What Matters Private Equity Interest in Physician Practices

A Primer for Physicians

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This is a series of 22 short blog posts that address some of the most important considerations for physicians considering selling their practice to private equity. These posts were originally published in early 2018.

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01. Fun with Accounting

I have written a lot of silly things in the space over the years, but none more hilarious than the subject of today's post.

Let's be very clear…some of my very best friends are accountants. For reasons that are less than clear, I have a lot of them in my life and I really, really like them all. Many of them, as people, are pretty fun to be around. So, this obviously sarcastic blog title is about the domain, not the people. (Many of these people could wreak havoc in my life and I lean on them heavily, so thanks for tolerating me covering my backside there.)

OK, we're returning to the question of why so many private equity funds are interested in buying physician practices and what it might mean as an option for your practice moving forward. Today, I want to pick up on the odd accounting term upon which a lot of this whole discussion pivots – EBITDA.

The pronunciation varies. Some say 'E-Bit-Duh;' others prefer 'E-Bit-D-A.' I think both camps look down on the other. Pretentiousness is bi-directional. The acronym beats the heck out of saying the whole thing all the time: Earnings Before Interest, Taxes, Depreciation and Amortization.

My dear accountant friends, do you see why 'fun with accounting' is so clearly making fun of you? Really? You guys are just a rolling party, aren't you?

EBITDA is sort of like profit, but not quite. Depreciation and Amortization are these 'kind of' fictitious accounting creations, but they are also real in another sense. No doubt, the Interest and Taxes are real and we have the canceled check to prove it. EBITDA is kind of like cash flow, but again, not exactly. But while it is not really this or that, it is a pretty good indicator of both. It is the profit from the operation, before we get to all of that other fancy accounting stuff.

This all matters because, most of the time, private equity investors value any business, including physician practices, starting with its EBITDA. Here's the very abbreviated, overly simplified model:

'We think your business is worth ___ times the EBITDA you produced in the most recent 12 months.'

We'll come back later in this series to all of the various machinations and negotiations around what the EBITDA even is (You think accounting is straightforward? Ha!) and how they decide if they are going to give you 2 times or 10 times your EBITDA.

To get started, we're going to explore a couple of things about this whole EBITDA calculation that are unique to physician practices. Here's a clue…do you have any idea what your EBITDA is? Probably not. And would you be troubled if I guessed it be approximately zero, especially if I'd likely be correct? This will shed a little light on the potential thinking of private equity investors who might come calling. You'll at least have your EBITDA decoder ring.

02. Card Trick

I only know one card trick, so I am constantly working to meet new middle schoolers so that I can keep doing it. This trick involves no real sleight of hand, no special card that is imperceptibly shorter than the others. It is just about my ability to count to 11 in order to find the right card.

The beauty of this is that if I just pick up the piles in order and then lay them down right a few times, the math works and the 11th card in the stack is always the card that was picked. Kids at that age are perfect because they are just old enough to be amazed by the trick, but not yet fully onto the immutable mechanics of arithmetic. I look like a genius, at least to a 12-year-old.

So, when I said in my last post that the EBITDA of your practice was likely at or very close to zero, some of you reacted like the kids with my card trick. 'Wow, how'd you know that?'

Like counting to eleven, it is just arithmetic.

Most independent physician practices are set up as some form of partnership, which means the simplified financials look something like this:

All of the revenue comes in the top. Then you pay all of the wages and bills. Whatever is left over goes to the physician owners.

As you know from Monday, I do love my accountant friends, but somehow, they've taken those three little sentences in the preceding paragraph and turned it into an entire industry. Really guys, why did you have to make it sooo complicated?

The point of the accounting is that there is <u>no</u> EBITDA. None. By design. I could say it is the legal structure that makes it this way since most practices are pass-through tax entities, and that would be true, but there is a deeper and more significant reason why most physician practices have no EBITDA.

You ready for it? I am about to reveal a big secret.

DOCS WANT TO GET PAID.

There. We said it out loud, in all caps even.

Let's go back to my simple accounting. It only has three elements: revenue, expenses, physician owner income. In order to create EBITDA, some operating profit that the private equity investors can multiply by something – 3, 4, 5, 9, 11, whatever – to create a price for your practice, one of three things must happen:

You'd have to produce more revenue. How's this been trending for you? Thought so.

Or, you'd have to cut expenses. And if you could have done so, you would have already because the owners get to keep whatever is left.

Which leaves just one thing…reducing how much gets paid out to the physician owners, thus leaving some 'profits' in the company as EBITDA.

Which gets me to my second secret.

DOCS DON'T LIKE TAKING PAY CUTS.

You see the problem here?

03. The Scrape

When physicians first contemplate selling their practice, someone will come up with something that sounds like this (math intentionally kept simple because it is Friday):

'Hey, there are 10 of us partners. We take home an average of $400,000 a year. If we each cut our 'salary' to $200,000, that would magically give us $2 million of EBITDA. I heard from a buddy that their practice got offered seven times EBITDA. That would mean we would be worth $14 million. That is $1.4M cold hard cash for each of us. Let's do it!!!' [cue Braveheart theme music]

This is euphemistically called 'the scrape,' that reduction in personal income that physicians must take in order to leave money in the practice to create the EBITDA that will get valued by the investors.

I am not sure what image comes to mind when I say, 'the scrape,' but if you've ever accidently run a cheese grater hard against your knuckles, that one will do because the scrape conversation will leave a little blood.

In thinking about the deal, docs want to take as big a scrape as possible because that EBITDA is going to get a multiple applied to it. Bigger scrape, bigger EBITDA, bigger check when you sell the practice.

But you see the problems that are coming.

First, even if those ten partners all take home the exact same amount of money, we know they don't have the same financial experience. Kids, college, divorces, dumb investment decisions, toy obsessions, and a thousand other things mean everyone at the table has a different number in mind on the size of the scrape they can personally handle. How do you think THAT discussion will play out? Can anyone say, 'hidden cameras and a reality TV show?'

Second, selective memory kicks in pretty fast. Which do you think physicians most acutely remember about six months after the deal – the size of the check they got at closing or the reduced amount they get paid every month? Right. That won't create any tension, will it?

Next, for some docs that big check pushed their nest egg over that magic total they have been chasing for years. Retirement is now possible, which is good for the physician, but for the new investors who just wrote that big check based on past financial results, a big revenue producer just took their money and walked out the door.

One more…investors buy companies to grow them. Imagine recruiting new docs. Are you going to offer them this artificially low salary (needed to keep the EBITDA going) when they did not get the big check? Or are you going to pay them fair market rates, which is a lot higher than the docs who built the practice over the years? Really?

Let's add some lemon juice to the cheese grater because working your way through the scrape issues is going to be a little painful.

But deals get done. Next week we'll look more at how that can happen given this reality.

04. Barney's Bullet

The Andy Griffith Show was a staple of Americana television back in the early 1960's. Those of us of a certain age remember that Ron Howard played Opie as a kid, roaming the streets of Mayberry with the lovable goofballs such as Gomer and Goober, long before he became a prolific movie director.

But those bumpkins were just the supporting cast to the real comedic genius of the show, Deputy Barney Fife, perfectly portrayed by Don Knotts. In 1999, TV Guide called Barney the 9th best TV character of all time.

Nothing better captures the essence of Barney than Andy's rule that the deputy be able to carry only a single bullet which it had to be in his pocket, not his gun. That it somehow ended up discharged often, generally into the floor or ceiling, sort of ruins the point I am going to make, but that was a long time ago, so things are a little fuzzy.

But, back to the single bullet.

In our continuing discussion of private equity as an exit option for independent physicians, let's address a particular item that comes up often with 'procedural' specialties (primary care physicians can skip this part or lament that you don't have this 'problem').

Again, we are going to speak in rough generalities, but this is right enough most of the time. In the financial terms that we have been discussing, those that attract the interest of outside investors, you really have just one economic bullet – the value of your procedures. So be careful how you use that bullet. Let me unpack that.

Most of these practices make all of their money off of their procedures, be it surgery or some other diagnostic or therapeutic procedure. If you were to take those out, the remaining 'office visits' part of the practice would barely break even, if that. We are not exactly breaking news here. That is just the math.

Here's the issue…many of you have shot this bullet already. You went and did a deal with a surgery center, be it with surgery center company or a health system. I am not casting dispersions on that decision. The quarterly dividend checks have generally been pretty nice, haven't they? And when you made this decision, it was clearly the best financial option available.

Now you are interested in this private equity idea, you've come to understand the notion of EBITDA and multiples, you've done some math on a cocktail napkin and you kind of like what this might represent.

You better stop and check on your procedure deal because most (not all) private equity investors are not that interested in owning your minority shareholder interests in a facility they do not control. If you can't shake those free, and in many cases your deal will make it really tough, the likely value on your practice changes a lot…maybe becomes a big fat zero, at least to an outside equity investor.

Unlike Barney, you don't get to keep shooting the same bullet over and over.

05. The Frost Fork

I think I have used this before, but it is good enough to use again and I am counting on the fact that if you were a reader whenever I used it previously, you, too, are losing about 100,000 neurons a day and maybe the ones that stored this memory have futzed out already. If you remember this story, don't be a hater and give me grief for my redundancy…be grateful for your youth and shut up.

One of my grad school professors had one of the great lines that has provided insight for me in my personal and business life for over three decades now. Hogan's First Law states:

'There is no such thing as irrational behavior; there are simply motives that you do not yet understand.'

Think about that and keep it handy if you have a spouse, kids, co-workers, friends, neighbors or other reasons to ever interact with people. It will help. Sometimes the humans in our lives do things that make us scratch our heads and wonder, 'Why in the world did you do THAT?' But what seems irrational to us makes perfect sense to them because their motives and incentives are different than ours.

Work through this if you are thinking about, exploring, in the middle of, or even on the backside of selling your practice to equity investors. You must understand their motives, really get in their shoes, for it will help you know what they are likely to do, what decisions they are likely to make.

Always assume they will be consistent with their motives, regardless of what is on their website or what they say over that nice dinner during the courtship process. I am not accusing outside investors of being duplicitous (not all of them, anyway), just human. Like the rest of us, their incentives and thus their motives, are powerful things.

Fortunately, applying Hogan's First Law to an equity investor is easier than using this to understand your teenager because their motive (yes, singular) is a whole lot simpler – they just want to make money. Specifically, they want to turn around and sell you again at some point in the future to someone else for a higher price than what they paid for you. That seems straightforward enough, but the thing you need to understand, at some level of detail, is how that would actually happen.

What drives the value of their equity, that asset they need to sell in the target 4-7 years, to three, six, twelve times their original investment?

Which gets us Robert Frost's famous line…

'Two roads diverged in a yellow wood.'

After the initial check gets cashed and spent, most of the physician's financial incentives are often tied to current production – their salary/compensation. That may align with the investor's value drivers, but often they begin to diverge. And here comes the conflict.

Investors are not irrational, no matter how maddening they might seem to you at times. They just may have different motives than yours.

06. The Second Sale

After years of waiting, Colorado finally got a professional baseball team in 1993. Play those first couple of years was in the old Mile High Stadium, a place built for football, not baseball. No one cared and 4.5 million people attended that first year, still the MLB record.

But everyone was really excited about Coors Field, being built in lower downtown Denver as the new home for the Colorado Rockies. There are still few places better on a beautiful summer night than the ball yard down at 20th and Blake.

In 1994, a guy got hired to sell all of the advertising signage in the new stadium. Because the whole state was ga-ga over the team and people could not wait to see the new stadium (my office at the time was about seven blocks away and I snuck away one afternoon to witness the groundbreaking), owners knew the demand for the in-stadium advertising would be strong. But they had no idea how strong. The sales guy returned them just a couple of days after he started with every spot sold out, each one at the target asking price. Everyone was thrilled.

Briefly.

That is, until they found out he bought them all…every sign in the stadium. Personally.

See, he, too, knew how hot Coors Field was going to be, so he went down to the bank, took out a big loan, and bought up all of the inventory. Then he marked it all way up and resold them to the real companies wanting to get some visibility with the crowd.

Was this genius or duplicitous? I guess it depends on your point of view.

He gave the team their asking price and took all the risk. But clearly, they had underpriced the value of their asset and left a lot of money on the table, money which went into his pocket and not theirs.

That is one of the most common ways to make money…buy an asset, do a little to spruce it up, turn around and sell it for a profit. Flipping real estate, reselling baseball advertising, buying and selling a physician practice.

There was nothing in the deal that prevented this guy from doing what he did (that clause is probably in there now, you think?). Once the Rockies sold it to him, he could then resell it as he pleased. And this is another consideration if you are considering selling your practice to private equity investors.

Most likely, they are buying it in order to sell it in the not-too-distant future. Once they get some growth and the EBITDA number is bigger and better, they will look for someone higher up the investor ladder who wants to buy it from them. And most likely, the physician owners who sold the first time will have little to no say about the second transaction. That is reality for every business owner who sells, you included.

BTW, it is 44 days until the home opener. Just saying.

07. Sharing an Apple

I am not a transaction veteran but have participated in a few deals. We sold part of our company to venture capitalists back in the early 2000s (see Charley Daniels, 'The Devil Went Down to Georgia' for the summary), and then did another deal with some investors to buy them out. We've acquired six small companies over the years and looked hard at several others.

In many deals, the question comes up about the seller 'rolling' some of the purchase price back into the deal. Let's say I want to buy your company and we agree it is worth $100. I could give you $100, and I would own 100% of your company. Or, I could give you $70 and buy 70% of the company, leaving you with some cash in your pocket, plus you would still own 30% and we'd be partners going forward. This means you decided to 'roll' 30% of your value as equity.

There are a lot of reasons for both sides of the deal to want, or not want, the seller to roll equity forward. It gets complicated. But for the seller, one of the primary motivations for passing on more cash now is what is known as 'getting a second bite at the apple.' Make sure you know your private equity slang so you can throw that around at the big dinner and look like this is not your first rodeo.

For the seller, it is a straightforward question, but the answer has a lot of dimensions. Sort of like, 'Honey, does this dress make me look fat?'

At the most fundamental level, you are evaluating two deals on the table – what would that extra $30 be worth to you in about four years vs. what would your 30% of the new company be worth when it gets sold again? The first half of the equation is easy; the second requires making a LOT of assumptions that may or may not be right. But if you are selling your practice to private equity, the roll of equity question will be one of the most important you have to answer.

The equity investor, especially if they want you to roll equity – and most do – is going to talk to you about that second bite at the apple. They will show you the math, the same math we've been discussing so far.

They will say that when we (we are partners, buddy) get the EBITDA from where it is up to this level in a few years, then we'll not only have more EBITDA, but we'll then get a bigger multiple when we sell it. Bigger EBITDA times a bigger multiple means that your percentage, even if it is small, would be big, maybe even bigger than what your 70% is worth today.

That is a compelling and important part of the story.

But the follow-up question is more important for you. Since we are now partners, how are we going to do that, buddy? You better get some real alignment on the strategy or hanging around for that second bite could be pure misery.

08. Marshmallows from Palo Alto

Stanford University psychologist Walter Mischel conducted a series of simple, but brilliant, studies in the late 60s and early 70s that became so famous that they have been replicated many times, which sort of qualifies him for ‘rock star’ status in the world of psychology. That does not come with the same benefits afforded a real rock star, but he he’s aged a lot better than those guys, that’s for sure.

Mischel sat a child, ages 4-6, down and offered the kid a deal – they could have one marshmallow now or wait 15 minutes and get two.

This little test of deferred gratification summarizes one – only one, but an important one – aspect of the deal physicians make when they sell their practice to private equity. Do you want your money now or later? Let me explain.

To review, most practices are organized as partnerships of some sort, pass through entities that distribute all of the money each year to the owners. So, there is no EBITDA for investors to value. In a sale, the partners willingly agree to reduce their annual salaries/distributions and leave money in the company in order to create some EBITDA. That gets multiplied by something – three, six, maybe even ten or eleven or twelve – to establish the value of the practice. The investors buy all or part of that, paying the partners a one-time payment at the closing.

In short, what this means is that the physicians have moved forward some of their future cash flow. They elect to reduce what they will get paid in the future in order to get that money now. The lawyers and the deal guys will need to overcomplicate this a bit to justify their fees, but that is the essence of this part of the deal.

Yes, as we mentioned, there is also a chance to retain some equity in the practice that could be worth more in the future. But when you are thinking about that one big check at the beginning, keep in mind this is the deal.

There are many reasons why taking the investor marshmallow now might be a good idea. Funding partner retirement without the younger docs having to take out personal loans to buy out the retiring crowd (that is not without risk) is one. Everyone just taking some chips off the table (more investor lingo) to diversify personal net worth is another.

Regardless of the motive, the basic deal is the same…cash now in exchange for less cash later. Don’t get confused by the gesticulations of the deal process.

Next time, we’ll look at another way you might accomplish the same outcome.

09. Another Possible Play

The old joke goes, 'There are two types of people in the world – those who always want to group everything into two types and those who do not.'

Well, there are fundamentally two types of capital investment in a company – equity and debt.

Of course, as with everything these days, there are about a million variations on the specifics of capital, but at the end of the day, everything is basically debt or equity. Unless you get some exotic hybrid that tries to function like both, but you get the point.

Let's say you have figured out how to create yourself some EBITDA, some operating profit. This is generally what equity investors value, and they will give you some multiple of your TTM (investor lingo of the day…trailing twelve months) EBITDA when they buy your practice.

Guess who else values EBITDA?

Lenders. The debt people. They will also give you a loan that is some multiple of your EBITDA.

Debt is an alternative to a PE buyer (private equity…get with the slang, dude) that you might want to consider if your owners want a chunk of cash now: leverage your newfound EBITDA and take out a loan.

Recall that a PE sale means, at least in financial terms, taking less money in the future in exchange for getting a check now. A loan is essentially the same idea with a few twists.

Say your owners want some money now (cash out retiring partners, buy a Tesla, whatever). And say you've figured out how to get $3M of TTM EBITDA. A lender (could be a bank, could be a specialty finance company, could be private investors) might loan you 3x that amount, or $9M. Wa-la…a pile of cash. Party!!!

Of course, unlike equity, you have to pay that back. The owners will likely sign some or all of their personal assets (yes, the house) as a pledge of payment, just like other loans. And the lender will have these little things called 'covenants' that will put some restrictions on what you do until the loan is paid off. So this ain't winning the lottery, but, when you pay off the loan, you still own 100% of your practice. If you make your payments on time and stay inside the covenants, lenders are far less intrusive in your business than equity buyers.

But a debt deal in lieu of a sale might be an alternative, depending on a myriad of factors in your practice. A recent deal of this type that I know about attracted a surprising number of lenders who wanted the deal.

The morale of this story, kids, is that having EBITDA is a good thing, more EBITDA is 'more better.'

Unfortunately, many practices don't have it and are not sure how to get it. This is the problem you have to solve before you think about a debt or an equity deal.

10. Ceteris Paribus

There may not be a more helpful – and dangerous – phrase in all of business and economic decision making than 'ceteris paribus.'

'All other things being equal.'

It is very helpful, as an intellectual exercise, to hold all variables but one constant when thinking through a complex issue. But most of the decisions that land in our lap as business leaders have a few more moving parts than you average high school chemistry lab experiment. Almost never are 'all other things equal.'

Let's take the value of your practice to outside equity investors. Assuming all other things are equal can lead to some bad thinking, which leads to bad deciding, which leads to a bad reality.

Imagine that your practice is now interested in selling. You start engaging on this whole private equity idea and you hear somewhere that this practice on the other side of the country sold for 11x EBITDA. You do a little math and multiply the EBITDA of your practice by 11, and because you have been reading along with these musings, you are smart enough to subtract the various fees and taxes, and then you divide by your number of partners, and you still get an eye-popping number.

Ceteris paribus error warning.

There are a whole bunch of things that effect the multiple that an investor would apply to your practice – how fast you are growing, what the future outlook is for your specialty, any downside reimbursement or regulatory risks, emerging competitive threats, how many of your revenue producing physicians are going to cash the big check and then just check out…the list is long.

But today, I want to focus on just one item to highlight that all things are never equal (Never? Rarely? Now we're just talking semantics). Is your practice a 'platform' or a 'tuck in' acquisition for the buyer? Yes, this is your PE lingo for the day. We are expanding our glossary, aren't we?

A platform acquisition is one upon which the investor can build an entire company. The executive team is (mostly) there; the infrastructure (IT, finance and accounting, RCM, compliance, HR, etc.) to handle the future growth is generally in place; the vision for how to rapidly grow this thing is pretty fleshed out and compelling.

A tuck-in, or add-on if you want to be less disparaging, is just what it sounds like. It is an acquired practice that gets added to an existing platform company.

Wanna guess, all else being equal (tongue firmly in cheek), which of the two gets a higher multiple from the buyer? Yep, the platform company is worth a whole lot more.

So, when you hear rumors about the sale of a practice, first, be a little skeptical. I am not saying that physicians ever lie about their financial matters, but…no but…I am stopping there. Second, watch for a ceteris paribus fallacy before you apply those numbers, even if they are accurate, to your practice. Not all things are equal.

11. Exogenous Factors

A guy who I used to work with taught me that you never want to do a deal with someone without first understanding their comp plan.

This sometimes required a little sneaky reconnaissance because it is a tad rude to start a conversation with, 'Hi, I am Tim and we are looking forward to working with you, but first I need to see your W2 from last year and understand how your bonus is calculated.' People who try that on a first date end up single and it doesn't work too well in a business setting either.

When you understand, at least directionally if not specifically, what matters to the other party – how they are measured and rewarded – you can better make sense of how they are likely to respond at various points in your dealings. So, if you are thinking about selling your practice to a private equity investor, you'll want to know a little about how things work behind the curtain. Now, if get all of your cash at closing, hand them the keys once you sign, buy your convertible and head to the beach, and don't care about what happens to your practice, you can ignore this, but most of you need to think about how they make money as much as you are pondering how much you will get.

There are many variations on private equity, but most of the deals getting done today are by funds. Roughly, here is how a private equity fund works.

The professional investors raise a 'fund,' a specific and defined pool of money that comes from wealthy people or institutional money, like a pension fund or a college endowment. They use that money to buy, or buy into, companies that fit within the bounds of what they said they would, or would not, do. Then they turn around and sell their stake in those companies to the next party. That is how they get the return for their investors. A significant part of their comp plan, and future viability as an equity fund, depends on the return they deliver.

There are scads of dynamics that will affect your new financial partner's decision making that have nothing to do with your business. Exogenous factors, we call them. Yes, you should drop that phrase in conversation somewhere today. Impress people.

This week I want to explore just a couple of the external forces that will impact how your partner will show up in your future board meetings, but before we dive into those, keep the fundamental reality front and center – they manage a portfolio of investments, of which your practice is but one line item.

You may be partners in the future performance of your practice, but your financial incentive is tied to the practice, where theirs is tied to the portfolio. When you understand things like 'fund lifecycle' and 'liquidity,' you will better understand how your motives might diverge.

12. Ripe Bananas

They say 'timing is everything,' though maybe 'location is everything.' Or, as Einstein taught us, time and space are relative. Already, our mind is wandering. Let's get back to this time thing.

As we discussed in the last post, a key dynamic that affects deal making – both getting in and then getting out – for most investment funds is where you are in the lifecycle of the fund. If the fund managers told their investors that they were shooting to have things mostly wrapped up in about ten years, it stands to reason that the folks making the decisions about the portfolio companies might start to think a little different in year eight than they need in year two.

In all fairness, a good PE investor would object here and say they have ways to manage around simplistic timing constraints. If they had a portfolio company that needed a few more years before they put it up for sale to get a better exit, they could make that happen.

But exceptions aside, there are logical things that change in their thinking over the life of the fund.

Early on, they have raised a lot of money and they want to 'put it to work.' They want to buy companies and make investments. They really like platform companies early on because they know they have time to nurture them and help them grow. And growth is the elixir that makes the exit math work. By 'exit math' I mean 'make a friggin boatload when we sell this thing.'

Later in the cycle, they want to make sure the assets they have on the books are getting all spruced up for the sale. Tuck-in acquisitions that enhance an existing platform company get more interesting.

There is one other little secret about fund timing and lifecycle that you should know. At some point late in the life of the fund, the fund managers want to raise another fund. That is how they keep their fees and income going (oh Lord, that is a whole other topic). The best people to raise money from are people who got a great return from you last time. So nothing, nothing, is better for a PE fund manager than to give their investors a big honking check from the sale of a portfolio company with their right hand and the solicitation prospectus for the new fund with their left.

Remember kids, know their reward and incentive system and you can probably predict their thinking and behavior.

Now you get the title of today's post – buy your green bananas early because you can wait, get the ripe bananas if you want to eat one now.

This is a subtle topic, one that you might not have thought should be on your list of evaluation criteria when selecting a PE partner, but that is exactly the point. Selling your practice is a very complex issue. There is a lot to think about.

Like fund liquidity. Next time.

13. Boot vs. Concerts

It is good thing when your kids come to understand the finiteness of money. We had just such a moment the other night.

Our 17-year-old, who was supposedly writing a paper, called me into the study for what I presumed to be some editing help. 'Dad,' she asked, 'can I go to the ___ concert?' Of course, the name of the artist was supposed to make to make me giddy with excitement, but as the previous blank indicates, I am such a cultural dunderhead that I did not recognize his name.

'How much is the ticket?' I asked out of curiosity.

$165 (!)

'Dang, that is expensive, but it is your money. Just think about how many hours of babysitting that equates to before you click the 'buy' button.'

She must have already done that calculation, because the BUY was clicked before I left the room.

30 minutes later, at dinner, it came up (turns out big sister was appropriately excited about the artist). Mom asked the price of the ticket as well and then commented, 'Well, for that much you could buy those boots you want.'

My thought bubble…which is worse, $165 for a concert or $165 for a pair of boots?

'Well, I can't do that because that money is spoken for.'

Yep, you only get to spend each dollar once. Welcome to reality, kid.

And it reminded me of the point I want to share with you about equity fund liquidity and how it might affect how your partner approaches decisions.

It is easy to think private equity funds have a limitless supply of cash because they throw around big numbers, but, their money is as finite, too, even if it is measured in hundreds of millions of dollars. (No, Maggie, they are not going to buy you those boots.)

Just as time in the lifecycle of the fund can impact the thinking of an investor, so, too, can their allocation of the fund across their various portfolio companies. For that matter, so can their current liquidity and where actual cash stands at the moment based on the timing of investments and sales and other fund expenses. Sometimes, as with boots, the money is already spoken for.

I don't want to get too lost in the weeds her - private equity investors are smart folks and they know how to manage their cash. But this is just one more example of how your practice, once you sell, becomes tied to your partner. These exogenous factors are things you cannot see, much less control, but they are real to your partner and they can, and do, affect how they see the world.

These issues, in and of themselves, should not scare you away from considering an equity partner, but you should just be smart. I promise, they will think hard about your issues that might impact them. Do the same.

14. Merchandise 7x

For years, Coca-Cola leveraged the mystery of its secret ingredient, known only as 'Merchandise 7x,' as a brilliant marketing play. Remaining coy over the years about the rumor their carbonated bubbly was laced with cocaine was smart.

About seven years ago, the radio program *This American Life* did a story on the unknown part of the formula. They had found a 1979 article in the *Atlanta Journal-Constitution* which was accompanied by a copy of inventor John Pemberton's original recipe. There, hiding in plain sight, was the formula for Merchandise 7x.

Turns out it is a bunch of oils and spices – orange, lemon, nutmeg, coriander, neroli, and cinnamon – all bathed in a little alcohol. No, no cocaine, but the secret ingredient that made Coke Coke.

Likewise, private equity investors have a secret ingredient that makes their deals work, and that is debt, or 'leverage,' if you want to speak like a pro.

A way overly simplistic example: Let's say you are going to sell your practice, and everyone agrees it is worth $25 million. You are going to roll 20% of your equity into the new deal, so someone (eventually…another post) is going to get $20 million in cash. Do you think the PE folks are going their ATM to take out $20 million?

Nope. They are going to 'leverage' their money with some debt. Typical deals right now might be 60/40 debt to equity, which means $12 million of that cash is coming from a bank loan and only $8 million is coming out of the PE fund. Some deals get leveraged even more…more debt, less equity.

You should know a couple of things about this use of debt.

First, when you do the math, and you should have a good advisor to help you with this, you will see how debt really improves the return for equity investors. To stay with our example, if you buy 80% of a company that is worth $25 million, but you can do that for only $8 million of your own cash, once you pay off the debt, you are sitting pretty. If you are rolling some of your equity forward, the leverage math will help you, too.

On the flip side, debt leverage, especially if it is aggressive (a lot of debt), comes with some risks and implications. Remember those bank covenants we discussed a few posts back? Yep, you get those imposed on your practice and your PE partner does NOT want to ever, ever bust a covenant, so you can imagine how certain decisions in the board room might change if you start getting close to the covenant line.

OK, this series has gone over for over a month now, so we'll try to wrap it up soon and get back to what is going on in the world. But as you are seeing, there are a lot of hidden nuggets that you need to understand before you go too far down this road. Just a few more to come.

15. Valuing the Future

NFL free agency started this week, a cacophonous affair similar to an open-air market in the Middle East, only with a couple extra commas in the bid and ask numbers being thrown around. It highlights one of the most difficult aspects in the negotiations around selling a business – What is the future worth?

Assessing the present – the trailing twelve-month EBITDA – is not terribly hard. Math and a modicum of reasonableness will get the buyer and seller pretty close, pretty fast. But when it comes to the worth of the future, things start to diverge.

Back to our sports analogy for a moment…the teams don't want to pay for what the player might be worth in the future, that is unless they think the future will be worse than the past and then they want a discount. The player does want to be paid for his potential, unless he acknowledges that his best days are behind him, which means he wants to be valued on the past. See the problem?

Same thing happens when a practice sells to private equity.

The buyer will look at your financials, focus on your TTM EBITDA and give you a valuation based on the past. Unless they find a big worry around the corner, which means they want to pay you even less.

But the practice will see all the things in the pipeline, all of the investments that have not yet paid off and want credit for those. There is that new managed care contract that will up the revenue, the new office location that is not yet ramped, the two new docs starting next month, the…you get the point.

Negotiating the value of the future is the hard part.

One of the ways this is solved is with an 'earn-out' and the discussion goes like this:

'OK,' says the investor, 'you believe in those projections so much that we'll tie part of your valuation and your payout to you hitting the targets.' This means portion, sometimes a very large portion, of your cash is held back for one, two, even three years and not paid unless you produce.

OK, you can handle betting on yourself. After all, that is what you've been doing forever, right?

Here's the rub. They bought your business. They want/need/have control, especially if they are rolling you into their already established platform…their management team, their IT, their marketing, their HR, their billing, their contracts. So, they will have a lot of impact on whether you hit those targets and get the remaining payout.

Now you understand why the attorney who was helping us buy our first company said to me, "The word for earn-out comes from a Latin term that means 'lawsuit waiting to happen.'"

Earn-outs are an important feature that can bridge the gap between the valuation expectations of the seller and the buyer, but they are more complicated than Thanksgiving dinner for a polygamist.

16. Tom Hagen

Robert Duvall has an incredibly impressive list of films to his credit. The octogenarian actor is both talented and prolific, demonstrating a wide range in the characters he has portrayed. Of particular interest to us today is his role in The Godfather movies.

Duvall plays Tom Hagen, a German-Irish orphan kid on the streets befriended by Sonny Corleone, who brings him home and demands the family take him in. That early friendship later blossoms into Hagen becoming the informal consigliere (not being Sicilian has its limits, you know) to Vito Corleone, the godfather. Why? As Vito said, 'Lawyers can steal more money with a briefcase than a thousand men with guns and masks.'

OK, time out. I am not here to bash the lawyers. Just the opposite (for once). They will help keep your money from getting stolen. I want to advocate several consigliere-types you need if you are considering selling your practice to equity investors.

Let's start with two things that are not in your favor.

First, this is likely your first deal as the seller of a business and the guys on the other side of the table do this for a living. There is major asymmetrical information here and you are on the short end of the stick.

Second, physicians are notoriously cheap when it comes to paying for professional advisors. Sorry if that is not you, but most are. Get over that before you get hosed. This is one of the biggest deals you will ever do. Don't be cheap/stupid.

Here are four roles you need, and four substitutes that you might think are the same but are not:

- Strategist: Long before you begin this process, you need help thinking through all your options, including whether a sale even makes sense. Your administrator who makes the trains run on time might be able to do this, but probably not. Getting the right advice here is worth most anything you will pay.
- Accountant: The person who does your taxes may not the right person to get your financials packaged and prepared in a way to best tell the story of your value. There are folks who do this for a living.
- Lawyer: Selling a business is a very complex transaction. The other side has an army of suits who know what every clause in the document means. The attorney who set up your LLC and help you sell your condo will get fleeced. Find a transaction attorney. Period.
- Investment Banker: Want to prove your naiveté right out of the gate? Pretend 'business broker' and 'investment banker' are synonymous terms. The first will put a sign in your yard and serve cookies at the open house. A good investment banker, particularly one who knows how to sell physician practices, will do more to balance the scales with the buyer throughout the process than most anything else you can do.

Get these four in place as soon as you even start thinking much about this. There, I just made you an offer you can't refuse.

17. Dangerous Analogies

I grew up in the south, so learning to speak in analogies was as natural as eating deep fried chicken. Though the colorfulness of my range has diminished over the years since I moved out west to the big city, I can still hold my own in this department.

Over the years, I have come to learn the danger of analogies, for they all break down eventually. So it is with a little hesitation that I share this one. But, with that disclosure, I plunge ahead. You decide how much applies to the current wave of private equity funds buying physician practices and where the differences are material. There is some of both.

About 20 years ago, the 'physician practice management company (PPMC)' sector hit its zenith. These companies were buying and managing physician practices at the speed of heat (an analogy within an analogy).

The pitch from PPMCs to physicians was straightforward: You don't have to succumb to managed care, and you don't have to work for the hospital. With our capital, we can own profitable services that now belong to the hospital. With our expertise, we can manage the business and you can retain your clinical autonomy. You'll make more money, and oh yeah, take part of your buyout in these magic publicly traded stocks and watch them go up, up, up.

Yep, these were often publicly traded companies. In 1997, there were 39 public PPMCs with a combined market valuation of over $11 billion. PhyCor, the second largest PPMC, had almost 4,000 physicians (MedPartners had 6,000). A buddy of mine was one of PhyCor's early M&A guys and I did a stint with a Nashville healthcare company, so I got to know a few PhyCor execs.

Founded in 1988, PhyCor grew to 57 groups. In mid-1997 its stock hit $36 a share, but trouble was brewing. With annual revenue of over a billion dollars that year, the company barely posted $3 million in profit. The list of issues was large –operational challenges; physician discontent; the harsh financial downside of risk-based managed care deals.

A year later, the stock was trading at less than $10 and PhyCor was negotiating to sell several clinics back to the physicians. By the end of 1999, the price was below $3 a share. PhyCor filed for bankruptcy in early 2002. But then again, so did 8 of the 10 largest publicly traded PPMCs.

This was the bursting bubble that the world forgot because it was overshadowed by that other one that popped about the same time…you know, that dot.com thing. But for the physicians who had sold their practice to a PPMC, this one was far more painful.

I'll come back Friday and highlight what I see as some material differences between the 1990s PPMCs and current PE buyers, as well as some cautionary similarities.

18. Homophones

Some people just struggle with homophones. And other people are not very tolerant of those who do, deeming confusion of ‘to’ and ‘two’ and ‘too’ an unpardonable grammatical sin (Yes, youngest daughter, I am looking at you).

I started my professional career as a recruiter for a large hospital. The CEO’s executive assistant was also in charge of the assistants for everyone in the C-suite and she, too (note the proper word), was intolerant of homophone misuse, as evidenced by the vocabulary test she gave all candidates that I sent over to her. Don’t know the difference between ‘principal’ and ‘principle?’ Well, how then do you actually plan to make a contribution to the planet?

The current wave of private equity acquisitions and the physician practice management companies (PPMCs) of the 1990s are like homophones – alike in some ways, but different in others.

One great irony of the PPMC era is that every one of those companies had an angle on what they were trying to do and how they were going to create economic value – those focused on specialty practices tended to build surgery centers; those that rolled up primary care practices were about taking on capitated risk – but none of them were actually very good at the supposed value proposition inherent in the name: actually managing a physician practice.

When we were launching ALN and deciding on the specifics of our business model, I sat down with some friends who had founded one of the specialty-focused PPMCs and asked them what went wrong. At the time, they were unwinding practice acquisitions and selling off the parts. The answer was that they really had two things to offer – getting the docs ownership in surgery centers (they had been ASC development guys before launching the PPMC) and this great group purchasing contract to save a lot of money – but tried to wrap those into a full-blown management services arrangement, something they did not know.

They also learned that some things just don’t succumb to scale. You may own 40 practices scattered across the nation, but if the nurse in Sacramento is out sick, that you have nurses in Atlanta or Minneapolis is not very helpful.

Like the PPMCs, most equity investors have an ‘angle’ on how their roll-up will create value. Some hold water, some are pretty suspect.

Fortunately, most are avoiding the PPMC mistake of assuming they should run operations. They are trying to build the right management team for each individual portfolio company.

That is where the trick comes. Many PPMC founders were really something (e.g., ASC developers) other than practice operators. PE buyers are even a step further away…they are deal guys who probably can’t spell operations.

Take two lessons from the ashes of the PPMC wreckage if you are considering a PE deal. Know the long-term angle and ask yourself if it holds water. And it turns out that the dirty work of operations actually matters. A lot.

19. Selling the Lottery

Years ago, I had my daughter and some of her friends trapped in the car for a several hour trip, which was perfect because they had to have a conversation with me. We had covered most of the normal topics – boys, high school, social media – and then got around to the lottery. The national Powerball number was big enough to be making the news and the next drawing was coming up. Of course, they all fantasized about winning and had their plans for what they would do with the cash (lots of dolphins would have been saved).

After I bit, I shared with them just how many lottery winners now have miserable lives. I detailed how relationships and even families got destroyed the moment that cash showed up. I had a teachable moment and was crushing it. 'Oh, that is horrible,' they would mutter as I poured it on.

When I finished, I asked, 'So, would you still want to win tonight's Powerball?'

'Yes. Absolutely. What a dumb question.'

There was not even any hesitation.

Epic parenting fail.

It is not like I have been trying to talk you out of selling your practice to a private equity investor, though it might have sounded over the past several weeks like I was reprising my 'evils of the lottery' talk. I don't have a particular dog in the hunt, but simply want you to get what you want out of the work you have put into building your practice. This is a hot and relatively new open on the table for you. My objective is to make sure you know all that you need to know if you decide to walk down this particular path.

So, in the spirit of fairness, let me bring this little series to a close by laying out some of the reasons why 'partnering' with an outside financial investor might be your best option. And note, they will use 'partner' a lot. It is a spoonful of sugar that makes the bad taste of selling your practice go down a little better.

First, the biggest why of all. Regular readers here know that there is no theme that we've pounded more over the years than your absolute imperative to get bigger. The world has changed, is changing, and will continue to change. All of the rules now favor size and scale (note, giving up building a practice and becoming an individual contributor – concierge medicine, stringing together sub-contracting gigs with urgent care and telehealth and covering an assisted living center – doesn't invalidate my argument, but is the exception that proves the bigger rule).

You are going to have to get bigger and that also means redefining, at a core level, what 'independent' means, regardless of the route to bigger that you chose. Bringing in a private equity 'sponsor' (they like that word, too, because it is vague) is an option that gives you some advantages that some of the other options do not. We'll explore those next time.

20. Separation of Church and State

Thomas Jefferson generally gets credit for the ‘separation of Church and State’ idea, traced back to a letter he wrote in 1802, but, credit should go to John Dickinson, one of the less famous founding fathers, who wrote in 1768 as the Revolution was about to begin in earnest:

‘Religion and Government are certainly very different Things, instituted for different Ends…While these are kept distinct and apart, the Peace and welfare of Society is preserved... By mixing them together, feuds, animosities and persecutions have been raised, which have deluged the World in Blood, and disgraced human Nature.’

I thought about trying to write this entire post in ‘founding father speak,’ but my powered wig is at the dry cleaners. We’ll just quote them and move on.

There are a whole set of potential acquirers of physician practices who have zero intent on maintaining any level of separation between their organization and yours. Hospitals, health systems, payers – all active buyers of physician practices and all with a very clear objective to do just the opposite. They are buying physician practices to make them part of their system, to integrate all the parts into a more glorified whole (close your eyes and maybe that last phrase had a hint of Alexander Hamilton’s linguistic flair). Any spiel you heard during the courtship aside, the plan is to absolutely graft your practice into the mothership. Would John Dickinson mix metaphors like that? Never.

One good thing about a financial buyer is that they know they have no business interfering with clinical decisions. They don’t want that risk and things like the corporate practice of medicine laws help keep them in their swim lane. The nature of the deal, the governance, physician comp, the day-to-day operations – all of that at least starts with the intent of letting the ‘doctors be the doctors’ when it comes to clinical matters.

Now, let me not be accused of oversimplifying and over selling this advantage. Like the policy line between the Church and State, the boundary between clinical matters that belong to the physicians and business issues where the new owner has a say is far from clear. Just watch docs and investors try to navigate a conversation about the appropriate clinical utilization of highly profitable ancillary services and you’ll see an awkward conversation that rivals two kids at a middle school dance.

I am not saying that the intrusions that come from health system buyers are bad per se. They are pursuing a vision for better care, but it is their vision. If you are an independent practice looking to do a deal, and if maintaining as much autonomy as possible over what you do day to day as a provider of care to your patients is an important value for you, have a lot of conversation about how everyone will manage this, but it is a major reason you might think about private equity.

21. The F Word

A buddy and I used to coach middle school football. Two hard charging executives with high standards and whistles meet about two dozen 13-year-old boys whose prefrontal cortexes are a long way from fully baked. Through a little pigskin machismo into the mix and you have a recipe for F-bombs being dropped left and right.

'FOCUS!!'

What F-bomb were you thinking? Hey, we were not cretins. We were molders of young men.

It was amazing how much better we played when we had focus. And equally amazing how hard it was to keep it for more than about three minutes.

Sounds like most businesses as well, likely your practice included. Any of your physicians have a new shiny object problem? Thought so.

Focus is the last thing I want to highlight that private equity buyers can bring if they become your partner. There are three unique things about a PE buyer, compared to other alternatives, that will help sharpen your focus and execution.

First, they have only one way to make money on their purchase of your practice and that is to make your practice more valuable. That may seem like I am spouting a tautology but let me clarify. If a hospital buys your practice, they have a lot of other ways to make money from you. If a health plan buys your practice, they, too, have other ways to monetize you. Are you supposed to be productive and see more patients, or admit a lot of patients to the hospital?

You can quickly see how such an owner can lose strategic focus. But a pure financial buyer views it more simply – they bought an asset for a dollar and now they need to figure out how to make that asset worth $2 to the next buyer. There is value in that clarity.

Second, as we have discussed, most PE buyers will leverage their equity with debt, sometimes a lot of it. Debt comes with covenants, which come with bad consequences if they are broken. Regardless of how you feel about using debt or not, it does have an amazing power to keep everyone concentrating on the main thing.

Third, they generally have a timeframe in which they need to turn around and sell you to someone else. That is the nature of their fund structure. A target exit window that everyone knows day one helps keep the team dialed in to the progress that needs to be made turn that $1 into $2.

Ironically, not even all financial investors have this particular combination of drivers. Early-stage venture investors are chasing a big vision and looking for a home run. Buy and hold investors think more about the cash flow the business can produce over the long term.

For good or for bad, this the PE mindset. In a time of industry turbulence and change, there is a lot of value in having this discipline.

So, buckle your chinstrap and FOCUS.

22. Family Counseling

When I first broached this topic of selling independent physician practices to private equity investors, I thought it might merit two posts. How about two months' worth? We hope our musings over that time have been helpful.

I want to close this series with a simple, but challenging, piece of advice. If this is something you are even remotely considering, before you engage an investment banker or start fielding phone calls, you need to do some family counseling.

The physician owners and key management leaders need to get a room and talk. It will likely take longer than that implies, so allow yourself plenty of time. If you are like most families, when you push past chatter about the news of the day and into the issues that matter, it often helps to have a third party there to facilitate the discussions.

What you need to talk about sounds straightforward enough – Hey, what does everyone want out of any deal we might do, and are there any deal breakers?

Easy, right? Uh, no.

Hidden stuff starts to come out and things can get complicated. Deals bring the singularity (we can only do one) and clarity (those numbers and terms and contracts are pretty black and white). That causes differences between the players to surface. That is not bad; it just is. You'd much rather get them out early, inside the family, than when you are in the middle of negotiating a term sheet with a buyer.

Here are just a handful of factors that might show up…

Divorce. The literal, marriage kind.

Two partners that look alike on most fronts – age, productivity – can take very different views of the same deal if one is divorced and one is not. The divorced partner will run everything (cash at closing, potential future value of the rolled equity) through the divorce settlement terms and may draw different conclusions about the type of deal that is better.

Age.

What happens when that highly productive partner, one that is making a major contribution to the EBITDA that will make the practice attractive to buyers, says that a little extra cash at closing will push their nest egg over the target and accelerate retirement? How does that play into disclosure to the buyer? How does it impact the type of contract the now close-to-the-end partner will sign?

Compensation.

Due to history, camaraderie, values, whatever, some practices have comp models that honestly help carry some lower producing partners. But an outside buyer might have a comp model that would result in a real squeeze on lower producers. That partner squirming in the corner, raising objections that don't seem to make sense? Might be doing this very math and not liking the results.

Whether it is private equity or any other transaction that disrupts the status quo, you need to have these conversations. They are hard, but good.

Best of luck and drop me a line if we can help you think through this stuff.

About ALN

ALN has been providing outsourced revenue cycle management services to independent physician practices across the country since 2001.

Tim Coan, ALN's CEO, writes an insightful and witty blog weekly about a variety of topics relevant to independent physician practices. To reach Tim or subscribe to his blog, please email him at: tim.coan@alnmm.com.