ONLINE EXCLUSIVE

What buyers look for in practice acquisitions

Contemplating a sale? Legal expert Jeremy Miller outlines some of the key decisions professionals may make prior to and during negotiations.

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When contemplating the sale of a group, savvy professionals will know what entices potential buyers so they are in a strong position to negotiate a sale and determine whether a buyer's goals are compatible with yours. Several decisions about how to structure the practice sale and understanding what is important to buyers are key to successful sales, say experts.

Unless the parties agree to a merger, a buyer will have to purchase either the stock of a group that operates through a professional corporation or purchase specific assets of a group. Groups often prefer to sell their stock because gains on the sale in excess of a shareholder's "basis" in the group's stock (what the shareholder paid for the stock increased by any capital contributions and decreased by any return of capital distributions) will likely be taxed at lower capital gains rates and avoid a potential "double tax" problem. And with stock purchases, buyers usually assume the seller's contracts, debts and other liabilities.

Buyers, on the other hand, may prefer to purchase specific assets, such as furniture, equipment and real estate, rather than acquire all of the group's assets and liabilities in a stock sale. A buyer may also want to purchase a group's accounts receivable (A/R) to finance working capital needs after the acquisition. If, however, a group's A/R is difficult to value, buyers may choose not to purchase that asset. Similarly, buyers may only agree to assume specific liabilities of the seller, such as office leases and service contracts, and be unwilling to assume bank loans and potential claims by third-party payers. Buyers may also prefer asset purchases because they get a "stepped-up" basis in the purchased assets from allocating the purchase price over the purchased assets in accordance with their fair market value. This enables the buyer to take more depreciation or amortization and reduce its taxable income.

An asset sale by an incorporated group can result in a significant corporate tax liability and then a second tax to the individual shareholders on distributions by the corporation. This so-called "double tax" problem can be avoided if the group has always been an S corporation, an Internal Revenue Code term for corporations that elect to enable the corporation to have its income or losses passed through to the shareholders rather than taxed to the corporation (or elected to be treated as an S corporation more than five years prior to the sale if it occurs in a tax year beginning in 2011 or 10 years prior for tax years beginning after 2011). It can also be avoided if the group is organized as a "pass through" entity, such as a partnership or limited liability company.

It may also be possible to mitigate the problem if some of the purchase price can be properly allocated to the sale of "personal goodwill" of the shareholders and to shareholder noncompete and consulting agreements. A seemingly attractive purchase price can be greatly diminished by liabilities for which the selling group will remain liable and by taxes due on the sale.

What are buyers paying?

Among the factors a buyer will consider are:

- Strategic importance to the buyer (such as for the development of an accountable care organization,

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consolidation of market position or to move into a new market)
- Payer mix
- Profitability
- Debt
- "Marquee" physicians who have outstanding reputations in their specialty or fill a geographic or specialist need
- Managed care experience
- Competing offers

Buyers backed by insurance company or private equity money, and hospitals, may be able to afford more than another medical group.

A commonly used formula for practice valuations is to pay a multiple of the group's yearly (or trailing 12 months) earnings before interest, taxes, depreciation and amortization (EBITDA). According to Thomas J. Cuccia, director of valuation services at Sinaiko Healthcare Consulting in Los Angeles, multiples can range from three to six times EBITDA and sometimes go even higher (but are also subject to downward adjustment for factors such as the assumption of the seller's interest-bearing debt and post-sale physician compensation). The five-year projected discounted cash flow is another popular valuation method. If the group is struggling and its physician compensation is below market, it may have little EBITDA. In that case, its valuation will likely be significantly reduced.

In most deals of any size, a valuation is performed by an independent appraiser. Often the purpose of the valuation is to provide backup (for tax, fraud and abuse, and Stark law purposes) for a price the parties have agreed upon as much as to figure out what the group is worth.

In most deals, the purchase price is paid in cash or by a cash down payment with a promissory note for the balance. If a promissory note is used, the parties will need to negotiate issues such as the amount and length of the note (usually 20 percent to 40 percent of the purchase price paid over two to three years), interest and security for payment.

Is your group attractive?

While buyers look for different things, factors that make a practice an attractive purchase option include:

- Meeting strategic needs of a buyer, including market position, provider alignment, care coordination and efficient care delivery
- Offering compatible clinical, compliance and corporate cultures
- The lack of significant regulatory hurdles or compliance risks
- Well-organized financial information that clearly presents the group's financial condition
- Retention of key physicians and management staff
- Strong physician leadership and good management
- Engaged, productive physicians
- Favorable rates with payers by the seller or the ability of the buyer to increase rates after the sale
- Not having to assume significant debt or other liabilities
- Successful EHR adoption by the group
- Experience with managed care and care coordination
- Unity in the practice about its willingness to be acquired by the right buyer
- Physicians who can bring desired inpatient cases and outpatient ancillary services subject to fraud and abuse and Stark law compliance.

Post-acquisition employment

In most acquisitions, the selling group's physicians will be offered employment, and former physician owners will be required to sign noncompete agreements to prevent them from going to another group in the buyer's service area, according to experts. Unless a physician expects to retire in the next few years, the value of the physician's employment agreement may greatly exceed his or her share of the purchase price. Therefore, selling physicians need to put equal emphasis on the terms of their post-acquisition employment and the purchase terms.

Hospital executives felt burned in the 1990s when they purchased practices at a premium price and gave physicians employment agreements with long-term salary guarantees.[1]

Today, purchasers are generally not willing to guarantee compensation for more than three years.

As a result, in addition to the length and amount of salary guarantees, selling physicians need to evaluate the compensation formula that will be used once a guarantee period ends. While purchasers may want to encourage and reward productivity, it will be difficult to measure that aspect of practice in the new "value vs. volume" era. Many purchasers use an RVU-based formula in which the minimum number of RVUs required and the dollar multiplier need to be agreed upon. Bonuses can take various forms, including pay-for-performance measures such as meeting RVU targets, patient satisfaction, immunization rates, emergency room visits, readmission rates and chronic care management. The relevant criteria, their relative weight and possible dollar values all need to be agreed on by the parties.

Other important post-acquisition employment terms include employment duties, hours, time off, on-call duty, benefits, term and termination, outside activities and restrictive covenants such as non-competes.

Notes:

1. Healthcare Financial Management Association. Integration in a reform environment: Strategies for success [Internet]. Westchester (IL): Healthcare Financial Management Association; 2010 June [cited 2011 Sept 30]. Available from: hfma.org/integrationstrategies/.