KPMG

A customized approach to due diligence can create value in healthcare deals

Process can empower businesses to more effectively assess potential targets, illuminate risks, and maximize opportunities

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Introduction

In the U.S. healthcare system, the push to switch from a "volume" to a "value" approach over the past several years has inspired many new business models to enter the healthcare market. This trend is designed to create better alignment and efficiency between healthcare stakeholders and to improve health outcomes.

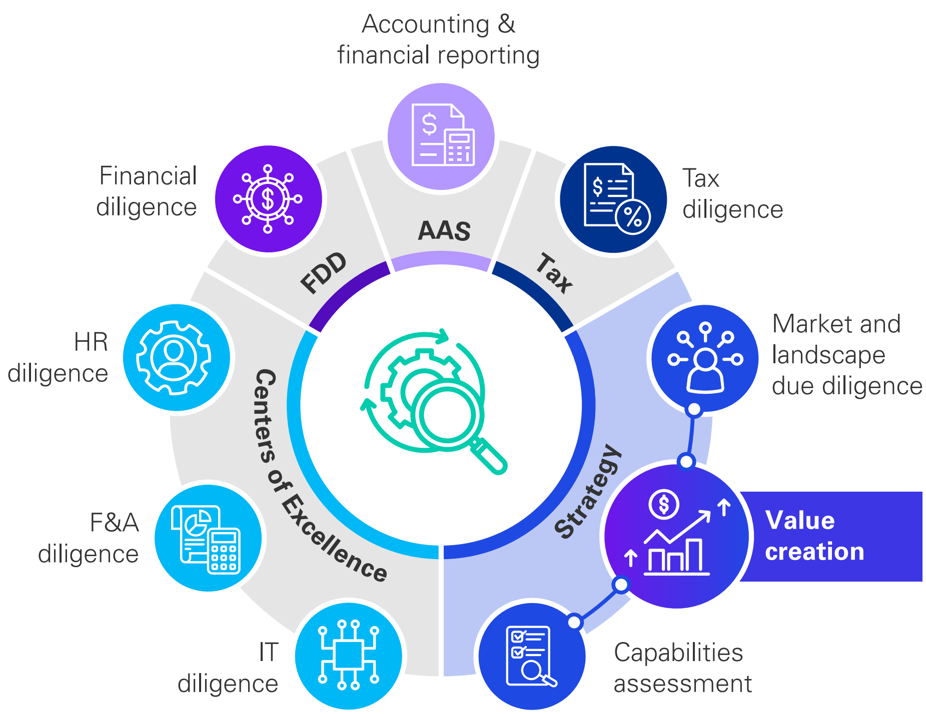
These models are tied to new approaches in healthcare delivery such as strategies for whole health, value-based care reimbursement, wellness programs, wearables, remote patient monitoring, and more. And these changes are driving the adoption of new business models in healthcare.

These new business models unlock potential value, which has fueled significant M&A activity over the last few years. For example, from 2020-2022 risk-bearing providers, staffing agencies, specialty physician practices, and other healthcare service providers have been hot investment areas. During this time, strategic clients, healthcare-focused PE clients, and generalist PE teams have pursued these healthcare assets.

To fully understand the tailwinds and risks associated with these healthcare assets, our clients are asking for a more comprehensive approach to diligence. In this paper, we describe an approach that can support investors navigating diligence in a challenging market through a suite of healthcare-focused analyses to highlight the upside and illuminate the detriments to value creation in a transaction.

As the deal market rebounds, KPMG specialists are best aligned to support investors as we have extensive experience conducting diligence across the full continuum of healthcare assets, including financial, tax, HR, IT, compliance, accounting and financial reporting, and, as the focus of this paper, value creation (Exhibit 1). We have observed that the traditional approaches to commercial and operational due diligence are adequate for answering basic questions about a target. However, they are often less helpful for an investor looking to understand the effectiveness of a target's care platform, growth and scalability potential, and potential operational and integration risks. Our team has the expertise in healthcare necessary to fully understand the nuances of provider platform businesses. We are experienced in both traditional fee-for-service and value-based care models, and we understand critical specialty and site-of-care implications to care. Finally, we have worked with numerous clinicians across all specialties in scaling and growing healthcare businesses.

Exhibit 1: Value creation sits in KPMG's suite of diligence offerings



Years of experience evaluating complex healthcare assets have led us to identify reoccurring themes and risk areas and have enabled us to develop a different approach to due diligence. Our differentiated diligence process to healthcare assets supports investors by answering traditional diligence questions, while also addressing key questions such as:

- How effectively and efficiently is the target managing care?
- What market share differences are there in various procedures or diagnoses, and by case mix?
- Does the market(s) being evaluated support the shift of procedures to an OP setting?
- Is the business model prepared to scale, or will significant investments be needed?
- Are there critical risks or gaps in technology that will be costly or disruptive to address?
- How effective and stable is the revenue cycle management process?
- How effective is the referral network?
- Are there any unforeseen operational, regulatory, or reimbursement risks?
- What are potential key integration/ separation risks?

Answers to these questions enhance a traditional diligence approach and provide a more robust understanding of a target, enabling our clients to more thoroughly assess a target's potential and uncover risks not seen through traditional diligence.

A comprehensive approach to value creation

At KPMG, our specialists have developed a flexible, "a la carte" offering for diligence that focuses on value creation. This process utilizes 15 differentiated analyses to provide thorough diligence support while identifying value creation opportunities (Exhibit 2). Depending on the target and/or target's sub-specialty, we customize our approach to focus efforts on evaluating the key areas critical to the deal thesis. Our suite of analyses gives our clients flexibility as different analyses can be scaled up or down based on deal timeline and depth required.

Exhibit 2. KPMG has 15 healthcare diligence offerings focused across both revenue and cost drivers

Revenue (existing)

1. Managed care contracting & rate parity
Analysis measures managed care contracting effectiveness and identifies revenue uplift opportunities by comparing contracted reimbursement rates to market benchmarks for profitable organic growth.

2. Revenue cycle management
Identifies opportunities to improve the revenue cycle management function, including opportunities to expedite cashflow and reduce bad debt while also identifying investments needed as the platform scales.

3. Service & case mix
Assess risks related to service mix and identifies key procedures by acuity and site of service.

4. Drug pricing analysis
Assess the potential revenue impact of future changes to the pharmaceutical landscape based on the target's top drug codes (e.g. loss of branded exclusivity).

Platform effectiveness

5. MSO analysis
Evaluates economic model, MSO capabilities, and performance compared to peer groups.

6. Longitudinal claims analysis
Analyze claims of risk-bearing provider practices by demographic characteristics to measure the effectiveness on care management programs of the platform.

7. Physician compensation & productivity
Evaluates physician compensation models, and compares physician compensation and productivity to regional benchmarks and best practices to identify risks and opportunities.

8. Physician supply & demand
Identify and analyze provider supply and demand dynamics by market.

9. Income repair
Evaluates historical and estimated future physician compensation to identity risks to provider stability due to provider dissatisfaction; evaluates effectiveness of platform in terms of physician compensation.

Cost

10. Operating model assessment
Identifies scalable functional areas versus those that may be bottlenecks by assessing future-state needs for people, processes, and technology.

11. Support staff & non-clinical labor diagnostic
Identifies if the staffing composition and investment is commensurate with the capabilities and maturation of the company's operating model compared to peer group.

New revenue & commercial considerations

12. Market size & competitive landscape
Estimates (or confirms) total addressable market is adequate to support future growth trajectory; evaluates competitive landscape in local/regional/national markets.

13. Market optimization & new market entry
Assess the attractiveness of existing markets, while also evaluating the potential growth for a target based on its pipeline of opportunities and its scalability.

14. Reimbursement & regulatory trends
Understand current/potential future regulatory trends and related risks to the target's reimbursement (e.g., Medicare rate changes, etc.).

15. Patient journey mapping
Understand risks related to the referral landscape and informs opportunities for greater management of the target's upstream channels.

Differentiated due diligence in action

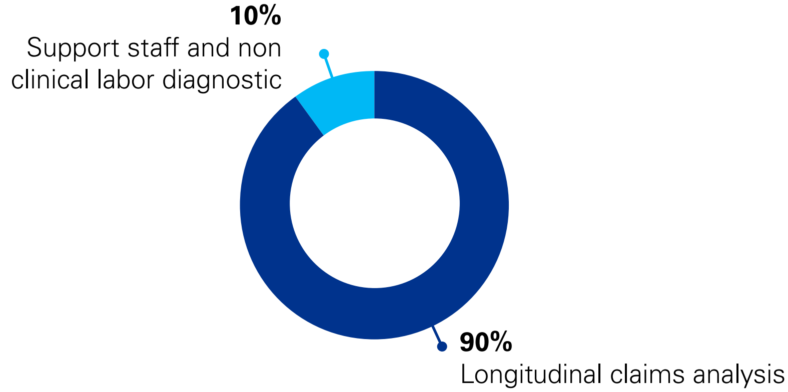
The deal frenzy of 2020 and 2021 enabled KPMG specialists to conduct diligence on a diverse range of healthcare assets for an array of clients and develop a new perspective on creating value for these healthcare transactions. The highly active deal market meant that our clients were often engaging in very competitive deal processes with short durations. To provide the maximum value, we adjusted our approach based on the specific deal components, making sure that our clients were asking the right questions and were performing the right analyses necessary to test their deal thesis. This approach included working with our clients (investors) to thoroughly understand their deal thesis in order to identify and prioritize a handful of key analyses in which we would use our deep bench of operators, data and analytics, and wide array of healthcare experience to help accelerate the analysis into the critical opportunities and risks. This enabled us to better measure performance and help our clients identify the risks and areas of strength and differentiation of the specific asset.

In some instances, clients will have us focus on a few key areas where we will conduct "deep-dive" analyses, while in other instances, clients will leverage our support to evaluate more areas at a "lower-touch" level to provide them with a "red flags" report, through which we identify critical risks as well as areas where we recommend further analysis should be completed or additional questions that need addressed. KPMG offers this flexibility based on our clients' budget, timing, and experience in the healthcare sector.

In one example, our client was a well-known PE investor with a robust healthcare portfolio looking to invest in a risk-bearing Medicare Advantage provider (Exhibit 3). Our client did not have a robust methodology to evaluate the effectiveness of care management programs of the platform. As with businesses in this maturing sub-sector, management struggled to identify which member cohorts were driving growth (i.e., age, chronic conditions, dual eligibility status, location, and cultural affinity).

By conducting detailed member population and cohort performance analyses, our team isolated the subset of members with multiple years on the care platform and identified the year-over-year changes in premium and profitability for distinct member cohorts distinguishable by demographic features. Results of the analysis identified no red flags and supported the client's deal theses and were used to inform a go/no-go decision to pursue the target. Ultimately, our client decided to make a bid and acquired the target. A traditional commercial and operational diligence would not have been able to measure the effectiveness of the care platform and the client leaned on our experience and data and analytical capabilities to help them answer some of their most pressing questions regarding the care platform.

Exhibit 3: Risk-bearing provider practice: Percent of effort spent

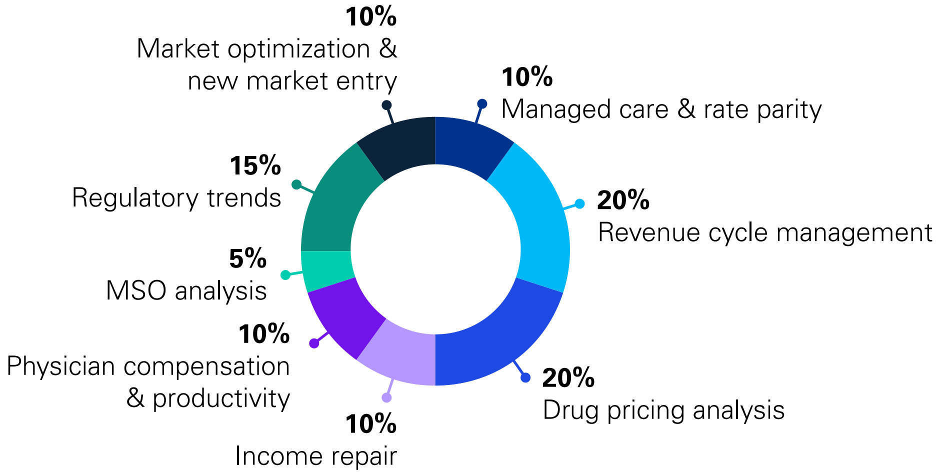


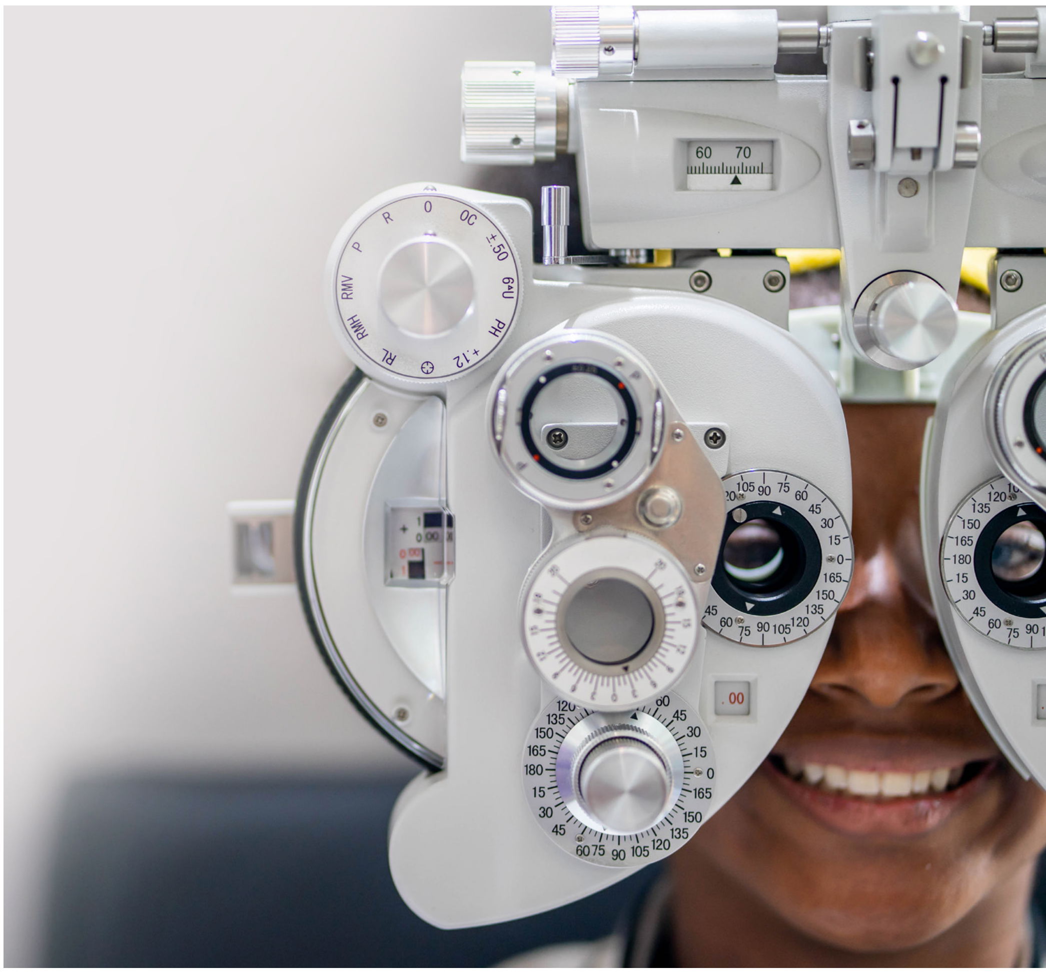
In a second example, the situation was much different. A longstanding PE client investor new to the healthcare industry was interested in acquiring a comprehensive eye-care platform provider (Exhibit 4). The client wanted a perspective on the reimbursement outlook in ophthalmology and optometry markets as their deal thesis revolved around profitable organic growth via rate increases from payer contracting as well as operational efficiency improvements.

Our team of experienced healthcare professionals have familiarity with these nuanced analyses, and we provide our clients with more information at a faster rate in a competitive bid setting. In the above example (Exhibit 4), several key analyses were identified to pressure test the client's deal thesis and identify red flags. These included understanding the rate lift opportunity for managed care, the maturity level of RCM operations, red flags related to physician income repair, and risks related to reimbursement trends and pricing for the target's top drugs. Our differentiated diligence approach illuminated key reimbursement and market trends within the ophthalmology sector and helped refine their valuation. Our work armed the client with foundational knowledge to pursue additional targets within this space.

We anticipate deal activity to steadily increase throughout 2023, however economic challenges will likely persist, which means that identifying opportunities for value creation and risks through enhanced due diligence will be more critical than ever.

Exhibit 4: Ophthalmology Provider Practice: Percent of effort spent





How KPMG can help

KPMG specialists have helped both strategic and PE investors evaluate a wide variety of healthcare assets. We have supported investors in assessing 15 healthcare-specific areas with quantitative data and/or qualitative insights they may not have gathered or known were even measurable. Through our differentiated diligence approach, we ask target's management team more relevant questions to illuminate the risks of the asset, getting to the core of an asset's true value. Our approach identifies opportunity areas that our clients can focus on post-close to drive value, and we identify initiatives that are "quick wins" versus those that could have a longer implementation timeline.

Our team's healthcare industry experience spans the continuum from healthcare systems, payers, multi-site providers, healthcare technology/digital health, and post-acute providers. Our team's ability to work under tight diligence timelines combined with our healthcare specific tools, methodologies, data and analytics and our foundational knowledge of healthcare diligence, makes us best equipped to support our clients in evaluating healthcare assets. In addition to our transaction experience, we also work closely with providers, payers, and healthcare stakeholders on growth initiatives such as service line strategies, joint ventures, physician alignment strategies, ambulatory strategies, payer strategies and risk models. This front-line experience makes us better positioned to support investors and c-suites by providing actionable recommendations that help maximize deal value.

In addition, we have a dedicated healthcare data and analytics team that truly understands the nuances of healthcare data, including healthcare claims data and other analytics critical to evaluating performance and care model design.

Finally, KPMG boasts a large healthcare Financial Due Diligence (FDD) practice. Our clients typically engage KPMG to perform financial diligence, commercial diligence, and value creation, allowing us to leverage the same financial and operational baseline data, as well as access to management, throughout the diligence process. This is helpful for our clients as it makes us less intrusive with target management and enables them to share reports and findings with their partners (bankers, lenders, etc.) that all leverage the same assumptions and source data.

Authors

Brett Glover *Partner*

Brett leads KPMG's US Healthcare and Life Sciences Transactions Practice and has led both domestic and global buy-side and sell-side transactions. Over the last 25 years, his experience includes both private and publicly traded companies and their associated accounting topics. His primary responsibilities have included due diligence assistance, integration assistance, financial analysis, operational diligence, commercial diligence, performance improvement, and technical accounting to assist clients through their transaction processes.

Ross Nelson, M.D. *Principal*

Ross is a Principal and is the National Healthcare Strategy Leader for the KPMG Strategy practice. Based in the Chicago office, he has over 25 years of experience and works with integrated delivery systems, academic and NFP health systems and hospitals, physician group practices, payors and other care delivery providers to develop strategies for more affordable, patient-centric care. Ross has experience with more than 250 strategy engagements and transactions–helping clients to develop and conduct growth and enterprise strategies, portfolio and care continuum strategies, service line strategies, funds flow strategies, M&A or collaboration strategies, synergies diligence, commercial diligence, operational diligence, integration planning and management, integration implementation, and business case/enterprise financial models.

Jeff Whitcomb *Managing Director*

Jeff is a Managing Director with KPMG primarily focused on strategic planning, mergers and acquisitions, and integration planning and execution in the healthcare industry. He has over 20 years of healthcare consulting experience, during which time he has facilitated deals between hospitals, physicians, and payers, performed financial and operational due diligence on a variety of healthcare assets for both corporate and private equity investors, led pre-merger strategy and post-merger integration efforts, conducted strategic planning and growth analyses, developed physician compensation and employment agreements, and performed other strategic and financial analyses.

Sushil Bose *Director*

Sushil is primarily focused on strategic planning, mergers and acquisitions, and various growth strategies. He has 11 years of healthcare consulting experience during which he has worked on growth initiatives with organizations through the continuum, i.e., large health systems, rural hospitals, physicians, payors, and universities. Sushil has performed managed care benchmarking, operational due diligence, pre-merger strategy, enterprise strategic planning and corporate re-design with the leading health organizations in the country.

Carrie Kmetzo *Manager*

Carrie is a Manager in the KPMG Healthcare Strategy practice with more than 8 years of industry experience and more than 5 years of strategy consulting experience. She joined KPMG after receiving her MBA from Columbia Business School in 2018. Carrie's areas of focus include growth strategy, performance improvement, commercial and operational diligence, and integration and separation planning & execution for corporate and private equity clients, including health systems, other care delivery providers, and payers.

For more information, contact us:

Ross Nelson, M.D.
Principal
630-207-7728
rossnelson@kpmg.com

Brett Glover
Partner
214-840-8579
bglover@kpmg.com

Jeff Whitcomb
Managing Director
813-301-2121
jwhitcomb@kpmg.com

Sushil Bose
Director
312-665-1000
sushilbose@kpmg.com

Carrie Kmetzo
Manager
713-319-2000
ckmetzo@kpmg.com

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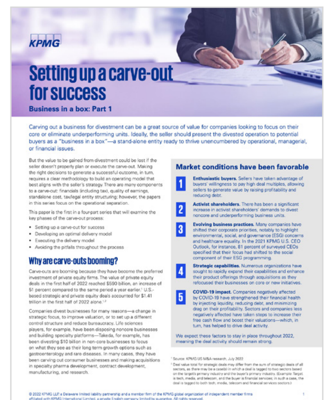

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