An In-Depth Look at Private Equity Transactions in the Healthcare Services Sector
Authors

ROSALIND “ROZ” CORDINI, JD, MSN, RN, CHC, CHPC
SENIOR VICE PRESIDENT/DIRECTOR OF CODING &
COMPLIANCE SERVICES
RCORDINI@COKERGROUP.COM
502.890.8196

AIMEE GREETER, MPH, FACHE
SENIOR VICE PRESIDENT
AGREETER@COKERGROUP.COM
704.417.5942

MARK REIBOLDT
SENIOR VICE PRESIDENT
MARKREIBOLDT@COKERGROUP.COM
678.832.2004

MAX REIBOLDT, CPA
PRESIDENT/CEO
MREIBOLDT@COKERGROUP.COM
678.832.2007

DAVID WALLINE
SENIOR MANAGER
DWALLINE@COKERGROUP.COM
734.864.5348
# Contents

<table>
<thead>
<tr>
<th>Page</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>Introduction</td>
</tr>
<tr>
<td>4</td>
<td>Defining Private Equity Transactions in Healthcare and Understanding Deal Options for Medical Groups</td>
</tr>
<tr>
<td>8</td>
<td>What is Private Equity?</td>
</tr>
<tr>
<td>10</td>
<td>PE Transactions with Medical Groups</td>
</tr>
<tr>
<td>12</td>
<td>Strategic Variables in Private Equity Transactions</td>
</tr>
<tr>
<td>14</td>
<td>The Role of Management Services in Private Equity Transactions</td>
</tr>
<tr>
<td>15</td>
<td>Basic PE Structures</td>
</tr>
<tr>
<td>17</td>
<td>Management and Services Business Value</td>
</tr>
<tr>
<td>18</td>
<td>Post-Transaction Utilization and Value of BSO</td>
</tr>
<tr>
<td>18</td>
<td>Valuation Trends and Approaches for Medical Practices</td>
</tr>
<tr>
<td>18</td>
<td>Post-Merger Integration Strategy Starts Early</td>
</tr>
<tr>
<td>18</td>
<td>Summary</td>
</tr>
</tbody>
</table>
Among the various types of transactions and the participants involved in them, the presence of private equity within the healthcare services space is not a new concept. Healthcare entities have been partnering with private equity investors for decades. Likewise, healthcare providers have been a high-valued target for these types of private capital investment firms for many years, and the current market trends indicate that such interest will likely continue to grow into the future.

In this paper, we look at some of the current trends in healthcare private equity, and we dive into some key elements of the overall discussion around private equity deals involving healthcare services organizations. This discussion begins by breaking down what “healthcare private equity” is and what it means for organizations that might consider engaging in a transaction with a capital partner, now or in the future. Then, we delve deeply into some of the nuances that we see and, in many cases, have dealt with directly in our work with clients on both sides of the private equity transaction. Finally, throughout our teams’ decades of experience working in healthcare transactions, we address some common themes and characteristics in the current healthcare private equity deal marketplace, which are helpful to understand and consider for both buyer and potential sellers exploring such transaction options.

In addition to the topics covered in this paper, Coker has published a number of articles, white papers, and digital media related to this topic, including multiple episodes of the Coffee with Coker podcast addressing these and other related topics. These pieces, like all of Coker’s published insights, can be accessed at www.cokergroup.com
Defining private equity transactions in healthcare and understanding deal options for medical groups
Medical groups have had numerous options when considering transaction types, structures, and valuations. Now, the partnering opportunities have expanded to include selling to private equity (PE) firms or private equity-backed platform companies. The acquisition of physician practices by private equity firms has increased dramatically during the past few years, and expectations are that the trend will continue.
What is private equity?

PE deals often entail unique structures, terms, and outcomes, which makes it essential for those considering such transactions to be aware of and understand the various factors that are unique to private equity. In discussions with physicians and practice executives across the country, it is evident that we should briefly consider a critical and distinctive question related to this overall topic, which is “what exactly is private equity?”

Private equity investments in the healthcare services industry is nothing new. However, “private equity” is a rather broad term, which has likely caused some confusion about what people mean when referring to PE deals.

The general concept of private equity buyers denotes phrases like investment banks, venture capital, hedge funds, investment funds, proprietary investors, merchant banks, institutional investors, and the like. When people reference transactions or firms involved in sales as private equity buyers, though, they are talking about a platform or operating company that is backed by private equity capital. Further, while there is a significant amount of overlap in many of these terms, it is easy to be unsure of what exactly is happening in the overall discussion of private equity investors, specifically in the healthcare services arena.
PE firms are privately held (not publicly traded investment firms) entities that manage capital raised from institutional investors, which is deployed into targeted markets, sectors, and business segments. PE firms acquire companies that are typically also privately held. Although there are cases where PE investors will expand their investment profile to include the purchase of publicly traded securities and/or derivatives, this matter is beyond the scope of this discussion.

The primary and often singular goal with these investments is to grow the businesses in a firm’s portfolio organically and non-organically (i.e., add-on acquisitions), thus increasing the value of those assets over a period. Expanding value over time can be an attractive investment strategy, but the real return of value on investment for PE firms is through an exit.

Generally, the two likely pathways are:

- A liquidity event where portfolio assets are sold to another buyer; or,
- A sale of such assets on the public market through an initial public offering (IPO) or similar vehicle.

Although there are variations, this general explanation is what ultimately happens in these types of transactions, and the interpretation covers most of what people are typically referring to when discussing PE investments, especially in entities such as medical practices.
The most typical scenario of PE transactions with medical groups goes something like this:

A private equity firm — let’s call them “ABC Capital” — manages a capital pool from various institutional investors. ABC’s focus is investing in healthcare services, and the firm’s leadership identifies medical practices as a primary opportunity for value in a market where there is ample room for growth. Further, there are plenty of eager buyers for a future liquidity event. ABC ultimately identifies a primary target in “AmeriMed,” which is a multi-specialty medical group consisting of 75 physicians across a particular geographic area of the U.S. that specializes in an effective mix of primary care and surgical sub-specialty medical services.

In a process consisting of significant time, effort, and compromise, which entails far more nuance extending beyond the scope of this extremely modest illustration, ABC ultimately closes on a transaction to acquire and operate AmeriMed. At this point, AmeriMed serves as the initial investment in this space by ABC. Thus, this will be the “platform investment” on which ABC will ultimately attempt to build and expand its value within this arena.
Hypothetically, for five to seven years, ABC will focus on two general objectives for this investment. First, they will bring in the necessary personnel, operational, and financial resources to maximize the efficiency and profitability of AmeriMed. Again, this description is almost laughable for what goes into this effort, but for a simple illustration, we will avoid going deep on what that process entails.

Simultaneously, ABC will work with AmeriMed’s management to identify, pursue, and eventually complete additional acquisitions of other attractive targets that can be incorporated into the platform. These add-on acquisitions are key to expanding the value because optimizing the foundational entity and pursuing organic growth options can only go so far. Organic growth typically takes more time to achieve significant benchmarks. However, by adding on other attractive entities to an efficient, well-functioning, and stable platform means that value is achieved in what can often be measured in exponential metrics, where acquired profits drop to the bottom line of the core entity almost overnight.
Fast-forward five or so years after ABC and AmeriMed have stabilized the platform and added earnings value through add-on acquisitions. At this point, ABC is ready to explore how they can achieve the maximum value potential on their original investment. This juncture is where an exit or liquidity event comes into play, and ABC will consider its options. As mentioned, there are several different possibilities of how this exit could play out. In this basic example, the assumption is that ABC will consider selling the entire enterprise to another buyer, or selling the asset on the open, public markets through an initial public offering (IPO) of stocks. While IPOs are not exactly rare, in the cases of PE-backed medical group entities, it is far more common for such assets to be sold to another party. There are many factors to consider and understand about these types of scenarios. In keeping the example simple, however, the assumption is that AmeriMed—now much larger and more valuable than when ABC first acquired it—is sold to another buyer.
Who would be a likely buyer of AmeriMed in a case like this? There are a few possibilities. It could be another PE firm, likely one that is larger than ABC and one that has existing assets in a similar space, where AmeriMed could be integrated with an existing platform. Also, other types of institutional investors might be interested in the arena, including hedge funds or publicly traded investment firms. Similarly, but with nuance, a more strategic acquisition could occur, whereby AmeriMed is acquired by a large healthcare services entity that could integrate the company in an existing operation. Alternative types of strategic transactions happen where large hospital systems acquire such entities, incorporating them within their established networks of medical services. Although there are many other possibilities, these are a few examples that are common in the current marketplace.

The example, above, is crude and extremely generalized. Yet it illustrates some typical characteristics of what occurs when discussing private equity investors acting within the healthcare marketplace, specifically in deals with medical practices. There are various details and considerations within each of the critical elements in this modest example. In considering the fundamental question of what people are referring to when talking about private equity, this information serves as a starting point for understanding this unique and growing component of the healthcare marketplace for those who might consider the possibility of exploring opportunities with private equity.
Strategic variables in private equity transactions
Lao Tzu, the ancient philosopher, said, "If your happiness depends on money, you will never be happy with yourself."

Why is it, then, that so many transactions focus so heavily on the monetary terms?
One of the important lessons to medical practice and hospital clients contemplating a PE transaction is that both the monetary and nonmonetary terms carry weight, and they should receive equal consideration before signing on the dotted line. Specifically, there must be consideration of the strategic, nonmonetary terms that will be in effect post-transaction, such as:

- **Who will sit on the organization’s governing committee/Board?**
  - What will be the extent of that Board’s authority?
  - What will be their role in setting and operationalizing the strategic, clinical, financial, and operational aspects of the organization going forward?

- **Is there a shared responsibility for determining the organization’s overarching strategy, or will that primarily be established and then handed down from the PE entity?**

- **Who maintains hiring/firing authority for physicians within the organization?**

- **What is the process for adjudicating physician behavioral issues?**

- **What will happen to the organization’s employees? Will all (or any) be retained, provided they pass background, drug, and other standard employment checks? Will the scope of their roles be maintained? Will any now have multi-site, regional, or otherwise more diffuse responsibilities than the single organization?**
Numerous benefits can come with any transaction, and this is true for those that are PE-related. However, appropriate preparation, due diligence, and strategic consideration must occur in advance to ensure the full scope of these benefits are achieved for all parties. Physicians should understand that their transaction’s economics will improve one day of their life, but the non-economic considerations could make them miserable every day for the rest of their professional life. In beginning to contemplate a PE transaction, it is essential to ensure the arrangement delivers the ultimate value.
The role of management services in private equity transactions
Private equity (PE) transactions have become of great interest throughout the healthcare industry. While they have their specific characteristics, a PE transaction usually does not include a hospital or health system. Instead, it is between the private practice or related healthcare entity and a PE firm.

With much flexibility in the transactional structure, many PE deals consider and, therefore, include a management services entity. Previously called management services organizations (MSOs), now they are known as business services organizations (BSOs). They have the characteristics of the traditional MSO, yet they are more adaptable and versatile in the context of PE transactions.
Basic PE Structures

Typical PE acquisition structural characteristics include the following:

- The up-front value paid to the owners of the practice/healthcare entity via the application of a physician compensation reduction.

- A multiple of earnings before income taxes, depreciation, and amortization (EBITDA), as derived from the compensation reduction is applied to the transaction value.

- The compensation reduction is treated as the newly formulated EBITDA. The newly created EBITDA may be applied in a discounted cash flow model that determines enterprise value or a market-based model that is a multiple of EBITDA.

- Practice owners retain a minority interest in the transaction.

- The physician compensation reduction is usually permanent, as the physicians receive the value of their reduced income in up-front dollars at closing.

- Some offset to the physicians’ compensation reduction comes through improved access to services and organic growth.

- Finally, the practice entity may be sold or further consolidated based on owner preferences. As such, a spin-off BSO is often established and may have its own separate identity and value going forward.
Management and Services Business Value

The management and services business value is usually carved-out separately and structured as a distinct management entity. The professional component (the practice) is removed from the management and business services part with its own infrastructure and possesses its own post-transaction value and utilization.
The presence of the BSO and potentially the transaction itself usually allows the professional entity (the practice) to stay out of the PE transaction, though not always. The strategy behind the BSO is to build infrastructure and overall enterprise value as a management entity. Building binary values creates future transactional benefits, i.e., the “second bite of the apple.” It also allows the professional component to remain intact and not commingled with the business and management/administrative services.

The establishment of a BSO results in a dual opportunity to create value and, post-transaction, management/business services. Moreover, it provides flexibility within the overall PE transaction. It promotes the growth and expansion of a robust administrative entity. It often allows for non-professionals (non-physicians) to have ownership interests in the BSO, both before and after the PE transaction. This action promotes the retention of key management talent and enables NewCo to move forward much stronger and more effective for the future.

BSOs will continue as a core component of PE transactions. They offer additional value and future growth and economic interest beyond the professional (practice) entity.
Valuation trends and approaches for medical practices
There are three generally accepted approaches used in business valuation, and within each approach, there are accepted methodologies that appraisers may rely on as the basis for their valuation. Historically, as the most common purchaser of a physician practice has been a hospital or health system, the transaction model has been one of relatively low up-front consideration alongside a post-transaction employment structure that matches or increases physician compensation. Under this model, the cost approach has typically resulted in the highest and best use value of the practice, as materially all earnings that would be subject to an income approach are captured within physician compensation.

Recently, with the entry of private equity investment in the healthcare industry, an alternative purchase model is becoming more predominant in negotiations. This model, which is commonly referred to as the “private equity-like model,” is predicated on the owner-physicians of a practice taking a reduced compensation under employment in exchange for a higher up-front purchase price. Further, as owner-physician compensation is reduced, there is a cash-flow stream that can be considered under the income approach. This model is generally favored by physicians who are more mature in their practice and, as such, prefer the economics of a higher purchase price versus the dollars associated with higher compensation under employment. Although there are apparent differences between the two transaction models, the key from a fair market value standpoint is the matching of dollars up-front versus dollars post-transaction for the owner physicians. Both components of the transaction (i.e., up-front purchase price and post-transaction compensation) must be at fair market value, and safeguards in place that verify that there is no overlap between the two transaction components. A balance between the two transaction models can often be found to accomplish the initiatives of both the buyer and seller.
Post-merger integration strategy starts early
Post-merger success and the ability to achieve a timely return-on-investment are often significantly impacted by post-merger integration with the acquired practice.

The most successful companies in this regard will have outlined a post-merger integration strategy with planning beginning early in the acquisition process. Early planning ensures, among other things, that compliance due diligence is addressed in addition to financial and regulatory due diligence. Surprisingly, many companies acquire practices with little forethought to post-merger integration, resulting in an often-chaotic post-close environment and potentially at-risk processes that remain unknown and/or unaddressed by the acquiring company.
The first step in a winning strategy is an affirmative decision regarding how and when post-merger integration will occur. Will the acquired target be permitted to operate independently or “as it always has” for a period? What is the anticipated timeframe? Why? Will a strategy be set for the timely integration of vital corporate functions? The Board, which is often deeply engaged in the pre-acquisition process, should extend its oversight to the post-merger integration function.

Some areas of consideration include:

- **The Electronic Health Record.** Will the new practice transition to the acquiring company’s system? If not, are the two systems compatible?

- **Communications.** How quickly will the acquired company be integrated into corporate communication systems (email addresses, access to the company intranet, etc.)?

- **Human Resources Programs.** How will the newly acquired employees/providers be onboarded to the same standard as the existing company employees/providers? When will the employee handbook be distributed and acknowledged? How will you ensure the timeliness of connecting benefits to employees/providers? When will the new employees/providers be placed in the existing payroll system?
Physical Facilities. Will the staff be integrated, or will two separate offices co-exist? Consider how culture may be impacted.

Day-to-Day Operations. How will the new practice be folded into the existing day-to-day operational procedures?

Financial Operations. With accounts payable, accounts receivable, revenue cycle policies and procedures, how will consistency be assured?

Compliance and Ethics Program. How will you ensure that the existing company’s Code of Conduct and policies and procedures are implemented as soon as feasible? When will the training of the officers, employees, and Board occur? Will the existing Compliance Officer manage the newly acquired practice? Will there be a separate Compliance Officer? How will consistency across the programs be assured?

Again, planning for post-merger integration is critical and will impact your actions in the diligence phase. With a post-merger integration strategy in place, for example, a meaningful review of existing agreements can occur and consider whether accepting the assignment of an agreement fits within your integration plan (EMR, financial systems, etc.). Additionally, a compliance diligence review component in the early acquisition phase allows for a timely update to the company’s compliance risk assessment and an update to the annual work plan to ensure identified compliance issues are addressed, audited, and monitored.
Some steps to take when acquiring a practice are:

1. Conduct compliance due diligence in addition to financial and regulatory due diligence.

2. Establish your post-merger integration strategy.

3. Assign post-merger integration to a senior leader.

4. Consider separating integration responsibility from day-to-day operational responsibility to ensure success and timeliness.

5. Set an integration timeline with key milestones.

6. Hold the integration team accountable.
Summary

This paper addresses many of the vital components of physician practice acquisition by private equity firms. Topics encompass defining PE transactions in healthcare and understanding deal options for medical groups, followed by a discussion of strategic variables to consider in making a deal. Another critical aspect is the role of management or business services in PE deals, along with valuation trends and approaches for medical practices in PE transactions. The final topic addresses post-merger integration and the necessity to start early in preparation.

Please contact us at www.cokergroup.com for additional information on PE and other transactions that apply to medical groups.
For further information about Coker Group, and how we could be of assistance, please call 1.800.345.5829 or visit cokergroup.com