# Effective Diligence in Health Care Transactions - Core Challenges and Key Steps


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The deal volume in the health care provider and services sectors remains high. Financial sponsors continue to make investments related to hospitals, surgery centers and dialysis facilities. Correspondingly, the deal volume in health care products, health care devices and health care real estate also continues to be steady. However, while the aggregate deal flow is stable, the average dollar value of deals has decreased. Further, there appears to be an increased proportion of deals being executed by strategic rather than financial buyers. The increase in transactions by strategic buyers can translate into less risks in the due diligence process.

Effective diligence begins either with companies or advisors - or preferably both - who are familiar with the industry or actual business being invested in. A thorough understanding of the revenue sources, legal and business risks and key stakeholders is tremendously important to the short and long term success of the deal.

Great diligence focuses on providing client decision makers with highly usable information and not catalogs of unnecessary data. Generally, for each deal there are ten to fifteen issues that are extremely critical. An effective reviewer of diligence will deliver a practical and useful analysis of these key issues together with a broader summary of peripheral issues. Providing quality due diligence depends on possessing knowledge of the specific business and the industry, and an ability to effectively focus resources on the pertinent issues.

**I. SEVEN OF THE KEY RULES THAT WE HAVE FOR DILIGENCE ARE AS FOLLOWS:**

**1) Understand the environment.** An effective provider of diligence should understand the business dynamics within the sector in which the target operates. Where do the revenues come from? Which variables have the greatest impact on margins? What are the unique legal risks related to this sector? How are relationships driven? If you engage people who have a comprehensive understanding of the environment, they can quickly identify the issues and challenges and focus their time effectively and intelligently.

**2) Conduct Interviews with Top Management.** Much diligence is conducted through paper and electronic communication. Increasingly, it is also performed through electronic data rooms (EDR). An EDR facilitates due diligence by providing a virtual location where materials are ubiquitously available. While impersonal communication is useful for background research and formal analysis, interviews and discussions with top management are invaluable for a comprehensive due diligence analysis. If conducted correctly, a great deal of detail and understanding comes out of in-person interviews and disclosures that may not be documented in the diligence materials may be revealed.

Balancing the need for thorough due diligence with the time constraints of top management becomes easier when the due diligence team is adequately prepared. It is critical that the diligence team understands the business fully, is well organized and focused, has done their research before the interviews and is poised to handle the interviews in an intelligent and efficient manner.

When conducted appropriately, in-person interviews can provide a richness in information that is absent in documentation.

**3) Understand the Significant Revenue Sources.** Where revenue sources are significant - such that they have the ability to impact the value of the target - they should be understood by the buyer. The relevant variables for each significant revenue source may relate to the stability of the business – are admissions and revenues steady? Are they heavily concentrated? Is there reimbursement risk? Additionally, the buyer should understand the nature of their contracting and payment relationships and their future plans for growth or change.

In some situations the revenue source assessment may include in-person interviews with leadership from the revenue source. One might speak to a tenant in a health care real estate acquisition or a business or referral source in a provider business. As with top management interviews, the narrative richness of an in-person communication can provide valuable insight which would otherwise be undetected.

For example, in one transaction, we found that the target had lent money to their top customer. This collateral transaction gave the buyer great concern. First, would the relationship between the target and their customer survive once the loan arrangement concluded? Second, the buyer didn't know whether the customer did business with the target because they provided a great service or if they did business with the target because the financial tie to the target obligated them to. Reviewing this revenue relationship allowed the buyer to make an intelligent decision on whether to move forward with the acquisition and assess the stability of the revenues.

**4) The target should be familiar with the buyer**

The better that the seller knows the buyer, the better the seller can quantify the risk of challenges after the deal and the risk of the transaction being closed. Where a buyer knows the target's business well, it is less likely that the buyer will run into problems after the transaction. In contrast, the buyer without knowledge of an industry is more likely to have problems running the business post transaction.

In challenging financial times, or with a great deal of leverage, buyer problems often translate into lawsuits and other kinds of difficulties. In essence, even though the buyer may have made errors, it is often the case that the buyer will try and blame negative results on the fact that the target mislead them or didn't tell them something. A target who knows the buyer can better assess the risk to closing and the likelihood of post close problems.

**5) Perform Billing and Coding Audits.** Is critical that a buyer in the health care sector undertake billing and coding audits of their target to better understand whether or not the revenue cycle is being operated appropriately. Health care companies generate income by delivering services, assigning a code to the work performed, generating a bill and collecting revenue.

In addition to the financial and operational necessity of a functional revenue cycle, there is also another important motivation to ensure revenue cycle precision. As the largest purchaser of health care in the United States, the Federal Government has a substantial interest in enforcing appropriate coding practices and preventing fraud and abuse. The largest target for provider investigations both by the government and third party payors continues to revolve around billing and coding. Often, billing and coding audits can be computer generated and it is relatively straight forward for a governmental investigator or a third party to uncover deficiencies. Thus, it is critical in a diligence audit that the process includes at least a sample billing and coding audit to ensure that the revenue cycle is healthy.

**6) Understand the Target's Key Contracts.** In diligence, it is critical for a buyer to understand which contracts are the most important to a company. I.e., which contracts, if terminated or breached, will create the greatest impact? The key contracts will be different depending on the company. For example, for a health care real estate company, the contracts with the tenants who lease the majority of the space are the key contracts; here the longevity of the lease through the renewal and resale terms is important information. Correspondingly, for a health care management services company, the contracts that generate 70-80% of its revenue constitute their key contracts; for each of these, it is important to know whether there are any problematic aspects of the agreements.

**7) Survey the License, Permit and Tax Requirements.** Increasingly, a buyer acquires a health care services business and does not realize that a certain type of filing or permit is needed to continue operations. Subsequently, there can be a time period when services cannot be delivered and/or billed for by the business. Additionally, some filing and permit requirements will preclude the deal from even closing before third party approval is obtained. These avoidable delays can significantly and negatively impact cash flow and should be prevented through proper due diligence. For example, where a new provider entity is formed, the buyer may need reimbursement numbers, a Drug Enforcement Agency number and they may need to complete the Certificate of Need permit process. Often, these requirements can be completed with minimal problems. However, the failure to address them early can cause unnecessary delay and damage.

## II. SUMMARY

Without background knowledge, preparation and research, effective diligence is impossible. While research to generate a due diligence report must go deep and wide, the final product for management and decision makers must be focused and concise. The scope of diligence should include all key variables of the business including the revenue sources, top management interviews, a revenue cycle audit, and the legal and regulatory environment.