

Opportunities In Health Care Provider Transactions

Law360, New York (July 27, 2010) -- Much of the discussion of the likely impact that the Patient Protection and Affordable Care Act will have on providers has focused on the negative: from Medicare and Medicaid cuts to medical loss ratio limitations. But whenever there is change, there also is opportunity. The new law will accelerate consolidation among provider organizations, creating business opportunities for providers and investors (including private equity firms). Hospital systems, medical groups and physician networks all have an opportunity to benefit from mergers, acquisitions, joint ventures and clinical integration initiatives spurred by health care reform.

Huge and Fragmented Market

The market is huge. The \$2.4 trillion spent on health care in the United States represents more than 17 percent of national gross domestic product. Demographics also support enormous future market growth: In 2000, Medicare provided coverage to approximately 43 million seniors, but by 2030, the year the last baby boomers reach Medicare eligibility, approximately 78 million people will be covered. The PPACA adds another accelerator. By 2014, with limited exceptions, all U.S. citizens must purchase health benefit coverage or pay a penalty. That means 32 million more Americans will have health insurance, with the increased spending on health services that this affords.

The provider infrastructure to serve this enormous market is fragmented. There are more than 820,000 hospitals, physician offices, clinics, nursing homes and social service providers in the United States. The most consolidated of the provider market subsectors is the hospital industry — and even that is only consolidated to a limited extent. With more than 5,500 hospitals nationally, the average operator owns only 8.8 hospitals. More than 200,000 physician offices operate in the U.S. with combined annual revenue of more than \$280 billion. About 75 percent of all physician offices are small, with fewer than 10 employees. The combination of this fragmentation with growing pressure to control costs and respond to expanding demand will compel further provider consolidation.

PPACA Incentives

One of the most critical things that the PPACA did to spur consolidation transactions was to provide some certainty and reduce the fear of the unknown with respect to investments in health care services. It also made clear that cost efficiencies will be rewarded and that subpar management will be punished. This can be seen in the broad recurring themes of the PPACA: cost reduction (through, among other things, the creation of so-called accountable care organizations that receive and distribute shared payment savings), value-based pricing (through incentives for achieving quality benchmarks in treating high-cost and/or chronic conditions) and increased accountability for compliance with quality and safety measures.

The combination of market forces and legislated incentives means that mergers, acquisitions and other consolidation activity will continue to increase significantly. Nonprofit health systems will evaluate their

operations, plan strategic acquisitions and may offload underperforming or noncore service lines and facilities, all for the purpose of enhancing efficiencies, reducing costs, eliminating duplicative services and improving quality. For-profit enterprises (particularly, those backed by private equity firms) also are increasingly interested in the U.S. health care industry, recognizing its recession-proof characteristics and potential for growth. The following are some categories of transactions and subsectors of the industry that are likely to see increased activity and interest by both nonprofit health systems and private investors:

- Physician Practices

By creating new payment incentives for cost and quality that will be easier for larger organizations to meet, the PPACA will make it more difficult for physicians to retain their fragmented business model. Earning these incentives will require substantial investments in information technology and other infrastructure.

The reform legislation also places great emphasis on the need to expand the number of primary care physicians and physician assistants in order to meet the critical shortages that aging baby boomers will create. Employment by, and other types of affiliations with, health systems and practice management companies may be the best way for many physicians to respond to this changing environment.

- HAGPs: Hospital-Affiliated Group Practices

There are a variety of models in which physicians and hospitals can establish closer working relationships: direct employment, joint ventures or participation in hospital-sponsored contracting networks. These latter arrangements come under such familiar acronyms as physician-hospital organizations, or PHOs; management service organizations, or MSOs; and independent practice associations, or IPAs.

However, from a transactional standpoint, one of the most innovative — and, in the post-reform era, attractive — transactions is the alignment model. In it, an affiliate of the hospital (or HAPG) purchases and/or leases an independent physician group's assets, leaving the physicians' employment agreements behind. While the hospital affiliate operates the practice, the physicians' professional corporation continues to employ the physicians, providing their services to the HAPG on a long-term, exclusive basis pursuant to a professional services agreement.

The HAPG model is significantly more integrated with the hospital than PHO, MSO or IPA alternatives. It has the advantage of allowing the hospital to make IT and other capital investments in its HAPG (which is usually a tax-exempt, nonstock corporation) and creates an opportunity for generating additional technical revenue by turning the HAPG practice sites into hospital satellite clinics.

The physicians' PC also benefits by being able to sell or lease tangible assets to the hospital while retaining its control over the physicians', and sometimes the support staff's, salary and benefits. The HAPG/PC arrangements could be unwound by termination of the professional service agreement (and the repurchase on a fair-market value basis of any tangible assets sold to the HAPG by the PC) and the resumption of provider status by the PC.

- Nonprofit Hospitals

HAPG/PC arrangements and other forms of hospital/hospital and hospital/physician consolidations will mean increased competition for those nonprofit community hospitals struggling to remain independent and keep up with increasing capital demands. The bond markets remain closed to lower-rated credits, and these hospitals have limited access to commercial credit supports or bond insurance that would improve their credit profile.

Moreover, the PPACA may increase the burden on tax-exempt hospitals by requiring them to identify and meet community health needs. As a result, many tax-exempt providers will seek affiliations with larger, financially

stronger nonprofit systems. For-profit investors also have better access to capital than these free-standing hospitals. For struggling tax-exempt community hospitals, all of these considerations make it more likely that they will consider affiliation or sale alternatives.

- For-Profit Hospital Systems

For-profit hospitals will continue to be a primary area for growth and consolidation. Knowledgeable investors, particularly private equity firms, see market opportunities in this subsector. Vanguard Health Systems Inc. (owned primarily by Blackstone Group LP) is purchasing eight hospitals from nonprofit Detroit Medical Center. Cerberus Capital Management LP is acquiring the six Caritas Christi hospitals in Massachusetts, and Warburg Pincus LLC has made a significant capital commitment to a new hospital portfolio company, RegionalCare. One reason for the attractiveness of hospital investments is that the threat from physician specialty hospitals has been greatly reduced, thereby protecting the acute care hospitals' lucrative specialty services, such as cardiovascular care.

- Physician-Owned Hospitals

The PPACA greatly restricted the whole-hospital exception to the Stark Law, preventing new physician-owned specialty hospitals from being created after this year and restricting grandfathered hospitals from expanding their operations. This puts at risk millions of dollars of capital invested in facilities under development. Physicians and other investors in these facilities will continue to scramble to gain licensure and Medicare certification, and in some cases to increase bed and surgical capacity, in anticipation of the permanent moratorium on development and expansion. This provides opportunities for investors with the financial resources to bring these deals to closure. In addition, physician investors may want to consider the "soft landing" of selling to a hospital partner or other consolidator.

- ASCs

Physicians and hospitals are entering into joint venture arrangements that involve ambulatory surgery centers, or ASCs. ASCs avoided the PPACA's moratorium on physician ownership and remain a useful vehicle for alignment of the clinical and financial interests of hospitals and their physicians. However, hospitals will demand, and often receive, majority equity positions in these deals so the venture can take advantage of their managed care contracts.

In addition to these ventures, there have been many acquisitions of physician-owned ASCs by hospitals. These facilities are often converted to hospital outpatient surgery departments to take advantage of higher hospital outpatient department rates, but with a management contract allowing the former physician owners to continue to manage the ASC.

Conclusion

Our analysis of health care reform's likely impact on the provider sector suggests that there are, and will continue to be, significant transactional opportunities for larger providers and investors. Health care is one of the largest- and fastest-growing business sectors in the United States. But it is also among the most heavily regulated. Organizations that understand how health care reform will affect investment — both now, and as new rules take effect in the future — will have ample opportunities to make informed, smart and profitable deals for years to come.

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