REPRINT November 2017

hfm

healthcare financial management association hfma.org

Daniel M. Grauman
Danielle Bangs
Sean Looby

using due diligence to optimize post-transaction benefits

The due-diligence period is the critical time during which organizations that are exploring possible mergers or affiliations should be assessing the proposed transactions' actual viability and ability to deliver the desired value.

AT A GLANCE

For healthcare organizations contemplating a merger or other type of partnership transaction, the preliminary due-diligence period is a critical time for assessing whether it makes strategic sense to proceed with the transaction. Organizations should pursue four tactics during this period:
> Engage in a collaborative due-diligence approach.
> Tailor efforts, while checking all the boxes.
> Consider risks and the options for mitigating them.
> Identify high-priority integration activities.

Today's healthcare environment continues to see numerous transactions involving partnerships between healthcare providers, to the point that pursuing a partnership may seem like the default option. All too often when organizations explore such opportunities, the pressure to complete the deal can interfere with making sure that the relationship is being pursued for the right reasons.

To ensure the success of any partnership transaction, organizations must be mindful of the critical importance within the deal process of the due-diligence period, which encompasses the time between execution of the letter of intent (LOI) and finalization of the definitive agreement. When effectively executed, due-diligence activities provide the means for ensuring the partnership makes sense and will create greater value than the partnering organizations could create on their own.

It therefore is imperative that efforts undertaken during the due-diligence period be conducted in a way that not only protects against significant transaction risks, but also provides a deeper understanding of a potential

DUE DILIGENCE AS PART OF THE PARTNERING PROCESS

Making the Deal: Getting to a Letter of Intent

Conducting Due Diligence

Objectives	**Key Activities**	
	Due Diligence	**Financial Planning**
1. Develop an understanding of the organization	> Review data/documents. > Conduct interviews. > Perform analyses.	> Analyze volume and financial trends. > Assess competitive environment and local market dynamics. > Develop baseline prospective financials.
2. Evaluate the transaction	> Identify risks and issues. > Evaluate the risks and issues.	> Quantify the risks and issues. > Analyze the post-transaction financial picture, incorporating risks, potential synergies, and the impact of capital commitments.
3. Inform action	> Flag deal breakers. > Identify the need for safeguards/contingencies.	> Consider revisiting the capital commitment based on impact on capital capacity and ROI. > Assess and understand the impact of not proceeding with the acquisition.
4. Lay a foundation for the future	> Prioritize implementation and integration efforts. > Collaborate and build relationships.	> Identify post-transaction financial planning priorities. > Plan for mitigation of key risks identified.

Closing the Deal: Executing a Definitive Agreement

partner and partnership. Here, we consider the essential elements of an effective due-diligence process.

Due Diligence: More Than Just a Checklist

To go beyond the core objective of identifying any significant "skeletons in the closet" that would make it undesirable to proceed with the deal, due diligence also should provide insight into the deal's potential to realize value and lay a foundation for a successful future. The following tactics provide a means for achieving all these objectives.

Engaging in a collaborative due-diligence approach. The organization would be well advised not to attempt to perform the due-diligence process without objective and impartial outside assistance. What works best is a collaborative approach that combines the efforts of internal and external subject-matter experts (SMEs), allowing for comprehensive consideration of risks, potential synergies, post-transaction implications, and integration issues in an efficient and compliant manner.

The external SMEs should oversee the process, ensuring sensitivity to antitrust concerns, other regulatory considerations, and the rapidly changing industry environment, as well as providing objective, third-party assessment of risks and implications. External SMEs should exhibit industry-specific and functional-area expertise across the key areas of the due-diligence review and strong analytic, financial, communication, facilitation, and problem-solving skills. Such an SME who also has broad experience with hospital merger-and-acquisition activity, including partnership negotiations and other transaction support activities, can provide context and guidance through the due diligence period.

Strategic involvement of internal SMEs (organization leadership and management) also is instrumental for considering partnership synergies. Internal SMEs—e.g., finance, operations, and nursing leaders; the physician medical group president and head of medical staff; and leaders from compliance, human resources, marketing, facilities and equipment management, and managed care contracting— provide the organization-specific insight and the context necessary for identifying risks and potential integration issues associated with the deal and its ability to produce value. Organizational SMEs will understand the rationale for the transaction, enabling them to ensure the assessment is conducted with a focus that's grounded in that context. Crucial roles for internal SMEs include cofacilitating interviews, examining key documents and data, and performing a preliminary review of draft findings. Involvement of internal SMEs also fosters the development of future working relationships, because interviews and due-diligence discussions often present the first opportunities for professional collaboration between the two organizations' top-level leaders and management.

Tailoring efforts, while checking all the boxes. Due diligence requires an orderly investigation of all matters pertaining to a potential partner or target organization—including financial, legal/regulatory, strategic, and operational areas—to serve the obligation of each potential partner to protect its organization against significant risk. To ensure efficiency and maximum impact, efforts within each area should be tailored to the specific parties involved, the nature and structure of the transaction, and the underlying deal rationale. Opportunities to tailor efforts will present themselves throughout the due-diligence period, but two considerations almost always necessitate customization.

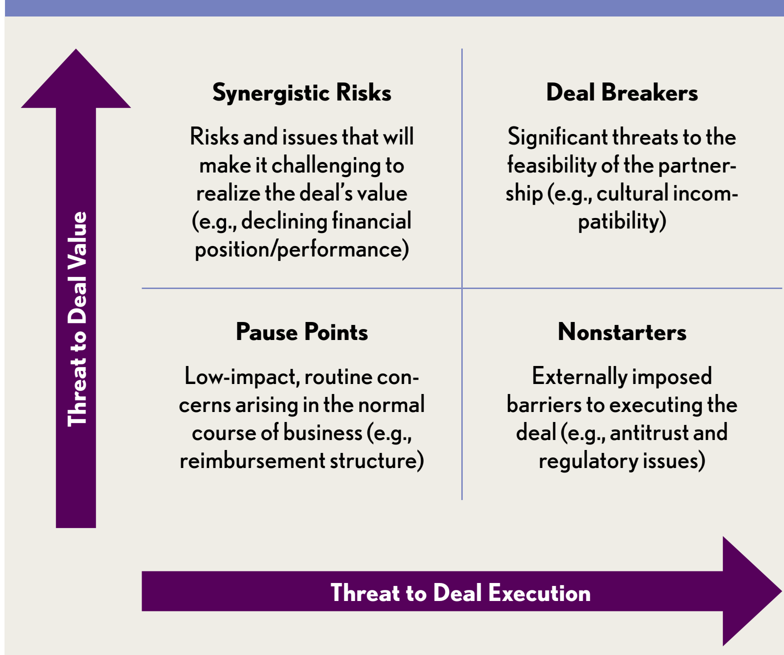
The first is the need to set priorities among data and document requests. Satisfying due diligence data requests takes time. To ensure that no critical, high-interest questions remain unanswered, data request items should be categorized by priority level, with the most critical, time-intensive assessments completed first.

The second consideration is the question of how best to involve internal SMEs. The efforts of internal SMEs are best focused on areas that will have the greatest potential impact after the transaction is completed. The most efficient way to make use of their knowledge and time is to involve them through interviews and selected data/document reviews.

Considering risks and the options for mitigating them. Risks and issues that are identified during the due-diligence period will have differing relevance to executing the deal and realizing its full value, and differing implications for steps required to mitigate each area of risk or concern.

Risks that fall into the categories of *nonstarters* and *deal breakers* pose an immediate threat of deal implosion, regardless of other findings. These risks are not commonly encountered, assuming initial negotiations and legal issues were handled

TYPES OF RISKS AND ISSUES THAT MAY BE IDENTIFIED THROUGH DUE-DILIGENCE PROCESS



POTENTIAL RESPONSES BY TYPES OF RISK IDENTIFIED DURING DUE DILIGENCE

Potential Actions	Pause Points	Synergy Risks	Deal Breakers	Nonstarters
Do nothing	■	■		
Prioritize for integration activities	■	■		
Pause for further exploration	■	■		
Build in contingencies		■		
Adjust capital commitments		■	■	
Alter purchase price		■	■	
Modify deal and/or governance structure		■	■	■
Walk away		■	■	■

thoughtfully. *Synergy risks* (risks that synergies will not be achieved) are more common. Although they may not present an immediate threat to consummating the deal, they should be carefully considered for their implications regarding realizing the deal's full value.

Synergy risks are specific to the transaction at hand, and evaluating them requires, first, a clear understanding of the rationale for the deal—that is, the specific type of value the deal presents. A regional health system and health plan seeking to increase its network reach and improve care quality and access by acquiring a rural community hospital may be less concerned with the target hospital's financial struggles and more focused on assessing the stability of its physician base and identifying opportunities for clinical service-line integration and consolidation. By contrast, a prominent academic medical center affiliating with a regional community health system to manage population health and foster innovative care delivery might be more concerned about the affiliating party's financial performance and ability to contribute to network growth objectives.

There are many different types of potential responses to a synergy risk, ranging from simply flagging a risk to be considered when setting priorities among integration activities to walking away from the deal. Quantification of these risks, as addressed below in the discussion of post-transaction financial planning, is critical to identifying the most appropriate response.

Identifying high-priority integration activities. Due diligence efforts should provide critical insights for implementation and integration planning. Although formal integration planning may not begin until the deal closes, much of the initial work to identify actions to be taken and issues to be addressed following the transaction are of highest priority and can occur during the due-diligence process.

Internal SME involvement is particularly helpful in this regard. Internal SMEs are most familiar with their systems and policies and are best positioned to ask the right questions and identify potential integration challenges. An external SME may lack the required context to evaluate the implications of vastly different employment-and-benefits eligibility criteria, for example, but these implications could be easily identified by interviewing SMEs from the organization's human resources department. Conducting such interviews early allows the organization the maximum time possible for integration planning and determining how best to manage potentially substantial integration issues.

Post-Transaction Financial Planning

As due diligence proceeds, the team also should be developing prospective financial estimates for the target organization and its likely impact on the larger health system. Prospective estimates should incorporate both due-diligence findings and other strategic and operational considerations. The comprehensive prospective financials should have four key objectives, discussed below.

Quantify risks identified during due diligence and understand future implications. Once a risk has been identified, the question becomes how significant its impact is likely to be, and how that may change over time. Determining which potential risks pose the biggest threat to realizing deal value, and assessing the ability to mitigate or eliminate the risks, will allow for thoughtful consideration of whether to move forward with the transaction, and whether key deal terms need to be revisited given the prospective financial picture.

Test the impact of capital commitments. Due to deal pressure and timing constraints, the capital commitments agreed to in the LOI are typically not assessed with great rigor before the LOI is signed. Testing the impact of these commitments on both the target organization and the acquiring system will enable the organizations to confirm whether the level of commitment and specific areas of investment are appropriate or need to be revisited.

For example, if the target organization is seeking a partner that will commit to new or expanded facilities, it's important to assess the need and feasibility studies already conducted for the proposed projects, as part of the due-diligence process. Prospective financials should incorporate the impact of the capital investment and resulting incremental revenues and expenses.

ROI for strategic capital investments in new facilities, services, or programs, and in physician network growth, should be assessed to ensure the investments make sound business sense. Due-diligence efforts may also uncover areas for program development or expansion opportunities that the acquirer wishes to pursue, which may require reallocating capital commitment dollars to identified initiatives with higher potential ROI.

Be diligent but realistic about potential synergies. Instead of making high-level assumptions on where and how much expenses can be cut, key service line and support service leadership should work with their counterparts to identify areas of opportunity. This will allow for realistic,

SAMPLE RISKS, FINANCIAL IMPLICATIONS, AND POTENTIAL MITIGATION STRATEGIES FOR A SMALL COMMUNITY HOSPITAL

	Poor Quality of Care	**Impending Physician Shortages in Key Specialties**	**Loss of Sole Community Provider Status**
Identified Risk	Lack of resources and standardization along with greater scrutiny and reporting requirements have resulted in increasingly poorer quality scores across multiple fronts.	Upcoming physician retirements in primary care, cardiology, and orthopedics.	Competitor hospital being developed 10 miles away will result in loss of Medicare Sole Community Provider status and accompanying additional payment.
Prospective Financial Implications	> Hospital Readmission Reduction Program penalties > Hospital Value-Based Purchasing penalties > Poor patient perception and declining market share	> Declining market share > Decrease in downstream hospital inpatient and outpatient volumes	Special payment constitutes 9 percent of total net revenue, causing significant financial implications.
Year 1 Estimated Impact Summary	Revenue: ($0.8M) Expense: $ – Net Impact: ($0.8M)	Revenue: ($2.5M) Expense: ($1.0M) Net Impact: ($1.5M)	Revenue: ($6M) Expense: $ – Net Impact: ($6M)
Mitigation/Elimination Strategies	> Extension of acquirer best practices > Investment in additional dedicated quality-team staff > Focused length-of-stay reduction initiative	> Alignment with key independent physicians and groups > Reallocation of acquirer physicians on part-time basis to meet current need > Initiation of recruitment efforts	Not applicable

Questions to Address When Assessing a Deal's Potential for Realizing Value

The key questions for any given deal will depend on why the organization that is pursuing the transaction is doing so, what it hopes to achieve, and what information it requires to make well-informed decisions about the path forward. Here are some questions that are imperative to ask during the due-diligence period:

> What impact will risks identified during due diligence have on the combined organization post-transaction?
> How will the capital commitments impact the combined target and larger system?
> How will acquisition of the target affect patient care patterns, considering care volume that may shift from acquirer facilities to target facilities and vice versa?
> What services should be consolidated, expanded, or redistributed among sites and locations?
> What impact will extending acquirer ACO participation, narrow network products, or other value-based payment and population health initiatives to the target have on future volumes and financials?
> What local market dynamics and competitor initiatives need to be accounted for when considering future growth estimates?
> If the transaction does not move forward, what would the impact be if a competitor acquired the target?

tangible opportunities to be included in the prospective financials.

Prioritizing opportunities and developing a timeline, reality-checked against other integration efforts that will be underway post-transaction, will result in realistic expectations. Most synergies are not realized in the first year, but there should be a short list of low-hanging fruit that can be implemented within the first three to six months post-transaction. Current target financial performance and trends will dictate the urgency of certain expense reduction efforts.

Plan for different scenarios, and subject assumptions to pressure tests. Financial models are driven by assumptions, and changing those assumptions can significantly affect the prospective financial performance. To this end, scenario-planning, including the possibility of walking away from the deal, is a valuable exercise.

Modeling several scenarios based on changes to key inputs will test the sensitivity of the results to changes in volume and other factors and provide an understanding of the potential range of outcomes. Different scenarios could include changes to key assumptions, including:

> Market share gains driven by estimated growth in the employed physician enterprise and facility and program investments
> Payer rate increases for government and commercial payers
> Incremental expenses related to necessary resources to support population health infrastructure and initiatives

With such information, the management team can manage risk and uncertainty more effectively and have the proper discussions about the path forward.

Although walking away from a deal can protect the organization from risks, it can also have a negative impact depending on the identity of the ultimate acquirer. To understand the impact of not acquiring, it may be necessary to analyze several different scenarios, depending on the presence and priximity of other potential suitors in the two organizations' service area. Contingency planning should be part of assessing the impact of not completing the deal.

For example, a target community hospital may transfer complex cases to several comprehensive, regional hospitals that compete with each other. If the target is acquired by one of those hospitals or health systems, the majority of transfers could shift to that hospital, potentially causing a negative impact on the other hospital.

A Judicious Time Frame

The deal-consummation process can take between 12 and 18 months, and sometimes longer, from discussions prior to signing the LOI to closing. Over that time, the parties often become increasingly anxious to proceed with integration and to move forward with important business decisions that have been put on hold during due diligence.

Organizations should temper these feelings, however, given the critical importance of carefully vetting a potential transaction to ensure that the deal value sought is actually attainable. By fully leveraging the due-diligence period and incorporating initial integration and financial planning efforts into the process, hospitals and health systems can ensure that they make the best deals for their circumstances, plan effectively for the future while setting realistic expectations, and move forward after the transaction to quickly reap the full benefits they had hoped to achieve. ■

About the authors

Daniel M. Grauman, MBA, CPA/ABV, is managing director and CEO, Veralon, Philadelphia, and a member of HFMA's Metropolitan Philadelphia Chapter (dgrauman@veralon.com).

Danielle Bangs, MHA, CVA, is manager, Veralon, Philadelphia, and a member of HFMA's Metropolitan Philadelphia Chapter (dbangs@veralon.com).

Sean Looby, MHA, is manager, Veralon, Philadelphia, and a member of HFMA's Metropolitan Philadelphia Chapter (slooby@veralon.com).

VERALON™

HEALTHCARE MANAGEMENT ADVISORS

- Strategy and Planning
- Mergers and Transactions
- Valuation and Physician Compensation
- Clinical Transformation and Value-Based Payment

PHILADELPHIA ATLANTA CHICAGO LOS ANGELES NEW YORK

www.veralon.com | 877.676.3600