Private Equity VS. Health System Acquisitions of Physician Practices — Similarities and Differences in a Transaction

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Overview of Topics

1. Trends in Health System and Private Equity Acquisitions of Physician Practices
2. Primary Goals & Motivations
3. Business Challenges & Considerations
4. Structural & Regulatory Considerations
5. Diligence & Focal Points
6. Physician Compensation Models & FMV Considerations
Trends in Health System and Private Equity Acquisitions of Physician Practices

Jonathan Helm, CVA
VMG Health
Total employed physicians increased 13.0% compounded annually, [from 95,000 in 2012 to 155,000 in 2016]. The total percentage of employed physicians has increased from 26.0% in 2012 to 42.0% in 2016.

Source: Physicians Advocacy Institute – “Physician Practice Acquisition Study”
Health System Physician Acquisition Trends

Key motivations for health systems to employ physicians are as follows:

- Clinical Alignment Reduces Costs by Reducing Variations of Care
- Improve Efficiency of Referral Networks
- Changing Reimbursement Models Tied to Quality Metrics
- Shift to Risk Based Contracting Requires Strong Physician Alignment
- Competitive Environment and Market Share Protection
- Continuum of Care Allows for Execution of System Goals

Available Capital Continues to Rise

A recent McKinsey report estimates available capital (“dry powder”) has approached $1.8 trillion across all private markets\(^1\).  

Global Fundraising Trends

10.0%  
Available capital has increased each year on average since 2012

1 McKinsey defines private markets as closed-end funds investing in PEE, real estate, private debt, infrastructure, or natural resources, as well as related secondaries and funds of funds. McKinsey excludes hedge funds and publicly traded or open-end funds.

Private Equity Focus on Healthcare Sector

Why Focus on Healthcare?

- Healthcare accounts for nearly 20% of US GDP – projected to exceed $4 trillion in spending by 2020
- Has led all sectors in total returns since 1990
- Favorable long-term trends: aging population, growth in chronic conditions, push towards a more efficient healthcare delivery system
- Remains very fragmented
- Internal Monetary Fund predicts $10 trillion in global healthcare spending by 2020

“Regardless of what happens with the ACA, the healthcare value chain in the US and around the world is under continued pressure to reduce costs and operate more efficiently. Recognizing that, PE funds invested in all of the major healthcare sectors ...”

Private Equity Investments In Physician Groups

Re-emergence of the Physician Roll-up Strategy

There has been a strategy of consolidation with various specialties similar to the 1990s:

- Primary Care
- Dermatology
- Ophthalmology
- Pain Management
- Orthopedic Surgery
- *Emergency Medicine
- *Radiology
- *Anesthesiology
- *Hospital-based Practices

Ten years ago only a few private-equity houses had dedicated health-care teams,” says Dmitry Podpolny of McKinsey. “Today nearly everyone does.” 2017 saw a frenzy of deal activity, the highest by value since the go-go year of 2007.

- Economist, Private Equity is Piling into Healthcare (August 2018)
Private Equity Investments In Physician Groups

Private Equity Interest

“It's a land-grab right now, these are very small companies that are really just getting started. They're going for crazy multiples just because [private-equity firms] see the potential there.”

–Todd Spaanstra, partner at Crowe Horwath

<table>
<thead>
<tr>
<th>Investment Firm</th>
<th>Practice</th>
<th>Specialty</th>
<th>Year</th>
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<tbody>
<tr>
<td>Chicago Growth Partners</td>
<td>Advanced Pain Management</td>
<td>Pain Management</td>
<td>2010</td>
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<tr>
<td>Sentinel Capital Partners</td>
<td>National Spine &amp; Pain Center</td>
<td>Pain Management</td>
<td>2010</td>
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<tr>
<td>Welsh, Carson, Anderson &amp; Stowe</td>
<td>US Anesthesia Partners</td>
<td>Anesthesia</td>
<td>2011</td>
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<td>Audax Group</td>
<td>ADCS</td>
<td>Dermatology</td>
<td>2011</td>
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<td>Beecken Petty O'Keefe &amp; Co.</td>
<td>Southern Anesthesia &amp; Surgical Inc.</td>
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<td>Ontario Teachers’ Pension Plan</td>
<td>Heartland Denta</td>
<td>Dental</td>
<td>2012</td>
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<td>Goldman Sachs Private Capital</td>
<td>Privia Health</td>
<td>Multi-Specialty</td>
<td>2013</td>
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<td>Harbour Capital</td>
<td>Oak Street Health</td>
<td>Primary Care</td>
<td>2013</td>
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<td>Oxeon</td>
<td>Village Practice Management</td>
<td>Primary Care</td>
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<td>Venrock</td>
<td>Aledade</td>
<td>Primary Care</td>
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<td>Varsity Healthcare Partners</td>
<td>Katzen Eye Group</td>
<td>Ophthalmology</td>
<td>2014</td>
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<td>OMERS Private Equity</td>
<td>Forefront Dermatology</td>
<td>Dermatology</td>
<td>2016</td>
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<td>GTCR</td>
<td>Riverchase Dermatology</td>
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<td>2016</td>
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<td>Harvest Partners</td>
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<td>Dermatology</td>
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<td>Ontario Municipal Retirement Systems</td>
<td>Varsity Healthcare Partners</td>
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<td>Audax Group</td>
<td>Gastro Health</td>
<td>Gastrology</td>
<td>2016</td>
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<td>KG Health Partners, Inc.</td>
<td>Access Foot Care, Inc</td>
<td>Podiatry</td>
<td>2016</td>
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<td>ABRY Partners</td>
<td>Advanced Dermatologic Surgery</td>
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<td>ABRY Partners</td>
<td>Dermatology &amp; Laser Center</td>
<td>Dermatology</td>
<td>2017</td>
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<td>Sheridan Capital Partners</td>
<td>Dermatologists of Central States</td>
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<td>HIG Capital</td>
<td>Barnet Dulaney Perkins &amp; Mesa</td>
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<td>2017</td>
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<td>HIG Capital</td>
<td>Southwestern Eye Center</td>
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<td>Waud Capital Partners</td>
<td>Minnesota Eye Consultants</td>
<td>Ophthalmology</td>
<td>2017</td>
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Multiples > 10-12x TTM EBTIDA not uncommon for high-quality platforms practices

Multiples sometimes generated by seeking prospective compensation reductions from physician owners

Multiples further justified when add-on practices are purchased at multiples that are 30-40% less than those paid for platform practices – immediate arbitrage

Source: Advance Healthcare Network
Is the PE Strategy Today Truly Different Than the 1990s?

“What is different is that these guys are operators. The ones before were acquirers.”
– Michael Parshall, medical practice consultant

“The problem with PhyCor is that only the bottom line matters to them. Sometimes what’s good for the business isn’t necessarily good for the patient or the doctor”
– Dr. Randall Bertolette, 1994

Private Equity Investments In Physician Groups

Will the Model Succeed Today?

Success of the strategy is dependent on the loyalty of physicians.

**FINANCIAL VALUE**
- Distribution Control
- Cost Reduction
- Strategic Acquisition
- Strategic management

**OPERATIONAL VALUE**
- Are physicians better off financially?
- Are firms delivering promised value-add?
- Can private equity firms deliver on earnings repair?

Yes
- Will shareholder physicians continue to work at historical production levels for the “promise” of equity returns

No
- Will non-shareholder physicians continue as employees or contemplate private practice again?
Comparing and Contrasting
Health System vs. Private Equity
Opportunities and Challenges

Roger W. Logan, MS, CPA/ABV, CMPE
Bon Secours Mercy Health
### Private Equity Investments in Physician Related Services

**Retail Medicine**
- Dental
- Veterinary
- Physical Therapy
- Urgent Care
- Dermatology
- Ophthalmology
- Fertility
- Allergy

**Single Disease Focused Services**
- Pain/Spine
- Orthopedics
- Gastroenterology
- Women’s Health
- Oncology
- Urology
- Podiatry

**Primary Care**
- Internal Medicine
- Multi-Specialty
- Risk-Sharing
- Concierge Medicine

**Hospital Outsourced Services**
- Anesthesia
- Emergency Medicine
- Radiology
- Hospitalists
- Air Transport
- Hospice
## Why Investor Interests in Physician Services?

<table>
<thead>
<tr>
<th>Attractive Sector for Private Equity</th>
<th>Attractive Business Model</th>
</tr>
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</table>
| • Fragmentation – Healthcare still remains ripe for consolidation  
• Proven Track Record – Strong returns and continued influx of capital  
• Industry Tailwinds – Projected healthcare spending by 2020  
• Attractive Model – Multiple reasons to be further discussed | • Employed physician model with consistency of compensation structures  
• Presence of high margin ancillaries (e.g., lab, pharmacy, products)  
• Ability to leverage providers with extenders  
• Capitalize on brand recognition given the local nature of care delivery  
• Direct to consumer marketing & payor diversification (retail medicine)  
• Clear benefits of scale  
• Consolidation opportunity |

<table>
<thead>
<tr>
<th>Consolidation Opportunity</th>
<th>Clear Benefits of Scale</th>
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</table>
| • Ample runway for acquisitions in fragmented markets, even within crowded subsectors  
• Multiple arbitrage for add-ons allows sponsors to buy down their blended multiples  
• Aging owners and recent reimbursement cuts are increasing the willingness to sell  
• Physicians out of residency / fellowship are less willing to start their own practice  
• Affords the opportunity to preserve private practice (retail medicine less options for hospital employment)  
• Capital needed to get to scale | • Ability to build out and support full suite of ancillary services helps the economic model and also assists in recruiting  
• Consolidation of back office support services (e.g., billing, finance / accounting, scheduling, HR)  
• More favorable vendor pricing  
• Ability to attract a higher caliber management team  
• Infrastructure to fold in additional practices  
• Easier to recruit and formalize training programs |
<table>
<thead>
<tr>
<th>A Comparison of Approaches and Motivations</th>
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<tbody>
<tr>
<td><strong>Health System Perspective</strong></td>
</tr>
<tr>
<td>• Oriented toward care delivery, clinical integration, market share, and historical and long-term relationships</td>
</tr>
<tr>
<td>• Focused on diagnostic services that are convertible to HOPD and hospital based reimbursement</td>
</tr>
<tr>
<td>• Services with quality, patient safety and performance initiative focus to take advantage of value based reimbursement and risk contracting opportunities</td>
</tr>
<tr>
<td>• Involve asset acquisitions coupled with a FMV and CR compensation packages to physicians due to regulatory constraints and requirements</td>
</tr>
<tr>
<td>• Primary use of operating funds, retained capital reserves and/or debt sources</td>
</tr>
<tr>
<td>• Limitations on physicians to maintain a continuing equity role in the practice entity or health system entity</td>
</tr>
<tr>
<td>• Limitation of physician to benefit from compensation models, equity upside from future transactions and any significant increase in scale of specialty roll-ups or prospective gains</td>
</tr>
<tr>
<td>• Premised on continuing long-term relationships (15-20 years or more) and targeted specialty clinical specialty service lines and PCPs</td>
</tr>
<tr>
<td><strong>Private Equity Firm Perspective</strong></td>
</tr>
<tr>
<td>• PE firms provide an alternative to health systems</td>
</tr>
<tr>
<td>• PE firms are focusing on specific and certain clinical services and delivery models</td>
</tr>
<tr>
<td>• PE firms are not constrained by legal/regulatory requirements on asset acquisitions, physician compensation</td>
</tr>
<tr>
<td>• Key focus on financial performance and “Return of and Return on” investment attribution to the physicians as well</td>
</tr>
<tr>
<td>• Physician receives FMV compensation and retains an equity position (e.g., 20%-30%) in the new entity – adjusted compensation to derived EBITDA basis for asset and acquisition valuation to provide equity for but-out</td>
</tr>
<tr>
<td>• PE firms focus on readily scalable and capital intensive services with stable or increasing levels of reimbursement with opportunities to manage risk through improved practice performance</td>
</tr>
<tr>
<td>• Use of capital from debt, wealth funds and high net-worth individual etc., with anticipate average annual returns of 20% or more</td>
</tr>
<tr>
<td>• PE managers enhance returns by rotation of their investments, typically within time horizons of five to seven years - known as a “liquidity event” or “second bite of the apple”</td>
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</table>
Emerging interest of Hospitals and Health Systems to begin looking at new approaches to provide an alternative to PE Firms for Physicians:

- Create new legal and operating organizational structures that permit jointly owned, governed and operated Physician Equity Corporations
- Similarities: Owners & Associates, Distribution and Equity to Owners, Compensation Plan based on Performance, and Economic Risks to Owners
- Differences: Health System Economic and Governance Partner, Clinical Integration Participation, Scale Advantage, and Cross Partnership Opportunities

Key characteristics:

- Acquisition prices and relationship based on EBITDA, a proxy for operating cash flow, restatement of historical income statement (i.e., FMV compensation and equity balancing to create cash payment and future returns)
- Combination of existing employed and market practices to provide arbitrage opportunity from scale

Requirements: Achieving Scale, Accessing Capital, Preserving a Sense of Autonomy and Preserving a “Fair Share of Physician Equity”
Health System – Physician Equity Corporation

LLC Units owned by Health System and Physicians/Groups

Board Positions by Ownership Percent

Operations managed by physician and executives

Major Decisions:
- Physician Opportunities to Own Units
- Entry and Exit of Physician Owners
- Earnings Distributions
- New Clinical and Ancillary Services Development and Placement
- Physician Recruitment, Retention, Deployment and Affiliation Strategy
- Payor and Business Relationships

Health System – Physician Equity Corporation

Board of Directors

Management

Clinical Practice

Ancillary
A Look Ahead – More to Come

Key takeaways from the McGuireWoods’ recently held 16th Annual Healthcare and Life Sciences Private Equity and Finance Conference in Chicago provides a glimpse of what’s ahead:

1. Debt capital continues to be readily available, with predictions that the bullish approach would continue for at least the next two to three years.
   - Going outside their comfort zones
   - Changing the strike zone (lower EBITDA companies) and non traditional healthcare companies

2. Increased involvement of Women lead private equity firms through recruitment, advancement and retention and power and influence it brings to this sector.

3. Physician alignment continues to be an area of focus for private equity-backed platforms.
   - Equity strategies, cultural, governance and compensation to align physicians and platforms

4. Issues with recruiting the next generation of providers.
   - Focus on signing bonuses, long guarantees, and student loan payments
   - Quality life balance, use of non-providers, and ensuring “top of license” performance

5. Predicted a growth in platform exits over the next couple of years.
   - PE and Funds exiting their initial platforms – regeneration or liquidity events
Due Diligence, Structural and Regulatory Considerations

Lisa Atlas Genecov
Katten Muchin Roseman LLP
Differences in Diligence Issues and Focus

Private Equity looks at corporate and transactional diligence as healthcare systems do, but has an additional, strong focus on future earnings, efficiencies and growth.

a. Reimbursement considerations and diligence for PE is largely focused on ROI (return on investment) of the transaction, while health systems typically focus on synergies, compliance, efficiencies and quality factors.
   - Most PE firms order a consultant’s Q&E Report (Quality of Earnings Report – assesses historical earnings and achievability of future projections.)

b. PE firms are looking for high rewards, and their non-financial diligence focus is typically targeted to greater risk areas, including:
   - Compliance Programs and HIPPA Compliance
   - Physician Arrangements
   - Billing and Coding Compliance

c. Some PE firms have a greater understanding of healthcare regulatory and compliance issues and other rely more heavily on outside consultants and attorneys regarding the diligence process
   - Billing and Coding Audits
   - Compliance Plan Review by Consultant

d. What issues could delay or impact the PE exit?
Competitive Auction Process

- NDA, Confidential Information Statement, Seller-Oriented Purchase Agreement.
- A competitive process through the execution of a Definitive Purchase Agreement generally:
  - Yields higher purchase price for the Target
  - Yields superior non-price terms for the Target
  - Is less susceptible to delays
  - Typically shorter completion time
- Downside to a competitive process:
  - Some potential investment partners will dislike lack of exclusivity
  - Pursuing a competitive process but then failing to generate a sufficient interest may effect future prospects for Seller, desired investment partners, or preferred terms
  - More complex to manage
  - From a Buyer standpoint, level of diligence is reduced
Typical PE/Physician Transaction Structure

- PE Investor(s)
- Holding Company
- Operating Company (Manager)
- Practice(s) (non-CPOM State)
- Practice (CPOM State)
- Dr. Owner
  - Professional Entity

MSA

Transfer Restriction and Option Agreement

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Rollover Equity

• What is “Rollover Equity”?
  • In lieu of cash proceeds, equity holders in the target company (such as founding physicians and other key members) take a portion of their sale consideration in the form of equity that is “rolled over” to the physician sellers or their entity
  • Rollover equity helps ensure that the interest of the key members of the target practice continue to be aligned with the incoming private equity investor
  • Rollover equity is sometimes subject to vesting
In jurisdictions that restrict CPOM, a transaction structure may include an investor-owned (or Holding Company-owned) Management Services Organization ("MSO")

- Non-clinical assets are transferred to the MSO, which provides business and financial management services and assumes the "business risk" for the entities
- Must transfer sufficient value to the MSO to attract the desired level of private equity investment, including through a long term management services agreement ("MSA")

The professional company ("PC") enters into MSA with the MSO, and the MSO collects fees from the PC to manage its non-clinical assets

- Licensed physicians own the PC, which holds all clinical assets
- Management fees must be "fair market value" (e.g., a sweep of profits might be a violation of CPOM in certain states)
- Clinical Advisory Board or Joint Operating Committee
Asset Sale vs. Stock Purchase or Merger

• Asset deals could impact timing of cash flow due to need for new provider numbers and possible new payor contracts (enrollment and credentialing)

• Stock or Merger transactions implicate potential successor liability issues
Private Equity Exit Strategies

- Private equity firms generally purchase “portfolio companies” with the intention of cutting expenses increasing the portfolio companies’ value, realizing a positive return, and then exiting the investment.
- Exits usually occur between three (3) and seven (7) years following the initial investment.
- Exit Strategies:
  - Initial Public Offering (IPOs)
    - Expensive, long process
    - Lock-up of PE shares for 180+ days
  - Sales to a third party (usually exercising drag-along rights)
  - Secondary Buy-Out: Portfolio Company sold by one PE Sponsor to another PE Sponsor
Regulatory Challenges and Considerations

(a) Corporate Practice of Medicine Prohibitions
   - State-by-State issues
   - Prohibits control over medical judgment/decision-making
   - Impacts structure of transaction, e.g., management company acquires non-clinical assets, and physician entity acquires medical assets
   - Typically requires physicians to be employed by entities owned by physicians or physician entities
   - Decisions on hiring, firing, peer review, credentialing and matters impacting care delivery typically need to be made by physicians

(b) Certificate of Need
   - Is government approval required prior to closing? (could impact timing of transaction)

(c) Fee-Splitting
   - Are the parties restricted in how the management fee is structured (e.g., fixed fee vs. percentage fee)
   - FMV analysis often recommended
(d) Licensure
   • Licenses, certificates and accreditations could trigger CHOW (change of ownership) notifications and possibly impact timing of the transaction

(e) Stark Law and Anti-Kickback Issues
   • Enforcement could result in exclusion, potential damages, corporate integrity agreement obligations, False Claims Act violations with treble damages
   • Consideration of Self-Disclosures prior to closing

(f) Privacy and Security Issues
   • Need for heightened diligence due to data breach risks
Responding to Due Diligence Risks

- Representations and Warranties, Indemnification, Survival Periods, Hold-Back, Escrow, Purchase Price Adjustment, etc.
  - Fundamental Representations and Warranties; longer survival periods
- Pre-Closing Remediation:
  - Self-Disclosure
  - Affirmative Reporting
  - Contract Revision
  - Adjusted Purchase Price
- Representation and Warranty Insurance
Governance

(a) Private Equity
- Typically does not want to manage day-to-day operations of the company
- Board often has subject-matter experts
- Shareholders may want designees on Board and/or veto rights over extraordinary actions to protect its investment
- Reserved powers; Supermajority voting rights
- CPOM prohibitions, if any, may determine how much control the PE can exercise
- Balance of Private Equity Control and Clinical Control, e.g., Clinical Advisory Committees, Joint Operating Committees, etc.

(b) Health Systems
- Will want more day-to-day control over operations, decisions and policies
- In an integrated health system, will require physician management to report to hospital/system boards
- CPOM prohibitions, if any, may determine how much control the health system can exercise
Physician Compensation Models & FMV Considerations

Jonathan Helm, CVA
VMG Health
## Physician Compensation Model Comparison

### Value Proposition

<table>
<thead>
<tr>
<th>Health System</th>
<th>Private Equity</th>
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<tbody>
<tr>
<td>✓ <strong>Compensation</strong> (stability, market-level amount, work-based)</td>
<td>✓ <strong>Monetizing earnings</strong> (up-front payment for partner physicians)</td>
</tr>
<tr>
<td>✓ Ability to focus on patient care vs. practice administrative functions</td>
<td>✓ Ability to become an owner (employed physicians)</td>
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<tr>
<td>✓ Work-life balance</td>
<td>✓ Less bureaucracy</td>
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<tr>
<td>✓ <strong>Protection</strong> from economic factors:</td>
<td>✓ Maintain independence</td>
</tr>
<tr>
<td>✓ Declining reimbursements</td>
<td></td>
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<tr>
<td>✓ Increasing operating costs</td>
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<tr>
<td>✓ Uncertainty of future reimbursement models and IT investment</td>
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<tr>
<td>✓ Increased ability to participate in compensated administrative functions of interest</td>
<td>✓ <strong>Size/scale</strong> that may improve:</td>
</tr>
<tr>
<td></td>
<td>✓ Reimbursement</td>
</tr>
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<td></td>
<td>✓ Expense management</td>
</tr>
<tr>
<td></td>
<td>✓ Focused operational management</td>
</tr>
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<td></td>
<td>✓ Participation in equity upside</td>
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</tbody>
</table>
Physician Compensation Model Comparison

Compensation Models

Health System

- Base compensation
- Production Incentive: Based on work RVUs
- Non-Production Incentive: Tied to value and/or quality measures
- Other Compensation:
  - Excess on-call coverage
  - Advanced practice provider (APP) supervision
  - Medical directorship services

Key Considerations

- Compensation amounts usually tied closely to market compensation surveys
- Compensation models and amounts focused on meeting community and patient needs rather than practice economics
- Fair market value documentation is crucial
Compensation Models

**Private Equity**

- **Base compensation**
  - Based on professional collections

- **Production Incentive**
  - Tied to value and/or quality measures

- **Leadership Role**

- **Equity Interest**
  - Employed physicians to become partners
  - Profits Interest
  - Opportunities to purchase equity in HoldCo

**Key Considerations**

- Compensation surveys may be considered, but are usually not the primary basis for compensation models
- Physician practice profitability plays a significant role in determining physician compensation
- Fair market value documentation less of a focus
Long-Term Considerations

<table>
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<th>Health Systems</th>
<th>Private Equity</th>
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<tr>
<td>Economic sustainability</td>
<td>Providing competitive compensation rates</td>
</tr>
<tr>
<td>Adequate incentives</td>
<td>Motivating senior/partner physicians</td>
</tr>
<tr>
<td>Achievement of value</td>
<td>Adding value through operational efficiencies</td>
</tr>
<tr>
<td></td>
<td>Creating equity value</td>
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Management Agreements

- Established between professional company and operating company
- Often used in corporate practice of medicine (CPOM) states
- Management fee typically set at fair market value rate
- Recommended fee structure may vary depending on the state

Value Drivers

- Services Being Provided
- Management Fee Structure (fixed, variable, cost-plus)
- Available Market Comparable Data
- Expected Costs of the Management Organization
- Other Management Agreement Terms