M&A Due Diligence

Seven Things the C-Suite Should Know About **IT**

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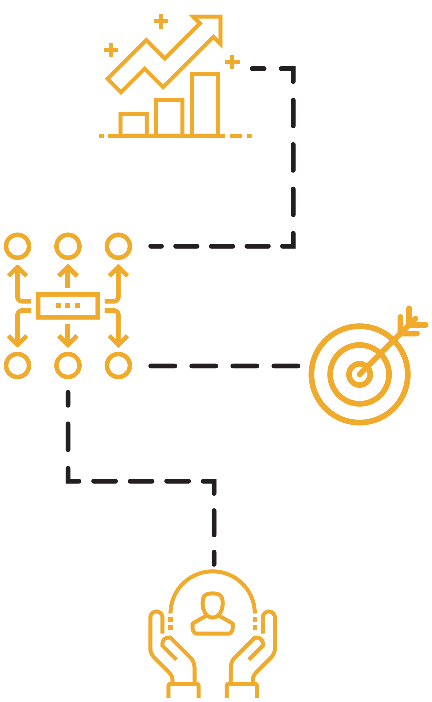
Until recently, many mergers and acquisitions took the form of a "holding company" approach as it pertained to IT assets and services. That is, acquisitions would largely function independently with their own IT organizations and only integrate where needed. Informed by experience working with many organizations before, during and following integration, our perspective is that this holding company model of IT integration for acquired entities is inadequate to meet the demands of today's market.

Today numerous market demands and internal, enterprise requirements for IT — including digital health and IT's role in advancing strategic imperatives and cost containment — often require integrating the IT platform of acquired entities more closely with the acquiring institution. As a result, it is more critical than ever to consider IT in early stages of M&A due diligence. Assessing the IT landscape and costs is a key step in getting the deal's financial model right and setting the course for a successful integration and post-Day One transition.

DIGITAL HEALTH

Consumer adoption of virtual care services has grown from 28 percent to over 53 percent in the past three years.[1]

When choosing a specialist, consumers prefer — by a four-to-one margin — to see a physician that has online scheduling even if there is less availability.[2] Consumer demand for digital health services is accelerating, and with it the expectations of a consistent, efficient and superior customer experience. Given virtual competition is increasing and consumer switching costs are being lowered, M&A activities must consider — from the earliest days of planning — both alignment of their technology platform and IT services with their overall digital strategy and the potential impact of digital health service disruption. Acquiring organizations must integrate (and wherever possible standardize) IT services, as the traditional holding company approach (e.g., acquired organizations maintain respective IT platforms) is obsolete and won't meet digital health demands.



ADVANCING STRATEGIC IMPERATIVES

Health systems face high-stakes expectations to realize the full benefits of integration, and IT's impact on the success of an acquisition is significant and will continue to increase.

While IT typically accounts for less than five percent of a health system's operating expense, it is not unusual for over 75 percent of an organization's strategic initiatives to have direct IT requirements. IT is imperative to achieving the intended benefits of the transaction and positioning the combined enterprise for true value creation — whether driving growth, improving affordability and access, advancing marquee programs and value-based care or driving further community benefit. Operations and IT must work side by side beginning in the earliest phases of a merger or acquisition to identify target benefits and map out the operational readiness plan to achieve them.

COST CONTAINMENT

The true IT costs and potential savings opportunities that could be unlocked by the partnership must be considered in developing the definitive agreement.

We have found that developing an IT cost model and associated IT budget early in the acquisition process is critical to understanding the total cost of the acquisition and can materially impact the value and success of the deal. Some partnerships have been abandoned as the time and cost required to integrate information systems such as EHRs and ERP solutions were found to outweigh the potential synergies. Some acquirers have been forced to make unplanned expenditures to mitigate longstanding technology and infrastructure or cybersecurity deficiencies of the party they were acquiring, while other organizations have needed to salvage major implementation programs that were neglected during transaction discussions. Divestitures involve added complexity as an acquirer must fully understand the cost implications of continuing to pay for IT support from the divestor during the post-close IT transition period. In addition to the overarching transition services agreement (TSA), it is critical to define and negotiate the terms of an IT-specific TSA during due diligence to avoid undue costs or missed expectations in service delivery during the transition period. Outside of payor contracts, this is one of the larger risk-mitigating efforts in an asset transfer.

It is mission critical for the full executive suite to know the key IT areas during due diligence to dramatically reduce acquisition costs, risks and time to completion. Below are seven leading practices you can follow during due diligence to position your enterprise for success during an acquisition.

1. Plan for rapid transition to a common, integrated IT services platform

Set expectations and lay the strategic groundwork with key stakeholders from both entities during due diligence to convert to a standard set of IT tools and services once — and as quickly as possible — to maximize integration benefits. This usually requires a small IT team to review IT expectations, major system upgrades and enhancements of major systems, and leadership commitment to supplement IT staffing to quickly transition.

The team should conduct an application review and a high-level roadmap with a consolidated approach and budget. The platforms that need to be consolidated/integrated Day One or shortly thereafter must be identified. This usually includes human resources, finance, supply chain, provisioning, email, badging and executive reporting. Clinical and revenue cycle system transitions represent an even more complex undertaking and lengthy timeline, typically requiring 6–12 months post-close to integrate. Remaining platforms should be transitioned (or decommissioned) by Year Two. For example, Chartis recently supported IT integration in an acquisition whereby this approach helped reduce the IT operational costs of the acquired entities by 40 percent within two years.

A rapid IT transition usually requires considerable workforce retraining, so the team is operationally ready for the change. By “bundling” this training with the transition’s other operational retraining efforts, it is far more effective (and less expensive or disruptive) than a delayed IT transition.

You can measure the value of a rapid transition by improved end-user satisfaction, increased workflow standardization and staffing, more comprehensive and accurate reporting and analytics and improved support for future business transactions. It is the fastest and most effective way to provide a unified "digital front door" for digital health services and realize strategic benefits from the transaction, including cost containment.

2. Know the data part of the deal

You may assume that information pertaining to patients, insurers, physicians and general operations are part of the transaction, which may be true if you are acquiring an independent entity. However, if you are pursuing a divestiture, the target's parent company may think you will receive only what is mandated by legal statute.

The data is one of the most valuable assets you will obtain. It is critical to assess what information exists, where it is kept, what is the relative data quality and what is needed to collect and transform that data for the acquired organization. Before you move beyond due diligence, ensure that key questions like these are answered:

- What happens with the original data? Do you get a subset of the information and does it remain shared with the target's parent company or should it be destroyed?
- How will co-mingled data be addressed and migrated?
- Is this data secure?
- Is it kept in the cloud or on site?
- What are the legal, financial, quality-of-care and overall customer service implications?

Answering these questions effectively requires very close coordination between your IT and operations teams during the due diligence process. Be sure to include expectations on data availability and acquisition in the definitive agreement.

3. Understand IT staffing and the contractual obligations and model a pro forma alongside the rest of the deal

IT staffing accounts for the largest cost driver in IT, typically accounting for more than 40 percent of IT operating costs. Understanding the organizational structure, IT staffing costs and shadow IT staffing costs is important to understanding the overall IT portfolio investment and go-forward potential implications.

Similarly, properly assessing IT contract obligations in due diligence can reduce your near-term IT cost exposure by 20 percent or more. Contracts are usually the second largest IT operating expense after salaries and are difficult to analyze, burdened by numerous revisions over the years. Also, IT contracts are often managed by the IT department instead of purchasing and as a result, are often overlooked in traditional due diligence purchasing-led reviews. Establishing educated positions on major IT contracts early — with a focus on terminations — can lead to substantial savings. While it may not be possible to get full access to the contracts in due diligence, it is possible to obtain a blinded assessment with key considerations like length and termination clauses. Most major IT vendor contracts require at least six months cancellation notification, so early reviews can help right-size coverage and minimize termination penalties. With presumed public anonymity during due diligence, you are probably in the strongest negotiating position with vendors before a deal becomes public.

These staffing costs and IT contractual obligations and costs are a critical component of the acquisition integration's total IT capital and operating expenses, and they are a key input to modeling a realistic pro forma along with the rest of the deal.

4. Solidify IT transition terms as part of the overall agreement for divestitures

Most transactions that involve acquiring an entity from a larger parent company will require material IT transition assistance and continued access to the target's IT services for up to a year or more after close. Many health systems underestimate the effort required from the divesting entity after Day One and make the mistake of addressing IT transition support only after the overall agreement is reached. By then, the divesting parent entity is far more focused on its core IT constituents and presumes your organization will fund all necessary support costs post-Day One — at whatever service level they can provide.

In divestiture deals, create a formal IT TSA that outlines the divesting entity's responsibilities for providing appropriate IT services pre- and post-close and the costs for those services. Insist on defined service levels (with financial penalties if not met) and include all vendor expenses and key transition commitments. These are very different from other organizational-focused TSAs, so include legal counsel with IT-specific experience and IT team members in the TSA development and negotiation in the due diligence phase.

One client avoided **$10 million** in unforeseen IT transition costs by creating a strong TSA in due diligence.

5. Review recent cybersecurity audit findings and insist on a follow-up third-party audit just before deal closing

There is no shortage of headlines and data highlighting the impact of cyberthreats. The fact that many healthcare acquisition targets are financially distressed also means they are likely to have underinvested in IT and preventive cybersecurity measures.

Review cybersecurity audits to identify compromised — and thus devalued — IT assets included in the deal and the remediation/preventive maintenance programs in place to guard against future attacks. To mitigate the risks you uncover, adjust the acquisition value and/or include cybersecurity remediation requirements in the definitive agreement. Another important and related safeguard is to insist on a follow-up third-party audit just before deal closing.

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6. Understand your facility IT

Creating a common patient and employee experience and brand across the integrated organizations requires common "smart" building technology such as building access, digital signage, wayfinding kiosks and smart patient rooms. If you expect employees to work across merged facilities, then integrated building access, timecard devices and security monitoring becomes critical.

Ensure joint IT/facility teams conduct site/physical plant assessments and answer key questions like:

- Is the physical communication network sufficient? (If not, it can take over six months to upgrade a hospital at a cost of over $200/device.)
- Can the facility equipment "talk" to one another?
- Can employees utilize badges across facilities or is an investment needed to standardize?
- Is asset tracking in place to avoid equipment "disappearing" on Day One?

A new ambulatory facility can cost $100-120/square foot for IT. What expenses are hiding in your newly acquired, old facilities? Knowing that information up front will be an important decision point as you evaluate the deal.

7. Set the stage for success with IT and operations working side by side

It is never too early to set the stage for integration success, even during due diligence. Operations and IT must be in lockstep to ensure the due diligence accurately reflects the operational and IT implications to valuation and realizes the intended organizational and community benefit from the deal. It is also helpful to set the stage for successful integration if the deal proceeds.

Clinical and corporate functions leadership will set the overall system strategic vision and operational and clinical direction. Operations and IT must work together to determine the risk, high-level operational transition timelines and the IT implications and constraints — and, importantly, plan for how to ready the organization for the changes.

Are IT and operations working in lockstep or in separate parallel paths? Critical decision points during due diligence and the resultant integration success depends on their working side by side — to ultimately support digital health demands, strategic imperatives and cost containment.

Moving Forward

Market demands ranging from digital health to cost containment are all making IT a critical component of any early-stage M&A efforts. Focusing on these seven key areas during due diligence will prepare your organization to make a more informed business decision on acquisition strategy, along with helping your organization dramatically reduce IT costs associated with acquisition and accelerate the time to reach the targeted business benefits of integration.

Sources

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About The Chartis Group

The Chartis Group® (Chartis) provides comprehensive advisory services and analytics to the healthcare industry. With an unparalleled depth of expertise in strategic planning, performance excellence, informatics and technology, and health analytics, Chartis helps leading academic medical centers, integrated delivery networks, children's hospitals and healthcare service organizations achieve transformative results. Chartis has offices in Atlanta, Boston, Chicago, New York, Minneapolis and San Francisco. For more information, visit www.chartis.com.

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