Financial due diligence overview

Quality of earnings, net debt and net working capital

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Agenda

1. Financial due diligence overview
2. Quality of earnings
3. Net debt
4. Net working capital

Key takeaways

This presentation will give you a high-level overview of the financial due diligence process, focusing on key topics and considerations for the quality of earnings, net debt and net working capital analyses.

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Financial due diligence overview

Health sector landscape

Care delivery providers		Payers/insurers		Health services and investors		
Hospitals	Academic medical centers	Health care insurance	Commercial	Private equity	Outsourced health care services	Pharmacy
Physician groups	Outpatient clinics/retail health	Long-term services and support	Managed Medicare/ Medicaid	Health and wellness	Durable medical equipment	Infusion services
Home health/ hospice	Post-acute care	Provider-sponsored health plans	Self-funded employers/ TPAs	Health care staffing	Health care technology	Outsourced vendors

Payment models

- **Traditional fee-for-service:** Oldest payment model. Providers are reimbursed a flat fee for each medical service.
- **Capitation:** A fixed amount for each patient is paid to providers in advance, for a set time period (typical one month). Specific services are identified.
- **Episodic:** A fee is provided up front for an entire “episode” of care. An episode is more specifically defined as a specific diagnosis and the services needed to treat that diagnosis over a period of time (such as 30 days). A single payment would cover all the costs of treating the patient.

Health care general glossary

- **Accounts receivable (AR):** The balance of money due to the provider for services delivered.
- **Adjudication:** The medical claim decision-making process once the claim reaches the insurance payer to determine if they will accept, deny or reject the claim.
- **Allowed amount:** The maximum dollar amount an insurance company will allow a provider to collect for an eligible health care service. Depending on the patient's coverage, this amount may be paid by the insurance, the patient or split between them.
- C**oinsurance:** Amount a patient pays the provider once their insurance has paid its portion (based on their benefit contract). Often, the patient must meet their deductible before coinsurance kicks in.
- **Co-payment (co-pay):** A fixed fee that the patient pays the health care provider for the services or treatment received.
- **Current procedural terminology (CPT®) code:** CPT codes were developed by the American Medical Association to describe a medical, surgical or diagnostic procedure that doctors and health care providers perform. CPT codes ensure uniformity and are required for billing medical insurance payers. Every calendar year, the AMA announces changes to the code set.

Health care general glossary (cont.)

- **Date of service (DOS):** The treatment date.
- **Fee schedule:** A fee schedule, which is included in the provider's insurance company contract (except for Medicare and Medicaid), states what the insurance company is willing to pay (allowed amount) for services the provider performs.
- **Medicare Advantage Plans:** Also known as Medicare Part C, these plans are an alternative to traditional Medicare plans that are offered through private insurance companies.
- **Provider enrollment:** The process of enrolling a provider with commercial or government health insurance plans to which the provider can be reimbursed for services rendered to patients.
- **Third-party payer:** An entity, such as insurance companies, government agencies, health maintenance organizations (HMOs) and employers, that pays medical claims on behalf of the insured.
- **Write-off or adjustment amount:** An amount written off or adjusted from a charge. Typically, this is any amount over the insurance's stated allowed amount but may include additional adjustments. Patients cannot be billed for any write-offs or adjustment amounts if a provider is in network with an insurance company.

Typical purchase price calculation

Component	Due diligence output
Enterprise value (adjusted earnings x multiple)	Quality of earnings
+/- Difference in working capital as defined and working capital target/peg	Quality of net assets/working capital
- Indebtedness and non-operating liabilities	Debt and debt-like items/commitments and contingencies
+ Transaction expenses	
+ Cash (if applicable)	
= Purchase price	

How financial due diligence provides value

Financial due diligence plays an important role in determining purchase price and presenting a clearer picture of the target's historical operations.

Currency: $000	**Reported**	**Sell-side CIM***	**Buy-side**
EBITDA	20,000	25,000	18,000
Multiple	10x	10x	10x
Enterprise value (adjusted earnings x multiple)	**200,000**	**250,000**	**180,000**
+/- Difference in working capital as defined and working capital target/peg	–	–	–
- Indebtedness and non-operating liabilities	(20,000)	(25,000)	(30,000)
+ Transaction expenses	–	–	–
+ Cash (if applicable)	1,000	1,000	1,000
= Purchase price	**181,000**	**226,000**	**151,000**

* Confidential information memorandum

Key deal considerations

What is the contemplated deal structure?

- Asset or stock purchase
- Is the buyer purchasing a whole company or carving out operations?
- Understand the basis of valuation: EBITDA, EBITDAR, revenue multiple
- Will the deal involve investors or lenders?

Other considerations

- Is accounting accrual or cash basis?
- Has the business been audited, and will workpapers be made available for review?
- Does the business have a sell-side diligence report?
- Acquisitions or discontinued operations?
- Are there multiple participating shareholders taking equity draws (especially physician practices)?
- How many provider entities and different lines of business?
- Are there significant capitated or risk-sharing reimbursement arrangements?
- Have there been any significant billing or clinical IT system conversions?
- Will they be able to produce the data files necessary to perform revenue analysis?
- Is the business subject to self-insurance risk?

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Quality of earnings

Overview

- The importance of EBITDA for buyer and lender:
  - Serves as proxy for free cash flow available to service debt
  - Definitional items (interest, income taxes, depreciation and amortization) addressed separately in model
  - Not “one size fits all”
  - Normalize results to help better depict underlying trends/drivers
- “Quality” and “normalization” require evaluation and judgment:
  - Is seller’s view of normalized earnings oversanitized?
  - Are “anomalies” an indication of reality?
- Typical EBITDA adjustment categories (details on next page):
  - Out of period
  - Noncash transactions
  - Onetime, unusual, nonrecurring
  - Pro forma items

EBITDA adjustment categories

Onetime, unusual, nonrecurring	Noncash transactions
▸ Restructuring charges ▸ Legal settlements ▸ Transaction-related costs ▸ System implementation costs ▸ Loss of a significant customer/payer/service line ▸ Significant change in contractual terms ▸ Payroll savings from vacant positions ▸ Noncore sources of revenue ▸ COVID-19 relief funds ▸ Tax holidays ▸ Medical loss ratio rebates	▸ Deferred rent ▸ Stock compensation ▸ Capitalized internal costs ▸ Impairment charges ▸ Unrealized gains/losses ▸ Amortization ▸ Minority interest or equity income ▸ Pension and OPEB (other post-employment benefit) charges ▸ Premium deficiency reserves
Out of period	**Pro forma items**

▸ Changes in estimate (benefit of hindsight):
  ▸ Bad debt, inventory reserves, allowances
  ▸ Self-insurance, compensation
▸ Timing related:
  ▸ Year-end true-up or audit adjustments
  ▸ Revenue recognition
  ▸ Improper cutoff
▸ Incurred but not reported (IBNR) development
▸ Medicare risk scores
	▸ Acquisitions or divestitures run rate
	▸ Discontinued operations or product lines
	▸ Stand-alone or TSA (transition services agreement) costs (carve-outs)
	▸ Cost saving initiatives
	▸ Changes in reimbursement (temporary COVID-19 rate lifts or annual fee schedule changes)

Provider diligence considerations

Several financial considerations should be considered when evaluating the investment thesis of M&A activity in the health care sector:

Business or model risks	Key diligence considerations
Revenue recognition and collectibility of A/R ▸ Does the profit and loss statement (PL) reflect the net realizable value of revenue? ▸ Do historical trends indicate current accounts receivable (A/R) may be collectible? ▸ Does the company have an established compliance function? **Reimbursement environment** ▸ How does reimbursement strategy (i.e., in network/out of network) impact the deal? ▸ Are there anticipated legislative changes that may impact future earnings potential of the post-transaction entity? **Acquisitions, de novos and immature providers** ▸ What is the mature contribution of recent acquisitions, de novos and/or immature providers? **Provider compensation and other physician costs** ▸ What is the impact of the aforementioned matters on providers' compensation?	▸ Assess whether historical accounts receivable and net revenue estimates have been realized through subsequent cash receipts ▸ Analyze third-party settlement balances ▸ Involve experts to perform a billing and coding analysis to assess the appropriateness of historical claims ▸ Analyze historical same store and provider performance (including utilization) to determine whether forecasted growth is (i) consistent with historical experience and (ii) achievable with current capacity and macro trends ▸ Analyze provider compensation models to quantify the impact of diligence and pro forma adjustments ▸ Analyze labor metrics and costs ▸ Analyze malpractice and other self-insurance reserves, considering the need to involve actuaries

Fee-for-service revenue recognition considerations

- Estimating revenue is a matter of significant judgment:
  - Not all payers reimburse the same amount for the same service:
    - Governmental payors: Medicare, Medicaid and others
    - Managed care payors: distinguished by types of plans and types of contracts
    - Other payors: commercial insurers, private pay and others
  - Many providers don't have contracts loaded into patient accounting systems.
  - Even when contracts are loaded, patient bad debt, denials and out-of-network cases complicate the process.
- Approaches used by providers to record revenue:
  - Percentage of gross charges
  - Unit-based: volume x historical rate per unit
  - Cash basis
- Gross-to-net presentation of revenue

Currency: $000	FY22	FY23	FY24
Gross charges	6,500	7,000	8,300
Less: Contractual allowances	(2,000)	(2,100)	(2,500)
Less: Bad debt allowances	(500)	(600)	(800)
Net collectible revenue	**4,000**	**4,300**	**5,000**
Other adjustments	(200)	(250)	(300)
Net recorded revenue	**3,800**	**4,050**	**4,700**

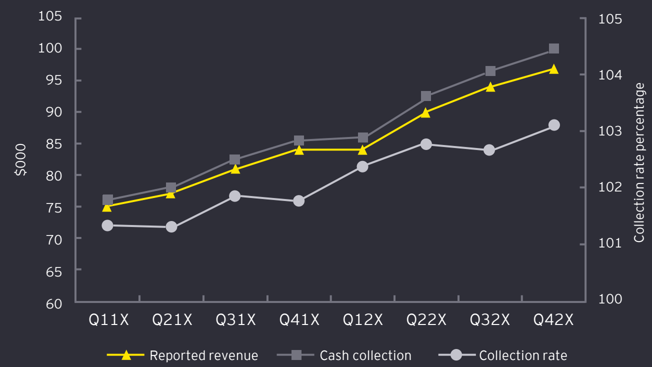
Provider diligence considerations

An inadequate reserve methodology could result in net revenue and associated accounts receivable in an excess/deficit position as compared to the net realizable value.

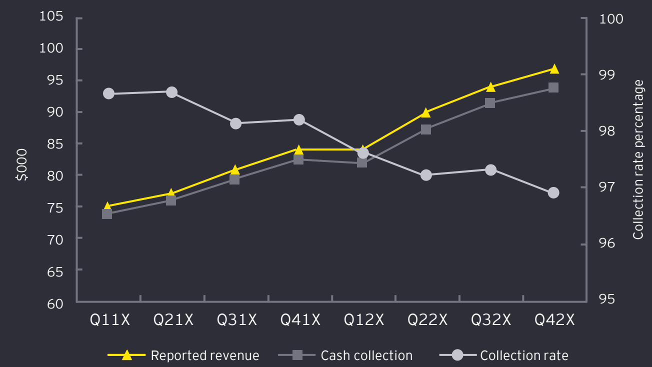
Gross-to-net accounting

- **Methodology**
  - Gross revenue is typically recognized in conjunction with the company's chargemaster, which stipulates per procedure rates.
  - Contractual adjustments represent the difference between the chargemaster and the agreed-upon reimbursement rate to be paid by third parties.
  - Insurance plans reimburse at different rates based on negotiated contracts.
- **Risk factors**
  - Changes in reimbursement and collection rates may not be reflected in contractual adjustments and bad debt percentages applied to gross revenue and accounts receivable.
  - Historical revenue trends may not be consistent with forecast revenues due to changes in service and payer mix.
- **Diligence procedures**
  - Historical look-back analysis comparing actual cash collections to net reported revenue including an estimate of future collections for immature claims based on historical collection percentages.

Scenario 1: Increasing reimbursement



Scenario 2: Declining reimbursement



Risk-bearing provider diligence considerations

Risk-bearing reimbursement models are becoming more common as the industry moves toward value-based care.

Business or model risks

- **Claims expenses and incurred-but-not-reported reserves**
  - Does the plan use fixed capitation payments, fee-for-service models or a blend?
  - Has the plan used consistent reserving practices or experienced large out-of-period reserve adjustments?
  - Does the plan have material risk-sharing arrangements or complex gain share calculations?
- **Regulatory/legislative environment**
  - Are there anticipated legislative changes that may impact future earnings potential of the post-transaction entity?
  - What are the potential impacts to the plan's business under different political scenarios?
- **Revenue recognition and collectibility of A/R**
  - Does the PL reflect the net realizable value of revenue?
  - Does the company have strong controls over the enrollment and member reconciliation process?
- **Sustainable operating cost model**
  - Does the company's headcount model balance between efficiency and achieving projected growth?

Key diligence considerations

- Analyze plan's different provider contract models and understand financial implications of such
- Coordinate with independent actuaries to review key reserve accounts and stress-test methods and assumptions employed by target
- Analyze third-party settlement balances
- Analyze historical product-type performance (e.g., trended medical loss ratio) to determine whether forecasted growth is consistent with historical experience
- Assess plan's mix of business (upside only, limited risk, global risk) to understand risk exposures
- Assess whether historical accounts receivable estimates have been realized through subsequent cash receipts
- Analyze labor metrics and costs

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Net debt

Overview

The importance of net debt for buyer and lender:

- Identifies on- and off-balance sheet (BS) obligations that need to be either settled upon the transaction close or by the buyer subsequent to close.
- Agreed-upon net debt items are direct reductions to the purchase price (i.e., the seller is responsible to settle the net debt items with the proceeds from the sale and the seller's cash on hand upon close).
- Different points of view: The seller wants limited net debt items, resulting in a higher net purchase price. The buyer seeks for more net debt items, so it does not have to cover future cash outflow.

Gross purchase price
$200m paid to seller

Net debt
$25m is paid by seller with proceeds

Net purchase price[1]
$175m

[1] Exclusive of purchase price adjustments for cash, working capital, transaction expenses and other matters

Examples

The identified net debt items are a negotiation between the sellers and buyers. The agreed-upon net debt items are generally included within the purchase agreement within the definition of indebtedness:

- Example 1: Annual bonuses vs. quarterly/monthly bonuses:
  - Estimated closing date: March 1, 2023
  - Due diligence net debt period: January 31, 2023
  - Negotiation:
    - Annual bonuses: If the target paid annual bonuses each March for the services in the prior year, the seller should be responsible for paying the accrued bonuses (e.g., included within the purchase agreement's definition of indebtedness) as they received the benefits of the employee's work during that period. The accrued bonuses for January through March of the 2023 could also be negotiated.
    - Quarterly/monthly bonuses: This is similar to the January through March 2023 bonus above, in that it is an item that could be negotiated, so the period in which the seller received a benefit is less than a full year's benefit.
- Example 2: COVID-19 liabilities:
  - Due to the COVID-19 pandemic, sellers have numerous liabilities (e.g., deferred employer payroll taxes due in FY20 and FY21 and potential payback of PPP loans) that need to be considered for net debt. Payroll taxes are generally not included within net debt but since the deferred taxes are in a form of extended liquidity, the seller should be responsible to cover the liability.

Some examples of net debt and debt-like items

Net debt

- Short- and long-term borrowings
- Accrued interest payable
- Finance leases
- Less: Cash and cash equivalents

Debt-like items

- Past due accounts payable (A/P)
- Taxation/escheatment
- Deferred revenue
- Commitments and contingencies
- Long-term provisions that will translate into long-term level of fixed assets creditors
- Transaction costs/bonuses
- Overdue patient refunds/credit balances within A/R
- Shortfall in risk-based capital
- Pension funding shortfall and other long-term benefit obligations
- Malpractice settlements
- Third-party payer settlements

Examples of off-balance sheet items

- Factored, securitized and discounted trade receivables
- Financial instruments valued at fair market value
- Deferred capital expenditures
- Breakage costs on financial instruments
- Letters of credit/other credit commitments (e.g., surety bonds)
- Committed capital expenditures

Example of sell-side vs. buy-side net debt

839	Sell side			Buy side		
Currency: $000	On BS	Off BS	Total	On BS	Off BS	Total
Financial indebtedness						
Term loans	2,862	–	2,862	2,862	1,500	4,362
Accrued interest	n.q	n.q	–	n.q	n.q	–
Total financial indebtedness	**2,862**	**–**	**2,862**	**2,862**	**1,500**	**4,362**
Cash and cash equivalents	(16)	–	(16)	(16)	–	(16)
Net financial indebtedness	**2,846**	**–**	**2,846**	**2,846**	**1,500**	**4,346**
Other items that may be considered as indebtedness						
Management bonuses	–	–	–	314	473	787
Tax provisions	348	–	348	348	–	348
Committed capital expenditures	–	–	–	58	240	298
Provisions for anniversary bonuses	228	–	228	228	–	228
Provision for severance payments	263	–	263	263	–	263
Provision for impending losses	–	–	–	40	n.q	40
Acquisition-related contingencies	–	–	n.q	n.q	n.q	n.q
Legal matters	–	–	n.q	n.q	n.q	n.q
Tax matters	–	–	n.q	n.q	n.q	n.q
Total other items that may be considered as indebtedness	**839**	**–**	**839**	**1,251**	**713**	**1,964**
Net debt and debt-like items	**3,685**	**–**	**3,685**	**4,097**	**2,213**	**6,310**
Other considerations						
Operating leases	*n/a*	2,360	2,360	*n/a*	2,360	2,360
COVID-19 funding	–	–	–	*n/a*	250	250
Trade A/R due from affiliated companies	54	–	54	54	–	54
Trade A/P due to affiliated companies	31	–	31	31	–	31
Patient credit balances and refunds	–	–	–	30	n.q.	30
Holding company guarantees	–	–	–	n.q.	n.q.	–
Total other considerations	**85**	**2,360**	**2,445**	**115**	**2,610**	**2,725**

n.q. - non-quantified

04

Net working capital

Overview

What is net working capital (NWC)?

- Generally: Current assets, less current liabilities, excluding cash, indebtedness and income taxes.
- All items identified in the net debt analysis, which are within current assets and liabilities, need to be removed from net working capital.

Why is NWC important?

- **Modeling importance**: Change in NWC is a key component to derive free cash flow and, in turn, debt pay-down.
- **Financing importance**: Understanding "peak to trough" inter- and intra-month NWC trends to assess revolver facility size.
- **Valuation importance:** Calculated enterprise value (EV) for a business typically contemplates a "normal level" of delivered NWC. Absent this concept, sellers could plunder corporate coffers between signing and closing through asset monetization and liability deferrals.

NWC peg overview

- Many sales and purchase agreements (SPAs) include an adjustment for the difference between a predetermined target NWC and a closing NWC, which is called the NWC peg.
- Makes buyer whole, dollar for dollar, for any deviation in delivered NWC vs. "normal" level of NWC (contemplated in EV of target).
- Locked box arrangements are becoming increasingly common.

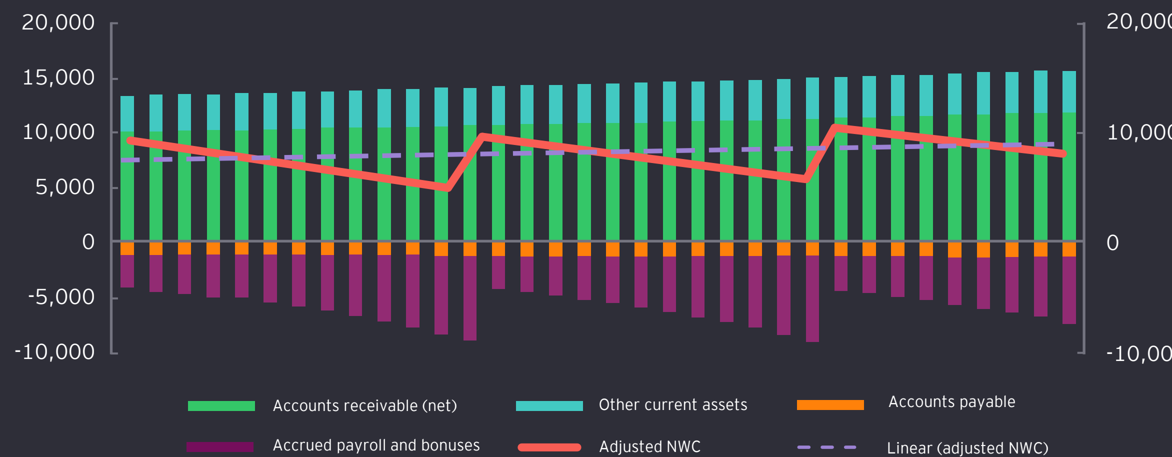
Peg example

Key considerations

Setting the SPA peg amount is a key consideration as the difference between the delivered NWC and the SPA peg results in a direct adjustment to the purchase price.

For provider-focused deals, the main driver in NWC is accounts receivable and accrued payroll/bonuses, so it is important to understand the items such as the timing of payroll and bonuses payouts. The presented schedules show an example at how the timing of close (e.g., the NWC peg true-up date) can impact how the SPA peg is set and the corresponding purchase price true-up.

Currency: $000	Dec22	T3M avg	T6M avg	TTM Sep23 avg
NWC peg based on the applicable dates	5,712	8,503	9,025	8,657
Closing NWC at December 31, 2021	6,000	6,000	6,000	6,000
True-up payment/(receipt)	**288**	**(2,503)**	**(3,025)**	**(2,657)**



Currency: $000	Oct22	Nov22	Dec22	Jan23	Feb23	Mar23	Apr23	May23	Jun23	Jul23	Aug23	Sep23	T3M avg	T6M avg	TTM Sep23 avg
Accounts receivable (net)	11,104	11,160	11,216	11,272	11,328	11,385	11,442	11,499	11,556	11,614	11,672	11,730	11,672	11,586	11,415
Other current assets	3,663	3,682	3,700	3,718	3,737	3,756	3,774	3,793	3,812	3,831	3,851	3,870	3,851	3,822	3,766
Total current assets	**14,767**	**14,842**	**14,916**	**14,990**	**15,065**	**15,141**	**15,216**	**15,292**	**15,368**	**15,445**	**15,523**	**15,600**	**15,523**	**15,408**	**15,181**
Accounts payable	(1,448)	(1,455)	(1,462)	(1,470)	(1,477)	(1,484)	(1,492)	(1,499)	(1,507)	(1,514)	(1,522)	(1,530)	(1,522)	(1,511)	(1,488)
Accrued payroll and bonuses	(6,516)	(7,102)	(7,741)	(3,000)	(3,270)	(3,564)	(3,885)	(4,235)	(4,616)	(5,031)	(5,484)	(5,978)	(5,498)	(4,872)	(5,035)
Total current liabilities	**(7,964)**	**(8,557)**	**(9,203)**	**(4,470)**	**(4,747)**	**(5,048)**	**(5,377)**	**(5,734)**	**(6,123)**	**(6,545)**	**(7,006)**	**(7,508)**	**(7,020)**	**(6,383)**	**(6,523)**
Adjusted NWC	6,803	6,285	5,713	10,520	10,318	10,093	9,839	9,558	9,245	8,900	8,517	8,092	8,503	9,025	8,658

Appendix: Prior-period reserve development example

Out-of-period earnings impacts can be large if the company is inaccurate or inconsistent with its reserve estimation process.

Multiyear reserve example

Methodology

- As claims experience emerges in the following period due to receipt and payment, actuarial estimates are adjusted and often result in meaningful adjustments to prior-period liabilities.
- If prior-period reserve development is favorable in one year and unfavorable in the next year, this can lead to large swings to earnings trends when activity is placed in the correct year.

Diligence procedures

- Coordinate with actuarial specialist to independently assess reserves. Review disclosures and underlying reserve support to determine out of period or other areas of management judgement.

In $000s	FY20	FY21	FY22
Reserve, beginning of year (A)	**8,700**	**11,600**	**15,300**
Claims expense			
Current year (Known claims + IBNR estimate)	149,000	179,000	220,000
Prior-year expense (income)	(1,000)	(2,000)	1,000
Net claims expense (B)	**148,000**	**177,000**	**221,000**
Claims paid			
Current year cash paid	138,000	163,000	200,000
Prior-year cash paid	7,100	10,300	16,000
Net claims paid (C)	**145,100**	**173,300**	**216,000**
Reserve, end of year (A + B - C)	**11,600**	**15,300**	**20,300**
EBITDA adjustment			
Reported EBITDA	7,000	9,000	11,000
Reverse prior-year impact of claims expense	(1,000)	(2,000)	1,000
Claims (expense) to correct period	2,000	(1,000)	N/A
Current year expense impact of actuarial assessment	-	-	(500)
Net income (expense) impact	**1,000**	**(3,000)**	**500**
Adjusted EBITDA	**8,000**	**6,000**	**11,500**

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