

Why Hospitals Are Buying Physician Practices . . . Again

by Randy Bauman

Remember the Internet business craze of the late 90s? Anyone with \$35 in their pocket could register a domain and launch a company. Anything with dot-com after the name had venture capitalists lining up to invest. We all know the end of that story. But think of the companies that survived: Amazon, eBay, Google. By all accounts, they're doing well and Internet entrepreneurs now look at those business models hoping to learn a thing or two.

And so it was with hospitals buying medical practices. This trend revved up full force in the early to mid 90s and everyone jumped on the bandwagon. It was a feeding frenzy, and that was part of the problem. A few big companies and healthcare systems began buying practices and, not wanting to be left out of the fun, hospitals large and small all over the country followed suit. In many cases, they had little reason or need to own practices. It just seemed like the thing to do at the time.

Like a lot of trends, there is an initial wave – and then a big crash. But during this process a few people figure out how to make something work. They are the fortunate ones who survive to play another day. The ones who didn't make it (after licking their wounds and patching up their bruised egos) regroup and try again, having learned from their own mistakes and from watching those who survived during the first go-round.

A history lesson

Back in the 90s, we consultants often had to hold our tongues as eager hospital administrators laid out their plans for rapid acquisition of physician practices. Many had no long-term strategy in place. Most had no idea how to manage a practice. Some were buying groups they couldn't afford and didn't need for the sole purpose of keeping a competitor from scooping them up. Administrators loved tossing out terms like MSO, primary care network, and full-risk contracting to their boards, but few understood fully what these things meant outside the conference room.

We worked with a nationally prominent hospital CEO who reacted with indignity when we had to tell him that the employment agreements he'd signed with physicians didn't allow him to fire them, or even to dictate work hours or minimum production standards. The physicians had a sweet deal and you can't fault them for having negotiated well. It's human nature to get all you can while the getting is good.

Right around 2000 I worked with another successful hospital CEO who proudly touted that he had one of the few successful MSOs in the country. It failed a year later. Turns out the MSO director and the hospital CFO were burying losses in the hospital books. The CEO only *thought* his MSO was profitable.

It seemed there was no end to the failed ventures. Could it possibly be that no one had figured it out? That no one had found a model that worked long term?

Before we get into how owning physician practices might work for you now, let's do a quick rundown of what went wrong a few years ago. Here are twelve lessons hospital administrators learned during the process of buying – and then in many cases divesting themselves of – medical practices.

1. You can't pay ten times what a practice is worth and expect to recoup your investment.
2. How a physician employment contract is crafted is crucial.

3. Physicians work harder when they have a production incentive, as opposed to a long-term salary guarantee.
4. From a business standpoint, the only similarity between a hospital and a physician practice is that they both have patients.
5. Hospital managers do not generally make good practice managers.
6. Cash is king in a medical practice. Physicians don't understand accrual accounting systems and, if you use one, they'll think you are hiding the money.
7. You can't do physician billing using a hospital system.
8. If you strip a practice of ancillary services you should not complain when it starts losing money.
9. Offering a hospital's benefit package to physicians and their staff is a significant contributor to that red ink on the bottom line.
10. Primary care physicians are important, but put them on a pedestal and ignore the specialists at your own risk.
11. A practice only has value when you are buying it. When it's time to sell it back to the doctors it has little, if any, value.
12. Once you have a group of doctors really mad at you, it's hard to keep your job.

By the late 90s deals were falling apart right and left, and the finger pointing that went on was enough to make you think you were inside the Beltway. Administrators said physicians wouldn't work hard enough (but couldn't prove it because of the terrible hospital system generated data they'd collected). Physicians blamed administrators for mismanaging their practices, driving away their loyal staff, and telling them how to practice medicine. Hospital and practice staff pointed fingers at each another and cried "They're incompetent!" It was very messy.

What's different this time around?

Hospital administrators are smarter. So are physicians. So are consultants. No one wants to see history repeat itself. Organizations engaging in practice acquisition are going about it with realistic expectations and viable strategies.

What hasn't changed are motives for buying practices. The primary reason administrators cite when getting into the practice acquisition game is a desire to maintain a loyal and robust medical staff. Accustomed to working with long-range strategy, astute hospital leaders recognize the need for an active recruitment program and succession planning. If you're in a growing area or have a number of physicians nearing retirement age, the ability to recruit is essential. Having a viable group that new doctors can step into can make all the difference in attracting quality candidates – often younger physicians who have little interest in running their own show. As a hospital, it's likely that you have pockets deep enough to offer first- and second-year salary guarantees for the right recruits. Other reasons to own practices include the ability to respond to competitive pressures, grow in strategic specialties and protect market share.

If you think getting back in the physician acquisition game might be a good strategy now, consider the following.

1. Understand what motivates a physician to consider selling a practice. Is the practice sinking financially under the weight of employee benefit costs? Are there physicians in the group nearing retirement who want to set themselves up for a smooth exit when the day comes to stop practicing? Are the managing partners overwhelmed with or just tired of the business aspects of running a practice? Are they in over their heads with real estate, looking for an exit strategy? In all of these cases, selling to a hospital might look quite attractive. Understanding what is motivating a group will help you negotiate toward the best outcome for everyone involved.

2. Do an evaluation, not just a valuation. Of course you'll do thorough financial due diligence but, beyond that, you need to know what you're really getting into. The financial picture will be the centerpiece around which to structure a deal, but once you own the practice, well, you own it for better or worse.

Better not to be surprised. Keep in mind that a seller won't always disclose defects in their asset. Political infighting, key staff about to leave, competence or behavioral issues among the doctors – these are things that won't show up in a review of the books. When you buy a house you have it professionally inspected. Do the same if you are considering buying a practice. The information gathered during the evaluation process will help you decide not only if you want to go forward with the deal, but also how to effectively manage the practice moving forward. Doing your homework is key because success or failure is preordained by what happens on the front end. And remember, the valuation of the practice can't take into account hospital referrals (it's illegal to "buy" referrals), so make sure you are paying fair market value – not fair market value plus some big number you think will guarantee future referrals to your facility.

3. Structure a compensation plan that keeps the doctors happy, productive, and efficient. Be realistic in terms of what you offer and what you expect. Physicians should be willing to put a portion of their compensation at risk, otherwise there is no goodwill value to speak of. Structure the purchase and compensation in a way that makes sense. Use objective measurements for productivity such as patient encounters and procedures, not things like RVUs and gross charges that doctors either don't understand or don't believe. Above all, negotiate in good faith.

4. Flexibility is a sign of strength, not weakness. As soon as you start saying "This is our deal, take it or leave it," physicians lose interest. No one wants to be part of a cookie cutter organization or feel like they are just another cog in the wheel. You'll win friends and influence people by being able to flex to the needs of individual physicians and groups. There are a number of options available when it comes to owning and managing groups. Don't rule anything out, especially in early discussions.

5. Get the right management in place and then let them manage. A practice manager's personality and experience are both fundamental to the success of the venture. This person needs to be politically astute, able to negotiate fairly on behalf of the physicians *and* the hospital, and be given authority over staff. Overrule your practice administrator one time, and they will be ineffective from that day forward. Hire someone with practice experience not hospital experience, but be aware that someone who was great at running a group and answering only to doctors may have a tough time making the transition to working on behalf of both the doctors and the hospital. The politics involved can be daunting.

6. Don't mess with the billing system. Even if it's not working perfectly, don't make it worse by pushing an ill-timed and ill-conceived computer conversion. Nothing will make staff bolt for the door like unnecessary technology-induced stress. If you ultimately need to replace or upgrade the system, make sure it is geared specifically to physician practices. Trying to cut corners and use your hospital system simply won't work.

7. Plan ahead to avoid cash flow problems. Don't underestimate the upfront time involved in re-credentialing the doctors under a new structure, obtaining new provider numbers, and renegotiating insurance contracts.

8. Expect overhead to increase. Hospital benefits are usually much richer than what the doctors have been providing their staff. Don't expect to turn a profit running a medical practice for several years, if ever. You're not doing this to get rich.

9. Mentor new physicians. Don't hire someone fresh out of residency and then leave them to their own devices on operations, scheduling, dictation, documentation and billing. Remember, they've just spent years learning how to be a doctor but may not know how to practice medicine. They may not know the relevance of a CPT code, how to complete a patient visit in less than an hour, and that their documentations need not be several pages long as if they're going to be graded on it. Protect your investment – find an experienced practicing physician to mentor your new recruits.

10. If things get rocky, don't immediately bail out. The first year or two is an adjustment period, a time for learning, a dance. Hospitals are often too quick to unravel relationships when there are bumps in the road. It's easy to place blame on the doctors, but hospitals are rarely without fault. If you play the blame game not only will you get a negative reaction, but you risk permanent damage to the relationship you so

carefully worked to create. Often the cause of a problem can be traced all the way back to a faulty initial structure. You may need to go back to the drawing board. If you do, you do. Whatever is going wrong can probably be fixed. It may take time and effort but it's worth it when you consider what it took to put the deal together to begin with. Avoid the temptation to jump and run simply because it will make you feel like you're "doing something."

Just like Amazon, eBay and Google, there are hospital leaders who have figured out how to own and manage practices. They've learned from past mistakes, are determined not to repeat them, and take the long view. You can be successful in pulling together a network of physicians if you are so inclined. Be realistic, plan well, execute even better, and you'll enjoy a solid relationship with loyal doctors.