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Hospital Acquisitions of Physician Practices

Legal Issues in Valuing, Negotiating and Structuring the Transaction

THURSDAY, NOVEMBER 29, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Carsten Beith, Co-Head of Tax-Exempt M&A, **Cain Brothers**, Chicago

Michael L. Blau, Partner, **Foley & Lardner**, Boston

David L. Klatsky, Partner, **McDermott Will & Emery**, Los Angeles

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McDermott Will & Emery

Hospital Acquisitions of Physician Practices

November 29, 2012

David L. Klatsky
McDermott Will & Emery LLP
2049 Century Park East, Ste. 3800
Los Angeles, CA 90067
310-551-9379
dklatsky@mwe.com

Typical Transaction Structures
MSO Model

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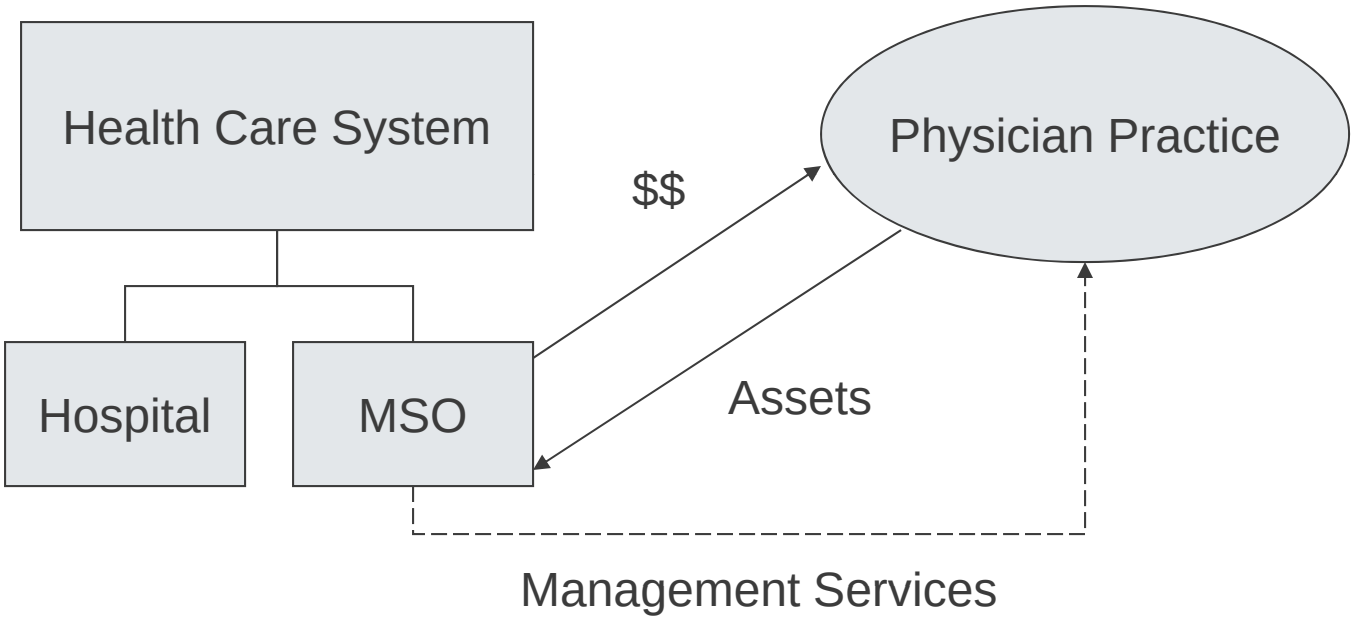


Typical Transaction Structures
MSO Model

McDermott Will & Emery

- MSO acquires tangible assets of the Physician Practice
- Physician Practice remains independent
- MSO provides turn-key management services to Physician Practice
  - Equipment
  - Physician extenders
  - Billing
  - Collections
  - Accounting

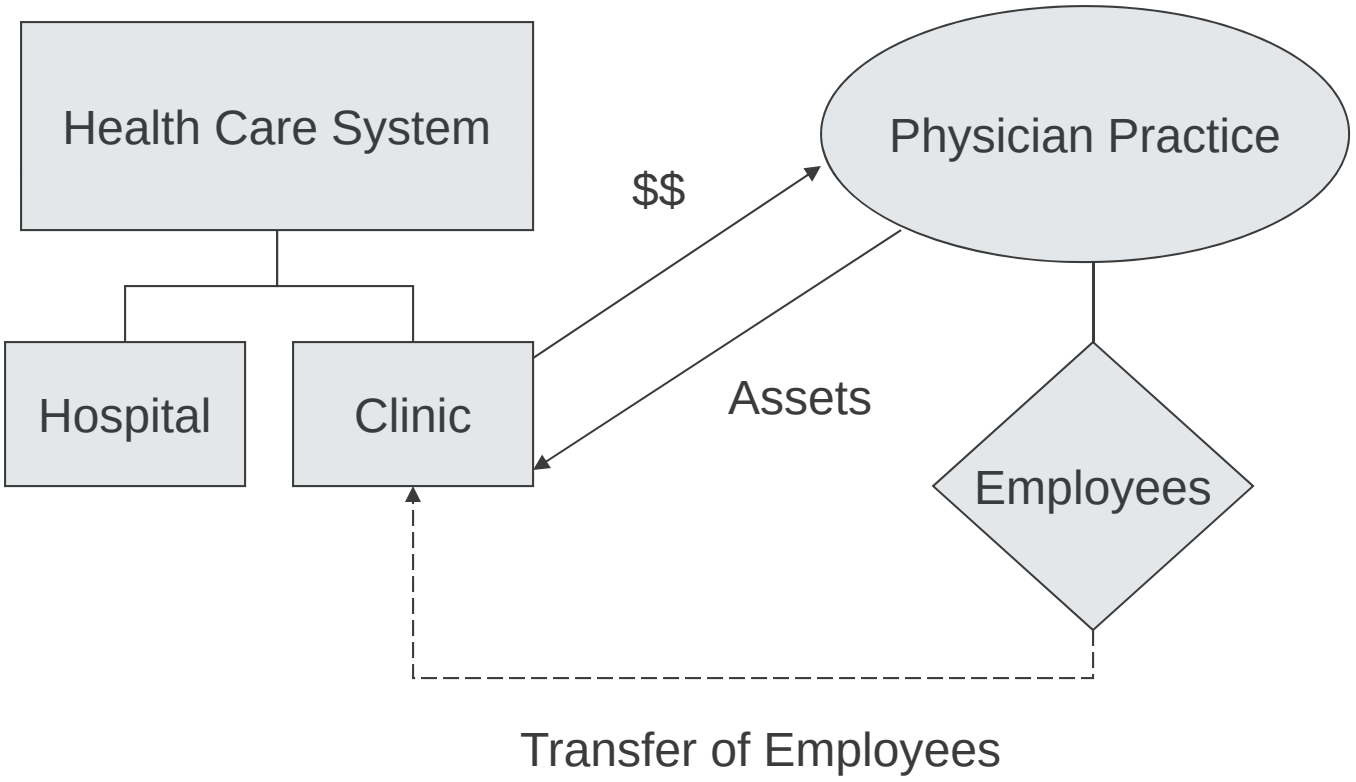
Typical Transaction Structures
MSO Model

McDermott Will & Emery

- 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

McDermott Will & Emery



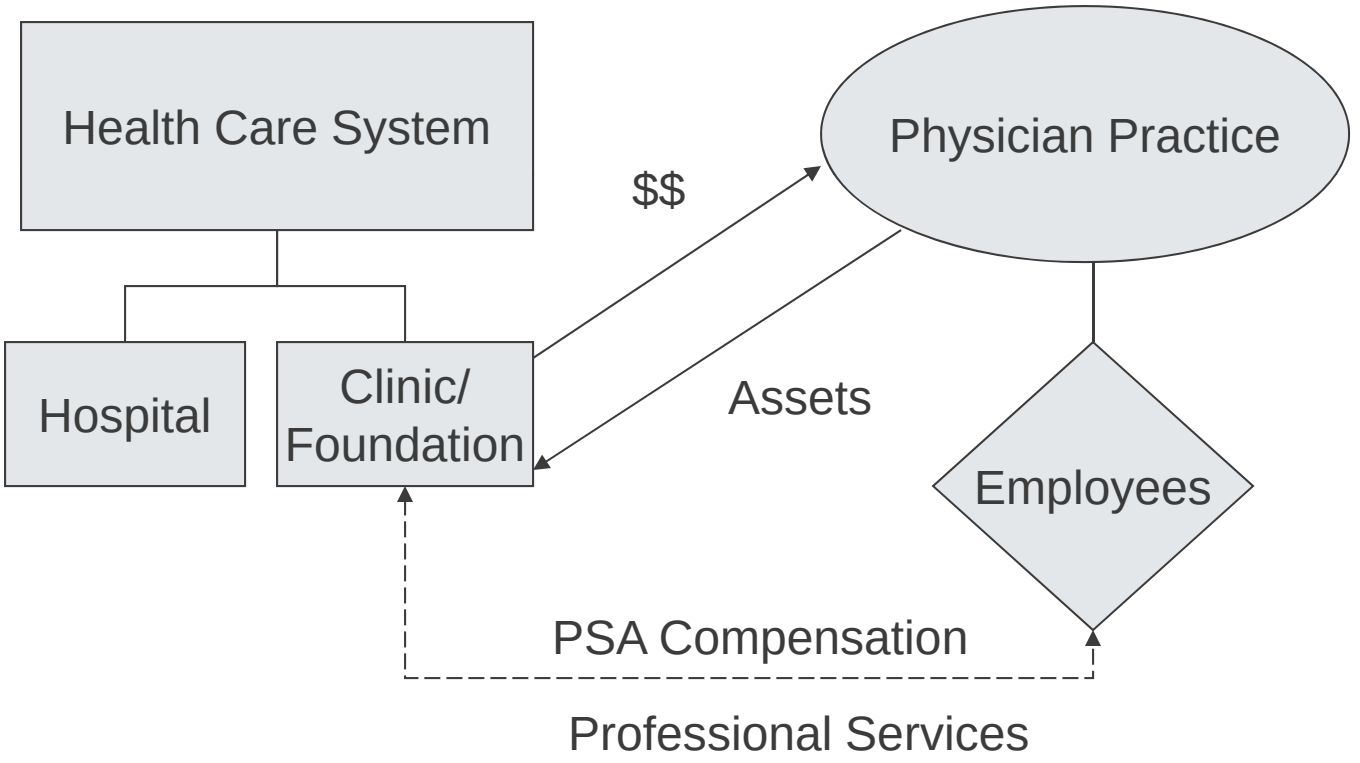
Typical Transaction Structures
Full Asset Purchase/Employment

McDermott Will & Emery

- 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

McDermott Will & Emery



Typical Transaction Structures
Asset Purchase/PSA Arrangement

McDermott Will & Emery

- 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

McDermott Will & Emery

- 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 (paid out of aggregate PSA compensation)

Typical Transaction Structures
Stock Purchase/Merger

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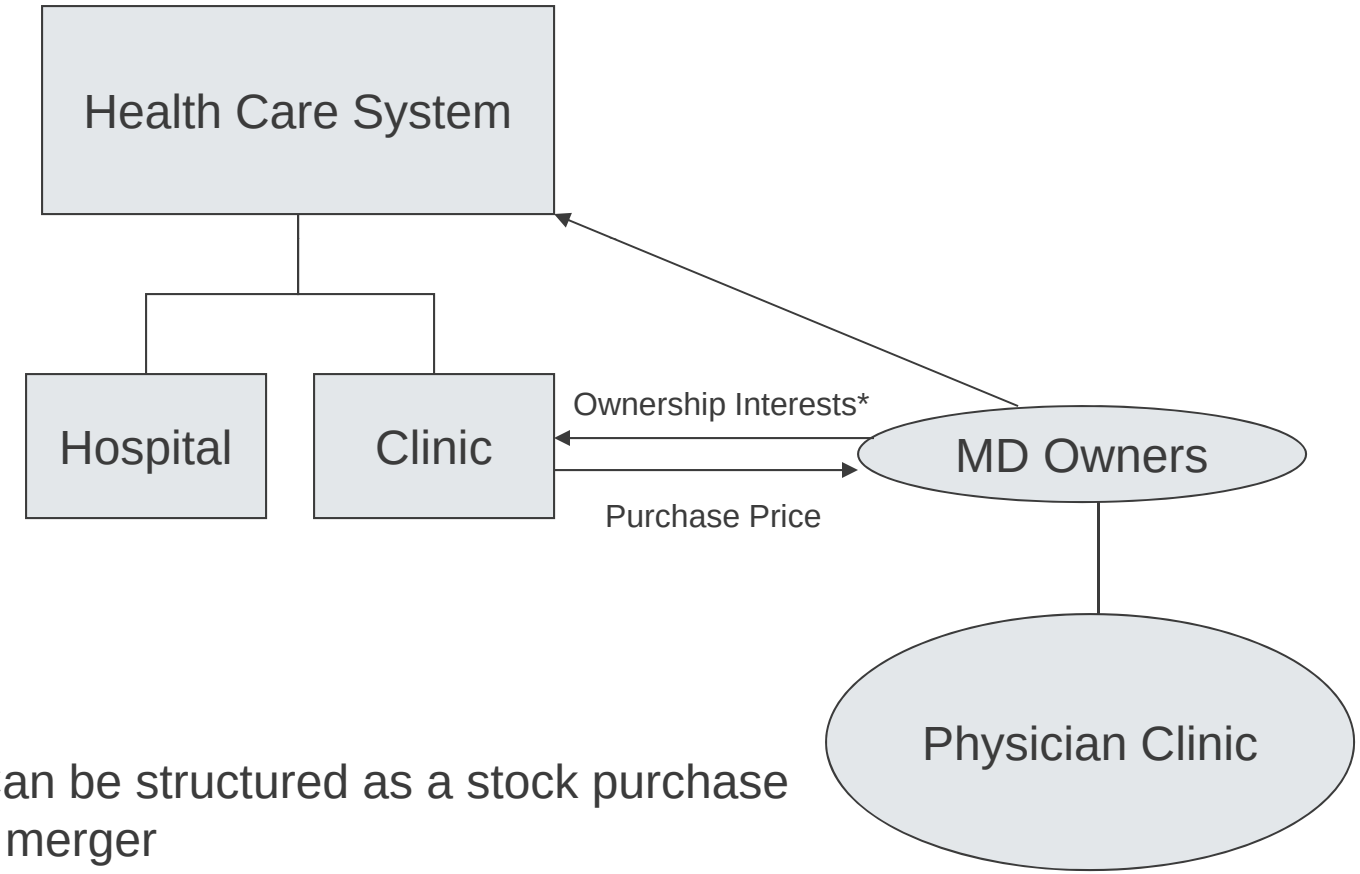

*Can be structured as a stock purchase or merger

Typical Transaction Structures
Stock Purchase/Merger

McDermott Will & Emery

- 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

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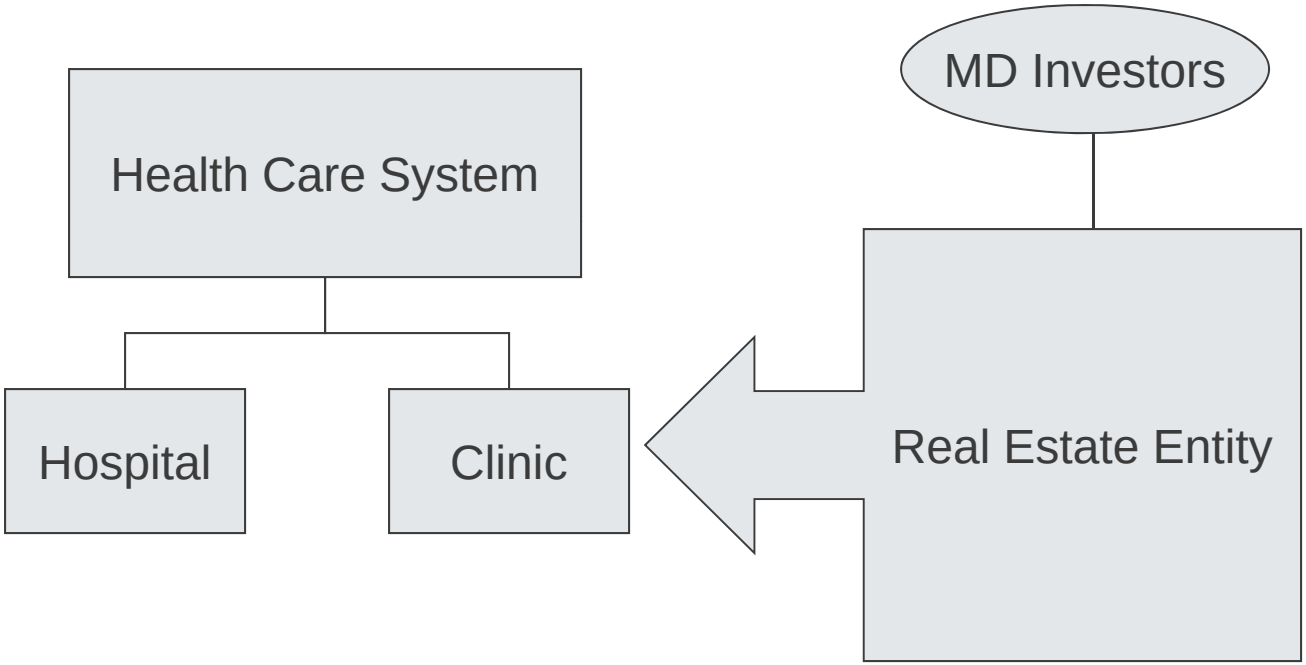


Typical Transaction Structures
Real Estate Component

McDermott Will & Emery

- Often, physicians will hold practice real estate in a separate entity
- Transactions often structured to allow physicians to retain real estate and enter into leases with Health System
- Current leases can be renegotiated to longer term arrangements
- Lease valuations often are advisable

Physician Compensation Models

McDermott Will & Emery

- Very few “guaranteed” salary models (mistakes of the 80s/90s transactions)
- Physicians generally compensated through production based models
  - Revenue *minus* expenses
  - Base compensation *plus* incentive compensation (incentive at risk)
  - Work relative value unit production (WRVUs allocated to CPTs)
  - Incentives for quality, good citizenship, etc.
- Physician participation in ancillaries
- Compensation must meet Stark Law exception
  - Fair market value a critical component

Critical Business Issues

McDermott Will & Emery

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

Critical Business/Legal Issues

McDermott Will & Emery

- Due Diligence
  - Not uncommon to find physician practices with compliance issues
  - Avoids later problems
  - Possibility of self-disclosure
  - Indemnity escrows

Critical Business Issues

McDermott Will & Emery

- Transaction Issues
  - Purchase price
    - Consider tax consequences to physicians
    - Installment payments v. lump sum payment
  - No more “covenant light” deals
  - Certain percentage of “inked” physicians contracts as a condition to closing
  - Regulatory approvals
  - Indemnity escrows

FOLEY

FOLEY & LARDNER LLP

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

November 29, 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/Trade-off of compensation and price?
- Discounted free cash flow/discounted earnings approach may take into account the value of future anticipated cash flows (from selling physicians?)
  - 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

- DCF Valuation (con't)
  - PharMerica settlement
  - Challenge is to value without taking into account future referrals by seller
  - modified DCF methods?
    - Value on a "re-start" basis?
    - Carve-out governmental business (but, some state all-payor statutes)?
- 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: Need true comparables
  - 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

- Market Approach (con't)
  - 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**
  - 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)
  - 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

Stark Law

- Isolated transaction exception standards (con't)
  - No other transactions for 6 months except:
    - Other Stark Law excepted transactions
    - Commercially reasonable post-closing adjustments
  - **Indirect compensation** analysis for physician owners of selling medical group and for acquisition by non-DHS affiliate of Hospital
    - Purchase price must be FMV and not vary with v/v of referrals
- Burden of proof is on defendant
  - Violations are not remedied until referring physician/DHS entity repays excess compensation or arrangement is terminated

Stark Law

- *U.S. vs. Bradford Regional Medical Center, et al.,* Civil Action No. 04-186 Erie (WD PA, Nov. 10, 2010)
  - 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

- Other Exemption issues/cases
  - Charitable deduction for donation of assets with value in excess of benefits received/Penalties for valuation misstatements (IRC § 6662)
  - Derby case, T.C.M. 2008-45 (Feb. 28, 2008) (Disallowance of claimed charitable contribution to Sutter Medical Foundation by physicians associated with Sutter West Medical Group)
  - 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)

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
    - Payment for professional level goodwill not tied to referrals
    - 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
  - Obtain compliance certification from appraiser, if available
  - 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

November 29, 2012

Carsten Beith
312.604.0500
cbeith@cainbrothers.com

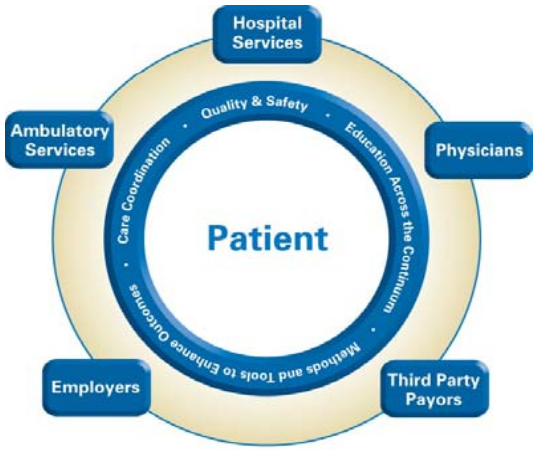
Physician Practice Consolidation Trends

Physician Practice Consolidation Trends

Consolidator Perspective

Internal and external pressures have resulted in many new forms of organizations, with affiliations between hospitals, payers, physicians and other provider organizations

- Decades of cost inflation have resulted in an unsustainable cost level for U.S. health care
  - National Health Care Expenditures ("NHE") accounted for 17.9% of GDP in 2010, projected to reach 19.6% of GDP by 2021
  - NHE per capita projected to increase from $8,402 in 2010 to $14,103 by 2021
- Governmental payers are experiencing severe budget pressure
  - Medicare and Medicaid accounted for 36% of NHE in 2010, projected to reach 41% by 2021
- Trend in cost shifting to private insurance is unsustainable
- PPACA is accelerating change
  - Over 30 million Americans are expected to join the ranks of the insured with a large portion gaining access via insurance exchanges
  - Increased push toward coordinated care delivery and focus on quality outcomes
- Increasingly unhealthy population
  - Nearly 90% of seniors have at least one chronic condition, ~70% have at least two and ~45% have at least three chronic conditions
- Aging U.S. demographics
  - 65+ population growing at a CAGR of 3.1% through 2012, 6.7x the pace of rest of population
- Physician shortages pose a challenge to all providers
- Managed care consolidation has shifted leverage
  - CIGNA completed $3.8 billion acquisition of HealthSpring on January 31, 2012
  - WellPoint announces $4.9 billion acquisition of Amerigroup on July 9, 2012
  - Aetna announces $7.3 billion acquisition (including $1.6 billion of assumed debt) of Coventry Health Care on August 20, 2012



Source: CMS' Office of the Actuary, U.S. Census Bureau, Centers for Disease Control and Prevention, company press releases

Physician Practice Consolidation Trends

Physician Perspective

Physician groups are facing unique challenges in the current market

- Changes in Medicare are driving down profitability of physician practices
- Physicians seeking greater certainty and security around compensation
- Managed care consolidation requiring competitive response
  - Payers have used increased bargaining leverage to extract significant price concessions from physicians
- Changes to the Stark law and other rules, leading physicians and hospitals to again find themselves competing for revenue from ancillary income streams (e.g. imaging, ambulatory surgery centers, labs)
- No balance sheet / no retained earnings
- Capital constraints
  - Outdated equipment and facilities and further delays in re-investment resulting is reductions in cash flow from previously profitable businesses
- New physician expectations for practice lifestyle (work/life balance)
- Physician reimbursement is in the "cross-hairs" for further payment reductions
- Burdensome capital requirements for investment in IT
  - Adoption of certified electronic health records (EHR/EMR) systems
  - Must demonstrate compliance with "meaningful use" mandate by 2015
  - Take advantage of Federal incentive payments funded by American Recovery and Reinvestment Act ("ARRA")
    - Up to $44,000 per physician
  - Avoid financial penalties for non-compliance
    - 1% in 2015, 2% in 2016, 3% in 2017 and 4% in 2018

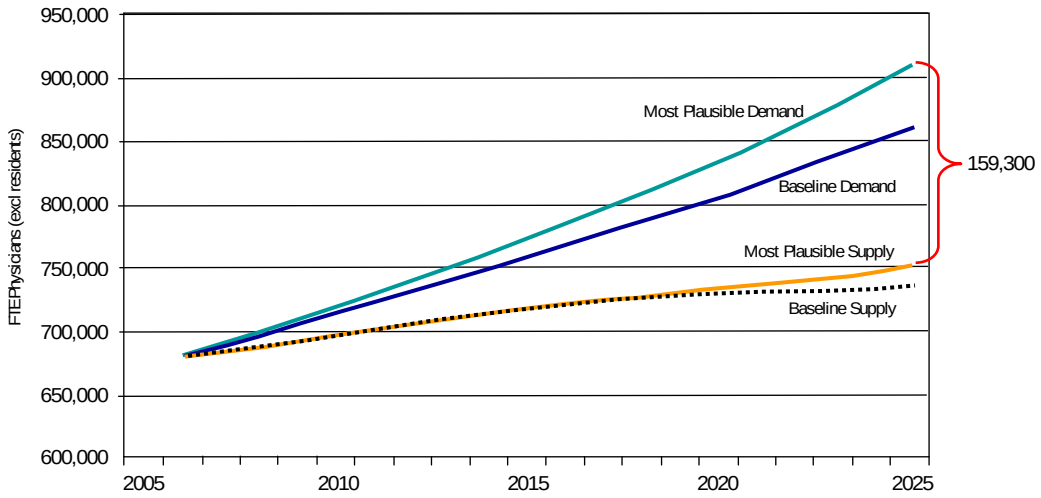
Source: Office of the National Coordinator for Healthcare Information Technology, HITECH Funding Opportunities

Physician Practice Consolidation Trends

Physician Shortages: A Key Strategic Challenge

- Physician supply shortages that existed since 2005 will be exacerbated by health care reform
  - More demand, less supply to meet demand
- 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 will increase
  - Funding of "unfunded" residency slots to secure new physicians
- Physician integration strategies such as employment models, affiliated foundation models, PHOs, clinical management and consolidation of existing practices into larger groups is occurring

Estimated Physician Demand Trends



Source: Association of American Medical Colleges (excludes expected physician supply needs as a result of health care reform)

Market Participants

Market Participants

Total Active Physicians in the U.S.

In 2010, there were approximately 800,000 active physicians(1) in the U.S. of which ~680,000 were classified as direct patient care physicians(2) and ~280,000 primary care physicians(3)

- Top 5 states (CA – 11.9%, NY – 8.5%, TX – 6.5%, FL – 6.0%, PA – 4.8%) accounted for approximately 38% of the total active physicians in the U.S.

State	Total Active Physicians	Total Active Patient Care Physicians	Total Active Primary Care Physicians
Alabama	9,508	8,418	3,419
Alaska	1,721	1,575	719
Arizona	14,694	12,904	5,151
Arkansas	5,518	4,921	2,223
California	95,198	81,017	33,822
Colorado	13,243	11,663	4,704
Connecticut	11,678	9,628	3,725
Delaware	2,393	2,079	852
District of Columbia	5,327	3,741	1,520
Florida	47,590	42,302	16,060
Georgia	20,511	17,823	7,335
Hawaii	3,970	3,452	1,535
Idaho	2,873	2,691	1,048
Illinois	33,594	27,935	12,336
Indiana	13,900	12,536	5,015
Iowa	6,294	5,459	2,530
Kansas	6,058	5,339	2,387
Kentucky	9,479	8,318	3,378
Louisiana	10,541	9,109	3,532
Maine	4,031	3,572	1,636
Maryland	21,153	16,120	6,755
Massachusetts	27,550	20,878	8,751
Michigan	26,325	22,344	9,609
Minnesota	14,262	12,363	5,492
Mississippi	5,221	4,718	1,882
Missouri	14,825	12,514	5,043
Montana	2,232	2,101	833
Nebraska	3,981	3,444	1,530
Nevada	5,264	4,728	1,889
New Hampshire	3,872	3,407	1,440
New Jersey	25,629	21,958	8,702
New Mexico	4,673	3,987	1,874
New York	68,042	54,306	21,824
North Carolina	22,367	19,096	7,864
North Dakota	1,558	1,418	619
Ohio	30,485	25,315	10,552
Oklahoma	7,406	6,655	2,817
Oregon	10,594	9,243	3,976
Pennsylvania	38,207	31,250	12,673
Rhode Island	3,515	2,843	1,190
South Carolina	9,922	8,902	3,559
South Dakota	1,779	1,636	719
Tennessee	15,302	13,307	5,467
Texas	51,691	44,395	17,659
Utah	5,598	4,798	1,828
Vermont	2,008	1,685	772
Virginia	20,270	17,570	7,251
Washington	17,796	15,366	6,612
West Virginia	4,485	3,841	1,777
Wisconsin	14,319	12,675	5,410
Wyoming	1,057	979	423
Total U.S.	**799,509**	**678,324**	**279,719**

Source: Association of American Medical Colleges State Physician Workforce Data Book, 2011

(1) Physicians who report working in administration, direct patient care, medical research, medical teaching, or other non-patient care activities are considered active

(2) Comprises only those physicians whose self-reported type of practice is direct patient care

(3) Physicians are counted as primary care physicians if their self-designated primary specialty is one of the following: adolescent medicine, family medicine, general practice, geriatric medicine, internal medicine, internal medicine/pediatrics, or pediatrics

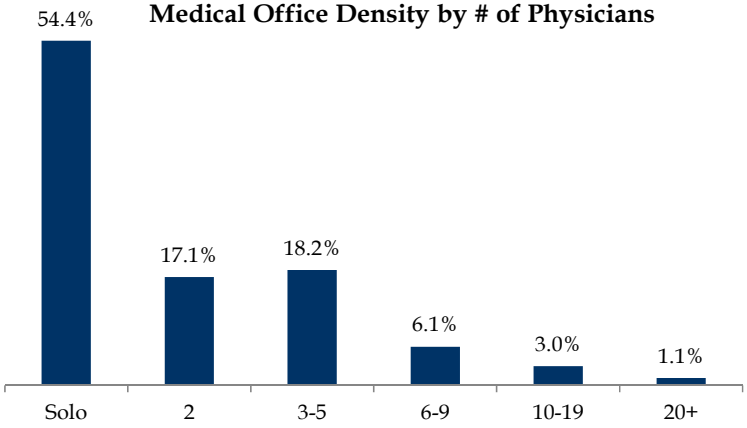
Market Participants

Number of U.S. Medical Offices with One or More Physicians

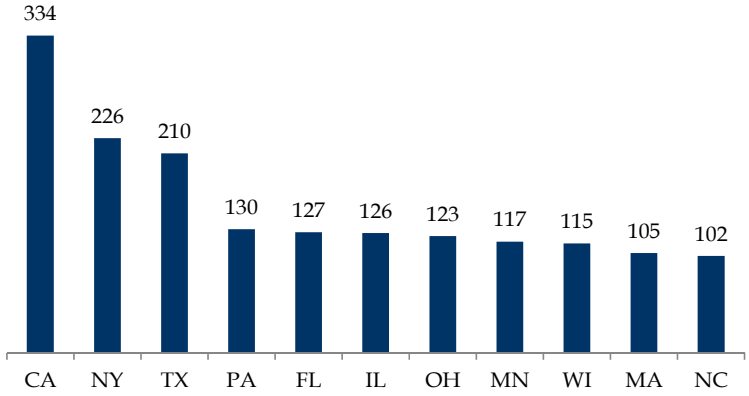
There are approximately 265,000 physician medical offices in the U.S.

- Solo practitioners and small group practices (2-5 physicians) still account for the overwhelming majority of the industry at 54% and 35%, respectively
- Medical offices with 20+ physicians account for just 1.1% of all the medical offices in the U.S.
- Only 11 states were home to at least 100 medical offices with 20+ physicians
- Only 3 states (CA, NY, TX) were home to at least 200 medical offices with 20+ physicians
- Only 1 state (CA) was home to at least 300 medical offices with 20+ physicians

Medical Office Density by # of Physicians



Top States with 20+ Physicians per Medical Office



Source: SK&A, June 2012

Market Participants

Top 50 U.S. Zip Codes with Most Physicians

15 zip codes in the U.S. are home to at least 1,000 physicians for a total of ~48,350 physicians

- 3 are in TX
- 3 are in PA
- 2 are in NY
- 2 are in IL
- 1 in IN
- 1 in MO
- 1 in MN
- 1 in MA
- 1 in CA

Rank	ZIP	City	State	Physicians	Site Count	Largest Hospital in ZIP
1	77030	Houston	TX	2,641	539	Memorial Hermann Hospital
2	78229	San Antonio	TX	1,739	357	Methodist Hospital
3	19104	Philadelphia	PA	1,553	234	Hospital of the University of Pennsylvania
4	10016	New York	NY	1,380	478	New York University Medical Center
5	76104	Fort Worth	TX	1,276	340	Harris Methodist Hospital Fort Worth
6	46202	Indianapolis	IN	1,239	186	Methodist Hospital
7	60612	Chicago	IL	1,132	203	Rush University Medical Center
8	19107	Philadelphia	PA	1,118	203	Thomas Jefferson University Hospital
9	60611	Chicago	IL	1,076	250	Northwestern Memorial Hospital
10	63110	St. Louis	MO	1,062	181	Barnes-Jewish Hospital
11	15213	Pittsburgh	PA	1,041	144	UPMC Presbyterian
12	55905	Rochester	MN	1,038	61	Saint Marys Hospital
13	2114	Boston	MA	1,011	200	Massachusetts General Hospital
14	90095	Los Angeles	CA	1,010	164	Ronald Reagan UCLA Medical Center
15	10065	New York	NY	1,000	334	New York Weill Cornell Medical Center
16	44195	Cleveland	OH	992	86	Cleveland Clinic
17	30342	Atlanta	GA	991	248	Northside Hospital
18	2215	Boston	MA	973	119	Beth Israel Deaconess Medical Center
19	48201	Detroit	MI	955	133	Harper University Hospital
20	21204	Towson	MD	940	240	Sheppard Pratt Hospital
21	10029	New York	NY	935	167	Mount Sinai Medical Center
22	10032	New York	NY	930	265	Columbia Presbyterian Medical Center
23	2115	Boston	MA	926	153	Brigham and Women's Hospital
24	94115	San Francisco	CA	916	232	UCSF Medical Center at Mount Zion
25	10021	New York	NY	913	492	Hospital for Special Surgery
26	40202	Louisville	KY	889	172	Norton Hospital
27	78705	Austin	TX	869	152	Seton Medical Center Austin
28	98405	Tacoma	WA	861	154	Tacoma General Hospital
29	90048	Los Angeles	CA	834	284	Cedars-Sinai Medical Center
30	72205	Little Rock	AR	829	229	Baptist Health Medical Center
31	92868	Orange	CA	819	222	St. Joseph Hospital of Orange
32	53226	Wauwatosa	WI	818	165	Froedtert Hospital
33	63141	St. Louis	MO	815	270	St John's Mercy Medical Center
34	10467	Bronx	NY	811	129	Montefiore Medical Center
35	75231	Dallas	TX	799	263	Texas Health Presbyterian Hospital of Dallas
36	37203	Nashville	TN	798	210	Centennial Medical Center
37	95816	Sacramento	CA	794	121	Sutter Medical Center
38	37232	Nashville	TN	792	129	Vanderbilt University Medical Center
39	10003	New York	NY	790	248	Beth Israel Medical Center
40	98104	Seattle	WA	785	154	Harborview Medical Center
41	75093	Plano	TX	778	269	Texas Health Presbyterian Hospital of Plano
42	45219	Cincinnati	OH	763	117	UC Health University Hospital
43	10461	Bronx	NY	757	189	Jacobi Medical Center
44	92037	La Jolla	CA	746	196	Scripps Memorial Hospital
45	94143	San Francisco	CA	718	113	UCSF Medical Center at Parnassus
46	93720	Fresno	CA	718	187	Saint Agnes Medical Center
47	35233	Birmingham	AL	715	124	University of Alabama Hospital
48	80045	Aurora	CO	692	106	University of Colorado Hospital
49	10019	New York	NY	689	169	St. Luke's Roosevelt Hospital
50	46260	Indianapolis	IN	678	137	St. Vincent Indianapolis Hospital
TOTAL				48,344	10,518	

Source: SK&A, September 2011

Market Participants

Review of Market Participants

Select physician group organizations that have in excess of 1,000 physicians

Group Name	Headquarters	State	Number of Physicians	Affiliation
Permanente Medical Group	Oakland	CA	6,943	Kaiser Permanente
Southern California Permanente Medical Group	Pasadena	CA	6,493	Kaiser Permanente
Memorial Hermann Healthcare System	Houston	TX	5,300	Memorial Hermann Healthcare System
Cleveland Clinic	Cleveland	OH	3,000	Cleveland Clinic
Montefiore Medical Center	New York	NY	2,800	Montefiore Medical Center
North Shore-LIJ Medical Group	Manhasset	NY	2,448	North Shore-LIJ Health System
Heritage Provider Network	Northridge	CA	2,300	
Mayo Clinic	Rochester	MN	2,023	Mayo Clinic
Massachusetts General Physicians Organization	Boston	MA	1,970	Massachusetts General Hospital
Brigham and Women's Physician Organization	Boston	MA	1,726	Partners HealthCare
UMMS Faculty Group Practice	Ann Arbor	MI	1,600	University of Michigan Health System
Mercy (formerly Sister of Mercy Health System)	St. Louis	MO	1,500	Mercy (formerly Sister of Mercy Health System)
Spectrum Health	Grand Rapids	MI	1,500	Spectrum Health
Aurora Health Care	Milwaukee	WI	1,350	Aurora Health Care
Morristown Medical Center	Morristown	NJ	1,302	Atlantic Health System
Fairview Physician Associates	Edina	MN	1,300	Fairview Health Services
Overlook Medical Center	Summit	NJ	1,290	Atlantic Health System
Emory Clinic	Atlanta	GA	1,164	Emory Healthcare
Crozer-Keystone Health System	Springfield	PA	1,100	Crozer-Keystone Health System
Henry Ford Medical Group	Detroit	MI	1,020	Henry Ford Health System
Park Nicollet Health Services	St. Louis Park	MN	1,000	Park Nicollet Health Services
Umass Memorial Medical Group	Worchester	MA	1,000	Umass Memorial Health Care
UNC Health Care	Chapel Hill	NC	1,000	UNC Health Care

Source: SK&A, American Medical Group Association Membership Database and Wall Street research

Market Participants

Review of Market Participants (Cont'd)

Select physician group organizations that have 500 to 1,000 physicians

Group Name	Headquarters	State	Number of Physicians	Affiliation
Yale Medical Group	New Haven	CT	944	Yale School of Medicine
Vanderbilt Medical Group and Clinic	Nashville	TN	924	Vanderbilt University Medical Center
Harvard Medical Faculty Physicians	Boston	MA	915	Beth Israel Deaconess Medical Center
Palo Alto Medical Foundation	Palo Alto	CA	909	Palo Alto Medical Foundation
HealthCare Partners	Torrance	CA	900	DaVita
Novant Medical Group	Charlotte	NC	868	Novant Health
Brown & Toland Physicians	San Francisco	CA	850	Sutter Health
Partners in Care	East Brunswick	NJ	850	
University Pittsburgh Physicians	Pittsburgh	PA	844	UPMC
EmCare	Dallas	TX	797	Emergency Medical Services Corporation (EMS)
Carolinas Physicians Network	Charlotte	NC	789	Carolinas HealthCare System
University Washington Physicians	Seattle	WA	788	UW Medicine
Marshfield Clinic	Marshfield	WI	729	Marshfield Clinic
Iowa Health Physicians and Clinics	Des Moines	IA	725	Iowa Health
Northwestern Medical Faculty Foundation	Chicago	IL	700	Northwestern University Feinberg School of Medicine
Beaumont Medical Group	Royal Oak	MI	700	Beaumont Health System
University Minnesota Physicians	Minneapolis	MN	694	University of Minnesota Physicians
Intermountain Medical Group	Salt Lake City	UT	692	Intermountain Healthcare
Scott & White Clinic	Tempe	TX	674	Scott & White Healthcare
UC Davis Medical Group	Sacramento	CA	646	University of California
Arizona Integrated Physicians	Peoria	AZ	600	
Physicians' Organization of Western Michigan	Grand Rapids	MI	570	
Allina Medical Clinic	Minneapolis	MN	564	Allina Health
University of Oklahoma (OU) Physicians	Oklahoma City	OK	560	OU Medicine
University Physicians Group	Hershey	PA	548	Penn State Hershey Medical Center
Geisinger Medical Group Knapper Clinic	Danville	PA	545	Geisinger Health System
Sanford Health	Fargo	ND	530	Sanford Health
Dartmouth-Hitchcock Clinic	Manchester	NH	512	Dartmouth Medical School
MultiCare Medical Group	Tacoma	WA	507	MultiCare
Providence Physician Group	Everett	WA	504	Providence Health and Services
Lahey Clinic	Burlington	MA	502	Tufts University School of Medicine
University Health Associates	Morgantown	WV	500	WVU Healthcare
Valley Emergency Physicians	Walnut Creek	CA	500	

Source: SK&A, American Medical Group Association Membership Database and Wall Street research

Market Participants

Review of Market Participants (Cont'd)

Select physician group organizations that have 200 to 500 physicians

Group Name	Headquarters	State	Number of Physicians	Affiliation
Jefferson University Physicians	Philadelphia	PA	496	Thomas Jefferson University
Ochsner Clinic	New Orleans	LA	493	Ochsner Health System
St. John's Clinic	Springfield	MO	476	Mercy (formerly Sister of Mercy Health System)
Advocate Medical Group	Oak Brook	IL	471	Advocate Health Care
Dean Clinic	Madison	WI	467	Dean Health System
Clinical Care Associates	Radnor	PA	463	University of Pennsylvania Health System
Harvard Vanguard Medical Associates	Newton	MA	458	Harvard Pilgrim Health Care
Concentra Urgent Care	Addison	TX	454	Humana (HUM)
Mednax Medical Group National	Sunrise	FL	445	MEDNAX, Inc. (MD)
Virginia Mason Clinic	Seattle	WA	440	Virginia Mason Health System
California Emergency Physicians	Emeryville	CA	424	
NorthShore University Health System	Evanston	IL	422	NorthShore University Health System
Fresenius Medical Care	Waltham	MA	418	
University Medical Associates	Charleston	SC	412	Medical University of South Carolina
University Medical Group - General Surgery	Greenville	SC	404	Greenville Hospital System
University of Texas Physicians	Houston	TX	402	UT Health
Adventist Health Medical	Portland	OR	325	Adventist Health
MCCI Medical Group	Miami	FL	305	Goldman Sachs / Pharos Fund
Queens Long Island Medical Group	Garden City	NY	300	
Summit Medical Group	Berkeley Heights	NJ	300	
Florida (Maitland) Hospital Medical Group	Orlando	FL	290	Adventist Health System
Mt. Kisco Medical Group	Mt. Kisco	NY	280	
Newton Medical Center	Newton	NJ	260	Atlantic Health System
Adena Health System	Chillicothe	OH	251	Adena Health System
Utica Park Clinic/Oklahoma Heart Institute Physicians Group	Tulsa	OK	215	Hillcrest HealthCare System

Source: SK&A, American Medical Group Association Membership Database and Wall Street research

Market Participants

The Return of the Physician Group

Recently there have been significant strategic and financial investments into physician groups – many of them have been "game changing"

Advisory Board Company	→	PivotHealth
AEA Investors Waud Capital Partners	→	HMG Hospitalists Management Group; COGENT HEALTHCARE
Banner Health	→	ARIZONA MEDICAL CLINIC
Beecken Petty O'Keefe	→	Hospital Physician Partners
Blackstone Group	IPO →	TEAMHealth
Brown Brothers Harriman Capital	→	Best Doctors
Clayton, Dubilier & Rice	→	EMSC
DaVita	→	HealthCare PARTNERS MEDICAL GROUP
Dignity Health	→	U.S. HealthWorks
Enhanced Equity	→	NextCare URGENT CARE
Excellere Partners	→	PhyMED MANAGEMENT; AMG
Flexpoint Ford	→	EAGLE HOSPITAL PHYSICIANS
General Atlantic Sequoia Capital	→	MedExpress URGENT CARE Great Care. Fast.

Goldman Sachs Pharos Capital Group	→	MCCI
Health Enterprise Partners Morgenthaler Sightline Partners	IPO →	ipc The Hospitalist Company
Hellman & Friedman Health Enterprise Partners	→	SHERIDAN
Humana	→	Concentra
J.W. Childs Associates	→	CHG Healthcare Services
McKesson	→	US Oncology
Metropolitan Health Networks	→	Continucare
TowerBrook Capital	→	SOUND PHYSICIANS
University of California San Francisco (UCSF)	→	Hill Physicians
UnitedHealth Group	→	Monarch HealthCare A Medical Group, Inc.
University of Pittsburgh Medical Center (UPMC)	→	EPN ERIE PHYSICIANS NETWORK
WellPoint	→	CareMore It's what we do.
WellPoint LLR Partners	→	Physicians ImmediateCare

Source: Company press releases and CapitalIQ

Market Participants
Physician Groups and Hospitalists

($ in millions)

Announced	Closed	Target	Acquiror	Enterprise Value	Enterprise Value / LTM Revenue	Enterprise Value / LTM EBITDA
09/10/12	09/10/12	ABQ Healthcare Partners	HealthCare Partners	NA	NA	NA
06/13/12	Pending	East Tennessee Medical Group PC	Blount Memorial Hospital	$24.4	NA	NA
05/21/12	Pending	HealthCare Partners	DaVita	$4,418.0	1.8x	8.4x
10/11/11	Pending	Solaris Heart & Vascular	WellStar Health System	$16.0-$20.0	NA	NA
06/27/11	10/04/11	Continucare, Inc.	Metropolitan Health Networks, Inc.	$413.5	1.2x	9.4x
05/31/11	05/31/11	California Cancer Specialists Medical Group	City of Hope	CONFIDENTIAL		
04/13/11	05/04/11	Cogent Healthcare Inc	Hospitalist Management Group LLC	CONFIDENTIAL		
04/12/11	04/12/11	US Radiosurgery LLC	Alliance Oncology LLC	$54.0	1.9x	NA
02/14/11	05/25/11	Emergency Medical Services Corp	Clayton, Dubilier & Rice	$2,962.7	1.0x	9.4x
01/11/11	01/11/11	North Pinellas Anesthesia Associates	Emergency Medical Services Corp.	$13.8	0.9x	NA
01/04/11	01/04/11	Medical Edge	Texas Health Resources	CONFIDENTIAL		
11/22/10	12/21/10	Concentra Inc	Humana	$790.0	1.0x	~8.5x
08/16/10	12/15/10	Prospect Medcial Holdings	Leonard Green & Partners LP	$363.0	0.8x	6.7x
12/02/09	12/02/09	Emergency Physicians of Naples	Team Health Holdings Inc	$13.5	NA	NA
06/02/09	06/02/09	Associates in Neonatology PA	MEDNAX Inc	$10.0	1.7x	4.0x
10/17/08	10/17/08	Templeton Readings LLC	EmCare Inc	$27.5	1.4x	NA
03/18/08	04/17/08	Advanced Medical Partners Inc	HealthTronics Inc	$13.1	0.5x	NA
01/01/08	01/01/08	Advanced Medical Specialties	US Oncology Inc	$71.3	NA	NA
11/14/07	01/04/08	Medical Associates Health Centers	ProHealth Care Inc	$40.0	0.4x	NA
05/21/07	05/21/07	Sheridan Healthcare Inc	Hellman & Friedman LLC	$925.0	2.1x	NA
				Mean	**1.1x**	**7.9x**
				Median	**1.0x**	**8.5x**
				Low	**0.4x**	**4.0x**
				High	**2.1x**	**9.4x**

Source: Source: Company press releases, SEC filings, Capital IQ, Irving Levin and Cain Brothers' estimates
NM = Not Meaningful; NA = Not Available

Market Participants

HealthCare Partners Business Overview

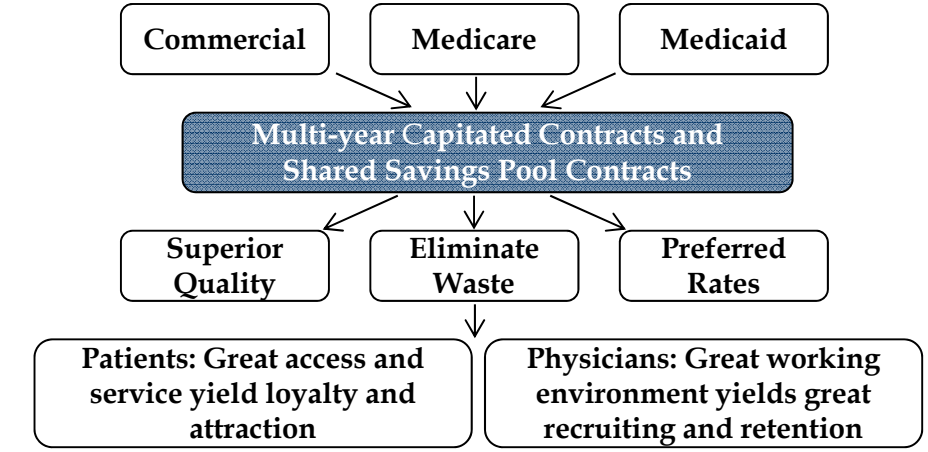
HealthCare Partners is a national leading manager and operator of medical groups and affiliated physician networks

- Patient-focused, physician-centric leader of integrated care
- Largest network of physician groups
- Opportunity to grow by entering into new markets

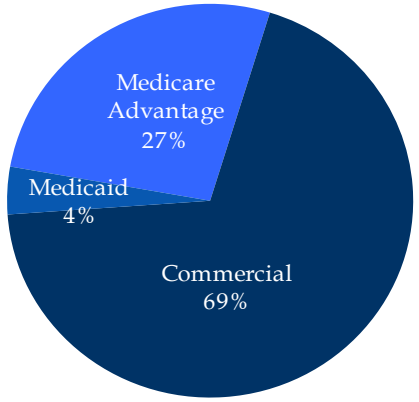
HCP Payer Mix by State(1)

	California	Florida	Nevada
Commercial	479,073	40,166	33,942
Government	99,263	4,164	28,016
Total	578,336	44,330	61,958
% of Total	*84%*	*6%*	*9%*

HCP Business Model



HCP Payer Mix



Source: CapitalIQ, company filings and Wall Street research

(1) Data as of 2010 and excludes September 7, 2012, acquisition of ABQ Healthcare Partners, which employs ~185 physicians and serves ~180,000 patients in New Mexico

Market Participants

HealthCare Partners Business Overview

HealthCare Partners operates on both a capitated and shared savings arrangement

- Focus on proactive patient management, improving care / outcomes and eliminating waste
- "Starting point of its business model is its patient database and EMR"
- Model consists of primary care physicians and specialists in addition to care managers, disease managers and social workers
- Ability to negotiate with payers in the event of unforeseen circumstances

Summary HCP Financials

($ in millions)	2008	2009	2010	2011	2012P	2013P
Revenue	**$1,600**	**$1,800**	**$2,100**	**$2,400**	**$2,609**	**$2,835**
Growth %	*NA*	*13%*	*17%*	*14%*	*9%*	*9%*
Operating Expenses	1,354	1,540	1,722	1,911	2,099	2,278
Operating Income	**$246**	**$260**	**$378**	**$489**	**$510**	**$557**
Margin %	*15%*	*14%*	*18%*	*20%*	*20%*	*20%*
D&A	24	26	29	31	32	33
Stock Based Comp.	8	7	7	7	8	10
Adjusted EBITDA	**$278**	**$293**	**$414**	**$527**	**$550**	**$600**
Margin %	*17%*	*16%*	*20%*	*22%*	*21%*	*21%*

HCP Acquisition History

Company Name	Year
ABQ Healthcare Partners	2012
Advanced Medical Center	2010
Talbert Medical Group	2010
Rainbow Medical Center	2010
Fremont Medical Centers	2009
Northridge Medical Group	2009
Physician Associates of the Greater San Gabriel Valley	2008
Arroyo Seco Medical Group	2007
Pinnacle Health System	2006
JSA Healthcare Corporation	2006
Harriman Jones Medical Group	2005
Greater Valley Physicians Associates	2001
Greater Valley Medical Group	2001
Unified Physicians of the South Bay	1997
Memorial Medical Group	1997
Alliance of Private Practice Physicians	1996
Bay Shores Medical Group	1994
3 Companies merge to form HCP Medical Group	1992

Source: CapitalIQ, company filings and Wall Street research

Valuation Issues and Fairness Opinions

Valuation Issues and Fairness Opinions

Valuation Considerations

Establishing Value

- "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

Source: Structuring Physician Practice Acquisitions: Something Old is Something New Again, July 2009.

Valuation Issues and Fairness Opinions

Process

How to Avoid Past Mistakes

- 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

Managing Physician Expectations

- 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 and Fairness Opinions

- Board members have a number of duties including *duty of care* that requires them to be reasonably informed when making specific decisions on behalf of their stakeholders.
  - Transactions involving change in control
  - Purchase or sale of significant assets
- A formal opinion, most often referred to as a "fairness opinion," rendered by an expert also serves as evidence that a board and its members have conducted a process that was sufficient and consistent with meeting its fiduciary obligations
- Overall attention to corporate responsibility and recent interest in the general topic of fairness opinions by nonprofit regulatory bodies are all signals that boards need to be careful in using and contracting for fairness opinions
- Boards should review their organization's individual circumstances match specific recommendations to their needs.
- Fairness opinions are often obtained where:
  - Boards are likely to be second-guessed about its ability to act on behalf of all stakeholders
  - Regulatory review is more aggressive
  - Tax opinions and legal opinions are required to complete a transaction

Valuation Issues and Fairness Opinions

- Fairness opinions are appropriate for both investor owned companies, whether publicly owned or privately held, and nonprofit organizations.
- The fairness opinion itself is a short letter from a firm considered expert in the area of health care M&A and finance expressing the expert's opinion that the transaction is fair from a financial point of view.
  - The opinion should be supported by detailed analytic calculations using standard industry valuation methodologies
  - Discussed with the board prior to the board making a final decision on a transaction
- Some health care transactions may also benefit from obtaining a valuation opinion instead of/or in addition to a fairness opinion
  - Anticipated regulatory review processes
- A valuation opinion specifically estimates the fair market value of what is being considered, which might be the equity of a company, a line or lines of business, or an asset or group of assets, with or without related liabilities

Valuation Issues and Fairness Opinions

- A fairness opinion can serve as an important contributor to a board's decision making. It also shows evidence that a board followed a reasoned and deliberative process, and it can be used to defend board members against potential legal challenges
  - IRS
  - OIG
  - Stakeholders.
- A fairness opinion is a determination by an expert that a proposed business transaction is "fair from a financial point of view" as of a specific date.
- The opinion is usually issued to the stakeholders of an organization or those with governance responsibility and fiduciary duties owed to the stakeholders.
- Expert firms that deliver fairness opinions have experience in the relevant market and in related financial matters.

Valuation Issues and Fairness Opinions

Business Considerations

Financial Impact	• Valuation • Funding sources • Pro forma financial impact on hospital system • Corporate allocations
Debt Capacity and Access to Capital	• Balance sheet • Income statement • Opportunity cost (capital allocation tradeoffs)
Impact on Organization Culture	• Shared vision and mission • Corporate citizenship • Fit with larger enterprise
Impact on Medical Staff	• Independent medical staff • Other employed physicians

Valuation Issues and Fairness Opinions

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