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Financial modeling a key step in mergers

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Small and medium sized medical groups are confronted with questions of survival on an ever-increasing basis.

Health systems are acquiring physician practices, and it is becoming more difficult for smaller practices to compete with these hospital-dominated organizations. So, the options facing many practices today are, "do we (1) sell out; (2) merge into a larger existing physician owned entity; or (3) take on the challenge of being involved in the creation of a new group?"

When the decision is made to join or form a larger group, there are several psychological barriers that the smaller practice must overcome. These include the loss of autonomy, legal and governance, culture and personalities, exit strategies, time commitment, and of course, financial issues.

After alleviating the initial anxiety of a proposed merger or formation, and after the initial "courtship" and structural issues are discussed, the next big question is: How is joining or forming a large group going to affect us financially? In my experience, this is the most significant issue that has to be addressed, and is why financial modeling is so important.

Financial modeling is critical in the early stages of a potential merger as it will project what the group will look like financially going forward. The modeling will project the cash flow and profitability of the group, both in its entirety and individually. During the process, budgets and projections of start-up costs will be developed. This will let perspective members know what initial start-up capital will be needed. It also indicates the amount of financing that the group will require, and will be used for securing bank financing.

In the developmental stages of creating a large group, there will be many meetings with the financial advisors and the "Founding Members" – or a finance committee that has been formed – in order to define the financial model that the group will follow. In order to operate under a single tax identification number, there are certain operations that must be centralized, such as billing and collecting, accounting, human resources, benefits, credentialing, EHR and other IT functions. These functions are considered the responsibility of the central business office ("CBO") of the group. One of the most important decisions the group will make is whether the CBO will be created internally, or if an outside Management Service Organization (MSO) will be hired to perform the above tasks.

Part of the financial modeling process is to create budgets to explore options. The CBO vs. MSO is perhaps the biggest decision the group has to make. A full projection of the cost of creating the CBO has to be prepared as does an annual operating budget. This has to be compared to the cost of outsourcing to an MSO.

The process of gathering the data needed to prepare the model requires that each potential member must provide their information to the preparer of the projections. A detailed data request is made including such items as financial statements, payroll data, productivity data, outstanding debt, leases, financial commitments, as well as other items. It is important to note that the financial modeling will be done on a “blinded” basis, so that each individual groups financials’ will not be disclosed to anyone other then the firm preparing the model. This comforts prospective members, in that they are dealing initially with competitors, and would not want them to see their financials.

The financial modeling will also indicate the impact of potential cost savings due to economies of scale and the centralization of certain expenses. It could also reflect that initially, there could be increases in expenses in the short term. The modeling will also indicate the methodology of allocating ancillary income and the effect it would have on the individual members.

It is important to note that there could be different variations of the model based on assumptions that will be made. For instance, the group might project revenue increases due to better purchasing ancillary services that could not be provided individually, higher reimbursement due to better outcomes reporting and or negotiating.

The most significant aspect of the modeling is that it gives transparency as to what the group will look like financially, gives prospective members a realistic picture of the financial impact joining the group would have on them, and reveals what their financial responsibilities would be in getting the group started.

Without a detailed financial model, the group will not be able to attract and sign up members. The model will also allow financial institutions to confirm that the necessary financing would be available to the group when it proceeds forward.

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