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HEALTHCARE MANAGEMENT ADVISORS

# Getting Financial Due Diligence Right in M&A

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Financial due diligence—assessing and understanding the financial past, present, and likely future performance of the organization you are considering a relationship with—is one of the most critical components of the due diligence process. Getting financial due diligence right requires a combination of teamwork, good information, strong analysis, and self-awareness.

## BUILD A TEAM OF EXPERTS

A strong financial due diligence team should include both internal and external experts.

- **External experts,** such as business and legal consultants, ensure that the process is conducted in a way that avoids anti-trust concern. They also provide objective third party assessment of possible risks and potential financial implications.
- **Internal experts** assure that the due diligence review is tailored to your organization's unique needs and circumstances. They are best positioned to identify specific risks and barriers to deal execution and implementation, and provide input on the likelihood of achieving potential synergies.

## ACCESS BROAD INFORMATION SOURCES

While review of internal documents, such as audited financials, audit reports, and debt agreements, is the backbone of financial due diligence, publicly available data and interviews are also essential data sources. Information found in press releases, news stories, and bond financing documents can suggest where you need to dig further in internal data or interviews.

## EVALUATE THE ORGANIZATION'S FINANCIAL PERFORMANCE AND POSITION

When assessing past, present, and potential future performance, pay particular attention to these:

- **Threatened margins:** While most organizations have slim margins, a quality of earnings analysis provides insight into the sustainability of current performance.
- **Shifts in revenue and expense structure:** These can reveal fluctuations in service line market share or changes in organizational focus and philosophy.
- **Heavy leverage:** A detailed assessment of debt capacity and coverage can reveal problems with payback ability, future cash availability, and access to capital.
- **Limited cash balances:** Assessing the organization's cash position can reveal potential concerns regarding liquidity, stability of current operations, and ability to meet debt covenant requirements.
- **Performance versus budget:** This can provide insight into the effectiveness of financial leadership.

## KNOW YOUR DEAL-BREAKERS

Deal breakers are specific to the goals and concerns of the involved parties; you need to identify yours. Examples might include:

- **Significant threats to profitability:** If an organization is facing significant cuts to inpatient reimbursement levels, and has not identified alternative routes to compensate for reimbursement cuts, its future profitability may deviate significantly from historical performance. Moreover, maintenance of current revenue may require more management involvement and additional resources, which could threaten profitability even if historical revenues are matched.
- **Significant capital investment needs:** These can be related to facility needs or other types of infrastructure, such as large scale information technology requirements. While the nature of the organization's capital needs are often put forth in letters of intent or definitive agreements, the *extent* of those needs may not be clear until due diligence is performed.
- **Significant liabilities:** Previously undisclosed unfunded pension obligations, long-term debt, or a known legal exposure that could result in a significant required pay-out by the organization could call the feasibility of the deal into question.

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