Physician Practice Spin-Outs:

The Opportunity for a Mutually Beneficial Private Equity Health System Partnership

CHARTIS

One consistent theme in the ever-changing healthcare landscape has been a persistent growth in physicians employed directly by hospitals or health systems, specifically specialists. Today, more than half of all physicians are employed by a health system or a practice fully aligned with a single health system. Over the years, health systems have become the employer of choice for specialists looking for a platform through which to treat their patients. However, a seismic shift is occurring, and we are seeing a slow-down in net-new hospital-based physician employment.

Meanwhile, private equity-backed options for physicians continue to proliferate. These platforms are now looking to health system physician practices to achieve growth in their businesses. This has long been a goal of private equity-backed physician practice management (PPM) companies but today is gaining traction and, we believe, becoming more practical than ever before.

To be sure, spin-outs of health system services are nothing new. We've seen many cases of ancillary services (such as lab or imaging), revenue cycle services, ambulatory clinical sites, and other high-value functions outsourced to specialized operators. Friendly physician spin-outs, by comparison, are more significant and novel, with few recent analogs of note. This paper will discuss the context for those spin-outs and posit an approach for private capital to successfully evaluate, de-risk, and execute them.

> **A physician spin-out** transitions health system-employed physicians into a different practice—in this case, a practice capitalized by private equity. It can include a subset of specialists or the entire medical group. The receiving practice can be existing or newly created for the purpose of the spin-out. The capital structure of the receiving practice can be designed any number of ways, such that the health system can participate in the ownership and/or management entity.

Why Private Equity Platforms Are Interested in Exploring Physician Spin-Outs

Private capital's interest in this model for building and scaling a business is a confluence of several factors:

- As private capital has continued to focus on PPM organization roll-up strategies, **the cost of acquisition has increased**. In some cases, valuations have grown to untenable levels. This has further fueled the desire to find unbanked, lower-cost points of entry.
- The **whitespace of acquirable practices is shrinking** as more small practices align with aggregator platforms and many newly minted physicians simply opt for health system employment early in their careers.
- **Many health systems have not maximized the economic value of their physician enterprise.** While physicians can be a value-generator for health systems that have optimized and integrated their clinical enterprise, the physician enterprise can also be a loss-leader for health systems. That leaves a value creation whitespace that private equity platforms are seeking to address.

The litmus test for specialties that are most appropriate for this approach are those that satisfy the bulk of these 3 criteria:

- There is a **disproportionate share of health system employment** today, which limits roll-up potential for remaining independent specialists and increases the value of a partnership approach to practice growth.
- The specialty **manages significant spend**, either procedurally or by managing costly and complex chronic conditions, which aligns with a value-based care thesis as an opportunity to better manage this spend.
- There are immediate **site-of-care opportunities** that directly affect practice economics or indirectly affect value-based economics, driven by shifting from the hospital outpatient department (HOPD) to ambulatory surgery center (ASC) settings.

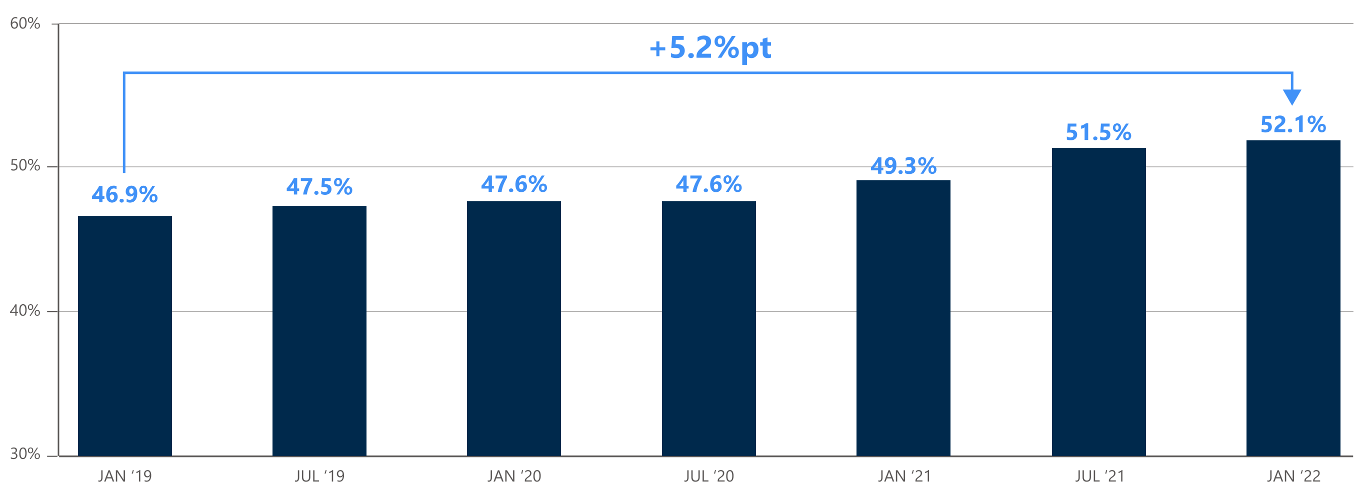
Why Health Systems May Be Interested in Exploring Physician Spin-Outs

We believe that health systems may be willing to explore this path for 3 reasons. The first is that health systems amassed many physicians over the past decade. The second is that health system finances have become challenged, creating a desire to find new ways to improve profitability. And third, a changing regulatory environment is creating more growth pathways for independent practices, at both the federal and state levels.

PHYSICIAN CONSOLIDATION HAS GROWN TO HISTORIC LEVELS

Today, health systems employ approximately 52% of all physicians nationally. While the trend is not new, it accelerated dramatically during the pandemic. Prior to 2020, approximately 47% of physicians were employed by health systems. By 2022, that number grew by 5 percentage points. Unsurprisingly, our research suggests that the consolidation focused on specialties that were economically valuable to health systems, including oncology (57% employed by health systems) and cardiology (59% employed by health systems).[1]

Percent of US Physicians Employed by Health Systems (2019-2022)[2]



Health systems have an appetite to find new growth avenues. Beyond physician practice growth, many health systems have developed sophisticated alternative investment portfolios, either through venture-style investing or creative commercial partnerships. Through a partnership strategy such as this, health systems can participate with experienced sponsors in a new value creation opportunity that extends beyond their core physician practice model.

HEALTH SYSTEMS NOW FACE CONSIDERABLE FINANCIAL HEADWINDS

Today, many health systems are experiencing financial challenges. The temporary pandemic volume losses were largely offset by robust federal support. But staffing issues, inflation, and obstacles to driving pricing growth have led to tenuous financial pictures for many of the nation's largest health systems. During the past 12 months, health system operating margins have fallen to -1.7%, from 1.05% and 1.35% in 2019 and 2021, respectively. Health systems are working to stabilize their financial positions in response.[3]

Health System Operating Margin (2019-2023)[3]

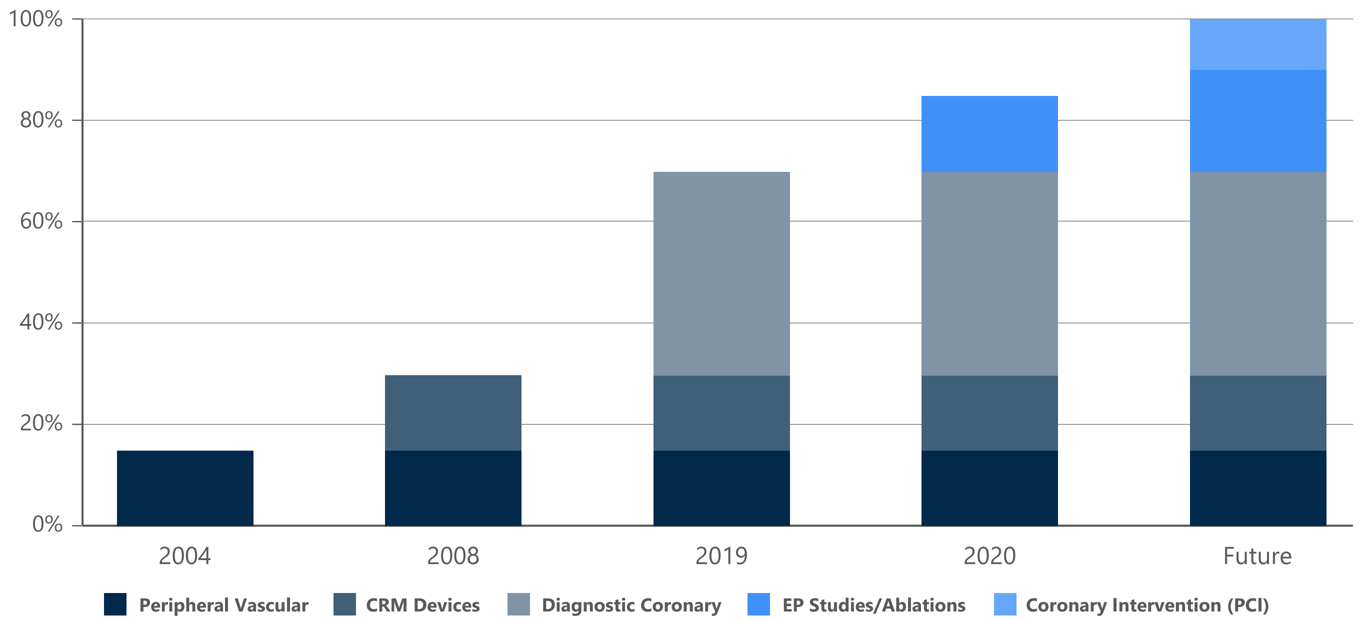
As a result, many health systems need to shed cashflow-negative services. While there are multiple ways to quantify and harness the value of employed physicians, many owned practices operate at a loss, given high compensation levels that may outpace revenue. Health systems also are realizing they may not need to directly employ physicians to derive the desired value from their alignment.

THE REGULATORY ENVIRONMENT IS GROWING MORE FAVORABLE TO INDEPENDENT PHYSICIANS

We see a continued loosening of regulatory barriers that favor independent physician practices, with some exceptions. At the federal level, the Centers for Medicare and Medicaid Services (CMS) has shown an increasing willingness to move high-value cases off the inpatient only procedure (IOP) list. This has created new ambulatory surgery center (ASC) growth opportunities in many specialties (such as cardiovascular medicine, as shown in the graphic below) that favor surgical care outside of an HOPD setting. Similarly, we continue to see state governments loosening their own regulations. In several recent cases, states have loosened certificate of need (CON) laws that had previously acted as barriers to ASC growth opportunities, such as North Carolina's[4] move to relax requirements and South Carolina's[5] recent move to repeal them entirely.

An exception to these relaxed regulatory barriers will be continued pressure by certain state regulators who seek to further restrict physician practice transactions. For example, New York state recently proposed a review rule for material physician transactions.[6]

% of Outpatient Medicare Cardiology Procedure Codes That Could Feasibly be Moved to the ASC Setting Which CMS has Made ASC Eligible[7]



Note: % guidelines are estimates

Orthopedics serves as a compelling case study for getting ahead of these regulatory shifts. Many health systems were caught off guard by the quick shift in orthopedic cases (led by private capital-backed platforms) into owned ASCs away from lucrative HOPD sites of care. Consequently, many health systems are more open to proactively participating in discussions ahead of and during major shifts in care, so they can be part of the care model evolution rather than left behind.

Conditions Are Right for Novel Conversations with Health System Leaders

Given private equity's incentives to explore this approach and the market dynamics facing health systems, we're seeing a convergence of models in new types of partnerships that are carving out employed physicians from health systems. While in some cases private capital may opt to attract physicians away en bloc (which could be a viable path in some situations), we generally see more benefit to a more mutually developed spin-out with a 3-way arrangement among investor, physicians, and health system.

As a result, we believe that the magnitude and immediacy of these factors will create the opportunity for private equity-backed PPMs to have previously unthinkable conversations with health systems. To be sure, the contexts for a spin-out are highly nuanced. Health systems and physicians will have to solve for non-economic issues, such as community perception and the long-term ramifications of a transaction, in addition to the presenting economic challenges and opportunities that a transaction will solve for. These issues and opportunities will likely differ by market and health system context.

How Private Equity Platforms Can Perform a Spin-Out

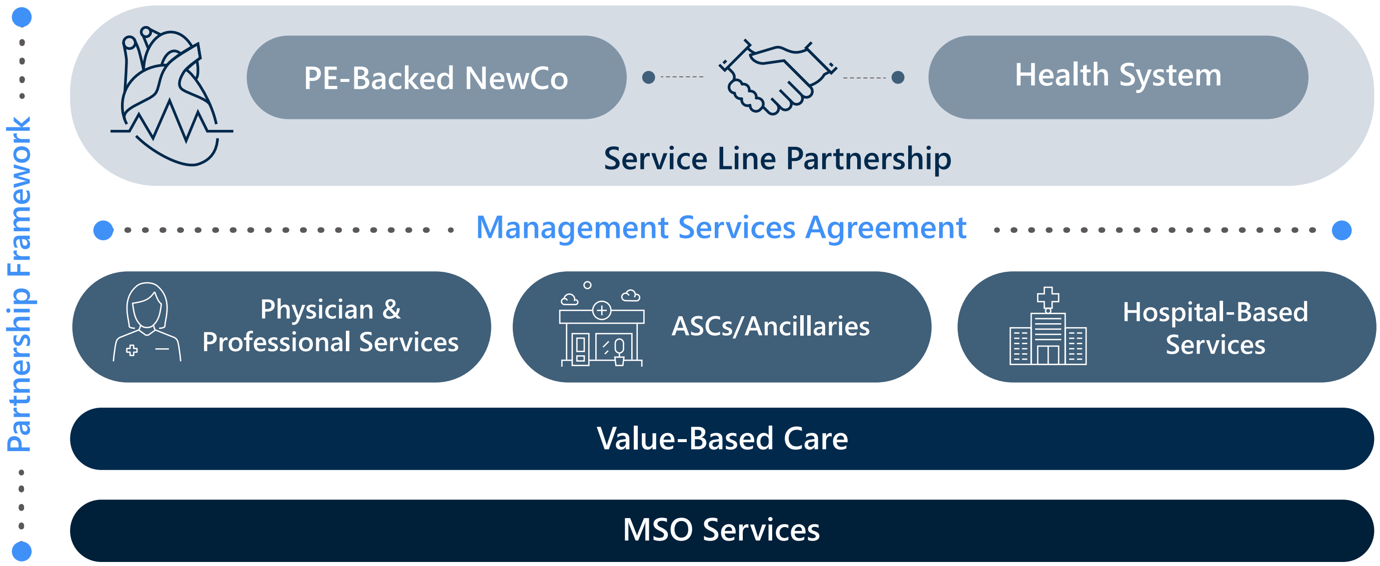
While cooperative relationships between health systems and independent specialty practices are nearly ubiquitous, they have primarily been arms-length partnerships, with the practice acting as a sort of vendor providing specific services (e.g., call coverage) to the health system or care to health system patients within a service line. These partnerships were often executed through co-management or professional services agreements.

A spin-out contemplates employing the health system's physicians inside of an entity not controlled by the system itself, often an existing private equity-backed physician platform. There are 2 diametrically different approaches to private equity accessing health system-employed physicians that are departures from historic relationships between health systems and private practices.

To execute a spin-out, some investors may be tempted to identify one or several dissatisfied or entrepreneurial physicians inside a health system practice to break off on their own and practice within the investor's own practice. However, in our experience, this is a limited market opportunity that requires a unique set of conditions to enable it. This approach also is fraught with risks and may irreparably damage volumes to the practice.

We recommend a true partnership model because it creates more sustained value to patients, physicians, sponsors, and the health system. Such a model involves a jointly facilitated spin-out of physicians with continued structural and economic alignment between the health system and the de novo practice. It also is materially de-risked as compared to an asymmetric approach of hiring physicians away from the health system practice, as it solves for the most important risks of that model around referral sources.

Framework for Facilitating a Spin-Out Partnership



The opportunity to build de novo or scale existing practices in partnership with each other creates an attractive growth opportunity for both health systems and private capital.

CLIENT SNAPSHOT: A LOOK AT THE COMPLEX DYNAMICS OF A CARDIOVASCULAR SPIN-OUT

The complexity of this strategy and the many considerations to navigate are illustrated in a recent evaluation focused on a cardiovascular physician practice spin-out we supported. A PE fund was interested in exploring this strategy and, as part of the effort, wanted to test the approach and receptivity with a group of health system-employed physicians.

Our work found demand from both parties to explore this approach, specific interests by physicians who would entertain this model, and reaffirming findings that the partnership approach is the optimal way to execute this strategy. In any specific situation, the health system and physicians will weigh the pros and cons, but the spin-out can be designed to preserve the best of both worlds and maximize the value to each stakeholder.

CLIENT SNAPSHOT CONTINUED

FINDINGS	SUPPORTING DATA POINTS[8]
There is demand for this strategy.	
A large cohort of health system-employed physicians are interested in going private.	• 52% are interested in joining an independent practice. • 34% think it is more desirable to join a PE-backed practice.
Many physicians believe that their health system may be interested in partnering with private equity, as well.	• 35% of physicians believe their system would be receptive to partnering. • 78% believe the 2 organizations would need to cooperate to be successful.
Physician interests are multivariate.	
Health system-employed physicians overwhelmingly desire a sense of economic participation in their practice.	• 79% of physicians said equity was important to them. • The top motivator for wanting to join was their ability to participate in the economics of a sale.
Physicians expressed the importance of key practice characteristics beyond economics.	• Leadership and management, access to leading clinical technology, and a budget that fuels practice growth and improvement were listed as the most important factors in evaluating a new practice.
Partnering de-risks the spin-out.	
Noncompete agreements highlight the barriers to executing a spin-out that does not include the health system as a partner.	• 58% of physicians were subject to a noncompete. • 86% and 77% of noncompete agreements had a geographic and time restriction, respectively.
Patient care continuity is critical to physicians because a significant volume of employed physician referrals are through other physicians employed by the health system.	• 52% of referrals come from other physicians within the health system. • 61% believe referral volume would decline as a result of going independent.

Now What? Key Takeaways for Private Equity

Private-equity-backed physician platforms seeking to grow should consider the following 3 key takeaways:

1. **This partnership-based physician practice spin-out strategy is worth evaluating—and soon.** Investors are quickly aggregating many focus specialties, and those aggregators are realizing the market's limitations in terms of tuck-ins. In turn, many investors are considering this approach to build their businesses.
2. **Carving out these practices must be done carefully.** Physician spin-outs must be designed not to cause harm to the practice's volumes as they're often enabled disproportionately by the broader health system's practice. Additionally, health system partnerships are complex, difficult to navigate, and often long in duration. Financial sponsors must consider the implications of how they are partnering with health systems when executing a transaction that contemplates employing health system physicians.
3. **The stakes are high.** The total addressable market this approach can unlock is considerable. More than half of the nation's nearly 1 million active physicians are employed by health systems. Within these practices exist a myriad of specialists, each with their own value proposition to the market and private capital-backed practices. For example, the TAM unlock in cardiovascular medicine alone is worth up to $22 billion for private capital-backed PPMs.[9] Conversely, not addressing this market is growth-limiting for existing PPM roll-ups.

We continue to see strong tailwinds for PPM investments. PPM investment theses are often enabled by a fragmented physician landscape, favorable regulatory changes, and a growing focus on value-based care. Considering how to incorporate a health system spin-out strategy into a PPM thesis is an important value creation lever that can help sponsors achieve their goals.

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