Healthcare Merger & Acquisition Due Diligence and Financial Reporting
Aaron Murski, CVA

Aaron Murski is a Managing Director at VMG Health. He focuses on providing valuation, transaction advisory and consulting services to healthcare businesses and healthcare investors across the United States. He regularly works with for-profit and not-for-profit organizations large and small, in support of the planning and execution of mergers and acquisitions, service line spin-offs, joint ventures, syndications, de novo projects, professional services arrangements, and other business transactions. His experience spans the healthcare services continuum, including everything from primary and specialty care clinics, retail medicine, surgical and ancillary services, diagnostic services, acute and post-acute care, independent physician associations, and health plans and other risk-bearing entities and networks associated with population health management.

Aaron is involved with several healthcare and valuation industry organizations, including the Healthcare Financial Management Association (HFMA) Lone Star Chapter, the National Association of Certified Valuators and Analysts (NACVA), and the American Bar Association Health Law Section. He maintains the Certified Valuation Analyst (CVA) credential issued by NACVA.
Background - Affordable Care Act

- PPACA of 2010, Supreme Court Upheld in 2012
- Notable Provisions...

- Accountable Care Organizations – MSSP and commercial
- Decreasing Reimbursement for Hospitals – shift inpatient reimbursement to “at risk” – VBP, Re-admissions, HAC (6% in 2016)
- Decreasing Reimbursement for Physicians – PQRI, Meaningful Use, VB Payment Modifier (5%-7% penalty)
- Health and Human Service’s goal to shift 30% of FFS Medicare payments to Value Based by 2016, 50% by 2018
- Coverage Mandate – Individual and Employer
- Impact of election? – Kaiser CEO says “people are demanding value... That’s going to continue.”

Quote: Modern Healthcare article, “Kaiser CEO Tyson says value-based care is here to stay, may invest in new growth”. Accessed January 18, 2016
## Healthcare Services M&A Volume, 2012 - 2016


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<thead>
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<tbody>
<tr>
<td>Behavioral Healthcare</td>
<td>17</td>
<td>16</td>
<td>21</td>
<td>35</td>
<td>41</td>
<td>-6%</td>
<td>31%</td>
<td>67%</td>
<td>17%</td>
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<tr>
<td>Home Health &amp; Hospice</td>
<td>35</td>
<td>35</td>
<td>65</td>
<td>41</td>
<td>55</td>
<td>-21%</td>
<td>-6%</td>
<td>31%</td>
<td>67%</td>
<td>17%</td>
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<tr>
<td>Hospitals</td>
<td>107</td>
<td>84</td>
<td>79</td>
<td>101</td>
<td>90</td>
<td>0%</td>
<td>3%</td>
<td>67%</td>
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<tr>
<td>Laboratories, MRI &amp; Dialysis</td>
<td>47</td>
<td>36</td>
<td>32</td>
<td>51</td>
<td>41</td>
<td>-23%</td>
<td>-11%</td>
<td>34%</td>
<td>17%</td>
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<tr>
<td>Long-Term Care</td>
<td>188</td>
<td>225</td>
<td>288</td>
<td>354</td>
<td>337</td>
<td>20%</td>
<td>28%</td>
<td>23%</td>
<td>-5%</td>
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<tr>
<td>Managed Care</td>
<td>28</td>
<td>15</td>
<td>22</td>
<td>41</td>
<td>21</td>
<td>-21%</td>
<td>-6%</td>
<td>34%</td>
<td>17%</td>
<td></td>
</tr>
<tr>
<td>Physician Medical Groups</td>
<td>70</td>
<td>65</td>
<td>58</td>
<td>78</td>
<td>119</td>
<td>-46%</td>
<td>47%</td>
<td>86%</td>
<td>49%</td>
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<tr>
<td>Rehabilitation</td>
<td>18</td>
<td>17</td>
<td>19</td>
<td>28</td>
<td>40</td>
<td>-7%</td>
<td>-11%</td>
<td>34%</td>
<td>53%</td>
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<tr>
<td>Other Services</td>
<td>125</td>
<td>105</td>
<td>129</td>
<td>174</td>
<td>196</td>
<td>-16%</td>
<td>23%</td>
<td>35%</td>
<td>13%</td>
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</tr>
<tr>
<td><strong>Total</strong></td>
<td>635</td>
<td>598</td>
<td>713</td>
<td>903</td>
<td>940</td>
<td>-6%</td>
<td>19%</td>
<td>27%</td>
<td>4%</td>
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</tr>
</tbody>
</table>
Notable Transactions

Major Provider Consolidations

Source: VMG observations and research
Notable Transactions

Major Payer Consolidations

2015-Q3

Announced Q3 2015 - $37B

Finalized August 1, 2015

Announced Q3 2015 - $54B

2015-Q4

2016-Q1

Closed Q1 2016

2016-Q2

DOJ to block:

Source: VMG observations and research
Notable Transactions

Cross Vertical Consolidations & Divestitures

Source: VMG observations and research
Healthcare Services M&A Volume, 2012 - 2016

- Broadly, the willingness to...
  - Merge or acquire has remained high
    - i.e., Traditional deals – horizontal consolidation / activity
    - Health system mergers, managed care mergers, practice mergers

- Move up and down the healthcare value chain
  - i.e., Non-traditional deals – “strange bedfellows”
  - Payor-Provider convergence, inter-vertical mergers, vertical consolidation

- “Call a spade a spade”
  - i.e., Risk acknowledgement, divestitures

Source: VMG observations and experience
Healthcare Services M&A Volume, 2012 - 2016

- For Health Systems in particular

Source: HFMA Value Project Report, June 2014
M&A Transaction Lifecycle – In Theory…

M&A Transaction Lifecycle – In Practice…

We have to...
...or our competitor will
...or we can’t survive
...or we can’t execute our strategy

Key persons discuss price, or basic terms, high level diligence info is exchanged

Internal stakeholders become aware a deal may happen, “pitch in” to “help”

Attorneys and consultants get engaged

Reality sets in, diligence begins, chaos ensues

Figure out how to work around landmines, close deal

Source: VMG observations and experience
What is Due Diligence?

“...due diligence, or care that is commensurate with the deal at hand.”

**Purpose:** To **predict** and **limit** the risks associated with transactions

- Post-merger risk
- Transactional Risk

A Process, that requires a many an understanding of many disciplines, to name a few

- Financial Statements
- Human resources
- Facilities and environmental
- Regulatory and licensure
- Coding and billing
- Legal

Common issues will vary by business type, and deal structure

Transaction Structure

Asset Purchase
• “Assets” of the business are sold
• Seller can identify/acquire specific assets and liabilities to assume
• Typically favorable tax treatment for buyer (step up/goodwill amortization)

Stock Purchase
• Equity ownership changes hands
• Same bank accounts, payor agreements, HR policies, etc.
• Typically favorable tax treatment for seller (capital gains)
• Liabilities (known and unknown)

Treat stock sale as an asset sale? 338 elections

Source: VMG observations and experience
Due Diligence Observations

• Common to find a mix of financial statement presentation: cash, modified cash or tax basis financial reporting.

• Overstatement of revenue and accounts receivable due to third-party billing and reimbursement issues is typical.

• Health care technology: Billing and accounting systems are not integrated.

• Human Resources: often very different benefits and payroll, employees maintain

• Common to see:
  ▪ Quality of Earnings analysis
  ▪ Coding Audit
  ▪ Reimbursement Analysis (“Black Box”)
Due Diligence Observations

- **Hospitals**: Impact on recurring revenue of revised payor contracts, Medicaid funding (e.g., EHR incentives). Salaries & Supplies are two largest items.

- **Labs**: Billing practices and “marketing” expenses can reveal sustainability of business model. Licensure and organizational structure crucial to understand.

- **Durable medical equipment**: Review accuracy of coding, accounting treatment of depreciation for rental or other items.

- **Physician practices**: Coding and billing practices, billing and coding issues are common. “Discretionary” expense adjustments. Compensation structuring is highest priority.

- **Surgery Center**: Quality of partnership, diversity of revenue sources. Availability of block time can impact post-transaction grow plans.

Source: VMG observations and experience
Quality of Earnings

- Analysis that reviews a target company’s financial statements and related accounting treatments and assumptions

- Not an audit!

- Results indicate what regular, recurring earnings could be expected over a given time period

- How is “quality” defined?
  - It depends
  - Lower “quality” implies higher degree of risk/sustainability, of revenues and earnings
  - Not an assessment of poor financial reporting or financial “funny business” – accounting standards are flexible

Source: VMG observations and experience
Coding Audit & Reimbursement Analysis

Coding Audit
• Scope can very, depends on business
• Review of level and sufficiency of clinical documentation relative to requirements and standards
• Benchmark coding frequency distribution (bell curve analysis)

Reimbursement Analysis
• Sensitive rate info may not be exchanged
• Estimation of two alternative rate structures, target’s utilization data
• Assists in understanding post-transaction risk
• Can inform and have implications for deal structure and approach

Source: VMG observations and experience
Quality of Earnings Case Study

- **DME Business**
  - Acquired by a PE investor group
  - Existing owner grew business from $0 to $10mm or revenue
  - DCF & Multiple of EBITDA was used by PE firm for valuation
  - $1-1.5 mm EBITDA run rate, annually

- **Quality of Earnings – material finding**
  - High dollar rental-to-sale items resulting in approx. $500K of depreciation (GAAP treatment), annually
  - Conceptually, could be cost of goods sold – capex mandatory to generate revenue
  - Treating as an adjustment implies a $500K-$1 mm EBITDA business, annually

**Takeaways?**

*Source: VMG observations and experience*
M&A Financial Reporting

- **Acquisition complete, how do we account for it?**
  - Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") topics
  - ASC 820 – Fair Value Measurements and Disclosures
  - ASC 805 – Business Combinations
  - ASC 958 – Not-for-Profit Entities

- **Fair Value** - “The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”
  - “Market Participant” perspective
  - As of a specific date – typically, deal close
  - “Purchase Price Allocation”

Source: VMG observations and experience, and FASB ASC 820, 805, and 958
M&A Financial Reporting for NFP’s

- ASC 958-805, recodification occurred 2010

  - Purpose: “Improve relevance, representational faithfulness, and comparability of the information that a not-for-profit entity provides in its financial reports about a combination with one or more other not-for-profit activities.”

  - Provisions:
    - Merger or Acquisition characterization guidance
    - Merger = Carryover Method
    - Acquisition = Acquisition Method
    - ASC 350 Goodwill and Other Intangible Assets amended to become applicable for NFP entities

  - Effect: **Same basic treatment for both for-profit/not-for-profit**

Source: FASB ASC 958
M&A Financial Reporting – Purchase Price Allocation

- Purchase Price Allocation Components
- Differentiate between consideration (assets) vs. price (price paid plus liabilities assumed)

Source: Houlihan Lokey 2015 Purchase Price Allocation Study
M&A Financial Reporting – Purchase Price Allocation

First: Tangible Property
- Working capital, accounts receivable, accounts payable, etc.
- Equipment, Land, Building, etc.

Second: Identified Intangible Assets
- 2 criteria: legally protectable, separately saleable
- Trade name, customer related, protective covenants, etc.
- Trained & Assembled Workforce in Place = part of Goodwill

Third: Goodwill

Source: VMG observations and experience, and FASB ASC 820, 805, and 958
M&A Financial Reporting – Purchase Price Allocation

<table>
<thead>
<tr>
<th>Industry</th>
<th>Count</th>
<th>Purchase Consideration</th>
<th>Intangible Assets, % of PC</th>
<th>Goodwill, % of PC</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>Median</td>
<td>Mean</td>
<td>Low</td>
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<tr>
<td>All Industries</td>
<td>563</td>
<td>$83</td>
<td>$1,269</td>
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<tr>
<td>Aerospace, Defense &amp; Government</td>
<td>18</td>
<td>177</td>
<td>1,924</td>
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<tr>
<td>Consumer, Food &amp; Retail</td>
<td>80</td>
<td>74</td>
<td>731</td>
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<td>Energy</td>
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<td>315</td>
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<tr>
<td>Infrastructure Services &amp; Materials</td>
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<td>Technology</td>
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<td>Telecom</td>
<td>8</td>
<td>89</td>
<td>11,418</td>
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</tr>
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</table>

- Healthcare median intangible % of purchase consideration = 42%
- Goodwill = 41%
- Healthcare services vs non-services
- Conclusions

Source: Houlihan Lokey 2015 Purchase Price Allocation Study
Questions & Discussion