



Valuation of Healthcare Service Enterprises for Purposes of Private Equity Investment: Private Equity's Healthcare Future (Part 3 of a 3 Part Series)

As discussed in the first and second installments of this three-part *Health Capital Topics* series on *private equity* (PE), investments from PE Firms experienced record growth in the healthcare industry in 2016,¹ and have realized greater returns on investment compared to other industries.² Nevertheless, concerns remain as to the similarity of this trend in PE investment to that of *physician practice management companies* (PPMCs) in the 1990s, which ultimately failed and left corporations such as *Phycor* and *MedPartners* with huge losses and stock prices that plummeted to under \$2 per share (once above \$30 per share).³ During this period, PPMC attempted to create value in the healthcare industry by supplying physicians with management services as well as an alternative means to access capital.⁴ However, this model eventually failed because it did not yield a return on the acquisitions that exceeded the PPMC's weighted average cost.⁵ Although PE investments do share similarities with PPMCs, PE arrangements may be able to prove more successful due to: (1) the drastic changes in the healthcare reimbursement environment under new legislation; (2) advancements in technology; and, (3) developments in data analytics.⁶

In the 1990s, PPMCs were marketed as a vehicle to accrue the necessary capital to achieve economies of scale for single and multi-specialty practices by: (1) building clinical information systems that would help manage care more efficiently; and, (2) creating bargaining power with vendors and payors for the member physician practices.⁷ With the emergence of managed care contracts, PPMCs also applied their management expertise to address the complex negotiations requisite in this managed care era, as well as, the emerging challenges stemming in part from a massive drive toward consolidation in the healthcare industry.⁸ While some physician practices were able to achieve small increases in revenues through PPMCs, most did not realize a large enough savings on practice operations to offset the costs associated with PPMCs.⁹ Generally, PPMCs struggled to manage the systems that they had created, particularly through proper utilization of technology to create a more efficient operation.¹⁰ Further, PPMCs failed to increase the bargaining power for the PPMC member physician practices because of the limited geographic proximity and the divergence of rates

and expenses across state lines inherent in a given healthcare marketplace.¹¹

Since the collapse of PPMCs in the 1990s, the healthcare industry has undergone significant reform through the passage of comprehensive laws such as the *2010 Patient Protection and Affordable Care Act* (ACA) and *Medicare Access and CHIP Reauthorization Act of 2015* (MACRA); technological advancements, including the widespread implementation of *electronic health records* (EHRs); and, the emergence of *big data* and data analytics. The *Centers for Medicare and Medicaid Services* (CMS): (1) advanced the movement from *volume-based* to *value-based* reimbursement, which built upon some of the bundled payment programs first developed under the ACA; (2) replaced the *sustainable growth rate* (SGR) formula for determining physician reimbursement with pre-determined payment updates through MACRA; and, (3) implemented multiple value-based measures and quality-centric programs under Medicare.¹² This shift allows providers, if properly managed, to capitalize on reimbursement incentives for providing high quality care to patients at a lower cost.¹³ PE firms are capitalizing on these new reimbursement models to make physician groups more profitable and to realize an improved return on their investment.

Technological advancements have benefited the healthcare industry in myriad ways, and PE firms have taken advantage to conquer one major shortcoming of PPMCs. PE firms are utilizing this newer technology to increase their return on investment through the use of EHRs. Over the past several years, EHRs have received governmental backing (beginning with billions of dollars in support under the *American Recovery & Reinvestment Act of 2009*),¹⁴ increasing significantly the number of physician practices utilizing this technology. In 2004, only 20 percent of physicians were using EHRs; as of 2015, approximately 90 percent of physicians had adopted EHRs.¹⁵ EHRs have improved practice efficiency by decreasing the wait time for laboratory results; enhancing data confidentiality; and, improving practice management through integrated scheduling systems.¹⁶

PE firms may also be more successful than PPMCs because there has been a significant development in data analytics since the 1990s.¹⁷ The healthcare industry has

been collecting and analyzing data to identify trends and, more importantly, model and manage physician behavior and compensation based on those trends.¹⁸ PE firms are making better use of benchmarking to analyze key performance data (both internally and compared to other industry participants) to increase their quality of care¹⁹ and to take advantage of enhanced reimbursement opportunities, such as, bundled payment schemes under the ACA and MACRA. Achieving these goals is particularly difficult for smaller practices with access to fewer financial and management resources, but PE firms may assist these physician groups by providing the financial and management capital to be able to “step-up”

to the next phase of growth and to facilitate the provider’s transition to *value-based reimbursement*.

Although the PE investment trend resembles that of PPMCs in the 1990s, it is likely that the outcome for PE firms will be quite different. Because the healthcare industry has seen: significant changes in reimbursement; technological advancements; and, the emergence of *big data* and data analytics, PE firms have the available tools to manage physician groups more efficiently. PE firms seem to have noted the PPMC failures of the 1990s and accounted for those shortcomings in their search for above average financial returns.²⁰

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Todd A. Zigrang, MBA, MHA, ASA, FACHE, is the President of **HEALTH CAPITAL CONSULTANTS (HCC)**, where he focuses on the areas of valuation and financial analysis for hospitals, physician practices, and other healthcare enterprises. Mr. Zigrang has over 20 years of experience providing valuation, financial, transaction and strategic advisory services nationwide in over 1,000 transactions and joint ventures. Mr. Zigrang is also considered an expert in the field of healthcare compensation for physicians, executives and other professionals.

Mr. Zigrang is the co-author of "[The Adviser's Guide to Healthcare – 2nd Edition](#)" [2015 – AICPA], numerous chapters in legal treatises and anthologies, and peer-reviewed and industry articles such as: *The Accountant's Business Manual* (AICPA); *Valuing Professional Practices and Licenses* (Aspen Publishers); *Valuation Strategies*; *Business Appraisal Practice*; and, *NACVA QuickRead*. In addition to his contributions as an author, Mr. Zigrang has served as faculty before professional and trade associations such as the American Society of Appraisers (ASA); American Health Lawyers Associate (AHLA); the American Bar Association (ABA); the National Association of Certified Valuators and Analysts (NACVA); Physician Hospitals of America (PHA); the Institute of Business Appraisers (IBA); the Healthcare Financial Management Association (HFMA); and, the CPA Leadership Institute.

Mr. Zigrang holds a Master of Science in Health Administration (MHA) and a Master of Business Administration (MBA) from the University of Missouri at Columbia. He is a Fellow of the American College of Healthcare Executives (FACHE) and holds the Accredited Senior Appraiser (ASA) designation from the American Society of Appraisers, where he has served as President of the St. Louis Chapter, and is current Chair of the ASA Healthcare Special Interest Group (HSIG).



John R. Chwarzinski, MSF, MAE, is Senior Vice President of **HEALTH CAPITAL CONSULTANTS (HCC)**. Mr. Chwarzinski's areas of expertise include advanced statistical analysis, econometric modeling, as well as, economic and financial analysis. Mr. Chwarzinski is the co-author of peer-reviewed and industry articles published in *Business Valuation Review* and *NACVA QuickRead*, and he has spoken before the Virginia Medical Group Management Association (VMGMA) and the Midwest Accountable Care Organization Expo. Mr. Chwarzinski holds a Master's Degree in Economics from the University of Missouri – St. Louis, as well as, a Master's Degree in Finance from the John M. Olin School of Business at Washington University in St. Louis. He is a member of the St. Louis Chapter of the American Society of Appraisers, as well as a candidate for the Accredited Senior Appraiser designation from the American Society of Appraisers.



Jessica L. Bailey-Wheaton, Esq., is Vice President and General Counsel of **HEALTH CAPITAL CONSULTANTS (HCC)**, where she conducts project management and consulting services related to the impact of both federal and state regulations on healthcare exempt organization transactions and provides research services necessary to support certified opinions of value related to the Fair Market Value and Commercial Reasonableness of transactions related to healthcare enterprises, assets, and services. Ms. Bailey-Wheaton is a member of the Missouri and Illinois Bars and holds a J.D., with a concentration in Health Law, from Saint Louis University School of Law, where she served as Fall Managing Editor for the *Journal of Health Law & Policy*.



Daniel J. Chen, MSF, is a Senior Financial Analyst at **HEALTH CAPITAL CONSULTANTS (HCC)**, where he develops fair market value and commercial reasonableness opinions related to healthcare enterprises, assets, and services. In addition, Mr. Chen prepares, reviews and analyzes forecasted and pro forma financial statements to determine the most probable future net economic benefit related to healthcare enterprises, assets, and services, and applies utilization demand and reimbursement trends to project professional medical revenue streams, as well as ancillary services and technical component (ASTC) revenue streams. Mr. Chen has a Master of Science in Finance from Washington University St. Louis.