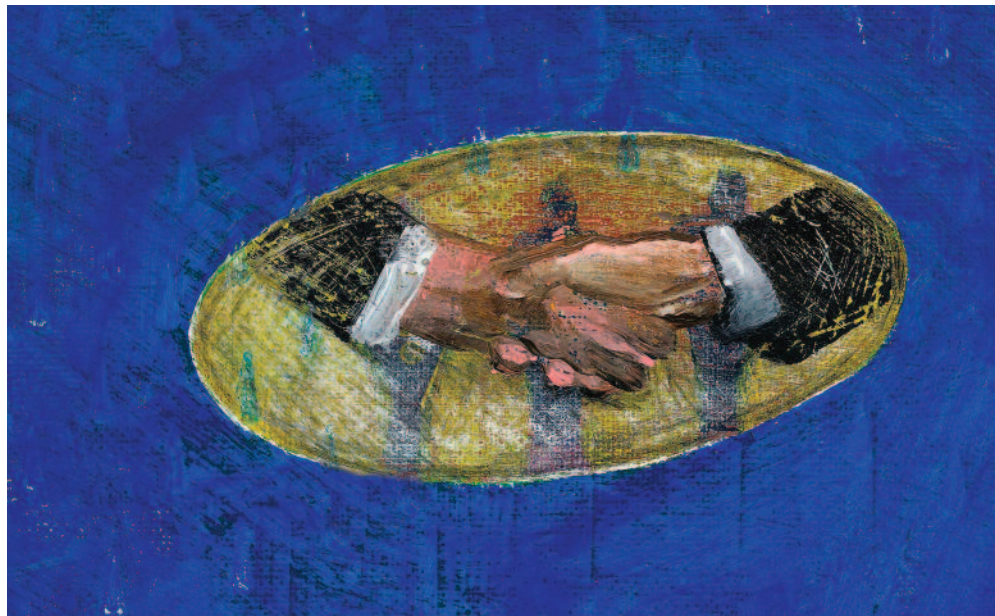


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physician practice acquisitions preparing for the transaction

Before talking dollars, hospitals that hope to achieve success with practice acquisitions should lay the groundwork for discussing valuation and compensation.

Many hospital leaders are embracing the trend to physician employment. But how many are fully prepared to respond effectively to acquisition opportunities when they arise?

In some instances, the drive—one could even say race—to build provider networks and acquire the right practices results in ad hoc transaction processes that create more work and less-than-positive physician-hospital relationships. Laying some groundwork before diving into practice valuation and physician negotiations can ensure that deals flow more smoothly, parties are satisfied with the results, and physician-hospital relationships are stronger.

When the groundwork is not set properly, compensation or purchase price offers made up front

can later turn out to be unsupportable, or the hospital may learn that some strategically critical element of the deal is a deal-breaking surprise to the practice. The negative publicity in the physician community created by these kinds of problems can be extremely problematic as the hospital pursues subsequent deals.

Thorough preparation, correctly sequenced, is essential to successful practice acquisition and employment transactions. To create a solid foundation for acquisition, a hospital should take specific steps and answer several strategic and tactical questions.

Step 1: Build a Framework for Consistency

Face it—talking with a large physician group that wants to be acquired is a lot more exciting than developing an organizational philosophy and process for handling practice acquisitions and physician compensation. But for hospitals that are building a physician enterprise, it's

important to establish standard answers to questions that will arise in every transaction:

- > How do we determine whether we want to pursue a specific acquisition opportunity? What criteria do we use?
- > Do we pay for identifiable intangible assets (practice name, workforce in place, etc.), unidentifiable intangible assets (goodwill), or just hard assets?
- > What compensation model and philosophy do we apply? Do we provide incentives based on physician work relative-value units or on collections? Does the model include a bonus for quality, patient satisfaction, or other factors?
- > Do we want this framework to be transparent to the physician community?

It's equally important to define a controlled internal, multidisciplinary process for moving deals along and identifying who will be involved in which discussions with acquisition candidates, at what stage of the process. Finance, legal, quality assurance, and other departments should be involved in supporting the lead negotiator.

Any hospital that makes a move without this kind of framework will likely find itself having to justify every individual compensation and purchase price decision not just to the practice under consideration, but also to every practice that might consider giving the hospital a purchase opportunity. If physicians have heard from colleagues around the country that the hospital pays for goodwill, how does the hospital manage that expectation? Once Physician Group A hears that the hospital offered Physician Group B a better compensation package than it offered Group A, the hospital's choices are limited. Outbid the previous offer? Explain why different rules apply in Physician Group B's case? Looked at in this light, the energy required to create organizational guidelines and controls for making acquisitions is an attractive one-time investment.

In developing a consistent informational and analytic framework, a hospital can establish qualitative guidelines—such as compensation approaches, target locations, due diligence

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procedures, and clear statements of what is and is not “on the table”—and create a basis for assessing potential acquisition opportunities and identifying practices to pursue actively. For example, if a health system intends to consolidate practices into a large ambulatory care facility, establishing this plan within the acquisition framework will help the health system target “movable” practices. Ideally, practice acquisitions and physician employment should be supported by a detailed medical staff development and implementation plan.

The more a hospital understands the networks of relationships among key physicians on its medical staff and other physicians both on and off staff, the better positioned it will be to understand a practice's potential value to the organization. For example, although primary care physicians may not admit many patients, virtually every community hospital will need to ensure that it has a strong, supportive base of primary care physicians.

Step 2: Prepare for Possible Exceptions

The organizational guidelines the hospital develops should work well for primary care practices and some specialties. However, in some situations involving certain specialty groups, the hospital may find it impossible to adhere to the guidelines and generate a deal attractive enough to satisfy the group. Such situations should be seriously discussed internally prior to any discussions with the physicians. The hospital should develop internal consensus on whether acquiring this specific practice is worth departing from the guidelines (and how far) and dealing with the precedent that might create.

AT A GLANCE

Hospitals embarking on acquisitions of physician practices should lay the groundwork for these transactions by:

- > Building a framework for consistency
- > Preparing for possible exceptions to the framework
- > Broadly assessing the practice before advancing to the thorough valuation of the practice
- > Being alert for red flags and potential deal breakers and ready to address them

Step 3: Assess the Practice

Too often, hospitals don't assess practices targeted for acquisition until the valuation phase of a transaction. Although a valuation will certainly include a detailed practice assessment, a hospital should avoid getting that far down the road before deciding whether it really wants these physicians within its orbit. Following an early assessment, which should also consider the practice's broader relationships, the hospital may decide it wants to explore business arrangements other than acquisition.

The assessment should answer several key questions:

- > What does the practice bring to the hospital now, and how might that change after acquisition (for better or worse)?
- > Will the acquisition produce side effects for other physicians?
- > Is the practice a mission-critical service that has a clear impact on practice patterns of other practices and ancillary services?
- > What does physician productivity in the practice look like?
- > Is overhead expense per physician higher or lower than the market average in the specialty?
- > Will the practice's payer mix present an opportunity or a concern for the hospital?
- > Do the physician's coding practices pass muster? Are there any issues regarding quality of care, or are there physicians who are recognized for their excellence in specific diagnoses or procedures?

If negative findings on any of these issues surface for the first time during the valuation process, it can kill both the deal and the physician relationship. Although a skilled valuation consultant who has resolved similar issues may be able to avert serious damage, concerns first discovered in valuation will inevitably make for a longer and bumpier acquisition process. The early-stage assessment will prevent that difficulty.

Special Considerations

In addition to taking these steps, hospitals should answer several questions that can have a bearing

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on the future success of the physician-hospital relationship.

Going up or going down? Is the practice on the ascent or the decline? Some cardiology or oncology practices, for example, have been hit hard by payment changes, and there may be limited financial value in the practice *in situ*. In such a case, the advantage of acquisition to the physicians may lay largely in future compensation. By being aware of this situation up front, the hospital will be better prepared to structure a deal, and can also manage physician expectations.

How will large practices change? It's important to consider how a large practice may change if acquired, and what impact this change will have on its attractiveness as an acquisition. Key physicians employed by the practice might leave. Patient flow patterns and patient mix could be affected. Revenues could decline, possibly changing the appropriate acquisition valuation.

Do you really want all that equipment? Highly capitalized specialties such as radiology or radiation oncology may present significant value because of their equipment. But will it all be used if the practice is acquired? If a hospital's policy is to buy hard assets only, and it will not be using most of the equipment, the hospital should make sure it clearly communicates that point. Although it will not change the valuation process, being clear on strategic objectives will help the hospital manage expectations and structure the transaction appropriately.

Can you at least match historical compensation? The hospital should consider whether, to the extent that a practice has relied on technical revenue for compensation in the past, it will be able to meet the practice's compensation expectations. A quick compensation assessment may identify constraints before the heavy lifting of an acquisition even begins.

Potential Deal-Breakers and Red Flags

Practice acquisition transactions are complex in many ways, and inappropriate expectations and misunderstandings occur all too often. Although many physicians and their group practices like the idea of a grand sale, they may not be ready for the realities of the acquisition process and results. Misperceptions about business valuation can cause time-consuming detours during the valuation process.

By identifying red flags and managing expectations up front, hospitals can avoid investing time and money in valuation processes for acquisitions that are doomed to self-destruct, and can make the path from valuation to closure shorter and straighter. Once the organization's interests in the practice have been clearly stated, it is time to start talking with the physicians and shaping expectations.

The hospital's leaders should meet with the physicians and discuss the entire transaction process, including the timing and philosophy of valuation and compensation and how they might be affected by the hospital's acquisition framework. It's helpful for the hospitals to have an experienced valuation consultant participate in this discussion to clarify the regulatory constraints. Discussion points divide roughly into transaction logistics, potential deal-breakers, and management of expectations.

Transaction logistics. Without agreement on basic logistical considerations, it will be impossible to complete any transaction. Items to be discussed include:

- > Whether the physicians are prepared to share data related to the practice operations and finances

- > Whether the group's lead physician contact actually represents the other partners to the extent that, if the lead physician formulates the broad terms of a deal, the other partners will readily follow
- > The point at which the hospital and practice are willing to discontinue discussions with other suitors and sign a "standstill agreement"
- > Whether a nondisclosure agreement and a letter of intent are warranted

Potential deal-breakers. Getting potential deal-breakers on the table early allows the hospital to determine what questions will require some level of resolution before any further steps are taken. It's better to know now than after a valuation has been done and a compensation offer made. Important questions to discuss include the following:

- > Does the group understand that they may need to sign a noncompete agreement? For some physician groups, this will be the end of the discussion. It's best to know this as early as possible.
- > Do the physicians have generally reasonable expectations about a sale? For instance, has a "Wall Street friend" suggested that 15 times EBITDA is reasonable?
- > Are there financial arrangements related to referrals or other referred physicians? Some arrangements may be commercially reasonable for a practice, but raise legal concerns for a hospital.
- > Are there patient care or practice pattern goals that the hospital wants to see as deal outcomes, but the physicians do not?

This is also the time to raise possibly troublesome issues. For example, if a simple evaluation and management code review has suggested upcoding may be a concern, additional review may be warranted and may impact valuation calculations. And if there have been rumors of pending litigation (even among the partners), they will need to be confirmed and addressed.

Management of expectations. The importance of managing expectations cannot be overemphasized. Physicians often hear about acquisitions

from friends and associates from many markets and situations. What they have been told may be inaccurate or not relevant in their market and situation. It is a good idea to start by finding out what the physicians think they know and want.

The physicians will need to appreciate the legal, strategic, and financial constraints of the transaction and valuation process and the terms of a deal. For example, they will need to understand why the value of referrals cannot be a consideration in the practice valuation or the compensation proposal.

Beyond these considerations, the physician expectations to be managed will vary with the situation.

For example, a specialty group may expect that that the hospital will be able to incorporate the post-transaction revenue stream at higher, hospital-contracted payer rates into the valuation, when fair market valuation (FMV) guidelines make that impossible. Or a strong practice that is all too aware of its attractiveness to the hospital may not realize that even with the highest possible level of interest, the hospital still faces constraints on what it can do. It's important that the hospital leaders communicate to the physicians that they will do everything they can, but the sky is not the only limit.

In some instances, there may be a strategic justification to minimize the initial practice assessment and move quickly to developing well-founded parameters or deal options for discussion.

Specialties that have historically enjoyed technical component compensation (e.g., diagnostic imaging) will need to understand that the hospital may not be able to improve on their current compensation level. In contrast, for practices where the physicians have had to limit their own partner compensation due to declining revenues (e.g., oncology and cardiology), discussions with physicians should highlight compensation.

Where a specialty or practice is a strategic focus or a center of excellence, physicians may gain not just employment, but also a leadership role—e.g., medical directorships or committee memberships. This possibility should be established up front.

The physicians need to understand that when properly executed, an FMV analysis provides everyone with the valuation conclusion needed to support a given transaction. These early discussions provide a good opportunity to put the process on the path to an open and informed conclusion.

Additional Steps

When initial steps have been completed, and key considerations have been addressed, important additional steps remain: Specifically, the hospital will need to conduct a valuation of assets (not always limited to tangible ones) as it determines post-transaction compensation, and it will need to create a comprehensive term sheet.

Now is the time for the hospital to bring in an attorney, if it doesn't already have one involved.

Valuation of assets and determination of post-transaction compensation. It's essential to handle asset valuation and compensation simultaneously, because the valuation will need to consider the level of postemployment compensation. If the valuation assumes a given level of compensation and the actual level is much higher, it can lead to later questions about whether market value was determined appropriately.

Creation of a comprehensive term sheet. The purpose of this sheet is to ensure that all parties have an opportunity to see the deal laid out in its entirety, rather than trying to judge each aspect in a vacuum. The sheet should include both the acquisition and compensation proposal, so the physicians can see the full picture. The physicians' attorney should be involved at this point. With the acquisition price and the compensation proposal presented together, the sheet can be used to show that a relatively small increase in

compensation for the former partners over the term of a new employment contract can be worth more than fighting over a few hundred thousand dollars on the acquisition price.

What Happens If You Miss a Step?

It can be very tempting to skip a step under the pressure to secure a deal. However, without building an acquisition framework, performing a preliminary practice assessment, and identifying deal-breakers, things can go wrong, and forward motion can be impeded or stopped cold.

Following are two actual case examples of how deals have been derailed because of missed steps.

In one case, a hospital system that sought to acquire a large internal medicine and cardiology practice made a compensation offer prior to completing the practice valuation. The proposed compensation ultimately raised concerns about the FMV for the practice. Those late-stage concerns, coupled with perceived inconsistencies with the terms for a prior purchase of a cardiology practice, caused significant embarrassment for the hospital. The deal had to be renegotiated.

In another case, a community hospital sought to acquire a 10-physician internal medicine practice and employ its physicians, when it was known that the lead physician had been “shopping” for a suitor in the area. The hospital completed a careful business analysis and compensation design effort, and then attempted to move the negotiations to a conclusion. At that point, it became clear that the partner physicians were less enthusiastic about the deal than the lead physician, who was not able to convince his partners to conclude the arrangement.

Even without any missed steps, a hospital can run into challenges, as shown in a third case example involving a hospital that sought to acquire a cardiology practice. The practice hired its own consultant, who did a back-of-the-envelope “valuation,” creating unrealistic expectations. In this case,

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even though the hospital did not miss a step, the physicians still got out ahead. Fortunately, the hospital and its valuation consultants met with the practice early to educate the physicians about valuation process and methodologies. This early education, while difficult, mitigated the expectations and the deal was able to close successfully.

The lesson is that no matter how a hospital handles an acquisition opportunity, it can expect that significant effort will be involved. By properly laying the groundwork before moving into the core of the acquisition process, however, the hospital can ensure that its energies will be focused only on acquisitions that are likely to be successful, and that the process will go well. ●

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