

Is It Time to Sell?

Randy Bauman*

Hospitals are purchasing physician practices at a rate not seen since the 1990s, and the action is widespread. Doctors all over the country—in practices large and small, successful and struggling—are jumping at the chance to leave the complexity, business risks, and stagnant economics of private practice for the perceived security of a larger organization. This article examines the trend and offers suggestions for physicians to determine whether or not selling is the right move.

Key words: Hospital; purchase; practice; partnering; merger; valuation; compensation; negotiation.

WHY ARE PHYSICIANS SELLING?

Running even the smallest practice—not to mention a large one—has become increasingly complex. Navigating the never-ending stream of regulations coupled with the risks associated with practice in today's economic environment has many physicians ready to give up.

The managed care battle has been fought, and solo and small physician groups lost. They have no leverage in negotiating payment rates, and Medicare operates under a perennial threat of double-digit rate cuts. Many areas of the country are now dominated by very few (sometimes just two) commercial third-party payors, which further diminishes physicians' ability to negotiate reasonable rates for their services.

All of this, along with another looming healthcare reform debate, makes giving up autonomy in exchange for the security of a large organization look pretty good.

Recruiting and retaining physicians is also becoming a big issue. Many areas of the country have become unattractive to lifestyle-focused Gen-X physicians due to the high cost of living, exorbitant malpractice rates, a poor payor mix, or dismal third-party reimbursement rates. Younger physicians increasingly have little interest in working long hours and often lack interest in the business side of medicine.

Physician starting salaries make the picture even bleaker. Shortages in some specialties, as well as the factors

described above, are making the economics of recruiting untenable. Many groups face having to offer starting salaries for newly trained physicians in excess of what senior partners earn. Absent significant changes in practice economics, this situation is making private practices unsustainable for many.

HOSPITALS TO THE RESCUE?

The relative security of being part of a larger organization with the deep pockets to sustain physicians through these times seems attractive. Physicians are approaching hospitals in droves; and hospitals, in many markets, are aggressively pursuing physicians as they seek to maintain or expand their market share.

The current trend is not, however, a repeat of the 1990s. The 90s move toward integration was driven by two main factors: pending healthcare reform and physician practice management companies. Healthcare reform failed, and most practice management companies followed suit a few years later. Hospitals were left with huge investments in practices and scores of long-term employment contracts—often with salary guarantees.

The biggest mistake physicians make in selling is that they jump in without adequate preparation.

This time, hospitals are approaching the business of acquiring and managing physician practices much differently.

*President, Delta Health Care, 783 Old Hickory Blvd., Brentwood, TN 37027; phone: 800-467-3310, x23; fax: 615-301-4058; e-mail: rb@deltahealthcare.com. Copyright © 2008 by Greenbranch Publishing LLC.

GETTING READY

If you think the time is right to approach your local hospital or if it has approached you, take some time to assess your situation. The biggest mistake physicians make in selling is that they jump in without adequate preparation. Planning ahead to make your business as attractive and as valuable as possible is a critical first step, starting with an honest evaluation of where you are.

The most basic aspect of this assessment is your income, because that's the common thread that runs throughout the process. Your income relative to the national average is a driving factor behind the value of your practice. The compensation package you are offered by the hospital will likely be based on your current income. The hospital's ability to successfully operate your practice and manage its finances will also be driven by your income.

If you haven't already done so, find out how your income compares with that of your peers. The Medical Group Management Association (www.mgma.com) publishes annual surveys of physician income by specialty, group size, geographic location, and years in practice. Any reputable consulting or CPA firm specializing in medical practice management will have access to this information.

If your income is below the median for your specialty, you need to understand why. Sometimes the answer is obvious. If it's not, seek outside advice to help you figure it out.

Physicians generally default to what I call the "overhead excuse," which holds that *overhead is too high and is the reason for everything bad about my practice*. Is it really? Don't fall into the trap of looking at overhead as a percent of revenue without considering that revenue is half of that equation. Refer to MGMA data to find out how your productivity compares with your peers. Overhead percent magically goes down when revenue goes up, even though actual dollar overhead doesn't change. Below-average revenue can be the result of many things: low production, poor collections, bad coding, poor payor mix, or low reimbursement rates. Often it is a combination of these factors.

A singular focus on overhead often causes physicians to overlook potential sources of revenue because "overhead is already too high." For example, mid-level provider salaries are on the rise as demand for those services increases. But in many specialties, these professionals generate a gross profit margin (that is, the percentage of direct incremental revenue in excess of direct cost) equal to or in excess of the gross profit margin of a physician. Yet many practices still resist the opportunity to enhance their incomes using mid-level providers out of fear that their overhead will go up. Mid-level providers don't expect to be a partner in the practice, and their gross profit bolsters physician income. This, in turn, vastly enhances the practice in the eyes of a potential buyer.

Pay close attention to coding, billing, and collections to maximize revenue. What is your collection percentage trend (collections divided by gross charges) over the past few years? Is it going up or down? Understanding this number will go a long way toward demonstrating to a potential hospital purchaser that you are on top of your practice's economics.

Make sure your practice is providing the full range of ancillary services for your specialty. I still see internal medicine groups without basic lab facilities and cardiology groups without nuclear capabilities. These services add significantly to the bottom line, and their absence may be the primary reason your income lags behind your peers in national surveys.

Look for ways to increase productivity through better utilization of mid-level providers, disease management clinics, and extended office hours. Showing a positive revenue trend over a two- to three-year period will make your practice more attractive and support a higher value.

When preparing your practice for sale, don't fall into the trap of thinking you'll somehow be more attractive to a hospital suitor if you invest in state-of-the-art technology. Technology investments have some of the shortest useful lives of any assets you will purchase.

Finally, in spite of the warnings above, don't ignore overhead. Make sure your staffing and salary levels are appropriate, review employee benefits, and look at what you're spending for drugs and supplies. A practice attitude that "company money" can be spent frivolously will result in bloated overhead.

PUT A HOLD ON TECHNOLOGY

When preparing your practice for sale, don't fall into the trap of thinking you'll somehow be more attractive to a hospital suitor if you invest in state-of-the-art technology. Technology investments have some of the shortest useful lives of any assets you will purchase. A five-year-old computer is ancient, and software depreciates at a rapid rate.

Don't invest in an expensive electronic medical record (EMR) system or new practice management software if you are planning to sell. Transitioning to a new EMR system cuts into productivity, at least initially. Changing your billing system always results in short-term cash flow reductions. The hospital you affiliate with most likely won't use the same hardware and software anyway, so you'll likely have another learning curve post-acquisition. Instead, concentrate on positive revenue trends and generating above-average incomes. Leave the bells-and-whistle stuff for the hospital to deal with later.

Alternatives to Selling

Join a management services organization (MSO). Many hospitals are revisiting the idea of providing management services to physician practices through an MSO. With an MSO, the hospital creates a practice management infrastructure including billing and collections, human resources, and other practice management services. The MSO typically supports the hospital's employed physicians and also offers services on a fee-basis to independent practices. A hospital can't legally provide these services for less than fair market value. But this type of arrangement can result in a higher level of practice management expertise, often for less cost, while allowing you to retain your autonomy.

Form or join a contracting organization. The big weakness of an MSO is that it cannot collectively negotiate payor contracts for independent groups. Current efforts in joint payor contract negotiation go back to the physician-hospital organization (PHO) model and the independent physician association (IPA) model, both of which also proliferated in the 1990s without much success. Recently we have seen renewed interest in an idea sanctioned by the Federal Trade Commission and Department of Justice in their 1996 Statements of Health Care Antitrust Enforcement Policy—Integrated Physician Network Joint Ventures.

Dubbed by many at the time as a “super-IPA,” these organizations allow physicians to retain their independence while negotiating collectively with payors by clinically and/or financially integrating. Full compliance with the 1996 policy governing super-IPAs allows physician networks to jointly market member physician services and contract with payors on an ex-

clusive single-signature basis without being challenged on antitrust grounds.

If it sounds too good to be true, it is because these regulations are complex and compliance is critical. Experienced outside consultants and legal counsel are needed from the outset to ensure you don't end up with a costly FTC investigation instead of a viable network.

When the statement of policy was published back in 1996, these types of organizations were widely viewed as too costly and complex to be a viable alternative to practice mergers, which were all the rage at the time.

Today, however, the drive for physicians to install electronic medical records systems may make many of the clinical and/or financial integration requirements in the statement of policy easier and less costly to attain. In addition, advances in software provide more readily available solutions for things like disease management protocols, clinical pathways, evidence-based medicine, and quality measurements.

Super IPAs can be effective if physicians are willing to make the investment. If not, the deep pockets of a hospital sponsor could make these organizations more attractive.

Merge with like-minded colleagues. This may mean joining an existing group, inviting other physicians to merge into your group, or forming a new entity. Merger activity is still being undertaken in parts of the country. If merging seems like a reasonable option, read “Better Off Alone? Why Physicians Don't Merge” in the September/October 2007 issue of this publication. It highlights many of the benefits and pitfalls of joining forces with other doctors.

If you do purchase other major equipment within a year or two of selling, be sure to keep good records to justify the value and be sure these items are taken into account when your practice is being priced.

CHOOSING A POTENTIAL PARTNER

Take a close look at the business viability of the hospital you are considering joining. Ask for current financial statements, and, if you don't understand them, work with your accountant to decipher the institution's financial picture. If the hospital is independent, consider the likelihood of it being acquired or merging in the foreseeable future. Hospitals operate on tiny margins, and while many still have deep pockets in the form of endowments, the trend is toward being part of larger systems.

As noted above, hospitals learned a lot from employing physicians in the 1990s, but some didn't embody the lessons. Running a hospital department is different

than running a physician practice. Make sure the hospital you cozy up to is committed to making the necessary investment in physician practice management infrastructure and expertise.

Make sure that the hospital you cozy up to is committed to making the necessary investment in physician practice management infrastructure and expertise.

Ask a lot of questions, and be leery if you don't get straight answers. What is the hospital's business plan, and how do physician acquisition and employment fit into the plan? How many physicians does it currently employ? Talk to those physicians who have already gone through the acquisition process. How was it handled? Are they happy? Does the hospital know what it is doing? Has it been willing to work to resolve problems and issues? How many

Do's and Don'ts

- Don't** get your attorney involved too early. Attorneys like to negotiate complex and unnecessary confidentiality agreements upfront that result in huge legal bills, take forever to execute, and often poison the relationship with your potential hospital partner before you even get started.
- Don't** be unrealistic about the value of your practice. The value of goodwill (if any) is in the earnings stream of the practice, and that is determined by your salary expectations after the sale. It doesn't matter what you think your practice is worth. It's the valuation that matters.
- Don't** threaten to redirect referrals if things don't go your way. This could be construed as soliciting an illegal inducement. Any hospital CEO worth his or her salt will walk away at this suggestion, and this tactic could hurt your valued reputation.
- Do** take the time to get your practice in order, show a positive revenue and earnings trend, and provide complete and accurate data.
- Do** talk to other physicians who have been through what you are contemplating.
- Do** be very clear at the outset about your needs and desires. Negotiate in good faith. Be honest about your intentions. There are no secrets in medical communities.
- Do** ask questions about the hospital's plans for your practice post-acquisition, including how it will handle staffing and billing, who will make decisions about buying new equipment, how you will factor into the organization's overall strategic plan, and how often compensation formulas will be updated.
- Do** negotiate on your base salary and incentive compensation. Be sure you understand how your incentive compensation will be calculated. Make sure your incentive compensation is largely based on things you can control.
- Do** hire an attorney experienced in these types of transactions, and make sure you have your attorney review any agreements before you sign them.

practices does it plan to acquire? What are its plans for managing employed physicians? Does it currently have practice management expertise, or what kind of background is it looking for to fill those positions? How does it do or plan to do billing? Who will do managed care contracting? And be sure to ask about a hospital's primary care strategy, which is key if it is acquiring specialty practices.

A hospital should take a healthy, proactive approach to practice acquisition. Ask about its reasons for buying practices. The answers you are looking for include: long-term strategic growth, an ability to better serve patients, increased

leverage in negotiation with third-party payors, and a desire to help its medical staff members survive and thrive.

Don't be afraid to ask questions specific to your situation. Will you have a say in the hiring and termination of staff? What about work rules and staff bonuses? Will your office be moved or consolidated with another office? While some details will have to be worked out in the future, "let's figure that out later" as the answer to most of your questions should be a red flag as to how well the hospital has thought through its strategy.

Consider your past relationships with the hospital. Is administration stable and trusted? Is the hospital part of a larger system that has the financial resources necessary to ensure long-term stability? Do you look up to members of the management team as good leaders and role models? Are the individuals in charge experienced and competent? Are they honest and forthright in their business dealings? A key consideration is how you would feel about answering to them. If you've had conflicts with administration in the past you'll have to decide if you can put those behind you and work in close partnership moving forward.

A hospital should take a healthy, proactive approach to practice acquisition. Ask about its reasons for buying practices.

Remember, too, that even if you have a rosy relationship with the hospital CEO and others, turnover at the executive level in hospitals tends to be fairly active. There is no guarantee that the people you deal with today will be in their positions a few years from now. Given that possibility, make sure all points of your agreement are in writing. What he or she said way back when matters little if a whole new team takes over the executive suite.

Ask yourself what the hospital has to offer that will improve the quality of your professional and/or personal life. Then consider if what it is offering is enough for you to give up your autonomy. An attractive buyout price, a solid compensation and benefit package, fewer administrative hassles, and more time for direct patient care might align quite well with your long-term career values and goals.

WHAT IS MY PRACTICE WORTH?

Once both parties are ready to pursue further discussions, be prepared to bare your fiscal soul. The hospital will generally engage an independent valuation firm (chosen and paid for by the hospital) to arrive at a fair market value for your practice. You will be asked to share extensive financial and operating data. The more you can deliver the better. Incomplete documentation tends to reduce the value of a practice because, absent documentation, the valuation firm is going to lean toward the most conservative assumptions.

What can a hospital provide?

- Professional practice management
- Negotiation with third-party payors
- Attractive benefit packages for staff
- Potentially lower malpractice rates
- Retirement plan
- Health insurance for you and your family
- Disability insurance
- Integrated electronic medical records
- Sophisticated billing and collections systems

Physicians tend to think their practices are worth more than they actually are. The first argument is usually how much revenue the practice generates for the hospital by admitting patients and making referrals for diagnostic testing and therapeutic care. This is an easy one to set aside as it's illegal for a hospital to factor this in, and no reputable hospital would do so.

The second argument a physician will make for placing a high value on his or her practice is related to goodwill—returning patients, the reputation of the doctors, an established referral base, and even the name and phone number of the practice. While this goodwill does exist, the ultimate value of any business lies in its future earnings stream. In a medical practice, that earnings stream is paid out to the owner of the practice in the form of salary and bonuses.

So if you want to maintain your current income *and* get a big price for your practice, prepare to be disappointed. Continuing 100% of your historical earnings post-acquisition will leave no future earnings for the value to be based upon, in which case there will be no value beyond the value of your furniture and equipment.

If you want to make an argument for goodwill, be prepared to show that your ability to earn is well above the national average for your specialty, that your practice has a solid history of revenue growth, and that you're willing to put part of your historical compensation at risk based on the future performance of the practice.

Even if your practice does have a goodwill value, many hospitals, having been burned with huge practice buyouts in the 90s, simply have a policy against paying for goodwill.

Valuation components (other than goodwill) include: (1) furniture and equipment; (2) accounts receivable; and (3) inventory and supplies.

Furniture and equipment will be valued less than your original cost but probably more than the current tax book value. A good rule of thumb is to take your original cost, less accumulated depreciation (this amount is called net book value) and then add back 50% of the accumulated depreciation. Your CPA can help you with this calculation to get an estimate.

Accounts receivable (A/R) represents work you've already done and is usually not part of the transaction. If a hospital does purchase A/R, it will do so at a discounted rate and then attempt to collect (and keep) what it can post-sale. In most instances, it's better for both parties for the physician group to keep the outstanding A/R and distribute whatever is collected to the physicians as compensation. Usually a hospital will allow your billing staff, who become the hospital's employees after the sale, to spend some time each week for a few months collecting your A/R.

Inventory and supplies are generally not a significant component of the value. If you have an extensive inventory of drugs and supplies, it will be to your benefit to provide copies of recent invoices to aid the hospital in assigning a fair value for these items.

NEGOTIATING

The value of a practice is generally not up for a lot of negotiation. In fact, many hospitals won't even reveal valuation reports to the physicians involved because it reduces their ability to negotiate. You should, however, have a clear understanding of the assumptions the hospital uses to arrive at their figures.

As you enter into discussions and negotiations, be aware of what you bring to the table. Understand the hospital's strategies and plans and how you fit into that plan. If you've properly prepared for selling and recognize the hospital's motivation, you can make a good case that the robustness of your business makes you an attractive candidate to fit into its strategy.

Physicians often focus too much on the value of their practice. If you plan to continue working for a few years, your compensation is much more important. When hospitals bought practices in the 90s, they offered physicians large, long-term guaranteed base salaries. Then they watched physician productivity plummet by an average of 20% to 25%. Hospitals learned their lesson, so don't expect the security of a long-term guaranteed contract. Expect a base salary—typically a percent of prior year's earnings—guaranteed for one or two years and tied to your meeting productivity standards.

You can always stay the course, but doing so may require that you take a hard look at how you manage your practice and alleviate some of the pain points that made you think about selling in the first place.

Beyond this base salary, look for an incentive compensation plan. How such a plan is structured varies widely from deal to deal and depends, in part, on whether the hospital is for-profit or not-for-profit. For-profit hospitals have an easier time paying incentive compensation

based on actual profitability, and it's more likely that they will factor in revenue derived from ancillary services. Not-for-profit hospitals, because they technically don't have profits, base incentive compensation on more complex formulas that are often based on RVU calculations and "enterprise goals." These incentive plans can be complex, so make sure you understand what is expected of you and that your bonus isn't based on things you cannot control, such as reimbursement rates, overhead, or the hospital's ability to bill and collect.

ALTERNATIVES TO SELLING

You may endure lengthy negotiations only to decide that selling isn't the right thing for you or your group. You can always stay the course, but doing so may require that you take a hard look at how you manage your practice and alleviate some of the pain points that made you think about selling in the first place. This may include taking on additional risk, investing in ancillary services or technology, recruiting new physician associates or mid-level practitioners to increase productivity, hiring a highly qualified

(and highly paid) professional administrator, or becoming more creative and proactive about promoting your practice. If you go this route, consider engaging an outside consultant to work with your group on developing a comprehensive strategic plan. (See the sidebar in this article for more information on alternatives to selling.)

So is it time to sell? The trend is well-established and seems irreversible. In many parts of the country, hospital acquisition of physician practices has reached tsunami proportions. Whether the result will be better this time around remains to be seen. Approach the process proactively instead of reactively, and take the time to prepare. This is a huge decision, not one that you make on a whim or after a couple of bad months. Selling your practice may seem like your best option, but it certainly isn't the only option. It is one that certainly shouldn't be undertaken lightly. ■

Editor's note: Look for Randy Bauman's new book, Time to Sell? Guide to Selling a Physician Practice: Value, Options, Alternatives, coming in October 2008 from Greenbranch Publishing (www.mpmnetwork.com).