Fox Rothschild Podcast

Featuring Partner William Maruca

We're talking today on FoxCast with William Maruca in Pittsburgh about private equity transactions with physician practices. Bill has been named as one of the leading health care attorneys in Pennsylvania by Chambers USA. He has extensive health care law experience, mainly representing health-related ventures. Bill also is a prolific speaker and teacher and writer on health care topics and is widely published. Bill, good morning.

William Maruca: Good morning. Glad to be here.

Question: *Bill, you've been published recently about the 1990s trend of publicly-traded physician practice management companies – or PPMs for short – where investor capital was infused into medical practices, and this concept has returned from oblivion in the form of private equity transactions.*

William Maruca: These deals make me think of the old saying "History does not repeat itself, but it rhymes," which was mis-attributed to Mark Twain. Like the ill-fated PPM company deals, these private equity deals have a lot in common. They offer physicians cash up front and ownership in the management company. They're designed to be sold in the future at a profit, and like the PPM deals, PE deals claim to be in a position to consolidate physician groups to achieve greater profitability.

Question: *Could you tell our listeners more about the private equity concept?*

William Maruca: Sure. The term "private equity" refers to the fact that these companies are non-publicly traded, and they are funds that directly are invested in private companies, or engage in buyouts of public companies. The old 1990s deals were typically done by publicly traded companies. PE firms are typically organized as limited partnerships, and the investors contribute capital as limited partners, and the fund organizers manage the company as general partners. The investors include pension funds and other large institutional players. The manager/general partner charges a management fee based on a percentage of the investments under management. And then the acquired companies become part of the fund's portfolio. Those companies are then positioned for subsequent resale at a profit to larger purchasers.

Question: *What are the obstacles that might get in the way of successful deals?*

William Maruca: There are quite a number of regulatory barriers. In Pennsylvania, as in many states, generally only licensed physicians can own a medical practice itself. That restriction is known as the "Corporate Practice of Medicine" doctrine. It prevents PE companies from acquiring direct ownership. One option that's often used is for the PE company to acquire the practice through a "friendly" or a "captive" physician-owned entity. That might take the form of a professional corporation, or an LLC, whose physician-owner is part of the acquiring company's executive team. But a more common work-around that doesn't require having a

physician as part of your executive team is for the acquiring company to form a management company, sometimes called a Management Service Organization – or an "MSO" – that provides space, equipment, staffing, recruiting, billing, collection, day-to-day management, and third-party payor contracting. In return, the MSO receives a management fee paid out of the practice's collections. The physicians may be offered an equity stake in the MSO company to share in revenues and ideally to cash in for a sizeable return when the MSO is sold. So far those attributes sound a whole lot like the 1990s PPMs, but there are a number of differences, because today's buyers have learned some lessons from the failures of their predecessors.

Question: *Why did the PPMs of old fail?*

William Maruca: One reason is they purchased practices at premium prices because of bidding wars, and then they continued to pay the selling physicians compensation packages comparable to what they earned as private owners. The math simply didn't work out. The presumption was that with infusion of professional management and technology, the elusive "economies of scale" would appear, and costs would be brought down. When you hear "economies of scale" in these physician deals, a lot of people roll their eyes, because they typically didn't happen. But they believed that additional profits would be generated to satisfy the MSOs, the physicians and the investors alike. But what they learned was that physician-owned practices were managed pretty well by the physicians who owned them. The reason was because every dollar not spent went straight to the owners' pocket. So there was little or any additional profit to be squeezed out. These companies would add layers of middle management which added costs but didn't produce much in the way of anticipated returns. And it turns out that management functions were not readily scaled-up and centralized. Now the hospitals and health systems that bought practices could rationalize losses on acquired practices, because they could make up the difference on admissions and facility fees that they would capture because the practices they owned would refer patients back to the hospitals. PPMs couldn't participate in that revenue stream. So ultimately many of them went bankrupt.

Question: *How do today's buyers hope to avoid a similar fate, especially or particularly considering that their investors often expect large annual returns?*

William Maruca: First, I think that purchasers have become more realistic about purchase prices and their relationship to the compensation of the selling physicians. Prices for practice assets are frequently determined by multiples of the term Earnings Before Interest, Taxes, Depreciation and Amortization, which the accountants will call "EBITDA," instead of market-driven valuations of the past that frequently assumed unrealistic growth. In fact, we often saw assumptions in the old 1990s deals that presumed the practices would grow by 20 percent of patient volume. If you added all those up, from all the deals from the 1990s, I think the population of Pittsburgh would have had to double for all those predictions to come true. Now the multiples of EBIDTA have been increasing in recent years so one element of the PPM history might in fact be repeating if the buyers aren't a little more careful. The higher the EBITDA multiple, the less money will be left over for physician compensation after the transaction. As a result, that may present internal conflicts among the older and younger members of a group. Importantly, the first seller in a market can often command a better price than others in the same

specialty, because the PE firm can then use that practice as the platform from which it will attract more physicians. Those later-acquired practices are sometimes referred to as "bolt-ons."

Question: *Won't selling physicians see their salaries initially reduced?*

William Maruca: Many times they will, but they hope to be rewarded instead with actual ownership, stock options, profit-sharing or "phantom" equity that reflects the buyer's financial performance. The goal is to more clearly align the incentives of the physicians with those of the management team. That was a feature that was often missing from the previous PPM arrangements. Many PE firms claim that they'll maintain a hands-off approach to clinical decision-making so that the physicians remain in control of medical matters. In fact, state regulators may intervene if they don't honor those promises.

Question: *Bill, what happens if and when that MSO entity is sold by the PE fund to a new owner?*

William Maruca: The doctors typically will become owners in the PE fund, or the management company, and as a result they can participate in a "second bite of the apple." From the PE investor perspective, the goal is to grow and consolidate practices so they're more attractive to a larger PE purchaser, then "flip" them for a profit, generally within three to seven years. Physicians are understandably wary that new owners might not be as responsive to their goals, or that they might potentially bring a more top-down management style that limits their autonomy. Because of that, physicians need to use experienced counsel to guide them through negotiating the initial sale and management documents to protect them from overreaching by the next owners.

Question: *What kinds of practices are being targeted by PE companies?*

William Maruca: They started out by looking at subspecialty practices, particularly ophthalmology, hospital-based practices, radiology, anesthesiology, pathology and emergency medicine. And then the next wave involved gastroenterology, otolaryngology, orthopedics. The one common factor of those is that they have potential for ancillary income – lab services, diagnostic testing, therapy, ambulatory surgery centers. Purchasers are also finding practices which focus on elective procedures or self-pay patients such as infertility, dermatology and dentistry to be attractive. They're beginning to acquire primary care practices with an eye toward capturing some new sources of revenue from some of the new reimbursement methodologies that involve population management and accountable care organizations.

Question: What are some factors to consider before entertaining a PE deal?

William Maruca: The physicians in the group need to sit down with each other and think about what their goals are. And whether all the goals of the physicians in the group are aligned. For instance, if there are age disparities among physicians, they may pit the older ones who looking for favorable cash-out terms against younger doctors with more years ahead to practice. You

also have to take into account the non-owner physicians of the group, make sure they'll be fairly compensated going forward, or if they leave, how easily you can recruit replacements.

Question: *So economic forecasting and judgment are critical.*

William Maruca: Certainly. Physicians need to know if the economics are going to work. You should ask yourself how confident you are in the financial projections presented that show your compensation and your anticipated returns. Are they really based on realistic assumptions? Remember, you may know your market better than a national company thinks they do. Ask yourself what your personal horizon is and if there's an acceptable exit strategy. How much are you depending on future distributions or sale from profits that might never materialize?

Question: *What other questions should physicians be asking? This is a lot to digest.*

William Maruca: There are quite a number of questions. Who's going to control key decisions after closing? What role will the selling physicians retain? Can your group be combined with another groups that's later acquired by the PE firm, and if so, how's that going to impact the dynamics of the practice? Will you have any say in the selection of newly recruited physicians?

Question: *Is there more?*

William Maruca: How much will you still control your medical decisions? Will your new capital partner force you to change your use of midlevels and physician extenders? Will they pressure you to see more patients in less time? Will they pressure you to order services you don't feel are necessary? Who ultimately will control coding, and if a payor demands a large refund, will they back you up?

Narrator*: Well, Bill, thank you for your time and for sharing your knowledge. We're about out of time for today. And listeners, thank you for being with us. To confidentially discuss how private equity transactions may benefit your medical practice, please contact Bill Maruca at 412-394-5575 or at wmaruca – that's W-M-A-R-U-C-A at foxrothschild.com.*

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