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The Role of Healthcare Reform on the 2010 Financial Markets

By Luc Arsenault
Transaction Services Practice Leader
Moss Adams LLP

By Chris Pritchard
Partner & Business Assurance Leader
Moss Adams LLP

A year ago, after the economic collapse, the only real financial transactions being completed were in pharmaceuticals, life sciences, and healthcare. Once healthcare reform became a legislative priority in Washington, D.C., however, the healthcare M&A market came to a halt.

Over the course of 2009, healthcare reform took on greater shape in the public sector and the uncertainty in the capital markets decreased. Toward the end of 2009, there was a renewal of healthcare M&A activity.

Looking ahead, we believe 2010 offers a tremendous amount of opportunity for a variety of healthcare transactions. And the next 12 months should easily make up for the stop-and-start nature of last year's market. Indeed, many of our clients who used to do two to three healthcare deals a year prior to 2009 did none last year; but they're telling us they plan to make up for the lack of 2009 transactions in 2010.

They'll be encouraged by an economy that's slowly healing as it emerges from recession. It's true that the financing environment isn't completely favorable today, but there are signs of life, and we see more and more lenders coming to the table with a renewed appetite for deals.

The positive macro transition, plus some sort of signed healthcare reform legislation, should, in the end, make the next few quarters very active ones when it comes to healthcare M&A. The only red flag—and it's an important caveat—is that healthcare reform coming out of Washington, D.C., could have a profound impact on valuations.

There are three kinds of healthcare transactions we see unfolding in 2010, and each one necessitates a different approach to due diligence.

The first involves venture-backed healthcare organizations seeking to acquire similar accretive business units because they want to create a larger healthcare organization that would be attractive to an upstream consolidator for future sale. Due diligence here demands that the acquiring healthcare organization substantiate robust EBITDA, a healthy payor mix, lucrative contracts, strong management teams, and a strategic market hold. The due-diligence process also must look for potential liabilities, such as unrecorded tax issues or regulatory issues that might place undue burden on the heath care organization. Finally, the due-diligence effort must examine structural integrity, which includes considering outdated IT systems, at-risk key employees, and deteriorating market reputation.

The second type of deal involves not-for-profit healthcare organizations seeking to acquire specific assets of target healthcare companies in order to strengthen or fill in current business needs. In this case, due diligence should consider the same items noted above, but to a lesser degree. Instead, the buyer must closely analyze the strategic nature of the target assets while minimizing possible liabilities.

The third type of deal involves healthcare organizations—either for-profit or not-for-profit—looking to divest themselves of unprofitable divisions, facing unpalatable regulatory requirements, confronted with an unworkable monopoly, or seeking a white knight to save the day with an acquisition. Due diligence in these distressed situations is usually more focused on the financial assets being acquired, the fair value of those assets, and the minimum purchase price that's acceptable.

The general rule of thumb is that the longer a due-diligence process takes, the greater the likelihood the deal will falter. That's why we recommend that healthcare buyers and sellers today focus on the push-pull dynamic, which leads to the ultimate sales price. In this dynamic, the buyer typically slows the due-diligence process down to make sure all the variables are considered and the lowest price is achieved. At the same time, the seller generally tries to speed up the process to complete the sale at the highest possible price.

These due-diligence guidelines and approaches are not hard and fast, but they do represent several potential courses of action that we believe will help buyers and sellers in the healthcare market as they complete necessary and meaningful transactions in 2010.

Mr. Arsenault is the Transaction Services Practice Leader for Moss Adams. He has more than 12 years of experience in mergers and acquisitions involving transactions ranging in size from several million to $20 billion dollars. Prior to Moss Adams, Mr. Arsenault

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Chris Pritchard (415) 677-8262 | chris.pritchard@mossadams.com
Luc Arsenault (415) 677-8287 | luc.arsenault@mossadams.com

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CERTIFIED PUBLIC ACCOUNTANTS
BUSINESS CONSULTANTS
www.mossadams.com

worked at Genentech and as a life science subject matter expert in the Transaction Advisory Service group of Ernst & Young in its San Francisco, CA office. Contact Mr. Arsenault at 415-677-8287 or luc.arsenault@mossadams.com.

Mr. Pritchard is a Partner at Moss Adams and business assurance leader of the firm's Healthcare Practice. He also leads the San Francisco office healthcare group. A member of the firm's business assurance and healthcare executive committees, Mr. Pritchard has over 16 years of public accounting experience serving healthcare organizations. Mr. Pritchard can be reached by phone at 415-677-8262 or by email at chris.pritchard@mossadams.com.

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