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Assessing the Financial Impact of a Hospital Acquisition: Six Factors

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Once a letter of intent ("LOI") is executed for the acquisition of a community hospital or health system, a due diligence process that assesses all aspects of the target organization will ensue. A key component of the due diligence process is developing a deep understanding of the likely future financial performance of both the organization you are considering acquiring, and of the full, expanded system once the acquisition has occurred.

During due diligence, a third party consultant can develop a robust financial model through access to strategic and financial documents and data from both organizations, some of which will need to be in a "clean room" and only made available to the third party, to ensure compliance with existing laws and contracts. A consultant experienced in hospital M&A brings expertise and objectivity to creating realistic, refined financial estimates. Key elements to be considered include:

1. **How will the acquisition impact the scope and volume of services?** What services provided by the acquirer can be leveraged and expanded at the acquired hospital? Key service lines may be bolstered by providing additional resources and improving access to specialists and sub-specialists through an expanded physician network. In addition, patients from the community hospital who require tertiary care may be able to be fully cared for within the newly structured system.

   If both the acquirer and acquired hospital are in the same market, some volume will likely shift from the system's current sites to that of the acquired hospital and vice versa. It's important to be sure that this shifted volume is not counted as incremental volume to the system.

2. **How will the acquisition affect market dynamics?** A larger, combined provider network may be better positioned to provide all of the care needs of a given population. At the same time, competitors may react to the acquisition with strategies to mitigate the impact on their patient volume. Considering competitor responses will provide a reality check for any potential volume increases resulting from the acquisition.

3. **What will be the impact of value-based payment contracts and programs?** If the acquirer has embraced the shift to value-based payment, which will likely be extended to the acquired organization, future estimates should account for changes in utilization and reimbursement under those models. How far the local market is in this transition should also be considered, as this may reduce utilization rates in the market overall, regardless of the acquirer's plans.

4. **Is the acquirer's capital commitment realistic?** Many community hospitals require facility and system upgrades that will entail significant capital investment from the acquiring partner. The amount and timing of capital commitment to the acquired hospital is typically negotiated as part of the deal structuring.

   The due diligence process provides an opportunity to test the implications of these commitments on the financial performance and position of the combined organization. The incremental capital-related expenses associated with improvements and expansions, and their financing, can have a significant impact on the financial position of the acquired hospital. Additionally, if the capital commitment includes funding for new or expanded facilities, both incremental operating revenues and expenses for those facilities should be estimated and included in the financial model.

5. **Are there operational synergies?** Potential economies due to scale are key drivers of hospital M&A activity, but it's difficult to estimate the benefits that will actually accrue. Projected savings should be limited to areas where there is concrete evidence of potential, such as mutual agreement, for example, that specific laboratory or diagnostic services will no longer be needed at one site.

6. **What is the range of possibilities?** Financial models are driven by assumptions, and changes to these can significantly impact the organization's estimated financial performance. Even when the financial model is developed by a third-party consultant, many assumptions are based on information provided by hospital representatives. By testing the model with key representatives in finance, business development, physician leadership, and other areas, you can refine the model, gain buy-in from key players, and ensure consensus.

   Modelling several scenarios based on changes to key inputs will test the sensitivity of the results and provide an understanding of the potential range of outcomes. This will enable the management team to manage risk and uncertainty more effectively.

Ideally, prospective financial estimate preparation will commence early in the deal process, be continually refined until the definitive agreement is executed, and subsequently be used for financial planning as the transaction closes and implementation begins.

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