aetna gets more patients to fill prescriptions at CVS, that could threaten health system-owned pharmacy revenues and affect medication management.11

As expected, groups like the American Medical Association and the Association of American Physicians and Surgeons were not fans of the merger plans. Though the U.S. Department of Justice forced Aetna to divest its standalone Medicare prescription drug plan to WellCare Health Plans and regulators in California and New York pushed back, the deal closed without much of a fight.

In February 2019, CVS opened its first three integrated HealthHUB stores in Houston, equipped with expanded health resources and less retail space. More floor space is dedicated to healthcare services, including spaces for yoga classes and expanded treatments, while pharmacists will make regular calls and in-person consultations for medication adherence.

CVS execs say it’s too soon to tell how quickly this model will scale to other locations, but this model could widen the front door of healthcare.
POLICY AND REGULATION

Providers can’t think that this is a passing trend they can ignore. PwC Health Research Institute noted that deals among health services companies are “likely to continue given capital availability, potential for disruption from cross-industry alliances and continuing long-term trends such as regulatory uncertainty, reimbursement pressure, and increased focus on the consumer.”

Providers can’t rely on the government to step in and block such deals. So far, vertical consolidation has been largely unchecked by antitrust agencies. In 2017, the FTC did block one large vertical healthcare deal: St. Luke’s Health System’s attempt to buy Saltzer Medical Group, a physician practice in Idaho. However, the decision was based on anticompetitive principles for horizontal consolidation, citing concerns that patient costs would rise.

That said, growing evidence could cause federal regulators to further scrutinize such deals in the future.

- A 1999 study on hospital competition found “patients from the least competitive areas experienced 1.46 percentage points higher mortality from [acute myocardial infarction]” in comparison to the most competitive areas.

- In 2014, researchers concluded that when hospitals own physician practices, market share increases – but so does the association of higher prices and hospital spending.

- In late 2017, researchers found little evidence that vertically integrated health systems provide improved quality.

Although regulators haven’t yet taken on vertical integration cases wholesale, increased volume and calls for scrutiny may spur regulators to look more closely. However, it should be noted that antitrust policy, at least according to one set of researchers, is unlikely to address the “long-term, seismic changes to the healthcare system” through both horizontal and vertical mergers in the space.

Therefore, providers still need to take a look at their business and markets to evaluate their vulnerabilities.
Optum, the healthcare service arm of UnitedHealth Group, has been slowly reshaping the paradigm of vertical integration. In 2011, United brought its care delivery services, data and analytics capabilities and pharmacy benefit service under one master brand.\textsuperscript{18}

In recent years, Optum has been acquiring care delivery vehicles, including urgent care, ambulatory surgery and managed care services. As of April 2018, Optum had 30,000 employed and affiliated physicians on its payroll. For comparison, the nation’s largest for-profit system, HCA, employed about 37,000 physicians at the time.\textsuperscript{19}

Optum executives have been reported to state they believe consumerism will change the healthcare landscape, citing changing service expectations from patients.\textsuperscript{20} Future activity could include consumer segmentation models and new capabilities to allow patients to digitally schedule appointments, enroll in insurance, view health records or renew medications.
FOR YOUR CONSIDERATION

Vertical integration won’t affect health providers in a uniform manner. It’s important to take stock of your market, anticipate changes within it and identify your strengths and weaknesses to best prepare your organization for industry-wide changes. Be aware of market movements and federal/state policy. Knowing your competition and assessing your vulnerabilities, as well as having open dialogue among your strategy team, will be critical to move forward in the new healthcare landscape.

POTENTIAL APPROACHES

Here are several potential approaches to spark conversation internally about ways to address the vertical integration trend.

1. Partner with untraditional allies.
2. Affiliate with or consider buyouts from larger, national brands.
3. Shorten budget cycles and involve CROs in strategic decisions.
4. Build out new service capabilities.
5. Remember the physician-patient relationship.
6. Consider venture investments and spinning out tech products.
7. Be aware of market movements and federal/state policy.
1. Health Affairs: “Hospital Prices Grew Substantially Faster Than Physician Prices for Hospital-Based Care in 2007-14”. Published February 2019.


For more information about vertical integration or other industry issues, contact HANYS’ Managed Care division.

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