

True Diligence vs. Due Diligence

By Kerry Shannon, Scott Bingham and Bina Patel

Success in Today's M&A Market Demands A More Comprehensive Approach

The recent resurgence in hospital and health system M&A activity has the potential to produce unintended and undesirable consequences. Unlike the hospital M&A wave of the 1990s, which was propelled by market share and profitability gains, the present upsurge is motivated by a different set of factors. Changing payment mechanisms, lower reimbursement and the need to enhance market power are driving health systems to consolidate in the hope of reducing costs and gaining efficiency of scale. If pursued wisely, these goals make sense and are achievable for many provider organizations. If not, however, organizations may find themselves weakened and competitively disadvantaged.

From a credit ratings standpoint, Moody's Investor Services has predicted a prevalent negative outlook for nonprofit hospitals in the U.S. through 2011 and into 2012—citing compounded negative credit factors and health reform directives.¹ Fitch Ratings is forecasting a stable outlook for nonprofit hospitals in the U.S. for 2011, but warns that ratings could turn negative if there are substantial losses in profitability.² This will likely translate into a continued upsurge in nonprofit hospitals being acquired by other nonprofits, private equity or for-profit health systems.

Given this outlook, it is certainly understandable to see weak and/or nervous organizations seeking to affiliate with one another without major change. They are hoping that 1+1 will equal 3, but logic dictates that this will not be the case in most instances. The reason is simple. Time after time, the history of deal making has proven that there is no

such thing as a merger of equals. If weaker market players are going to affiliate, the only way to make gains is for the merger to create a new and potentially much different entity. Said another way, the only way 1+1 will equal 3 is when organization A and organization B truly turn into organization C.

The situation is far different when a strong player looks to enhance geographic reach or referrals by affiliating with a smaller enterprise. In this instance, it's most important that the smaller or less advantaged organization be very honest about what they would be bringing to the arrangement.

With the current trend in hospital, physician group practice, health system, and medical school deals expected to accelerate, it is imperative that hospital stakeholders who are considering a transaction be prudent in their approach.

Inherent Drawbacks of a Traditional Due Diligence Approach

The traditional banking or finance-oriented due diligence approach may only consider portions of the potential deal, focusing on only the historical performance of the entities, for example, or only engaging a limited scope of inquiries, stakeholders and resources.

While this approach informs components of due diligence, it is by no means complete or comprehensive, and can be deceiving to the real potential for success. Although we know that most transactions do not achieve targets due to operational and cultural issues, most due-diligence processes still fail to take these into account, with some extraordinarily expensive results.

In one unfortunate instance, an organization discovered, post-acquisition, that the nurses they acquired had a very high average age. The implications of this fact were never considered inside the deal, i.e. replacement costs, high PTO utilization, etc. In a counterexample, a mature and highly sophisticated academic medical center was seeking capacity and geographic differentiation. They engaged in a purely strategic and operational process that they termed "pre-due diligence" in order to explore their own thinking relative to potential transactions as well as look at the market from a fresh perspective. They believed that the time and money spent doing this was extremely valuable in positioning them to make solid, strategic decisions around affiliation.



Lessons Learned: Foresights and Forecasting

To avoid the potential negative consequences of a failed affiliation strategy, performing a thorough diligence process is of paramount importance. This True Diligence should encompass financial, clinical/compliance, operational and cultural components.

The following highlight the key takeaways and attributes of a *True Diligence* approach:

- ✓ **Really know what you are getting into and avoid wishful thinking.** Consider just some of the items that will make or break your affiliation: the culture, market, boards, physicians, employees, technology and payers. Know the "players" and the "stray-ers." It is essential to have multifaceted buy-in from parties on both sides of a deal, but not to be held hostage by vocal minorities.
- ✓ **Freshly assess the local healthcare market, and your place in it.** These are critical external influences that vary by market and time. Know the various perspectives and what they mean. Objectivity here can be critical. That's because the local "folklore" often doesn't hold true.
- ✓ **Realistically model the future financial impacts.** Seek to understand the future financial picture—not just the historical and present realities (i.e., payer environment, contractual/negotiations, payer/competitor clout, impact of transaction, separation and incentive costs).
- ✓ **Know the legal/regulatory requirements and implications.** Know the local, regional, state, and federal policy realm.

Kerry Shannon is a Senior Managing Director and leads the Strategy and Planning practice at FTI Healthcare. Scott Bingham is a Senior Managing Director in FTI Consulting's Transaction Advisory Services practice. Bina Patel is a Senior Consultant in FTI Healthcare's Strategy and Planning practice.

How To Achieve A Comprehensive Due Diligence For a Hospital M&A Transaction

Consider a "true due diligence" for a merger involving two regional health systems in the Midwest. Antitrust issues were of paramount concern, and due diligence was accomplished with attention to all relevant components. But the primary focus for both parties was the strategic business case around the proposed transaction. Both systems sought to ascertain:

- the **strategic opportunities and implications** of such a merger from high-level, overall hospital and community perspectives, as well as a detailed service line perspective, recognizing the unique characteristics of each hospital campus, medical staff, capabilities and challenges;
- the **national factors** driving the transformation of the U.S. healthcare delivery model and hospital industry consolidation;
- the key **local drivers** impacting the strategic benefit of consolidation;
- the **rationale** for provider consolidation in the local market;
- the specific opportunities that existed for clinical synergies and efficiencies associated with programmatic consolidation/collaboration;
- an understanding of **specific actions** to be taken post-merger to drive cost reduction;
- a full comprehension of the **interdependencies** between each functional area in order to avoid delays;
- a post-close **focus on revenue growth**;
- **threats** to the transaction; and
- threats to **successful implementation**.

Key Activities

- 1) Considering provider consolidation within the national and local context, including an assessment of community physician needs and physician organization by specialty, as well as the overall local competitor landscape.
- 2) Assessing the potential benefits of consolidation around the sustainability of merging hospitals, the value to healthcare purchasers, and overall community health.
- 3) Exploring the potential long-term effects and consequences absent hospital consolidation.
- 4) Developing a high-level vision for how the hospitals can best provide enhanced, complementary services to the community and, in that context, analyzing re-configuration by service line between the two hospital campuses. This comprehensive approach was well received by both parties and the two health systems have signed an affiliation agreement.

1 Source: "Negative Outlook for Hospitals Persists: Moody's," Healthcare Financial Management Association, February 8, 2011 2 Source: "Fitch Gives Nonprofit Hospitals a Stable Rating for 2011," Healthcare Financial Management Association, January 24, 2011