



HFMA ANNUAL MEETING

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PREPARING FOR A STRATEGIC  
ALLIANCE:

*DUE DILIGENCE --A TWO-WAY STREET*

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MOSS-ADAMS CAPITAL<sub>LLC</sub>

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# Preparing for a Strategic Alliance: *Due Diligence--A Two-Way Street*

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# Due Diligence

## Overview

- The formal review of all relevant operating, financial, legal, governance, employee, client, competitive, and related information.
- **Due Diligence is always a two-way street.**
- Prior to commencing a material affiliation, or merger, all businesses must understand how invasive the Due Diligence process will be and, almost without exception, have performed their own internal Due Diligence review.
- Targets need to **presume that any internally identified material concerns, questionable practices, etc. will be discovered** during a formal Due Diligence examination, and may have a significant impact on the final price or terms of an affiliation.
  - i. **A key indicator of the depth, quality and efficiency of a target's executive team.**
- By identifying material issues prior to allowing an external Due Diligence examination, management has time to resolve the problem, or prepare an appropriate explanation for the issue.

# Due Diligence

## Characteristics of the HC Services Industry

- Hospitals, professional practice groups and other health care-related entities are more interested today in entering into strategic alliances than at any time in the past.
- The entities most likely to form the most effective strategic partnerships are already well known to each other before partnership or merger discussions commence.
  - i. **Both parties generally have a good working knowledge of each other's professional staff, the type, reputation and quality of services the other party offers, and detailed market share data about their competitor.**
- Unlike other industries, and for hospitals especially, most alliances take place among parties who operate in closely neighboring, often overlapping, geographic markets.
  - i. **Improved expense controls and long-term operating efficiencies are critical considerations in selecting a strategic partner.**

# Due Diligence

## Characteristics of the HC Services Industry (cont.)

- The number of viable, key strategic partners is fairly limited.
  - i. Concomitantly, **the strongest parties tend to align first, and gain significant competitive benefits in their markets.** Institutions interested in aligning with the new, larger entity may find discussions to be more one-sided than expected.
- Many transactions, especially between hospitals, involve little or no cash at closing. The primary financial benefit to the target is an improved, more secure long-term work environment, and better quality service for the community it serves.

# Due Diligence

## Planning & Timing Issues

- Macro-issues (Uncontrollable)
  - i. Strength of the overall capital markets.
  - ii. Demographics and general attractiveness of the target market.
  
- Partially Controllable Issues
  - i. Competitive environment in your target market.
  - ii. Type of strategic fit needed by party seeking alignment.
  
- Micro-issues (Controllable)
  - i. Market(s) served.
  - ii. Institution's overall reputation (of its professional staff and in the community served)
  - iii. Quality of services provided/Expertise of specialty groups.
  - iv. Quality of executive management team (and the Board).
  - v. Historical financial performance (5 yrs).
  - vi. Forecasted financial statements (5 yrs).

# Due Diligence

## Other Considerations

- Certain issues or lapses identified during an internal Due Diligence review may at first seem to be material, but are not. Certain issues that a target's management believes should be immaterial are not.
  - i. Discuss: Materiality, transaction structure, indemnifications, representations.
- **Not all Due Diligence items requested necessarily need to exist.**
- **Not all Due Diligence items are equal.**
  - i. Discuss: Timing, staging of release of Due Diligence material.

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# Due Diligence

## To Summarize

Being properly prepared for an external Due Diligence examination is critical to:

- i. Creating confidence in the depth and quality of a target's management team and professional staff;**
- ii. Maintaining an efficient deal flow and focus during a transaction;  
and**
- iii. Developing as much leverage as possible to negotiate favorable deal terms.**





# Summary Due Diligence Checklist

# Summary Due Diligence Checklist

## Sample Major Categories

1. General corporate matters
2. Corporate governance
3. Description of operations
4. Licenses; accreditations; certificates of need
5. Financial data
6. Physician arrangements
7. Description of partnerships/alliances/JVs with other parties
8. Compliance and regulatory
9. Contracts

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# Summary Due Diligence Checklist

## Major Categories (cont.)

10. Professional staff & Other employees
11. Employee benefits/Personnel policies
12. Competition
13. Real Estate
14. Capital assets and equipment
15. Information technology
16. Insurance & Litigation
17. Environmental

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# Due Diligence Checklist

## Selected Due Diligence Items

### 1. General Corporate Matters

- **Minutes of meetings of the Board for the last five years.**
- Minutes of meetings of any major operating committee (Executive, Finance, Audit etc.) of the District and its affiliates for the last five years. Describe how the District Board oversees quality, credentialing and privileging.
- **Detailed organization chart.**
- **List, and brief bio, of Board members, senior Admin. Management and senior Medical Staff/Dept. Heads.**
- Articles of Incorporation and Bylaws, as amended.

## 2. Corporate Governance

- **Codes of Conduct.** Copy of codes of conduct for the District and its affiliates. Describe how the system conducts its screening for exclusion.
- **Mission/Vision:** Summary of the mission, vision, and/or values of the District and its affiliates.
- **Sample:** *Conflicts of Interest Policy: a) Copy of the District and its affiliates' Conflict of Interest Policy; and b) Copies of all current conflict surveys or questionnaires completed by directors, officers and senior managers for District and each of its affiliates.*

### 3. Description of Operations

- **Annual patient volume** and payer mix statistics for the current year-to-date, and for the past 5 years, **including market share, future trends and demographics data.**
- List of key service lines and programs and for each identified programs, provide volume/growth over the last 5 years and projected 2 years out, payer mix breakdown over same periods and current downstream multipliers and referral sites.
- **Physician and employee satisfaction surveys and results for the last 5 years.**
- **Performance for the last 5 years on quality metrics, broken down by service line, program and delivery site where available.**

• **Sample:** *Statistical information concerning the operation of the practice, including, e.g.: FTEs by department/month, trend report related to patient volumes, patient visit total by provider, new patient visit total by provider, unit volumes by CPT code by provider (for 3 years), surgical case volume by provider, revenue collection by doctor and by facility, revenue and collection rate by payor, payor mix including number of enrollees for any capitated plan, work RVUs, compiled annually for the last 3 years and monthly for the calendar year-to-date. (And they get worse....)*

## 4. Licenses; Accreditations; Certificates of Need

- **All federal, state and/or local licenses to operate the system** and affiliates, including hospital license, pharmacy license and other licenses issued; state and local business licenses; etc....
- **Indicate if accreditation has been denied to any program or department** at the District or any of its affiliates in the prior three years.
- **Applications for Certificate of Need for any projects currently requested but not yet approved**, any Certificates of Need received for any projects that have been approved but not completed, and any Certificate of Need applications denied that are under appeal.
- **Sample:** *Provide copies of all Accreditation Surveys, Correspondence and Policies. Letter and accompanying report(s) evidencing most recent survey results and accreditation of the District's facilities by any accrediting body, including but not limited to ....*

## 5. Financial Data

- **Audited financial statements for the last five (5) years.**
- **Copy of monthly, internally prepared, detailed I/S and B/S statements for the prior 24 months.**
- **Summary of known liabilities not reflected in financial documents, or any other unrecorded liabilities or commitments such as off balance sheet liabilities such as capital leases.**

• **Sample:** *Current biennium operating and capital budgets, those proposed for the succeeding biennium, and those for the immediately preceding biennium budget, as well as a comparison to year-to-date actual results (if not reflected in the unaudited financial statements) for the company, including all budget assumptions.*

• **Sample:** *Medicare and Medicaid cost reports, notices of program reimbursement (“NPR”), audit adjustments associated with each cost report year and their impact and related correspondence for the last three years for the District and its affiliates.*



## 5. Hospital Operating Statements (cont.)

5 Years Historic

5 Years Projected

**Revenues, by payor mix**

**Operating Expenses**

All primary oper. exp. categories

**Proforma Adjustments**

Staff salary rationalization

Practice consolidation/Start-up

Admin. overhead

Facility oper. cost benefits

Capex--Investment in P&E

Purchasing efficiencies

Interest savings--Bonds/LTD/WC Terms

IT integration savings

Sale of redundant assets

One-time legal/other expenses

## 5. Selected Hospital Operating Metrics (cont.)

### Selected Metrics

5 Years Historic

5 Years Projected

# Of licensed beds at end of period

Revenues per bed

Weighted avg licensed beds

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Admissions per day

Equivalent admissions

Avg length of stay

Avg daily census

Occupancy rate

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Emergency room visits

Outpatient surgeries

Inpatient surgeries

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Days revenues in accounts receivable

Days cash on hand

Current ratio

Debt/service coverage ratio

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## 6. Physicians Arrangements

• **Physician employment and/or service agreements currently in effect (or currently being negotiated) to which the District or any affiliate is a party.** Also provide copies of any such agreements in effect at any time during the previous two years, including ....

• **Sample:** *Physician recruiting agreements to which the company or any affiliate is a party, including any promissory notes, security agreements and financing statements under which any party to the agreement has continuing obligations. For each recruiting agreement that is not in writing, place provide: the physician's name and specialty, date recruited, relationship with physician (e.g. employee of community physician) location from which the physician was recruited, types and amounts of benefits (such as cash bonus, moving expenses, office start-up and operation expenses, loan/guarantee, malpractice insurance), duration of all benefits, and duration of forgiveness period.*

## 7. Description of Partnerships/Alliances/JVs

- **List of each affiliate**, including its name, all of its owners, and a brief description of the agreements with such affiliate and the services provided under such agreement.
- **Copy of joint venture agreements with non-physicians to which the District or any affiliate is a party. Please specify whether the contracting party or parties are for-profit, non-profit, and/or tax-exempt.**

• **Sample:** *For each of the system and its affiliates, describe any business dealings or agreements within the last five (5) years with: (a) a director, officer or senior manager (not including employment agreements); (b) any firm that is owned or partially controlled by such persons, (c) any physician individually, (d) any practice group operating within, or affiliated with, the system, and (e) any other interested party affiliated with the system. Also describe in detail any actual, anticipated or promised investments made by the system, or any of the parties listed above, with any entities where a benefit of that investment is the development of products or services that may be use by the system or other similar systems or healthcare providers.*

## 8. Compliance & Regulatory

- **Citations, notices or inquiries received from government agencies, including inquiries concerning potential violations of laws, rules or regulations.**
- **List and describe each pending or threatened claim or investigation by any governmental agency** which might have an effect on practice's operations or assets, including copy of correspondence if applicable.
- Copy of all correspondence with regulatory authorities, including CMS, state agencies, and Medicare intermediaries for the past 5 years.
- **Sample:** *Summary of the compliance governance structure for the system, including policies, designation of a compliance officer, education, sanctions, monitoring/auditing, and incident management. Please describe operation of the company's hotline if applicable. Also describe the company's Environment, Health and Safety Compliance and HIPAA Privacy and Information Security Compliance programs (including the definition of the covered entity, exiting business associate agreements, the 7 elements of your related compliance programs in these 2 areas, relevant policies/procedures, agreements with regulatory bodies, settlements and disclosures, audit and work plans), and EMTALA compliance. Please describe the compliance reporting relationships and organizational structure, existing consulting relationships and the role of those consultants in meeting the organization's compliance requirements.*

## 9. Contracts

- **All contracts or commitments of any kind--written or verbal, stated or implied.**
- **Description of any default by any party under any contract or commitment.**

• **Sample:** *For any contract listed in this section, state whether any party is in default or claimed to be in default.*

- Copy of all leases and subleases of all property, equipment, and fixtures.
- Copy of all loan agreements, notes, guarantees, compensating balance arrangements, lines of credit, lease financing arrangements, installment purchases.
- Data processing agreements, including maintenance and communication contracts.
- Contracts and other documents regarding arrangements with referral sources, marketing agents, patients and third-party payors.

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## 10. Professional Staff & Other Employees

- Names, titles, and brief descriptions of officers and Senior management (as that term is defined in Section 1) along with organizational charts of the company and its affiliates.
- All agreements or other documents related to compensating strictures for all the company employees.
- A list of labor organizations that represent the employees of the company or any affiliates. A list of recognized union stewards. For purposes of the requests in this section, “employee” includes physicians, as well as anyone employed on a temporary/hourly, part-time or fulltime basis.
- List and a summary of all employment lawsuits of any kind files within the last 5 years.

## 11. Employee Benefits/Personnel Policies

- **Copies of employee handbooks, personnel policies, procedure manuals, and human resources policy descriptions for the District and its affiliates.**
- Copy of any collective bargaining agreements. Description of labor disputes relating to the practice's operations within the last three years. List of current union representation, organizational efforts and projected schedule of future collective bargaining negotiations (if any).
- Copy of HR agreements for claims administration and stop-loss reimbursement for employees.
- Description of staffing plans for expansion of the staff.

• **Sample:** *Copies of all personnel policies and procedures not otherwise contained in employee handbook/manual, including: any anti-harassment/discrimination policies; paid and unpaid leave policies; electronic communication policies; on call/call back policies; confidentiality policies; solicitation and distribution policies; severance pay policies; paid rest and meal period policies; drug and alcohol testing policies; and record retention policies.*



## 12. Competition

- **List of the District's and each of its Affiliates primary competitors.**
- **Description of the District's and each Affiliate's, primary competitive strengths and weaknesses, including a description of primary current and projected competitive threats and opportunities.**

## 13. Real Estate

- **Most recent Master Facility Plan for the District and its affiliates.**
- Copy of all contracts for the sale or purchase of any real estate in which the District or any affiliates are a lessor or lessee.

• **Sample:** *List each property owned, leased or occupied by the District, including : (a) location; (b) most recent appraisal whether it is owned or leased; (c) description of general use or function; (dc) the lease term and expiration date; (d) square footage; (e) rent and, if rent or lease payments are below market rates, please indicate; if land is vacant, including last time site was visited or inspected for potential environmental problems; (e) any known potential hazardous adjacent land use; and (f) any known pas land use.*

## 14. Capital Assets and Equipment

- **Detailed listing of all capital assets owned by the District, including:**
  - **Date of purchase**
  - **Historic cost**
  - **Current book value**
  - **Current market value**
- Copies of all capital equipment appraisals completed within the past two (2) years.
- Detail on location of each capital asset having a current market value of greater than (\$50,000.)

## 15. Information Technology

• **Sample:** *Summary of the current state of information technology systems and information security program, including their status from a “meaningful use” perspective. Also, describe:*

- Location(s) where systems are physically stored*
- Physical and environmental controls in effect around primary systems*
- Inventory of systems in use, and corresponding operating systems and databases*
- Data warehouses or other ancillary systems in use*
- Logical access controls*
- Strategic technology plan(s)*
- Backup/recovery practices and disaster recovery plan(s)*
- IT Organization chart and staff/positions in plan*

## 16. Insurance, Litigation

- **Copy of all insurance and indemnity policies and coverage carried by practice**, including policies or coverage for professional liability, properties, business risk, casualty and workers compensation....
- **List and describe all outstanding , pending and threatened** lawsuits, arbitrations, proceedings and other **claims**, whether as a defendant or a plaintiff.
- Copy of the District's standard settlement agreements.
- A list of insurance reserves for each claim.
- **Sample:** *Please provide 10 years of claims history for the company and its affiliates and any employed LIP insured by the company, including open and closed and pending claims for the following types of coverage: (a) professional liability; (b) general liability; (c) employment practices liability; (d) auto liability; and (e) property. This loss information should breakout indemnity and ALAE for open and closed claims and identify the involved defendants, the date of the event and a brief description of the allegations.*

## 17. Environmental

- **Copy of previous environmental surveys conducted by the District and any of its affiliates.**
- **List of any known environmental risk exposures, including** EPA issues, occupational disease, poisonous substances, dust/airborne substances, mold, aquifer contamination, dump sites. Provide any related reports, and indicate who has evaluated the risk.
- **Description of any current and ongoing environmental cleanup and remediation practices** being undertaken by the District and any of its affiliates.
- Copies of all correspondence for the prior five (5) years between any state, local or federal environmental agency and the District or any of its affiliates.

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**IN CONCLUSION:**

**Due Diligence is *always* a two-way street.**

Those parties that are **the best prepared** when negotiating a transaction invariably **get the best terms** with the best strategic partners.