

The Due Diligence Imperative: Competition

Part 4 of a 6 Part Series

As discussed in the first installment of this six-part series, *due diligence* may be generally defined as:

- (1) “such a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case”; and,
- (2) “an investigation in order to support the purchase price of the business.”¹

There are two distinct classes of information generally required for *due diligence* related to a healthcare valuation engagement:

- (1) *General research* – Research that is not specifically related to, or obtained from, the subject *enterprise, asset, or service* being appraised; and,
- (2) *Specific research* – Information specific to the subject *enterprise, asset, or service*, that is typically obtained from the subject entity, or the appropriate contact designated by the subject entity.²

The first part of this six-part series set forth an overview of the due diligence imperative for valuation professionals, in the context of the *Four Pillars of Healthcare Value*, i.e., *Reimbursement, Regulatory, Technology, and Competition*.³ The second and third installments reviewed the due diligence process related to the *reimbursement* and *regulatory* environments, respectively. This fourth installment will review the due diligence process as relates to *competition* in the healthcare industry.

Professor Michael Porter, MBA, PhD, of Harvard University,⁴ the author of 19 books and over 125 published articles, is considered to be one of the world’s leading authorities on competitive strategy and international competitiveness. In his book, “*On Competition*,” Dr. Porter discusses the need to analyze the competitive environment within the framework of the “*Five Competitive Forces that Shape Strategy*,” which asserts that all businesses operate within a competitive marketplace defined by an underlying structure comprised of the following five competitive forces:

- (1) Threat of new market entrants;
- (2) Bargaining power of suppliers;
- (3) Threat of substitute products or services;
- (4) Bargaining power of buyers; and,
- (5) Rivalry among existing firms.⁵

Heated debate has persisted related to the potential benefits and costs of free market competition within the healthcare industry. While proponents of free market competition claim that competition can reduce costs, increase quality, improve efficiency, and provide an incentive to innovate,⁶ opponents argue that there are unique differences between the healthcare provider and payor markets and the markets for other industry sectors; therefore, generally applied economic models cannot be adequately utilized to draw conclusions related to outcomes within the U.S. healthcare delivery system.⁷

The various regulations that govern competition in the U.S. healthcare industry also differentiate it from the other industries. For example, state *Certificate of Need (CON)* programs are aimed at restraining healthcare facility costs and facilitating coordinated planning of new services and facility construction.⁸ These CON laws act as barriers to entry in the healthcare industry, restraining competition.

In conducting the *general research* for the competitive analysis related to the subject interest being appraised, the analyst should:

- (1) Develop a working knowledge related to the competitive environment in the subject interest’s location;
- (2) Obtain the data required to conduct a financial benchmarking study of the competitors in the geographic area proximate to the subject interest; and,
- (3) Based on that data, reach a requisite understanding of the competition in the marketplace.

This process will allow the analyst to appropriately develop their observations, findings, conclusions, and opinion, and determine any necessary assumptions to be made regarding the appraisal of the subject property interest.

Some of the valuation techniques for which the general research is useful are: (1) financial ratio benchmarking;

and, (2) a determination of the specific competitors in the market service area of the subject interest.

In order to compare the subject interest's financial performance to others in the industry, the analyst may utilize industry normative benchmarking survey data, as well as the financial data of publicly traded firms, depending on the type of subject interest being appraised.

To determine the competitors in the market service area of the subject interest,⁹ the analyst may consider factors such as: geographic location; types of services provided; the size of the entity; the ownership structure of the entity; and, the socio-economic demography of the relevant market service area. Upon constructing a list of competitors, the analyst may collect information pertaining to these competitors, such as: financial information, size, services provided, and type of facility.

Information that can assist the analyst in collecting pertinent data related to market service area includes, but is not limited to:

- (1) Federal and state government antitrust laws that are applicable to the entity;
- (2) CON laws of the state(s) in which the subject interest is located;
- (3) Benchmarks for patient population;
- (4) Physician information;
- (5) Profiles of competitors; and,
- (6) Financial information of competitors.

The various sources of information (some of which sources are free, and some of which are available for purchase) that may contain this data includes, but is not limited to:

- (1) *American Hospital Directory (AHD)*, which "provides data and statistics about more than 7,000 hospitals nationwide... [and] includes both public and private sources such as Medicare claims data, hospital cost reports, and commercial licensors";¹⁰
- (2) *American Health Care Association (AHCA)*, which provides "cutting edge, comprehensive research and data concerning the long term and post-acute care sector";¹¹
- (3) *United States Census Bureau*, American Fact Finder, which provides data, such as population, income, and the number and type of businesses in a state, county, city, town, or zip code level;¹²
- (4) Specific websites of the state in which the subject interest is located (e.g., the Secretary of State website, state office of insurance regulation);
- (5) *U.S. Securities and Exchange Commission (SEC)*, *Electronic Data Gathering, Analysis, and Retrieval System (EDGAR)*, company filings, which provides "free access to more than 21 million filings," which filings typically contain financial information and competitive market analysis;¹³

- (6) *The Risk Management Association (RMA)* Annual Studies Financial Ratio Benchmarks (organized by NAICS code);¹⁴
- (7) *Bizminer*, Multiple Year Industry Financial Report (organized by NAICS code);¹⁵ and,
- (8) *Microbilt Integra*, Multiple Year Industry Report (organized by specific NAICS code).¹⁶

The above materials present some of the data sources and means by which the analyst may gather information regarding the competitive environment in the healthcare industry, the laws and regulations governing it, and information about particular competitors, specific to the subject interest, to facilitate the analyst's assumptions and calculations necessary in developing a *Fair Market Value* opinion.

As noted above, *specific research* is typically collected from the subject interest, and specifically from the client; the appropriate contact designated by the client, e.g., *chief information officer (CIO)*, *chief financial officer (CFO)*; or, legal counsel, when pertinent. As the requested documents and information are gathered, an engagement-specific database may be useful to appropriately account for the data in a manner that adequately *identifies, classifies, and stores* it, so that it may be timely and efficiently *retrieved* for use (ICSR).

The data requested of, and obtained from, the subject interest to determine the pertinent competitors should include information that may be used to define the market service area, as well as financial information, and strategies used by the subject interest to differentiate itself from its competitors. The information and documents to be requested from the subject interest may include, but are not limited to:

- (1) Patient location zip code distribution report;
- (2) Marketing plans and marketing materials;
- (3) Any market service area analysis for the subject interest, including any documents and information which may address the origin (e.g., zip codes) of the subject interest's patients;
- (4) Any utilization or demand forecast prepared by or for the subject interest;
- (5) Strategic plans of the subject interest, including documents or information which relate to any increased expansion into new geographic areas or service lines; and,
- (6) Copies of all licenses, certifications, accreditations, permits, and other regulatory approvals, including (if applicable) CONs.

As this research is client and project specific, the documents and the information required may change, depending on the facts and circumstances of the engagement.

Over the past several years, there has been a paradigm shift within the healthcare industry due to the increased number of transactions occurring among healthcare providers.¹⁷ These transactions are increasing in both size and complexity, resulting in emboldened efforts at regulatory review, requiring that the analyst seek and obtain robust general and specific research data and

(Continued on next page)

information in conducting a complete and thorough due diligence process (that will withstand scrutiny) related to

the subject property interest being appraised, whether an *enterprise, asset, or service*.

- 1 For more information, see the first installment of this six part series: "The Due Diligence Imperative – For the Valuation of Healthcare Enterprises, Assets, and Services" Health Capital Consultants, Vol. 10, Issue 9, September 2017, https://www.healthcapital.com/hcc/newsletter/09_17/PDF/DILIGENCE.pdf (Accessed 10/26/17).
- 2 *Ibid.*
- 3 "Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services" By Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, Volume 1, Hoboken, NJ: John Wiley & Sons, Inc., 2014, p. 2.
- 4 Michael Porter is also the director of the Harvard business school's Institute for Strategy and Competitiveness.
- 5 "On Competition" By Michael E. Porter, Boston, MA: Harvard Business School Publishing, 2008, p. 4.
- 6 Robert James Cimasi, 2014, p. 465-466.
- 7 Robert James Cimasi, 2014, p. 466.
- 8 "CON-Certificate of Need State Laws" National Conference of State Legislatures, <http://www.ncsl.org/research/health/con-certificate-of-need-state-laws.aspx#Program> (Accessed 11/21/17).
- 9 The market service area may be determined based on the areas that the current and historical patients come from, or the analyst may use the metropolitan service area that the subject interest is situated in.
- 10 American Hospital Directory, <https://www.ahd.com/> (Accessed 11/21/17).
- 11 "Research and Data" America Health Care Association, https://www.ahcancal.org/research_data/Pages/default.aspx (Accessed 11/27/17).
- 12 "American Fact Finder – Search" United States Census Bureau, <https://factfinder.census.gov/nav/jsp/pages/searchresults.xhtml?refresh=t> (Accessed 11/27/17).
- 13 "EDGAR – Company Filings" U.S. Securities and Exchange Commission, <https://www.sec.gov/edgar/searchedgar/companysearch.html> (Accessed 11/21/17).
- 14 "2017-18 Annual Statement Studies: Financial Ratio Benchmarks" The Risk Management Association, <https://www.rmahq.org/productdetail.aspx?productId=591948896> (Accessed 12/7/17).
- 15 For more information, see: "Industry Financial Profile Series" Bizminer, <https://www.bizminer.com/products/analysis/industry/financial-ratios-profiles.php> (Accessed 12/7/17).
- 16 For more information, see: "Integra 3-year and 5-year Industry Reports – Business critical benchmarking data from Integra" Microbilt, <http://www.microbilt.com/product/integra-industry-reports> (Accessed 12/7/17).
- 17 "A merger between CVS Health and Aetna could be what the doctor ordered" The Economist (November 4, 2017), <https://www.economist.com/news/business/21730906-vertical-integration-could-put-brake-americas-un sustainably-soaring-health-care-costs> (Accessed 11/13/2017).




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