PE Hub

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PUBLISHED: 16 August 2022

GUEST WRITER OPINION

How physician practice companies succeed – and why some don't

Experience teaches that aligning investors and management is particularly challenging in physician practice enterprises.

The US healthcare services sector enjoyed robust deal activity in 2021, with 1,457 deals closed, representing over $49 billion of capital invested.

And within this volume of health care services deals the pace of US M&A transactions involving physician practices remained strong, with nearly 100 such deals closed in 2021 as compared with 70 in 2020 and 59 in 2019.

Not your average deal

M&A transactions involving US health care providers are somewhat unique. The most important resource of the enterprises are highly trained professionals, and their charge involves preservation and improvement of the health of living beings, with substantial governmental regulation. Partly to address these features, enterprises involving physicians and private equity investors often involve separate management service organizations (MSOs), internally or stand-alone, that provide a range of back-office support services to the practices.

Private equity deals typically succeed or fail based on a set of common factors – having the right management team, investing in a sector with tailwinds, buying on favorable terms, not over-leveraging, making operational improvements and (usually) building through acquisitions. In an MSO deal, additional factors include getting the allocation of equity ownership and cash flows right, having a culture of partnership and creating an environment where compliance, growth and top level patient care occur. The art is to combine all of these elements in a way that creates alignment, retention and motivation. No single model for these arrangements has yet emerged.


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Experience teaches that aligning investors and management is particularly challenging in physician practice enterprises. The sector has seen a relatively high number of notable failures, some disastrous. Yet many of the most effective and successful providers of medical care today practice in sponsor-backed enterprises.

What separates success and failure?

Culture

Market participants who have enjoyed MSO success generally cite "soft" factors when asked to describe the most critical elements of a successful physician practice enterprise.

The question a sponsor-backed physician practice company must answer is whether joining the company makes life better for physicians and thus the patients. With regard to patient care, the key question is whether the company enhances the ability of medical practices to achieve the coveted "triple aim" of the US healthcare system – improving patient outcomes and the patients' experience of care, improving the health of populations and reducing the per capita cost of healthcare.

In the areas of economics and work environment, a sponsor backed MSO must enhance the operations and profitability of the practices and provide a long-term economic incentive, attractive year-to-year cash flow and a positive day-to-day experience that outpaces competing alternatives.

Organizations that deliver this value proposition have a partner-like culture with regular, transparent, two-way communication. The physicians are valued, and also, in a sense, are "customers" rather than contracted employees. What is centralized and what is decentralized are in balance. Effective leadership occurs at all levels of the organization. The positive culture produces a virtuous cycle, as references from prior deals facilitate future acquisitions and hires.

Compensation

Successful physician practice management companies also offer compliant, metric-based compensation and incentives. These typically involve salary, a stake in annual profits (typically at the practice level for the physicians), retained/rollover equity for sellers, and well-crafted incentive equity awards.

Kirk Ogrosky

Compensation models vary widely. Some emphasize the "second bite at the apple," where the most meaningful economic value for physicians arises via a sale or initial public offering of the MSO.

Other models emphasize annual physician compensation at the local or regional level. These often utilize a profit-sharing arrangement that looks and feels like the physicians' familiar profit-sharing dynamic based on RVUs. Equity in the management company is oriented toward management company personnel.

No single compensation and equity structure has become dominant; variation is wide.

Building by smart acquisitions

Although MSO history is littered with failures that prioritized acquisitions over service and culture, most physician practice companies seek to increase earnings and equity value through serial acquisitions to complement organic growth.

Importantly, an acquiror must be able to paint a clear picture of how life will unfold for the prospective selling physicians. Happy prior sellers are the best ambassadors. Looking ahead, it is important to create conditions and terms that will keep the physicians committed to efficiently and effectively provide excellent care.

Having a well-oiled acquisition team that knows the market and what to prioritize in due diligence, spots problems early and unobtrusively, and executes flawlessly, without friction and at predicable cost, are also essential.

Conclusion

MSO deals continue apace in the first half of 2022. Future history will delineate those who have discovered the formula for success and those who have not.

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