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Consolidating Retail Medicine:

Positioning Single-Specialty Practices for Acquisition

Market Corner Commentary
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Single-specialty medical practices are the front door of American medicine. Dentists, Dermatologists, Ophthalmologists, GI doctors, ENT doctors, Internists, Gynecologists, Obstetricians, Urologists and their "retail medicine" counterparts provide high volumes of medical care to consumers in community-based facilities.

In a throwback to the practice consolidation wave of the 1990s, solo and small-group specialists are selling their practices at an accelerating rate to Physician Practice Management organizations ("PPMs"). PPMs offer physicians stable income, centralized management, administrative and operational support, unique branding and malpractice insurance coverage within large group practices.

Importantly, private-equity (PE) firms, typically with 5- to 7-year investment horizons, are funding this current consolidation wave. The consolidation of these retail care practices is occurring within a dynamic market environment that increasingly rewards efficient, low-cost, high-volume providers.

PE buyers all have "exit" requirements to generate investment profits. Successful exits for PE investors require a doubling or tripling of their investment value under their ownership. Consequently, understanding the market dynamics shaping valuations is essential to successful acquisitions and sales for both buyers and sellers of these retail care practices.

Consolidation of physician practices ultimately failed in the 1990s. The initial success of PPMs and their subsequent dissolution tracked the rise and fall of health maintenance organizations (HMOs). By focusing on value creation, the current consolidation wave has the potential for longer-term sustainability.

Market dynamics will influence acquisition prices and multiples for individual practices. Valuation multiples could compress as PPMs grow in scale, growth rates mature, and operating efficiencies stabilize. What strategies should retail medicine's operators and buyers employ to best position themselves for successful consolidation transactions now and in the future?

REVISITING THE 1990s

The demise of the Clinton healthcare reform initiative in September 1994 and the subsequent shift in Congressional control to Republicans that November created conditions for private health reform initiatives, most notably HMOs, to control skyrocketing healthcare costs.

Enrollment in HMOs more than doubled between 1990 and 2000 from 38 million to over 80 million.[1] HMOs essentially charged a fixed, "capitated" rate per member to cover all necessary healthcare costs. The HMO business model helped moderate national healthcare expenditures, which approximated 13.5% of GDP throughout the decade.

The HMO business model required larger physician group practices to manage the care of enrolled members within budgeted revenue levels. Public companies, including PhyCor and MedPartners, emerged to fill the void. They used capital raised through the public equity and debt markets to acquire physician practices. Newly-forming health systems also became active acquirers of physician practices.

"Cheap" money and ample demand drove the prices for physician practices ever upward. In 1997 alone, PPMs raised over $2 billion of public equity capital to fund acquisitions of physician practices.

HMOs began employing "gatekeepers," narrow provider networks, and prior authorizations to limit the amount and costs of care services provided. After receiving ample compensation for their practices, productivity among now-employed physicians dropped dramatically.

Reduced access to care services created a consumer backlash and a drive toward open, higher-cost networks. Financial losses mounted for PPMs managing care under HMO contracts, placing enormous strain on their operations.

By late 1998, the 15-largest publicly-traded PPMs had lost almost two-thirds of their value, declining from $10.6 to $3.8 billion. The market quickly and dramatically pivoted away from PPMs. Capital sources evaporated as groups lacked sufficient funds to cover operating costs, including physician salaries. Almost all PPMs reorganized or dissolved. PhyCor, the largest PPM, filed for Chapter 11 bankruptcy in January 2002.

These 1990-era PPMs failed because they overpaid for physician practices and focused on rationing care to achieve profitability. They did little to promote value-based care delivery (the right care at the right time in the right place at the right price). In most instances, PPMs introduced incremental costs that compromised their operational effectiveness. It was clearly time to regroup.

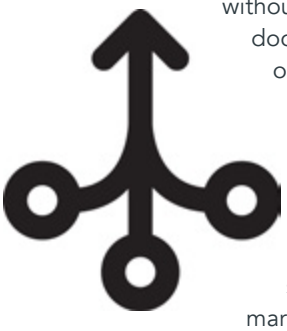
THE CURRENT CONSOLIDATION WAVE

It took several years to unwind the 1990s-era PPMs. Management Services Organizations ("MSOs") emerged from the ashes. These groups centralized non-clinical support services and applied economies of scale to provide more efficient and cost-effective back-office support.

Current PPMs employ MSOs to manage operations and typically access private capital through PE funds. PPMs with PE backing have a more disciplined approach to practice acquisition and focus on value creation. Large practice consolidators currently seek "tuck-in" or franchise acquisitions of specialty-specific care practices (e.g. dental practices). Their goal is to offer uniform customer experiences under unified brands.

Small acquisitions create considerable value at the practice level but become less meaningful as consolidators increase in scale. The market is now entering a new phase where larger M&A transactions may be necessary to "move the needle." Key investment considerations include:

- the competitive landscape for each sub-vertical in 15 to 20 years
- the character of dominant operators (regional or national; single speciality or multispecialty)
- the preferred PPM ownership model (independent or controlled)
- the sustainability of sole practitioner / single practices
- the consolidation/integration trends among payers and providers
- the emergence of new business models and competitors
- the final buyers of specialty-care practices



The MSO approach helps PPMs achieve efficiencies while attracting and retaining providers who focus on care delivery without operational or administrative responsibilities. New doctors generally prefer PPM employment over practice ownership. Most doctors carry sizeable student loans upon completing medical training. They are reluctant to incur more debt to start a new practice or buy into an existing one.

The acquisition "runway" to acquire practices remains long given the sheer volume of solo/small practices and the current degree of healthcare market fragmentation, but it will not last forever. Forward-thinking consolidators will be better positioned to create and capture value as the industry evolves toward value-based delivery.

TODAY'S PPM CONSOLIDATORS

Despite a growing presence, large consolidators of specialty-care practices control a small fraction of the overall market. The sector's fragmented ownership provides a significant investment opportunity to build scale, improve geographic density and expand service offerings.

Practice consolidators come from multiple industry sectors. Their motivations reflect their core business operations as described below:

- **Hospitals and Health Systems:** Health systems focus on growing their provider networks through employment and/or practice acquisitions.
- **Payers:** Insurance companies are selectively providing care services directly to consumers. For example, Optum, a division of UnitedHealth Care, is the nation's largest employer of physicians.
- **Large Independent Groups for Hospital-Based Care:** Several large provider groups, such as DaVita, Envision, Mednax, and TeamHealth, focus on providing hospital-based services (e.g., anesthesia, radiology, ED staffing, hospitalists, etc.).
- **Large Independent Multispecialty Groups:** Geographically concentrated multispecialty groups with large established primary care practices and broad specialties are expanding through hiring and acquisitions (e.g., Summit Medical Group, DuPage Medical Group, etc.).
- **Independent Platform PPMs:** Single-specialty groups deploy a geographic density strategy to build regional, multi-regional or national provider groups. These include Heartland Dental, Aspen Dental, Advanced Dermatology, U.S. Dermatology Partners, Eyecare Services Partners, etc.

Independent practices are experiencing increased urgency to align with larger groups either through sales or contract arrangements. With so much fragmentation among providers, platform PPMs have enjoyed a prolonged period of "valuation arbitrage" when consolidating single practice or small practice groups. It's a buyers' market. Dentistry illustrates this pattern.

The dental sector has been consolidating for over twenty years. Despite the longevity of this consolidation curve, solo practitioners still dominate the dental marketplace. Only 15% of dentists in the U.S. today are affiliated with Dental Service Organizations, or "DSOs." However, the pace of consolidation has accelerated in recent years and some projections estimate that DSO representation will double in the next five years to over 30%.

In the last 24 months, there have been over 25 stand-alone DSO transactions involving private-equity investment. Of the approximately 50+ DSOs backed by private equity today, around one third received their initial round of PE investment in just the last two years.

As the calendar flipped from 2018 to 2019, the PPM market witnessed the first examples of large practice consolidation. Within a period of just a few weeks, the dental industry saw three large DSO to DSO acquisitions. These were Western Dental's acquisition of Guardian Dental's business; Mid-Atlantic Dental Partners' acquisition of Birner Dental; and Smile Brands' acquisition of Decision One.

This phenomenon is not unique to dental. Similar trends exist across the PPM space as PE firms sprint to create new platforms in evolving retail medicine sectors, including ophthalmology and dermatology. Consolidation also extends into specialty verticals with less historic consolidation. These include orthopedics, women's health, urology, and podiatry, to name a few.

New and existing retail healthcare platforms are pursuing aggressive market expansion strategies, largely through acquisitions of solo or small-group practices. This trend won't continue indefinitely. Acquisition prices and multiples will eventually compress as company growth cannot continue at such accelerated rates when the overall markets are roughly flat or marginally growing.

THE FUTURE OF THE PPM SECTOR

Large-scale consolidation has been slow to materialize and only represents a small portion of consolidation today. The current landscape resembles the retail sector in 1950s America before neighborhood pharmacies and Five-and-Dime stores gave way to national chains like Walmart, CVS and Walgreens.

The economic reasons make sense. Big acquisitions are expensive while small acquisitions are cheap. Investors can pay a "big value" on the initial platform investment, then "buy down" that value over time by acquiring individual or small groups for significantly less.

This value arbitrage can mean that a PE firm might need to pay 12x to 15X earnings to buy a large group practice. In contrast, it can buy small groups at 3x to 5X earnings, then roll those into a larger practice and immediately achieve value arbitrage, even before driving synergies.

Long-term holds are not an option for PE firms. To return capital to investors, they must sell to new investors. The largest PE firms already own many PPMs today and increasingly are the logical buyers of smaller PPMs along with health systems and vertically-integrated payers.

A tantalizing question is whether the public markets will provide exit opportunities for large PPM through IPOs. In recent years, private market valuations have greatly exceeded public market valuations. This could change if consolidators improve PPM performance, reduce volatility, and generate consistent, sustainable financial returns.

What is the mix of characteristics that leads to long-term PPM profitability? Here are some considerations:

- **Size / scale / covered lives:** Large providers gain economic clout by negotiating directly with payers to deliver care to patients. A large catchment area offers financial benefits in negotiating better rates from payers, and economic benefits through scale.
- **Regional concentration vs. national reach:** The extent to which practices evolve into super-regional and even national organizations.
- **Vertical specialization:** The extent to which related sector verticals combine to improve referrals. For example, an ophthalmology group could combine with a retina specialty group to offer a vertically integrated service platform with enhanced patient access.

- **Multispecialty platforms:** The extent to which more comprehensive primary-care service platforms emerge to serve consumers' multiple retail healthcare needs.

In all likelihood, multiple business and ownership models for specialty care services will compete with one another in the post-reform marketplace. Winning companies will be those that deliver the services consumers want with convenience at competitive prices.

HEALTHCARE GOES RETAIL

The second coming of PPMs reflects a maturing healthcare marketplace that is repositioning to deliver single-specialty care services in retail settings. The emergence of competitive retail business models implies accelerated consolidation of solo and small practices within efficient platforms operating as unified brands.

The transformation of specialty care services is overdue and challenges traditional practice models that have dominated the medical sector. Greater scale is a prerequisite for retail healthcare services to meet consumer/customer expectations for price, consistency, interoperability and service excellence. Active PE consolidators are accelerating the transition to cost-effective and high-performing retail healthcare.

In many ways, this transformation resembles the transition from local to big-box retail that occurred during the 1990s. While many bemoaned the loss of "mom and pop" stores, consumers voted with their wallets by shopping at Walmart, Target, Home Depot and other big-box retailers. These companies offered greater selection, convenience, lower prices and better service. Mom and Pop didn't have a chance.

While the overall trends in advancing retail healthcare services are clear, their application will vary by market, payment models, competition and consumer preferences. Time is running out for solo and small-group practices. There is still first-mover advantage in some markets, but the valuation peak is likely in the rearview mirror.

The exit strategies for PE-funded PPMs are more nuanced, but ultimately rely on the ability to generate consistently growing cash-flows. What is less clear are the mechanics through which vertically-integrated business models will incorporate specialty care services. Our sense is the historic tendency to own these practices will shift toward partnership and outsourcing arrangements on unified delivery platforms (think Amazon).

The consolidation music plays on. PE firms scan the dance hall looking for good partners. Smaller PPMs try to look attractive. When the music stops, PPMs constructed to meet strong market demand will get the prize; those that don't will be left standing against the wall. It's high school all over again.

SOURCES

1. https://www.rand.org/content/dam/rand/pubs/rgs_dissertations/RGSD172/RGSD172.ch1.pdf

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