25th Annual Health Sciences Tax Conference

Mergers, acquisitions, joint ventures and other transactions

December 7, 2015
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Mergers, acquisitions, joint ventures and other transactions
Discussion topics

► Trends in health care mergers and acquisitions
► Due diligence considerations
► Integration considerations
Trends in health care mergers and acquisitions
## Health care environment and trends

<table>
<thead>
<tr>
<th>Growth drivers</th>
<th>Observations</th>
<th>Trends/opportunities</th>
</tr>
</thead>
</table>
| Universal coverage/regulatory changes | ▶ Insurance exchanges and newly insured patient population  
▶ Ongoing reimbursement reductions intensifying pressure for operating efficiency | ▶ Many players adding scale to maintain or to increase leverage in contract negotiations |
| Hospital capacity and provider availability | ▶ Knitting an inpatient/outpatient network  
▶ Lack of health care capacity and trained caregivers, particularly primary care physicians (PCPs)  
▶ Market-based site selection  
▶ Local focus with national impact | ▶ Hospitals and payors increasingly focused on developing outpatient and/or specialty management capability by either investing in-house, acquiring, partnering or outsourcing |
| Geographic footprint | ▶ Evidence-based decision-making driven by clinical data  
▶ Benchmarking clinical and financial outcomes | ▶ Accelerating migration to home/off-site treatment |
| Coordinated, accountable care | ▶ Value-based reimbursement  
▶ Reduced readmissions  
▶ Focus on therapeutic continuum of care  
▶ Expansion of consumer-driven health care, transparency, patient education and treatment compliance  
▶ Payment models focus on prevention, wellness and modifying patient behaviors | ▶ Shift to non-physician medical professionals (e.g., RNs, PAs) |
| Condition/disease management protocol | | ▶ Closer to the patient and higher patient touch = population management, sticky service and monetizable data |
| Engagement of patient and caregivers | | ▶ Hospitals and payors moving to capture more of the health care dollar by deepening/expanding service lines via acquisition and partnership |
A seller’s market

- High valuations
- Cash on balance sheets and in private equity coffers
- Robust debt markets
- Economic confidence
- Strategic buyers are active
- Financial sponsors are net sellers
Multiples are increasing

Purchase price multiples

- 2001: 5.9
- 2002: 6.7
- 2003: 7.0
- 2004: 7.2
- 2005: 8.5
- 2006: 8.1
- 2007: 9.3
- 2008: 8.3
- 2009: 6.6
- 2010: 8.4
- 2011: 8.2
- 2012: 7.9
- 2013: 8.8
- 2014: 9.8
- 2015: 10.0
2015 deal volume increased 25% over 2014
Q2 2015 deal volume declined from Q1
Since the passage of health care reform, the payor and provider competitive landscape has transformed as a result of increased strategic activity, including value-added partnerships and alliances, advantageous joint ventures, and mergers and acquisitions.

The increased strategic activity is expected to continue to drive significant convergence and consolidation as payors and providers look to gain scale, improve quality, reduce costs and capture a greater portion of the health care continuum.

### Overview of strategic alternatives

<table>
<thead>
<tr>
<th>Description</th>
<th>Commercial partnership/alliance</th>
<th>Joint venture</th>
<th>Merger or acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Least transformative</strong></td>
<td>Strategic arrangement with another party designed to provide strategic flexibility and a mutual competitive advantage in the market</td>
<td>Business arrangement in which two parties agree to pool their resources and create a separate entity to accomplish a specific task or common goal</td>
<td>Buy or sell majority of company, thereby creating significant near-term liquidity event</td>
</tr>
<tr>
<td><strong>Most transformative</strong></td>
<td></td>
<td>Go-forward entity will integrate operations and financials</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Lower</th>
<th>Medium</th>
<th>Highest</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Execution risk</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Post-deal change of control</strong></td>
<td>Zero to low</td>
<td>Lower to medium</td>
<td>Highest</td>
</tr>
<tr>
<td><strong>Stakeholder potential reward</strong></td>
<td>Lower</td>
<td>Lower to higher</td>
<td>Highest</td>
</tr>
</tbody>
</table>
Due diligence considerations
Simplified transaction timeline

Due diligence → Negotiate deal terms → Definitive agreements → Closing

Future state part of new system
Integration and realization of cost savings and efficiencies
### Transaction timeline

<table>
<thead>
<tr>
<th>Phase</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Preparatory/proposal/investment phase</td>
</tr>
<tr>
<td>2</td>
<td>Phase I: Preliminary diligence</td>
</tr>
<tr>
<td>3</td>
<td>Phase II: Exclusivity diligence</td>
</tr>
<tr>
<td>4</td>
<td>Signing to close assistance</td>
</tr>
<tr>
<td>5</td>
<td>Post-deal integration</td>
</tr>
</tbody>
</table>

#### Preparatory/proposal/investment phase
- Analyze public/data room/VDD info
- Analyze tax structure and make initial structure assessment
- Understanding of commercial markets position
- Benchmark working capital internally and externally with peers
- Benchmark potential intangibles based on industry averages
- Understand industry and operational opportunities and risks

#### Phase I: Preliminary diligence
- Insights based on information provided through:
  - VDD, data room, management meetings and data room
  - Access to auditors and tax workpapers
  - Industry specialist findings
  - External research
- Supplemental request list for additional information
- Refine initial tax structuring assessment, as applicable

#### Phase II: Exclusivity diligence
- Complete due diligence
- Insights for draft business model and plan and SPA/APA
- Identify post-close working capital improvements and operational opportunities
- Preliminary purchase price allocation and potential impact on future earnings

#### Signing to close assistance
- Draft SPA/APA assistance
- Tax structuring assistance
- Assistance on purchase price mechanisms – escrow, earn-outs, working capital benchmark, net debt and net assets
- Finalize 100-day plan for integration, cash flows and forecast
- Analyze business model for post-close

#### Post-deal integration
- Implement 100-day plan, integration plan, tax structuring and working capital improvements plan
- Finalize purchase price allocation
- Track actual results against plan and reassess post-close integration plan as applicable
Due diligence workstream

- Strategic/commercial priorities
- Financial risks
- Operations
- Synergies
- Regulatory
- Financial statement impacts

- Financial and accounting
- Contracts and other legal commitments
- Compliance
- Payor contracting
- Insurance coverage
- Operations and technology
- Human resources and benefit plans
- Integration and synergies
- Valuation and purchase price allocation
- Legal
<table>
<thead>
<tr>
<th>Consideration</th>
<th>Potential action steps</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial and accounting</td>
<td>► Evaluate the quality of financial information and the integrity of the systems, people and processes used to develop it. Assess the quality of revenue by analyzing the patient billing and collection systems and methodology used for establishing the contractual allowances and bad debt reserves. Analyze all revenue and expense accounts to identify nonrecurring items that may impact the quality of earnings after the transaction. Understand and analyze key business drivers, working capital trends, historical and expected capital expenditures, and debt and debt-like items.</td>
</tr>
<tr>
<td>Tax</td>
<td>► Understand the target’s legal entity structures and inquire into tax-exempt and public charity status. 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).</td>
</tr>
<tr>
<td>Contracts and other legal commitments</td>
<td>► 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.</td>
</tr>
<tr>
<td>Investment performance and management</td>
<td>► 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.</td>
</tr>
<tr>
<td>Compliance</td>
<td>► Review the functioning and design of the target’s corporate compliance program to assess the ability to educate employees, identify fraud and reduce the risks of regulatory non-compliance. 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.</td>
</tr>
<tr>
<td>Payor contracting</td>
<td>► 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.</td>
</tr>
<tr>
<td>Insurance coverage</td>
<td>► 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.</td>
</tr>
<tr>
<td>Operations and technology</td>
<td>► Understand the quality, scalability and reliability of software and hardware platforms of the target and the associated capital and operating expenditures. Consider the upcoming conversion to International Classification of Diseases 10 (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 integration process.</td>
</tr>
<tr>
<td>Human resources and benefit plans</td>
<td>► 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 post-retirement 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.</td>
</tr>
<tr>
<td>Integration and synergies</td>
<td>► Understand and quantify any anticipated synergies, cost reductions and additional investments that need to be made as a result of the transaction. Assess needed transition service agreements to be in place as a result of the transaction (for continuance of operations).</td>
</tr>
<tr>
<td>Valuation and purchase price allocation</td>
<td>► Understand how assets (both tangible and intangible) will be valued and the related depreciation and amortization implications in the financial forecast.</td>
</tr>
</tbody>
</table>
Financial diligence considerations

► Quality of historical earnings for the most recent two fiscal years and the most recent trailing 12-month period
► Forecast earnings
► Quality of revenue (and related provisions for contractual adjustments and bad debts) based on cash collections and trends in volumes, mix and acuity
► Reserves for self-insurance risks (including involvement of actuaries)
► Trends in operating results at a disaggregated level (e.g., by location)
► Net working capital trends and needs
► Debt and debt-like items that should reduce purchase price
► Quality of assets and measurement of liabilities (including contingent liabilities)
Other diligence considerations

► Information systems
► Compliance (including billing and coding) matters
► Potential synergies and integration costs and negative synergies
► Payor contracting analyses
► Human resource and benefit plan matters (including union and organized labor considerations)
► Legal
Integration considerations
Integration approaches

Transform existing business model by driving fundamentally new value proposition pursuing new opportunities:
► Focus is on top line revenue growth rather than driving operating efficiencies
► Often minimal integration in the short to medium term, other than business continuity/organizational needs

Enhance performance of existing business model by changing product/service mix of existing portfolio:
► Generally focused on filling gaps in a product portfolio and/or adding new geographies to an existing footprint
► Deal value a mix of revenue and cost
► Often more selective integration with a focus on back office

Improve performance of existing business model by driving scale efficiencies:
► Scale play with focus on cost reduction and operational efficiencies: price leverage and reduced
► Fast, full integration into acquirer

The acquisition intended to supplement the capability of an acquirer BU, often focused on a key differentiator or technology:
► Focus on key employee retention
► Back office integration is often a component of deal value; planning should start as early as possible in order to have the back office fully integrated on day one
The full integration journey

Executive alignment workshop
- Integration principles
- Vision and values
- Executives interviews
- Integration scorecard

02 Merger integration kickoff
- Level of integration assessment
- Integration blueprint
- As-is/interim/to-be design
- Scalable platform

03 Target operating model
- Program management setup
- Integration governance
- Key milestone plan for the project
- Methodology and tools

04 Synergy valuation and development
- Confirm the initial synergy case
- Detailed bottom-up synergies calculation
- Quick wins identification

05 Human capital management
- Cultural alignment
- Talent retention/selection
- Change management and training
- Onboarding
- Communications

06 Detailed business integration planning
- Linking with target operating model (TOM), organization design, synergies case
- Dependency tracking
- Reporting and controlling

07 Organizational design and planning
- Organization design
- Management selection
- Retention plan
- Job descriptions
- TSA need identification

08 Day one readiness planning
- Day one checklists
- Cross-functional dependency resolution
- Readiness certification approach
- Transition service agreement (TSA) management

09 Cutover execution
- Claims denial management
- IT systems rationalization
- Transformational road map
- Synergy realization

10 Transformation
- Succession planning
- Post-close training
- Spend and category analysis

Day 1
- Ensure continuity of care
- Increased patient population
- Increased quality of care
- Integrated patient care model
- Benefits tracking

Day 0
- Market analysis
- Target identification
- Letter of intent
- Clean room
- Due diligence

Target state

Current state
Key integration risks and areas of focus

Vision
- Strategic intent, value drivers, integration approach
  - What are we doing and why?
  - Will the integration of the target be inherently complex, and if so, how?
  - What integration approach should we use?
  - What is the operating model on day one? After 12 months? End state?

Value
- Preserve, enhance, create and measure
  - What are the sources of benefit?
    - Cost reduction
    - Revenue growth
    - Transformation
    - Who owns the benefits?
    - How can they be tracked and measured?
    - What are the critical areas of integration focus?

Risk management, accountability, governance, decision making, tools
- Program priorities and milestones?
- Day 1/Day 100?
- Consistent, flexible, standardized processes, tools and templates?
- Program structure?
- Program leadership?
- Decision-making process?
- What issues/risks exist and what decisions must be taken now?
- How will we report progress and impact?

Effect change needed to generate value and realize the vision
- Stakeholder communications?
- Behavioral and cultural differences?
- Extent of integration?
- Key operating model changes?
- Target talent retention and principles for employee selection?
- Lessons learned capture?

Control

Change

- Confusion
- Misalignment
- Poor morale
- Apathy

- Dilution
- Missed targets
- Reduced management credibility

- Chaos/rumor
- Fatigue
- Distraction
- Increased risk
- Reduced accountability
- Silos

- Frustration
- Uncertainty
- Reduced productivity
- Employee and customer churn

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- Apathy
## Key integration risks and areas of focus

- **Plan ahead of the deal:** Detailed integration planning should begin well before close to mitigate transaction risk and increase likelihood of transaction success.

- **Align strategic rationale and tactical planning:** Establish a vision for the future, agree on degree of integration and incorporate into tactical plan.

- **Establish clear goals and manage expectations:** Clearly define and establish goals for the integration effort and your organization and proactively manage all stakeholder expectations through the project.

- **Establish organizational leadership quickly:** Establish leadership structure, clarify roles and responsibilities to reduce confusion.

- **Focus significant attention on tactical implementation:** Dedicate senior leadership to project management structure and tactical teams to bring discipline and focus, establish clear success criteria and decision-making processes and create a sense of urgency.

- **Prioritize and manage risks rigorously:** Prioritize initiatives most critical to success and establish a detailed risk mitigation plan; conduct periodic assessments.

- **Establish explicit customer focus:** Keep the organization focused on key customers and day-to-day operations; retain customers and develop competitive defense plans.

- **Communicate and lead change:** Establish a frequent, clear and timely communication process for all stakeholders; implement change management programs to address cultural issues.

- **Implement financial controls early:** Establish financial baseline and integrate financial targets; integrate internal audit, financial systems and treasury functions early.

- **Talent and workforce assimilation:** Establish comprehensive plans to retain, transition and assimilate key employees.
Questions?
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