Private Equity

Current and emerging financial due diligence considerations when acquiring physician practices

CFGI

Although the volume of healthcare deals has slipped in the past three years, values remain strong, and private equity (PE) funds are likely to accelerate investments in healthcare businesses over the coming decade. This bullish outlook is due, in part, to the ongoing growth of U.S. personal healthcare spending, which is expected to climb an average 5.5% annually through 2026, increasing from 17.9% of GDP in 2017 to 19.7% by 2026.[1]

Demographic and economic changes are fueling expansion of healthcare services. Today's aging population requires more, and more complex, procedures and treatments. Disruptive industry forces like changing payment models, implementation of advanced electronic medical record (EMR) systems, and the proliferation of game-changing technologies like data analytics and telemedicine are providing ample opportunities for PE firms looking for investments.

As PE acquisitions of healthcare businesses have surged over the past decade, investments in physician practices and physician practice management (PPM) companies have accelerated apace. PE has become increasingly comfortable investing in a wider range of physician practices and is moving into areas where it's beneficial to have a practice outside of a hospital setting.

From the seller's perspective, the aging physician workforce is a top driver of practice sales. As Baby Boomer-generation physicians start to consider exit strategies, the traditional route of selling to a junior associate has declined. That's because many younger physicians would rather be employees than owners responsible for running a business. Also note that younger physicians may be burdened with sizable student loan debt, which limits their ability to invest in a business.

[1] Centers for Medicare & Medicaid Services, CMS Office of the Actuary Releases 2017-2026 Projections of National Health Expenditures, February 14, 2018

Why physician practices are so attractive

PE firms see a lot of opportunity in physician practices. Even in specialty areas such as dental, dermatology, and ophthalmology, market concentration remains limited and opportunities for consolidation abound.

Consider, as an example, dental practices. This subsector has seen very active consolidation over the last decade. Practices with fewer than 20 employees still represented over 80% of the market as of 2012 (the most recent data available), and only 8.3% of dentists were affiliated with a dental service organization (DSO).[2] This provides an exemplary perspective on opportunities available in other subsectors.

[2] American Dental Association, Health Policy Institute Research Brief, April 2016

Challenges PE firms face

Many deals are based on continued involvement by owner-physicians post-transaction. PE firms typically offer owner-physicians an upfront payment in cash and/or stock and a percentage of future profits in exchange for ownership. Their goal is to build the value of the practice through investments in services and consolidation with other businesses, and then later resell the practice on a timeline that aligns with their fund life-cycle objectives.

The challenge for PE firms is to establish upfront the right return and risk expectations for both private equity and the selling physicians. Sometimes, the initial upfront payment to a practice owner is subsequently forgotten in the face of lower go-forward compensation.

Today's high multiples for in-demand subsectors—and high-quality practices in particular—are spurring sector players to seek the next big "roll-up" opportunity. Many are looking at subsectors like orthopedics, gastroenterology, and urology. They are also considering down-market deals, whether in scale or operational quality, for better value plays. Experienced industry leaders, however, remember the consolidation and resulting problems (and deconsolidation) in the late 1990s; it's a situation they don't want to see repeated.

New directions in due diligence for physician practice acquisitions

As physician practice acquisitions shift to more complex medical subsectors with less sophisticated practices, a tailored due diligence process will be increasingly important. CFGI views the following to be critical success factors.

Get the basics right

Nailing the key risks in physician practice transactions is critical. The smaller the practice, the more likely that bookkeeping will be unsophisticated and financial reporting will be tailored to cash or modified-cash tax reporting. That's why cash proof and cash collection waterfall analysis of revenue and cash receipts remain critical elements of financial due diligence. Additionally, determining how key working capital accounts (accounts receivable and accounts payable) will be treated after the close is essential. PE funds must also assess debt and debt-like items, including unfunded compensation such as bonuses, student loan pay-off commitments, and retirement plan liabilities.

This becomes a larger issue when PE firms explore relatively new subsectors in which selling physicians may not be familiar with deal structures and vernacular. Proof of adequate third-party due diligence remains key not only for PE investors but also for lenders and representation and warranty (R&W) insurance providers.

More meaningful sell-side due diligence

As the complexities of target companies increase, it's more likely that initially agreed-upon deal values based on limited information will be challenged by due diligence findings. Having an independent sell-side due diligence report can validate the asking price. Even limited-scope, sell-side financial housekeeping can help facilitate value capture on both sides as more deals are closed and the aggregate deal flow of physician practice transactions increases.

Coordinated buy-side due diligence

After the exit of an initial buyout, secondary transactions are often executed through a competitive bidding process, with sophisticated buyers and sellers on both sides of the table. This can produce a compressed timeline in which a buyer may need to conduct financial due diligence work in parallel with other diligence workstreams, such as legal, reimbursement, regulatory and operational. In today's tech-enabled world, efficiency can be gained by simply encouraging and facilitating collaboration across due diligence service providers and then sharing relevant findings and data—while retaining the cost benefits of using boutique specialists.

An M&A attorney recently revealed to CFGI that he never allows his team to issue a legal due diligence report before it is checked against financial due diligence for consistency. When possible, acquirers should use consistent data sets to help ensure a comprehensive, accurate analysis. An integrated, collaborative approach at the service-provider level can potentially mitigate risks associated with more complex subsectors and less sophisticated practices.

More advanced data analysis

Most financial due diligence providers go beyond examining the general ledger in ways that are consistent with how physician practices operate in the middle market. Today's practices typically have separate billing and collection systems that are connected to their EMR solution. But few middle market and lower-middle market practices integrate these systems with their general ledger.

Payer dynamics, service mix, and provider productivity are integral in assessing performance. The analysis should scrutinize charges, service codes, and procedures performed. This assessment should be as granular as possible, ideally on a transaction-by-transaction basis. Likewise, identifying outliers in reimbursement and operational activity is critical to compliance risk assessment. Use of enhanced data-analysis tools and approaches facilitate identification of risks and opportunities and allows for more sophisticated modeling and risk identification in a target business.

Data on the horizon

Multiple drivers are creating an explosion of new data that can be analyzed in due diligence. For example, as payment models move away from traditional fee-for-service toward value-based care, PE firms should consider multiple internal and external factors when analyzing revenue. Similarly, analysis of payer mix can involve assessment of complicated networks that are outside of traditional payer relationships. Lenders may focus on what reimbursement should be rather than current or historical amounts. As adoption of EMR matures and disparate EMR systems are integrated, the collection of relevant, clean, and more reliable operational and financial data will generate more information that can be used in due diligence. It's up to PE funds to take full advantage of this data.

Helping PE shape the right healthcare deals

CFGI has deep experience helping both buyers and sellers effectively navigate the due diligence process. Our team of M&A professionals understand the complexities in medical practice valuation, business processes, accounting methods, and technologies.

Our dedicated operations and IT group helps PE firms assess IT risks and investment needs during due diligence. Using current market knowledge, we can efficiently drive the due diligence process and enable PE firms to concentrate on negotiations and other aspects of the acquisition. What's more, PE clients use our assessment reports to support funding from banks, while our in-depth financial analyses have garnered positive recommendations from banks that specialize in the healthcare industry.

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