

Provider post

News and analysis of current issues affecting healthcare providers

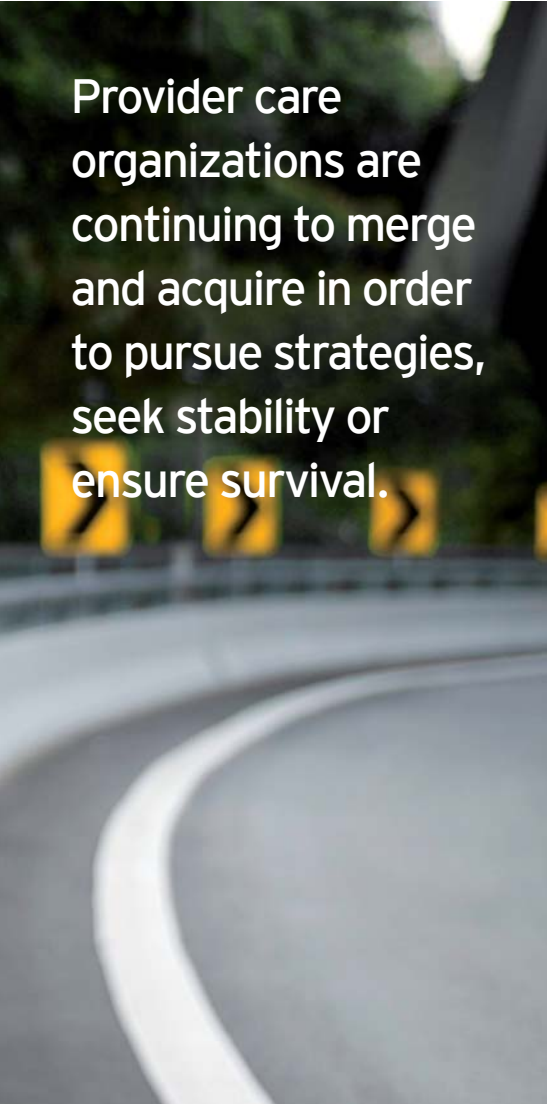
Merging for strategy, stability or survival

Unlocking the value in healthcare mergers and acquisitions

Healthcare providers have long sought Mergers and Acquisitions (M&A) for a variety of strategic reasons -- from new markets, vertical integration and economies of scale to improved access to capital and better leverage in payor negotiations. While for many industries, the recession has reduced M&A activity, healthcare has experienced less of a decline. Provider care organizations are continuing to merge and acquire in order to pursue strategies, seek stability or ensure survival.

Hospital M&A activity has not been limited to the investor-owned sector; not-for-profits were the acquirer in 7 of the top 10 hospital deals of 2008 and in 20 of 28 transactions announced during the first half of 2009. With the likelihood of healthcare reform legislation, and the expectation that some form of payment bundling will be a part of that reform, we can expect to see even more consolidation of provider businesses (reminiscent of the move toward integrated delivery systems in the 1990s) in anticipation of these changes.

Yet regardless of its strategic motivation or form, a business combination is one of the most complex and risky transactions any organization can undertake. In pursuing the intended benefits of an M&A transaction, either party can become vulnerable to risks – operating, regulatory, financial and market. In some forms of business combinations, particularly those involving multiple not-for-profit organizations, the terms “buyer” and “seller” may not be clearly definable. All parties in a proposed transaction must comprehensively assess potential risks before moving forward. This assessment is typically organized as a rigorous due diligence process, carried out by a combination of external advisors and internal resources. The M&A due diligence program for healthcare providers should include multiple areas of analysis (see Exhibit 1).



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Exhibit 1. Some M&A due diligence considerations for provider care organizations

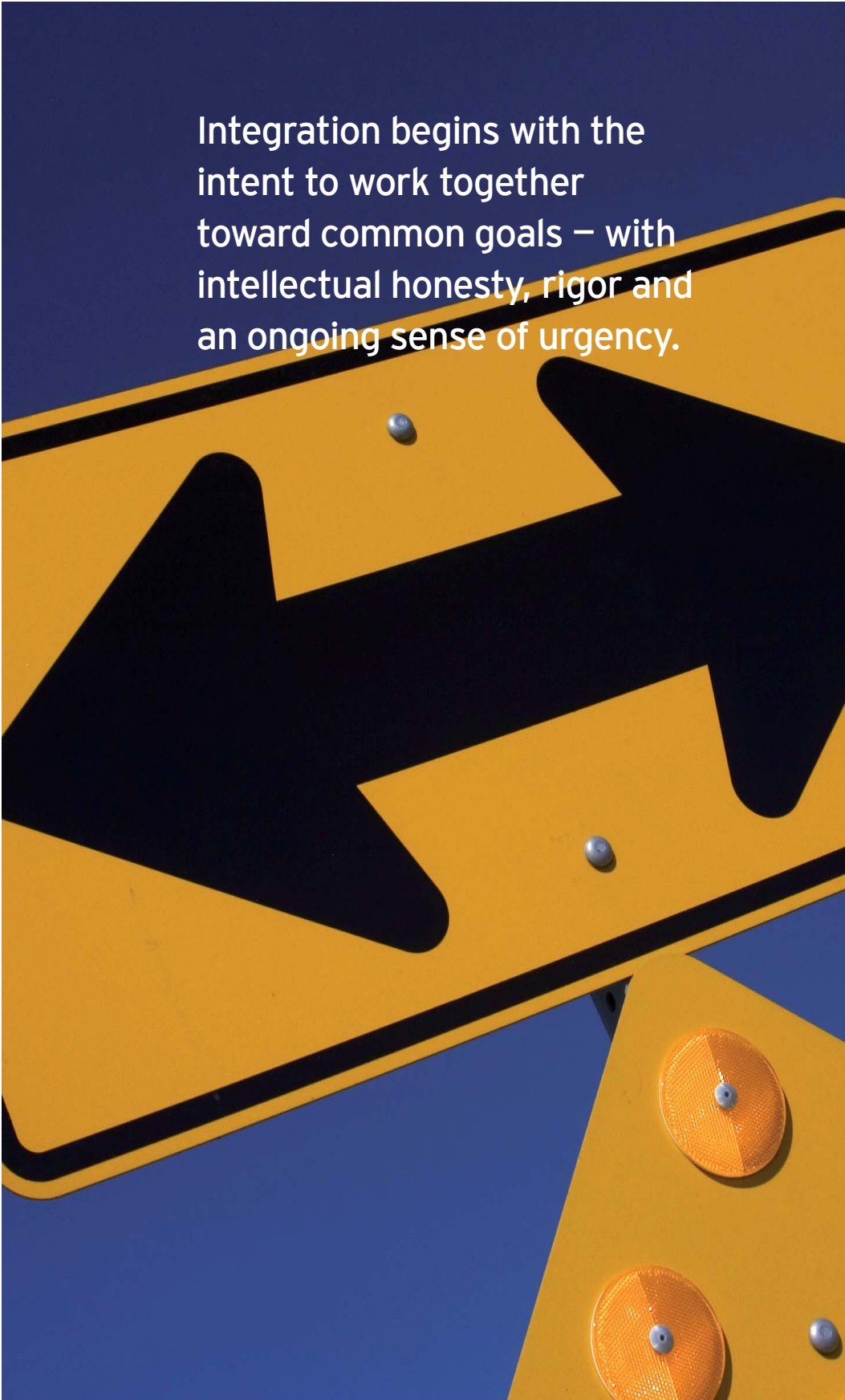
Consideration	Action steps
Quality of information	Validate critical information about the other participants and the integrity of the systems, people and processes used to develop it. For example, analysis can include accessing and reading the independent auditor's working papers and reconciling the audited financial statements to management's internal financial statements.
Quality of revenue	Assess revenue reporting and analysis. Understand the patient billing and collection systems and methodology used for establishing contractual allowances and bad debt reserves. Reconcile reported net revenues to cash collections for at least the most recent two years. Analyze revenue by service line and changes in revenues caused by, for example, patient volumes, pricing, payor mix, and new, expanded or discontinued service offerings, as well as operational statistics.
Costs and expenses	Analyze historical and budgeted operating expenses by department; salaries, benefits and full-time equivalents by job classification; physician compensation and turnover by clinical service; and supplies, equipment and pharmaceutical expenses.
Quality of earnings	Analyze the prospective merger partner's historical revenue and expense accounts for unusual or nonrecurring items that may affect the quality of earnings after the transaction and must be considered in the combined entity's forecast models.
Accounts receivable and third-party accounts	Analyze aged accounts receivable balances, days revenue outstanding by payor class, methodology for determining reserves for bad debts and contractual allowances, and components of any amounts due to or from third-party payors.
Working capital	Analyze all of the other current assets in addition to patient receivables and current liabilities of a prospective merger partner's working capital. This analysis should cover a trailing 24-month period to assess the level that will be required to operate and whether any incremental short-term financing will be needed. It can also help to identify potential post-transaction compliance and operational integration issues.
Tax matters	Understand the prospective merger partner's legal entity structures and recent corporate history and inquire into tax-exempt and public charity status, where applicable. Review required federal income tax and/or Form 990 returns for all years for which the statute of limitations is not closed. Identify material actual and potential federal, state and local employment tax issues and exposures, as well as other non-income tax items (e.g., sales and use taxes, property taxes, abandoned/unclaimed property taxes).
Operations, technology and integration	Understand the quality, scalability and reliability of software and hardware platforms of the prospective merger or acquisition partner and the associated capital and operating expenditures. Consider the upcoming conversion to ICD-10 and the related implementation and remediation requirements across multiple clinical and financial systems, which may pose a significant challenge. Understand and quantify the terms of any anticipated transition services agreements to be in place during the merger integration process.
Payor contract analysis	Quantify the potential benefits of payor contracts in compliance with antitrust guidelines. Consider using external advisors and "blinded" analysis of the potential net revenue impact of applying commercial managed care contract terms of each party to the applicable utilization statistics of the other.
Insurance coverage	Conduct an actuarial-based analysis of insurance for general and professional liabilities, workers' compensation, property and casualty losses or directors' and officers' liability losses to evaluate the adequacy of recorded reserves and corresponding assets. Shortfalls in funding reserves for these may constrain future cash flows.
Contracts and other legal reviews	Analyze contracts with physicians to determine regulatory compliance and future commitments. Evaluate physician relationships. Review debt agreements, lease agreements, purchase agreements, joint ventures, employment contracts, restrictions, covenants, and any other agreements under which a merger participant is bound. Analyze for assignability, change in control provisions and other terms that could change or become effective as a result of a transaction.
Investment performance and management	Analyze investment income and contributions used to support operations. Understand the underlying causes of poor investment results and implications for future funding requirements. Assess the relationships with any affiliated, but not controlled, foundations.
Corporate compliance	Review the functioning and design of the proposed partner's corporate compliance program to assess the ability to educate employees, identify fraud and reduce the risks of regulatory noncompliance. In addition to long-standing Health Information Portability and Accountability Act of 1996 (HIPAA) privacy and security regulations, the American Recovery and Reinvestment Act of 2009 has created new and enhanced requirements for providers and their business associates.
Human resources and benefit plans	Compare pay rates, employee health benefits, pension plans and other benefit programs across the organizations, and quantify the potential costs and opportunities of consolidating plans, which may include defined benefit pension plans and postretirement medical and life plans. Evaluate assumptions and calculations supporting ongoing trust funding requirements for the plan sponsor based on actuarial calculations of the present value of future benefit payments.

Managing post-merger integration

After due diligence is completed and agreements are signed, the real merger work – the nuts and bolts of combining – begins. Successfully merging two distinct organizations, even those with similar cultures, requires focus, patience and discipline. Hospitals that successfully manage their post-merger integration typically address six major areas that deliver the most value over time:

1. Preserving and leveraging key relationships
2. Retaining high-performing employees
3. Aligning cultures
4. Creating an operating structure and policies that unlock value
5. Achieving synergies
6. Developing financial and operational reporting structures for the interim and long term

Each of these activities requires an in-depth examination of the current strengths and weaknesses of merger participants. It is critical that the teams charged with addressing these areas include representatives from both parties and that they start their work as soon as is legally possible. Integration begins with the intent to work toward common goals – with intellectual rigor, honesty and an ongoing sense of urgency – and continues long after the deal has been “inked.”



Integration begins with the intent to work together toward common goals – with intellectual honesty, rigor and an ongoing sense of urgency.

Identify ways to involve key employees in designing the new organization – a powerful incentive that can alleviate short-term uncertainty.

Let's consider each of these six keys to successful integration in more detail, starting with the human factor.

1. Preserving and leveraging key relationships

During the merger process, combining organizations must have a detailed plan for managing communications with key constituents, including employees, payors, medical staff, vendors and community representatives. Communication gaps can make for a disorderly transition and result in lingering doubts, damaged relationships and, ultimately, lost opportunities and revenue.

Regular, transparent communication can maintain stability and provide a platform for solid performance after closing. The plan must ensure that:

- ▶ The strategic rationale for the transaction (e.g., greater scale, enhanced service offerings) rapidly becomes a shared reality for all participants
- ▶ The combined organization's brand strategy has been clearly identified, and employees are aware of and engaged in the new plan for market positioning

2. Retaining high-performing employees

In an acquisition, employees – especially those from the acquired (or perceived weaker) partner – may feel uncertain of the outcome or believe that the new organization will not be a good fit for them personally. They may begin looking for opportunities elsewhere. Losing too many high-performing employees or key medical staff members damages morale and, with the loss of experience and knowledge vital to consistent operations, can disrupt business continuity. However, if management communicates organizational changes consistently, directly and honestly, employees will typically see a merger through to completion.

Develop a detailed employee retention plan that identifies the following:

- ▶ Critical intellectual capital – those employees from each of the combining organizations who manage relationships, generate admissions, serve as important technical resources, or have indispensable expertise in operations or business processes
- ▶ Individuals or groups most likely to feel threatened by the merger or acquisition
- ▶ Best ways to effectively manage employee expectations throughout the process, while keeping in mind that money alone is not a substitute for management credibility
- ▶ Ways to involve key employees in designing the new organization – a powerful incentive that can alleviate short-term uncertainty

3. Aligning cultures

Create the environment and behavior needed to achieve the new organization's strategic goals. Identify cultural similarities and gaps in such areas as how decisions are made, how employees are rewarded and how work is performed – to leverage commonalities and mitigate differences. If differences are not understood and addressed, they can easily create competition among employees and departments – an “us versus them” mentality that can take years to overcome.

Identify the cultural differences that can have the most impact on achieving the strategic objectives behind the merger or acquisition. At times it may be acceptable to allow different operating models to coexist. However, if the strategic objective is rapid integration or an augmented service offering, some level of alignment must be achieved. Leveraging the facilitation skills of a trusted third party can greatly enhance the transition.



A continuous and coordinated effort can yield a more streamlined, efficient and high-performance organization – and deliver returns for years to come.

4. Creating an operating structure and policies that unlock value

Determine the desired level of integration between the two organizations, including detailing the reporting structure and communicating it clearly. Make it a priority to establish controls that mitigate interim operating risks and implement a financial and organization structure that will improve margins. Focus on processes and structures that can enhance revenue, reduce costs and avoid future expenditures.

One of the first things companies typically do post-merger is make rapid changes to realize value from the deal. Cost reductions – especially in personnel, facilities or other general and administrative expense items – are often a priority, followed by rationalization of noncore businesses and outsourcing of nonessential tasks. Move with caution in this area, however, because these types of decisions can have significant consequences.

5. Achieving synergies

Once there is clarity around the core business structure, seek to achieve synergies. Consider the promises made to stakeholders during the merger process, the availability of “quick wins” that can demonstrate momentum, and the possibility of combining staff functions, operational departments or outsourcing functions. Strive to offset any “negative” synergies of alignment, for example, compliance costs, rebranding costs, one-time integration costs, financing costs and potential increases in employee benefit costs.

6. Developing financial and operational reporting structures, interim and long term

Determine what reports and indicators management will need to monitor the new organization’s operations during the transition, how key accounting policies and closing procedures will be aligned to ensure consistent financial statement classification/presentation, how cash will be managed and the treasury centralized, what “early warning” system will be used to indicate problems, and how the new organization will transition to management reporting and forecasting activities.

Assess current and future requirements for information technology. Determine early on whether the new organization will use a single information-technology platform or will support and maintain separate networks. Many mergers and acquisitions have been less than successful because enterprise architecture or platforms are not designed to support the combined organization or disparate businesses.

Delivering the value promised

Combining two organizations into one is rarely easy. It is often a time of upheaval and uncertainty. Healthcare providers who realize that integration doesn't end when the deal is signed are most likely to achieve the objectives stated, and deliver the value promised, in the strategic rationale for combining. A continuous and coordinated effort can yield a more streamlined, efficient and high-performance organization – and deliver returns for years to come.



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