Understanding Primary Care's Consolidation: Partnership Motivations & Trends

Provident Healthcare Partners

Introduction

Primary care's impact on the healthcare ecosystem is continuously evolving and the increasing importance of primary care services is no longer just recognized from an operational perspective, but also from a financial perspective, leading to increased consolidation activity within the industry. Looking at primary care's function historically, the main role of a provider was diagnosing a patient's medical condition and then passing the patient along to the appropriate specialist who would assume care services; resulting in minimal coordination among providers, lack of execution/structuring of treatment plans, and high-risk for re-hospitalizations. Therefore, the historic merger and acquisition environment within primary care involved health systems and larger strategic players[(1)], bidding to acquire providers in order to accumulate a larger patient population and drive referral streams to highly-reimbursed sub-specialists, rather than acquisitions serving as a catalyst to improve patient care. The current model for primary care is in a transitionary period and there has been an emergence of value-based reimbursement methodologies, subsequently placing primary care physicians as the "quarterback" of effective care. Since healthcare is very localized, this evolution is more apparent in certain geographies, however the Centers for Medicare and Medicaid Services anticipates 90% of Medicare payments will be tied to quality-based programs across the country by 2018. The push for this movement has squeezed out smaller medical groups who do not have the means to continue running their practices efficiently (IT improvements, billing and coding requirements, EHR systems, development of care coordination teams, etc.). This has spurred consolidation activity for traditional, typically smaller, primary care providers who seek a transaction as a means for pay stability and reducing the increasing burdens of running a practice. At the same time, organizations that are well-positioned to handle risk contracts are recognizing the opportunity to take advantage of a competitive buyer environment and the ability to further introduce emerging payment methodologies that reward physicians' ability to achieve the "triple-aim" (improved health, affordability, and patient experience through increased access and care coordination). In regard to the competitive buyer environment, it is rapidly progressing as payors and private equity firms[(2)], along with traditional partners in strategics and health systems, are considered viable partners for primary care organizations. Within the last 12 months there has been a significant increase in the number of primary care investments among each potential partner type.

(1) Provident defines strategic organizations as medical groups or medical group management companies, such as DaVita Healthcare Partners, Mednax, TeamHealth, etc., that look to acquire smaller groups with similar services to capture synergies.
(2) Private equity firms are investment groups that look to utilize capital to acquire an ownership stake in a company in order to expand growth initiatives and improve the equity value of the group over a three to seven-year time period.

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Health Systems

Rationale: Similar to historical trends, health systems are actively acquiring primary care groups to increase patient volume, provide referral avenues to sub-specialty services, and improve the health systems ability to negotiate contracts with third parties. In the fee for service environment, primary care services, without taking into account sub-specialty or ancillary revenue, typically operate at a loss for health systems. As the structure of provider-system relationships change (i.e. development of ACOs), health systems are motivated to acquire primary care providers so they may increase care coordination, grow covered lives, and manage global expenditures attributed to their patients. On average, a health system with approximately 300 affiliated primary care providers can anticipate total medical expenditures under management to range between $1.8 to $2.1 billion(3). Control of market share is another major motivation of a health system's investment within a local primary care group, as potential mergers among insurers pose a significant risk to a system's leverage in negotiation of contracted rates. Provident expects health systems to remain a strong potential partnership avenue for primary care providers regardless of the changing reimbursement environment.

Recent Landmark Deal: May 2016 – Wake Forest Baptist Medical Center's acquisition of Cornerstone Healthcare, a 275 provider multispecialty practice in North Carolina.

(3) The Chartis Group, "The Revolution In Primary Care"

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Payors

Rationale: Prior to 2015, payors (primarily Anthem, Cigna, Humana, Kaiser Permanente, and UnitedHealth Group) weren't nearly as active in acquiring medical groups as public strategic groups and health systems. However, payors are pivoting strategic goals in an effort to acquire primary care groups, as reimbursement trends shift and the managed care environment continues to develop. Contrary to motivations among other acquirers, payors are particularly interested in providers' ability to reduce costs through reduction in utilization of emergency care settings, eliminating redundancies in care coordination, and re-defining referral patterns to improve successes in the managed care market. Humana and UnitedHealth Group have been the most active payors with specific focus on managed care populations, which is intuitive given they are the two largest payors in the Medicare Advantage marketplace. From a simplistic standpoint, payors with large managed care populations are willing to offer a premium price to medical groups in order to increase visibility in care, invest in data analytics, improve EHR capabilities, and capitalize on operational synergies, so they can capture a larger profit on per member per month capitated arrangements. Conflicting with common assumption, a partnership with a payor wouldn't inhibit a medical group's ability to negotiate reimbursement contracts with other insurers, and in fact, can greatly improve reimbursement rates among all contracts due to the way payor's investments are independently operated from the insurance divisions. In terms of deal structures, payors are creatively orchestrating ways to entice physicians in addition to offering large upfront cash consideration in a deal process. Mirroring the structure typically seen with private equity groups, payors are offering physician shareholders the option to retain ownership in the organization post-closing and negotiate a buy-out clause years after the initial investment. The benefit to the shareholder base is the appreciation of ownership value over the holding period of their equity position, with an increased payment on their ownership value at the end of the timeline. Payors employ this strategy to solidify a true partnership and entice the physicians to surpass historic productivity levels. As the managed care environment continues to evolve, payors are expected to increase their pace and frequency of acquisitions for primary care organizations.

Recent Landmark Deal: December 2015 – Optum's (subsidiary of UnitedHealth Group) acquisition of ProHealth Physicians, a 370 physician multispecialty group in Connecticut.

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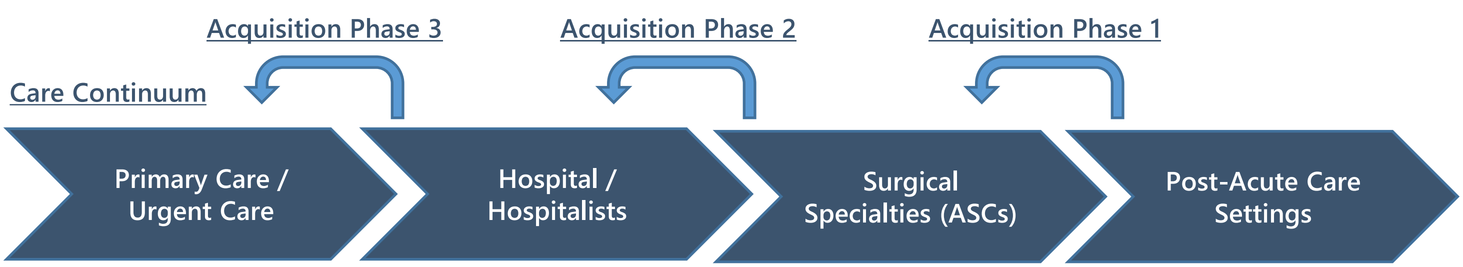
Strategic Companies

Rationale: Large, mostly publicly traded, strategic groups are also increasing investment activity within primary care organizations in an effort to enhance service offerings and improve visibility throughout all care points. DaVita's acquisition of Healthcare Partners in 2012, a portfolio company of private equity firm Summit Partners at the time of the deal, was one of the first landmark acquisitions among strategic organizations in an effort to integrate all care points. A dialysis provider acquiring an organization like Healthcare Partners was significant, particularly because Healthcare Partners was also one of the largest medical group operators to have a majority of its payments arranged in a capitated structure. Larger strategic competitors have been slower to adopt such a strategy, but there have been some recent significant developments: AmSurg's announced merger with Envision Healthcare, Envision Healthcare's acquisition of Questcare, Brighton Health Group's expansion of their subsidiary Privia Health, TeamHealth's acquisition of IPC Healthcare.

In the past 5 years, strategic groups have been bolstering their participation in the post-acute care setting in addition to acquiring highly reimbursed surgical specialties. Essentially the strategic community has been integrating in a way that seems backwards to the traditional care continuum (see exhibit below).

Provident anticipates the buyer community to continue to follow DaVita's lead and begin demonstrating themselves as a more active participant in merger and acquisition activity among primary care providers. Strategic groups will soon be competing with other potential acquirers to develop hubs around different markets of the country. Additionally, as patients continue to expect increased quality of care and a more comprehensive "one-stop-shop" services, strategic organizations will have to adjust and begin developing additional de-novo service lines or acquire providers outside their core competencies.



Recent Landmark Deal: March 2016 – DaVita Healthcare Partners completed a $385 million acquisition of the Everett Clinic, a 20 location multispecialty group serving 315,000 patients.

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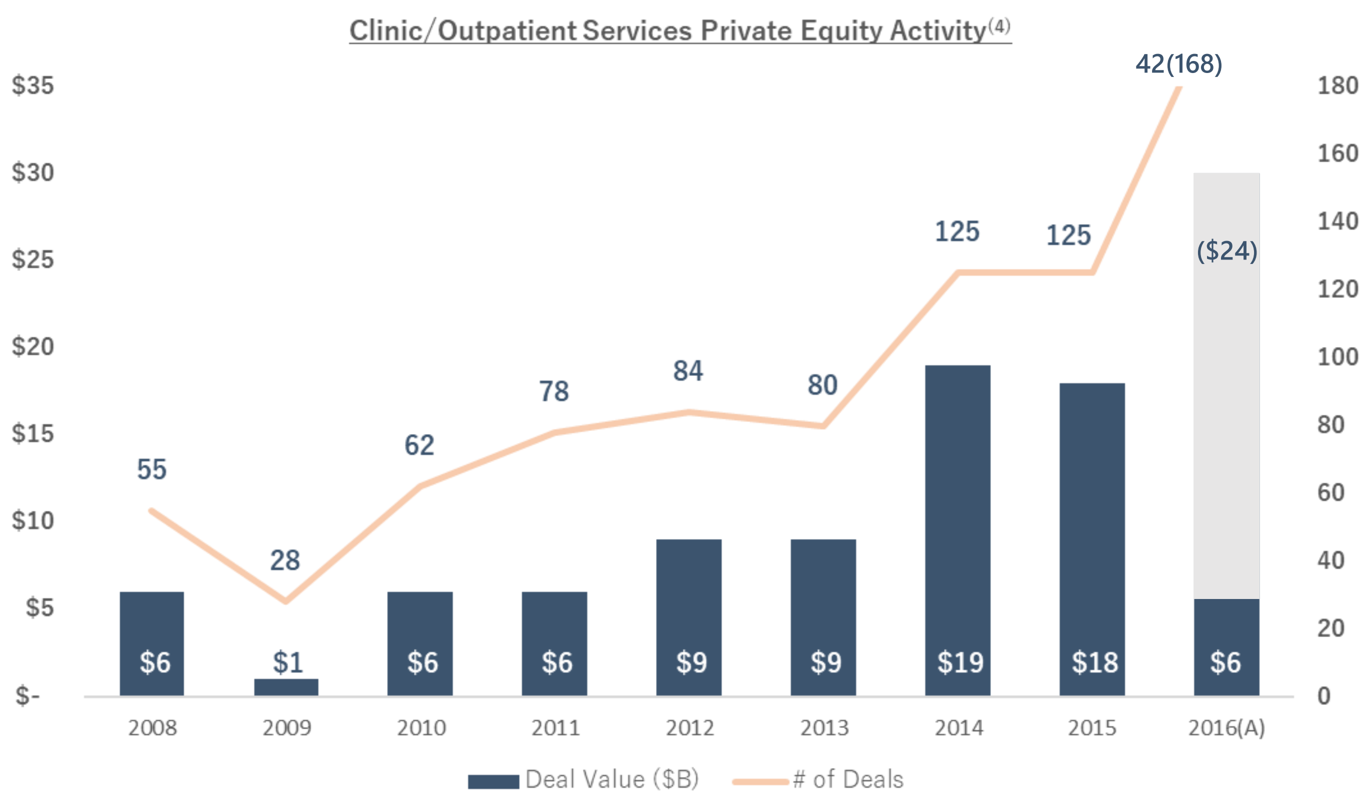
Private Equity

Rationale: Private equity refers to a large community of investors and funds that seek to make direct equity investments into privately-owned companies. After the recession, private equity funds looked to invest within industries that had safe assets and posed less of a risk to variability in the broader markets. Healthcare has emerged as a leading benefactor. As a result, many healthcare-focused private equity firms began forming, and the investor base increased their knowledge on the complex healthcare industry. Particularly within the last 2 years, private equity investments within physician services have picked up in an increasingly rapid pace (see exhibit below).

Private equity groups are looking to acquire geographically dominant primary care providers that will serve as platform investment opportunities (organizations that have a strong infrastructure and the ability to grow rapidly internally and externally). Private equity firms are motivated to acquire primary care groups that generate strong cash flows and have shown historic profitability, due to the fact managers of funds have a fiduciary duty to their fund sponsors to generate a healthy return on an investment. Since primary care practices are viewed as cost savers rather than revenue producers, private equity firms will typically look for primary care groups providing ancillary services that have a direct effect on the bottom line – dieticians, lab, imaging, pharmacy, etc.



*2016(A) includes data through 3/31/2016 and annualized 2016 figures in parenthesis

(4) Pitchbook

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Private Equity

Rationale: One caveat to this notion is that private equity firms are very attuned to the managed care environment and recognize the potential for significant gains in the way risk-contracts are structured. If they recognize an opportunity that isn't as strong financially, but has the tools in place operationally to adopt risk, they will have a significant interest in the opportunity. Through the use of capital and expertise, private equity groups are able to easily execute add-on acquisitions of smaller providers, acquire or create sub-specialist divisions, invest within data analytics and health population management tools, supplement the management team to assist in expansion, utilize industry relationships to improve reimbursement rates, etc. So they are capable of achieving these objectives, the private equity community seeks management teams with an entrepreneurial mindset and the ability to jointly execute strategic decisions in a timely manner. As explained previously, private equity groups acquire an ownership position in the organization through an upfront cash payment and require the shareholders of the company to retain an equity position that can be financially realized when the private equity firm exits the opportunity three to seven years later. In the current environment, low capital borrowing costs allow private equity organizations to increase the amount of debt used to fund investment opportunities and thus cause an appreciation on the valuation for primary care providers. The investment community, like strategics and payors, are interested in attempting to get ahead of the curve in the primary care space by investing within groups that truly demonstrate higher quality care and lower costs for services. Future success of these portfolio operations will be determined by the ability to integrate smaller medical groups and achieve best practices.

Recent Landmark Deal: Summit Partners completed a $250 million minority investment within DuPage Medical Group's managed services organization.

Concluding Thoughts

Primary care providers that have proven a successful model will continue to generate strong interest in the market. In the current environment, valuations for these groups are exceeding historical levels due to the increased competition and scarcity of true investable assets. Therefore, primary care providers have increased their leverage in a deal process and are able to find advantageous partnerships among a diverse group of buyers. Provident predicts the primary care sector will undergo further consolidation as the broader healthcare industry requires effective and efficient services.

To the extent that it is of interest, members of the Provident team would be happy to elaborate on any of these trends & provide specific insights on particular healthcare niches, specialties, and industry verticals. Please feel free to call (617) 742-9800 for additional information.

Provident

Provident is the leading investment banking firm specializing in merger and acquisition advisory, strategic planning, and capital formation for middle-market and emerging growth healthcare companies.

The firm has a vast network of senior industry relationships, a thorough knowledge of market sectors and specialties, and unsurpassed experience and insight into the investment banking process.

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