MSO-Private Equity Transactions in Orthopedic Surgery Practices

APRIL, 2020

Examples of Pressures on Independent Orthopedic Practices

- Continually rising costs
- Reimbursement is not keeping up with COLA or rates may actually be decreasing
- Primary Care/Referral Physicians are being absorbed by larger groups that have Orthopedics in house
- Narrowing Networks
- Increasing paperwork and regulatory compliance

Notes:

5 major drivers shifting the market away from the private practice model

|Need for economies of scale

Consumers' expectations are evolving: there is a need for more robust information systems

Progression to value-based payment and pressure to take on financial risk.

High degree of physician burnout.

Less appeal for young physicians to be in Private Practice due to all the above

Notes:

Alternatives for Dealing with the Rewards/Risks of Private Practice

Keep the status quo

Become an employed physician (e.g. Kaiser, Sutter Dignity, Stanford….)

Join a multispecialty medical group, fee for service/HMO

Grow your Orthopedic practice footprint and compete while maintaining independence, with or without Private Equity- (is bigger better?)

Notes:

Is Bigger Better / Practice Consolidators for Single specialty Private Practice

- **Independent Platform PPMs:** Single specialty groups deploy a geographic density strategy to build regional, multi-regional or national provider groups.

- **With or without Private Equity**

Example of a Recent non- PE California Transactions in Orthopedics

Hoag orthopedic institute partners with surgery center in Marina Del Rey, marking first expansion into Los Angeles county….They're coming

In Bay Area there are a number of Orthopedic Groups that have between 16 and 30 providers that consciously grew their practice for all the reasons discussed

Notes:

Why Consider Private Equity Investment in Your Practice

The answer is pretty straight forward:

1. Grow your regional footprint to compete
2. Realize the advantages that come with economies of scale
3. Position for alternative payment models
4. **Monetize and take risk off the table**

Notes:

The growth of Private Equity in Physician Practices

In the U.S., private equity investor deals related to physician practices amounted to $22 billion in 2018, but then surged to **$60 billion** by November 2019.

"Private equity in healthcare," *Medical Economics*, Nov. 12, 2019.

Notes:

Examples of a PE backed Pure Orthopedic Plays

Nov 14, 2019: Vail, Colo.-based The Steadman Clinic recently partnered with orthopedic practice company Orthopedic Care Partners. OCP is the holding company for five practices including The Orthopedic Institute in Gainesville, Fla., and is backed by private equity company Varsity Healthcare Partners (a California PE firm) .

“September 2019: Beacon Orthopaedics and Sports Medicine, a large orthopaedic practice in Cincinnati with 27 orthopedists, took on a private equity investor in July to spur future growth. The practice aims to become a regional and national leader in orthopaedics, growing its footprint by partnering with orthopaedic practices and ASCs.

Notes:

Private Equity: What They Do

Key Characteristics:

- ✓ Private Equity's ("PE") goal is to align with physicians as doctors are the revenue generators of the business.
- ✓ PE structures the new MSO entity so physicians receive ownership and are active in day to day operations.
- ✓ PE's business model dictates they must grow any company into which they've invested so in the future they can sell their position and make a profit for themselves / investors/ physician partners.
- ✓ Funds plan to exit investments after a set period (typically 3-7 years post transaction).

Subset of Private Equity Firms

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EW Healthcare Partners

FRAZIER HEALTHCARE PARTNERS

GENERAL ATLANTIC

KKR

NAUTIC

REVELSTOKE CAPITAL PARTNERS

CHICAGO PACIFIC FOUNDERS

DEERFIELD®
Advancing Healthcare®

Audax Group

WINDROSE

SUMMIT PARTNERS

LLR Partners

TA ASSOCIATES

BainCapital

LINDEN

GAUGE CAPITAL

OAK HC/FT

H. I. G. ADVANTAGE

SV HEALTH INVESTORS

LEE EQUITY

NAVIMED CAPITAL

PE Firms are **NOT** Created Equal

Some provide capital:

- To purchase portion of cash flow
- Assist with growth- practices and ancillaries

A number have management expertise and many years of experience

Relationships with Payors, health systems, insurers

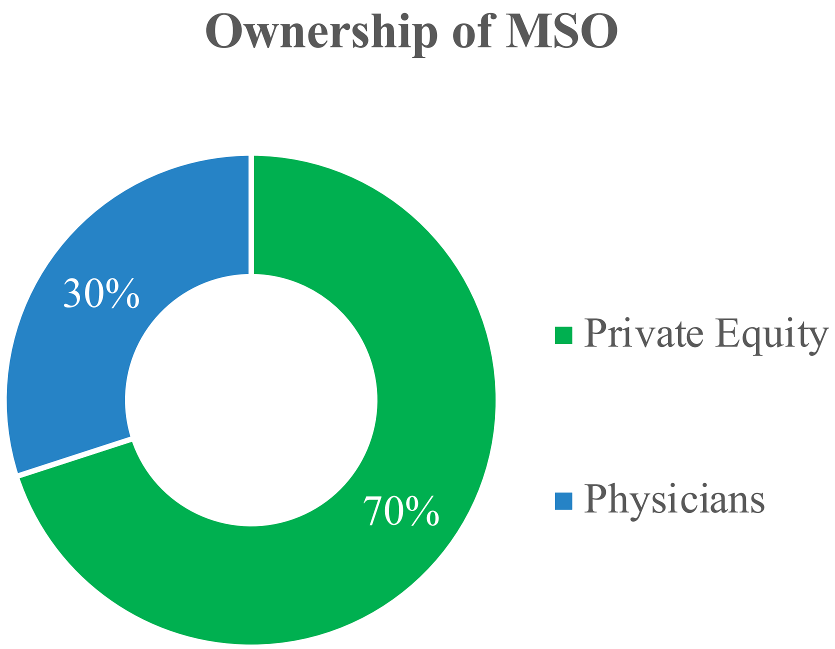
Notes:

What are Management Service Organizations (MSO)?

Key Characteristics:

- ✓ Private Equity partners look to form a Management Service Organization ("MSO") with physician partners.
- ✓ In Corporate Practice of Management states, PE cannot profit share with physician practices
- ✓ MSO affiliates with each practice via management agreements.
- ✓ MSO provides practice management and administrative support services.
- ✓ Physicians maintain independence and control of their respective private practice.
- ✓ Compensation systems will be productivity based.
- ✓ Necessary especially in states with. A corporate practice of medicine statutes

Generic Transaction Structure



Notes:
Physician Practices would contribute 30% of their income to the MSO.
Then, the MSO is owned 70% by PE and 30% by Physicians.

Why Consider the MSO-PE Partnership?

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Financial

- ✓ Monetization at high multiple
- ✓ Obtain partner motivated to invest in and grow business.
- ✓ Share in upside through retained equity
- ✓ Possible additional monetization in 3-7 years

Economies of Scale[1,2]

- ✓ Increased leverage to negotiate enhanced payer contracts.
- ✓ Purchasing economies of scale.
- ✓ Access to technologies designed to streamline processes
- ✓ Risk Sharing
- ✓ Access to management, clinical, business and operational expertise

Growth[1,2]

- ✓ Increase patient referrals from larger physician network
- ✓ Corporate partner with capital access and growth incentive
- ✓ Access to large network and resources to grow physician base and facilitate succession plans
- ✓ Management bandwidth to expand geographical footprint
- ✓ Develop ancillaries formerly not attainable

Notes:
[1] These items can only be added with the scale created by an MSO.
[2] Merritt pushes potential Buyers to give credit on these when valuing the MSO.

Generic Valuation Example and Flow of Dollars

	Aggregate	Avg. Per Physician
Current Net Revenue of Practice	**$ 25,000,000**	**$ 892,857**
Currenet Ancillary Income	**$ 1,500,000**	**$ 53,571**
Expenses of Practice	(12,500,000)	(446,429)
Total Physician Income	**$ 14,000,000**	**$ 500,000**
Saleable Income Contribution to MSO [2]	**$ 4,200,000**	**$ 150,000**
Multiple On Earnings	*10*	*10*
Valuation of Saleable Income	**$ 42,000,000**	**$ 1,500,000**
Cash to Physicians	**$ 29,400,000**	**$ 1,050,000**
Physician Equity Contribution to MSO	**$ 12,600,000**	**$ 450,000**
Residual Physician Compensation (70%)	$ 9,800,000	$ 350,000
Residual Share of MSO Income (9%)	$ 1,260,000	$ 45,000
Total Residual Physician Income	**$ 11,060,000**	**$ 395,000**
Portion of Original Income	*79.0%*	*79.0%*

Notes:
The above analysis assumes the Practices involved would have 28 physicians participating in and owning 30% of the MSO.

Valuation Example and Cash Flow

- ✓ Post-transaction, physicians maintain:
  - ➢ 70% of current income
  - ➢ 30% of MSO income = 9% of starting income stream

- ✓ Cash to physicians is taxed at capital gains tax rates.

- ✓ Physicians maintain control of their private practice.

- ✓ Potential for second sale once private equity partner.

Goals of a Successful Transaction

- ✓ Identify the universe of potential partners.
- ✓ Maintain productivity based compensation system.
- ✓ Maximize value and monetize income stream.
- ✓ Income repair.
- ✓ Succession planning for older physicians.
- ✓ Career track for younger physicians.
- ✓ Governance issues / **maintaining clinical autonomy**.
- ✓ Addressing all additional concerns of medical group prior to close.
- ✓ Participation in more sophisticated payment models

Orthopaedic & Neurosurgery Specialists in Greenwich, Conn partnered with private equity firm Kohlberg & Co. to equitize, expand its clinical offerings and ancillary services in July 2019

Quote from Timothy Corvino, M.D, CEO at ONS in Greenwich, Conn February 14, 2020

I believe there is a significant opportunity to expand our footprint outside of our current service area in a meaningful way. We're growing through new partnership opportunities and geographies in order to take better care of patients.

The Kohlberg & Co. partnership has gone extremely well. The interaction between Kohlberg and the physicians is great; they are there to support the physicians in whatever way they can. When Kohlberg was looking for partnership opportunities, the most important thing in a prospective partner was alignment in values of providing excellent clinical care and patient experience to create a meaningful footprint in the communities. ONS also had a lot of choices and potential partners, and I think that during the process to find the right partner, we did our due diligence to find the right fit. It’s because these shared values are aligned that the partnership has really played out nicely and met people’s expectations.

Notes:

Potential Future Liquidity of MSO/Second Bite

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Goal is to Grow the MSO[1]

Grow Volumes, Revenue through:

- ✓ Addition of Ancillaries
- ✓ Managed Care Contracting
- ✓ New Revenue Models
- ✓ Economies of Scale
- ✓ Strategic Additions of Practices

Works best when interests are aligned.

	Aggregate	Avg. Per Physican
Starting MSO Income	**$ 4,200,000**	
MSO Income Year 5	**$ 8,400,000**	
Multiple on Second Sale	15	
Valuation	**$ 126,000,000**	
Physician Ownership of MSO	30%	30%
Physician Equity Value	**$ 37,800,000**	**$ 1,350,000**
Original Equity in MSO	*12,600,000*	*450,000*

Notes:
[1] Any private equity company that becomes a partner in the MSO will have a strong vested interest in growing the company with the physicians. Their business model dictates they must grow any company into which they've invested so in the future they can sell their position and make a profit for their investors and themselves.

Example of a Subsequent Transaction (Second Bites)

First Transaction   January 23, 2017

PHOENIX--(BUSINESS WIRE)– **The Core Institute,** a leading provider of healthcare solutions, care redesign, and service line management for musculoskeletal medical practices, announced it had raised equity financing from Frazier Healthcare Partners and Princeton Ventures. Terms of the transaction were not disclosed.

Second Transaction August 15, 2019

Frazier Healthcare Partners VII's portfolio company, the Center for Orthopedic & Research Excellence, Inc. ("**CORE**"), was sold to the Audax Group and Linden Capital Partners.

Notes: The sale is of the MSO only, not the practice. The physicians participate in the proceeds of the MSO prorate.

Pros / Cons Of a PE transaction

Economies of Scale Possible Only With Consolidation
(Contracting, Ancillaries, Management, Purchasing)

Unique Opportunity to Monetize Practice

Scale Can Lead to "Income Repair"

Consolidating Positions Well for Future

PE versus Strategic Partner Dichotomy

Operational/Cultural Integration Challenges

Possible Income Drop if Scale Benefits Don't Materialize

Other Considerations

- ✓ Current size of your individual group may not provide scale for contracting or growth synergies.
- ✓ Income Repair
- ✓ Very difficult to go at risk or migrate from ‘fee for service’ without scale.
- ✓ Governance
- ✓ Significant overlap of business functions among groups provides efficiency and cost savings opportunities.
- ✓ Without scale, it is not possible to maximize value and cash flows from ancillaries.
- ✓ Current trajectory of income for smaller practices is mostly negative.

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