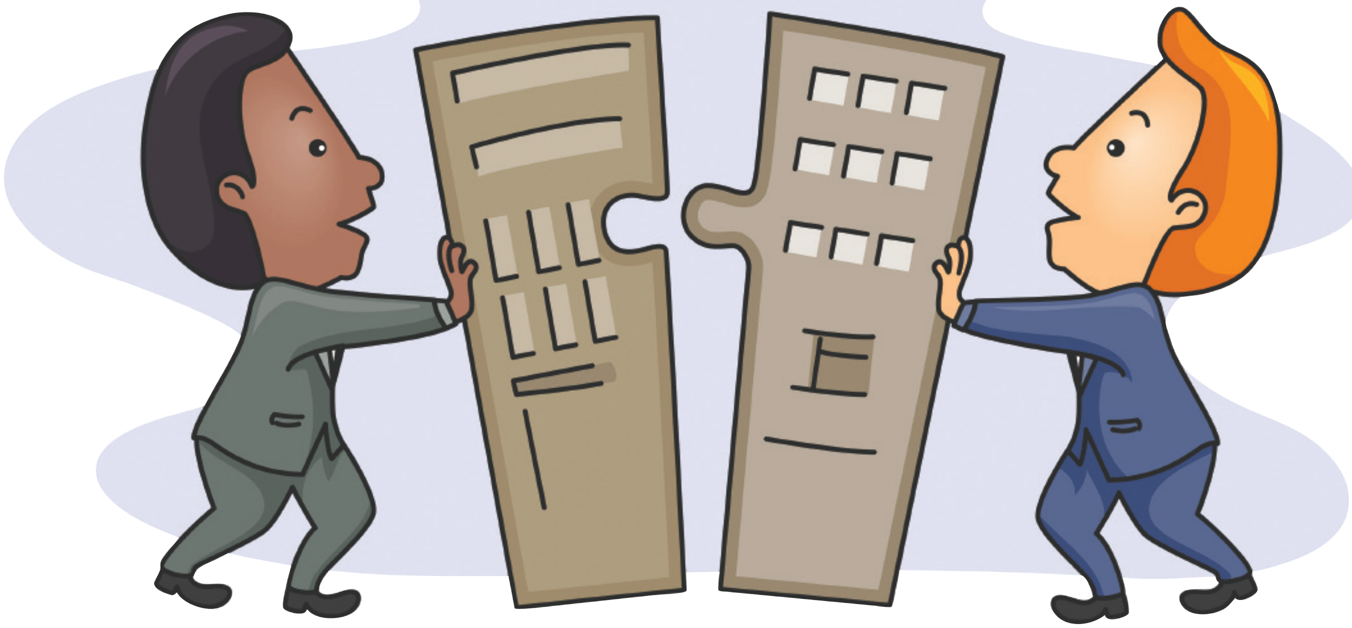
Merger and Acquisition

Transactions Involving Imaging Centers and Radiology Practices:



Factors Driving Current Trends and Factors to Be Considered if Contemplating a Transaction

BY KIRK A. REBANE AND RICHARD S. COOPER

There are general economic issues that can be seen as drivers of consolidation in an industry, including radiology and imaging. The U.S. economy continues to recover, albeit at a slow pace. Transactions that had been delayed by the recession have created a pent-up demand for acquisitions by buyers and an over-supply of willing sellers. The credit markets are continuing to thaw. Sellers will be motivated to sell prior to tax rate increases; capital gains tax rates revert from 15 percent back to 20 percent on Jan. 1, 2013. The 2010 healthcare reform legislation included an additional 3.8 percent Medicare tax surcharge on certain investment income, so the capital gains rate for many taxpayers will actually be 23.8 percent.

In addition, there are general business issues that motivate consolidation in an industry. A company might seek to improve its market share and gain access to new customers, service lines, and business. Eventually, a growing company would reach a size which would allow it to benefit from economies of scale, with enhanced coverage of fixed costs leading to exponentially improving profits. A larger company would generally have better access to capital and technology. A larger company would be in a better position to afford sales and marketing, which can further lead to branding, recruiting better talent, and cross-training personnel. Within healthcare, a larger company would have more clout with payors, would possess a greater ability to sub-specialize, and would be able to centralize billing, scheduling, finance, sales and marketing, and equipment purchasing.

Within the healthcare industry, including radiology and imaging, there are factors that can be seen as drivers of transactions and drivers of consolidation. Some of the factors motivate sellers, and some of the factors motivate buyers.

From a buyer's perspective, the healthcare industry has several extremely attractive qualities. Demographics remain the most compelling reason to stay in, or enter, this market. The U.S. population continues to age at an ever-accelerating rate. In 2009, there were 39.6 million people over age 65, representing 15 percent of the U.S. population and one third of healthcare consumption. By 2030, those over 65 years old will increase to 72 million. Diagnostic imaging remains an extremely valuable service that represents a very small percentage of healthcare expenditures, but influences a very large percentage of physician decisions. Early detection can reduce downstream healthcare costs. Therefore, diagnostic companies such as imaging centers are seen as valuable components of an overall healthcare organization's strategic plan. Despite years of consolidation, the diagnostic imaging industry remains highly fragmented. Finally, private equity is attracted by the industry's strong fundamentals and the non-cyclical nature of the industry. Twelve percent of private equity deals completed in 2011 were investments in healthcare.

From a seller's perspective, both independent imaging operations and hospital-based and –owned imaging operations can be extremely motivated to sell. Historical reimbursement cuts, expected lower reimbursements in the future, and tighter control over utilization have weakened the financial performance of many current industry providers; finding a partner or a suitor may be the only way to salvage the business. Radiologists who are increasingly challenged by their private practice's financial situation are turning to their hospitals in search of clinical integration, operational combinations, and even employment. Radiologists need to develop and become a conspicuous presence within their healthcare system; they need to be proactive and not reactive. Many hospitals continue to operate at negative margins, and it is only going to get worse. Hospitals are facing budget cuts from government payors and programs ranging from $125 to $360 billion over the next decade. Traditional operational strategies to improve liquidity and generate capital, including revenue cycle improvements, expense reduction programs, operational efficiency efforts, and deference of capital expenditures, have been fully implemented in many cases – there is no more cash to squeeze out for many hospitals. In addition, deferred capital investment in plant and IT will need to be satisfied at some point—some cost cuts are unsustainable.

Healthcare reform has exacerbated the rate of consolidation by creating the need, whether real or perceived, for consolidation of providers and service lines into healthcare systems. Regardless of the ultimate fate of the Patient Protection and Affordable Care Act (the Act), healthcare reform is becoming a powerful catalyst for consolidation and integration in the healthcare industry. Payment rates will continue to decrease, indirectly encouraging consolidation by forcing healthcare participants to find new ways to decrease costs and increase negotiating clout with both suppliers and payors. At the same time, the cost of doing business will increase as healthcare entities spend more on compliance, technology, and physician employment. The ACO-type of model will encourage network formation and greater clinical integration by rewarding integrated healthcare systems that can reduce costs and improve quality. Even if the Act is overturned by the Supreme Court, in whole or in part, or reversed, in whole or in part, as a result of election outcomes, many health systems will continue to implement ACO-like models. The acquisition of physician practices and ancillaries is central to the care coordination efforts discussed in the Act. In turn, independent healthcare entities may have restricted access to payor contracts and patient populations. Larger organizations that have greater critical mass will be able to compete more effectively, will be able to spread fixed costs over a broader revenue base, will have better access to affordable capital, and will be better able to develop sophisticated systems that can measure quality and allow for sharing of best practices.

Traditional not-for-profit healthcare systems can pursue one of two completely different directions. Some systems are looking at expansion as the solution to healthcare reform and are trying to develop one-stop shopping and coordinated care, thereby minimizing leakage from their covered population. At least for now, the ranks of the insured are expected to rise dramatically as the political uncertainty over healthcare reform slowly changes. Focus on population management will drive providers to consolidate in order to integrate services, generate economies of scale, and minimize leakage out of the system. Providers must demonstrate to both government payors and commercial payors that they can provide high-quality care at a lower cost. There is a paradigm shift toward outcome measurement and evidence-based medicine. Such efforts will require not only a diverse array of service offerings within an organization, but also the financial strength and breadth of management to analyze and demonstrate outcomes.

Other systems are instead seeking to capitalize on the hidden value in their non-core assets, such as the imaging center operations, with an objective of raising much-needed cash. The allocation process for scarce capital resources (including cash capital, management resources capital, and space capital) can result in the classification of imaging operations as non-core. Hospitals are seeking to monetize non-core and/or underperforming assets and service lines through joint ventures or outright sales. The benefits of selling an ancillary service line can be numerous:

- Generates immediate and substantial cash proceeds for a healthcare system
- Can reduce a health system's ongoing cost for ancillary services
- Allows for the redeployment of capital—both financial and human capital—into more optimal strategic areas for the system
- Ensures the ancillary's offerings will be at the technological cutting edge
- Enables the avoidance of capital investment in the ancillary
- Preserves employment in the community, often critical to a mission statement
- Maintains or improves current service levels
- Lets management focus on core assets/business of the institution

While considering a sale, a healthcare system should determine the strategic implications of disposing of, or entering into a joint venture on, the identified assets, service lines, or both. For those assets or service lines that survive the strategic test, the system should conduct a preliminary valuation in order to quantify the monetization opportunity.

A successful transaction requires that the partner, buyer, or seller that you are sitting at the table with is the best party in terms of meeting your organization's strategic objectives. Whether a buyer or a seller, deal terms can be as important as transaction price. Both parties want to minimize organizational disruption during the sale process and want to structure a process that facilitates regulatory approval. At the end of the transaction, both parties should be left with an organization which is consistent with their respective mission statements.

The selling process should include:

- An assessment of all strategic options, transaction planning, and strategy development
- Development of acceptable confidentiality agreement
- Development of confidential information memorandum
- Development of acceptable buyer list
- Information exchange coordination and process
- Proposal evaluation and negotiation
- Negotiation of a Letter of Intent
- Due diligence coordination efforts
- Negotiation of definitive purchase agreements and ancillary agreements

The buying process should include:

- Development of acquisition target criteria
- Transaction planning and strategy development
- Development of acceptable confidentiality agreement
- Target identification
- Assessment of strategic and financial implications to your organization with respect to each identified target
- Financing analysis
- Valuation and transaction structuring
- Development and negotiation of offer
- Negotiation of a Letter of Intent
- Due diligence coordination efforts
- Negotiation of definitive purchase agreements and ancillary agreements

Changes in law, and the anticipated move away from a fee-for-service environment to ACO-type structures, have led to an environment of uncertainty in the merger and acquisition marketplace. Transactions have become more complex and require more advanced planning.

There are various types of transactions which can be pursued. On the one end of the spectrum, a capital raise will allow you to raise money to expand, and provide you with continued full control, but no liquidity will be obtained. A slight variation of a capital raise would be a recapitalization, in which you sell a partial interest, thereby obtaining some liquidity while maintaining most of the control. A sale with equity involves the sale of the majority of the stock to a larger company, but leaves the seller with a significant enough piece to encourage the seller to pay continued close attention to performance; significant liquidity is achieved, but majority control is relinquished. The sale of a 100 percent interest maximizes the proceeds and liquidity, but leaves you with no control over future operations. Other types of transactions include joint ventures, or low integration models such as clinical affiliations and management agreements.

Generally speaking, there are three types of buyers. Strategic or industry buyers typically are in a position to pay a higher price based on synergies, economies of scale, and industry familiarity/knowledge. Financial buyers, or private equity firms, typically pay a slightly lower price, especially if the target represents the buyer's initial foray into an industry space. However, sellers do receive the opportunity to get a "second bite of the apple" due to their retained minority stake in the target. Management buyers typically pay the lowest price due to their constrained financial resources, but may be the most flexible in terms of deal structure.

A transaction could involve either the assets of an entity or the stock/equity of that same entity. An asset deal, in which only certain identified assets change hands, allows the buyers to protect themselves from off-balance sheet liabilities and "write-up" the assets to fair market value, thus providing greater depreciation and tax treatment. A stock deal, in which the actual equity changes hands and therefore all assets and liabilities—whether identified or not, whether on the balance sheet or not—change hands, typically provides the seller with better tax treatment options, but requires greater due diligence efforts on the part of the buyer due to potential off-balance sheet liabilities and concerns. A stock deal inherently allows for the transfer of contracts, licenses, accreditations, and other similar assets subject to certain approvals and notifications, whereas many such assets are not transferable in an asset deal.

Valuation is typically driven by the future anticipated cash flow that the target is expected to generate on a sustainable basis. Therefore, the owner or manager of a radiology and imaging practice should not wait until the decision has been made to sell to begin the process of wondering about valuation. Instead, the manager should practice value-based management continuously, whether or not a sale is imminent. If valuation is a topic not discussed until a decision has been made to sell, then dollars have already been left on the table by a seller. When using value-based management, the owner or manager should seek to maximize the sustainable value, monitor performance on a fairly real-time basis, understand and monitor the direct correlation between actions and value creation, manage the internal value-driving factors which can be controlled, and anticipate the external value-driving factors which cannot be controlled. A true organizational leader should have the goal of creating value for all the stakeholders, including employees, vendors, owners, and customers of a business.

In addition to monitoring value creation efforts, there are other planning steps which should be undertaken prior to going to market. Every radiology practice or imaging facility has problem areas—some modest and some more severe. These problems can impact whether one ultimately receives offers, the deal value, whether a deal gets done, and the deal timing and cost. Not all problems are known. It is better for business owners to conduct their own audit, using internal means or independent vendors, in order to identify and solve problems—prior to any potential buyer finding such issues. A thoughtful, timely audit and correction of a problem are less onerous and disruptive for both management and staff than is an audit under the fire of due diligence. Audits of coding and billing practices can result in certain disclosure and repayment obligations, which should be discussed with legal counsel in advance of undertaking the audit.

Speaking of due diligence, a seller should be prepared for extensive and thorough due diligence by a potential buyer or partner. Diligence will focus on:

- Ownership/governance
- Financials and financial trends
- Billing and coding compliance
- Legal (tax structure, fraud and abuse, HIPAA and data security, licensure and accreditation, litigation, employee vs. independent contractor issues, other current, threatened, or anticipated third party actions, including government actions, etc.)
- Operations
- Clinicians/management/employees
- Payor relationships and contracts
- Referral source relationships
- Customer relationships and profile

Merger and acquisition activity within radiology and imaging—indeed within all of healthcare services—is very strong and is being driven by standard business motivations, standard economic motivations, and new healthcare reform initiatives. Successfully completing a transaction is a complicated process which requires years of planning and anticipation, and which requires sound counsel from your legal, accounting, and valuation advisors.

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