PHYSICIAN PRACTICE MANAGEMENT ORGANIZATIONS AFTER COVID-19: WHAT DOES THE FUTURE HOLD?

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The COVID-19 pandemic has wrought a swift and unprecedented impact on the United States economy following implementation of efforts to fight the spread of the disease, including the forced closure of many businesses and issuance of stay-at-home and shelter-in-place orders across the country. Unlike preceding recessions and economic shocks during which healthcare providers have generally fared better than many other sectors, governmental orders limiting non-emergency visits and procedures have caused many physician practices and other clinic-based providers to experience staggering declines in patient volumes, almost overnight. Through mid-April, volumes for various medical specialty practices have declined between 30 to 75 percent.[1] Physician Practice Management ("PPM") organizations are no exception, although some may be better equipped to handle the downturn. Looking forward, many participants in the PPM space are optimistic that the outlook for these organizations remains positive and expect robust transaction activity to resume once the pandemic is contained.

IMPACT FROM COVID-19 ON PHYSICIAN PRACTICE OPERATIONS

In addition to the sharp decline in patient/procedure volumes, there are many potential short-term and longer-term impacts to physician practices and PPMs resulting from COVID-19. The following list highlights some of the operational and financial considerations that will challenge PPM platforms in the coming months and years.

- **Pent-Up Demand or Extended Downturn?** While no one knows when and in what form physician practices will be able to return to normal operations, many operators and service providers in the PPM space expect volumes to bounce back strongly in the second half of 2020 due to suppressed demand resulting from cancelled and postponed visits and procedures during the first half of the year. To the extent that this surge of volume materializes, operators may need to utilize telemedicine, independent contractors, and advanced practice professionals to help service the additional demand without increasing wait times or losing patients to competitive practices. In addition to expanding capacity through such means, practices will need to develop plans to maintain a safe, sterile environment while potentially accommodating social distancing guidelines as well. The expectation that volumes rebound strongly is not shared by all, as a recent survey of physician practices suggested physicians anticipate a slow recovery of volumes, and

[1] Medical Economics. "Physician Practices Reeling From COVID-19 Financial Losses." https://www.medicaleconomics.com/news/physician-practices-reeling-covid-19-financial-losses. Accessed April 30, 2020

expect volumes may still be down by more than 10 percent through early 2021.[2] Issues potentially contributing to an extended downturn for PPMs, and physician practices in general, include a second wave of COVID-19 in the fall and/or rolling stay-at-home or shelter-in-place orders throughout the United States, ongoing shortages of personal protective equipment and other medical supplies, and people remaining unemployed and uninsured for an extended period of time. HealthCare Appraisers expects surgical practices and affiliated surgery centers to experience some pent-up demand from delayed elective procedures, while certain clinic-based specialties, such as primary care, are less likely to benefit from a spike in patient volume, as cancelled visits are less likely to be rescheduled immediately. This expectation is consistent with recent analyses prepared by Moody's regarding the outlook for surgery centers following the resumption of elective procedures.

- **Telemedicine.** Governmental orders to cancel or postpone non-emergency visits and procedures in many states have led physician practices to ramp up their telemedicine capabilities dramatically. The ability to utilize telemedicine has enabled physicians to continue to provide care to patients and help soften the decline in revenue, while also making it easier to practice socially distancing and slow the spread of disease. Teledoc indicated on a business update call with investors on April 14th that its daily patient volumes have doubled, and Teledoc has contracted with thousands of additional healthcare providers since March. PPMs have transitioned to telemedicine with varying success during the pandemic. In our experience, PPMs have generally been able to replace between 15 percent and 60 percent of their typical practice volume. The relaxation of certain restrictions on the practice of telemedicine could endure beyond the initial outbreak period, particularly if efforts to socially distance remain in place. More broadly, the COVID-19 pandemic is expected to accelerate adoption of telemedicine throughout the healthcare system, a trend that was already in place before the pandemic. This acceleration is being enabled by companies like Google[3], which now provides links directly to providers' telehealth platforms through its search engine. On the Teledoc call previously referenced, management indicated that it believes the role of virtual care has changed forever. For more information on the increased use of telemedicine during the COVID-19 pandemic, please see our FMVantage Point on the topic.

- **Advanced Practice Providers.** In addition to relaxing restrictions on telehealth, CMS has enhanced the ability of advanced practice providers ("APP") to provide certain services to help ease the staffing strain resulting from COVID-19. While these measures are mostly aimed at facilities experiencing a surge of COVID-19 cases, it is anticipated that the ability of APPs to provide a wider range of services could remain in place beyond the pandemic.[4] Such a long-term change could provide a boost to PPM platforms that heavily utilize APPs.

- **Payor Mix.** In the near term, the payor mix for many organizations will likely shift unfavorably due to mass layoffs. Specifically, with the unemployment rate increasing, many individuals covered by commercial insurance through their employers will become uninsured, shift to Medicaid coverage, or purchase private insurance through an ACA exchange. While furloughing could temper the severity of this shift in the near-term to some degree, any substantial increase in Medicaid and uninsured patients will negatively impact collections and earnings for PPMs.

- **Increase in Variable Compensation for Providers.** As practices struggle with declining patient volumes and collections, some private equity owners have asked physicians to restructure their compensation plans to forgo fixed base compensation and rely entirely on productivity-based

[2] Healthcare Dive. "Doctors Say COVID-19 Has Slashed Patient Volumes, Made Finances Shaky." https://www.healthcaredive.com/news/doctors-say-covid-19-has-slashed-patient-volumes-made-finances-shaky/575876/ Accessed May 1, 2020

[3] Google. "Connecting People To Virtual Care Options." https://blog-google.cdn.ampproject.org/c/s/blog.google/technology/health/virtual-care-covid-19/amp/ Accessed May 1, 2020

[4] Modern Healthcare. "APPs Hope That Temporary Scope of Practice Tweaks Bring Lasting Change." https://www.modernhealthcare.com/operations/apps-hope-temporary-scope-practice-tweaks-bring-lasting-change Accessed May 1, 2020

compensation instead.[5] This trend is not isolated to practices affected heavily by COVID-19. Large operators, including Mednax, are shifting more of their physicians to pure-productivity models, specifically collections-based models, as they anticipate facing future payor mix headwinds.

IMPACT ON PPM TRANSACTION ACTIVITY

Private equity firms have more than $2 trillion in uncalled capital and many operators in the PPM space expect robust transaction activity in the second half of 2020 and into 2021. 2020 Transaction activity got off to a strong start pre-COVID-19, and some PPM transactions that kicked off prior to the pandemic have closed, including deals in gastroenterology, ophthalmology, and behavioral health. While very near-term transaction activity will likely be muted due to uncertainty surrounding the duration of stay-at-home and shelter-in-place orders, there are many factors that point toward a strong rebound in deals once the outlook becomes less uncertain.

- **In-bound Inquiries Picking Up.** PPMs are experiencing an uptick in inbound calls from struggling practices looking for a partner with strong financial backing. Many physician owners have a meaningful portion of their wealth in their practices and have experienced significant wealth destruction as a result of the COVID-19 outbreak and response. PPMs offer a solution for many of these physicians. Having a strong pipeline of potentially motivated sellers could contribute to robust transaction activity once the outbreak has been contained.
- **Lower Valuation Multiples.** There are a few factors that could contribute to lower valuation multiples for transactions in the near term. Public markets have been extremely volatile and remain well below their pre-pandemic peak. For transactions taking place in the near term, the high level of uncertainty surrounding financial performance in the coming months and years could lead to lower valuation multiples, even if adjustments are made to normalize financial performance (*i.e.*, using *pro forma* earnings adjusted for the negative COVID-19 downturn). There is also a possibility that fewer strategic buyers, particularly health system owner/operators, will be competing for these deals, as they focus on shoring up their balance sheets and reducing expenses. While some facility operators and health systems may be less likely to pursue deals in the near term, Optum indicated on its recent earnings call with investors that its balance sheet remains strong and the company will still pursue transactions if attractive opportunities present themselves. This activity ultimately may not be a bad thing for PPMs, as Optum could very well be a potential consolidator of the some of the PPM platforms that exist today.
- **Attractive Deal Terms.** In addition to lower valuation multiples, PE sponsors and their PPM platforms may adjust deal structures or provide alternative sources of financing to practices that could offer attractive returns. In the near term, there will likely be an increase in bridge loans or similar types of financing arrangements to help practices get through periods during which revenue is depressed. Distressed lending funds will also likely come into focus, with funds focused on senior housing having raised fresh capital during the crises[6], and other funds sitting on ample dry powder.[7] Given that the disruption from COVID-19 could last well into 2021, practices may need to access capital from outside the traditional banking sector. In terms of adjustments to deal structures, we expect to see increased amounts of rollover equity and long-term escrows as buyers potentially look to shift some near-term risk onto the sellers in transactions.

[5] Modern Healthcare. "Private Equity-Owned Doc Practices Shut Out of Small Business Bailout." https://www.modernhealthcare.com/finance/private-equity-owned-doc-practices-shut-out-small-business-bailout Accessed May 1, 2020

[6] Senior Housing News. "McFarlin Group Raising $100M Fund to Target COVID-19 Distressed Senior Housing." https://seniorhousingnews.com/2020/04/13/mcfarlin-group-raising-100m-fund-to-target-covid-19-distressed-senior-housing/Accessed May 1, 2020

[7] Reuters. "As Coronavirus Fears Grow, Private Equity Eyes Distressed Investments." https://www.reuters.com/article/global-privateequity-distressed/as-coronavirus-fears-grow-private-equity-eyes-distressed-investments-idUSL5N2AQ4WY Accessed May 1, 2020

HOW HEALTHCARE APPRAISERS CAN HELP

In a recent article by Bain & Company regarding the impact of COVID-19 on private equity, the authors indicated sector expertise would be crucial to generating strong returns going forward.[8] With over 20 years of experience in healthcare valuation and transaction advisory, HealthCare Appraisers is well positioned to guide PPMs toward stronger future performance. Specifically, PPMs may need outside expertise in the following areas of transition:

- **Provider Compensation Plan Consulting.** PPMs may become increasingly interested in restructuring provider compensation plans or implementing organization-wide compensation models to align their compensation arrangements with their platform's objectives.
- **Transaction Advisory Services.** To improve due diligence efforts following the COVID-19 pandemic, PPM organizations may look to outside consultants to perform benchmarking analyses of a physician practice's procedure mix, collections, payor contracts, and financial statements to provide insight into a practice's operations and financial performance. In our experience, *pro forma* adjustments to seller financial statements can often reflect a more optimistic view of the future than what is ultimately feasible. Having expert consultants with rich benchmarking datasets to assist in developing projections provides more informed investment decisions.
- **Fair Market Value and Fair Value Analyses.** HAI has provided thousands of fair market value and fair value opinions to assist clients with their pre- and post-transaction valuation needs. Common engagements include business enterprise valuations, intangible asset valuations, purchase price allocations and goodwill impairment testing in connection with FASB Accounting Standards Codifications 805, 350, and 360 reporting requirements. Our understanding of the regulatory and economic environments in which practices operate enables us to provide insightful and defensible valuation opinions. In some cases, COVID-19 may represent a triggering event for impairment tests. More broadly, COVID-19 will likely lead to further consolidation requiring post transaction fair value analyses.
- **Tax Matters.** As transaction volume is expected to increase, successful PPMs will benefit from utilizing tax efficient transaction strategies for sellers. Leveraging outside expertise to evaluate personal goodwill for physicians in connection with the sale of their practice could differentiate one offer from another and result in closing more transactions. For more information on personal goodwill valuations, please see our FMVantage on the topic.

Many operators in the physician practice and PPM space expect robust transaction activity later in 2020 and beyond due in part to the impact of COVID-19 on independent physician practices. HAI's expertise and experience in providing valuation and consulting services for these transactions can be an invaluable resource for platforms and their physician partners. Contact one of our experts today.

[8] Bain & Company. "The Impact of COVID-19 on Private Equity." https://www.bain.com/insights/the-impact-of-covid-19-on-private-equity/ Accessed May 1, 2020