Private Equity & Health System Acquisitions of Medical Groups

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Disclosure Slide

These materials and associated remarks are intended to facilitate a general discussion of issues that may arise in the context of healthcare transactions. They are not intended to be comprehensive or to serve as a substitute for legal or other advice, and they should not be relied upon as such. Attorneys, accountants and other professionals need to draw their own conclusions relative to the facts and circumstances of any particular situation and take into account all applicable laws when formulating advice.

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Agenda

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Overview of Physician Market

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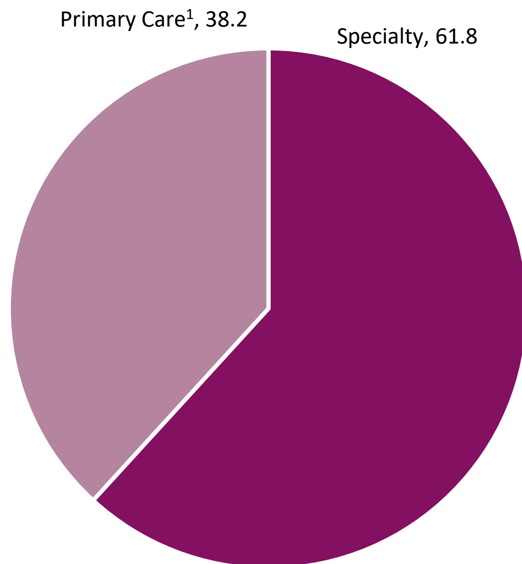
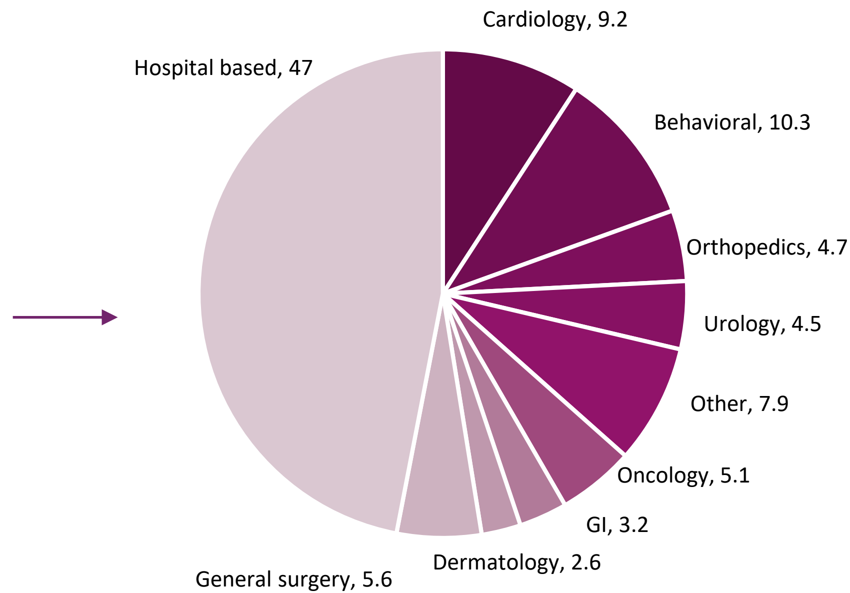
Composition of the Physician Market

Primary vs Specialty



Specialty Breakdown



Key Trends

>1M
Active physicians in US

38.2%
Physicians in primary care

620K
Physicians in specialties

4.7%
Specialists in Orthopedics

Notes: (1) Primary Care: Family Medicine, Internal Medicine, Pediatrics, OB/GYN, Preventative Medicine

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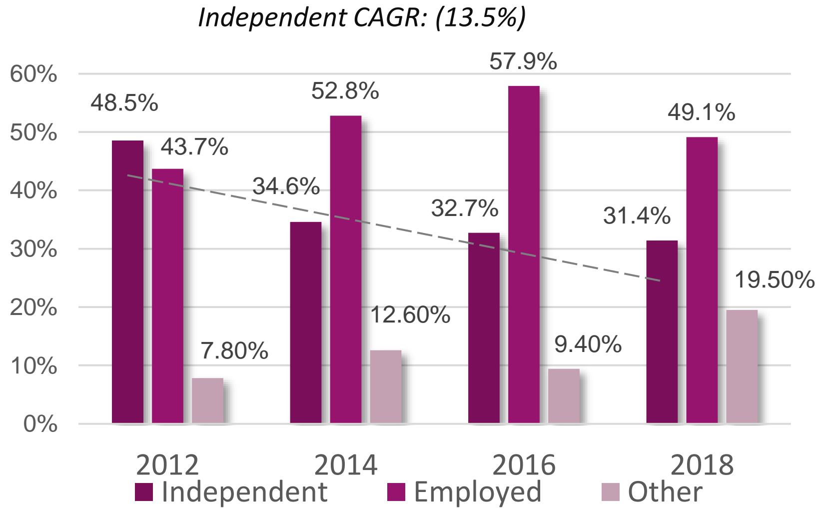
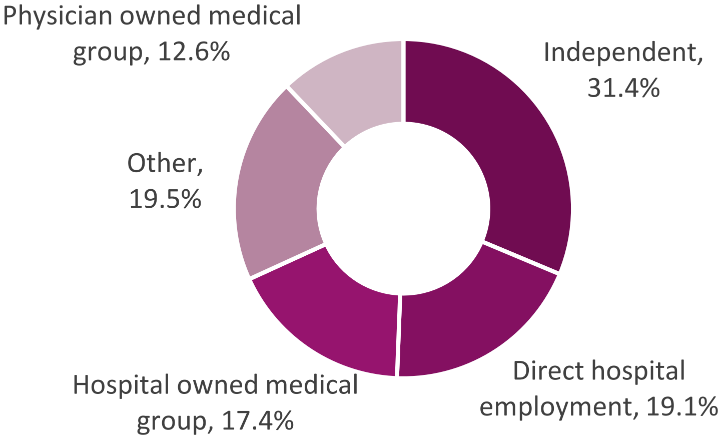
2018 Merritt Hawkins Physicians Foundation Survey

Employment Trends



2018 Detailed Results



Observations

- From 2012 to 2018, independent physicians declined from **48.5%** of the workforce to **31.4%**
- Physicians continue to shift into an employed setting either through a health system or a large group setting

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AMA Physician Practice Benchmark Survey

"2016 was the first year in which **less than half** of practicing physicians had an ownership stake in their practice. 2018 marked the first year in which there were fewer physician owners than employees."

"Between 2012 and 2018, the percentage of physicians in practices with 10 or fewer physicians dropped from 61.4 percent to 56.5 percent with much of that change driven by a **shift away from solo practice**."

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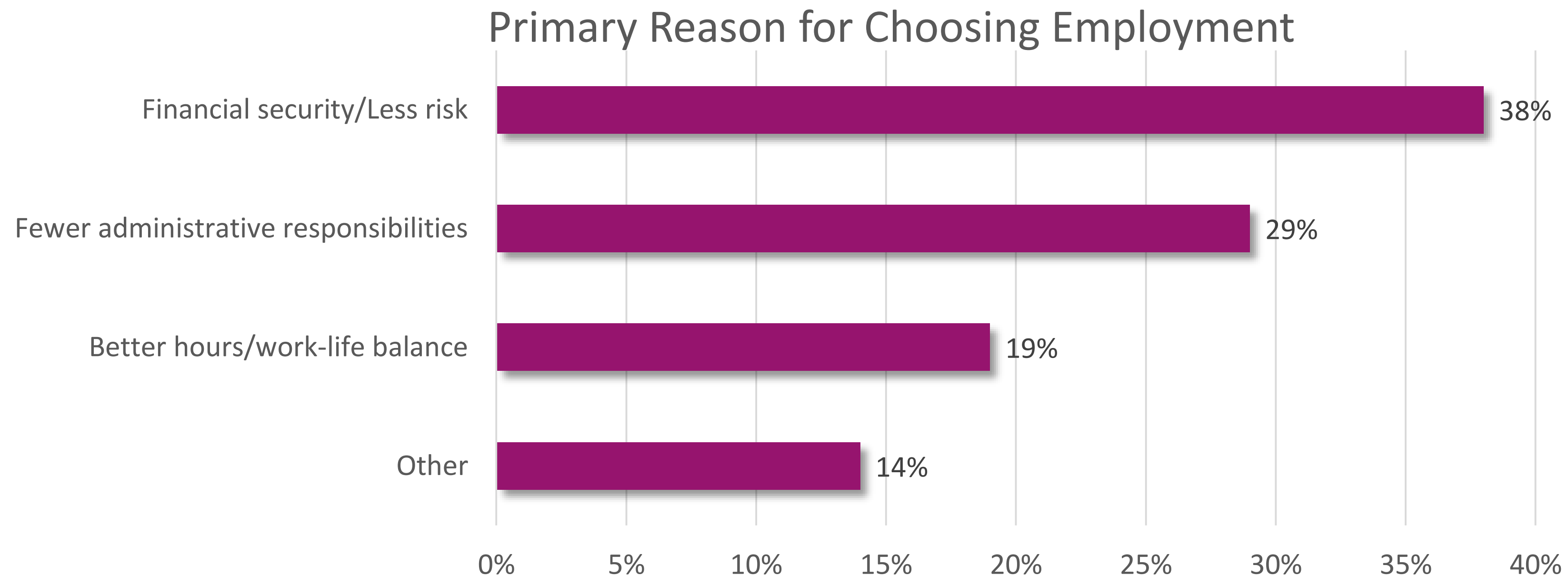
Decreased Risk – Physician Perspective



Medscape "Employed Doctors Report"

OBSERVATIONS: The most common reason physicians cited for leaving private practice and choosing employment was for **financial security / less risk**

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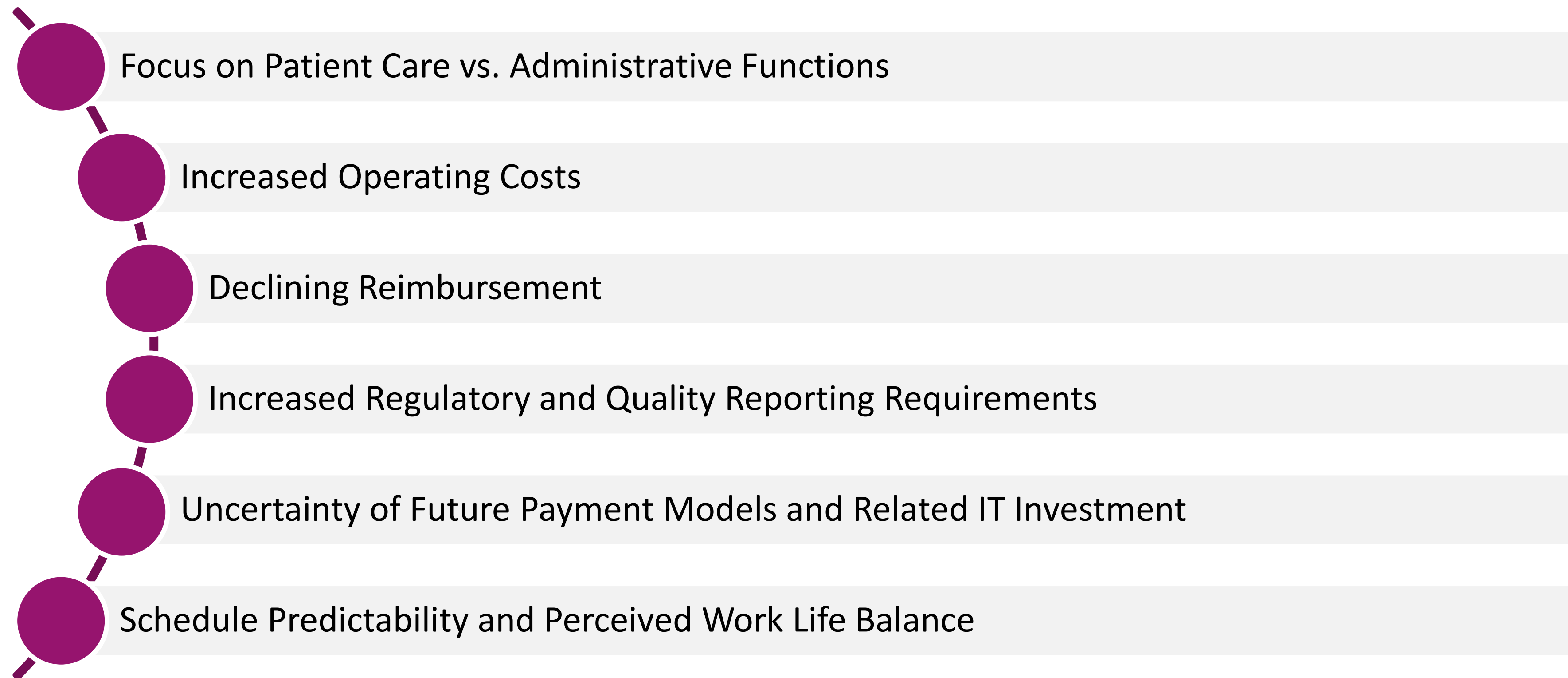
Value Proposition to Physicians



Source: Physicians Advocacy Institute – "Physician Practice Acquisition Study", American Medical Association – "Principles for Physician Employment", New England Journal of Medicine – "Understanding the Physician Employment Movement"

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Overview of Hospital Market

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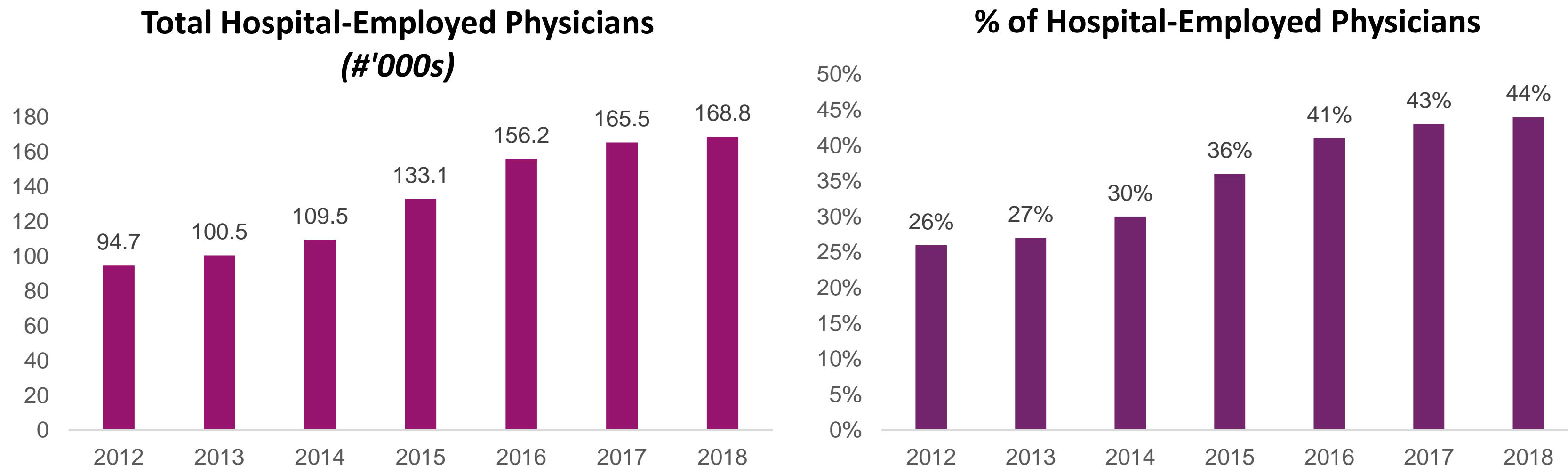
Health System Physician Acquisition Trends



Total employed physicians increased 10% compounded annually, [from 95,000 in 2012 to 169,000 in 2018]. The total percentage of employed physicians has increased from 26.0% in 2012 to 44.0% in 2018.

Source: : Physicians Advocacy Institute – "Updated Physician Practice Acquisition Study" 2012-2018

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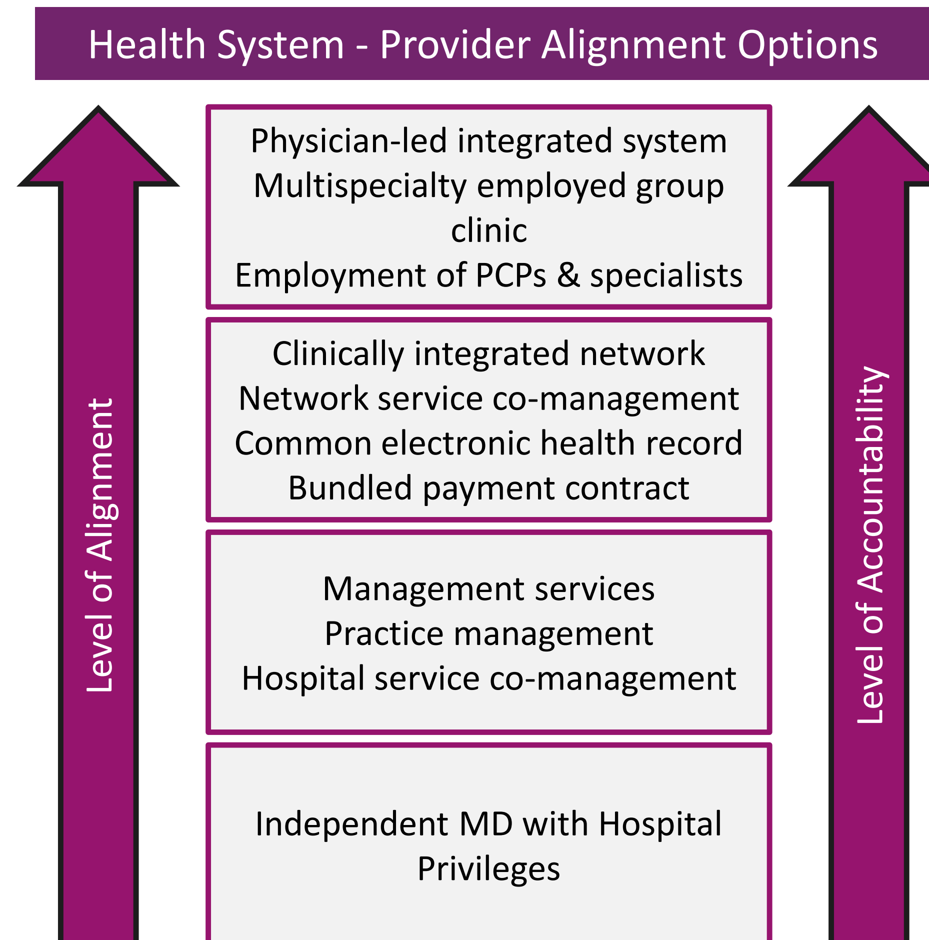
Physician Value Proposition to a Health System

The main advantages to physician employment over alternative alignment options are as follows:

- Physician employment allows health system to have greater control of physician group
- Employment results in the highest level of integration and accountability
- In markets where physician employment is high, health systems must employ physicians to remain competitive
- Health systems are still required to make significant investments when choosing an alternative alignment (e.g. **investing in a common IT platform**)
- The right alignment model is the product of market dynamics and health system and physician group organizational needs and preferences



Source: HFMA – Value Project Report

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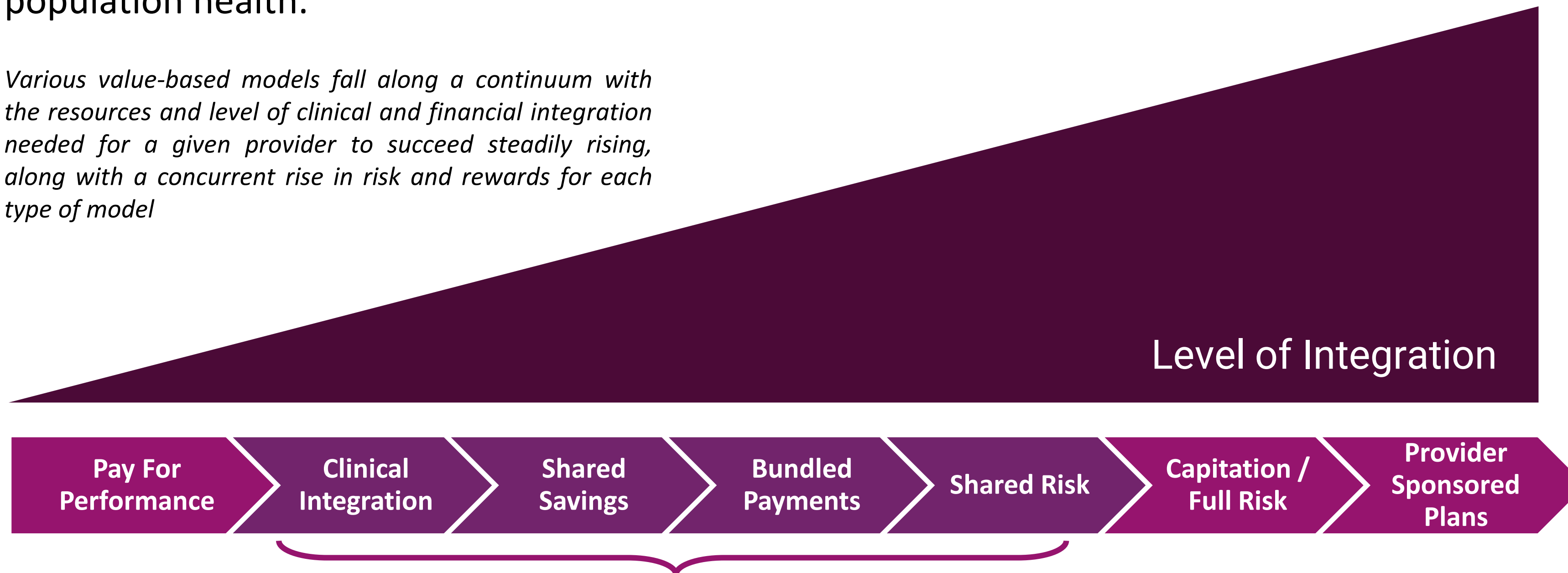
Value Based Care

Value-based contracting can take a variety of forms, ranging from a pay for performance, bonus, shared savings (upside only), shared savings/shared risks (upside and downside), bundled payment (often based upon episode of care), to full risk arrangement based upon population health.

Various value-based models fall along a continuum with the resources and level of clinical and financial integration needed for a given provider to succeed steadily rising, along with a concurrent rise in risk and rewards for each type of model



Many health systems have major initiatives along this spectrum of the risk continuum

Source: "Health Care Facilities & Managed Care" - Bank of America Merrill Lynch, October 26, 2015.

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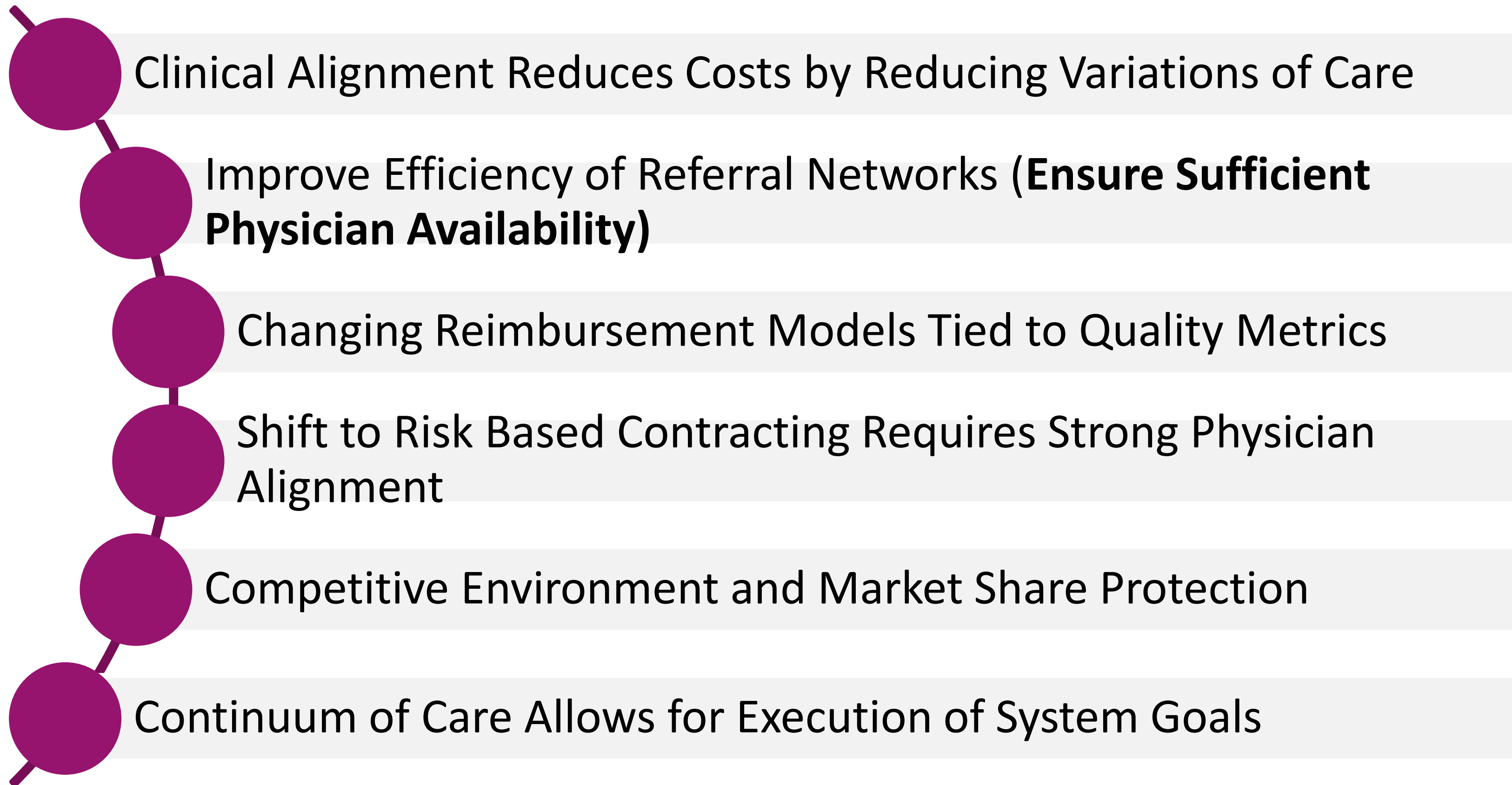
Key Motivations for Health Systems to Employ Physicians



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Physician Impact to System Economics

Merritt Hawkins Survey Results

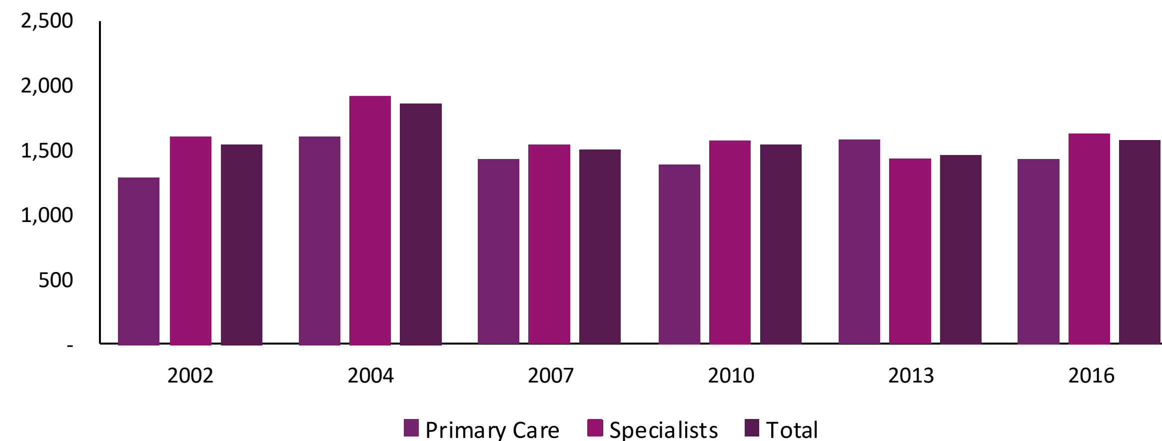
- Employed physicians generate significant revenue for their affiliated hospitals through patient admissions, procedures, treatments, and tests as employed physicians are more likely to refer "in-house" than non employed physicians.
- The average annual revenue generated by physicians is around **$1.5 million.**

Specialist Physicians

- Revenue generated by specialist physicians ranged from a low of $1.4 million to a high of $1.9 million over the survey period.

Primary Care Physicians

- Revenue generated by primary care physicians ranged from a low of $1.2 million to a high of $1.5 million over the survey period.



Source: Merritt Hawkins "2016 Physician Inpatient / Outpatient Revenue Survey"

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Overview of Private Equity Market

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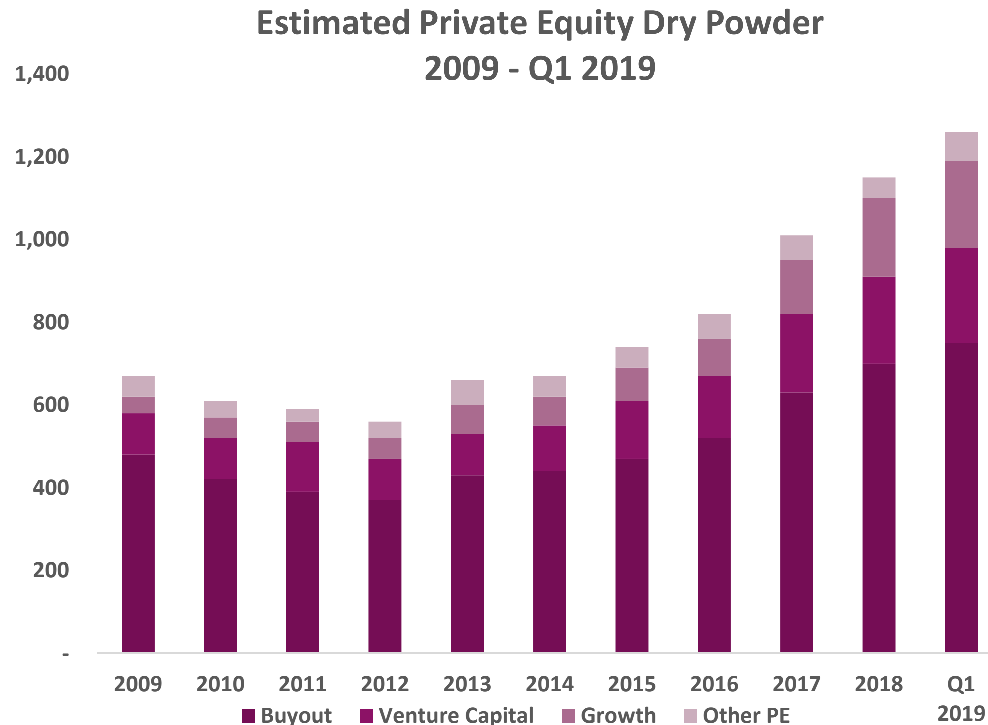
Private Equity Investment in Healthcare

The Preqin Q1 2019 report estimates available capital (“dry powder”) – money raised but not invested – has approached **$1.26 trillion** across most private markets.



Source: Preqin Quarterly Private Equity Update

Global Fundraising Trends

- Available capital has increased each year on average since **2012**
- Investors have poured money into PE funds
- PE managers struggling to find attractive deals with such high asset values

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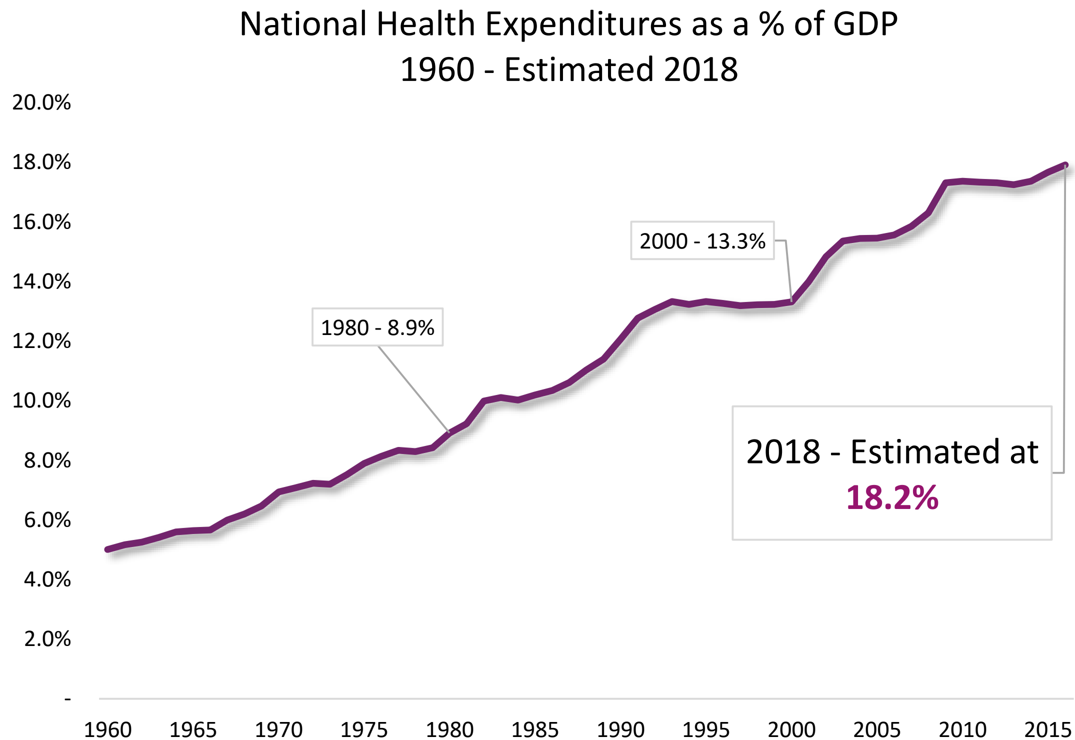
Private Equity Investment in Healthcare



Healthcare Spending Trends

8.9%

- Spending as % of GDP, 1980

13.3%

- Spending as % of GDP, 2000

18.2%

- Spending as % of GDP, 2018 (Estimated)

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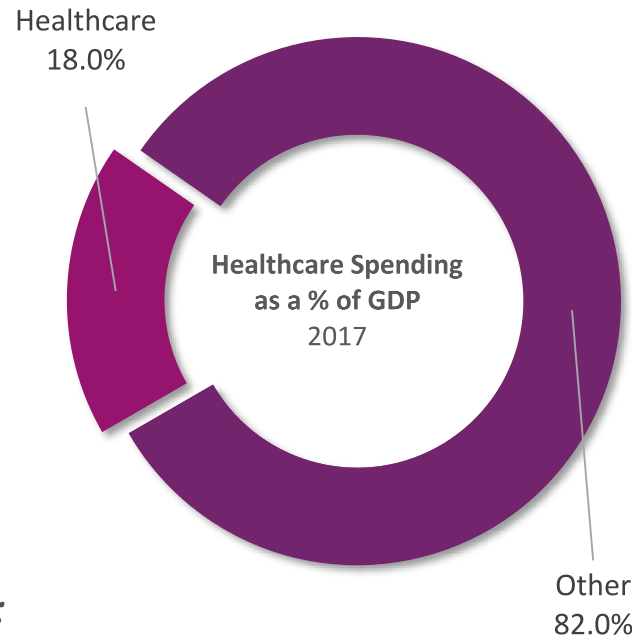
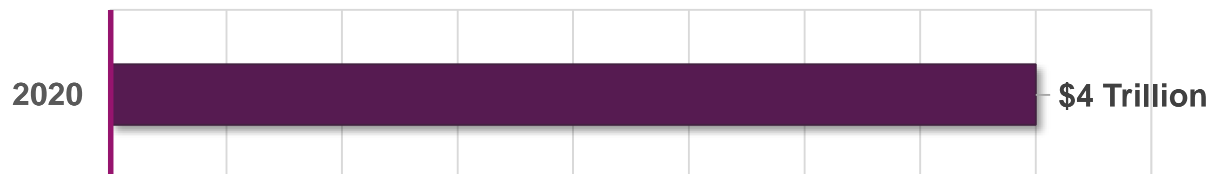
Why is Healthcare Attractive to Private Equity?

- Fragmented, large market
- Sector has historically yielded good returns
- Favorable long-term trends



> *"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 …"*
>
> *- Bain Global Healthcare Private Equity and Corporate M&A Report 2017*

Projected healthcare spending by 2020:



Source: Bain Global Healthcare Private Equity and Corporate M&A Report 2017, Bain Insights; McKinsey & Company – "Capturing returns in healthcare"

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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)

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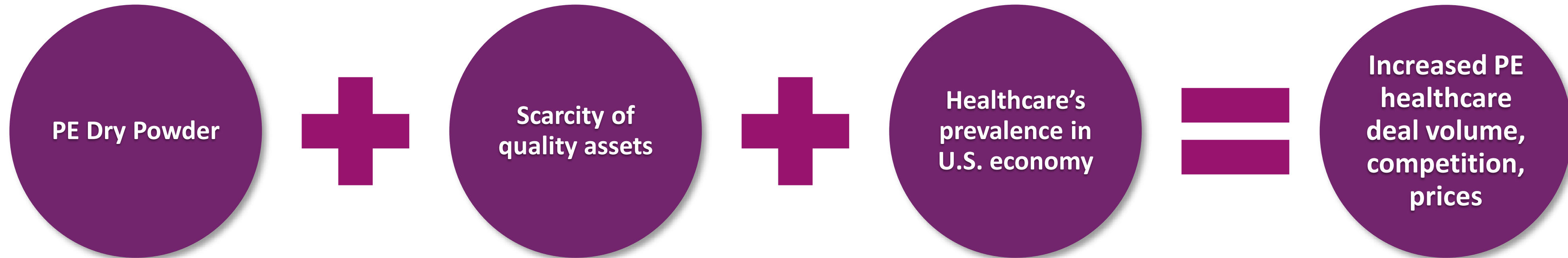
Private Equity Deploys Significant Capital



- February 2017 – Blackstone acquired TeamHealth Holdings for $6.1 billion
- April 2018 – Veritas Capital entered agreement to purchase GE Healthcare's value-based care division for $1.05 billion
- June 2018 – Clayton Dubilier & Rice acquired a 55% stake in NaviHealth from Cardinal Health
- June 2018 – KKR entered agreement to acquire Envision Healthcare for $9.9 billion
- July 2018 – Humana, TPG Capital, and WCAS completed acquisition of Kindred Healthcare
- July 2018 – Apollo Global Management announced a $5.6 billion deal to acquire and merge LifePoint Health with existing Apollo portfolio company RCCH HealthCare Partners

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Comparison of Approaches to a Transaction

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A Comparison of Approaches and Motivations

Health System Perspective	Private Equity Firm Perspective
▪ Focused on care delivery, clinical integration, market share, and historical and long-term relationships ▪ Potential for diagnostic services that are convertible to HOPD and hospital-based reimbursement ▪ Services with quality, patient safety and performance initiative focus to take advantage of value-based reimbursement and risk contracting opportunities ▪ Typically involve asset acquisitions coupled with fair market value compensation packages to physicians due to regulatory constraints and requirements ▪ Primary use of operating funds, retained capital reserves and/or debt sources ▪ Limitations on physicians to maintain a continuing equity role in the practice entity or health system entity ▪ Limit to the ability of physician(s) to share in equity upside from future transactions and any significant increase in scale of specialty roll-ups or prospective gains ▪ Premised on continuing long-term relationships and targeted specialty clinical specialty service lines and PCPs	▪ PE firms provide an alternative to health systems ▪ PE firms are focused on specific and certain clinical services and delivery models ▪ PE firms are not as constrained by legal/regulatory requirements on asset acquisitions, physician compensation ▪ Key focus – financial performance and “return of and return on” investment ▪ Physician receives compensation and may retain 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 buy-out ▪ 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 ▪ Use of capital from a variety of sources including debt, wealth funds and high net-worth individuals etc. ▪ PE managers enhance returns by rotation of their investments, typically within time horizons of three to seven years - known as a “liquidity event”

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Asset Purchase (Preferred Model)

Often a preferred model for both private equity and health system buyers

- Buyer can exclude liabilities and choose which liabilities to assume
- Lower risk of successor liability (in contrast to a stock purchase or merger)
- No acceptance of claims liability (whether professional, general, or overpayments)
- Diligence remains important (because unknown or contingent liability and successor liability is still possible issue)

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Due Diligence Issues and Focus

Health System Due Diligence	Private Equity Due Diligence
▪ Counsel typically engages a valuation professional ▪ Valuation must contain reasonable assumptions (fair market value v. investment value) ▪ Valuation must exclude any value from actual or anticipated referrals ▪ Compliant professional services agreement for staffing arrangements ▪ Not-for-profit health systems must conduct an examination of private inurement and unrelated business income ▪ Potential unwind – defined period after which the practice may exercise a right to repurchase the assets or determine whether mutual agreement is necessary ▪ Unwind – market value of the assets	▪ PE looks at corporate and transactional diligence just as health systems do, however PE firms tend to have additional, strong focus on future earnings, efficiencies, and growth ▪ Reimbursement considerations and diligence largely focused on return on investment (ROI) of the transaction, while health systems are typically focused on synergies, compliance, efficiencies and quality factors ▪ PE firms are looking for high rewards, and their non-financial diligence focus is typically targeted to greater risk areas (compliance programs and HIPAA compliance, physician arrangements, billing and coding compliance) ▪ Some PE firms have a greater understanding of healthcare regulatory compliance issues and others rely more heavily on outside consultants / attorneys regarding the diligence process ▪ Concerned and focused on issues that could delay or impact the ultimate exit of the investment

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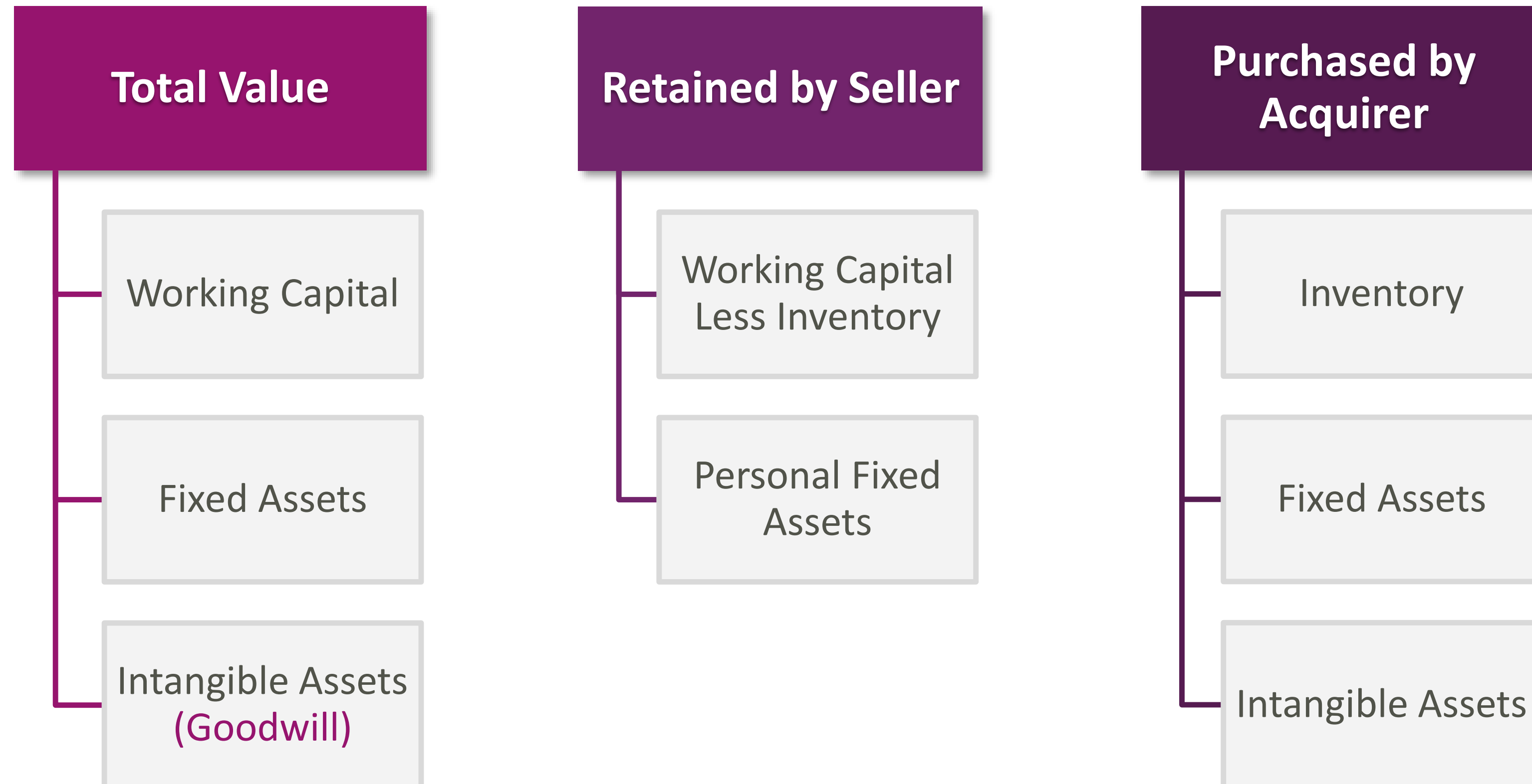
Health System: Valuation Methodology



Goodwill = the established reputation of a business regarded as a quantifiable asset, e.g., as represented by the excess of the price paid at a takeover for a company over its fair market value.

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Private Equity - Valuation Methodology

EBITDA

Earnings before interest, taxes, depreciation & amortization

- Total Purchase Price often a multiple of ***"Adjusted" EBITDA***
- ***Common Adjustments:***
  - *Non-recurring and non-operating expenses*
  - *Capitalization of historical partner compensation*
- **HIGHER** Adjusted EBITDA implies **HIGHER** Purchase Price

Total Revenue	**$1,000**
Less: Total Expenses	*(999)*
Net Income	**$1**
Plus: Interest	*9*
Plus: Depreciation & Amortization	*10*
Historical EBITDA	**$20**
Plus: Physician Base Salary	*830*
EBPC	**$850**
20.0% Capitalization	*170*

Adjusted EBITDA Calculation

Historical EBITDA	**$20**
Plus: Normalized Compensation	**170**
Plus: Other Non-Recurring / Non-Operating Expenses	35
Plus: Other Income	5
Adjusted EBITDA	**$230**
Times: Transaction Multiple	*9.0x*
Implied Purchase Price	**$2,070**
Adjusted Provider Compensation	*$680*

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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 often subject to vesting

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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) (can be expensive and long process / lock-up shares for 6 months+)
  - Sales to a third party (usually exercising drag-along rights)
  - Secondary Buy-Out: Portfolio Company sold by one PE Sponsor to another PE Sponsor (probably most common)

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Compensation Models

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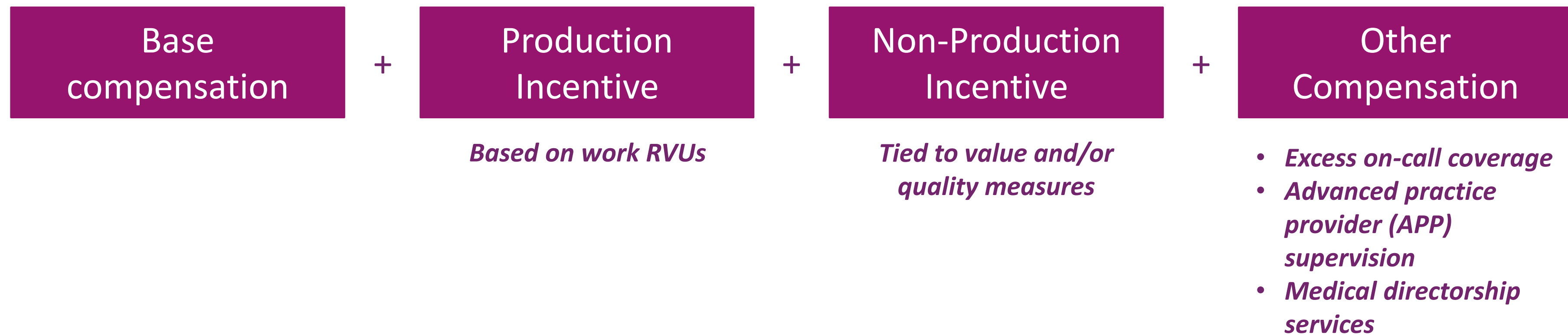
Compensation Models: Health System



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

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Compensation Models: Private Equity

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

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Physician Compensation Model Comparison

Health System

- ✓ Compensation (stability, market-level amount, work-based)
- ✓ Ability to focus on patient care vs. practice administrative functions
- ✓ Work-life balance
- ✓ Protection from economic factors:
  - ✓ Declining reimbursements
  - ✓ Increasing operating costs
  - ✓ Uncertainty of future reimbursement models and IT investment
- ✓ Increased ability to participate in compensated administrative functions of interest

Monetizing earnings

independence

Size/scale

operational management

equity upside

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Governance

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Governance

- **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
  - Corporate Practice of Medicine (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.
- **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

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Long-term Considerations

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Long-Term Considerations

Health Systems

Economic sustainability

Adequate incentives

Achievement of value

Private Equity

Providing competitive compensation rates

Motivating senior/partner physicians

Adding value through operational efficiencies

Creating equity value

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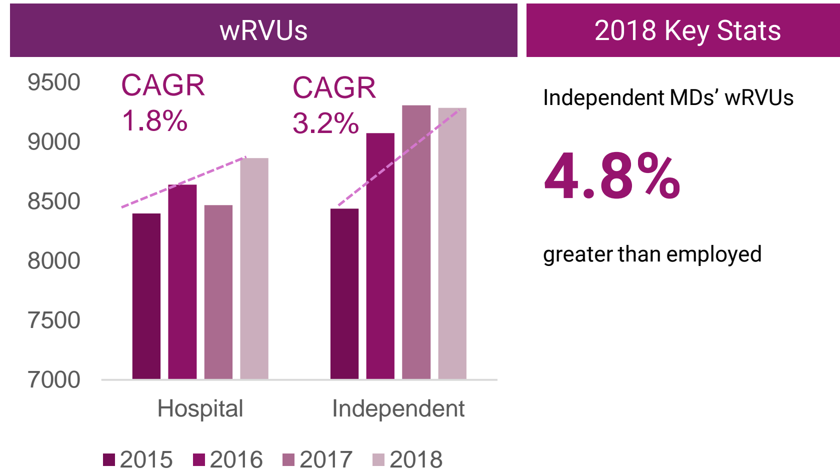
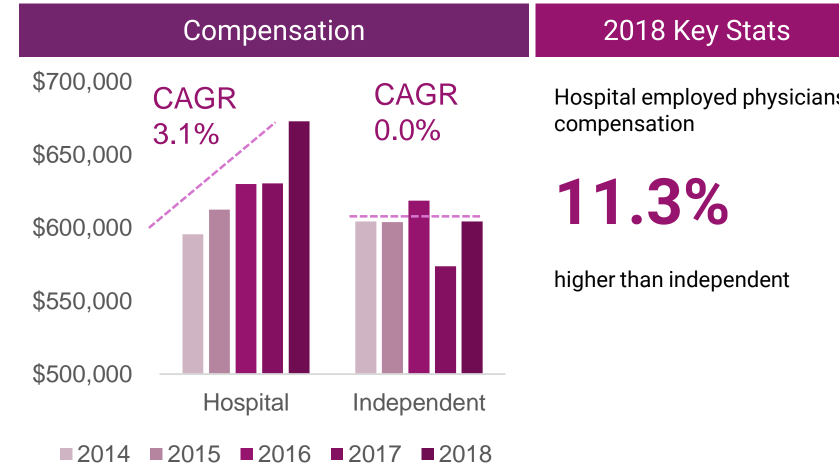
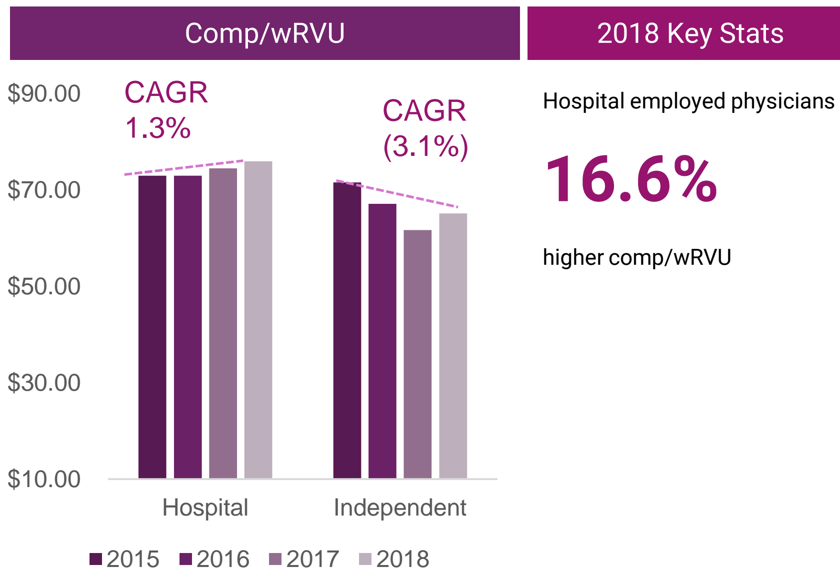
Hospital Employment Overview

Compensation: Orthopedics







Observations

- Across all metrics, hospital employed orthopedic physicians earn higher compensation for less wRVUs
- This observation is consistent for urology; data is inconclusive for other specialties

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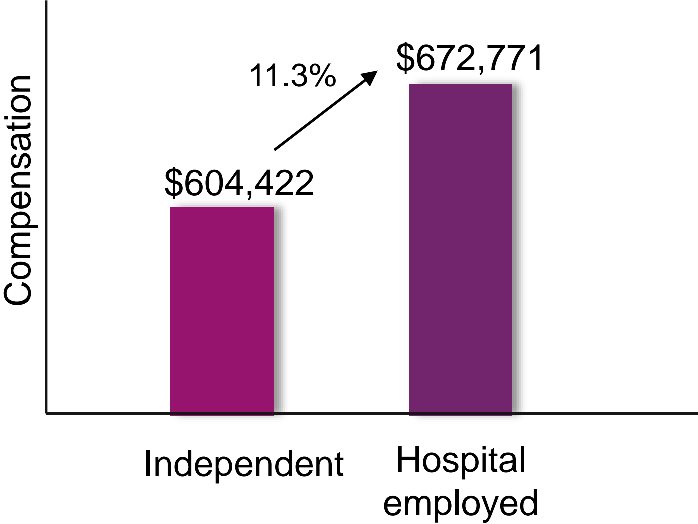
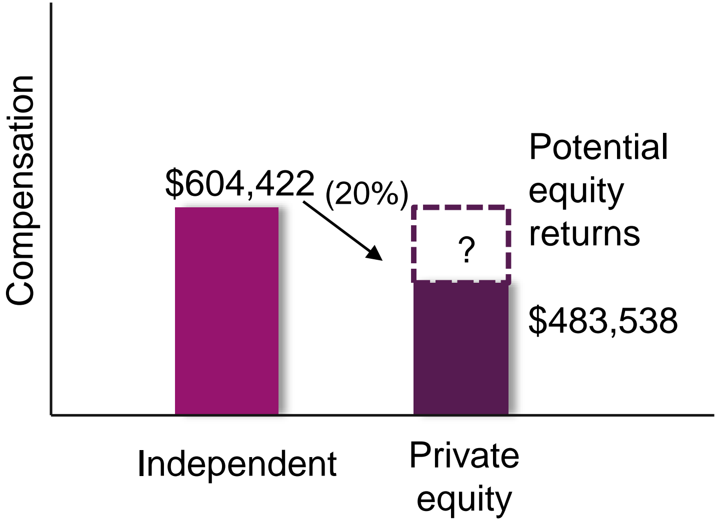
Future Considerations

Comparison of Compensation





COMPENSATION **INCREASE**

COMPENSATION **DECREASE**

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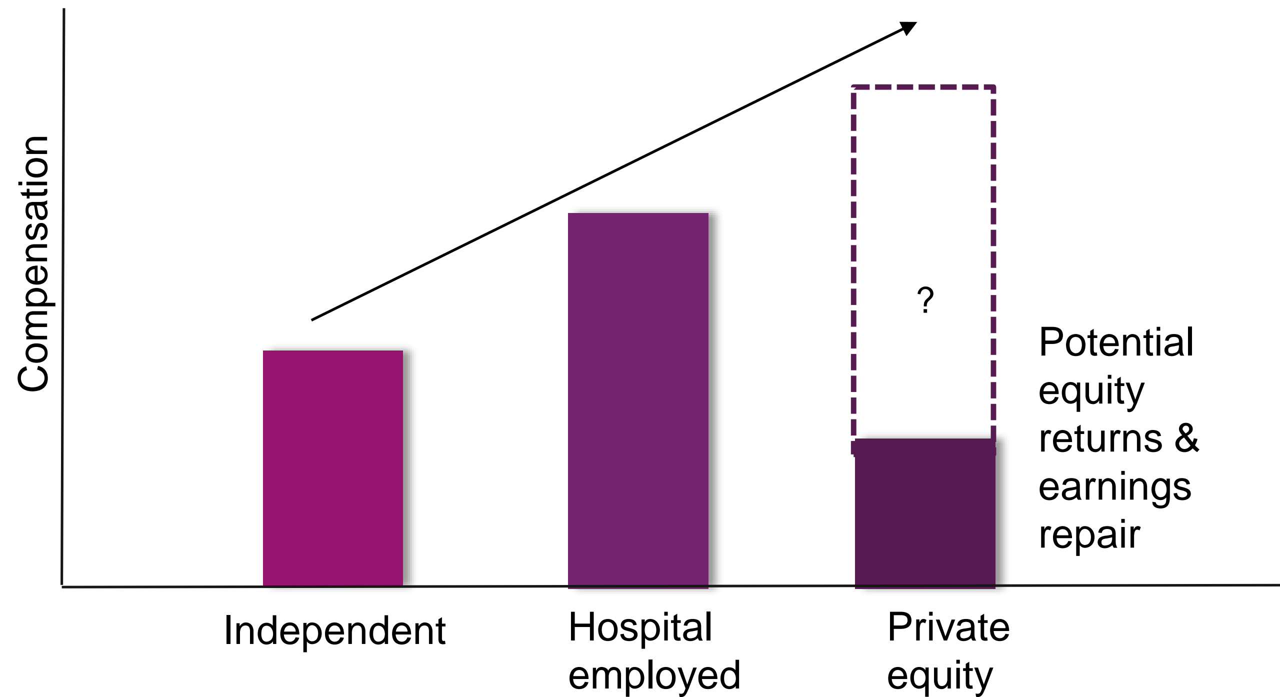
Future Considerations

Comparison of Compensation



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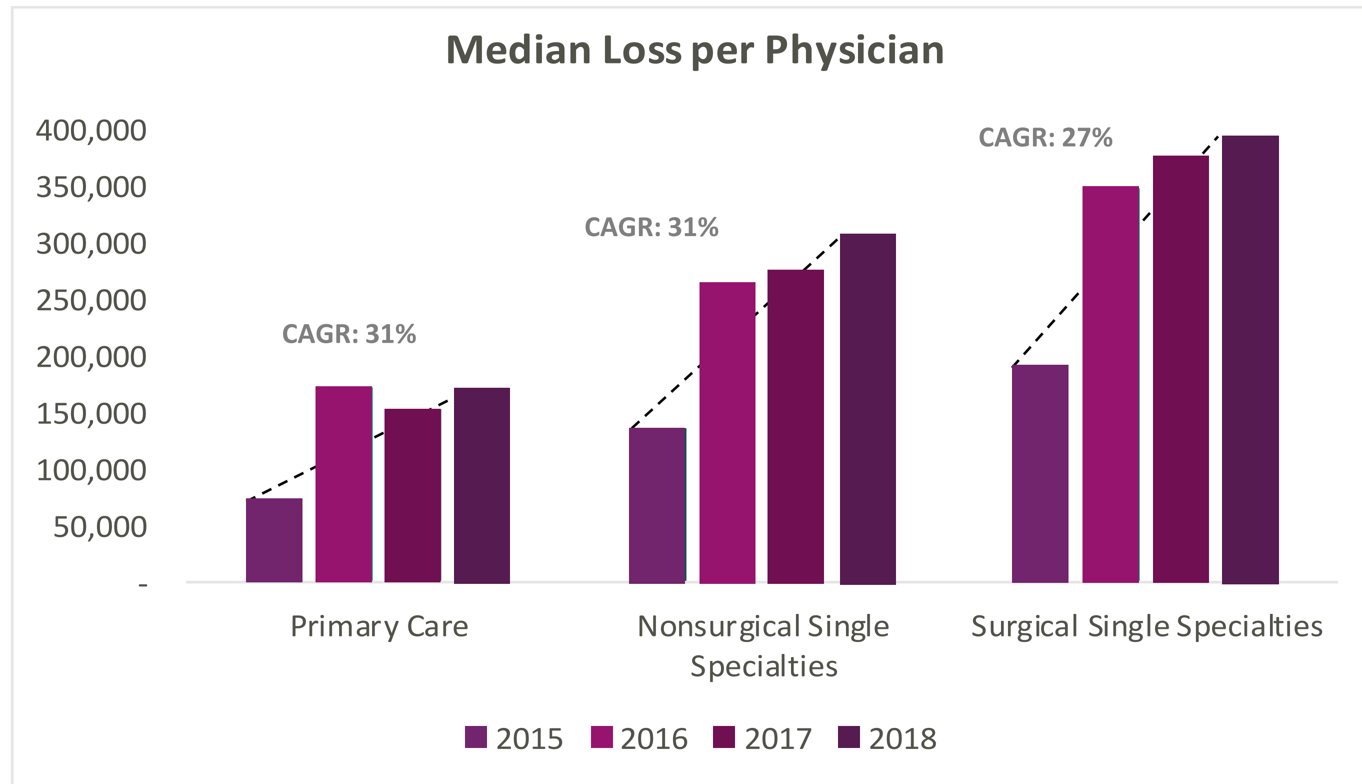
Hospital Physician Losses



Median Loss per Physician in 2018

- **$171,000** median loss per Primary Care Physician
- **$309,000** median loss per Nonsurgical Specialty Physician
- **$396,000** median loss per Surgical Physician

Given current losses, historical compensation models may be at risk in the future.

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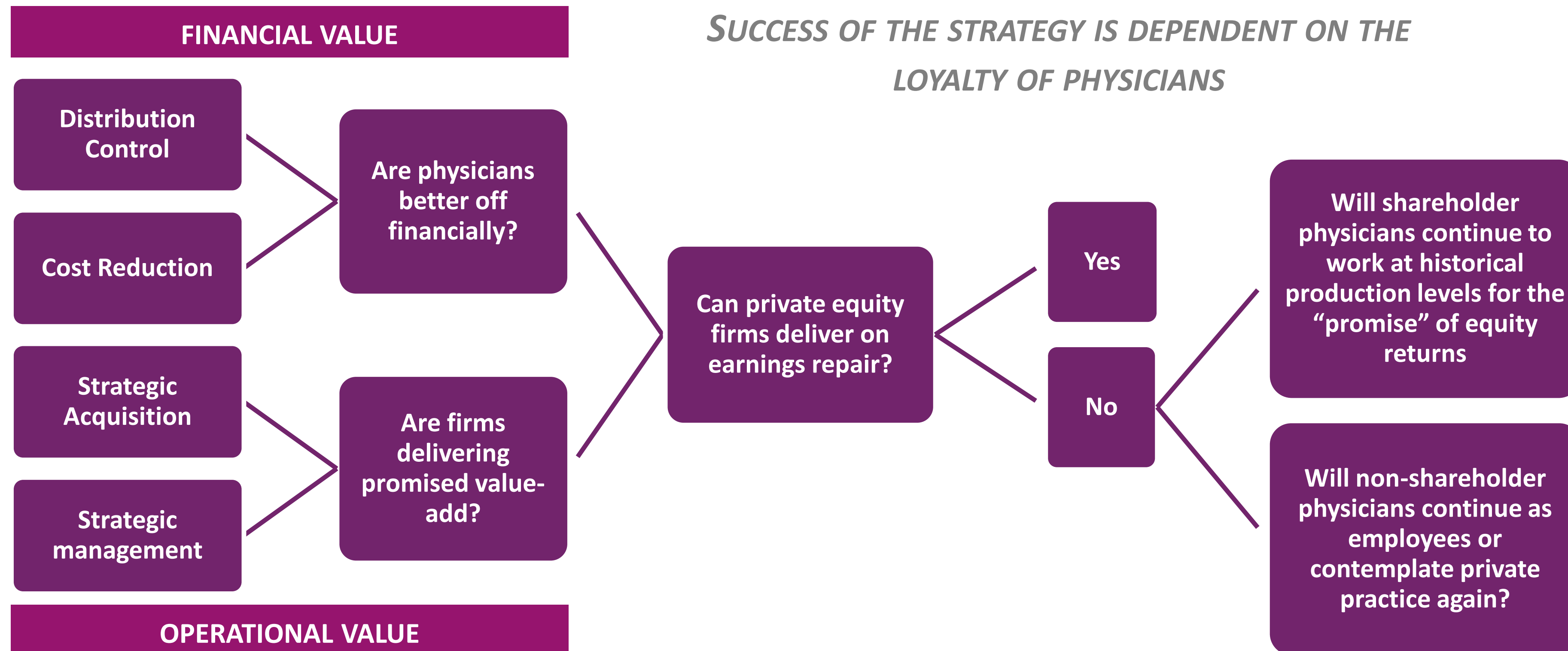
Equity Returns and Earnings Repair



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Questions?

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