CAPITAL INSIGHTS

CLINICAL CARE M&A OUTLOOK: THE PROGNOSIS FOR 2018 DEAL FLOW

INTRODUCTION

US Healthcare consolidation is surging—with $164 billion of M&A activity in the first half of 2018, up 87% from the first half of 2017 and already nearing the decade-plus high of $211 billion in 2017. Sweeping changes in healthcare are having particularly significant effects on patient-facing clinical practices—a category that includes ambulatory care and outpatient facilities, as well as physicians groups.

Physician practices make up a small but growing percentage of this M&A activity as these doctor-owners recognize and respond to seismic shifts in patient care, technology trends, and reimbursement dollars. In particular, these new payment schemes, combined with increased margin pressures, and greater industry consolidation trends have resulted in a flurry of physician practice M&A.

A SHIFT IN PAYMENT MODELS

According to a 2017 survey conducted by Modern Healthcare, nearly 40% of the healthcare CEOs surveyed expect more than 25% of their revenue to be tied to bundled payments, accountable care organizations, population health initiatives, value-based contracts and other payment reforms within two to five years. Evaluating changing payment models in the context of changing cost structures is a challenge even for hospital systems, let alone standalone physician practices.

INCREASED MARGIN PRESSURES

The universal imperative to reduce operational inefficiencies, while nevertheless producing desirable health outcomes, is placing added pressure on patient-facing clinical practices. These pressures are compounded by increased regulatory pressure in addition to efforts by the Centers for Medicare & Medicaid Services to ensure accurate billing practices.

INDUSTRY CONSOLIDATION

Fueled by record-levels of private equity capital, the current uptick in M&A activity in the healthcare industry, including the acquisition of patient facing clinical practices, is expected to continue, according to a recent survey of 150 CEOs, chief financial officers and other top executives. In addition, the recent spate of hospital and health system mergers is expected to continue due to ongoing revenue and cost pressures.

"In prior reports, we shared there would be accelerated, wholesale changes to the healthcare industry and that is beginning to play out," said Christopher Helmrath, Managing Director of SC&H Capital. "And the variables driving much of the transformation are the need to reduce costs, while increasing the quality of patients outcomes."

HOW PATIENT-FACING CLINICAL PRACTICES ARE BEING AFFECTED

These changes are undermining the profitability of ambulatory care and outpatient facilities, as well as physicians groups. According to a 2017 survey of 49 organizations representing more than 13,000 physicians conducted by the consulting arm of the Medical Group Management Association, many medical enterprises are struggling to grow revenues amid mounting cost pressures:

1. The operating loss per physician increased from a **loss of 10%** of net revenue found in the 2016 survey to a **loss of 17.5%** of net revenue in the 2017 survey.

2. Total losses per physician during this two-year period went from **$95,138 to $140,856** per physician at the median.

3. During this period, while gross professional revenue increased from **$1,217,350 to $1,328,625** at the median, net professional revenue actually decreased at the median from **$682,735 to $681,322.**

"Previously, many patient-facing clinical practices were challenged in optimizing the efficiency of their operations. The heightened margin pressures, along with the shift in payment models, are going to make these challenges even more formidable," said Kevin O'Sullivan, Principal, SC&H Capital.

So pronounced are these challenges that only 47.1% of physicians in 2016 had ownership stakes in a medical practice, according to an American Medical Association study, down from 53.2% in 2012. The milestone marks that the first time that the majority of physicians are not practice owners.

The same study also reveals that doctors—and younger physicians especially—increasingly prefer to join larger practices, as opposed to owning their own practice.

"The data we're seeing signal that fewer physicians are electing to go it alone by owning and operating their own patient-facing clinical practices, especially the new generation of physicians," said Gregory Hogan, Director of SC&H Capital. "We're fielding questions from physicians and administrators who are trying to unpack what the latest trends mean for their businesses."

WHO ARE THE BUYERS AND WHAT IS DRIVING DEMAND?

Many factors go into determining the buyer for a physician group or patient facing clinical practice. We see transactions trending relative to the practice type, but recently buyers have been active across the spectrum of healthcare.

Hospitals remain the most active buyer of practices, particularly in hospital-based services such as anesthesia, radiology, and ER. While hospitals have also been active in primary care, insurers are increasingly focusing on vertical integration targeting the frontline of healthcare deliver with the ultimate goal of saving dollars. In December, UnitedHealth's Optum acquired DaVita's medical practice group, which employs more than 750 primary care physicians, for $4.9 billion.

Private equity firms are focused on opportunities within healthcare, of which they see many in physician and patient facing clinical practices:

- Growth opportunities for the practice
- Service offerings which complement other offerings and increase patient quality in closed network continuum of care environments
- New markets opportunities for population health management
- Driving revenue and cost synergies through professional management and scalable infrastructure
- Economies of scale like leverage with payers, suppliers and HR
- Largely fragmented markets with many avenues for acquisition growth/expansion

Many of these private equity buyers are very strategic and have seasoned healthcare executives who provide not only acumen in the particular areas in which they invest but also bring contacts and networks which can be leveraged. They differentiate themselves beyond the firms who only have financial resources to deploy. These types of strategic private equity buyers have been most active in traditional and retail-based office settings such as dermatology, dental, and ophthalmology. In 2018 alone, we have seen 15 new platform investments from private equity investors in these specialties alone.

WHAT BUYERS AND INVESTORS VALUE IN PATIENT-FACING CLINICAL PRACTICES

Given the status of the market, it is important to note what buyers and investors are looking for in a transaction. PE firms and larger healthcare provider organizations interested in purchasing, or making a strategic investment in, a patient-facing clinical practice typically evaluate such opportunities on the basis of the following criteria:

STRENGTH OF REPUTATION
Extraordinary awareness and reach of the practice itself and/or individual physicians, especially if they are nationally recognized. Strong brand reputation can add value to hospital networks, attract enrollee for insurers, and deleverage investment risk for private equity buyers. In addition, having a nationally recognized partner in the practice can help with new physician recruitment, a growing challenge in the industry.

SIZE OF PRACTICE
The number of doctors, the gross and net billings, as well as the gross revenue per physician.

PHYSICIAN MIX
The age of physicians with emphasis on top earners and ability to recruit younger doctors.

PROFITABILITY AND PAYER METRICS
The overall cost structure, along with an advantageous payer mix.

"Each potential strategic suitor has its unique approach to assessing a clinical practice, often weighting individual criterion differently, but they are alike in that they are seeking to precisely estimate the current and future value of the business.

Christopher Helmrath
Managing Director
SC&H Capital

HOSPITAL AND INSURER INTERESTS

REFERRAL METRICS
Where and how often are consumers referred to other service providers is important to potential buyers. These buyers will want to understand how and if that can be directed to optimize dollars within the system.

AT-RISK MODEL OPPORTUNITIES
If properly capitalized and operationalized, are there reimbursement models ready to be rolled out that could result in increased income or savings?

PRIVATE EQUITY INTERESTS

MANAGEMENT TEAM
Physicians or administrators capable of driving operational value and practice growth.

REVENUE CYCLE MANAGEMENT (RCM)
An automated process for tracking patient care episodes from registration and appointment scheduling to the final payment of a balance. A well-functioning RCM can help private equity buyers realize instant accretion with smaller, add-ons to the practice where best practices in billing and collection can be applied.

DEFINED IT AND INFRASTRUCTURE
An industry standard platform with finance and compliance functions that support the growth of the practice.

GROWTH PLANS AND OPPORTUNITIES
Well-conceived plans to grow revenue, along with a track record of capitalizing on ancillary revenue opportunities (subject to Stark Law restrictions).

WHAT PATIENT-FACING CLINICAL PRACTICES SHOULD KNOW

The leaders of clinical practices contemplating a strategic investment or sale should be knowledgeable about a variety of key issues so they can make informed decisions about potential transactions:

EXIT ALTERNATIVES
The first question should be who is buying physician practices like mine and what is the acquisition climate in my geography. Secondly, understanding the goals and objectives of the practice partners is crucial to developing a plan. Finally, practice owners should be thinking about building the long-term enterprise value of the practice given the potential buyer community and objectives of the partners.

PRIVATE EQUITY ACTIVITY
If private equity is a route that I would consider with my practice, what would a purchase or investment entail? How would the transaction be executed? And what is the overarching business strategy?

Practice owners should be thinking about objectives with liquidity, in particular the potential tradeoff in partner earnings. Private equity is potentially an alternative for practices who are looking for a growth partner to accelerate plans and finance investments in the practice.

Typically, private equity will invest 50-80% of the equity in a transaction, requiring the practice partners to make up 20-50%. For physicians, partnering with a private equity owner can result in a loss of control of some decision processes, though ultimately retail all clinical control in regards to patient care.

"M&A involving clinical practices has never been simple, especially now given the increased complexity of managing these practices profitably. Unless you don't foresee a scenario in which you would sell or facilitate the strategic investment in a practice, it's only prudent to discuss the current landscape with an experienced advisor.

Greg Hogan
Director
SC&H Capital

CONCLUSION

As a result of the increased focus on increasing the quality of care with the reduction in overall cost, healthcare's transformation will continue for some years to come. Consequently, ambulatory care and outpatient facilities, as well as physicians groups, will be operating in different environments with significantly greater opportunities for growth and assimilation into a bigger healthcare ecosystems, but with less margin for error.

The complexities of both transitioning ownership from senior partners to the next generation, as well as preparing for ongoing changes in healthcare can be overwhelming for practice owners, most of whom want to focus on patient care and improving outcomes.

Determining the appropriate strategy for each business and then finding the right buyer or investor will be accretive, yielding liquidity,resources and access to healthcare ecosystems, all of which best position your practice for the future.

ABOUT SC&H CAPITAL

SC&H Capital, an affiliate of SC&H Group, is a premier investment bank and advisory firm providing merger and acquisition (M&A), employee stock ownership plan (ESOP), and business valuation solutions globally leading middle market companies. SC&H Capital advises leading companies across numerous industries including technology, healthcare, manufacturing, and government contracting to help owners maximize their exit planning goals and liquidity objectives. To learn more visit www.schcapital.com

CONTACT US

CHRISTOPHER HELMRATH

Managing Director
410. 988.1351
chelmrath@schgroup.com

GREGORY HOGAN

Director
410. 988.1352
ghogan@schgroup.com

KEVIN O'SULLIVAN

Principal
410. 988.1358
kosullivan@schgroup.com

CRAIG BOWDEN

Vice President
410.988.1357
cbowden@schgroup.com