

Practice Acquisition Strategy and COVID-19:

Adjusting for the New Normal

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Since the signing of the Affordable Care Act in 2010, independent physician practices have faced a growing number of financial challenges. These challenges have been driven by a decline in reimbursement, an increase in operating expenses, the need for greater capital investment (e.g. electronic medical records), new competitors, the rise of consumerism and more. The evolving COVID-19 pandemic has surfaced several new and more urgent financial issues for physician practices as revenues rapidly decline due to the cancellation of elective surgeries, decreased patient visits and limited ancillary services.¹ A recent report from Barclays PLC states that doctors' offices have seen visits drop by 50% on average.¹ This disruption has been compounded as operating costs at independent practices are difficult to scale. Debt obligations must still be met while workforce retention and compensation issues are exacerbating tensions. Perhaps the greatest variable of all is the uncertainty organizations are facing regarding the duration of the pandemic or the business model required to support a "new normal."

Due to these COVID-19-related financial implications, SullivanCotter expects a substantive increase in practice transaction and consolidation activity over the next six to twelve months. For this reason, health care organizations should have a strategy in place in order to act quickly and decisively on future acquisition opportunities.

THE CURRENT ENVIRONMENT

Global economic uncertainty across all industries is at a record high as the International Monetary Fund forecasts the sharpest downturn since the Great Depression.² Health care organizations are not immune to this uncertainty. Furthermore, the health care outpatient sector lost 40,700 jobs in March 2020 after nearly 30 years of month over month growth.³

Never has the federal government and the Centers for Medicare and Medicaid Services (CMS) restricted hospital and physician operations as much as they have during the COVID-19 pandemic (e.g., postponing elective surgeries, cancelling in-person visits, etc.).⁴ Although evolving reimbursement models have always presented challenges for health care providers, the rate of change is at an all-time high as evidenced by CMS' recent telehealth reimbursement updates.

Moreover, health care organizations face significant workforce challenges regarding supply and demand as select services hit their peak while others have excess capacity. These changes are testing the ability of physician practices to adapt, but most are not built for major shocks to the system.

Traditionally, health care has been considered a recession-proof industry by having stable and consistent revenue streams through the provision of essential services. As a result, independent physician practices have generally operated with low cash reserves. Without a significant cash buffer or access to credit, the current economic reality is not sustainable for smaller independent practices. Many practices are experiencing an inability to meet payroll and other critical financial obligations during COVID-19 and employee furloughs continue to rise at an alarming rate. In combination, these factors will threaten the future of physician practices – both operationally and financially.

INCREASED TRANSACTION ACTIVITY

Given the current financial distress and long-term economic uncertainty, we expect to see a significant increase in transaction activity as practices will look for new capital partners to help ensure future sustainability. Maintaining operations in today's evolving health care marketplace is difficult enough for independent practices. The challenge

has now been compounded during COVID-19 due to delayed procedures, employee furloughs, and the urgent shift to telehealth.

Planning for post-COVID-19 recovery remains extremely difficult as practices are unable to predict the pandemic's duration, broader economic impact, future patient habits and other critical implications. When will patients feel comfortable entering clinics again? Is there a new perspective on elective visits? Will telehealth and the associated reimbursement models be maintained? A number of important unanswered questions remain, which is causing practices to seek a financial safety net. This often comes in the form of a joint venture, strategic affiliation, or full acquisition by a larger and more financially stable organization.

DEVELOPING YOUR STRATEGY

Health care organizations with a strong balance sheet are in a unique position. The current environment represents an unprecedented buying opportunity, and financially stable organizations must be prepared to move quickly and act decisively. Organizations should develop a strategy that enables them to adapt to the evolving marketplace in real-time.

SullivanCotter recommends the following guidelines as organizations consider the way forward:

Develop a transaction team.

A few immediate questions organizations may consider are:

- **Why do we need a team to assess new transactions? We've bought/affiliated with plenty of practices in the past.** Regardless of your organization's experience in acquiring practices, a dedicated team is required to move quickly. Specifically, this team serves as a decision-making body where each member understands their specific roles and responsibilities — allowing organizations to take a proactive approach.
- **Who should serve on this team?** Team composition should be split between internal and external stakeholders. Internally, it is imperative to represent executive, legal, and key service line/physician leadership stakeholders. Externally, a standing agreement or statement of work should be in place with third-party valuation, legal, financial, and compensation advisors.
- **Where do we begin?** Effective leadership is increasingly important in times of crisis. A supportive executive team is required to ensure that resources are prioritized, decision-making authority exists and an effective communication process is deployed.

Understand organizational needs.

Despite the influx of transactional opportunities expected as a result of COVID-19, financially stable organizations should assess practice needs and priorities to ensure alignment with long-term goals. This includes traditional factors such as market growth, physician recruitment targets and performance initiatives. Additionally, organizations must consider what effect the pandemic may have on its own operations. Is there a need for additional telehealth capabilities? What services will see an increase in demand after months of national shelter-in-place restrictions?

Create a roadmap for acquisitions.

A thoughtful and intentional acquisition strategy should focus on four key elements:

- **Regulatory Environment**
 - Are all future arrangements considered fair market value and commercially reasonable for both the practice acquisition and subsequent employment arrangements?

- Are there any **anti-trust** issues?
- What is the **funds flow** for ancillary services, outside investments, physician compensation, etc.?
- **Financing**
 - What are the sources of **capital**? Is outside financing required? What type of internal approval must be secured to access this capital?
 - What is the organization's targeted **capital structure**?
- **Transaction Terms**
 - What are the **must-have** elements of an acquisition? Is anything non-negotiable?
 - Has internal and external counsel approved **standard language** for acquisitions?
 - How is **value** being assessed? What assets will be considered in determining **purchase price** (e.g., workforce in-place, active patient charts)?
 - What **protective measures** and **control mechanisms** are in place to help govern these transactions?
 - What is the desired **level of affiliation**? Physician affiliation relationships run along a continuum ranging from a low level of affiliation to full practice integration/employment.
- **Integrations**
 - What is the **timeline** for integration? How would an integration impact **existing initiatives and priorities**?
 - Who will **lead** the integration internally?
 - What are the **technology requirements** for a successful integration (e.g., consistent EMRs)?
 - How can integration occur in a way that aligns with an organization's **culture**?

CONCLUSION

The health care industry is in the midst of unprecedented change, disruption and even opportunity as a result of COVID-19. In order for organizations to effectively evaluate and act upon any forthcoming transactional opportunities, a thoughtful and well-considered strategy must be in place. Planning now allows for the development of a proactive approach that is aligned with key organizational goals and objectives.

SullivanCotter brings unique insight into the practice valuation and physician affiliation process with an in-depth understanding of the market forces, regulatory environment and operational infrastructure required to drive successful transactions. Please contact Kyle Tormoehlen or Tom Trachtman to learn more about how SullivanCotter can partner with your organization.

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