MERRITT HEALTHCARE ADVISORS

WHITE PAPER

Strategies for Growth and Maintaining Independence

A private equity blueprint for physician practices

Merritt Healthcare Advisors
INVESTMENT BANKING

According to a recent Physicians Advocacy Institute report, hospitals now employ more than 40 percent of physicians. In the two years leading up to 2018, hospitals acquired 8,000 medical practices and 14,000 physicians left private practice and entered into employment arrangements.[1] Why is this happening and why is the trend accelerating?

After delivering his opening remarks during a nationally televised Affordable Care Act signing ceremony in 2010, Vice President Joseph Biden famously leaned into President Barack Obama and offered his boss a decidedly off-color assessment of the new law.[2]

It was the whisper heard around the world. At the time, however, few observers outside of the Beltway fully comprehended Biden's suggestion: That the ACA would, in time, irrevocably remake the nation's healthcare system, altering the delivery, payment and utilization of services — for better or for worse.

Looking back a decade on, Biden's now-famous quip, to paraphrase his own words, still rings true: The law continues to be a very big deal indeed. In addition to accomplishing its stated goal of extending healthcare access to millions of uninsured Americans, provisions of the landmark legislation's 906 pages are now causing a wave of consolidation in healthcare services.

Nearly a decade after the ACA's passage, stakeholders today are competing for scale and integration across the spectrum of care, primarily to accommodate value-based payment models and other aspects of the law. And as these effects of the ACA are coming into focus, they're giving rise to rapid growth in managed care, physician hospital employment and enhanced ambulatory services, as well as an increased focus on the patient experience and convenience — all while reimbursements decline and competition among providers intensifies.

Fragmented no more?

Once the dust settles, the total price tag of healthcare mergers and acquisitions in 2018 alone is expected to surpass $5 trillion, with proposed megadeals between Cigna and Express Scripts, CVS and Aetna, Walmart and Humana, and Optum and DaVita announced during the first half of 2018 alone.[3] And with roughly half of healthcare executives surveyed recently by Capitol One expecting 2019 M&A activity to continue at a similar rate as the previous year, it's a pace that's not expected to cool anytime soon.[4]

In particular, physician practices remain a top acquisition target, especially by hospitals and health systems: Over 40 percent of all physicians in the United States are now hospital employees,

[1] "Updated Physician Practice Acquisition Study: National and Regional Changes in Physician Employment 2012-2018," Physicians Advocacy Institute (February 2019)
[2] Youtube.com (accessed 2019)
[3] "The 4 biggest health care mega-mergers of the past year—and how they could impact you," Advisory Board (Aug. 28, 2018)

and fewer than half own their own practices.[5] Primary care physicians, specifically, are among the most coveted: In the decade leading up to 2016, the rate of hospital employment by primary care physicians increased from 28 to 44 percent.[6]

Managed care organizations also are fueling the buying spree. William Blair research shows that Optum, a division of UnitedHealth Group, Inc., is now the largest employer of physicians in the United States, with more than 50,000 on its payroll. To put that into perspective, the Minnesota-based MCO is "more than two-and-a-half times the size of the employed physician group at the largest provider-owned medical organization in the United States (Kaiser's Permanente Medical Groups, with roughly 19,200 total physicians) and roughly five times the No. 2 provider/employer (the Veterans Health Administration, with roughly 11,000 employed physicians), according to William Blair."[7]

THE NEW PROVIDER LANDSCAPE[8]

Group	Description	Number of Health Systems
Large Health Systems/ National Chains	• 10+ Hospitals • Multi-Region or Multi-State Footprint	80
Mid-Tier Health Systems	• Two to Nine Hospitals • Local Regional/Metropolitan Area Footprint	273
Academic Medical Centers (AMCs)	• Academically Affiliated • Independent and Multi-Hospital Systems • Local Regional/Metropolitan Area Footprint	134
Small Community Health Systems	• Independent • Located in Urban, Suburban and Rural Markets	1,346
	Total: Non-Government Health Systems	**1,833**

[4] "*Healthcare industry optimism reaches new heights*," *Capitol One Commercial Banking (2019)*
[5] *Ibid.*
[6] *Ibid.*
[7] *"Healthcare Mosiac," William Blair equity research (Aug. 28, 2018)*
[8] *"The great consolidation: The potential for rapid consolidation of health systems," Deloitte*

The Rise of the MSO Model as a Viable Alternative

Given this complex confluence of events, larger, well-capitalized health systems have pushed to integrate across the spectrum of care by acquiring physician practices. Complex data reporting requirements, flat reimbursement rates and a shift towards a larger percentage of government payers have pushed many private practice doctors into employment for these large systems.

In fact, according to a 2018 Premier Inc. survey of healthcare executives, the "strongest drivers of merger and acquisition (M&A) activity are linked to the need to integrate and better manage care across the continuum and meet consumers where they want to be seen."[9] Still, not every physician wants to work for a hospital, health system, managed care organization, or retailer, and this is why the management service organization (MSO) model is emerging as a viable choice for physicians who want to modernize their practices while remaining independent.

Typically backed by a private equity (PE) firm, MSOs can create economies of scale — leading to more growth, access to ancillaries and, if sufficient scale is reached, an increase in reimbursement rates. For private equity firms, these entities are optimal for consolidating highly fragmented physician practices, with the end goal of selling to established, integrated operators or larger group practices. Consolidation syncs up well with the typical PE business model wherein these firms typically look to sell their assets within five to seven years after the initial investment, which gives ample time to purchase additional practices during the lifespan of their investment. To achieve this growth, PE firms also develop ownership structures that align incentives with their physician partners as doctors are the revenue generators of these businesses. If the MSO can grow profitably, the opportunity can exist to sell the business, which can create an additional monetization event for the partners.

For physician practices, MSOs allow them to compete in today's dynamic, hypercompetitive market, provide demonstrable growth opportunities and an avenue by which to remain independent.

Why do physicians consider an MSO-PE partnership? There can be numerous benefits:

- Monetization at high multiple;
- Obtain partner motivated to invest in and grow business;
- Share in upside through retained equity in MSO;
- Possible additional monetization in three to seven years if MSO experiences another capital event or transaction;
- Increased leverage to negotiate enhanced payer contracts;
- Purchasing economies of scale;
- Access to technologies designed to streamline processes;
- Risk sharing;
- Access to management, clinical, business and operational expertise;
- Growth;
- Increased patient referrals from larger physician network;

[9] *"Premier Inc. C-Suite Survey: Clinical Integration and Consumer Satisfaction Driving M&A Activity Among Healthcare Providers" (2018)*

- Corporate partner with capital access and growth incentive;
- Access to extensive network and resources to grow physician base and facilitate succession plans;
- Management bandwidth to expand geographical footprint; and,
- Develop previously unattainable ancillaries.

There are potential downsides as well. Are PE firms able to provide the specific expertise to meet the goals listed above? Many may not be as prepared to provide those benefits as are established hospital systems or large medical groups. Additionally, once the income is sold, the growth-driven "income repair" promised by investors may never materialize. Last but not least, significant due diligence into how the ongoing operation will be managed should be performed. Any newly formed MSO will experience operational and cultural integration challenges. Some of the key items driving a successful deal will include:

- Maintenance of a productivity-based compensation system;
- Maximization of value;
- Income repair over a reasonable period from growth and operational synergies;
- Succession planning for older physicians;
- Career track for younger physicians; and,
- Maintenance of clinical autonomy.

Interested in learning more about the options for selling your practice in a consolidating market? Let's talk. Merritt Healthcare Advisors is the industry's leading healthcare advisory firm focused exclusively on representing owners of healthcare businesses, surgical facilities and practices that are considering a strategic transaction, whether it is partnering with another group, selling an interest in their business or growing their business through acquisitions. We offer:

- **M&A expertise:** We leverage our investment banking background, and as registered securities brokers, we have both the experience and the qualifications required to manage this extremely complex process.
- **Practice and outpatient surgery center focus:** As the only firm with actual "owners" experience, we have unique knowledge that comes from owning, developing and managing our own facilities. This insight enables us to best understand and present your business.
- **Unmatched experience:** Our leadership team has more than a century of combined experience working in healthcare and has successfully completed over $2 billion in transactions on behalf of our clients.
- **Proven process:** Positive outcomes are the result of a deep understanding of your business, transactional expertise, knowledge of the seller and buyer communities and the ability to most effectively package, market and manage the sales process.
- **Exceptional results:** By eliminating risk for the owners, effectively positioning your organization, creating the most effective marketing piece, validating our projections and the integrity of the offering, creating the most competitive environment for your business and then understanding how to push potential buyers to agree to the terms of the deal we want, we make a significant impact on the financial and non-financial outcomes of your sale.

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