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acquiring physician practices

key strategic considerations for a successful transaction

With the dwindling availability of acquisition prospects, health systems now more than ever must develop thoughtful strategies for evaluating physician practice acquisition opportunities.

AT A GLANCE

When developing a strategy for acquiring physician practices, health systems should address the following considerations:

> The extent to which the strategic focus should be on primary care physicians versus specialists
> Whether the objective for acquisitions is defensive or offensive
> The need to acquire essential leadership talent
> Whether acquiring practices or recruiting physicians is the more cost-effective approach

Over the past 15 years, health systems nationwide have successfully aligned with independent physicians through practice acquisition and employment strategies. The rapid pace of mergers and acquisitions is likely to continue unabated in 2019 because physician engagement and integration are critical to a health system's financial well-being and ability to achieve the all-important Triple Aim of enhancing the patient experience, improving population health, and reducing the per capita cost of health care.

Employed physicians not only add direct financial value to the health system through retained or increased market share, but also have the potential to contribute tremendous value in advancing the development of clinical pathways that lead to greater patient satisfaction and improved clinical outcomes. Therefore, as health systems continue to pursue practice acquisitions, it is critically important for them to take a holistic view of the role acquired physician practices play in their organizations and take steps to fully realize their value.

As the consolidation trend continues, the market for physician practice acquisitions is starting to mature. In 2016, for the first time ever, there were fewer physicians in private medicine than were employed by health systems, as the proportion of physicians having an ownership stake in their practices dropped to 47 percent.[a] Meanwhile, many markets also have seen shortages of specialists in areas such as vascular surgery, neurosurgery, dermatology,

a. American Medical Association, *Physician Practice Benchmark Survey*, 2016.

and psychiatry. A similar trend is occurring with primary care physicians: The Association of American Medical Colleges forecasts the nation will see a shortfall of as many as 43,100 primary care physicians by 2030.[b]

The decline in the available supply of independent physician practices has done nothing to decrease the demand from potential acquirers to purchase such practices. Accountable care organizations (ACOs) require large populations of patients to provide the necessary scale to manage costs and achieve savings targets. As a result, primary care physicians and their respective patient panels are highly sought by health systems looking to compete under an ACO model. Hospital alignment with specialists also is necessary for effective participation in bundled or episode-based payment models. Meanwhile, new entrants to the physician practice market, such as managed care and private equity firms, have further increased competition for acquisitions of physician practices, thereby improving the targeted practices' negotiating leverage.

Given these market factors, it is more important than ever for health systems to develop a thoughtful strategy for evaluating practice acquisition opportunities. Although purchase price and the subsequent compensation offered to physicians will always be critical to a successful close, acquirers also should consider the following four factors when evaluating targeted practices.

Strategic Focus on Primary Care Physicians Versus Specialists

As the market consolidates and competition for key talent intensifies, health systems often pursue physicians first and develop strategies second. Although some organizations still take this shotgun approach to acquiring practices, narrowing the strategy to focus on either primary care physicians or on other required specialists can help an organization get the most from its development resources. Refining the approach, streamlining due diligence, and standardizing purchase and compensation packages are tactics that allow for more time and cost-effective use of internal and external resources.

The strategy that is more prevalent in today's marketplace is to focus on primary care physicians because acquirers look to this group as the gatekeepers to achieve the necessary scale for value-based payment. An organization's objective with this approach is to increase its ongoing primary care market share to maintain or improve patient access and outcomes. Nevertheless, certain key specialties such as cardiology, oncology, and anesthesia always will be in high demand by health systems because of the strategic importance of these specialties in hospital operations.

Acquisition Objective: Defensive or Offensive

In defensive acquisitions, organizations seek to protect their existing market share. For reasons such as patient volume, coverage of critical service lines, and physician leadership, certain practices are critical to a health system's overall success. With the loss of a key practice, a health system could incur not only financial damage but also damage to its market reputation.

In offensive acquisitions, organizations seek to expand market share. These acquisitions can be difficult to achieve because the targeted practices may already be aligned with another hospital that has established the relationship. Offensive acquisitions often can require an aggressive purchase offer to overcome the target practice's reluctance to change affiliation without significant financial motivation.

Acquisition of Essential Leadership Talent

Health systems nationwide are seeking to engage physicians as the next generation of corporate leadership. Independent physicians are uniquely positioned to navigate the evolving healthcare landscape with direct experience in providing quality patient care coupled with the financial goals of running a business enterprise. These interdisciplinary skills are increasing in strategic

b. IHS Markit, *The Complexities of Physician Supply and Demand: Projections from 2015 to 2030*, 2017 Update, Association of American Medical Colleges, Feb. 28, 2017.

Health systems with an understanding of a practice's motivation can tailor an offer accordingly and will have a distinct competitive advantage.

importance as healthcare delivery models shift from volume to value.

Organizations often use practice acquisitions as a conduit to align with new physician leaders. Typically, a health system's offer to purchase a practice is accompanied by an offer to the practice leader to take on a leadership position in the post-acquisition employment arrangement. Moreover, as the physician leader develops the requisite skills and experience, there is an expectation that he or she will transition into a full-time executive leadership role.

Physician advocacy and engagement also can help boost an organization's win rate on future practice targets. Physician-to-physician communication can be an effective strategy when the physicians in a practice being sold are uncertain about future employment or apprehensive about potential changes in practice operations, or when they have questions regarding the prospective compensation plan or the acquisition in general.

Cost Savings Through Acquisition Versus Recruitment

In many instances, a health system will make the strategic decision to purchase a business that provides goods or services the health system requires in its own operations. Buying often takes less time and is more cost effective than creating the business line through *de novo* development. For a health system, transitioning a practice from independent status to employed status is cost-effective because the practice already has the necessary physician-patient relationships and business processes in place.

Conversely, a hospital is likely to incur significant losses when developing a startup practice. These losses can be attributed to several fixed costs associated with operating a physician practice: non-provider staffing; occupancy expense; and a minimum compensation guarantee for practice physicians, regardless of the revenues generated. Fees paid to recruiting or staffing companies for assistance in hiring a new provider from outside the marketplace can significantly increase the losses as well.

Although the savings gap between an existing and a startup practice is likely to close within two to three years, the aggregate savings generated from an acquisition over this period can still be substantial when compared with the alternative.

After a health system has determined its motivations for an acquisition, strategic and thoughtful execution is key to a successful transaction. Once the organization has decided it intends to acquire a practice, its next consideration will be the purchase price.

How to Determine the Purchase Price

Purchase price is a significant factor in determining the success of a practice acquisition. Unlike in other industries, healthcare transactions are subject to great regulatory scrutiny because the price paid for medical practices must be consistent with fair market value (FMV). The Office of Inspector General of the U.S. Department of Health and Human Services has stated that *FMV* means "value for general commercial purposes" and that it "must reflect an arm's length transaction which has not been adjusted to include the additional value which one or both of the parties has attributed to the referral of business between them."[c] As such, it is critical for health systems to develop their purchase offer to comply with these definitions and avoid an arrangement whereby purchase price is based on the volume or value of referrals.

To be sufficiently thorough and performed according to the highest professional standards,

c. Office of Inspector General, Special Fraud Alert: Arrangement for the Provision of Clinical Laboratory Services, October 1994.

a valuation of a business must encompass three approaches: an income approach, a market approach, and an asset approach. No single valuation approach is appropriate in all situations, so it is always important to consider the specific circumstances of the arrangement when determining FMV.

Income approach. The income approach is a general way of determining the value of a business by using one or more methods through which anticipated benefits are converted into value. It is applied by forecasting the future cash flow stream that the physician practice is expected to generate and then discounting it to the present value using a risk-adjusted rate of return. This approach can be challenging to apply because most independent physician practices distribute all available cash flow to physician owners as compensation. Furthermore, physician compensation is likely to be higher once the practice has been acquired by a health system. To comply with the FMV standard, the expected post-acquisition physician compensation must be consistent with the compensation assumption used in the financial forecast. If the practice is not expected to generate free cash flow, the income approach will not produce a positive enterprise value for the targeted practice.

If the acquiring entity offers a reduced post-acquisition compensation package to the physician owners, the practice is likely to generate a future return and the income approach can reasonably be applied. Private equity firms have been successful in implementing this model to close physician practice transactions, particularly for larger practice deals. However, health systems should consider the following potential challenges when agreeing to reduce physician compensation to pay a higher purchase price:

> Physician productivity, as measured in work relative value units (wRVUs), tends to decline with reduced compensation levels as demonstrated by the collapse of physician practice management companies in the 1990s.
> Physicians are likely to be dissatisfied with the reduced compensation and will request a compensation enhancement commensurate with their peers.
> Physician recruitment can become difficult if compensation is below the market value level.

Accordingly, most health systems make the strategic decision to enhance physician compensation while remaining both competitive and within FMV guidelines.

Market approach. The market approach is a general way of determining the value of a business by comparing the target business with similar businesses that have been sold. Transactional data are used to derive valuation multiples such as price to revenue and price to earnings before interest, taxes, depreciation, and amortization (EBITDA). However, most practice acquisitions are private transactions with minimal public information regarding purchase price, historical financial performance, and post-acquisition employment terms. Therefore, the market approach typically is not used to value physician practices.

A health system's first step in acquiring physician practices should be to determine its primary motive or motives for doing so.

Asset approach. The asset approach is based on the principle of substitution, which assumes that a prudent buyer would pay no more for a business than it would cost to assemble all the individual assets and liabilities that constitute the business. Under the asset approach, a practice's tangible and intangible assets are valued separately, then aggregated to determine the FMV purchase price.

Competition will influence whether intangible assets, such as workforce in-place, will be purchased. Other intangible assets such as patient charts, website, tradename, and phone number may be considered when determining a

FMV purchase price given the specific facts and circumstances of the practice and the market.

Other Considerations

Organizations should consider the following two additional factors that can further inform their decision to acquire physician practices.

Practice demographics. Practice demographics are critical to understanding the motivations behind the practice sale. Physicians closer to retirement may be seeking a liquidation event and place a higher importance on maximizing purchase price. Younger physicians may be willing to accept a lower purchase price in exchange for higher compensation that can provide greater security over the long term. Health systems with an understanding of a practice's motivation can tailor an offer accordingly and will have a distinct competitive advantage.

Market competition. Certain organizations acquiring physician practices are located in markets that have minimal or no competition. Such buyers are in a strong position to be thoughtful about what is required to finalize the transaction while limiting the total cash expenditure. The organization also may elect not to pursue a practice if there are no other viable buyers in the market. In these situations, the organization may be able to hold out for more favorable terms in the future or establish an effective partnership with the practice without the need for acquisition. In more competitive markets, buyers must be willing to be aggressive in terms of what assets are purchased and the compensation package offered. Sellers have greater negotiating leverage when multiple parties are interested in acquiring the practice.

Alignment of Compensation Plans

The extent to which the physicians in acquired practices remain engaged, both clinically and operationally, is critical to the acquisition's success. Compensation remains a key motivator, and acquirers often will find it beneficial to develop a program that increases compensation in lieu of paying a higher up-front purchase price. Acquiring entities that offer an enhanced compensation package often allow the physician sellers to annuitize the value of the practice over time so the physicians can focus on goals that have strategic value to the organization.

As healthcare revenue sources continue to shift from volume to value and organizations take on more risk, new physician and advanced practice provider compensation strategies are emerging. The healthcare industry is adapting to new payment and care delivery structures with increasingly complex compensation models to match. Organizations now must consider a growing number of components when developing these plans, including recruitment, retention and engagement, patient satisfaction, access, quality of care, and governmental regulations.

As it stands today, the majority of compensation plans still consist of either a combination of base salary and productivity components or a pure productivity model—typically measured in wRVUs. For the most part, physicians are comfortable with the accuracy and predictability of personally performed wRVUs, whereas they tend to be wary of the nonproductivity elements that are becoming more prevalent in compensation payment models.

According to one recent industry survey, 54 percent of organizations now use some form of value-based physician compensation.[d] This can account for anywhere from 3 to 9 percent of total cash compensation. Compensating physicians based on a mix of productivity, quality, and value-based metrics enables the acquiring entity to align physicians with its organizational strategy and with the metrics that support its efforts to optimize payment with payer contracts. Creating flexibility and transparency in compensation models can allow organizations to increase the value-based portion of a compensation model along with the changes in payment by insurers.

d. Sullivan, Cotter and Associates, Inc., *Physician Compensation and Productivity Survey Report,* 2018.

Imperatives for Success

As the marketplace evolves, moving into 2019, the volume of physician practice acquisitions is projected to remain strong. Recent consolidation continues to decrease the supply of viable practice targets, and transaction complexity will increase as competition grows. Although purchase price and the post-acquisition employment agreement remain key components of successful transactions, health systems must evaluate many important factors when developing a practice acquisition strategy.

It is imperative that the health system approach this effort systematically: The health system must first determine its primary motive or motives for acquiring physician practices—such as adding primary care physicians or specialists, taking defensive or offensive actions, obtaining key leadership, or seeking cost savings. Only then should it turn its attention to the next critical steps: determining the right purchase price and strategically aligning compensation plans. ■

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