Knock, knock... *Who's there?* Considerations for when private equity comes for physician acquisitions

By Joe Aguilar *MBA, MPH, MSN, CVA*
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The physicians with ABC Women's Care Group, an independent OB/GYN group, have come into your office to discuss their options of aligning with the health system. They mention the offer they just received from a private equity firm buying up some of the local practices in the market. As Director of Development and Physician Compensation, you are concerned about the private equity offer given the large up-front payment. You and your team begin to strategize regarding ways to compete and develop a proposal that is compliant yet tailored to the circumstances surrounding ABC Women's Care Group and the reasons for engaging in these discussions.

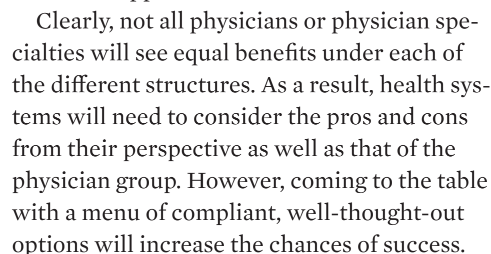
Private equity (PE) firms have shown increasing interest in acquiring physician practices over the years, viewing them as profitable investments. This trend has gained momentum in recent years due to various factors, including changes in healthcare regulations, financial pressures on small practices, and the desire for operational efficiencies. According to one study, the number of healthcare deals overall rose from 75 in 2012 to 484 in 2021.[1] This high volume of deals in 2021 is consistent with Bain's reporting in their Global Healthcare Private Equity and M&A Report 2023.[2] Despite some economic headwinds in labor, reimbursement, and interest rates, private equity continues to see opportunities in physician practices. The ability to capitalize on these opportunities to optimize operational efficiencies, reduce costs, and foster growth is how these firms generate their financial returns. When hospitals and health systems try to align with physicians through various partnerships or employment models, it's challenging due to competing with private equity firms, and they must find the right way to work together. Even though it might be daunting for health systems to compete with the initial capital outlay to medical groups, they are not without their own unique leveraging power. While each physician's practice and set of circumstances are unique, health systems can offer flexible alignment strategies, leverage their community ties/physician network, address risk tolerance, provide financial/operational support and demonstrate their financial competitiveness in the long term.

FLEXIBILITY IN ALIGNMENT STRATEGIES

Health systems can create alignment models beyond the traditional employment agreement, which may not be as attractive to some physician groups who have enjoyed their independence. Providing more options for physicians to choose from increases their likelihood of aligning with the system. Examples of possible arrangements included:

- Engaging physician involvement in specific service line goals (e.g., co-management agreements or joint ventures); or
- Building a network of physicians across the care continuum (e.g., professional services model or clinically integrated networks [CINs]).

While these structures may be attractive, employment models can also be designed with financial incentives that motivate physicians to continue to play a leadership role in the growth of their service line. Regardless of the structure, most physicians wish to see an arrangement that clearly and transparently sets up a governance structure that fosters clinical independence, demonstrates investment in clinical outcomes, and delivers administrative/financial support.



Clearly, not all physicians or physician specialties will see equal benefits under each of the different structures. As a result, health systems will need to consider the pros and cons from their perspective as well as that of the physician group. However, coming to the table with a menu of compliant, well-thought-out options will increase the chances of success.

LEVERAGE HOSPITAL TIES TO THE COMMUNITY AND PHYSICIAN NETWORK

Hospitals and health systems have a history within the community they serve that has been shaped by the organization's mission and shared cultural values. This commitment to the community resonates with many physician groups where providing quality patient care is central to their mission and values. While PE firms may concern themselves with clinical outcomes, there is little doubt that one of their primary concerns is to maximize their investment in the short term. In contrast, the health system is a part of the community with a past and a future that can certainly demonstrate a long-term commitment to not only the patient population but also the physicians themselves. This is contrary to the defined exit strategy of three to five years for most PE transactions.

Second, while PE groups can certainly amass a large network of providers, health systems should promote the benefits of being a part of a larger integrated care network with numerous other physicians across specialties as well as various sites of service (e.g., hospitals, ambulatory surgery centers, diagnostic facilities, therapy clinics, etc.). This will give physicians unique opportunities to access specialized services, research/teaching opportunities, and improved coordination of care. These added benefits are critical given the growth in value-based arrangements, where success will be contingent upon utilization management, clinical outcomes, and cost control.

ASSESS RISK TOLERANCE

Not all physicians will have the same financial risk tolerance. This has certainly been a motivator for many physicians to become employed. According to a study by the Physicians Advocacy Institute, 74% of physicians in the United States were employed by a hospital, health system or other corporate entity as of Jan. 1, 2022.[3] See Figure 1 for a breakout by employer type.

According to AMN Healthcare data for 2023, approximately 95% of physicians are being recruited into an employment agreement,[4] which could be an indication of risk tolerance as compared to those physicians who have elected to remain in private practice. As a result, those physicians who have remained in private practice may be more apt to align with a health system if the model resembles an entrepreneurial structure with shared financial risk and potential reward.[5] Putting the standard employment agreement in front of these physicians may not be as appealing.

This may especially be the case for physicians at the end of their careers looking for an exit strategy. For older physicians, it may not be about the risk given their desire for the up-front cash payout in lieu of a higher compensation package. However, for younger physicians, risk tolerance may be a larger factor given the years of practice ahead of them. Physicians entering these transactions need to understand the very real risk associated with these partnerships. This has been evident in recent news with Standard & Poors downgrading the corporate credit ratings of Aspen Dental and Radiology Partners,[6] as well as the bankruptcy filings of Envision Healthcare[7] and American Physician Partners.[8]

FIGURE 1. PERCENT OF PHYSICIANS EMPLOYED BY ENTITY (AS OF JANUARY 2022)

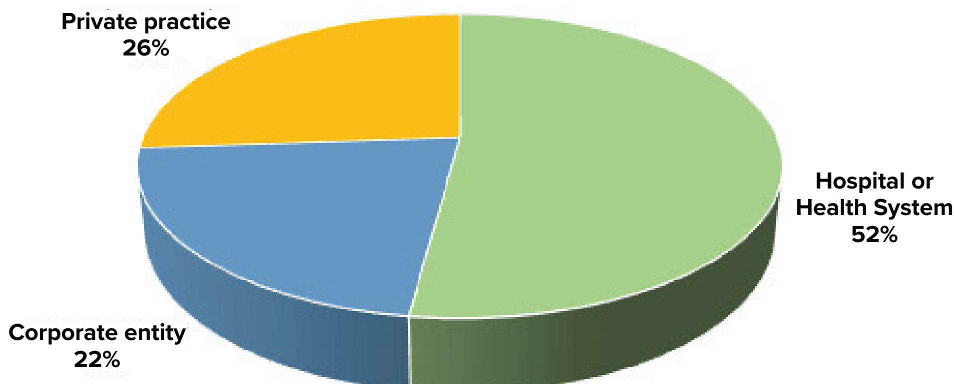


TABLE 1. SAMPLE PHYSICIAN PRACTICE TRANSACTION MODELS, PE AND HEALTH SYSTEM EMPLOYMENT

Transaction Value	Year 1	Year 2	Year 3	Year 4	Year 5	Years 1 - 5	Comments
Practice wRVU Totals	72,000	72,000	72,000	72,000	72,000	360,000	Based on 9 FTE Physicians
Private Equity Model							
Purchase Price (20% Rollover)	$1,000,000	-	-	-	-	$1,000,000 ??	Total value = $1,250,000 ($1M Cash plus $250K Rollover Equity)
Professional Services	$2,304,000	$2,304,000	$2,304,000	$2,304,000	$2,304,000	$11,520,000	Lower compensation under PE Model; $32 per wRVU
APP Supervision	$270,000	$270,000	$270,000	$270,000	$270,000	$1,350,000	$30,000 per APP FTE per MD under PE Model
Miscellaneous Incentives	$724,500	$724,500	$724,500	$724,500	$724,500	$3,622,500	Based on $80,500 per MD annually
Equity Rollover	-	-	-	-	UNKNOWN	UNKNOWN	
Total Annual Compensation (PE Model)	$4,298,500	$3,298,500	$3,298,500	$3,298,500	$3,298,500+	$17,492,500+	
Employment Model							
Purchase Price	$385,000	-	-	-	-	$385,000	Structured as an Asset Purchase Agreement typical of Health Systems
Professional Services	$3,528,000	$3,528,000	$3,528,000	$3,528,000	$3,528,000	$17,640,000	Compensation $49 per wRVU under EA Model
APP Supervision	$135,000	$135,000	$135,000	$135,000	$135,000	$675,000	$15,000 per APP FTE per MD under EA Model
Miscellaneous Incentives	$0	$0	$0	$0	$0	$0	
Total Annual Compensation (EA Model)	$4,048,000	$3,663,000	$3,663,000	$3,663,000	$3,663,000	$18,700,000	
Variance - PE Model less EA Model	$250,500	($364,500)	($364,500)	($364,500)	($364,500) ??	($1,207,500) ??	Portion of PE Transaction at Risk

PROVIDE FINANCIAL/ OPERATIONAL SUPPORT

While health systems may not structure their alignment in the same way as PE, there are other financial/operational support offered by hospitals that may be more attractive or at the very least similar to what PE groups offer. Health systems should focus on their ability to bring their existing infrastructure along with some capital infusion to upgrade the facilities and technology, as well as implement operational enhancements. Although PE firms will be laser-focused on enhancing efficiencies and reducing costs, health systems have the same incentive to use their economies of scale to reduce supply costs, increase negotiating power with payers, and save on operating expenses through centralized administrative functions.

Hospitals can also achieve this by bringing in professional management teams with expertise in physician practice operations. This expertise is also in risk management and compliance. Health systems are uniquely qualified to assist practices in navigating complex healthcare regulations and mitigating legal and regulatory risks.

COMPENSATION NOW OR LATER

Just as in the example above, physician practices are being offered upfront cash payments that are significantly higher than the traditional asset purchase transactions that many health systems propose. This can be and often is very attractive to the physician owners. This is especially true when you consider physicians in the twilight of their career who view this payment as reflective of their hard work throughout their career in private practice.

However, the PE model is not without its shortcomings. To generate the desired return, PE groups will often achieve the desired earning stream by reducing physician compensation. In a typical physician practice, the physician compensation is comprised of the net income left over after paying all operating expenses with very little if any set aside as retained earnings. In addition, there is often a portion of the practice value that is rolled over into equity in the PE firm. This is where the term “second bite of the apple” is derived. The goal of the PE firm is to maximize profits of the practice to eventually sell it within three to five years at a much higher value. If they are successful, then the physicians will also benefit through the increased value of their equity position in the firm and enjoy the “second bite of the apple.”

However, it is not without risk as stated above and may not be that simple. See Table 1, which illustrates a sample physician practice transaction under a PE model and under a health system employment model.

PE model
The purchase price of the practice is set at $1.25M with $250,000 rolled over as equity. Physician compensation post-transaction will be set at $32 per work RVU (historical = $42 per wRVU). In addition, the physicians will receive APP supervision compensation set at $30,000 per advanced practice provider (APP) FTE per physician and miscellaneous incentives (e.g., management services organization [MSO] shares) based on $80,500 per physician annually.

Health system employment model
The purchase price of the practice is based on an asset purchase agreement set at $385,000. Physician compensation post-transaction will be set at $49 per wRVU, which is an increase of 15% from their historical compensation per wRVU. In addition, the physicians will receive APP supervision compensation set at $15,000 per APP FTE per physician annually.

The key information in the table is to collectively view the economics of each model over a five-year timeline, based on the exit strategy of most PE firms. Below are some key takeaways from this example:

1. Physician compensation was reduced in the PE model from historical levels by $10 per wRVU. This reduction in compensation funded the $1.25M purchase price. On the contrary, physician compensation went up by 15% under the health system employment model.
2. The PE model provides the group with $250,500 more in cash year 1 plus $250,000 in equity.
3. In years 2-4, the health system employment model yields $364,500 more per year given the post-transaction compensation terms.
4. The net financial impact for the physicians is **unknown** given the value of the "second bite of the apple." This unknown is critical to determining which model is financially better for the physician practice.

Not only is there risk regarding the PE firm's viability, but there is risk associated with achieving the target return based on the limited exit options due to regulatory fair market value (FMV) concerns for some of the potential buyers (e.g., health systems). Their options are often limited to other PE firms or, in rare cases, a public offering of the newly assembled entity. Neither of these are great options, let alone a guarantee.

The table illustrates a $1,207,500 net positive toward the health system employment model if you do not factor in any value associated with the equity rollover or "second bite of the apple." What this implies is that the value of the "bite" needs to be at least $1,207,500 for the PE model to be equivalent to the offer put forth by the health system. This is not often shown or put side by side for physician practices to understand their risk. Not only is there risk regarding the PE firm's viability, but there is risk associated with achieving the target return based on the limited exit options due to regulatory fair market value (FMV) concerns for some of the potential buyers (e.g., health systems). Their options are often limited to other PE firms or, in rare cases, a public offering of the newly assembled entity. Neither of these are great options, let alone a guarantee.

SUMMARY

Physician practice acquisitions remain active in today's very competitive market. While private equity may offer significant upfront

financial incentives, health systems are not without their own unique benefits to physician practice. With each transaction, one needs to consider the composition of the physician group in terms of specialty, age, risk tolerance, etc. Understanding the group's motivation and the key decision-making factors will determine the health system's approach. Mission alignment, community presence, integrated networks and long-term stability are all compelling propositions for physician practices. ■

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Considerations for medical group practice administrators

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Practice administrators have a role to play in preparing the physicians and practice leadership for a potential PE transaction. While there is a lot to prepare for leading to a sales transaction, administrators need to understand their current earnings stream's impact on value, normalize revenues and expenses during due diligence, and begin discussions/education early with the physicians surrounding critical aspects of the transaction itself.

CURRENT EARNINGS STREAM HAS A SIGNIFICANT IMPACT ON VALUE

The value of a practice is largely derived from the earning stream. The earning stream is a function of many factors, including (but not limited to) the training and skillset of the physicians, payer agreements, revenue cycle management, operating cost structure and capital infrastructure. While administrators focus on all of these factors to improve the bottom line, it cannot always be known when private equity will come calling. As a result, the practice's financial position, measured in terms of their earnings stream, is material in determining its value.

For example, a medical practice is undergoing some operational changes that are projected to increase the earning stream in the coming year or two. Their current annual earnings stream is approximately $200,000 and is projected to grow to $450,000 in two years after all of the benefits are realized from the operational changes. Holding a few things constant, valuing the entity today with an earnings stream of $200,000 would result in a value that is less than if the practice was valued in two years. This is largely due to the income approach method whereby the projected earnings stream in each of the future years is discounted back to present day dollars. The discount increases with each year beyond the current base year. Therefore, starting from a higher base year earnings position will yield a greater value. Furthermore, there could be additional risk built into the discount rate for the possibility of not realizing to the fullest the potential $450,000 earnings stream.

This is important for medical practice administrators to consider as they contemplate the value being offered in the transaction. If there is head wind in the value derived today, consider the pros and cons associated with postponing a desired transaction to position the practice in its best financial light.

TABLE 2. SAMPLE PHYSICIAN PRACTICE TRANSACTION MODELS, PE AND HEALTH SYSTEM EMPLOYMENT

	Year 1	Year 2	Year 3	Year 4	Year 5	Total Present Value
Forecasted Earning Stream (Now)	$200,000	$450,000	$459,000	$468,180	$477,544	
Discount Period	0.5	1.5	2.5	3.5	4.5	
PV Of Future After-Tax Cash Flows	$200,000	$450,000	$459,000	$468,180	$477,544	**$2,054,724**
Forecasted Earning Stream in Year 2	$450,000	$459,000	$468,180	$477,544	$487,094	
Discount Period	0.5	1.5	2.5	3.5	4.5	
PV Of Future After-Tax Cash Flows	$450,000	$459,000	$468,180	$477,544	$487,094	**$2,341,818**
Difference in Value						**$287,094**

Assumption: Discount Rate 18.00%

NORMALIZE REVENUES AND EXPENSES DURING DUE DILIGENCE PHASE

During the due diligence process for the potential sale of the practice, the value will be dependent upon the revenues less expenses. Potential transactions can come at less-than-ideal moments when the true economic earning power of the practice is not reflected. As a result, practice administrators need to not only provide the practice financial statements to the PE firm but need to first normalize the revenues and expenses. Normalization of the financial statements is not only common but standard practice when valuing any business entity.[9]

Financial statement normalization is the process of modifying financial statements to exclude non-recurring expenses or revenues. Often, financial statements include expenses unrelated to a company's core business operations, potentially impacting its earnings negatively. Normalization aims to remove these irregularities to offer precise historical data from which forecasting may be performed more accurately.

Examples of normalized adjustments to practice revenues:

- **Non-recurring impact on revenues**
  1. One-time payments made to the practice that may not be expected to continue.
  2. Space or staffing constraints that have impacted revenues in the past but are not expected into the future.
- **Revenue cycle management performance**
  1. Recent billing system or billing and collections service change due to poor performance.
  2. Expected change to payor reimbursement due to recent contract changes.
- **Provider production impact**
  1. Loss of revenues associated with a provider leaving the practice, assuming that those revenues are not expected to be absorbed.
  2. A provider may have had less than normal revenues associated with having been on leave (e.g., medical leave, paternity/maternity leave, etc.).

Examples of normalized adjustments to practice expenses:

- **Non-recurring expenses**
  1. Expenses occurring early in the year that should not be annualized (e.g., insurance payments, equipment purchases)
  2. Professional fees spent on legal and/or consulting services for a specific non-recurring purpose.
- **Owner discretionary expenses**
  1. Auto expenses
  2. CME costs in excess of norms under an employment model (e.g., destination CME trips)

3. Larger than typical entertainment expenses (e.g., season tickets to events, annual parties)

- **Reflect any expenses that are needed to generate projected revenues**
  1. If the practice is currently understaffed, you would need to adjust staffing costs accordingly. However, don't forget to adjust revenues upward as well if there is a corresponding impact (see note above).
  2. Include any upcoming capital expenditure needs.

BEGIN DISCUSSIONS, EDUCATION EARLY WITH PHYSICIANS REGARDING PE TRANSACTIONS

Considering the sale of any portion of a medical practice elicits a wide variety of emotions. This is not unusual, as many financial decisions are influenced by one's understanding surrounding the transaction. While a medical practice may not be actively looking to sell some portion of their equity, now is the time to gain insight into the process. Medical practice administrators are in a great position to help guide the physicians to understanding the following key factors when evaluating a potential offer:

- **Purchase price — its impact on physician compensation and the potential future upside**:
  1. It will be important for the physicians to understand that the payment up-front is a function of the physician compensation post transaction. If the practice had historically distributed most of their net income to the physicians as compensation, then the physicians need to review the compensation methodology post transaction as it often involves a decrease in compensation in lieu of the large cash payment made at the time of sale.
  2. In addition, many transaction terms retain a portion of the practice value for equity stake in the new entity going forward. This is a means for the physicians to take on some risk but benefit from any upside they achieve through the PE firm synergies.

- **Potential offers for comparison**:
  1. **Health system transactions** — generally come in the form of an asset purchase agreement. As such, the value will tend to be less than the cash-payment made by PE firms. However, physician compensation is usually increased or at a minimum kept at historical levels. Under most of these scenarios, there is no equity stake offered.
  2. **Other medical practices** — Offers from other practices can take on many different structures. These would have to be evaluated on a case-by-case basis.

- **Understanding operational terms**
  1. **Governance structure** — Physicians should understand that there will be a degree of control relinquished as part of the transaction. However, consideration should be given to physician leadership roles in the new entity.
  2. **Clinical decision-making** — It will be important to clearly delineate professional practice from business decisions. Most PE firms are not interested in making clinical decisions; however, clinical practice can be impacted by operational changes. As a result, the physicians need to ensure that they can maintain control over clinical practice patterns.

- **Evaluating the PE firm on its own merits** — In any transaction, the physician practice is just one party. They should also scrutinize the PE firm and whether they fit with the financial and operational goals of the practice. Here are just a few questions that may help physician practices evaluate the firm:

1. What is the historical performance of the PE firm?
2. Are they solely focused on the healthcare industry?
3. Do they have a footprint within your service area already? If so, what types of healthcare entities?
4. Does the firm bring any operational expertise?
5. Aside from building value, is there a demonstrated alignment with the mission of the medical practice to serve the community?
6. What is their exit strategy? ■