Hospital Acquisitions of Physician Practices
Legal Issues in Valuing, Negotiating and Structuring the Transaction

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Today’s faculty features:
David L. Klatsky, Partner, McDermott Will & Emery, Los Angeles
Michael L. Blau, Partner, Foley & Lardner, Boston
Carsten Beith, Managing Director, Cain Brothers, Chicago

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Physician Practice Acquisition

David L. Klatsky
McDermott Will & Emery LLP
January 19, 2012
Typical Transaction Structures

**MSO Model**

- Health Care System
- Hospital
- MSO
- Physician Practice
- Management Services
- Assets
- $$
Typical Transaction Structures

**MSO Model**

I. MSO acquires tangible assets of the Physician Practice

II. Physician Practice remains independent

III. MSO provides turn-key management services to Physician Practice

   A. Equipment
   B. Physician extenders
   C. Billing
   D. Collections
   E. Accounting
Typical Transaction Structures

**MSO Model**

- Purchase price limited to value of hard assets
- Physicians relieved of burdens of:
  - Capital investment
  - Administration of practice
- Physician Practice remains at risk for reimbursement and physician compensation
- MSO services must be provided at FMV
Typical Transaction Structures

Full Asset Purchase/Employment

Health Care System

Hospital

Clinic

Physician Practice

$\$\$

Assets

Employees

Transfer of Employees
Typical Transaction Structures
Full Asset Purchase/Employment

• Assets of Physician Practice are purchased by Health System Clinic at fair market value
• Physician employees, along with clinical and non-clinical staff, become employees of Health System Clinic
• Physician employees are compensated at fair market value in Stark Law compliant employment arrangements
Typical Transaction Structures

Asset Purchase/PSA Arrangement

- Health Care System
- Hospital
- Clinic/ Foundation
- Physician Practice
- Employees
- Assets
- PSA Compensation
- Professional Services
Typical Transaction Structures

Asset Purchase/PSA Arrangement

- Assets of Physician Practice are purchased by Health System Clinic or Foundation at fair market value
- Clinical and non-clinical staff become employees of Health System Clinic or Foundation
- Physicians remain employed by Physician Practice and enter into a long-term professional services arrangement to provide professional medical services to Health System Clinic or Foundation for fair market value compensation, which may include a medico-administrative fee
- Health System Clinic or Foundation retains right to bill for physician services
- Clinic or Foundation operated as 501(c)(3) organization
Typical Transaction Structures
Asset Purchase/PSA Arrangement

• Model works best in states where corporate practice of medicine is an issue
• Physician relieved of burden of capital investment and administration of Physician Practice
• Physicians remain responsible for their compensation utilizing PSA compensation
• PSA compensation can be structured utilizing various compensation methods
Typical Transaction Structures
Stock Purchase/Merger

*Can be structured as a stock purchase or merger
Typical Transaction Structures

Stock Purchase/Merger

- If possible, can be used to avoid double tax on physicians
- Also, can be used to avoid changes in licensure or assignment clauses
- Can be used in non-CPM states
- In certain states, physician practice can be converted to traditional stock corporation to allow for stock purchase by Health System or merger
Typical Transaction Structures

Real Estate Component

Health Care System

Hospital

Clinic

MD Investors

Real Estate Entity
Typical Transaction Structures

Real Estate Component

I. Often, physicians will hold practice real estate in a separate entity

II. Transactions often structured to allow physicians to retain real estate and enter into leases with Health System

III. Current leases can be renegotiated to longer term arrangements

IV. Lease valuations often are advisable
Physician Compensation Models

I. Very few “guaranteed” salary models (mistakes of the 80s/90s transactions)

II. Physicians generally compensated through production based models
   A. Revenue *minus* expenses
   B. Base compensation *plus* incentive compensation (incentive at risk)
   C. Work relative value unit production (WRVUs allocated to CPTs)
   D. Incentives for quality, good citizenship, etc.

III. Physician participation in ancillaries

IV. Compensation must meet Stark Law exception
   A. Fair market value a critical component

V. Consider recent DOJ activity around physician compensation
Critical Business Issues

I. Valuation Issues
   A. All regulatory analyses turn on FMV
   B. Formal valuations close the gap between perception and reality
   C. Most tax exempt systems insist on third party valuations of physician practices
   D. Physician professional component generally has relatively low valuation
   E. Most value embedded in ancillary businesses that spin off cash flow (imaging, ASC, lab)
   F. Certain intangible assets have value
      1. Workforce in place
      2. Medical records
      3. Trademarks and trade names
   G. Use of “stay bonuses”
   H. Payments for covenants not to compete
Critical Business/Legal Issues

I. Due Diligence
   A. Not uncommon to find physician practices with compliance issues
   B. Avoids later problems
   C. Possibility of self-disclosure
   D. Indemnity escrows
Critical Business Issues

I. Transaction Issues
   A. Purchase price
      1. Consider tax consequences to physicians
      2. Installment payments v. lump sum payment
   B. No more “covenant” light deals
   C. Certain percentage of “inked” physicians contracts as a condition to closing
   D. Regulatory approvals
   E. Indemnity escrows
Critical Business Issues

I. Physician Compensation
   A. Physician compensation must meet Stark Law bona-fide employment exception
   B. AKS compliance requires “only” that physicians are bona-fide employees
   C. Tax exemption concerned about excess benefit transactions and private inurement/private benefit issues
   D. Most compensation plans are production based
   E. All plans must yield compensation that is FMV
   F. Possible to structure compensation to include ancillaries (DHS)
Critical Business/Legal Issues

I. Physician Compensation
   A. Covenant Health System (Waterloo, IA)
   B. $4.5 Million to settle Stark Law/False Claims allegations
   C. Whistle blower competitor
   D. 5 highly paid physicians (also highly productive)
QUESTIONS?

David L. Klatsky
McDermott Will & Emery LLP
2049 Century Park East, Ste. 3800
Los Angeles, CA 90067
310-551-9379
dklatsky@mwe.com
Hospital Acquisitions of Physician Practices: Legal Issues in Valuing, Negotiating and Structuring the Transaction

January 19, 2012

Presented by:
Michael L. Blau
Foley & Lardner LLP
mblau@foley.com
617-342-4040
Regulatory Issues

- Federal Issues
  - Federal Anti-Kickback Statute
  - Stark Law
  - False Claims Act
  - Civil Monetary Penalty Law
  - Tax Exemption Issues
  - HIPAA
Regulatory Issues

Select State Law Issues
- State anti-kickback statutes
- State Stark laws
- Corporate practice of medicine
- Fee splitting
- Covenants not to compete
- Clinic/facility licensure
- Certificate of need
- State privacy/security laws
- Fiduciary issues
- Physician licensure standards/professional ethics
Anti-Kickback Statute

- Prohibits knowing and willful offer or receipt of remuneration intended to induce or arrange for referrals of business paid for by Medicare/Medicaid programs

- Civil monetary and criminal penalties
  - CMP of $50,000 per violation
  - Criminal penalties: $25,000 per violation and/or up to 5 years in jail
  - Exclusion
Anti-Kickback Statute

- Any purpose test and problem of mixed motives
  - ACA § 6402(f)(2): violation does not require actual knowledge of AKS or specific intent to commit a violation
  - ACA 6402(f)(1): claim for items or services resulting from AKS violation constitutes a false claim under the False Claims Act

- Safe harbors

- Advisory opinions not available on FMV
Anti-Kickback Statute

- Is the purchase price a disguised kickback from the buyer (overpayment) or seller (underpayments) to induce post-deal referrals?
AKS and Practice Acquisitions

- Practice acquisition safe harbors
  - Practitioner-to-practitioner safe harbor
  - Practitioner-to-other entity (hospital) safe harbor
    - Practice acquired is located in a HPSA
    - Sale completion with 3 years
    - Seller not in a position to refer after sale completion
    - Purchaser must use diligent and good faith efforts to recruit a successor within 1 year to take over the practice
      - Most practice acquisitions are not safe-harbored
- Bona fide employment exception and safe harbor
AKS Valuation Issues

- Valuation Importance – independent appraisal of fair market value in arms-length transaction may negate adverse inference of improper intent.
- Fair market value means the value in arm’s-length transactions, consistent with the general market value.
- “General market value” means the price that an asset would bring as the result of bona fide bargaining between well-informed buyers and sellers who are not otherwise in a position to generate business for the other party, or the compensation that would be included in a service agreement as the result of bona fide bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party, on the date of acquisition of the asset or at the time of the service agreement. Usually, the fair market price is the price at which bona fide sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition, or the compensation that has been included in bona fide service agreements with comparable terms at the time of the agreement, where the price or compensation has not been determined in any manner that takes into account the volume or value of anticipated or actual referrals.
AKS Valuation Issues

- Legitimate business purpose and commercial reasonability
- Goodwill – payment for intangibles to physician who continues in a position to refer is suspect (OIG letter to IRS (Dec. 22, 1992); OIG letter to AHA (Nov. 2, 1993))
  - Professional v. practice level goodwill
  - No professional goodwill in absence of enforceable non-compete
  - No EBIDTA, no goodwill?
- Discounted free cash flow/discounted earnings approach may take into account the value of future cash flows
  - See e.g., OIG Adv. Opinion 09-09 (footnote 5) – contribution of ASCs to hospital-physician joint venture should not include intangibles valued on cash flow-going concern basis
Anti-Kickback Statute Issues

- PharMerica settlement
- Challenge is to value without taking into account future referrals by seller; modified DCF method

- Other matters affecting value under income approach
  - Salary to selling physicians post-sale
  - Overcoding
  - Revenue growth assumptions
  - Deferred capital investments
  - Size of practice
Anti-Kickback Statute Issues

- Market Approach Valuation Issues
  - Existence of true comparables under market approach
    - Same specialty and mix of services?
    - Same market?
    - Same time period?
    - Same context?
  - Private vs. public company transactions
    - See Sta-Home Health Agency vs. Commissioner, Case No. 02-60912 (5th Cir. July 11, 2006) (Inappropriate market approach to valuation based on public company comparables for home care company with no invested capital and no history of profitable operations/no goodwill)
Anti-Kickback Statute Issues

- Problem of tainted comparables
  - “Depending on the circumstances, the ‘volume or value’ restriction will preclude reliance on comparables that involve entities or physicians in a position to refer or generate business.” 66 Fed. Reg. at 944

- Other Issues
  - Earnouts of sellers who remain in a position to refer
  - Use of attorney-client privilege
Stark Law

- Prohibits a physician who has a direct or indirect financial relationship with a DHS entity from referring patients to the DHS entity for "designated health services" for which payment may be made under the Medicare or Medicaid program; unless a specific exception applies
  - "Designated health services" includes all inpatient and outpatient hospital services, lab, imaging, pharmacy, DME, radiation therapy, PT, occupational and speech therapy, perenteral and enteral drugs, nutrients, and supplies, prosthetics, orthodics, and home health services
  - $15,000 civil monetary penalty assessed against physician for each prohibited referral
  - DHS entity must refund DHS billed pursuant to a prohibited referral
  - $15,000 civil monetary penalty assessed against DHS entity for billing for service rendered pursuant to a prohibited referral, unless it can show that it did not have actual knowledge and did not act in reckless disregard or deliberate ignorance of the prohibited referral
  - $100,000 civil monetary penalty for circumvention schemes
  - Requirement to report to HHS financial relationships with physicians upon request; $10,000 penalty for failure to report
  - Potential exclusion
Stark Law

- Stark law – purchase price transaction creates financial relationship that will prohibit referrals to hospital buyer (or other DHS entity) unless an exception applies
  - Strict liability/Zero tolerance law
  - Stark analysis has changed with “stand in shoes” rule
    - Stock transactions – payment to physician (direct)
    - Asset transactions – payment to medical group (indirect)
    - Direct compensation exception needed for physician owners (other than titular-owners)
    - Direct or indirect compensation exception for titular owners and non-owners (e.g., employees)
Stark Law

- Principal direct compensation exception for practice acquisitions is isolated transaction exception
- Isolated transaction exception – compensation exception only (not applicable if stock, warrants, options or other investment interests are part of purchase consideration)
- Isolated transaction standards
  - Aggregate payments fixed in advance (no earn outs)
Stark Law

- Payable even if default by buyer (negotiable note or guaranteed by third party)
- FMV, not taking into account volume or value of referrals or other business generated between the parties
  - Similar to valuation issues under AKS if seller will continue to be in position to refer
  - Particularly acute if selling medical group provides DHS/ancillaries
  - Advisory opinions on fair market value not available
- No other transactions for 6 months except:
  - Other Stark Law excepted transactions
  - Commercially reasonable post-closing adjustments
  - Burden of proof is on defendant
  - Violations are not remedied until referring physician/DHS entity repays excess compensation or arrangement is terminated
Stark Law

  - Payment for non-compete from hospital to cardiology group in connection with sublease to hospital of nuclear medicine camera was found to violate Stark Law, notwithstanding fixed fee and independent appraisal of FMV
  - Court finds that appraisal method takes into account volume/value of anticipated referrals from cardiology group
Stark Law

- Appraisal based on expected revenues from cardiology referrals in the absence of an interest in their own cardiac imaging service
- Constitutes “indirect compensation”
- No exception available because, by definition, payments are not fair market value if they take into account volume or value of referrals
- Should not use valuation method that takes into account volume or value of actual or anticipated referrals
Stark Law Issues

Other Stark Law Issues

- Sale of physician lab or DHS services – not permitted if price is based on anticipated post-transaction referrals by physician owners
- Installment sales – permitted if integral to transaction and payments guaranteed even if buyer defaults
  - Secured debt instrument treated as investment interest (isolated transaction exception does not apply)
- Investment interests in buyer (DHS entity)
  - Stock options and convertible securities issued as “compensation” are not investment interests
  - Investment interest exceptions for rural providers, and publicly traded securities
  - No small entity exception
Stark Law Issues

- Associated transactions (e.g., employment, consulting, lease agreements) must meet other Stark Law exceptions
  - Employment
    - Identifiable services
    - FMV and commercially reasonable
    - Not take into account v/v of DHS referrals
  - Personal services
  - Space rental or equipment rental
  - Fair market value
  - Indirect compensation
- All based on FMV
Tax Exemption Considerations

- 501(c)(3) Exemption Standards
  - No inurement
  - Not more than incidental private benefit

- Revocation authority and intermediate sanctions
  - Modern Health Care Services (d/b/a LAC Facilities) 94 TNT 216-38 (Nov. 3, 1994) – revocation
Tax Exemption Considerations

- **Carracci** (Sta-Home) case – proposed revocation and intermediate sanctions overturned due to IRS valuation errors

- Lessons of **Carracci** Case
  - Select a qualified appraiser with particular expertise and experience
  - Properly take into account third party payor methodologies and rates
  - Use true market comparables
  - Follow process for rebuttable presumption of reasonableness (to shift the burden to the IRS to establish that appraised value is incorrect)
Tax Exemption Considerations

- Rebuttable presumption process
  - Approved by board or committee with no conflict of interest
  - Rely on appropriate data as to comparability
  - Determine that the property transfer is at FMV
  - Document basis of decision within 60 days after decision
Tax Exemption Considerations

- Charitable contribution of practice assets/valuation misstatement cases
  - Charitable deduction for donation of assets with value in excess of benefits received
  - Penalties for valuation misstatements (IRC § 6662)
    - 40% if overvalued by 400% or more and deduction exceeds $5,000
    - 20% if overvalued by 400% or more and deduction does not exceed $5,000
    - No penalty if taxpayer makes good faith investigation and relies on valuation by a qualified appraiser
Tax Exempt Considerations

- Derby case, T.C.M. 2008-45 (Feb. 28, 2008)
  - Disallowance of claimed charitable contribution to Sutter Medical Foundation (SMF) by physicians associated with Sutter West Medical Group (SWMG)
  - Part of practice consolidation transaction by which SMF purchased tangible assets, guaranteed compensation, and paid sign-on bonus of $35,000/M.D.
  - SWMG physicians did not meet their burden of showing that value of intangibles donated exceeded value of benefits obtained from SMF, notwithstanding independent valuation using DFC method
    - Potentially above market compensation
Tax Exempt Considerations

- **Derby case (con’t)**
  - Sign-on bonuses
  - No post-termination non-compete; personal goodwill not transferred
  - No valuation misstatement penalties

- **Bergquist case, 131 T.C. 2 (July 22, 2008)**
  - Tax court reduces charitable deduction of $401.79/share to $37/share for contribution of PC stock, and imposes valuation misstatement penalties
Tax Exempt Considerations

- **Bergquist case (con’t)**
  - Tax court found that practice should not have been valued as going concern
    - Wind-down and payout of A/R at point of consolidation
    - No tangible assets
    - No non-competes
  - IRS valuator assessed value at $37/voting share using market approach (assets net of liabilities, discounted for lack of control interest and marketability)
  - Penalties imposed because physicians unreasonably relied on assumption of going concern value when they knew (or should have known) otherwise
Regulatory Compliance

- Advice
  - Document proper purpose of acquisition: community benefit
  - Disclaim improper purpose: induce referrals
  - No evidence of improper purpose
  - Independent appraisal of FMV
  - If seller will continue in position to refer, use valuation method that does not take into account future referrals by seller
    - Do not value professional level goodwill?
    - Do not pay for unenforceable non-competes
    - Do not value DHSs on basis that takes into account v/v of future referrals
    - Avoid earnouts
    - Avoid exclusive use agreements
Regulatory Compliance

- Advice re: Independent Appraisal of FMV
  - Select knowledgeable appraiser who has experience with medical practice valuations and is sensitive to health regulatory issues
  - Diligence appraisal for health regulatory compliance
  - Make sure valuation takes into account all aspects benefits received by sellers in transaction documents
  - Rely on true market comparables
  - Do not use going concern value (income or market approach) for practice that is otherwise going out-of-business
Regulatory Compliance

- Advice re: Tax Exemption
  - Follow steps for rebuttable presumption of reasonableness if buyer is a tax-exempt entity
  - Properly value any assets contributed to exempt organization
    - Assure that charitable deduction is reduced by value of benefits received by “seller” in connection with donation
Hospital Acquisitions of Physician Practices

January 19, 2012

Carsten Beith
312.604.0500
cbeith@cainbrothers.com
Overview of Key Trends Driving Physician Acquisitions
Overview of Key Trends Driving Physician Acquisitions
The U.S. Health Care Industry Undergoing Dramatic Change

Unpredictable Capital Markets
- Low interest rates and easy money policy ease access to debt capital for strong credits
- Weak credits have limited access to debt
- Private equity robust
- Eurozone problems create highly volatile environment

Increased Financial Pressure
- Reimbursement pressures from reform
- Payor consolidation
- Lower volumes due to economic conditions
- Rapid expense growth

New Capital Demands
- Federal mandates mean many updates necessary
- Meaningful use incentives for IT
- Non-accretive investments in physician and provider networks

Accountable Care
- Risk assumption will be necessary
- Expanded scope of services across care continuum
- Cost, quality, and accountability have financial implications

Investment and M&A Activity
Overview of Key Trends Driving Physician Acquisitions
Health Care Reform: Mandate for Industry Change

Health Care Reform legislation has created significant uncertainty for the industry but there is a mandate for change under any scenario that may emerge.
Overview of Key Trends Driving Physician Acquisitions
Opportunities from PPACA

Through health care reform, hospitals, physicians and payors have an opportunity to take advantage of several quality and accountability initiatives

- Providers and payors, through ACOs, can take advantage of providing high quality care
  - “Risk” associated with providing care can potentially be transferred to/mitigated by physicians who demonstrate superior quality outcomes

- Hospital/Physician-based ACOs can operate similar to tightly managed HMOs where lower costs drive profitability at the provider level (“integrated health system”)

- Health care reform bill provides financial rewards to physicians for reducing overall health care costs
  - Perception that physicians can ultimately reduce health care costs as most care decisions are made by physicians and patients rather than other providers in the care continuum

- Physician and professional services account for approximately 21% of overall health care spending
  - Most primary care physicians do not have ownership positions in specialized centers (surgical hospitals, ambulatory surgery centers and other outpatient settings)
  - Dependent on professional fees and would likely be supportive of opportunity for financial upside to quality care

- The two largest components of health care expenditures are hospital services (31%) and physician and physician clinic services (20%) which suggests that any reductions in cost growth will be heavily born by these two sectors.

- Physician groups are in a unique position to drive the change needed to reduce the growth rate in health expenditures given that physicians control directly or indirectly approximately 80% of health spending.

Source: Kaiser Family Foundation.
(1) Data as of 2009.
Overview of Key Trends Driving Physician Acquisitions
Integration Strategies

Strategic considerations that will positively impact the value of acquired physician practices include:

- Combine or achieve clinical integration with physicians through strong affiliation models
  - Employment
  - ACO JVs

- Increase physician participation in the management of the hospital facility (technical) costs of care with aligned incentives to share in the benefits of achieved cost savings and influence the overall cost and quality of hospital services

- Control the relationship with patient population
  - Medical home
  - PHOs

- Manage the referral flow to physician networks

- Develop tools to measure, manage and demonstrate quality and cost of services provided

- Differentiate services to benefit from patients shifting from traditional PPO and managed care products to PPACA exchanges

- Develop the financial models and build the appropriate balance sheet reserves to offer risk-based models with payors
Overview of Key Trends Driving Physician Acquisitions
The Return of the Physician Group

After being an outcast for the past 10 years, private and strategic capital is flowing back into the physician practice management industry

- What went wrong the first time?
  - Several disparate practices were amalgamated with additional infrastructure costs added without finding any synergies, which resulted in negative efficiencies and operating margins
  - Permanence was disrupted by “pre” and “post” transaction physicians and relative distributions of proceeds

- What is different this time?
  - Best in breed groups that have worked together for a long period of time in a specific practice area are providing care at a lower cost with better outcomes
  - Physician networks have become the key to major initiatives around quality, safety, disease management, and IT standardization

<table>
<thead>
<tr>
<th>AEA Waud Capital</th>
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<tr>
<td>Flexpoint Ford</td>
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*Note: IPO indicates an Initial Public Offering.*
Overview of Key Trends Driving Physician Acquisitions

Current Investment Environment

Investment capital is flowing into the physician sector along with sectors benefiting from PPACA

<table>
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<tr>
<th>Announced Date</th>
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<th>Acquirer</th>
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<th>EBITDA Multiple</th>
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<td>Welsh, Carson, Anderson &amp; Stowe</td>
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<td>INC Research</td>
<td>Avista Capital Partners/ Ontario Teachers’ Pension Plan</td>
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<td>Leonard Greens &amp; Partners</td>
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<td>MultiPlan</td>
<td>BC Partners / Silver Lake Partners</td>
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<td>Garstar Capital</td>
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<td>Virtual Radiologist</td>
<td>Providence Equity Partners</td>
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<td>inVentiv Health</td>
<td>Thomas H. Lee Partners</td>
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<td>04/12/10</td>
<td>Liberty Dialysis</td>
<td>KRG Capital Partners</td>
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<td>03/25/10</td>
<td>American Renal Holdings</td>
<td>Centerbridge Partners</td>
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<tr>
<th>Announced Date</th>
<th>Target</th>
<th>Acquirer</th>
<th>Value ($mm)</th>
<th>EBITDA Multiple</th>
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<tr>
<td>11/07/11</td>
<td>HealthTrans</td>
<td>SXC Health Solutions</td>
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<td>National Healing Corp</td>
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<td>Metropolitan Health Networks</td>
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<td>WellPoint</td>
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<td>Johnson &amp; Johnson</td>
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<td>Acadia Healthcare Company</td>
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<td>RehaCare Group</td>
<td>Kindred Healthcare</td>
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<td>01/21/11</td>
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<td>Humana</td>
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<td>CBILPath</td>
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<td>11/01/10</td>
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<td>McKesson</td>
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<td>10/18/10</td>
<td>Accelerated Care Plus</td>
<td>Hanger Orthopedic Group</td>
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<td>09/27/10</td>
<td>NightHawk Radiology</td>
<td>Virtual Radiologic</td>
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<td>09/14/10</td>
<td>The Broadlane Group</td>
<td>MedAssets</td>
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<td>09/07/10</td>
<td>Chamberlin Edmonds</td>
<td>Emdeon</td>
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<td>08/16/10</td>
<td>Axcodot</td>
<td>Ingenix</td>
<td>~$175.0</td>
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</table>

Source: Capital IQ, company filings and Cain Brothers’ estimates.
Overview of Key Trends Driving Physician Acquisitions
Physician Shortage Remains a Policy and Strategic Concern

- Resources dedicated to retain and recruit medical staff will need to expand
- Cost and time to recruit will increase
- Payments to physicians to support hospital needs (call coverage, medical directors, performance improvement, etc.) will increase
- Stable practice models must be developed to assure continuity

Source: Association of American Medical Colleges
Overview of Key Trends Driving Physician Acquisitions
Managed Care Consolidation Has Changed the Landscape

- Since the mid-1990’s, the managed care industry has seen significant consolidation
  - In many markets, providers are price takers with reduced clout to secure favorable contract terms
  - Providers in markets that consolidate either horizontal (hospital/hospital) and/or vertically (hospital/physicians) are better able to offset concentration of managed care payors
  - Health care reform is likely to reconfigure the payor landscape dramatically
    - Battle to control ACO dollars by partnering with providers
    - Shift to acquisition of “unregulated” providers to “arbitrage” medical loss

Managed Care Companies (as a Percentage of Total Market Capitalization)

1995 – Total $40.6 billion
Top 5 = 67% of total

2000 – Total $54.5 billion
Top 5 = 83% of total

2011 – Total $110 billion
Top 5 = 87% of total
Valuation Issues
Valuation Issues

Valuation Drivers

What Is Going on Out There?

- Today’s physician acquisition deals are bigger, more complex, and riskier than those that took place during the 1990’s
- Many common characteristics seen in most practice acquisitions
  - Employment arrangements include production-based compensation formulas
  - Purchase price valued by one or more independent, third-party valuation firms
  - Significant value derived from ancillary services
  - Physicians provided an ongoing role in group governance and management
  - Acquisitions represent material investments by the hospital buyers

What Else Impacts The Trend?

- Changes in the federal and state regulatory environment, especially the Stark law, have resulted in physicians and hospitals once again competing for ancillary income streams
- Facilities and equipment owned by physicians have often become outdated, and the already highly leveraged, no retained earnings groups have delayed reinvestment, resulting in reduced cash flows
- Employment of physicians by hospitals is reducing supply of physicians to groups and limiting new investors in ancillary revenue streams such as ASC, diagnostic imaging, etc.
- Changes in Medicare along with consolidated managed care companies are driving down the profitability of physician practices and their ancillary revenues
- Acquisition of physician practices has become a strategic imperative for many hospital systems to address medical staff shortages and to position for ACO/risk assumption reimbursement

Valuation Issues
Valuation Considerations

- “Value" is an opinion, not a "price" and depends on facts and circumstances
- There is no single answer as what constitutes fair market value. The standard is a reasonably defensible opinion of value
- Traditionally, the question of valuation was determined by hospital buyers anxious to placate their physician partners
- Generally, physician practices generate minimal free cash flow beyond what is needed for working capital and servicing debt
  - The value of physician practice assets to be acquired will be constrained by the expected cash flow generated from these assets after physician compensation is paid
- To the extent physician compensation remains the same or even increases after an acquisition, expected cash flow to the hospital from the practice may be limited and the value of the practice is limited
- Hospitals must be careful to not pay a strategic premium to buy a practice above fair market value
- Third-party valuations have become a staple of physician/hospital relationships

**Valuation Issues**

**Process**

- The 1990’s physician practice acquisition craze resulted in overpaying for practices, salary guarantees and failing to actively manage acquired practices
- Today’s transactions are often hotly negotiated and heavily scrutinized
- The size and complexity of these transactions has increased the need for third-party opinions
- The value of physician practice assets is constrained by the expected cash flow after physician compensation is paid
- Ancillary revenues are often a key value component

**How to Avoid Past Mistakes**

- Physician practice acquisitions are as much about physician emotions and expectations as they are about deal points
- Most physician practice leaders over-value their practices
- Gaps in expectations can create challenges for hospital acquirers
- Discuss and negotiate physician employment contracts very early in the process with careful consideration for the following:
  - Hours of practice
  - Control that can be exercised by the hospital
  - The ability of the hospital to relocate the physician’s practice
  - Compensation formulas and benefits
  - Covenants not to compete

*Source: Structuring Physician Practice Acquisitions: Something Old is Something New Again, July 2009.*
### Valuation Issues

**Business Considerations**

<table>
<thead>
<tr>
<th>Financial Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Valuation</td>
</tr>
<tr>
<td>- Funding sources</td>
</tr>
<tr>
<td>- Pro forma financial impact on hospital system</td>
</tr>
<tr>
<td>- Corporate allocations</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debt Capacity and Access to Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Balance sheet</td>
</tr>
<tr>
<td>- Income statement</td>
</tr>
<tr>
<td>- Opportunity cost (capital allocation tradeoffs)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Impact on Organization Culture</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Shared vision and mission</td>
</tr>
<tr>
<td>- Corporate citizenship</td>
</tr>
<tr>
<td>- Fit with larger enterprise</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Impact on Medical Staff</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Independent medical staff</td>
</tr>
<tr>
<td>- Other employed physicians</td>
</tr>
</tbody>
</table>
Valuation Issues
Business Considerations

Resource Assessment
- Management
- Systems
- Scalability

Compensation Structure
- Impact on value
- Incentives for productivity
- Alignment of other incentives
- Core measures
- Citizenship
- Education and research

Other Issues
- Clinical care coordination and quality impact
- Non-compete restrictions
- Impact on third-party relationships and contracts
- Community impact and perception
- Brand impact; especially if operations continue to be operated under same