

FINANCIAL ANALYSIS IN MERGERS AND ACQUISITIONS: AN ANCHOR IN EMOTIONAL CURRENTS

Another round of mergers and acquisitions is looming. It will be driven by the constraints faced by independent hospitals and even small hospital systems in accessing capital to meet emerging imperatives, including the need to respond to healthcare reform. Many independent hospitals will be considering their options, and healthcare systems may find themselves approached about acquisition possibilities.

While it's obvious that exploration of merger and consolidation options calls for careful financial analysis, it may be less clear why the content and emotional context of an M&A analysis makes it different from other financial analyses. An M&A exploration is always surrounded by strong emotional currents and financial analyses must be uniquely robust and credible to serve as a durable anchor throughout the discussions. This article offers DGA's perspectives on structuring an effective analysis in this context.

THE EMOTIONAL DEPTH CHARGES OF M&A

Discussions of merger or acquisition usually carry a deep emotional charge for the board and senior management. Board members have invested wealth and wisdom in their hospital, and have pride in their independence. They may be concerned that a merger partner won't care about their immediate community. They don't want to have a legacy of independence abandoned on their watch, even if the hospital's survival depends on it. The CEO may have his or her own conflicts.

Without a rock-solid analysis, carefully presented, these emotions can crush further consideration of an option which could be the best course for all parties.

CREATING AN UNSHAKEABLE BASE CASE

The underpinning for an M&A financial analysis is a well-constructed, convincing picture of how an independent future will look, which will serve as a baseline for comparison with M&A options.

In preparing this analysis, remember that board members and senior leadership may need help understanding the financial situation and benchmarks. The CFO knows what 20 days of cash means, but the broader audience may not. Make sure that everyone understands why "let's wait and see" can lead to desperation and poor terms in an eventual M&A arrangement.

To bring the board and senior management along, respond to any rosy scenarios they raise, no matter how off-target. If you're hearing, "What if admissions stabilized?" it's better not to respond, "It won't happen." Rather, do the analysis that lets you answer, "Even if admissions stabilized, our access to capital would not improve sufficiently."

WILL COMBINING MEET GOALS FOR IMPROVED CAPITAL ACCESS?

The dynamics around access to capital are often central to a merger or acquisition decision. It's critical to determine whether the merger will produce an entity with the structure, assets and creditworthiness to be viable on a long-term basis.

Consolidation offers two benefits in improving access to capital. By coming together, hospitals can rationalize some capital expenditures. And because a hospital system can spread risk, it will have a higher credit rating and lower cost of capital than an independent hospital with the same financial performance benchmarks.

REVENUE PROJECTIONS: SENSITIVE AND COMPLEX

Doing revenue projections for a combined entity requires shared considerations of strategy—a challenge when you are not yet certain if the combination will ever occur. For legal and competitive reasons, you may not want or be able to share certain information with competitors.

The first key in revenue projections is the patient volume assumptions. The complex interactions of market and legal dynamics may make "what if" analysis valuable. For example, a change of

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DGA PROFILE: KARIN CHERNOFF KAPLAN, DIRECTOR

Karin Chernoff Kaplan knows healthcare providers from the inside out. Her managerial experience spans academic medical centers, physician networks and a long-term care facility. She also holds certification as an Accredited Valuation Analyst from the National Association of Certified Valuation Analysts.



"I use my extensive practical experience in giving DGA clients advice that works," says Karin. "The success of an acquisition or a business plan is built on a foundation of well-integrated financial and operational details, and my knowledge helps make sure that all those details are correct."

During her 10 years at DGA, Karin has helped clients create strategic, business and financial plans, conducted practice and business valuations and designed and modeled compensation arrangements.

Prior to joining DGA, Kaplan helped develop a 250-physician primary care network for the University of Pennsylvania Health System, for which she became Regional Director. Her previous experience includes serving as administrator for the Division of Hematology/Oncology at Boston's New England Medical Center and healthcare consulting for Laventhol & Horwath.

Kaplan and her husband helped develop and now run a Community Supported Agriculture (CSA) program in her community, providing members with local, organic produce while preserving farmland and building community.

Karin holds an MBA in Health Administration from Temple University and a BS from Pennsylvania State University.

FINANCIAL ANALYSIS IN M&A

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control could allow a group of employed physicians to terminate their employment. The ideal way to assess this risk would be to talk with these physicians, but confidentiality agreements for the merger discussions may limit you to considering contract terms and market knowledge. There could be a number of possible physician relationship scenarios to assess in this way.

The second critical factor in the analysis is an understanding of how and when changes in governance and ownership will change reimbursement under each major contract.

This requires understanding the specifics of each party's contracts with the major payers. At what point, if ever, will the merged entity be treated as a single entity for reimbursement purposes? Ultimately this may be determined by negotiation with each payer. A third party can read contracts, determine the implications and use those as a basis for making revenue projections, without disclosing contractual details.

EXPENSE PROJECTIONS: WHAT'S MATERIAL?

While leadership may view reimbursement considerations as a subject for experts, everyone thinks they are an expert on merger savings. To prevent the discussions from getting bogged down in details, keep the focus on items that will have a material impact on the bottom-line results.

For example, if you are contemplating a realignment of services, it's important to determine whether that would require significant renovation expenses. Capacity analysis will tell you whether you can combine lab services or specific clinical services at one facility. In contrast, at this stage, it's not important to nail down contract terms for physician partnerships. An overall estimate based on historical trends will suffice.

CONCLUSION

The financial analysis of an M&A option must withstand the weight of emotion. By exploring a range of utilization and financial scenarios, you can ensure that leadership will not feel their perceptions are being ignored. The key to success (whether moving ahead or an informed decision to consider further options) is a thorough analysis conducted with an open mind.

DGA NEWS

We've relocated our New York City offices. Our new space is bright, airy and conveniently located at 34th Street and 7th Avenue (right on the new Macy's parade route!).

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DGA Principal Jeff Simmons has become a Fellow of the American College of Healthcare Executives (FACHE), the premier credential in healthcare management.

John Harris, Principal, will be speaking on, "Accountable Care Organizations—A Game Changer?" at the American Association of Integrated Delivery Systems conference, April 22nd in Orlando, FL.

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