Whitepaper

The Art of Physician Consolidation

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Roy Bejarano
Co-Founder and CEO

Emma McGregor
Associate

Elizabeth Scoda
Villanova University MBA Candidate '20 and Intern

Gary Herschman
Health Care and Life Sciences Attorney, Epstein Becker & Green

This is a collaborative piece written by SCALE and our partners at Epstein Becker & Green.

Now more than ever, individual physician practices face complex challenges and an unpredictable industry environment. One way to protect themselves from these challenges and the obstacles associated with evolving market dynamics is to grow.

Growth can be beneficial regardless of whether a group wants to remain independent, or partner with a hospital, private equity investor or national healthcare company. Being part of a larger organization has many benefits that can enhance a group's ability to survive and thrive in the uncertain future, most significantly by having a professional, corporatized infrastructure – such as advanced EMR, finance department, managed care contracting, population health expertise, billing/collection, HR and compliance functions, etc. – that can be shared by many, as well greater access to capital for strategic positioning, and weathering pandemics and economic downturns. Physician practices are thus faced with a very difficult decision – how do we grow?

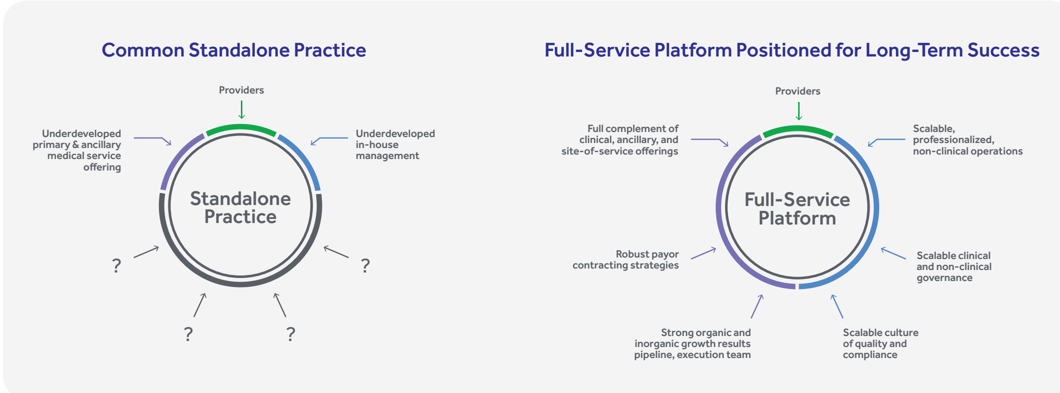
The following pages focus on why practice consolidations offer a broad range of benefits to stakeholders and can result in a more valuable or sellable platform in the future, or increase the likelihood of success in remaining independent. We at SCALE, along with the expertise of our vast network of operating partners, have developed a playbook for executing a successful physician growth strategy, and believe that practice consolidation is a significant opportunity for many existing physician practices looking to grow. Together, SCALE and consolidating practices are able to tackle the unique complexities that come with combining business processes; all while creating significant value in both the short and long-term.

Why is Growth Necessary?

Over the past five to ten years, we have seen transformation in the physician marketplace, including a significant decrease in private practice physicians and a correlated increase in those working in hospitals and large investor-minded companies. These large and growing health systems change the competitive dynamic for independent practices, who are now faced with the need to grow or develop a niche market in order to survive.

In addition to health system growth, the market push to value-based care puts pressure on practices to grow in order to spread the risk and implement a successful value-based model. Smaller practices do not have the operational ability or infrastructure to implement the models. Larger practices need to grow to reach the scale required for effective value-based care. Similarly, the formation of Accountable Care Organizations (ACOs) has also driven physician practices to grow in order to offer the coordinated care required.

Lastly, medical practices are becoming more complex from both an organizational and an operational perspective. Practices need to invest significantly in technology, be ready and able to quickly adapt to new regulation, compete on pricing, and otherwise maintain and/or grow market share.



Pressure to deliver higher-quality care and results conveniently and at a lower cost will continue. On top of preference changes for the ways in which healthcare services are delivered, there is a shift in expectations from patients, policymakers and payors alike. The fluctuating demands of provider care are diverse in nature and require an array of time, expertise, and resources to navigate. All of these dynamics and challenges require growth to overcome or execute a successful and effective strategy.

How Should Practices Grow?

"The question that must be answered is how to consolidate in ways that support independent physicians and improve patients' access to cost-effective, high-quality care."[1]

Unlike many other industries, physician practices are unable to sacrifice any segment of operations to ensure consistent quality with growth. Patients expect quality in every aspect of care that is provided. Thus, maintaining or improving the quality of care is a key consideration for organizational growth.

We generally see physician practices choosing to maximize their value through means of organic growth, practice consolidation, or some sort of timely mix between a private equity transaction and consolidation occurrence. However, we have found that the most effective pathway to create meaningful and significant value for many practices has been through the implementation of a practice consolidation strategy prior to initiating any private equity backing or other partnership with a large healthcare organization.

Standalone organic growth allows the physicians in charge to retain control and capture all of the upside benefits of growth. However, this method of growth tends to require a longer time to execute and has higher risk as all investment is supported by one entity. For example, practice mergers in advance of or simultaneous with a private equity deal can offer a catalyst for consolidation through the private equity partners. However, this process can reduce the list of potential longer-term viable buyers, create deal complexity, spread focus and priority across two projects – consolidation and an M&A deal – and thereby increase the potential for both forgone valuation upside and post-close execution risk. Practices that enter early private equity deals prior to scaling see a faster pathway to liquidity and delay merger integration complexity until after the deal closes. However, the up-front valuations are likely to be less as they reflect the practice's limited scale and effort required to grow after the deal closes, and instead, the private equity firm captures most of the scaling upside.

Compared to the growth methods mentioned above, practice mergers prior to pursuing a private equity deal have the most benefits.

1 *https://www.statnews.com/2020/02/27/physician-practice-consolidation-its-only-just-begun/*

Through consolidation, the new organization formed is able to have significant opportunities the standalone practice may not. These opportunities include economies of scale, market attention, shared investment, diversification, access to capital and equity value.

Although there is always some merger and integration risk, consolidation allows for a faster pathway to achieving scale relative to standalone growth, allows the practice owners to optimize their bottom line and strategic market positive prior to selling, and offers future add-on targets the competitive differentiation of being an independent alternative. By first putting a focus on the planning and implementation of the merger itself, consolidated practices are equipped to reap the most benefits if they do decide to later pursue a private equity arrangement (or other partnership) in their next step of development. Practice consolidation is not a substitute to a sale transaction, but rather, it is a step toward building a more valuable and sellable platform.

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Economies of scale is the ability to negotiate cheaper prices from suppliers by increasing the number of purchases. A larger practice is able to enjoy this purchasing power. Market attention is in reference to the combined practice's access to strategic partnerships, payor relationships, and referral relationships – all of which can help the newly combined group increase its value. Shared investment is all services that can now be shared across the large group rather than the smaller group – management expenses, marketing, technology and infrastructure, recruitment, and innovation. In terms of diversification, an expanded group enhances the provider and referral network stratification by bringing new providers into the fold and improves provider succession planning alternatives. Having greater access to capital allows a growing group to achieve all of the foregoing characteristics of a professional and corporatized infrastructure. Lastly, the combined group has an increased equity value – they have the momentum by being the larger group and a more developed practice of reasonable scale tends to receive a more favorable valuation.

Deciding to Consolidate – Now What?

As highlighted above, while practices have many avenues to pursue growth, we at SCALE believe that the most effective pathway for many practices is through practice consolidation. But simply deciding to pursue consolidation as a growth strategy does not guarantee successful growth or long-term value. Practice consolidation is both an art and a science – there are many steps and formulas to follow as well as experience and knowledge the appropriate partner can bring into your unique situation. Each consolidation scenario is unique in certain respects, but we believe that there are a few key components one must consider to be effective and create value through any transaction.

Practices should "begin with the end in mind" (as coined by Stephen Covey) when it comes to beginning a consolidation. This includes picking the right practice(s) to consolidate with and developing the new combined group's strategy. The team needs to know what their goal is before entering into any transaction. Throughout the life of the consolidation, three areas one should think through are the following:

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1. What are we building?
2. Why are we building it?
3. How are we building it?

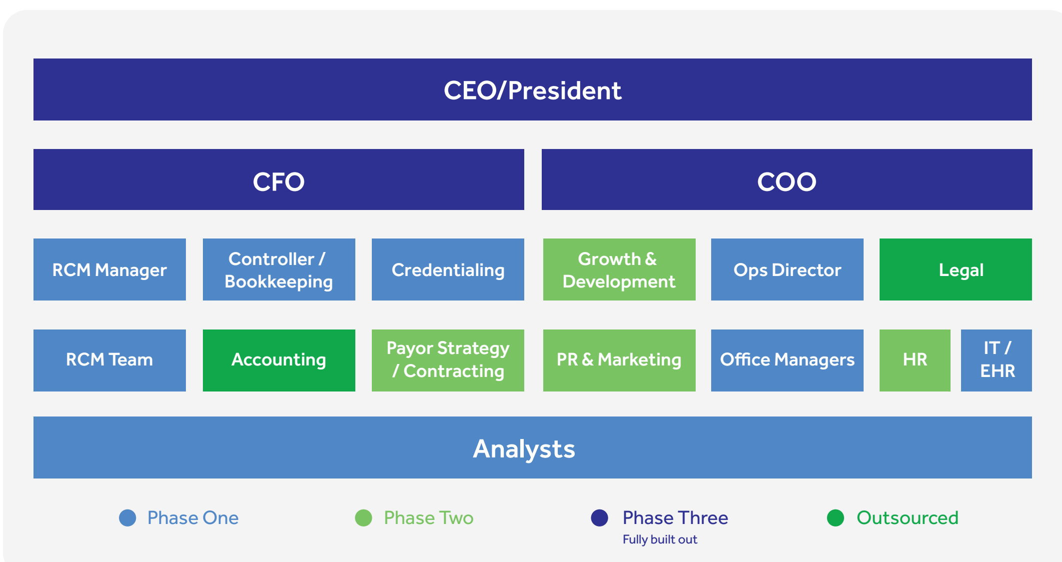
What are we building?

First, you need to look at the current state of your practice. What are your core capabilities? What is your position in the market? Next, think through the end goal of your consolidation – what is the ideal future state of the combined practice? Most likely, this target state will include centralized non-clinical functions with a reduction in the overhead cost as a percentage of revenue. It will also most likely include a new standardized IT system across the entire practice.

But this ideal future state should also include both operational improvements and expansion plans. The goal of consolidation should not be to simply increase the number of physicians or patients seen. Instead, the practice should take this as an opportunity to review all operational processes and determine what makes the most sense moving forward. This review process can also help in choosing a target practice to consolidate with. Try and think through what your practice does not excel at – and find a target that is stronger in those areas. Again, the key question here is: What do you want your practice to become in an ideal world? Thinking through this question can help you determine your priorities when pursuing a consolidation.

As mentioned earlier, one of the opportunities of consolidation is for a practice or optimize its strategic position prior to a private equity sale or other strategic partnership. Therefore, it is important here to think about what that strategic position should be. This includes the combined practice's growth targets. Are you trying to grow through adding patients in one clinical area? Are you growing by expanding clinical services or adding ancillary services? There is no right answer when it comes to determining a strategy or goal for the combined practice, but there needs to be one.

In addition to high level strategy and goals, once a target is identified and the deal is finalized, a clear organizational structure needs to be developed. This usually involved creating a Management Services Organization (MSO) that all practices roll up to. One example of an MSO is shown below.



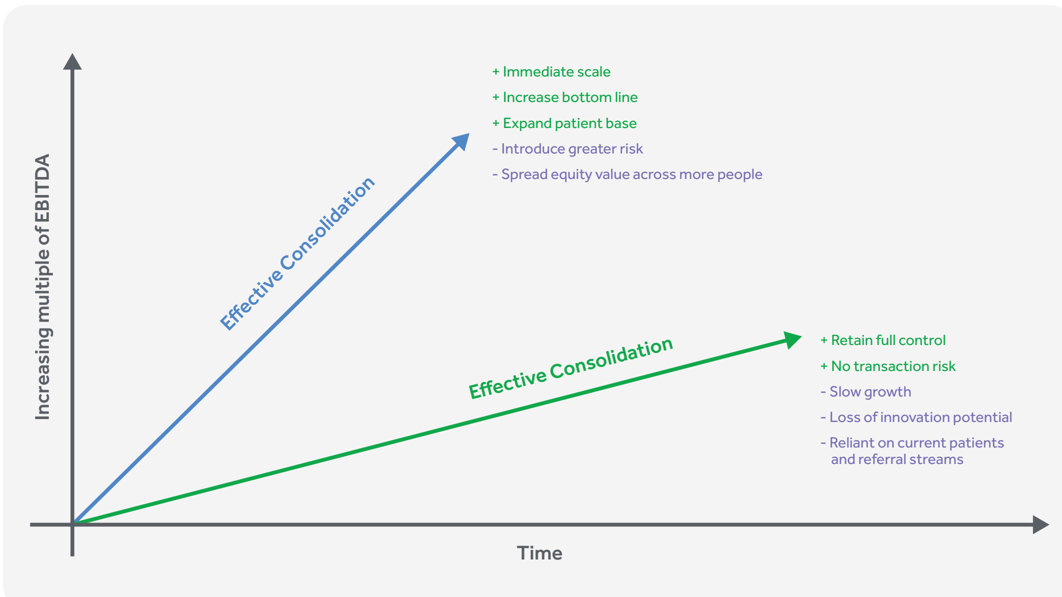
Within this organization, you next need to think through which functions will be outsourced to a third party and which will remain in-house. The organization's structure should always reflect the strategy and expansion plans.

Why are we building it?

The 'why" for consolidation was most likely discussed before entering into any agreement or consolidation planning. However, it is important to think through. Why is consolidation the best growth opportunity for your practice as opposed to the other options? As mentioned earlier, we believe that consolidation makes sense for many groups, but not for all. It is very dependent on your size, specialty, and market position.

Practice owners need to think through what opportunities consolidation will provide and why those opportunities are crucial to practice growth. Think about these opportunities from both an offensive and defensive position. Offensively, does consolidation allow you to have an increase in shared capital for innovation investment or platform development? Will this growth put you in a better position to negotiate with payors, hospitals, or other vendors? Defensively, will this consolidation improve your market position by capturing more share or a different segment? Does this allow you to pool investment in operational systems to decrease the financial burden of these overhead shared services?

Lastly, you need to think long term. How will this consolidation change your practice's equity value over the next five years?



Will this transaction set you up better for future transactions – whether they are with a private equity group or another consolidation? Within the market, a particular platform's ability to command a premium valuation will be driven largely by how developed the platform is and how well the platform can execute standalone growth and development. Will this consolidation help you work towards commanding a premium valuation?

How are we building it?

Once the what and why have been discussed and appropriately thought through, the practice leaders, and most likely a consolidation execution partner, need to develop the roadmap of how to integrate and execute the transaction effectively. Developing a strategic roadmap is key – you won't get to where you're going unless you know how to get there.

This roadmap will most likely include multiple phases – the entire integration will not happen all at once – and operational workstreams. Breaking down each phase into a handful of objectives based on a timeline helps a team stay on track and understand what the priorities are. Within each non-clinical area, the team should mock-up what it would look like to have minimal integration and full integration to decide which scenario makes the most sense for initial rollout. Similarly, it is important to delegate responsibility effectively – whether that be to internal stakeholders or a third-party partner engaged to assist in executing the consolidation.

From a legal perspective, some important issues that need to be agreed upon by all parties in advance of any practice consolidation include:

- Are acquisitions & mergers achieved via payment of a purchase price to smaller groups, or allocation of ownership percentage in the surviving, larger practice entity – and what methodology is used to achieve the respective valuations?
- What physician compensation methodology will be employed moving forward, and to what extent will there be overhead allocations?
- How will profits be allocated from different regions and ancillary services?
- How will the post-consolidation governance of the organization be structured, vis-à-vis both a Board and regional/division determinations, what if any major decisions require a vote of equity owners, and what percentage votes are required for actions at the Board and owner levels?
- What, if any, terms of a future investor/partnership transaction are agreed upon in advance?

At SCALE, we believe that there are many levels of third-party support that a practice may need. This could range from an advisory role, to fully outsourced solutions across one or many workstreams. Support could also range from clinically focused to more operational. As a practice leader, you need to determine what makes the most sense for you and your team in terms of the support required to execute a successful consolidation.

Consider building out a summary roadmap, like the one we built out below for a client consolidating eight urology practices, and use it to guide the team throughout each phase. Consolidations can be complex, but the more you do at the beginning to keep everything organized, the easier it will be.

	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21
Engagement, prelim-inary diligence and kickoff	Completed									
Legal										
Agree and signoff on Entities and Structures										
Draft MSO, Care Center, Withdrawal, PLLC and other Docs										
Execute legal documents				Ready						
RCM										
Committee decision on EHR / PM										
Develop billing solution and structure										
EHR / PM Implementation										
Billing Team Implementation:										
Credentialing										
Go live with initial plans, and continue transi-tioning plan billing to single TFN							Ready			
Finance										
Discuss and signoff on finance solution and preform diligence										
Develop chart of accounts, policies, adopt software										
Vendor lists, import of historical financial data										
Integration and conver-sion of systems across all practices over 60 days						Ready				

EMR	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21
Diligence and confirm Urochart (or other eCW)										
Buildout application, dictionary and other functions of EMR										
Develop and test all relevant interface (lab, PM, software, etc,)										
First clinical and appointment go-live										
Eight practice platform integration							Ready			
HR										
Confirm common payroll platform										
Payroll integration					Ready					
Payor Contracting										
Begin credentialing										
Complete IPA credentialing					Ready					
Begin independent contracting strategy										

Throughout the execution, always think back to the What and Why you outlined at the beginning of the process. Are you still on track to build what you wanted? Are you still on track to achieve the goals that you set and grow in the way you wanted?

There is no "one size fits all" model to consolidation, but the outline above should be used as a tool to help you frame the consolidation as a whole – from idea to execution. At SCALE, we are excited about physician practice consolidation as we believe it is a way to create immense value for both practice owners and patients. Thoughtful planning and execution of a consolidation can create significant growth, increase your ability to innovate, and provide a better experience for your patients.

SCALE prides itself in developing customized solutions for its clients and helping physician groups grow and thrive in a challenging marketplace. Now, we are ready to help you. We look forward to sharing examples of how we have helped our clients and invite you to schedule a 1-on-1 complimentary consultation with us.

Contact Kevin Gillis at kgillis@scale-pg.com, or +1 (603) 440-3375 to continue the conversation.