Mary Vandenack provides the transcript from Legal Visionaries podcast on Capitalizing Care: Exploring the Surge of Private Equity in Healthcare.

TRANSCRIPT:

Mary: On today's episode, my guest is Tracey Salinski. Tracey is a partner at the Chicago-based law firm of DUGGAN BERTSCH, LLC. I will note that while DUGGAN BERTSCH is based in Chicago, it has an Omaha office that will be including myself and actually has attorneys in several locations across the country. With more than two decades of experience in both private practice and as a senior leader in various in-house roles, Tracey is a trusted advisor and counselor to healthcare organizations offering strategic counsel on a broad range of healthcare, regulatory, corporate, and compliance matters. Prior to joining DUGGAN BERTSCH, Tracey was counsel at an AM Law 100 law firm, and prior to that served as an in-house General Counsel and Senior Vice President of Legal for Illinois' largest multi-specialty physician directed medical group. So, I just have to note, that had to be one challenging job. Was it?

Tracey: Oh my goodness, it was insane, but in all the best ways. I'll tell you about it over coffee or drinks sometime.

Mary: I was reading your bio before and I sort of missed the...and I was like going, "Oh wow, that had to be a very great challenge."

Tracey: It was unbelievable, yeah.

Mary: I asked Tracey, so we were just talking about we both have a passion for healthcare, and I really loved her background, and so that's an area that I really need to get some coverage on my podcast because there's been a lot of transactions that have come my way this year. And so, one of the topics we talked about that Tracey's an expert on that we're going to discuss today is private equity in healthcare. Well, first of all, thanks so much for joining me to discuss this topic today, Tracey.

Tracey: Hi Mary. Thank you so much for having me. It's a pleasure to be here and to have the opportunity to talk about this exciting topic. Private equity investments have certainly generated quite a bit of attention in the healthcare space, and my clients regularly reach out to me with questions about this topic. PE firms are investing in a variety of healthcare providers, including hospitals, health systems and nursing facilities. However, for purposes of this podcast, I'd like to focus on private equity investments in and the impact upon physician practices.

Mary: So, we're really hearing a lot about this topic and I've seen a lot of different types of structures evolving in terms of physician groups making themselves attractive for private equity investments, et cetera. But just how have these private equity investments in healthcare proliferated? How big is the investment in healthcare?

Tracey: Sure. By way of reference, let's look back over the last 10 years or so. In 2012, there were a reported 75 private equity deals for physician practices across a wide range of specialties. By 2021, there were a reported 484 deals, marking a more than sixfold increase. And in that same year, global healthcare buyouts exceeded the $200 billion mark in annual deal value. Yes, that is $1 billion with a B, so we are talking very big money here. And these deal dollars may be under-reported given private equity sponsors are not subject to reporting requirements in contrast to public corporations.

Not only PE firms are getting in on the action, but some notable corporate healthcare transactions in the past few years also include, and these are on the public side, Amazon's purchase of One Medical for $3.94 billion. Optum's acquisition of Healthcare Associates of Texas for $300 million. CVS' $10.6 billion acquisition of Oak Street Health. And Village MD, which is a Walgreens subsidiary, recently acquired Summit Health City MD for $8.9 billion. While these large mega deal transactions have garnered a significant amount of attention, we have seen a trend over the past couple of years towards a greater portion of deal volume being driven by smaller roll-ups and add-ons or complimentary transactions as opposed to these mega and platform deals.

Mary: I have to just share a little story. So, I know with the Amazon and the One Medical, I think you can actually go to Amazon.com and schedule a medical call. I didn't even realize that was there until my son was sick one day and I was trying to get him to go to a doctor and he goes, "Oh mom, I just called the Amazon doctor." I was like, "What?" I didn't even know there was such a thing.

Tracey: Yes, they are seemingly taking over the world and the world of healthcare as well, really capitalizing upon this demand and making it really easy to get appointments and to get prescriptions.

Mary: Which can be a challenge. So, I can see that there is a place in the market, but let's just dive in a little further and what is private equity's interest in the healthcare industry?

Tracey: Yeah, so there are a few factors that are driving the interest, and it really relates back to PE sponsors holding large levels of capital that they need to deploy, and healthcare is generally thought to be recession resistant. Another driving factor is that physician practices often represent profit opportunities. In particular, those that offer higher margin specialties such as dermatology, plastics, orthopedics, and gastroenterology. Strong profit profiles are often achieved through optimization of both clinical and nonclinical operations, largely through expansion of clinical and ancillary services, and through back office and supply chain efficiencies. In fact, PE sponsors are typically underwriting a 20% or more internal rate of return over an approximately five-year holding period of their investment. Further, the market is highly fragmented, and for various reasons the independent practitioner model is on the decline making the market ripe for consolidation.

Mary: And so that private independent practitioner model on the decline, which makes me a little sad to be honest, but is definitely accurate. But why are providers so interested in selling out to private equity?

Tracey: Healthcare sector dynamics are changing as well as patient expectations. Mary, you just referenced your son making an appointment through Amazon. Well, patients are becoming very demanding with respect to healthcare and their expectations are very much elevated. For example, not only are patients demanding more access and faster access to their practitioners, but they’re also demanding more access to healthcare technology, whether to communicate with their providers, make or check into an appointment, or for quick and easy access to test results. They really like to do this over their cell phone, iPad, or other personal electronic devices. These changing dynamics, coupled with the continued rise in healthcare costs, are really putting pressure on providers to adapt and reinvent processes to optimize the quadruple aim performance metrics of improving experience, reducing the cost of healthcare, improving overall population health and reducing or preventing physician burnout.

A private equity investment brings an infusion of capital, a platform to off-board administrative burden, and has the potential to accelerate growth opportunities and add strategic resources, all of which can be quite compelling benefits when faced with these industry headwinds. Also, while practice purchase price values have significantly elevated over the past year and EBITDA multiples, while they have softened from their peak of a few years ago, remain around 13.6x across various sub-sectors. This means potentially significant returns for younger physician investors upon a subsequent buyout of their rollover equity, and potentially significant payout for those physicians looking to wind down and retire upon an initial PE transaction.

Mary: And in your traditional private practice world, that was always an issue for young physicians is they came into a practice that had been around for a long time and perhaps owned a building and had really developed strong things. And I guess the other thing, seeing why your provider's interested, if you are a physician and you've got four kids who are heading off to college and that might be pretty attractive to get those types of numbers. Looks like there's other advantages here though for physician practice. What are those?

Tracey: Yes, as I just mentioned, it removes the administrative and nonclinical operational duties from the clinicians, which is really huge when you are looking at physicians who are growing a practice and they're really focusing on providing the healthcare to their patients. Also, access to capital may enable a practice to keep up with advancing health technologies, including upgrading EMR, helping with HR and IT systems, as well as other major capital investments. And of course, with more capital comes the opportunity for improved office infrastructure, improved patient experience and improved clinic workflow and operations. Payer contracting optimization may provide increased bargaining power and result in higher reimbursement rates as well. So, these are just some of the advantages of a private equity infusion.

Mary: So, I know as a patient, I went to see a particular physician who was familiar with a particular type of testing and I saw another physician in the exact same practice and I said, "Well, I went to physician X and we did this testing." And physician Y says, "Well, I never even heard about that." So, for a physician rather than dealing with all the administrative aspects of their practice, it allows them really to focus on the practice of medicine a little bit and to have access to some of those advanced technologies. So there do seem to be some fairly significant advantages to private equity investments in physician practices, but what are some of the challenges?

Tracey: Well, this is a really important question. I see clients get really enamored with the idea of a big payout, but there are some challenges that they do want to consider and contemplate. Individual physician equity stakes in a PE investment can make up a significant purchase of the purchase price consideration. And we've seen clients so focused on potential significant increases in the value of that equity that they often ignore certain considerations. And physicians really should also consider that there may be potential uncertainty as to when and how their rollover equity will be realized.

Mary: So that's a really important point. That is what I am seeing in these deals. And when you're saying that I'm just going to clarify, so clarify further for me if I'm not on track. But so, you're not selling out a hundred percent. Part of what you're getting in value is I'm getting an equity interest, maybe some stock, whatever the interest is, in the venture on a go-forward basis that I may or may not be able to cash out, may or may not actually grow in value. But sometimes this gets looked at as like, oh, this is like owning Apple stock early in the pandemic and it's not always the case. So you really need to dig into the what's and how’s of how that structure works when you'll actually get the rest of it. And I always kind of like to say, Tracey, make sure you get enough upfront.

Tracey: Yeah, that's exactly right. In a lot of these deals, we see rollover equity in the 20% to 40% range. Oftentimes, it can be higher. And you're absolutely right, Mary, these investments may not make money. They're private equity investments versus public corporation investments. So, there are different reporting requirements, and they are in fact a security, but they're not publicly tradable. So oftentimes, actually most times, and probably in all circumstances, an equity holder is really compelled to hold because they're unable to sell because there really is no market for the particular equity holding. In fact, I have a client now who was required by the private equity sponsor to have the physicians roll over 80% of the value. So that can be a lot of value that can be locked up for quite a long period of time, and there's no guarantee on the backend that it will be worth more than what it was at the initial transaction.

Mary: And I've seen a couple, despite all the professionals going in with five-year contracts, still seeing the group blow up and people say, "I don't care, I'm leaving." And so, then your investment goes with it because the professionals are often a part of that value if you're selling a practice. What are some other considerations, Tracey?

Tracey: So, more challenges unfortunately lie ahead for physicians considering a PE investment and one of those relates to the debt burden. The physician practice will most likely assume a large amount of debt to finance a transaction and the liability to pay back the debt facility is on the physician practice. You have to remember, and our people listening and our clients have to remember, that the PE sponsor there is there to make money and they're not there to assume any debt. So unfortunately, the debt facilities do fall back onto the physician practice. I mentioned earlier that a PE sponsor's annual return on investment expectations typically is at or exceed 20% annually. So, the pressure is really on the clinic leaders to grow the practice and to expand access. This typically results in additional pressures for the providers to increase revenue streams such as elective procedures and ancillaries to direct more referrals internally and to implement changes which may impact the practice's delivery of care. For example, the practice may need to increase the use of lower cost clinicians and/or expand higher margin and higher volume services, primary care and value-based service models while reducing or discontinuing those services which are deemed less profitable. This, of course, can have a lasting negative effect on a practice and its patients as those patients lose access to certain services deemed less profitable and results in the patients being transferred to other providers for continuity of care purposes, and that's providers outside of the particular physician group.

So, a practice should also understand which physicians benefit from increased equipment or capital improvement expenditures. Practices need to ask which physicians in the group share in the savings or increase revenue resulting from those capital expenditures. Conversely, which physicians may be negatively impacted from decreased expenditures? Meaning what if resources are directed away from those providers that are deemed to be less profitable and they aren't provided with the equipment and/or staff they need or want? This has been an issue with several clients of mine as I've moved back into private practice and these issues are something that physicians often think about, but they really have to take a good hard look on what the private equity sponsor is looking for and to try to understand that at least some of the PE sponsor's goals with respect to growing and managing the practice are aligned with the physician group. So, there are a lot of questions here. There's a lot to think about.

Mary: I have to just share a story. We had a healthcare client and my original partner that founded my firm with me actually took on the role of CEO of one of our clients who's in the healthcare space, got bought out by private equity, and I just have to share a comment he made to me, which was, "Well, private equity doesn't necessarily understand that there's really only 160 hours in a week." And I think that's an appropriate comment in that what private equity does is come in, purchases, and tries to make these changes and the goal is to increase the profits and turn around and sell it. And that's what drives private equity, versus necessarily a physician who may, "Hey, I really care about patient care." Because I say one of the comments you made in that part of the discussion, Tracey, was just about pushing everything down to lower cost providers, which actually makes sense. That's something we do in our business as well, right? It makes sense to the extent somebody's capable of doing it, but we are seeing a lot of changes in terms of primary care being handled a lot more by nurse practitioners or your Amazon calls, which I guess I don't even know what the qualifications, I'll have to check into that. But let's just talk about what other things physicians should consider.

Tracey: So, from a practice perspective, and I'm talking about the clinical practice perspective, of course, the physicians should maintain governance authority over their other clinicians and over the physician practice itself. And I don't mean just seeing the requisite language in the deal documents, which state that the management service organization or the private equity sponsor entity won't retain any power to exert control over or interfere with the clinical judgment of the physicians or their healthcare providers in the treatment of the practice's patients. What I mean here is that the physicians should retain the right to elect and/or replace the designated physician owner and to retain board seats at the management board level. This will give them a voice, it may not be a majority voice, but it will give them a majority voice at the private equity sponsor level, and at least concerns can be discussed and aired at that management board level.

It's also important that the physicians understand that there are personal estate planning and income tax considerations to be taken into account as physician investors. And we're pivoting a little bit, obviously from the practice considerations to individual considerations, but I saw this all the time in house. I would get a lot of physicians coming up to me saying, "I just don't know what I need to do from an estate planning perspective." Or "How am I going to be taxed on these profit interests or this equity that I hold?" So the profit interests or the equity as we've talked, it could potentially present a significant growth opportunity given the growth potential. However, the transferability of the profit interests, or stack, or the equity for estate planning purposes may be prohibited or limited by the MSO governing documents.

Now, this is something I found in my in-house career. It's fairly easy to navigate around, meaning, I've gone to management boards and said, "Hey, can we amend or modify the operating agreement to allow transferability for estate planning issues?" However, a lot of times these boards are focusing on growth. We've talked about the 20% internal rate of return annually. We've talked about growing the practice in other ways. So, what it really comes down to, it's much easier to address these issues before the deal is signed and before the documents are signed. Because really on the back end of a deal, people are often running and working hard, and individual estate planning concerns tend to fall to the wayside.

Also, from the income tax side, an individual physician that holds equity in the form of profit interest will want to file an 83B election for potential income tax advantage treatment upon a subsequent sale of the equity. Of course, the tax and estate planning considerations are very fact and circumstance dependent, and they're also dependent upon which of the various types of equity a physician investor holds. But it's worth mentioning these issues here as these considerations are often overlooked and it becomes a real scramble when a physician equity holder needs to do some tax planning or estate planning.

Mary: Well, and as you know, I really appreciate you mentioning that since I'm passionate about everything tax and estate planning related. I'm just going to footnote what I think is the really important comment. Well, they're all important, but one that's really important to me is that, as we're recording this, we're closing in on a year-end and we'll get calls the day before year-end. "Can you close this deal?" And the answer is no. And the same thing is they've signed a letter of intent. "Can we figure out my tax planning?" So, physician practice is just like any other business, and we've done a whole series of podcast episodes on business exit planning, is the best planning is thinking about this well ahead of time. I'm working with one practice right now who is doing one of these interesting combinations with practices across the country, positioning themselves and are actually considering all of those things. But it's very much that those of us who assist physicians in the practice sells can do a lot better job if we work a little bit ahead and probably save them a lot more money. Any last thoughts on this topic, Tracey?

Tracey: Yes, I completely agree with those statements. Not only saving time and money, but I think a lot of stress as well. So yes, as far as last thoughts, while it is important to remember that the goal of any private equity sponsor is to optimize operations in order to meet aggressive return expectations, physicians considering a private equity investment have myriad considerations to take into account when analyzing whether the transaction is appropriate for the practice, and they want to ensure that the objective of the sponsor does not negatively impact patient wellbeing once the deal is closed.

Mary: And something you mentioned earlier in the podcast is also the physician wellbeing. You want to make sure, and that's part of why that planning piece is important, you want to make sure that going into this different structure is not just a good thing financially, but a good thing in terms of you like going into work and at the end of the day, you feel good about what you did. Well, as we reach the end of our episode, I want to thank our sponsors, Interactive Legal, Foster Group, Veteran's Victory, and Carson Private Client. That's all for now. Thanks for listening to today's episode and stay tuned for our weekly releases.