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THE ASCA JOURNAL | JANUARY 2020 | ascfocus.org

WHAT'S IN STORE THIS YEAR?

Opportunities and challenges facing the ASC industry

ASCA Ambulatory Surgery Center Association

WHAT'S IN STORE FOR 2020?

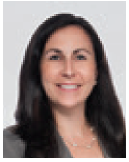
Opportunities and challenges facing the ASC industry

Industry professionals weigh in on the key trends.

Proliferation of Private Equity Investment in ASCs

Transactions are unlikely to slow down

BY MICHAEL F. SCHAFF AND ALYSON M. LEONE



For a number of years, ASCs have been an investment target of private equity firms (PE) interested in seizing opportunities in a fragmented market. As providers seek to increase profitability, by decreasing expenses while increasing reimbursement, consolidation has become the norm.

In 2018, PE merger and acquisition transactions in the healthcare space hit record levels at $63.1 billion and 316 deals, according to the Global Healthcare Private Equity and Corporate M&A Report 2019. The two most significant PE transactions in recent times include KKR & Co.'s acquisition of Envision Healthcare Corp. for $9.9 billion in October 2018 and Athenahealth's sale to Veritas Capital and Evergreen Coast Capital for $5.7 in February 2019.

PE's Interest in ASCs

ASCs have enjoyed a reputation of providing high-quality care and safe, efficient services to patients. They are generally more convenient than hospitals for both patients and surgeons and offer increased scheduling flexi-

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bility and minimal disruptions from emergencies. At the same time, ASCs have the benefit of offering a lower cost alternative to the hospital environment. In general, they are better able to contain costs and have less overhead than hospitals. It is the ultimate trifecta that results in a good investment for PE: patients, physicians and payers all are happier.

Over time, thanks to advances in techniques and technology, ASCs have been able to perform a growing number of types of procedures. Most recently, the Centers for Medicare & Medicaid Services (CMS) added total knee arthroplasty, a mosaicplasty procedure and six coronary intervention procedures, including cardiac stenting, to the list of Medicare's covered surgical procedures at ASCs in 2020. CMS found that these procedures "can be safely performed in an ASC setting and would not pose a significant safety risk to beneficiaries if performed in an ASC setting." CMS also is considering adding 13 additional coronary intervention procedures to its ASC covered list in the future.

Recently, we heard an ASC valuation expert say that healthcare is often referred to as "recession-proof." With the advancing age of Baby Boomers, it is likely that healthcare services will continue to remain in high demand. Healthcare's impact on the economy is significant, accounting for almost 20 percent of the gross domestic product and growing, according to CMS data. This makes for a solid investment for PE.

With a reputation for quality care at reduced costs, increased opportunities for reimbursable cases and protection from economic downturn, PE continues to show strong interest in investing in ASCs.

> *"As healthcare spending continues to increase and more currently hospital-based procedures are shifted to the ASC setting, PE's interest in investing in ASCs is unlikely to slow down."*
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> *—Michael F. Schaff and Alyson M. Leone, Wilentz Goldman & Spitzer, P.A.*

ASCs' Interest in PE

Physicians want to practice medicine without the headaches of administrative tasks and chasing insurers for payment. PE investors allow doctors to do just that. Often, PE firms already have relationships with payers and strategic expertise that can help grow ASC revenue and profit. They can provide capital for improvements, expansion and technology that facilitates data aggregation.

Physicians continue to remain interested in a PE investor, since, plainly stated, PE firms are offering more money than other investors, including physicians and hospitals. PE is paying anywhere from 6–12 times EBITDA for the ASCs. EBITDA, or earnings before interest, tax, depreciation and amortization, is considered the benchmark of an ASC's profitability. Purchases are generally structured to give sellers long-term capital gains treatment, which creates significant tax savings. Many physicians consider this purchase price a windfall, and physicians who are close to retirement sometimes view these purchases as an exit strategy that allows younger physicians to take some money off the table immediately by realizing value for their interest now while continuing to share in the growth of the center.

Common Terms in PE Transactions

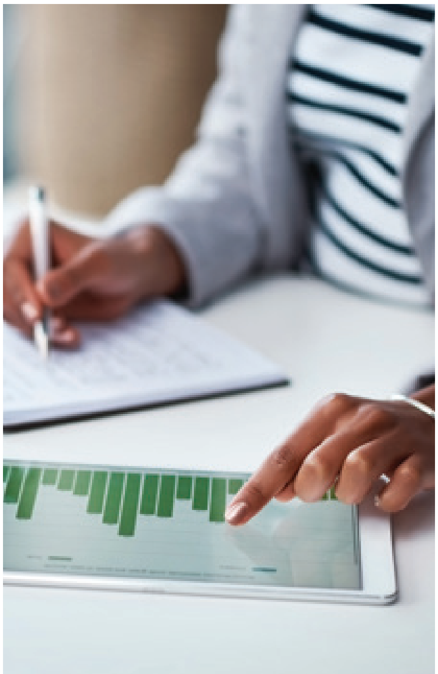
An initial consideration in structuring a transaction is whether the PE firm will form a new entity and purchase the assets of the ASC or purchase ownership interests in the existing entity. Both liability and licensing concerns take precedence in this decision, as buying into an existing entity results in the PE assuming the liabilities of the ASC. It may be difficult, however, and in some states prohibitive, for the ASC to obtain a new license. In those instances, a change of ownership application to the licensing department might be the easier path.

In connection with the purchase agreement, selling owners should expect restrictive covenants prohibiting them from owning or operating a competing facility within the catchment area. Since the selling physicians will remain owners, a new shareholder or operating agreement will be negotiated and drafted. This agreement will likely give significant decision-making authority to the PE firm. It will further restrict transferability of the physicians' ownership interests, set forth when their interest can be redeemed and impose expanded non-compete restrictions. Physicians also will be expected to make a commitment to the ASC of up to 10 years, with penalties for early withdrawal.

Frequently, a PE firm will request or require that most of the current ASC owners roll over part of the proceeds or ownership interests into a new entity. Rollover equity may result in a second "pay day" for physicians, since a PE firm will look to sell its portfolio in about five years for a significant profit.

Legal Considerations in PE Transactions

State licensure and certificate of need regulations govern the ownership of ASCs. Compliance with these laws is essential to maintaining an ASC's license in good standing. The ASC will need to navigate the notice and approval process of the applicable department for



any change of ownership or new license as a result of a PE transaction.

The ownership of, and referral to, an ASC implicates the federal Anti-Kickback Statute (AKS), and likely any state counterpart. The AKS provides "whoever knowingly and willfully solicits or receives [or offers or pays] any remuneration (including any kickback, bribe or rebate) directly or indirectly, overtly or covertly, in cash or in kind—(i) in return for referring an individual to a person for the furnishing or arranging for the furnishing of any item or service for which payment may be made in whole or in part under a Federal health care program . . . shall be guilty of a felony and upon conviction thereof, shall be fined not more than $25,000 or imprisoned for not more than five years, or both."

If an investor meets the AKS safe harbor for ASCs, then any return on his or her investment will not be deemed impermissible remuneration. The safe harbor, however, only protects arrangements where the owners are physicians, group practices or owners who are not employed, are not in a position to provide items or services to the entity and are not in a position to make or influence referrals to the ASC. Oftentimes, PE firms do, in fact, provide management services or are considered referral sources and, thus, their ownership in the ASC prevents physicians from meeting the AKS safe harbor. Failure to meet the safe harbor is not fatal to an AKS analysis, but ownership must be structured carefully to avoid a violation.

Corporate practice of medicine (CPOM) laws state that it is illegal for a person or entity to employ a physician or practice medicine and surgery without first having obtained a medical license. Most state CPOM laws, however, permit ownership by lay persons of licensed facilities, such as ASCs. If an exception does not apply, the PE firm will usually form a management company to provide space, equipment, non-clinical personnel and supplies to the ASC in exchange for a significant fee.

Where physician owners get rollover equity in the ASC or management company, the rollover of proceeds or ownership is subject to both state and federal securities laws and regulations.

The Future of PE Investment

It is likely that PE investment in ASCs will continue in 2020. PE has invested in many sectors of the healthcare field, including physician practices in ophthalmology, dermatology, urology, urgent care and dentistry; lab and toxicology companies; health IT companies and behavioral health. As healthcare spending continues to increase and more currently hospital-based procedures are shifted to the ASC setting, PE's interest in investing in ASCs is unlikely to slow down. «

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