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Healthcare Consulting | Valuation

Partner Insight Series:

The QofE: An Essential Tool in Your Arsenal

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How are Quality of Earnings Reports being used in the Transaction Process?

The primary purpose of a Quality of Earnings Analysis ("QofE") in a business enterprise transaction is to normalize EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) to assist with valuation, financing, and establishing the purchase price. This process also allows both buyers and sellers to build their respective analyses on validated financial information. In theory, this process is objective and should not favor the buyer or the seller. However, as market dynamics have shifted over the last three years, we have begun to see the QofE used strategically in the negotiation process to achieve a particular party's desired results.

To understand how this tool is being leveraged today, one must first understand the purpose of a QofE and its main objectives, summarized below.

Purpose

- Validate financials and underlying documentation.
- Identify opportunities for growth and/or improvement.
- Identify threats to future cash flows.
- Assist with negotiations and setting Net Working Capital targets.

Services

- Analysis of the quality and stability of the company's revenue streams and cash flow, which could include development of waterfall analyses and/or detailed revenue modeling.
- Assessment of normalized EBITDA, including identification of one-time and non-recurring items and scrutiny of proposed adjustments.
- Analysis of debt and net working capital.
- Cash to accrual conversion.
- Correction of timing and/or accounting issues.

While the procedures performed in a Quality of Earnings engagement generally do not vary for buyers or sellers, the uses and perceived benefits may.

Buyer's Perspective

For buyers, a QofE is a well-known and accepted component of the due diligence phase, and they typically view the cost of a Quality of Earnings as justified by the value this analysis adds to their decision-making process. Buy-side QofEs summarize the historical success of an acquisition target, validate seller-proposed adjustments to EBITDA, and ensure that accounting methodologies are sound, all of which provides a buyer peace of mind that unknown accounting or financial errors will not diminish future returns.

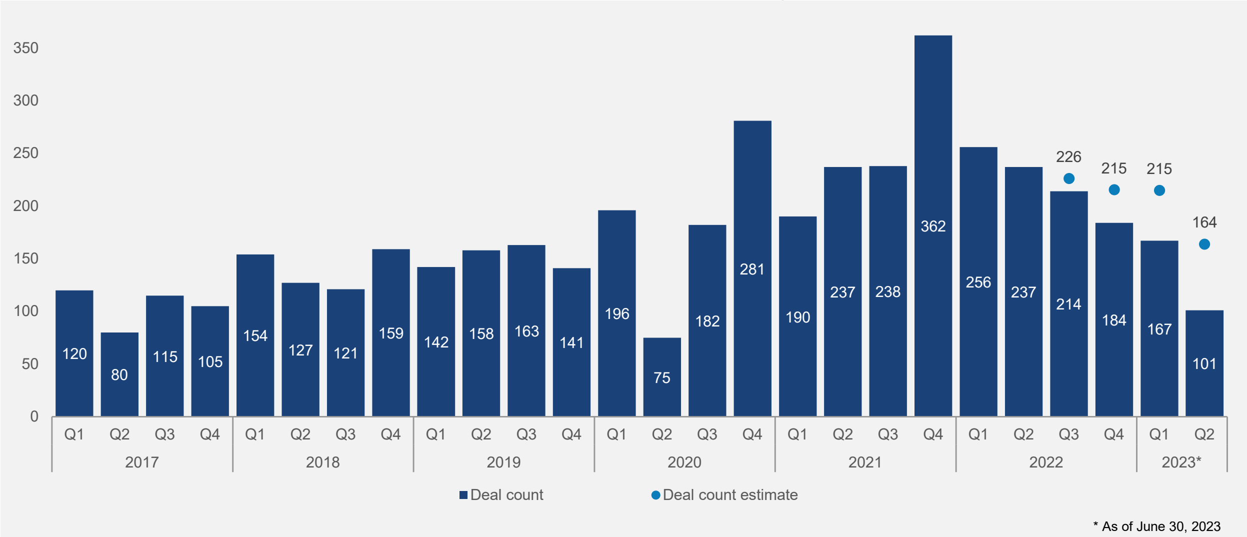
Seller's Perspective

Initially not as valued by sellers, the sell-side QofE is a proven tool that not only helps sellers prepare for a transaction but also assists in the brainstorming of key negotiating points. Engaging an accounting firm to perform a sell-side QofE allows the seller to calculate reasonable EBITDA adjustments that are supported by reliable data, understand areas of risk that a buyer might try to exploit, help management understand and aggregate data that a buy-side team will request, and ultimately streamline the transaction process.

QofE Value Magnified even as Transactions Slow

In the past ten years, the healthcare industry has experienced a wave of transaction activity. Private equity ("PE") transaction activity in the healthcare sector peaked in 2021 with over 1,027 deals closing that year[1], and many of the country's largest hospitals and health systems were acquisitive. However, in the past eighteen months both the quantity and value of healthcare transactions have experienced downward pressure from macroeconomic uncertainty in the U.S., rising interest rates, and heightened antitrust concerns. Beginning in the second half of 2022 and continuing into early 2023, the number of large hospital and health system transactions have decreased, as these have faced particular scrutiny from the Federal Trade Commission ("FTC") and typically require larger amounts of debt funding due to their size.

Healthcare Services PE Deals by Quarter



Derived from data contained in "Industry Research: Healthcare Services Report – Q2 2023" published by PitchBook.

As noted above, 2021 saw fast-paced deal activity where financial diligence often took a backseat to getting a deal completed while interest rates were low and access to capital was high. With transaction volumes slowing in recent years, many might have expected QofE volume to decline along with it. However, we have experienced the opposite; more potential buyers and sellers are now engaging a firm to perform a QofE, and these QofEs have a more influential role in the transaction and diligence process. It is apparent that diligence is becoming more valued today as deals are inherently becoming riskier within the current transaction ecosystem.

Banks are Requiring QofEs

Banks have historically requested QofEs to understand the reliability and sustainability of a target company's earnings. However, as the overall transaction landscape tightens, we have seen banks rely more heavily on these reports to assess the associated risks and ultimately determine to what extent credit will be extended.

[1] Pitchbook Data, Inc. (2023, August 11). *Industry Research: Healthcare Services Report, Q2 2023*.

Investment Banks and Brokers are Encouraging Sell-Side QofEs

As buy-side gears up its diligence efforts, sell-side brokers and investment banks ("IBs") are encouraging their clients to do the same. No one wants to be caught flat-footed, and a sell-side QofE helps sellers prepare for a buyer's potential questions and concerns. This may not have been as important in 2021 when it seemed that transactions were being completed no matter what risks the diligence process uncovered, but today, deals are taking longer and diligence is heavily influencing a buyer's offer.

Unfortunately, sellers may perceive this as an unnecessary transaction cost. In recent conversations with our IB partners, some sellers are pushing back, claiming that pre-transaction financial documentation preparation should be the responsibility of the IB firm. While the IB does prepare the vast majority of the marketing and forecasting material, a QofE provides a deep dive into the historical accounting and financial mechanisms of the company, which is best done by an experienced CPA firm. In the words of one IB partner, "we [the IB] could get roughly 90% of the transaction's legal structure and requirements in line, but the last 10% is extremely important and requires a transaction attorney. In a similar fashion, we could do 90% of the diligence for a deal, but the last 10% would require a reputable accounting firm." A sell-side QofE arms investment bankers with the necessary financial information to be included in the marketing materials and is viewed more objectively than if the information were prepared by the seller's representatives, who are inherently incentivized to achieve a higher transaction value. Sellers are also pushing back on the additional costs because QofE firms typically do not work on contingent fees, but rather get paid for their services regardless of whether the deal goes through. Because of this, sellers run the risk of incurring significant fees but still not getting the deal closed. In contrast, IBs usually operate on success fees, are not paid until a deal closes, and are paid from the sale proceeds.

Healthcare Complexities

A well-done QofE should investigate all aspects of the complex and ever-changing nuances of healthcare companies. Payer dynamics, staffing structures, policy changes, and governmental program reimbursement all make historical earnings less replicable, but a QofE can help both parties understand the underlying risks and become aware of the external factors that may impact the company the most. Further, recent changes within the entity (new providers, new locations, new services lines/service offerings, etc.) might not be fully captured within the historical trailing twelve-month ("TTM") financial picture of the organization, thus the seller could be leaving value on the table if the potential incremental EBITDA derived from those changes is not quantified.

For example, most small to middle-market healthcare organizations maintain their financials on a cash basis. If the organization has been experiencing high growth, the cash basis revenue is not going to fully capture that growth, particularly when a typical healthcare revenue cycle can be anywhere from 1 to 12 months long. Further, on a recent QofE we performed, the physician organization opened a new ambulatory surgery center ("ASC") that expanded their capacity and allowed the providers to shift services they historically performed in a hospital setting to their own ASC. JTaylor was able to identify the non-recurring start-up costs associated with this new facility, quantify the increase in volume and associated reimbursement, and propose a pro forma adjustment to the TTM EBITDA that would reflect the true value the sellers brought to the transaction that was not fully captured in the historical earnings the transaction price was being based upon.

Another Tool in Negotiations

With increased fees spent on financial due diligence, involved parties are formulating unique ways to use the QofE strategically in negotiations. Buyers and sellers have different perspectives within a transaction and will therefore use this tool in different ways. Below are a few effective tactics we have seen utilized on each side of the equation.

Buy-Side:

- **General Diligence and Peace-of-Mind:** The buy-side QofE is a common tool used to validate the historical financial information and proposed adjustments made by the seller. This analysis gives a buyer confidence that the historical operating results of a business have been substantiated and reduces the risk of surprises that may impact future earnings.

- **Use the Buy-Side Diligence Team as a Buffer:** During negotiations, buyers often leverage their diligence team to create counter arguments backed by detailed financial models or analyses. Seller-proposed adjustments will typically only be accepted if the buyer's diligence team has independently validated them. We often hear buyers reject adjustments because "our QofE team couldn't get home on it," which is a way to deflect responsibility to the third-party diligence team. This allows the buyer to preserve their relationship with the seller as negotiations continue, and potentially during a post-transaction transition period.

Sell-Side:

- **Combat Buy-Side Assertions:** Without a sell-side QofE, sellers have little firepower to refute claims made or concerns raised by a buy-side QofE team. Having a QofE team on their side helps the seller level the playing field and provides an opportunity to question the buy-side's findings.

- **Propose Validated EBITDA Adjustments:** A sell-side QofE helps ensure that seller-proposed EBITDA adjustments have merit and can be supported by historical data and/or assumptions impacting future earnings potential. Without a sell-side QofE, we have seen proposed adjustments picked apart by a buyer because of the lack of diligence supporting the adjustments. A sell-side team will help identify reasonable adjustments, build supporting models, and formulate a presentation strategy. Although a reputable sell-side team won't propose baseless adjustments, they will generally be more likely to propose adjustments when warranted by the facts and circumstances.

- **Expedite Transaction Process:** Overall, a sell-side QofE helps make the transaction a quicker and smoother process by establishing a starting point that can be trusted by the buyer more than information provided by the seller alone. A buyer will still perform their own diligence, but will have more readily available information that has already been vetted, and the seller's diligence team will already be ramped up and prepared to respond to any questions or concerns that may arise.

Final Thoughts

While each side of a transaction has their own agenda, both can benefit from a QofE performed by a reputable accounting firm. Buyers can utilize a QofE to protect themselves financially, but also to maintain a positive working relationship with the seller by using the QofE firm as a buffer – particularly in situations where the seller is going to continue to be involved in the business post-transaction. Meanwhile, sellers can utilize a QofE to maximize their potential value in the market – and associated sales price – and arm themselves with additional supportive team members who understand their business and can speak intelligently on complex accounting matters.

We can all agree that both sides (buyer and seller) having reliable, timely, and accurate financial information regarding the acquisition target leads to a higher likelihood of a successful transaction.

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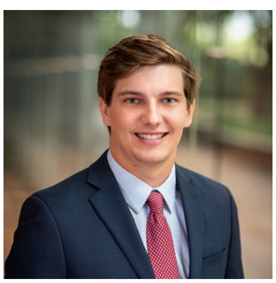
Julie specializes in providing comprehensive consulting and valuation services. With a primary focus on the healthcare industry, her skills encompass due diligence for mergers and acquisitions, quality of revenue/earnings evaluations, transaction support, business valuations, and fair market value assessments. Within the healthcare sector, Julie has successfully served diverse clients, including local and multi-specialty physician practices, large multi-hospital health systems, ambulatory surgery centers, national physician management companies, and private equity firms specializing in healthcare acquisitions.



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