Despite ongoing margin pressures, evolving business models, and continuing regulatory uncertainty, investors are finding a lot to like in the healthcare industry these days. To characterize the pace of merger and acquisition (M&A) activity as brisk or robust is an understatement. The market is downright hot—and shows every sign of staying that way for some time.

In recent months, the increase has been dramatic in both the number of healthcare industry M&A deals and the overall value of the deals that were completed. According to a report in the April 18 issue of *Modern Healthcare*, there were a total of 294 deals in the first quarter of 2015—up more than 25 percent from the first quarter of 2014—with the total value of deals doubling from $48.9 billion in 2014 to $97.9 billion in 2015.a

Clearly, investors are undeterred by the continuing uncertainty surrounding care-delivery and payment systems. In fact, as experienced industry observers have pointed out, investor groups typically are attracted by the opportunity to be early participants in systems that are still evolving—an apt description of what is happening in the healthcare industry.

As always, however, the opportunities investors see in healthcare acquisitions should be balanced against the potential risks associated with the transactions. To fully assess the risk-reward balance, buyers and sellers alike should understand critical factors that can affect their ability to successfully mitigate the risks and ultimately realize the gains they are pursuing. These factors include:

> Economic, business, and cultural forces that are driving today’s M&A market
> Funding sources and financing structures that can affect enterprise value
> The critical importance of effective postmerger integration
> The numerous regulatory, tax, and accounting issues that can affect an acquisition

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Complications during due diligence that can delay or derail an otherwise promising transaction
> The critical importance of effective postmerger integration—and what can go wrong
> The numerous regulatory, tax, and accounting issues that can affect the viability, pace, and ultimate success of an acquisition

What’s Driving the Market
In many ways, the current situation in the healthcare M&A market is comparable to a car that is moving fast and still accelerating, even as the driver approaches an unfamiliar stretch of road. The pace of activity in today’s market demands that buyers be able to move quickly to capture opportunities. At the same time, the changing nature of the healthcare industry’s fundamental business and economic models requires investors to be alert and responsive to unexpected developments. The combination of speed and uncertainty can make for an exciting ride, but also a risky one.

Perhaps the most notable trend in M&A activity is the growing investor interest in a variety of specialist physician practices and primary care groups. This interest arises in part from the fact that the robust competition for facility-based organizations (e.g., hospitals, surgical centers, imaging centers) is driving up prices, leading investors to start looking at other potential acquisitions. Medical groups in specialties that offer high-reimbursement potential (e.g., dermatology, pain management, dentistry) have attracted private equity interest for many years. But in today’s market, acquisitions of primary care and general surgical groups also are increasing.

In recent years, these opportunities might have been ignored because they were heavily dependent on Medicare and Medicaid revenue, with the accompanying uncertainty and vulnerability to changing payment structures. Today, however, the uncertainty surrounding the Affordable Care Act is gradually easing, and there is considerable movement toward value-based payment and managed care programs in which providers and insurers share a portion of the risk of providing care. Investors’ interest in making sure they have opportunities to participate in value-based care as that approach becomes more prevalent in the industry is an important point noted in the aforementioned Modern Healthcare article.

From the seller’s perspective, the movement toward managed care programs and shared savings models has led providers to recognize the need to incorporate business principles into their practices and to acknowledge the value these principles can add. This growing acceptance of the business of health care also reflects more subtle cultural changes that have occurred over the past several decades. Unlike in previous generations, when the majority of physicians pursued the independent, private practice model, residents finishing medical school today are much less likely to envision themselves as being self-employed and are more open to employment by a hospital or a group of investors.

Funding Sources
In addition to comprehending the general economic and cultural forces that are driving today’s market, buyers and sellers should understand certain factors that can be particularly critical in healthcare M&A deals. One such issue is how the method of financing an acquisition can complicate the transaction and, in turn, affect the feasibility of a deal. These complications are more likely to arise in certain types of debt financing, specifically when warrants or other derivatives are attached to the funding instrument.

For example, some creative debt-financing arrangements provide lenders with a greater share of ownership if specified events occur. Although such a clause can be an attractive incentive from a lender’s perspective, all parties to the transaction should be sure they understand the ramifications of such terms with respect to their financial statements. U.S. generally accepted accounting principles contain very complex requirements related to derivatives attached to debt. Any adverse effects could call into question the viability of the proposed acquisition.

Performing Due Diligence
Financing arrangements are not the only source of potential complications. As the scope of the entities being acquired has expanded to include a growing number of medium-size private and group practices, more acquisition targets employ cash-basis—rather
than accrual-basis—accounting methods. This change means that to generate the granular level of detail required for adequate due diligence, accounting methods must first be converted to the accrual basis—which can cause delays in the due diligence process.

Other issues can further complicate the acquisition. Unless prohibited by state statutes related to corporate practice of medicine, most physician- or group-practice acquisitions tend to be equity or stock deals rather than asset purchases. This approach is necessary to maintain the practice’s credentials and contracts with insurers and other payers and to avoid requiring a buyer to renegotiate those contracts, as would be necessary in the case of an asset acquisition.

The due diligence process in an equity transaction is inherently more complex because buyers must examine potentially unrecognized liabilities. Also, valuation questions are more likely to come up, given that all assets and liabilities must be evaluated. The valuation of receivables is often a subject of contention, and other complications can arise when sellers fail to anticipate how defined benefit plans and other previously unrecorded liabilities can affect a practice’s balance sheet.

In view of these issues, buyers and sellers alike should allow adequate time for due diligence. Early involvement by the valuation team also can help reduce the risk of last-minute surprises.

Post-Deal Integration

The most immediate concerns for most sellers are the initial purchase price and the tax ramifications of selling their equity to a new group of owners. In many cases, however, the sellers are required to stay involved with the organization, usually with an ownership stake, so they also have an interest in gauging how the acquisition will help the practice be more successful and valuable in the future. Among the many immediate potential advantages are new management systems and processes, improved procurement strategies, greater negotiating power with vendors and payers, and overhead savings through centralized administrative and billing functions.

All too often, however, buyers quickly turn their attention to the next opportunity without making sure the acquired organization is being successfully integrated into the newly combined entity. In fact, there are numerous examples of growing healthcare chains in which a dozen or more facilities and specialty practices continue to operate their own billing, purchasing, and administrative functions long after being acquired by a parent company. When that happens, the purchasers obviously lose significant value because they fail to achieve economies of scale and centralized efficiency.

The sellers lose value as well. Not only is their ownership stake less valuable than they might have anticipated, but also higher operating costs leave less cash available for their compensation. As the initial windfall received from the transaction recedes, physicians eventually start questioning why so much of their profit is going to the private equity partners—especially if the physicians do not see the partners contributing to a smoother, more efficient operation.

Experience suggests that many private equity buyers fail to devote adequate attention to integration because they become distracted by pressure to compete for new deals. What acquirers must remember, however, is that today’s high multiples—the number applied to a financial metric such as earnings before interest, taxes, depreciation, and amortization (EBITDA) to calculate the value of a business—make it even more important for them to quickly inject value into their acquisition targets.

Accelerating the integration process helps lower costs and push up EBITDA, which, in turn, can reduce the effective multiple that is paid. For example, not long ago a billing services provider was acquired for a price equal to 12 times EBITDA—a figure many industry observers found surprisingly high. Within the first year after the acquisition, however, the new owners were able to trim so much cost and inject so much efficiency that they drove up the target’s earnings substantially. As a result, their effective purchase price amounted to only about eight times EBITDA going forward.
Regulatory, Accounting, and Tax Issues

Large, high-profile acquisitions in the healthcare industry naturally draw considerable scrutiny from state and federal regulators. In some instances, this scrutiny leads to direct regulatory and legal challenges. For example, a five-year antitrust investigation by Massachusetts regulators against Boston-based Partners HealthCare delayed that hospital system’s proposed acquisition of three medical centers, and culminated in a settlement that limits the company’s negotiating power with insurers. In Georgia, the Federal Trade Commission (FTC) challenged an acquisition by Phoebe Putney Health System and extracted a settlement that requires the company to get FTC approval for future acquisitions. The FTC also persuaded a federal judge to order Idaho’s largest hospital group, St. Luke’s Health System, to unwind a pending acquisition of the state’s biggest physician group. The order is being appealed.

Healthcare acquisitions also may run into more routine complications—particularly those stemming from corporate practice of medicine laws, which vary greatly from state to state. These statutory requirements closely regulate ownership structures and the degree of control retained by the sellers. As a result, private equity partners often must rely on service agreements as a legally permissible way to collect an ROI.

The details of what is acceptable in such service agreements also vary from state to state. In some states, service agreements are regulated loosely; in others, the fees paid to investors must be supported by a fair-market-value analysis of the services the investors are providing. Such complications add significantly to the time and cost of evaluating and structuring a healthcare acquisition.

Balancing Risks and Rewards

As healthcare industry M&A activity continues its rapid pace, buyers, sellers, and their financial management professionals should remain vigilant in identifying and evaluating potential opportunities. By understanding the forces that are driving today’s market, and by recognizing the financing, due diligence, integration, and regulatory challenges that are likely to arise, they will be in a better position to balance the potential risks and rewards that these opportunities present.

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