Physician Practice Strategy: The Private Equity Play

Health systems, outpatient facilities, payors, and private equity firms (PE) are all vying for alignment with physicians since they drive practically all healthcare decisions. As a result, physicians are faced with many choices regarding employment and strategic partnerships. Of all these choices, the PE play appears to have grown the most among physician practices. The following outlines fundamentals to the PE option, as well as how health system partners offer different opportunities.

The Evolution of PE

Private equity (PE) investment in healthcare is not particularly new. However, the level of PE investment in healthcare has climbed from $19.5 billion in 2015 to $74.4 billion in 2022. (1) The growth of PE activity is also not projected to slow down anytime soon as the total number of deals has exceeded 1,000 in each of the past three years. (2) With projected increases in healthcare spending, along with significant stores of uninvested capital, PE investment in healthcare is still anticipated to flourish in the coming years. (1)

Over time, PE has expanded its area of focus from a few specialties to a much broader range of specialties. VMG Health has observed that there was a time when PE investment was focused primarily on specialties such as anesthesiology, dermatology, and gastroenterology. (3) Today, VMG Health has observed that significant PE investment is now focused on a wider range of specialties, such as primary care, urgent care, ophthalmology, and dentistry. (4) Additionally, the pandemic brought about new opportunities for PE investment including, but not limited to, behavioral and mental health as well as telehealth. (5)

Even with the growth of PE activity, health systems still maintain a significant advantage over the PE model- the advantage of specialty mix. PE firms typically have the limitation of focusing on a single specialty or at most a few similar specialties. Health systems, on the other hand, have the ability and infrastructure to integrate across a broad spectrum of specialties, which can lead to a larger referral stream for affiliated physicians. This larger referral stream also carries the secondary benefit of a higher quality of patient care by providing patients with a more connected continuum of care, which is a significant theme in healthcare today.

Regulatory Landscape

PE investment in healthcare is not as straightforward as PE investment in other industries. In most other industries, a PE firm could simply utilize its capital to purchase a controlling stake in a business. However, the financially driven nature of PE has the potential to negatively impact the quality of patient care. This makes PE investment into healthcare a bit more complex by adding regulatory hurdles such as the Corporate Practice of Medicine (CPOM) Doctrine.

The CPOM Doctrine was developed to protect the quality of patient care. It is described by the American Medical Association (AMA) as a doctrine that “prohibits corporations from practicing medicine or employing a physician to provide professional medical services.” (6) The CPOM Doctrine in individual states may vary slightly; therefore, it is very important that the PE firm is aware of the specific state level adaptations that could impact a potential transaction or investment.

In addition to CPOM, there are additional regulatory factors that could impact the growth of PE activity in the healthcare space. One such event is a recent executive order that was issued by President Joe Biden in July 2021 that will likely cause further scrutiny of PE activity in the healthcare space. (5) Further, there have been instances where PE firms were held liable and were forced to pay damages for wrongdoing perpetrated by a healthcare entity related to the PE firm, even though the PE firm itself was not found to have perpetrated any wrongdoing. (7) Lastly, there is a growing focus by the Department of Justice and Federal Trade Commission to focus on anti-trust enforcement in private equity related ventures. (8) The regulatory scrutiny found in the healthcare space is somewhat unique and certainly provides a new challenge for the typical PE firm.

Unlike PE firms, health systems have long been aware of the regulatory environment surrounding healthcare. This is an advantage to a physician practice since health system leaders are typically apprised of regulatory risks and understand how to protect the parties from scrutiny. Many healthcare regulations, such as CPOM, require value exchanged with physicians to be set at fair market value. It is important for physicians to understand this standard is applicable in most transactions whether it be a health system or PE company.

The MSO Structure

Even with the presence of the CPOM Doctrine, many PE firms are still investing in the healthcare industry through the creation of a Management Services Organization (MSO). Once a PE firm creates an MSO, that MSO will typically enter into a comprehensive management services agreement (MSA) with a physician practice. Through the MSA, the MSO will typically provide as many services allowed under the state's CPOM Doctrine. These services may include, but are not limited to, the provision of accounting, billing and collection, non-clinical personnel, supply procurement, equipment, office space, and numerous other services. In exchange for the provision of the subject services the physician practice will compensate the MSO through a management fee. This management fee is what effectively serves as the return for the PE firm's investment and should be set at fair market value.

The MSO model provides numerous benefits for the physicians. The first benefit is the physicians receive a lump sum amount upfront which carries a high multiple on the physician practice's earnings. This lump sum comes in exchange for the physicians' agreement to lower levels of compensation moving forward. Many PE healthcare transactions also involve the physicians receiving "roll-over" equity in the MSO. This "roll-over" equity provides the physicians with some future compensation upside, and serves to keep the physicians motivated to maintain (and/or grow) the clinical operations of the practice. In addition to the monetary benefits the physicians receive from the MSO model, they also retain physician control and governance over the clinical operations of their practice.

A major strategic difference between an MSO and partnering with a health system is PE firms are typically eyeing shorter and more defined time horizons between transactions. On the other hand, health systems often have longer strategic time horizons which allow them to employ physicians for longer terms. This ability to align with a health system for the long term can be very beneficial for a physician seeking stability. Additionally, health systems have the ability to implement unique compensation models that can better support physician motivations.

PE vs. Health System Take-Aways

It is obvious physician practices are in high demand and have numerous choices for partnerships in the market. Due to the fragmentation that exists in the healthcare space, the significant stores of uninvested capital, and the growth of new healthcare services, PE activity in the healthcare space is not projected to slow anytime soon. PE firms have brought an innovative model to the healthcare space that many practices are considering. However, physician practices should consider the differences between the MSO model and health system opportunities prior to pursuing a strategy.

1 Sourced from Pitchbook, Inc. data

2 Sourced from Pitchbook, Inc. data

3 VMG Health observed these specialties being the most common specialty for PE investment for several years.

4 Based on observations of common specialties in the valuations the authors have done.

5 Sourced from the article titled "Private Equity and Health Care Investments: How Has COVID-19 Impacted Deal Flow?" that was published by the Transaction Affinity Group of AHLA's Business Law and Governance Practice Group on September 15, 2021.

6 Sourced from file:///C:/Users/Taylor.Anderson/Downloads/corporate-practice-of-medicine-issue-brief_1.pdf

7 Sourced from https://www.reuters.com/legal/government/private-equity-firm-hig-capital-settles-fraud-case-20-million-2021-10-14/

8 Sourced from remarks made by Andrew J. Forman at the American Bar Association's Antitrust in Healthcare Conference Keynote Address, June 3, 2022.

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This article was published by VMG Health's Valuation & Transaction Advisory Division

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