PARAGON
HEALTH CAPITAL

Physician Practice: A Healthy Investment
May 2017
Committed funds raised by private equity firms reached an all-time high in 2016, with undeployed reserves at almost $541.8 billion nationwide, up 12 percent from the previous year.¹

The physician practice industry has become increasingly appealing to private equity firms. This document outlines the key reasons why more capital is being dedicated to this industry sector.
Investment Dynamics

Thriving & Recession Resistant Market
Increasing Cash Flow
Consolidation Potential
Active Private Equity Interest
There are 870,000 active physicians in the United States.\(^2\) Sixty percent of these physicians are part of independently owned practices,\(^3\) which generate 922.6 million office visits per year.\(^4\)

This demand is only expected to increase as one-third of physicians prepare to retire, healthcare becomes more accessible, and obese and aging populations continue to grow.
Physician Shortage

The Association of American Medical Colleges projects a **shortage of 62,000 - 95,000** physicians by 2025.\(^5\)

Practice consolidation and the use of improved technology leads to more efficient practice management, which can help combat physician shortages. Practices have started to look to private equity firms as financial and strategic partners to facilitate this transition.

### PROJECTED PHYSICIAN SUPPLY & DEMAND\(^5\)

![Graph showing projected physician supply and demand from 2017 to 2025.](image)
In the next 10 years, over one-third of all active physicians will reach the age of 65. The retirement decisions of this group are anticipated to have the largest impact on physician supply in the United States.
Access to Health Care

Current political and economic factors are contributing to positive trends in the health care market. The industry will continue to grow as access to affordable healthcare and insurance increases.

Since 2010, **20.4 million** Americans have gained access to health care.⁶

The insured rate in the United States has increased from **83.7 to 91.2 percent** in under seven years.⁶

A 2016 survey by Deloitte found Americans are increasingly prepared to handle medical costs. In 2016, 34 percent of Americans felt prepared to handle future health care costs compared to 16 percent in 2015.⁷
Increasing Obesity Rates

In addition to the current political and economic climate, organic growth factors continue to affect the health care industry. While health care regulations change over time, data shows the obesity rate and the older population will continue to account for a large percentage of healthcare spending in the future.

2016 Obesity Rate\(^8\) 2030 Obesity Rate\(^8\)

36% 50%

$200 billion\(^8\)
Estimated health care spending directly tied to obesity by 2030 in the United States

$3,400
Annual cost of health care, average weight\(^9\)

$4,870
Annual cost of health care, overweight\(^9\)

By 2030, obesity will cause or contribute to...

6 million cases of diabetes
5 million cases of heart disease or stroke
400,000 cases of cancer
Aging Population

The percentage of Americans over the age of 65 is expected to **double** between now and 2060.¹⁰

This growth of the elderly population will increase demand for Alzheimer’s care, cancer treatment and many other health care services.

While the older population is the smallest age group in the United States, it accounts for **34 percent of all healthcare spending**. Individuals over the age of 65 spend five times more than the average American on health care.¹¹
Increasing Cash Flow

Annual healthcare spending for physician and clinical services reached $634.9 billion in 2015, a 6.3 percent increase from the previous year.¹²

The industry is projected to grow at an average rate of 6.6 percent per year from 2017 – 2022.¹³
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**Increasing Cash Flow**

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**$717 billion**

ESTIMATED PHYSICIAN & CLINICAL SERVICES SPENDING FOR 2017\(^\text{13}\)

**20%**

% NATIONAL HEALTH CARE SPENDING ON PHYSICIAN & CLINICAL SERVICES\(^\text{11}\)

**6.6%**

COMPOUND ANNUAL GROWTH RATE (CAGR) OF PHYSICIAN & CLINICAL SERVICES SPENDING\(^\text{13}\)

**FACTORS INCREASING CASH FLOW**

**Alternative payment models:**
- Accountable Care Organizations (ACOs)
- Patient-centered medical homes
- Bundled payments
- Pay-for-performance

**Out-of-pocket payment for cosmetic procedures or specialty products:**
- LASIK surgery
- Plastic surgery
- Specialty medication
- Non-medical dermatology procedures
PHYSICIAN & CLINICAL SERVICES EXPENDITURES$^{13}$
Consolidation Potential

The four largest firms in the primary care sector accounted for only 3 percent of industry revenue in 2016.\textsuperscript{20}

It is becoming more difficult for small practices to navigate increasingly complex regulations. Additionally, the price of medical education, equipment costs and the time commitment of practice management are leading physicians to consider alternative options.

These industry trends have substantially improved consolidation opportunities for financial and strategic investors in physician and clinical services.
In a largely fragmented physician practice market, opportunity for consolidation through acquisition is readily available.

Consolidation allows standalone practices to form a larger group and streamline their operations for increased efficiency. The increased practice size facilitates growth by increasing ancillary revenue streams, so practices often see an immediate improvement in their processes.

There are 230,187 physicians practices in the United States,\(^\text{14}\) of which 60 percent are still independently owned.\(^\text{3}\)

### PHYSICIAN PRACTICES IN THE UNITED STATES\(^\text{15}\)

<table>
<thead>
<tr>
<th>Number of Physicians</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 physician</td>
<td>18.6%</td>
</tr>
<tr>
<td>2-4 physicians</td>
<td>22.3%</td>
</tr>
<tr>
<td>5-10 physicians</td>
<td>19.8%</td>
</tr>
<tr>
<td>11-24 physicians</td>
<td>12.1%</td>
</tr>
<tr>
<td>25-49 physicians</td>
<td>6.3%</td>
</tr>
<tr>
<td>50+ physicians</td>
<td>13.5%</td>
</tr>
<tr>
<td>Direct hospital employee</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

44% Independent physicians expecting to sell their practice by 2025.\(^\text{16}\)
The shift away from single or small physician group practices is caused by:

- **Need for efficiency**: Consolidated administration can lessen allow physicians to spend more time with patients.

- **Complex regulations**: New regulations, value-based care incentives and insurance policy changes increase the administrative burden on physicians.

- **High costs**: Rising medical fees have resulted in increased compensation demand.

- **Infrastructure improvements**: Upgrading to electronic billing and records systems can be complicated and time consuming.

- **Market position**: Small practices have little leverage compared to large hospital systems.

- **Access to capital**: Small practices are looking for ways to access additional capital to cover these costs.

49% Physicians often or always experiencing burn-out.17
What is value-based care?

MACRA, the 2015 Medicare Access and CHIP Reauthorization Act, reimburses physicians based on the value and quality of care as opposed to the previous Fee-For Service plans.

The program is broken into two tracks known as:

1.) The Merit-based Incentive Payment System (MIPs)

2.) Advanced Alternative Payment Models

ICD-10 Explained

ICD-10, or the International Classification of Diseases, Tenth Revision, is a classification list by the World Health Organization to catalog health-related procedures, symptoms, and diagnoses.

The revisions increased the number of medical codes from 13,000 to 68,000 and increased the number of categories for coding as well. The modification is meant to provide better data for public health research, insurance reimbursements, and investigating health care fraud.

The 2016 Survey of America’s Physicians found complex regulations are the least satisfying aspect of medical practice for physicians.\(^{17}\)

In 2016, the majority of physicians felt the implementation of new regulatory burdens detracted from the efficiency of their practice and required additional administrative work to study and enforce these new policies.
Physicians want to spend more time providing quality health care to their patients and less time on practice management.

In order to accomplish this, physicians are seeking out strategic and financial partners to help them streamline their responsibilities. This is often accomplished by the consolidation of multiple small practices to form a larger practice group with centralized technology and administrative efforts.
What **options** do independent physicians have for improvement?

- Join a **health system** or **hospital**
- Join a **nationwide physician group**
- Grow their practice **on their own**
- **Sell** their practice
- Partner with a **private equity firm**

**66.2 percent** of physicians believe the employment of physicians by hospitals is a negative trend that will not enhance quality of care or decrease costs.\(^\text{17}\)

What is **drawing** physicians to private equity over other options?

- Ability to **monetize partial equity** while remaining **involved** in their practice
- Avoiding **hospital employment**, allowing for greater **autonomy** and **input** on the future of their practice
- Private equity deals **yield a higher return**
- Ability to **focus on patient care** while their practice realizes its **full potential**
Active Private Equity Interest

Health care merger and acquisition activity was strong in January 2017, with $44.7 billion spent across all sectors, and $3.28 billion spent in physician medical groups alone.

In 2016, a record breaking 120 physician medical group transactions closed. The number of physician medical group deals increased from six in January 2016 to 18 in January 2017, 12 percent of the total health care market.¹⁹
Steady Deal Flow

While the future of health care policy was uncertain in January 2017, deal volume in the health services sector remained steady during Q1 at over 200 deals for the seventh quarter in a row. Additionally, private equity healthcare deals are expected to remain resilient due to current dry powder reserves and fund cycle timelines.

Physician services represented 41 percent of the total value of health services deals in Q1 2017.20

While deal value appears to have decreased in January, this is because many of the deals announced did not disclose value.
Increasing Multiples

EBITDA multiples continued to increase year-over-year. Due to positive trends in health care, private equity firms are continuing to show interest in physician practice.

Multiples were up **38.14 percent** between January 2016 and March 2017.\(^{21}\)
Return Potential

Private equity firms are hoping to replicate trends in the global healthcare market within smaller middle-market transactions. Data shows that, globally, health care has led all sectors in total returns to shareholders, at 15 percent.

GLOBAL TOTAL RETURNS TO SHAREHOLDERS

- Healthcare - 15%
- Consumer Staples - 13%
- IT - 11%
- Consumer Discretionary - 11%
- Telecom - 9%
- Industrials - 8%
- Financials - 7%
- Utilities - 6%
- Materials - 2%
- Energy - 1%

*Based on global companies with revenues >$500 million
Jim Palazzo is the founder and president of Paragon Health Capital and has worked in the healthcare industry for nearly 30 years.

As both a physician group administrator and founder of a hospital & physician consulting, transaction, and interim management firm that was sold to a publicly traded healthcare consulting firm in 2011, he developed a deep understanding of the unique factors that lead to organizational success. These include: effective governance, strategic positioning, developing measurable clinical excellence, operational efficiencies, IT management, revenue cycle management, contracting, recruiting, and staffing. He has gained experience in many different markets across the United States working with doctors, hospitals, systems, payers, and government. His primary focus over the years has been in support of optimizing and bringing greater value to physician practices.

Paragon Health Capital was founded to offer investment banking and business brokerage services focused on the physician practice, in addition to offering more traditional transaction and provider consulting services. Paragon takes great care in matching physician practices with the right kind of optimal outcome for practice owners, primarily with private equity firms through management recapitalization.

Better deals, better options and a brighter future.

Paragon Health Capital is a firm of medical practice specialists bringing together a depth of experience and proven networks to advise physicians towards maximizing the value of their practices.

We are specialists like you. We are not advisory and transaction services generalists, working in many industries – or even more broadly in the healthcare industry. The mission of our firm is to facilitate activity between doctor groups and potential partners. We have a deep understanding of physician practice operation, governance, cash flow, and staffing.
References


