Understanding the Surge in Private Equity Interest in Medical Groups

Presenter: Krista Teske, Consultant
Playbook for Maximizing Your Performance in MIPS
Wednesday, March 8, 2017 at 3:00-4:00 PM ET
Learn about nine tips that can help you maximize your score in the MIPS track of MACRA.

The State of the Union: Health Care Reform Beyond the ACA
Thursday, March 16, 2017 at 1:00 – 2:00 PM ET
Focused on what you need to know now about the repeal and replacement plan.

Rethinking Your Medicare Risk Strategy Under MACRA
Thursday, March 30, 2017 at 3:00-4:00 PM ET
Understand how to determine the right risk model and amount of risk to take on under MACRA.

Combating Physician Burnout
Tuesday, April 18, 2017 at 3:00-4:00 PM ET
Explore what burnout is, what’s causing it, and strategies to restore joy in the practice of medicine.

Partnering with Mega Groups: What Independent Physician Leaders Need to Know
Wednesday, May 10, 2017 at 3:00-4:00 PM ET
Learn about recent transaction in this space and the pros and cons of partnering with these groups.

Understanding the Surge in Private Equity Interest in Medical Groups
Thursday, June 1, 2017 at 3:00-4:00 PM ET
Examines the benefits and drawbacks of securing private equity investment in your group.
The drive to partnership

Understanding the private equity partnership landscape

Capital partnership toolkit resource walk through
Physician Aggregation On the Rise

Large Medical Groups Continue Growth

Percent of physicians in various-sized groups, by year

<table>
<thead>
<tr>
<th>Size of Group</th>
<th>2013</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Groups of 1-2 physicians</td>
<td>22.5%</td>
<td>19.8%</td>
</tr>
<tr>
<td>Groups of 3-9 physicians</td>
<td>17.6%</td>
<td>15.5%</td>
</tr>
<tr>
<td>Groups of 100-499 physicians</td>
<td>17.0%</td>
<td>19.7%</td>
</tr>
<tr>
<td>Groups of &gt;500 physicians</td>
<td>12.6%</td>
<td>15.4%</td>
</tr>
</tbody>
</table>

Growth in Median Group Size

25% Percent growth in median medical group size, 2013 to 2015


Health Affairs, September 2016

“What is becoming clear is that the country as a whole is moving away from smaller physician practices and toward larger ones.”
Pressures Facing Independent Medical Groups

Seeking Additional Capital, Resources to Confront Growing Challenges

Market Pressures

Risk-Based Contracting Model Adoption
Public payer pressure to take on new risk models necessitates growth of patient lives, investment in population health management infrastructure

Elevated Quality Reporting Burden
Elevated pressure to invest in resource intensive reporting and improvement initiatives to meet MACRA\(^1\) requirements

Heightened Competition
New competitors are stepping in and commanding market share and providers are facing new competition for inclusion in narrow networks

Rising Practice Costs
Escalating practice expenses drive need for greater economies of scale


Source: Advisory Board interviews and analysis.
Underlying Needs Drive Continued Growth Cycle

Achieving Scale
- Ability to centralize and share expensive practice resources, minimizing per physician costs
- Growth in patient lives to enhance potential success under risk-based contracts

Accessing Capital
- Ability to invest in initiatives that will further the value of the organization, enhance patient care
- Ability to acquire, integrate new practices

Source: Advisory Board interviews and analysis.
In Search of More Capital

Tapping Into Equity Sale May Now Be Necessary for Some Groups

**Typical Capital Sources**
For Independent Medical Groups

- **Debt financing:** Securing a bank loan or other form with joint and several liability

- **Real estate sale, lease back:** Selling owned real estate to real estate investment trust (REIT) and leasing it back, providing upfront capital from asset sale, cost savings through tax benefits

- **Retained earnings:** Retaining portion of each physician’s earnings to re-invest in the future of the group

- **Equity sale:** Selling all or portion of organization equity to strategic investor

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**Traditional Sources Not Enough**

“We have always been able to achieve all of our goals through debt financing, but when we began seriously investing in care transformation, we quickly realized our traditional sources of capital were no longer going to cut it. We needed to turn elsewhere.”

*Independent Medical Group Leader*

Source: Advisory Board interviews and analysis.
But Selling Equity Evokes Considerable Concern

In Considering Equity Sale, What are Your Biggest Concerns?

n=90 independent medical group leaders

- **Loss of physician owned and managed culture**: 79%
- **Loss of strategic control over the direction of the group**: 72%

Barriers to Equity Sale

- “Selling equity would strip us of control, leaving us to feel like employees in the group we built from the ground up.”
- “Selling equity would fundamentally counteract our group’s physician-owned culture and values.”
- “To many of our shareholders, selling group equity feels like the ultimate failure.”

Source: 2016 Physician Practice Roundtable Strategic Partnership Survey; Advisory Board interviews and analysis.
Underlying Needs Conflict with Our Mission, Values

**Achieving Scale…**
- Ability to centralize and share expensive practice resources, minimizing per physician costs
- Growth in patient lives to enhance potential success under risk-based contracts

**Accessing Capital…**
- Ability to invest in initiatives that will further the value of the organization, enhance patient care
- Ability to acquire, integrate new practices

**…While Preserving Autonomy**
- Retaining independence from hospitals and health systems
- Preserving ability to make quick, nimble decisions where necessary

**…While Preserving Physician Ownership**
- Retaining shareholder equity value
- Preserving ability to attract high-quality physicians seeking more than employment

**Finding a Balance**
“We are trying to find a good balance between autonomy and scale, but we want to remain independent and preserve our physician-owned culture.”

*Independent medical group leader*
Finding the Middle Ground

Two Options for Equity Sale

<table>
<thead>
<tr>
<th>Description</th>
<th>Relinquishing Full Ownership</th>
<th>Preserving Partial Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Description</td>
<td>100% sale of medical group</td>
<td>Partial sale of practice and management services organization or equity transfer</td>
</tr>
<tr>
<td>Sample Models</td>
<td>• Cash-based practice sale</td>
<td>• Joint venture management services organization</td>
</tr>
<tr>
<td></td>
<td>• Employment model</td>
<td>• Partial equity, partial cash-based practice sale</td>
</tr>
<tr>
<td>Impact</td>
<td>Complete integration, loss of autonomy, management control</td>
<td>Maintain some degree of medical group autonomy, control</td>
</tr>
</tbody>
</table>

Today’s Focus:

Strategic Capital Partnership

1) Some national practice companies will require full equity sale with no physician ownership maintained.

Source: Greene, J, “Rising administrative costs have small physician practices seeking safety in numbers,” Crains Detroit Business, June 2016 available at: http://www.crainsdetroit.com; Advisory Board interviews and analysis.
Many Currently Actively Evaluating

Independent Groups Actively Evaluating Strategic Partners…

40%

Percent of independent medical group leaders who indicated that they are already involved in a strategic partnership or are actively evaluating potential partners.

…And Recognizing Their Importance

“Having a strategic capital partner is more important for independent medical groups now than it was 3 years ago”

n=89 independent medical group leaders

<table>
<thead>
<tr>
<th>Agree</th>
<th>Disagree</th>
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<tbody>
<tr>
<td>40%</td>
<td>32%</td>
</tr>
<tr>
<td>Tend to agree</td>
<td>28%</td>
</tr>
</tbody>
</table>

68% Percent independent medical group leaders that agree

Source: 2016 Physician Practice Roundtable Strategic Partnership Survey; Advisory Board interviews and analysis.

1) Includes strongly disagree, disagree, and tend to disagree.
2) Includes strongly agree, agree, and tend to agree.
## Certain Partners Stand Above the Rest

### Types of Partners Currently Being Evaluated by Independent Medical Groups

*Percentage of Survey Respondents Indicating Interest in Each Partnership Type*

n=31 independent medical group leaders

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Partner Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>45%</td>
<td>National Practice Company (NPC)</td>
<td>Large, multi-state, non-hospital affiliated practices seeking to achieve greater practice management scale</td>
</tr>
<tr>
<td>45%</td>
<td>Private Equity Firm</td>
<td>Investment entities that infuse capital into medical groups in exchange for equity stake in the group</td>
</tr>
<tr>
<td>40%</td>
<td>Health Plan</td>
<td>Health plan affiliated physician aggregators like OptumCare that aim to better manage patient populations</td>
</tr>
<tr>
<td>10%</td>
<td>ACO Aggregator</td>
<td>National organizations that help groups set up or join an ACO in exchange for a percentage of shared savings</td>
</tr>
</tbody>
</table>

**Today’s focus**

**Key Commonalities**

- Involves sale of some equity to partner
- Allows medical groups to maintain some ownership stake, hospital independence

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**Partnering with Mega Groups: What Independent Physician Leaders Need to Know**

*Wednesday, May 10, 2017 at 3:00-4:00 PM ET*

Source: Advisory Board interviews and analysis.
1. The drive to partnership

2. Understanding the private equity partnership landscape

3. Capital partnership toolkit resource walk through
Medical group valuation

Valuations Not Bound by Fair Market Value

Medical Groups May Be Valued Higher by Strategic Capital Partners Than Hospitals

Strategic Capital Partnership Valuation

- Not subject to same Fair Market Value scrutiny as hospitals, health systems
- Calculated by applying multiple to group’s EBITDA\(^1\)

Hospital/Health System Valuation

- Stark, Anti-Kickback statutes dictate that transactions involving hospitals, health systems receiving payment from federal programs must be completed at Fair Market Value
- Subject to rigorous legal scrutiny

Strategic Value: Price at which a specific *buyer is willing* to make an investment, not necessarily tied to the market value of that property

Fair Market Value: Price at which property would change hands if both the *buyer and seller were in an unrestricted market*, aware of all facts, and acting under no compulsions

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\(^1\) Earnings before Interest, Taxes, Depreciation and Amortization.

Partnership Models Legally Complex

Laws Influencing Professional Corporation (PC) Ownership

Corporate Practice of Medicine

Regulations exist in more than half the states that prohibit non-licensed business entities from employing or managing physicians, licensed health care providers.

Stark Law

Set of federal laws that prohibit physicians from referring Medicare and Medicaid patients to facilities or services in which the physician (or an immediate family member) has a financial relationship.

Anti-Kickback Statute

Federal law that prohibits the exchange of anything of value in an effort to induce or reward patient referrals for medical services.

Two Ways to Legally Structure Strategic Partnership Deals

1. Traditional PC¹-MSO² Model
   - Shareholders own PC, strategic partner invests in MSO entity

   ![Diagram showing Traditional PC-MSO Model]

   - **PC**: (owned by medical group shareholders)
   - **MSO**: $Strategic Partner
   - **Investment**

2. Captive PC-MSO model
   - Strategic partner employs physician (that owns PC) and invests in MSO entity

   ![Diagram showing Captive PC-MSO Model]

   - **PC**: (owned by physician that is employed by partner)
   - **MSA**: $Strategic Partner
   - **Investment**

Source: Advisory Board interviews and analysis.
Today’s Medical Group Multiples on the Rise

Strategic Capital Partner Medical Group Valuation Formula

\[ \text{EBITDA} \times \text{Multiple} = \text{Medical Group Valuation} \]

**Earnings before Interest, Taxes, Depreciation, and Amortization**

* A measure of a medical group’s total earnings

**Medical Group Multiple**

* A subjective assessment of the growth potential, value of the medical group’s assets

**Factors contributing to medical group multiple**

- Payer mix
- Specialty mix
- Reimbursement climate
- Practice operations and efficiency
- Patient accounts receivable
- Tangible and intangible assets
- Patient population
- Physician productivity
- Certainty of future earnings
- Care quality

**Practice Multiples Rising**

“[Medical groups] are going for crazy multiples just because (private-equity firms) see the potential there.”

**Todd Spaanstra,**
*Partner at Crowe Horwath accounting and consulting firm*

**Today’s Multiples**

~7-10 Range of multiples for independent medical groups today

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1) Range of multiples heard in research calls with investment banking firms.

“Platform” Groups Typically Garner Higher Multiples

Two Ways Potential Investors Define Independent Medical Groups

“Practice”: Collection of physicians that practice in a group, but are not integrated operationally or invested in centralized scalable resources

“Platform”: Group that has invested in centralized, standardized approach to care delivery and practice management that enhances efficiency

Greater Platform Sophistication Tied to Higher Valuations

Baseline Platform Capabilities

- Unified, centralized strategy
- Centralized billing, back-office operations

Advanced Platform Capabilities

- Expanded availability of centralized, scalable service offerings (IT development, care management expertise, purchasing, etc.)
- Investment in experienced centralized management team (finance executive, HR executive, other critical business roles)

Source: Advisory Board interviews and analysis.
Private Equity Firms

Overview:
- Investment model overview
- Private equity firm’s value proposition

Profiles:
- Westfield Medical Group<sup>1</sup> partners with Oakton Partners<sup>1</sup>
- DuPage Medical Group partners with Summit Partners

Key Considerations

1) Pseudonym.
The Ideal Investment Process, Outcome

How Private Equity (PE) Investment In Medical Groups **Ideally** Works

**Before Investment**
- Size of group: ⬇️
- Value of equity: $

**Initial Private Equity Transaction**
- Medical group creates separate legal entity¹ that houses all non-clinical medical group staff
- Medical group offers certain percent of that entity’s equity, board seats to PE firm in exchange for upfront capital
- Legal entity distributes capital to owners², retains some capital

**Accelerated Growth Period**
- In partnership, PE firm and medical group undergo period of accelerated growth through acquisitions, and service expansion—seeking to enhance value of equity

**After Investment**
- Size of group: ⬆️
- Value of equity: $$$

**Equity Re-sale:**
- **PE Firm** profits by selling higher-valued equity to one of the following:
  - **Another private equity firm**
  - **Strategic buyer** (e.g. a national practice company, health system)
  - **The general public** (i.e. IPO³)

- **Medical group** profits from equity value growth, can choose to capitalize on growth by:
  - Redistributing owned shares to new investors
  - Selling equity to general public through IPO

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¹ Commonly a Limited Liability Company (LLC).
² Owners of LLC; typically also the shareholders of the Professional Corporation.
³ Initial public offering.
Understanding the Appeal

Typical Components of the Private Equity Investment Pitch

**Equity Liquidation**
Upfront liquidation of portion of medical group equity, ongoing recapitalization opportunities

**Infrastructure, Acquisition Support**
Gain access to capital to fuel population health investments, new practice acquisitions, M&A\(^1\) due diligence support

**Business Expertise**
Gain access to fundamental business resources to enhance efficiency, drive further growth

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Sample “Business Expertise” Offerings

- Management personnel
- Legal, financial expertise
- Networking with other portfolio groups

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1) Mergers and Acquisitions.

Source: Advisory Board interviews and analysis.
Double Clicking on Two Recent Deals

Illustrative Profiles of Multispecialty and Single-Specialty PE Deals

Profiles of Private Equity Investment in Independent Medical Groups

Westfield Medical Group¹
50-physician single-specialty practice based in the Southwest received private equity investment from Oakton Partners¹ in August 2016

DuPage Medical Group
480-physician multispecialty practice based in Downers Grove, Illinois received private equity investment from Summit Partners in December 2015

¹ Pseudonym.

Source: Advisory Board interviews and analysis.
Inability to Realize Strategic Ambitions

Groundwork in Place, But Unable to Achieve Strategic Goals Alone

Established Platform Offerings

• Extensive management team with centralized leadership structure
• Centralized advanced patient call center
• Established back-office billing, sophisticated finance function, coding team
• Established ancillary services including multiple ASCs, pathology labs, pharmacy services

Missing Pieces

• Growth capital
• Acquisition, integration due diligence
• Expertise to expand technology platform

Strategic Goals

• Grow nation-wide specialty presence
• Support acquired groups in ASC development in new markets
• Increase value of group by >$50M in five years
• Maintain independence from hospitals, health systems

Source: Advisory Board interviews and analysis.
Case in Brief: Westfield Medical Group¹

1) Pseudonym.
2) Mergers and Acquisitions.
3) Ambulatory Surgery Center.

- 50-physician independent single-specialty group located in the Southwest
- Westfield invested heavily in resources, expertise, infrastructure to scale across other similar specialty practices, but required capital, M&A² expertise to expand
- Westfield evaluated strategic capital partnerships with their local hospital, a national ASC³ management firm, and private equity firms
- Unanimously voted to partner with Oakton Partners¹, a middle market private equity investment firm based in the West
- Oakton invested in newly developed MSO entity that houses all of Westfield's practice management and business functions, non-clinical staff
- Westfield intends to leverage capital and expertise from Oakton to grow regionally and eventually nationally

Source: Advisory Board interviews and analysis.
## Identifying the Partner to Meet Strategic Goals

Private Equity Deemed Best Fit Partner to Provide Missing Pieces

<table>
<thead>
<tr>
<th>Westfield-Identified Benefits of Partnering with Private Equity Firm</th>
<th>Westfield Primed for Private Equity Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>➢ Upfront capital</td>
<td>History of Retained Earnings</td>
</tr>
<tr>
<td>➢ Ongoing capital access to help fund future acquisitions</td>
<td>Prove shareholder’s commitment to investing in the future of medical group, centralized business functions such as billing, collections, etc.</td>
</tr>
<tr>
<td>➢ Due diligence support for future acquisitions</td>
<td>Strong Centralized Leadership</td>
</tr>
<tr>
<td>➢ Physician retention of clinical autonomy, equity ownership</td>
<td>Experienced c-suite allowed WMG to remain cohesive as an organization, influence decision making among shareholder ranks</td>
</tr>
<tr>
<td></td>
<td>Cohesive Culture</td>
</tr>
<tr>
<td></td>
<td>Developed common culture across disparate practices, aligning shareholders on singular vision for the future</td>
</tr>
</tbody>
</table>

Source: Advisory Board interviews and analysis.
Preparing for Private Equity Investment

Westfield’s Path to Partnership

1999
Westfield created after merger between two groups

2007
Westfield executives brought in consultants to assess their business, build foundation for future business growth¹

Jan 2016
Westfield executives introduced to Oakton Partners

Aug 2016
Westfield closed deal with Oakton

Westfield committed to developing scalable resources, unified culture focused on growth among disparate groups

2008
Westfield hired new CFO, converted to retained earnings model

Feb 2016
Due diligence process began

Practice Transformation Efforts

• Developed unified, centralized management services platform

• Secured shareholder buy in to grow management team twofold¹

• Invested in CFO charged with transitioning to retained earnings model, accrual-based accounting

Evolving from a Medical Group to a Business

"Hiring consultants to help us assess and elevate our practice management capabilities was a real turning point for our group. It was when we evolved from a medical group to a business."

President, Westfield

¹ Hired VP of Human Resources, VP of Marketing.
Westfield Receives Majority Investment From Oakton Partners

Formation of New MSO Entity Required to Complete Deal

Deal in Brief: Westfield & Oakton Partners

- Oakton made majority investment into newly developed MSO entity that houses all of Westfield's practice management and business functions, non-clinical staff
- Partnership allows for Westfield to maintain clinical practice autonomy while gaining access to necessary capital as well as financing, contracting, legal, accounting, marketing support
- Physician owners unanimously voted to approve the deal

Partnership Structure Overview

1) Management services agreement.

Source: Advisory Board interviews and analysis.
### Shareholders Across all Age Brackets See Value in Private Equity Investment

<table>
<thead>
<tr>
<th>Shareholder age:</th>
<th>Ages 30-45</th>
<th>Ages 45-60</th>
<th>Ages 60+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage breakdown:</td>
<td>44%</td>
<td>38%</td>
<td>18%</td>
</tr>
</tbody>
</table>

**Rationale:**

- **Ages 30-45**
  - Upfront, continuous recapitalization opportunities help pay off medical school debt, help start, support families
  - Ability to focus on practicing medicine, not management

- **Ages 45-60**
  - Upfront, continuous recapitalization opportunities help pay for children’s college, save for retirement
  - Ability to have ownership stake in and influence over growing group

- **Ages 60+**
  - Upfront payment provides retirement cushion
  - Offered lucrative financial exit

Source: Advisory Board interviews and analysis.
Physician Shareholders Feeling Growth Fatigue

Driving Medical Group Leaders to Evaluate New Options

Growing at Unprecedented Pace

+20K Growth in managed care lives 2013-2016

53% Percent growth in physicians from 2011 to 2015

Leadership, Physicians at Odds Over Growth

• Shareholders disgruntled with changes required due to growth, didn’t see value of further expansion

• Leadership wanted to continue growth, with goal to reach over $1 billion in EBITDA in four years

Source: Advisory Board interviews and analysis.
Case in Brief: DuPage Medical Group (DMG)

- 480-physician independent multispecialty medical group based in Downers Grove, Illinois
- DMG grew 53% (from 300 physicians in 2011 to 459 physicians by the end of 2015), a trend that leaders wanted to maintain in the coming years
- Sought a partner who could help show physician shareholders the value of past growth, provide acquisition expertise, and capital to continue expansion
- DMG vetted 22 potential partners, but ended up unanimously selecting Summit Partners, a private equity firm based in Boston, Massachusetts specializing in growth equity
- DMG received a $250M investment—a combination of equity and debt—into DMG Practice Management Solutions, an LLC that houses DMG’s management functions
- In exchange, Summit Partners took minority ownership of the LLC’s equity, while DMG shareholders maintained majority ownership
- DMG gave $200M of the $250M back to physician shareholders to show the value of past growth, then re-invested $50M into the organization as growth capital

Source: Advisory Board interviews and analysis.
Proving Value of Growth Through PE Partnership

DMG’s Key Reasons for Seeking Private Equity Partner

- Compensate shareholders for portion of prior equity growth
- Incentivize future growth, offering physicians new reason to pursue aggressive acquisition path
- Gain access to capital for future acquisitions
- Maintain hospital independence, physician ownership

"Some physicians were feeling growth fatigue and were against continued growth. This deal was a way to prove to the physicians the value of the equity they had built in the organization and to incentivize future growth."

Mike Kasper,
CEO, DuPage Medical Group

Source: Advisory Board interviews and analysis.
Making a Deal with Summit Partners

Deal in Brief: DMG & Summit Partners

- DMG selected Summit Partners, a private equity group with considerable healthcare experience.
- DMG received a $250M investment that was a combination of capital investment and debt financing.
- Summit Partners became a minority investor in DMG Medical Group’s business arm, allowing DMG shareholders to maintain majority ownership.

Key Reasons Summit Partners Selected DMG

- History of retained earnings demonstrated commitment to future growth.
- Efficient, consolidated leadership team.
- Proven history of growth.
- Commitment to corporate governance.

Partner Structure Overview

- DuPage Medical Group
- Professional Corporation
- DMG Practice Management Solutions
- MSA
- Owned by DMG shareholders
- Owned by Summit Partners

Source: Advisory Board interviews and analysis.
## The Path to Partnership

### DMG’s Multi-year Partnership Process

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>New CEO joined group, pushed to help physician shareholders better understand value of organization</td>
</tr>
<tr>
<td>2012</td>
<td>Board voted to conduct valuation of practice</td>
</tr>
<tr>
<td>2014-2015</td>
<td>DMG narrowed in on Summit Partners from 22 potential private equity partners</td>
</tr>
<tr>
<td>August 2015</td>
<td>Brought in investment bank, Cain Brothers, to help negotiate the deal with Summit Partners</td>
</tr>
<tr>
<td>December 2015</td>
<td>Signed the deal, distributed $200 million to the physician shareholders</td>
</tr>
</tbody>
</table>

**Source:** Advisory Board interviews and analysis.
Critical Components to Finding, Executing on Partnership

Three Core Components of DMG’s Partnership Evaluation Process

Developing “Must Have” Criteria
- Convened shareholders to develop list of “must have” criteria for evaluating partners
- Focused on cultural fit, not monetary capital

Building Consensus Around Best Fit Partner
- Conducted detailed analysis of short-listed partnership options
- Communicated, built consensus around partnership decision with shareholders using empirical reasoning

Prioritizing Communication, Transparency
- Created multiple avenues for shareholders, physicians, and staff members to ask questions about partnership process
- Transparency served to align shareholders, leading to unanimous agreement for partnership

Source: Advisory Board interviews and analysis.
Narrowing Down Prospects Using “Must Have” Criteria

Created List of “Must Have” Criteria For Partnership

Seven Criteria

1. Minority investment
2. >5 year minimum investment period
3. Maintain physician majority in the clinical, corporate board
4. No compensation changes
5. Experience in the physician space
6. Additive to portfolio of capabilities
7. Maintain physician-driven organization

Monetary Value Not Included as Criterion

"There were opportunities for us to increase the enterprise value of the organization but our shareholders were willing to sacrifice valuation for these seven principles."  
Mike Kasper, CEO, DuPage Medical Group

22 Private equity potential partners

Any partner that didn't meet one of the seven criteria was immediately disqualified

9 partner options

Source: Advisory Board interviews and analysis.
Analysis Helps Identify Partner, Build Consensus

Illustrative Partnership Analysis of DMG “Must Have” Criteria

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Partner option #1</th>
<th>Partner option #2</th>
<th>Partner option #3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Criterion #1</td>
<td>☀️</td>
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<tr>
<td>Criterion #2</td>
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<tr>
<td>Criterion #3</td>
<td>☀️</td>
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</tr>
</tbody>
</table>

Meets ☀️  Exceeds ☀️  Greatly Exceeds ☀️

Building Shareholder Consensus Around Partnership Selection

"Once we solicited all our bids and narrowed in on the most promising partners, we used the Harvey ball analysis to build consensus around our partnership decision among the physician shareholders."

Mike Kasper, CEO
DuPage Medical Group

Source: Advisory Board interviews and analysis.
Ongoing Communication Critical to Shareholder Buy In

Key Physician Concerns
- Business interference in clinical care
- Impact on physician compensation
- Potential changes to clinical practice

Addressing Concerns Through Multi-layered Communication Forums

- **Town Hall Meetings**
  - **Group questions**
  - Why are we evaluating strategic partnerships?
  - How would this specific partner help us with our future goals?
  - What are the benefits of partnering with private equity over other potential partners?

- **24/7 Hotline**
  - **Individual questions**
  - Would I still have control over my own schedule?
  - Are there compensation changes associated with partnership?
  - How will this effect my retirement package?

- **Anonymous Feedback Boxes**
  - **Individual concerns**
  - I’m afraid we may lose our physician owned culture if we bring on a partner
  - I agree that we need a partner even though some of my colleagues don’t
  - I’m worried about what will happen to my practice staff after we partner

Source: Advisory Board interviews and analysis.
Upfront Cash Pay Out Comes at a Cost

Investment Outcome Must Outweigh Lower Initial Shareholder Income

Key considerations

- Investment period
- Shareholder annual income reduced to retain earnings for continued growth
- Equity re-sale
  - Owners may profit only if growth targets are met

Illustrative Shareholder Income Trend With Private Equity Investment

- Pre-investment: All medical group earnings distributed among shareholders
- Initial transaction: Shareholders get upfront cash payout in exchange for equity
- Investment period: Shareholder annual income reduced to retain earnings for continued growth
- Equity re-sale: Owners may profit only if growth targets are met

Decrease in shareholder income

Value of shareholder-owned equity dependent on ability to grow

Growth challenges:
- Attracting physicians to model without diluting shareholder equity value
- Maintaining aggressive growth pace

Source: Advisory Board interviews and analysis.
Cautionary Considerations When Evaluating PE Firms

- For private equity firms, generating a return on investment is the number one priority.
- Private equity firms will likely charge ongoing management fees on top of the transaction.
- Having a private equity investor will likely impact your ability to recruit physicians.
- You won’t always have a say in who the private equity firm sells to.
- Recognize that your definition of autonomy may be different from the private equity firm’s.
- Upfront cash payout is often tied to lower shareholder income during growth period.

Source: Advisory Board interviews and analysis.
## Assessing Private Equity Partnership

### Partnering with Private Equity: Evaluating the Pros and Cons

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Drawbacks</th>
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</table>
| **Capital** | • Potential for large payout to physician shareholders upfront and on ongoing basis  
• Potential access to growth capital can help fuel acquisitions, other investments  |
|  | • Capital access comes at the cost of loss of management autonomy  
• Shareholders may see reduced incomes for the first few years after the transaction |
| **Governance and Management** | • Experienced business professionals may be added to medical group board  
• May elevate importance of adding new positions to senior management ranks  |
|  | • Loss of 100% physician-ownership of the group may impact group culture  
• Added hierarchy in business decisions (e.g. in M&A transactions, budgeting, etc.) |
| **Services** | • Possible access to other business resources necessary for continued growth  |
|  | • Many additional services PE firms provide to medical groups typically come at an additional cost |
| **Autonomy** | • Physicians can usually maintain their clinical autonomy and some degree of input into management decisions (based on ownership structure)  |
|  | • Medical group unable to make decisions without consulting PE partners  
• If growth targets are not met, medical group leaders may lose significant control |
| **Other** | • Medical groups can preserve their independence from hospitals and health systems  |
|  | • PE firms typically have no experience negotiating risk-based contracts with payers  
• Medical groups may have little to no say in who PE firms later sell them to  
• PE firms are not long-term partners |

Source: Advisory Board interviews and analysis.
Insights for Navigating PE Partnership

Executive Summary

1. For private equity firms, generating a return on investment is the number one priority
2. The medical group’s definition of autonomy may be different from the private equity firm’s
3. Private equity firms will likely charge ongoing management fees on top of the transaction
4. Upfront cash payout is often tied to lower shareholder income during the growth period
5. Having a private equity investor will impact the medical group’s ability to recruit physicians
6. To achieve return on investment, the medical group will need to undergo considerable growth
7. Private equity firms are selective of medical groups; those that have developed a scalable platform, invested in internal infrastructure, and converted to advanced financial accounting methods are well positioned to attract partners
8. It will take significant time, energy, resources to position the medical group for PE investment
9. Ensuring medical group leaders align around their group’s internal partnership priorities prior to engaging with potential partners can streamline the evaluation process
10. When evaluating private equity partnership options, don’t be blinded by the medical group valuation; cultural compatibility and similar vision are far more important
11. Developing open communication channels throughout the partnership evaluation, and selection process is critical to building shareholder consensus
12. It is important to think through the optimal exit strategy for the group and, where possible, include securities in the agreement that will ensure the group’s equity is not sold to a misaligned partner down the road

Source: Advisory Board interviews and analysis.
1. The drive to partnership

2. Understanding the private equity partnership landscape

3. Capital partnership toolkit resource walk through
Introducing Our Capital Partnership Toolkit

Capital Partnership Toolkit

Resources and tools for independent medical group leaders

Meeting Resource | February 24, 2017

Rising practice costs, MACRA reporting requirements, growing health care consumerism, and hospital employment are threatening independent medical group sustainability. Some groups are able to navigate these changes alone.

Others, however, are turning to strategic capital partners—such as national practice companies or private equity firms—to gain access to the capital and other resources that may be necessary to survive and thrive in today’s health care economy.

While interest in strategic capital partnerships continues to grow, many independent medical groups lack the understanding and preparedness to properly evaluate this path. Unfortunately, this can prevent the group from selecting the best fit partner—or even considering the option before it is too late.

Learn the three most common challenges to evaluating strategic capital partners and get the tools to overcome them.

Challenge #1: Understanding how the strategic capital partnership market works and its key players

Independent medical group leaders should educate physician shareholders on the medical group investment market to help build consensus around the decision to take on a partner.

Capital Partnership Toolkit
Includes:
• Ready-to-use slides on the strategic capital partnership landscape
• Cheat sheet for how to determine an independent medical group’s valuation
• Independent medical group strategic planning template
• Capital partnership assessment tool
• Strategic capital partnership guide

Available at: www.advisory.com/capitalpartnershiptoolkit
Please take a minute to provide your thoughts on today’s presentation.

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