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HEALTH SYSTEMS INVEST AND GROW PHYSICIAN PRACTICES (AGAIN)

MANY CONSIDER OUTSOURCING PRACTICE MANAGEMENT

By John A. Deane

THE HISTORY OF PHYSICIAN PRACTICE MANAGEMENT COMPANIES (PPMCs):

ONE COMPANY'S EXPERIENCE

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A Physician Practice Management, Interim Management & Consulting Company

HEALTH SYSTEMS INVEST AND GROW PHYSICIAN PRACTICES (AGAIN)

Many Consider Outsourcing Practice Management

By John A. Deane

Concurrent with the development of the PPM industry in the 1990s, hospitals, health systems and some academic medical centers acquired primary care physician practices.[1] Most of these acquisitions were a defensive response to the threat of competing institutions and PPMs acquiring their loyal referring physicians. In addition, these institutions were almost universally pursuing a global capitation strategy that required significant primary care capacity.

Much has been written about the demise of health system sponsored physician practices.[2] While many health systems have elected to divest all or a portion of their owned physician practices, most institutions continue to employ physicians for a number of reasons:

New breed of physicians wants a "JOB" – Physicians out of training are seeking employment opportunities that offer a balanced lifestyle. It is rare for new physicians to "hang a shingle" and open a private practice.

Ensure long term commitment – Physician employment continues to serve as an important vehicle for aligning physicians with the institution over time.

Facilitate succession planning – Mature physicians are reluctant to accept the business risk of recruiting and hiring their replacement, or to grow their practice. Through employment, the institution is able to accept this risk and the initial investment while partnering with senior physicians to serve as mentors and leaders of the employed physician practice.

Platform for expansion – Just as physicians are reluctant to invest in succession planning, they are reluctant to invest in growth. Employment offers a vehicle to grow a loyal physician compliment, including the ability to locate new, loyal practices in strategic geographic areas.

Address malpractice crisis – Especially in certain specialties such as OB/GYN, physicians are increasingly seeking health system support for the cost of professional liability insurance.

Managed care clout – Aligning with physicians through employment offers the ability to strengthen managed care contracting leverage with third party payors.

Deal with Unfriendly Aggregators – For health systems that face specialty groups seeking to open hospital like facilities, those institutions that maintain a strong employed primary care physician base are positioned to ensure that referrals remain

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1 See related article beginning on page 3 entitled, "The History of Physician Practice Management Companies (PPMCs): One Company's Experience."

2 Deane, John A. and Cecala, Alan H., "Seeing the Light at the End of the Tunnel: Why Many Health Systems Continue to Own Physician Practices," MGMA Connexion, October 2001.

inside the system. For this reason, many institutions find ways to share system financial success with their employed physicians in order to align incentives against unfriendly aggregators.

***Vehicle for quality initiatives (EMR)* –** The holy grail of employed physician practices, the ability to deliver documented quality health care through large physician groups on a common information system platform, continues to represent a significant opportunity for health system sponsored medical groups.

Increasingly, today's health systems are investing in and growing their employed physician practices. Moreover, a sea change is taking place with respect to system management's willingness to consider outsourcing the management of their physician practices. While in the 1990s hospital administrators were aspiring to own and operate HMOs, physician practices and other "non-core" services, many health system executives today see the need to own practices but not manage them. This presents a mutual opportunity for systems in need and Southwind, a provider of physician practice management services.

THE HISTORY OF PHYSICIAN PRACTICE MANAGEMENT COMPANIES (PPMCs):

One Company's Experience

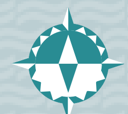
By John A. Deane and Peter M. Kindrachuk

From the late 1980s through the 1990s, a new industry devoted to the ownership and management of multi-specialty physician group practices developed. PhyCor, Inc., a leader in the physician practice management (PPM) industry, was a publicly traded firm that entered into over 60 management services agreements with medical groups ranging in size from 25 to 250 physicians whereby PhyCor acquired the non-real estate assets of these groups (furniture, fixtures, equipment and accounts receivable), employed all non-physician support staff and management (but not the physicians themselves) and provided ongoing corporate oversight and management support.

PhyCor became a huge success story during the initial 15 years of operation, growing to over $2 billion in net revenue and experiencing a ten times increase in the value of its stock price. Key reasons underlying PhyCor's success included the following:

***Aligned Financial Incentives* –** PhyCor's model aligned financial incentives such that the company's profits increased only when physician earnings also increased. Moreover, physicians were never employed by PhyCor. Instead, the physicians continued to exist as employee shareholders of their own professional corporation which entered into long term (as much as 40 year) management services agreements. All of the financial incentives inherent in private practice, including individual and group accountability for physician production and practice expenses remained in play. PhyCor and the physicians split the contribution margin before physician compensation, with PhyCor earning between 11 and 20 percent of the "predistribution pool."

***Strong Local Management Teams* –** Historically, physician group practice management executives were home grown. While professional development activities were led by the Medical Group Management Association (MGMA), most physician practice



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executives learned on the job by making mistakes and learning not to repeat them. In the 1980s, the PPM industry was characterized by management that was often dominated by their physician leaders who themselves had very little business training. Moreover, while many large medical groups would invest a reasonable compensation package for a talented administrator, typically these groups had very little bench strength in financial operations and other subordinate management.

> PhyCor was successful in developing a new breed of physician practice management executives characterized by "cream of the crop" medical group executive directors who were enticed by the excitement surrounding the success of the company, the reputation of its corporate management and the opportunity to have an equity stake in PhyCor through the awarding of stock options. As weak, mostly legacy clinic executives were weeded out for non-performance, those demonstrating promise were offered professional growth opportunities through relocation to larger size medical groups and/or corporate roles overseeing operations in multiple markets.
>
> The PhyCor executive directors were supported by a new player on the local medical group management team, the clinic's chief financial officer. These key positions represented a new focus on financial discipline that served to enhance accountability for performance for management and physicians by ensuring key stakeholders access to consistent, reliable, accurate, timely and relevant financial and operational information on a monthly basis.[3]

Strong Corporate Operations Teams – PhyCor developed an elite group of senior executives with extensive large group management experience and financial operations experience to support its local management teams. For every four to five medical groups, PhyCor would assign a team composed of a Vice President of Operations and Director of Finance who served on each clinic's Joint Policy Board along with the local executive director and three physician leaders. In collaboration with the local physician leadership, the local executive director was hired by and reported to the Vice President of Operations. This level of oversight provided enhanced accountability and financial discipline while also strengthening the local management team who, prior to PhyCor, were often lonely voices in the wilderness when dealing with physician leaders around difficult business decisions.

Over time, PhyCor supplemented the corporate operations team with an impressive array of specialized corporate support services, including:

- Group purchasing for professional liability insurance, employee benefits, supplies, equipment and maintenance contracts;
- A Service Improvement Program (SIP) that benchmarked operating expenses and operating indicators of performance across all affiliated medical groups as a tool for continuous quality improvement;
- A Performance Improvement Program (PEP) that benchmarked physician productivity and earnings;
- Physician recruitment;
- Billing, collections and accounts receivable management;[4] and
- Human resources, including pension plan administration.

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3 Within the first two years of a PhyCor affiliation, half of legacy clinic executive directors were replaced for non-performance. In 90 percent of the cases, a new CFO was recruited to support the clinic, sometimes replacing a weak legacy CFO and sometimes through creation of a new CFO position.

4 PhyCor waited over 12 years before investing in corporate support for the professional fee revenue cycle. In hindsight, this was undoubtedly a mistake, since cash collections represents one of the most important (perhaps *the* most important) elements of success.

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Focus on Long Term Relationships **–** PhyCor management agreements were for 40 years because they were acquisition based. Affiliated physicians appreciated PhyCor's intent on building and sustaining long-term relationships. Physicians, unlike most professionals, generally expect to practice in one location for the duration of their medical career. They are distrustful of unplanned changes in management and structure.

Institute for Health Care Management **–** PhyCor developed an opportunity for local clinic management and physician leadership from affiliated medical groups nationally to share information, network and for education focused on financial, operating and clinical improvement initiatives. Although this initiative was expensively produced and sometimes lacked focus, the Institute was a powerful vehicle for building a sense of identity among PhyCor affiliated groups nationally.

Emphasis on Values **–** PhyCor was founded by seasoned health care management executives who exhibited strong values of honesty, integrity and a commitment to "do the right thing." These values were prominent both in word and deed as many business decisions were made in the interest of long term success as opposed to short term profits.

In summary, PhyCor developed a strong formula for success that included aligned financial incentives and exceptionally strong management complimented by a focus on long term success and a spirit of integrity that permeated the company.

THE LESSONS LEARNED

In 1998, PhyCor began a public and humiliating decline that resulted in a precipitous reduction in its stock price and eventual bankruptcy and re-emergence as an Independent Practice Association (IPA) focused company. This decline was even more remarkable in contrast to the company's history of success over the prior 15 years. The reasons PhyCor failed are instructive.

Competitors Focused on Aggregating Clinics vs. Adding Value

As PhyCor's success became increasingly obvious in the marketplace, competitors sprang up across the country that attempted to replicate its success. In order to compete with the market leader, PhyCor's competitors offered dramatically higher acquisition prices, often paid in the form of stock. Physicians became caught up in the opportunity to monetize their practice assets in what became more of a stock play than a business decision focused around improving practice performance

PhyCor made the mistake of increasing its acquisition prices in order to compete with other PPMs. The result of increasing acquisition prices was increasing management fees. While initially PhyCor purchased good-will for $50,000 per physician, by 1998 PhyCor was acquiring good-will for as much as $350,000 or more per physician. Concurrently, management fees were initially in the range of 11 to 13 percent of the "pre-distribution pool," later these fees were as much as 20 percent or more in order to support the more aggressive acquisition prices that were being paid. These management fees failed to stand the value test over time, resulting in permanent pay reductions for physicians who became frustrated and either left the group or sought to terminate the PhyCor relationship.

New Recruits Didn't Value Initial Proceeds

Physicians hired subsequent to the initial PhyCor transaction, having not participated in proceeds but obligated to share the management fee, became increasingly resentful over the passage of time. As the "tipping point" was reached where the majority of physicians were not participants in the initial purchase price, yet were carrying a management fee that served in large part to finance the initial purchase, the overall relationship became unstable. The specialists, in particular, who were already subsidizing

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the primary care physicians within the group, resented the management fees. This resulted in instability in some groups.

40 Year Agreements Not Realistic

PhyCor's approach to the relationship as a 40 year marriage, while noble in its commitment, was not realistic. Without a reasonable and fair mechanism for separation, PhyCor management and physician affiliates became trapped in a long term commitment where in many cases both parties would have been better served by terminating the relationship gracefully prior to the end of a 40 year contract term.

Lack of Focus on Collecting Cash

Like most hospitals, as a publicly traded company, PhyCor affiliated clinic operations were accounted for based on the accrual method of accounting as opposed to cash accounting. This served to de-emphasize physician and management focus on collecting cash and managing accounts receivable. Only after 12 years of operations did PhyCor hire its first corporate executive focused on the professional fee revenue cycle, a strategy that was "too little, too late" to impact cash collections in a significant way.

Excessive Influence of the Stock Market

In the last half of the 1990s, the market was moving money into the dot.com companies when several PPM companies experienced severe financial difficulties, and PhyCor took a substantial charge relating to its few primary care groups. Wall Street abandoned the industry segment as too volatile and physicians felt this was a sign to sever their relationships.

SUMMARY

What was learned from the PhyCor experience was that even if value added is great, there is a limit as to the extent of management fees. Also, acquisition structures that require long term relationships are difficult to maintain. Likewise, physician practice management is probably better suited for a private structure, not a public one, in today's healthcare environment.

At the same time, the early success of the company (which was sustained for over 15 years) revealed that a disciplined approach to management, hiring, providing appropriate incentives for the right people and operating with integrity were all key success factors that work when the economic model is in balance.

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A Physician Practice Management Option For America's Health Systems

Southwind is expanding its client offerings to include ongoing physician practice management (PPM) services. The Company seeks to enter into three-year, renewable management services agreements with hospitals, health systems and academic medical centers to provide superior management through the provision of a locally based management team, supported by senior corporate executives with deep experience in physician practice management.

Southwind will manage health system sponsored physician practices that have at least 25 physicians and net revenue of at least six million dollars annually. This size organization can well afford a quality management team to manage, improve services, implement long range plans, develop practices and improve long term security. This

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service will be provided at an affordable cost that compares well when measured against the value provided.

Through a three year, renewable management services agreement, Southwind provides the following essential services to support health system sponsored medical groups:

Local Management Team – Depending upon the size of the group, Southwind employs the following key members of the local medical group management team:

- Executive Director, CEO or equivalent
- Chief Operating Officer (larger groups)
- Chief Financial Officer
- Business Office Director or Manager

These local Southwind executives are compensated based on incentives that tie to mutually determined client goals and objectives, including optimizing financial and operating performance. They participate in bi-annual corporate educational meetings at Southwind's corporate headquarters in Nashville and have direct access to Southwind corporate resources.

Corporate Management Team – The local team is backed up by the following key corporate executives who will have a span of control of between four and seven medical groups (depending upon size):

Vice President of Operations – a senior physician practice management executive with 15+ years experience, including large medical group experience and experience in working with multiple medical groups in disparate geographic locations; The VP of Operations directly oversees and manages the local Executive Director and the other members of the operations management team; The VP attends monthly clinic Board meetings as a resource and will provide consulting support in physician compensation plan design, managed care contract negotiation, and strategic planning.

Director of Financial Operations – a senior finance officer with practice management experience working with large and small medical groups; The Director of Finance assists in the recruitment and hiring of local chief financial officers and serves as a mentor to the local CFO;

Senior Vice President, Revenue Cycle Operations – a senior business office executive with extensive experience in professional fee billing, collections and accounts receivable management, including both front-end and back-end clinic operations – provides monitoring, oversight and support of professional fee revenue cycle operations;

Management Continuity through Interim Management – Southwind will ensure management continuity through its corporate operations team by providing interim management when key positions are vacant, including on the front-end of assignments. Southwind ensures that when engagements are terminated pursuant to a contract that a solid transition plan is in place to keep things running smoothly.

Benchmark Comparisons of Financial and Operating Performance – Using detailed data from comparable Southwind clients supplemented by available industry benchmark data, affiliated medical practices are provided a "dashboard" key indicator report highlighting financial, operating and clinical performance.

Group Purchasing – Southwind offers group purchasing for medical group supplies, pharmaceuticals, life, disability and professional liability insurance (through a

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self-insured captive) as well as access to cost effective physician recruitment and other essential services.

***After the Sale* –** Management services are very much a "what have you done for me lately" business. In order to ensure client satisfaction, Southwind places a special emphasis on communicating to the client on at least a quarterly, if not monthly basis regarding its progress, obstacles encountered and new goals and objectives. Equally important, Southwind continuously identifies, seeks client approval for and executes follow-up plans that will ensure that Southwind's contributions beyond the first 12 to 18 months are significant and represent a true value.

FLEXIBLE CONTRACT TERMS

Ongoing management services contracts have a term of three years and are renewable pursuant to renegotiations that will occur at the end of Year Two. At the end of Year Two, clients will have several options:

***Renew for Another Three Year Term* –** The contract may be renewed for a subsequent three year term (six years total) with fees revised according to cost factors and renewable for yet another three year term;

***Terminate at the End of Year Three* –** The client may choose to terminate the agreement at the end of Year Three with no penalty, in which case Southwind will cooperate with the client regarding a smooth transition of management at the end of Year Three.

***Terminate at the End of Year Three and Retain Local Management Team* –** In consideration for a prospectively identified one-time recruitment fee, the Health System may retain members of the local Southwind management team following termination of the management agreement;

Each Southwind management services agreement provides for a base fee and an annual incentive of up to twenty percent based upon mutually agreed to goals and objectives. Included in the base fee are the compensation and benefits of the local physician practice management team (typically the Executive Director, Chief Financial Officer and Business Office Director or Manager), the Corporate Operations Team, access to group purchasing program and other value added services.

The key advantage to Southwind's long term management services option is confidence that financial and operational performance will continue to be optimal year after year. Health system clients benefit from the support of a seasoned corporate management team with deep experience in physician practice management at a reasonable cost.

If we can be of assistance to you, please call John Deane at 1-888-624-9684

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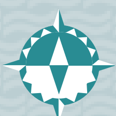

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