# PRIVATE EQUITY DEALS OFFER BOTH POTENTIAL SIGNIFICANT RETURN AND SIGNIFICANT CHALLENGES

If history actually does repeat itself for those who ignore it, then physicians should be cautious about the emerging trend for private equity acquisition of physician practices, because the current private equity resurgence could well be Physician Practice Management Company (PPM) 2.0.

One newsletter suggests private equity may be repeating the mistakes of the physician practice management companies of the late 1990s, many of which ended up in litigation and high profile bankruptcies, providing this historical perspective:

*"With its explosive rise in popularity, the PPM sector alone grew to over 30 publicly traded companies with an aggregate market capitalization in excess of $11 billion at its peak in January 1998. However, by 2002, eight of the 10 largest publicly traded PPMs had declared bankruptcy and many more were ultimately dissolved."*

The concept is similar: multiple physician practices, either in a specific area or of a specific specialty, are acquired by non-physician venture or private equity companies, sometimes referred to as "roll-up" transactions, and the structure is fairly standard:

- The practices are acquired with a combination of cash and equity in the private equity vehicle (PEV)
- The physicians sign long-term employment contracts
- Depending upon state corporate practice of medicine laws, the acquired practices are either operated and managed by the PEV, or execute long-term management agreements

The value proposition of these deals, both in the past and present, is the goal of increasing the profitability of the practice through scaling and patient volume, economies of scale for expenses and infrastructure, and more professional management. The fundamental challenge with this concept, especially in regions with either highly concentrated institutional healthcare delivery systems or dominant third party insurers, or a combination thereof, is the difficulty of increasing either patient volume or revenue, since the payment per procedure, other than with cash-based practices, is strictly limited by government and commercial third party insurers. This stress on volume and profitability often leads to either unreasonable productivity requirements or the transfer of clinical activities to lower cost non-physician practitioners, which could easily impact the physicians' incentive compensation arrangements, and even base salary.

The profitability problems are exacerbated by the challenge of paying the development expenses of these new ventures, paying the new "professional management", and providing a return for the PEV venture capital investors. If volume and revenue cannot be increased, these costs are simply additional burdens. This model would tend to work better in areas without high concentration of the referral volume control exerted by large systems or the reimbursement control exerted by third party payors.

## Evaluating the Offer

The basic value comparison for the physicians is to compare the purchase price of the practice (cash, private equity interests, and compensation) to the projected compensation the physicians would have generated had they simply maintained their practices. The challenge is that most of these future variables are contingent; the only fixed value is the cash in the acquisition price. The intangible valuation issue here is the incentive compensation and a future value of the private equity. Compensation for both the current practice and the PEV practice are projections, within the very important caveat that the physicians will remain in control of their own destiny if they remain in private practice.

## Physician Practice Options

When viewing this transaction from the perspective of the physicians, another complicating factor is whether

the target is a solo physician practice or a physician practice with multiple owners. In the solo situation, the choices are fairly binary and the decisions are in the sole control of the physician.

In a multiple physician owner scenario, not only is there an issue of whether all physicians are receiving the same dollar value offer, for either their private practice interest or in the new employment contracts, but there are governance issues associated with multiple owners, as well as the options of the physicians declining to participate to maintain their existing private practice, i.e. are there restrictive covenants, etc.

## PEV Physician Employment Contracts

The PEV employment contracts are typically long-term contracts, i.e. 5 years or more, because the PEV typically requires this commitment from the physicians to continue to operate the practice. Maintaining the patient referral base is obviously critical to maintaining the long-term revenue of the practice.

The employment contracts typically provide a lower-based compensation than the physicians have been accustomed to, which is intended to be offset by the acquisition cash and long-term incentive compensation possibilities, plus the potential upside of the PEV equity. The incentive possibilities obviously depend upon the personal availability and productivity of the physician, i.e. how many WRVUs can reasonably be generated, and how that volume is distributed by the PEV managers among the existing physicians, new physicians, and potentially non-physician practitioners.

An essential part of the PEV transaction is usually a non-compete associated both with the sale of the practice and with the employment contracts, and the applicability of those restrictive covenants in the event of mismanagement of the practice is a critical issue.

## Management Contracts

The long-term management contracts typically provide the professional managers of the PEV the ability to staff the office, equip the facility, hire the staff, schedule the hours, etc. If physician compensation is tied to productivity, then physicians must be aware of the potential complications of being stymied by the management contract, resource restrictions, staff restrictions, etc. Furthermore, the physicians should clearly understand the administrative services to be provided in exchange for the management fee, and the value thereof.

## Acquisition Value

As mentioned, the acquisition value is usually cash and equity in the PEV, usually split about 80% cash and 20% equity, but that is also a negotiable item. The acquisition value is usually based upon an EBITDA method, which establishes the earnings history of the practice and multiples that by an acquisition conversion factor, typically referred to as the “multiple”. There are two potential problems here:

1. EBITDA means earnings before income tax, depreciation and amortization. However, physician practices rarely have actual earnings, so EBITDA must be adjusted for FMV physician compensation and normalization of expenses i.e. fringe benefits for in excess of market.

2. The conversion factor is often just a discretionary plugged variable.

Finally, another major issue is the future value of the private equity obtained in the transaction. This involves some due diligence with respect to the acquiring company, a review of the documents to determine the future marketability of the private equity stock, restrictions on transfers associated with the maintenance of either the management agreement or the employment contracts, etc. In short, this is usually not a “guaranteed value” so, while it may be an upside, it’s a risky upside.

## Conclusion

Don’t be seduced by the cash; do your homework, do the math, make an educated decision.

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