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PHYSICIAN MEDICAL GROUPS: Buying, Selling, and Valuing

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Excerpts selected from the *Merger and Acquisition Webcast Series*
“Physician Medical Groups M&A: Buying, Selling and Valuing”
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Physician Medical Group: Buying Selling and Valuing

When the Supreme Court upheld health-care reform—The Patient Protection and Affordable Care Act—2012 became a very busy year for physician medical group deals, and transaction values actually increased. Among the very large deals, DaVita acquired HealthCare Partners for about \$4.2 billion and United HealthGroup acquired North American Medical Management (NAMM) for an amount thought to be just under a billion dollars. There has also been a high degree of activity in this sector by hospital acquirers. Many hospitals across the country continued to snatch up physician groups in an effort to consolidate their physician networks and, through IT system integration and a focus on increasing patient health outcomes, position themselves to take advantage of the incentives offered through the Affordable Care Act's new ACO models.

PHYSICIAN GROUPS HAVE STEADILY MOVED TOWARDS AFFILIATING WITH HOSPITALS AND OTHER LARGE ORGANIZATIONS DUE TO CUTS IN REIMBURSEMENT RATES, INCREASING REGULATION AND ENFORCEMENT, IT REQUIREMENTS, IMPLEMENTATION OF THE INSURANCE EXCHANGES ACROSS THE COUNTRY, AND THE RECIPROCAL INTEREST IN TAKING ADVANTAGE OF THE NEW ACO MODELS. And with the new focus on payment models centered on patient outcomes, there has been a rise in managed or coordinated care models of physician and hospital compensation. The concept of taking risk on health-care outcomes has been in place in California for several years but the preference elsewhere has been the fee-for-service model.

Who's buying what?

THE GOAL OF MANY ACQUISITIONS IS TO TAKE MARKET SHARE AWAY FROM COMPETITORS, TO KEEP THE COMPETITOR FROM GAINING MARKET SHARE, AND/OR TO COMPLETE THE CONTINUUM OF CARE AND POSITION THE HEALTH-CARE SYSTEM FOR HEALTH-CARE REFORM.

Outpatient care is growing at a faster rate than inpatient care in terms of revenue, so hospitals are very interested in either acquiring large primary care practices or developing their own large primary care practice by acquiring one, two, three, or more different or allied groups.

FURTHER, DECLINING REIMBURSEMENTS AND LOWER INCOMES ARE REASONS WHY PHYSICIANS JOIN GROUPS, AND MANY OF THOSE PHYSICIAN GROUPS ARE NOW LOOKING TO MERGE WITH A HOSPITAL SYSTEM IN ORDER TO PROTECT THEIR INCOME LEVELS. ALIGNING WITH A SYSTEM CAN CREATE MORE LEVERAGE WITH PAYERS AND INCREASE SECURITY FOR THE FUTURE.

Many physician medical group transactions are so small that they aren't even announced. In 2011, 108 transactions were announced; in 2012, only 68 transactions were announced.

Nevertheless, the transaction values have been increasing, reaching a high in 2012 of \$4.4 billion. Of that \$4.4 billion, however, \$4.2 billion reflects the DaVita/HealthCare Partners deal. Since 2012, though, transaction activity has fallen off. From January through May 2013, 19 deals were reported versus 37 during the same period in 2012. All of 2012 was busy, in fact, because many physician practices wanted to complete their transactions in anticipation of changes in the tax laws at the end of 2012.

Traditionally, buyers of physician medical groups have been hospital companies and larger physician practice groups. Recently, however, other players—such as insurance companies, other healthcare companies, and private equity firms—have shown an increasing interest in this sector.

The consolidation of physician practice groups reflects what is occurring throughout the health-care world, as everyone is facing the changes involved in health-care reform. Groups are looking to expand their networks, expand their geographic coverage, and build scale in order to have a louder voice in their discussions with other large players in the health-care community, whether those players are hospitals, health systems, or large insurance payers. And as reimbursement moves from a fee-for-service model toward a value-based reimbursement model, risk must be assumed. So companies are looking to increase their ability to assess, analyze, and assume risk in a value-based reimbursement environment. One way to accomplish that is to acquire practices with complementary skills and resources.

Another driver of physician medical group deals is the need to leverage corollary investments in IT systems and infrastructure in order to respond to the requirements of health-care reform. As an example, American Family Care, a family clinic out of Birmingham, Alabama, purchased Doctors Express, an urgent care company; and TeamHealth, a public company and a very active acquirer, recently acquired Emergency Physicians PA and Valley Emergency Physicians Medical Group.

IN THE PAST FEW YEARS, INSURANCE COMPANIES HAVE BECOME SERIOUS BUYERS OF PHYSICIAN MEDICAL GROUPS, DRIVEN PRIMARILY BY THEIR INTEREST IN TAKING A MORE AGGRESSIVE STRATEGY WITH REGARD TO THE DELIVERY OF CARE AND TO MEET THE GOAL OF REDUCING THE OVERALL COST OF CARE, AS WELL AS TO IMPROVE THE OVERALL WELLNESS OF THE POPULATION THAT THEY'RE INSURING. Insurance companies also want to be as closely involved with the patient as possible, as that gives the company greater leverage in discussions with the other players such as hospitals and other health-care providers in the market. It also helps to diversify some of their business risk.

Hospitals are traditional acquirers of physician medical groups and continue to be very active acquirers. Their rationale is to gain greater control over referrals, to increase their outpatient services, and to have greater leverage in discussions with other large players and, in particular, the payers in the markets that they serve. Examples of these kinds of transactions: Integrated Health Associates, part of the not-for-profit St. Joseph Mercy Health System,

bought a large multispecialty physician practice in Michigan; Community Health announced an acquisition of Diagnostic Clinic of Longview; and Dignity Health bought an occupational health and urgent care company called US HealthWorks.

Traditionally private equity firms have been primarily interested in single specialty groups such as anesthesia or dermatology, but now they are actively looking at multispecialty practices in order to find platform investments that can capitalize on health-care reform. Private equity firms are specifically looking for transformative and replicable business models that might benefit from changes in the health-care system. And they are looking for opportunities where geographic expansion—both organic and through acquisitions—exist and models that are scalable. Enhanced Equity Group made two such investments, one in Primary Care Associates, a primary care business, and the other in Black Glove Health, a concierge medicine business. Welsh, Carson, Anderson & Stowe invested in CareSpot, an urgent care business. And in a larger deal, Clayton, DuBilier & Rice invested in Emergency Medical Services, which provides emergency department, anesthesia, hospitalist and other physician medical services; renamed Envision Healthcare Holdings, the company recently filed to do an initial public offering.

The strategy of the individual acquirers or investors has a lot to do with the attractiveness of the target. A particularly important factor is the relative strength of the physician medical group compared to the other players in its market, whether those players are hospitals or insurance companies, and how that position might benefit the acquirer. Also, the attractiveness of the group's patient, case, and payer mix is key. For example, primary care patients—in particular, those that are eligible for Medicare and/or are approaching Medicare age—are particularly attractive to certain acquirers.

For various practices, particularly multispecialty practices and certain specialty practices, the scope of ancillary services that the business provides can also add to its attractiveness. And, of course, the community standing of the physicians and the physician medical group itself is always important, because health-care remains a very personal business. Likewise, the willingness of key physicians to continue working post-transaction will affect the value of the business.

What influences the valuation of physician medical groups?

THE EXPECTATIONS AND PREFERENCES OF PHYSICIANS HAVE CHANGED, AND THE DEGREE TO WHICH PHYSICIANS HAVE DESIRED TO BE INDEPENDENT HAS CHANGED. SURVEYS INDICATE THAT NEW PHYSICIANS PREFER TO BE PART OF A HOSPITAL OR HEALTH SYSTEM RATHER THAN GOING INTO INDEPENDENT PRACTICE, AND THIS TREND HAS BEEN FAIRLY STEADY.

There are a lot of unique challenges when valuing physician practices. The biggest challenge of all is setting expectations for the physicians. Appraisers often find that their role in the valuation process is to educate physicians, attorneys, and sometimes even the investment

bankers on the rules that apply uniquely to health care. It's important, therefore, to ensure that the valuation and pricing models are consistent and compliant with all of the rules and regulations required by the regulatory bodies that govern health-care deals. It is very important to educate and set expectations regarding what can and cannot be considered in terms of valuation within that context. A lot of stakeholders are involved in these deals, and a lot of due diligence issues need to be resolved, so having an intermediary navigate through some of those issues can help set the groundwork for a successful deal.

One thing that is unique to acquisitions in the physician practice space is the importance of incorporating the post-acquisition compensation model for the physicians into the purchase price (or at least considering it). For smaller practices, this often reduces the upfront value of the practice.

PHYSICIANS ARE HIGHLY EDUCATED, PROVIDE NEEDED SERVICES, AND, AS INDIVIDUALS, BRING A LOT OF VALUE TO THE TABLE. IN MOST CASES, THEIR COMPENSATION LEVELS ARE COMMENSURATE WITH THEIR REPUTATION AND KNOWLEDGE. THEIR INDIVIDUAL VALUE MAY BE RAISED TO THE EXTENT THAT THEY ARE PART OF A SUCCESSFUL GROUP PRACTICE, BUT IT TAKES A SIGNIFICANT EFFORT TO TRANSCEND INDIVIDUAL VALUE INTO WHAT WOULD BE CONSIDERED BUSINESS VALUE OR PRACTICE VALUE.

Valuing a physician medical practice is actually very similar to valuing any other business. There are three approaches:

- *THE INCOME APPROACH* values a practice by drawing reference to the ability of the practice to generate income beyond physician compensation to serve as a return on investment for the investor. The income approach is most appropriate for large practices that have generated some institutional value.
- *THE MARKET APPROACH* looks to the marketplace for comparable transactions and values a particular practice based on those transactions; it is typically referred to as valuation multiples.
- *THE COST APPROACH* refers to the cost of recreating an asset, both tangible and intangible, and assigns value with reference to the underlying or intrinsic value of the practice. The cost approach is generally most appropriate for smaller practices.

Most physician medical group valuations apply the income or cost approach, and the overall valuation process is rather straightforward. The deal terms dictate what can be paid up front, and a lot of time is spent doing due diligence, looking at financial and operational data, and coordinating with attorneys, developers, physicians, etc. It is important to build valuation models and discuss the compensation structure, as well as to actually visit the site, meet with the physicians, and give them an opportunity to explain what they believe drives value for the group. Then comes the analysis, and frequently there is a dialogue between the target and the acquirer to make sure everyone is on the same page with regard to the assumptions, the mechanics, the model, etc.

In response to health-care reform, hospitals are focused on a few core elements:

- *QUALITY*: This will dictate how physicians will be paid in the future.
- *INFORMATION*: Correct coding will be required for future payments.
- *EFFICIENCY*: Everything must be standardized in order to run efficiently.
- *CLINICAL INTEGRATION AND COLLABORATION*: Hospitals are looking for ways to improve care, decrease costs, and demonstrate value.
- *OTHER INTEGRATION STRATEGIES*: Hospitals may look to co-management or clinical arrangements where hospitals provide physicians with certain services.