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2024 Market Update: Private Equity and Physician Practice Transactions

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There has been plenty of discussion of physician practice consolidation by private equity (PE) firms. The market has matured faster than virtually any other, looking more like a tech bubble than an investment in the services space. PE investment went from no interest to hyper interest to heavily consolidated in just over a decade. Many investments have spanned the lifecycle from platform to the proverbial second bite; some are on their third or fourth investor.

While most of these deals have proven wildly successful financially for investors and physician-sellers, a few have struggled. Further, while many of the deals used minimal leverage (e.g., debt) in the early days (having only recently emerged from a massive credit crisis in the financial industry when this trend kicked off in the early 2010s), as valuation expectations increased and access to cheap credit increased, there was some concern around an enormous game of musical chairs: who will be holding the highly leveraged asset when there are no more buyers.

PE Investments in Physician Practices: A Retrospective

PE's involvement in healthcare has changed over the years. The high potential return on investment and lesser risk due to the somewhat recession-proof industry initially drove interest in healthcare. It began in the 1990s by acquiring nursing homes and hospitals and converting them into larger, for-profit businesses. Market consolidation and effective cost controls brought success, thus demanding to go deeper into healthcare. Next, PE invested in many emerging niches, including hospital ancillaries such as anesthesiology and radiology, urgent care, and physician staffing firms. Still, investors were slow to enter the world of clinic-based physician practices. For seasoned investors, the risks were high, and opportunities for return were low: managing physicians and professional services, "stroke of the pen" risk related to high payor concentrations, significant liabilities related to the services, and a range of other factors were all seen as barriers to entry into this market.

Some who took a unique perspective saw an opportunity, and if the risks were appropriately managed, one could capitalize on many positive factors. Factors such as a highly fragmented market, limited platform opportunities, younger partners not wanting to become practice owners, and the need to build critical mass to maximize revenue opportunities while controlling costs were all considered indicators for consolidation.

The idea was familiar, however. It had been undertaken with little long-term success in the late 1980s and 1990s with the growth of physician practice management companies (PPMCs). Despite having a similar investment thesis, the practice of how these were put together caused virtually all of them to crash and burn. Most of these were not backed by PE (a relatively nascent concept then) but had gone to the more traditional public equity market. Vast amounts of wealth were lost when these investments failed.

By the mid-2000s, however, the concept of PE had grown. The number of investors investing in alternative investments like PE flourished, and the PE firms needed a place to invest.

To create a market, you must have buyers and sellers. While most physicians cringe at the thought of working for someone else, most also agree that practicing medicine is not what it used to be. There are more regulations, continued revenue pressures, and rising expenses. Because of this, fewer and fewer people are going into medicine, and those pursuing medical careers lack the entrepreneurial spirit of the last generation.

However, where some see challenges, others see opportunities. Several more business-minded physician group leaders saw this opportunity; they realized there was one thing that the physician practice needed more of and could never access: capital. Thus, there was an opportunity to partner with PE investors who could bring the model proven in other industries to medical practices. The downsides to doing a deal were formidable. Most physician groups did not retain earnings, and thus, they had no excess cash flow on which to capitalize. This standard measurement is earnings before interest, taxes, depreciation, amortization, or EBITDA. The only way to generate EBITDA was for physicians to give up part of their compensation. Some tax benefits are related to capitalizing a portion of compensation, but delivering and understanding that message does not always go together.

Other factors complicate these transactions, like the corporate practice of medicine, physicians' general lack of trust in outside investors, and others. For those who could effectively navigate these issues, the opportunity was real: physician partners had the chance to create, in some cases, significant personal net worth, diversify their risk

exposure, and gain a partner to help promote growth. It wasn't always a win-win, but it was more often than not.

This is not to say there has not been any consolidation in the provider space. Hospital-based specialties have been a target for investors for many years. In the mid-2000s, some of the largest publicly traded companies were provider organizations. Specialties like hospitalists, emergency care, urgent care, and anesthesiology had been undergoing consolidation for many years, but the idea hadn't caught on in the clinic space. 2011 is the year things kicked off--and the growth caught on like a prairie fire. It started with dermatology; within 18 months, eye care was everyone's darling, and interventional pain management was also hot. Then came gastroenterology (GI), orthopedics, otolaryngology (ENT), women's health, urology, etc.

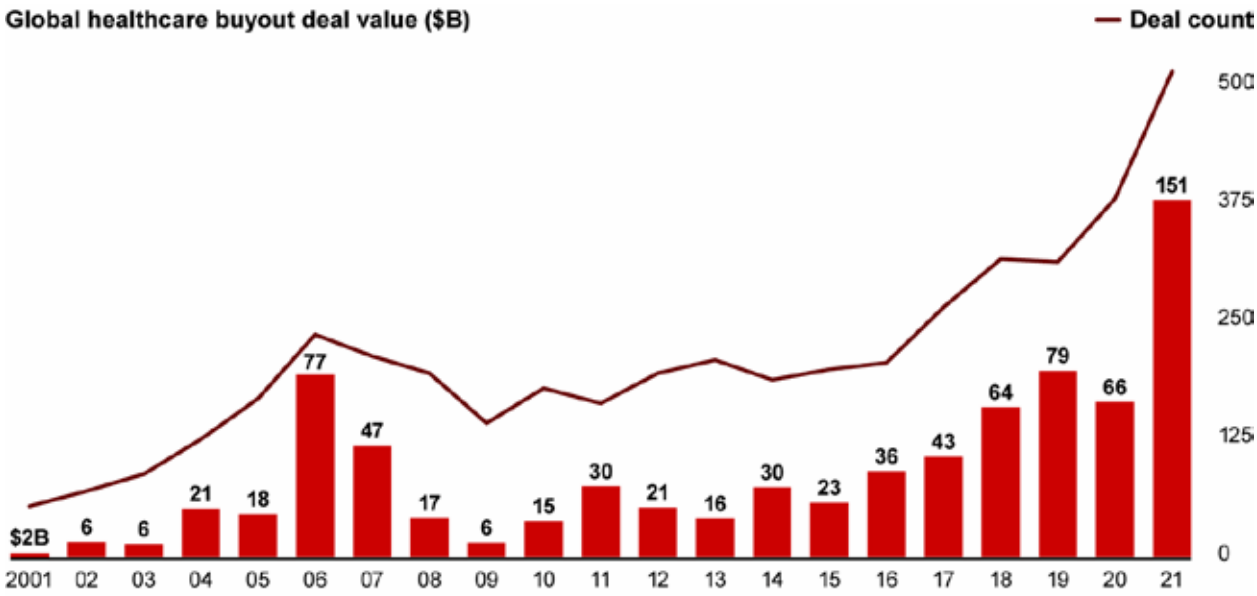
The fascinating aspect was how rapid the growth in consolidation occurred. In 2010, the number of PE firms invested in healthcare was relatively small, and no PE funds *only* focused on healthcare. Today, most large PE firms have a significant amount of their capital devoted to healthcare services, and some only invest in this space. The onslaught of new funds and growing investment in established funds became a self-fulfilling prophecy and juiced an already fast-growing space into one ready to go to the moon.

COVID–19 and the Post–COVID Market

Healthcare has always been viewed as a recession-proof market. In 2008, healthcare had done pretty well, as it always had in market downturns. But it does not matter how recession-proof you are if your doctor's office is shut down, and the first few months of 2020 led many to believe that even healthcare could not stand up to a worldwide pandemic.

Healthcare is fundamentally rooted in pain, specifically treating your pain. No one wants to deal with pain. No one wants to forego lifesaving cancer treatment. If you have a broken bone, you want it fixed. If you have a polyp, you want it diagnosed. Consequently, healthcare was one of the first "businesses" to open (notwithstanding the critical care being given directly related to the pandemic), with many doctors' offices opening for both emergent and elective surgery before other businesses. Healthcare was not only recession-proof, it was pandemic-proof. This led more and more investors to the space, and with a need to put money to work, investments in the physician space skyrocketed.

Of course, deals went on hold during the early stages of COVID-19, and most deal volume in 2020 closed before the pandemic began in the first quarter. But there was so much pent-up desire to invest money and the realization by many physician-partners of what could happen if their business went away that 2021 proved to be a breakout year. Deal volumes increased in number and size, and 2021 set a record for both.



Notes: Dollar numbers are rounded; excludes spin-offs, add-ons, loan-to-own transactions, and acquisitions of bankrupt assets; numbers based on announcement data; includes announced deals that are completed or pending, with data subject to change; deal value doesn't account for deals with undisclosed values; total buyout deal values updated based on Dealogic 2021 sponsor classifications
Sources: Dealogic; AVCJ; Bain analysis

To call 2021 a record year is a little misleading. The volume should be spread over 18 months, given the pause that occurred in 2020. Regardless of how you spread it, 2020 was huge. Buyers, both initial investors and companies already owned by PE (called PE-backed strategics), went on a buying spree. And while many physicians were committed to doing a deal, fewer sellers than buyers still existed. The market has to balance somehow; in this case, the balancing effect came through valuations.

When the market really started moving in the early 2010s, valuations were trading for an EBITDA multiple (a very crude way of measuring transactions, but generally speaking, the most often-used measurement tool) in the high single digits to low double digits, generally between 8.0 – 10.0x. A valuation in this range was considered very attractive. By the early 2020s, valuations were routinely in the 15.0 – 17.0x range, and numbers exceeding 20.0x were not unheard of.

A Maturing Market

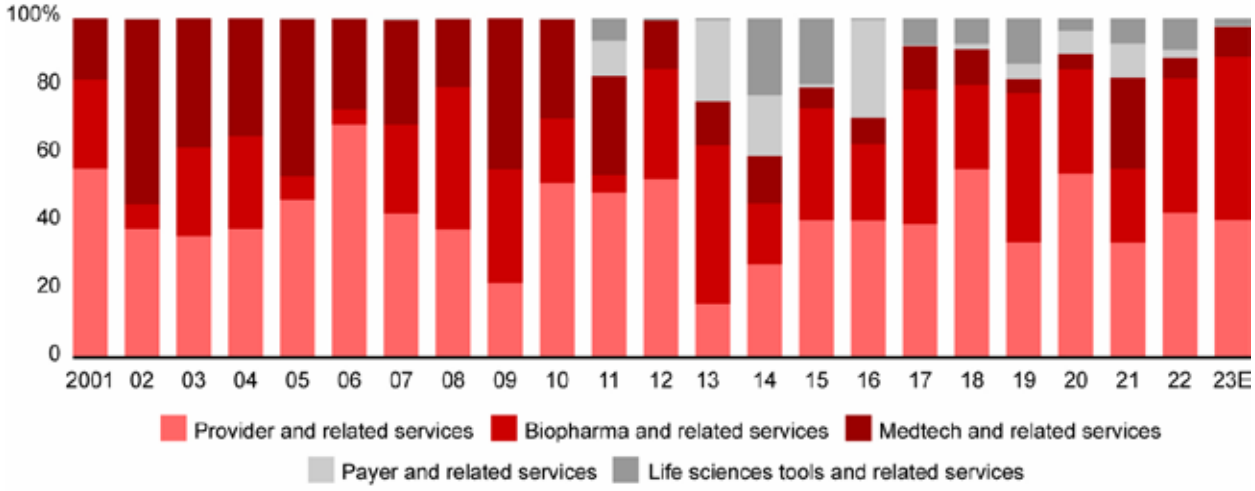
The trend continued into 2022 with it being another banner year for physician practice M&A. While the early days were mainly focused on PE firms creating new platforms by making initial investments into large physician groups (i.e., the platform investment) and then growing by acquiring other groups (i.e., bolt-on investments), the market had matured. Much of the M&A growth was fueled by trading those platforms to other, usually larger, PE firms. This is the *second bite* transaction that we often hear about. By this time, many of these initial platforms have been through their second bite and are even on their third or fourth investor. The market had matured.

The good news is that significant wealth has been created for many investors and physicians. Most of the original physician partners for the platforms are now employees and do not have any ownership in the practice. The practice looks materially different than it did five or ten years ago. It may have undergone one or even a couple of name changes.

Many cautioned the merging of healthcare and business, citing the risk to patient care, but besides a few bad actors, patients continue to receive the level of care they did pre-investment. No investor has ever told a physician how to deliver care.

The chart below shows the deal value and types of entities acquired by PE.

Percentage of global healthcare buyout deal value (excluding add-on deals)



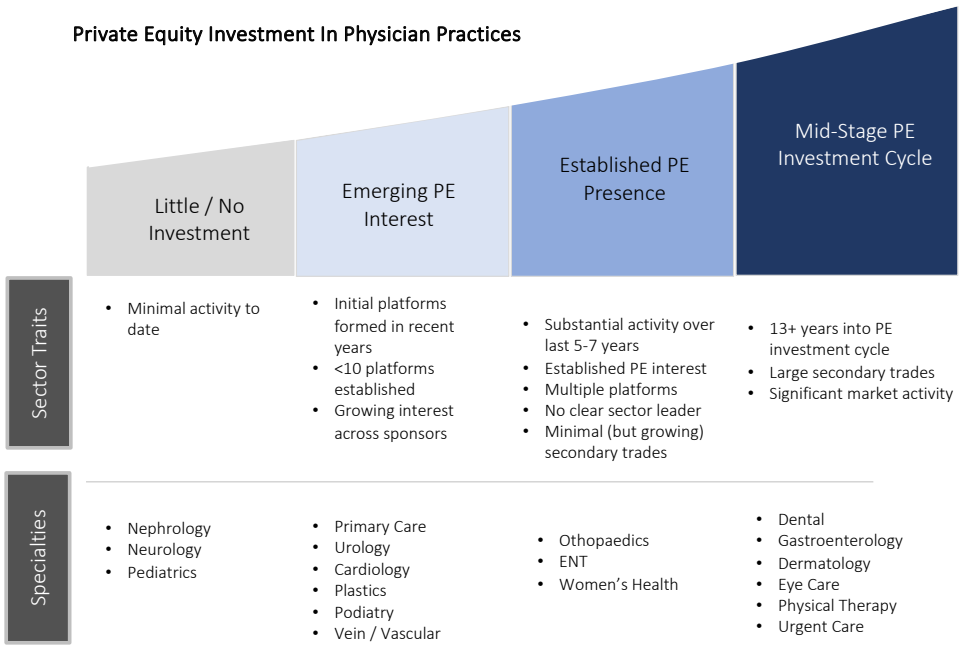
Notes: Excludes spin-offs, add-ons, loan-to-own transactions, special purpose acquisitions, and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; deal value does not account for deals with undisclosed values; values updated based on Dealogic 2020 sponsor classifications; values include net debt where relevant; 2023E annualized assuming the average ratio of January–November to December from 2019 to 2022, based on data through November 30, 2023; 2010 value includes $1 billion of uncategorized deals
Sources: Dealogic; AVCJ; Bain analysis

Established PE Interest

The original platforms primarily comprised GI, dermatology, and eye care. While some sizeable practices in these spaces never traded and are firmly committed to being private, for the most part, most of the large physician practices have completed transactions. The market is highly consolidated at the large practice level (which differs by specialty).

In dermatology alone, there are over 30 PE-backed groups. GI is closer to half of that, but most of the large GI groups in the nation have consolidated. The market remains fragmented despite the high level of consolidation at the large group level; however, significant opportunities still exist for consolidators to add smaller groups. This will allow PE firms to continue to deploy the significant capital they have raised over the past few years.

Spectrum of Physician Services and Private Equity Investments



Emerging PE Interest: Growth Opportunities

Cardiology

Like other specialties attracting PE interest, cardiology boasts significant tailwinds due to an aging population, technological advancements, and regulatory changes to catheterization (cath) labs and ambulatory surgery centers (ASCs). As the population ages, the need for cardiology services increases due to the prevalence of numerous chronic cardiovascular diseases. Heart disease remains the leading cause of death and is exacerbated by the multiple comorbidities of older patients.

PE investment in cardiology practices will be interesting to watch. Due to fairly significant reimbursement cuts in the mid- to late 2000s related to the specialty's largest ancillary services, cardiac cath labs, many cardiology groups fled to hospitals. They became employed or entered professional service agreements (PSAs). While many large platforms exist, they are not as numerous as other specialties. We have seen several PE investments in the space, including Summit Partners' investment in US Health Partners and Ares Management's investment in US Heart & Vascular. Still, given the total addressable market for the number of inorganic opportunities, the number of platform investments is limited.

Orthopedics

Orthopedics has always been attractive to investors due to several favorable market forces. These include the large breadth of ancillary services that orthopedics offers, the shift to outpatient surgical centers, and growing demand from an aging population.

The loosening regulatory requirements allow private practices to perform more procedures in an ASC environment than ever. Additionally, these procedures are well reimbursed as the Centers for Medicare and Medicaid Services (CMS) seeks to incentivize faster expansion of outpatient care. Finally, the sheer breadth of orthopedic ancillary offerings promises the potential for high returns. Physical therapy, imaging, durable medical equipment, sports medicine, and pain management are only a sampling of the different revenue streams from which a sophisticated orthopedics group can benefit.

Over the past few years, there have been huge transactions with large groups in the orthopedics space. More notable deals include Revelstoke Capital Partners' investment in Beacon Orthopaedics to form OrthoAlliance, and Welsh, Carson, Anderson & Stowe's investment in Resurgens Orthopaedics to form United Musculoskeletal Partners.

Orthopedics looks to continue its position of enviable attention from PE. Moreover, a full service line of musculoskeletal specialties can often be assembled. This bodes well for the physicians and other providers within the service line and the PE firm.

Primary Care

Primary care does not fit the traditional PE model of high compensation, robust ancillaries, and limited hospital interest. It is generally the polar opposite of these characteristics. Primary care is one of the lower-paid specialties; there is little to no ancillary revenue, and hospital ownership and employment are high, given the gatekeeper standing many PCPs maintain. However, there has been a significant change in the PCP market that has driven both public and private investor interest: risk-based medicine. Specifically, this is caused by the aging population and the reliance on the Medicare Advantage (MA) space.

Not only has this proven to be a significant growth area, but some of the largest and most notable investments in healthcare have happened in this space. Risk-based medicine can be profitable for organizations that do it correctly, but this requires large MA populations and adequately managed patients. Some are huge proponents of this model of care, saying that it provides a holistic view of treatment, while others say that it incentivizes just the opposite, i.e., limiting care to manage expenses. Regardless of your view regarding care delivery, the economics, again, if done correctly, can be very significant.

Over the past few years, we have seen some substantial transactions in the space, including Cano Health, Inc.'s SPAC merger in 2021 for $4.4 billion, Amazon, Inc.'s acquisition of One Medical in 2022 for $4 billion, and CVS's acquisition of Oak Street Health for $10.6 billion in 2023. These were PE-owned before their acquisitions, and unfortunately, many have not performed very well. For example, in early February 2024, Cano Health filed for Chapter 11 bankruptcy, and there have been reports of troubles at some of the other large companies focused on risk-based medicine, so it will be interesting to see how this market plays out.

Future of PE in Healthcare

PE is fundamentally reshaping U.S. healthcare. That cannot be argued. Most firms have deep pockets, a keen eye for opportunity, and an extensive history of building successful businesses. PE capital, innovation, and operational excellence may help make healthcare a more effective ecosystem. Investors, physicians, and patients will benefit from the collaborative, forward-looking partnerships between PE and physician practices. Numerous investments and entities have already begun building an improved healthcare system and profiting from their successes. Due to significant market tailwinds, PE involvement is expected to increase further, and the number of patients these developments impact will climb. With this relatively new, dynamic player involved, health systems and hospitals will remain vital. They may still affiliate and partner with physicians and PE. However, it will require new thinking and adjustments from their typical mindsets. Physician employment, for example, may be replaced by contractual arrangements that allow full affiliation with hospitals and a PE firm simultaneously. Time will tell exactly how such relationships will unfold.

PE will maintain its opportunistic approach to achieve financial success. Market forces, regulatory pressures, and technological innovations will direct future PE engagements. They will continue pursuing fragmented specialties and work to bring much-needed consolidation. The savvier PE firms and their practices will learn to

be inclusive of all providers, especially hospitals. Historically, hospitals have viewed PE as a negative, seeing them more as competitors. This perspective will likely change over the next few years. There is a significant opportunity for hospitals and PE-backed physician groups to collaborate and create considerable value for all involved.

Physician Value

Physician partnerships are paramount to PE's success in healthcare, but the physician owners also stand to gain considerably. Historically, physicians would spend 30 years building a practice with a steady base of patients, only to retire without reaping the full benefits of their hard work. A trusted medical practice with a reliable patient population carries tremendous intrinsic value. PE provides physician owners with a large cash payment for the value the physicians created. Of all the affiliation options physicians currently have, PE also pays the most upfront, making them an excellent partner for physicians nearing retirement or needing help with succession planning. Furthermore, since PE funds the expensive technology purchases and ASC buildouts, physicians can enjoy the new opportunities they provide without taking on debt. The value physicians gain from PE partnerships extends beyond the financial benefits. Working as part of a larger group lessens the administrative and call burdens while providing fulfilling participation in a collaborative community. A larger patient population allows physicians to focus on value initiatives, enabling them to pursue bundled and value-based payments. Providers can focus on medicine and giving patients the best possible care instead of relying on antiquated fee-for-service payment models. Finally, and most importantly, physicians who partner with PE groups can help direct the future of healthcare. A thriving healthcare ecosystem *must* have physician leadership so that patient needs and quality clinical outcomes are given the full attention they deserve.

Patient Perspective

Patients also benefit from innovative PE and physician practice partnerships. Traditionally, healthcare was a local business heavily intertwined with the community. As the world grows more connected, patients can access medical services from regional, national, or even global providers. While this brings tremendous opportunity, the patient-provider relationship must be preserved. Physician-PE partnerships that place patient care at the forefront of their business models represent a vital iteration in healthcare. Specifically, patients benefit from the value pursuits that consolidated physician practices undertake. Extra diligence is given to care for patients since value payments increase based on the health and clinical outcomes of the patients. Aligning financial incentives with patient outcomes creates a win-win scenario for everyone involved. Furthermore, ASC procedures have increased quality and better post-op care. As CMS allows more ASCs to perform a broader array of procedures, the number of patients positively impacted will grow. Finally, ASCs provide unmatched patient experience due to the flexible scheduling options. Patients can schedule procedures when it suits them, and receive high-quality treatment and world-class care, all without paying for expensive hospital markups. With the right partnerships and investments, the future of healthcare for patients is bright.

Challenges

When PE started investing in medical practices nearly 15 years ago, many cautioned the merging of healthcare and business, maintaining that profits would win over quality patient care. While you can always find one or two stories where this has been the case, it has not proven pervasive. Healthcare delivery has always been inefficient, but bringing best practices from business, organizational, and process development has helped to make it more efficient. There is nothing wrong with running a practice like a business.

Partnership with PE brings unique challenges for the physician partners. Younger physicians may not be interested in PE ownership due to the reduced compensation and shorter-term focus. Since their compensation haircut is permanent, physicians who stay in practice for a lengthy time after the initial sale are financially better off remaining in private practice. Additionally, agreements involving rollover equity may entail less cash upfront. Further, physicians may not appreciate the loss of autonomy and control. Private practice emboldens physicians with the freedom to practice medicine how they wish, but a partnership with PE means ceding operational control to the new owners. Further, ownership will likely change again due to a subsequent sale of the practice. It is common for PE firms to seek a return on their investment within 3-5 years and move to the next opportunity. Physicians should carefully deliberate before selling to PE as they will lose much control of the practice and cannot revert to the prior structure. For the right physician and practice, partnering with PE can be a lucrative, meaningful way to influence your community and improve patient care.

One matter that could have significant negative effects on PE-backed physician platforms over the coming years is the significant levels of debt they have incurred and how this will play out in a high-interest rate environment. In the early days of these investments, PE used only limited debt levels to fund its acquisitions. The debt level is often expressed as a multiple of EBITDA, similar to valuations. Early in the investment cycle, debt levels were generally in the 2.0 – 3.0x levels, and in some cases, buyers used no debt.

Generally, most people think of debt from a negative perspective, but from a business perspective, prudent debt levels are good. Using debt to fund an acquisition can benefit both the buyer and seller. Using debt to fund specific growth measures is preferable to putting up one's cash. Again, this is only the case when *prudent* debt levels are used.

As valuations that were being paid for initial investments and larger bolt-on transactions increased significantly, especially in the last two

years, investors sought higher returns, and the access to cheap debt burgeoned; many of the second and third-bite investments were funded with significant levels of debt, reaching 6.0, 7.0, and in some cases, 8.0x EBITDA. That is a staggering level of debt and leaves little room for any operating or economic error. Or, as fate would have it, any significant increases in the cost of debt. This is precisely what has happened. Since the financial crisis of 2007-2008, we have been operating in an extraordinarily low-interest rate environment, with the key Federal Funds rate operating somewhere around 0.25%. However, since March 2022, the Federal Reserve has increased its target interest rate by approximately 525 basis points, or 5.25%. When many debt instruments are variable, this leads to a massive price increase in the cost to service this debt.

In cases where these deals were priced very thinly, there was little room for anything negative to occur: no significant reductions in reimbursement or cost increases. If either of these happened, then it would be virtually impossible to meet debt covenants. Many of these platforms that used excessive debt to fund buyouts have seen massive increases in the cost of debt.

While there have been a few major headline collapses, several PE-backed investments are struggling mightily. Indeed, not all of these companies are highly leveraged, but those that are may not survive in this high-rate environment. It will be very interesting to see what happens over the coming months.

Because of this, the M&A environment has slowed significantly, with only a handful of deals completed in 2023. Many are looking to 2024 to be a better year for deals, but deal volume around election cycles can be slow. Those entities that are not highly leveraged will continue to make smaller acquisitions and use their PE fund's cash to fund the investments. And at some point, they will ride out the M&A downturn until it picks back up, as it always does!

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