Even with COVID, practice M&A market better than expected; watch terms

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Effective Nov 12, 2020

Published Nov 16, 2020
Last Reviewed Nov 12, 2020

Practice management

You might think the mergers and acquisition (M&A) market for physician practices would be weak, thanks to COVID-19. But experts say there's money out there — and some properties may be almost as hot as they were before March.

A recent report from consultants VMG Health in Dallas was optimistic: While acknowledging a general financial downturn at the start of the pandemic, the report by VMG's John Meindl, director, and Winston Smart, manager, transaction advisory and research, argued that recent shake-ups might actually spur activity. "While buyers tend to proceed cautiously in the face of uncertainty, large changes affecting health care providers have historically been accompanied by an increase in M&A activity," the authors wrote.

This seems to have been borne out in recent months: Bloomberg Health Law & Business News reported in September that the volume of announced and closed merger and acquisition deals in the health care space had "accelerated to end Q3, up from 166 in August and just shy of the year-to-date high in January (213)," and that "the surge over the past month suggests that investment activity may be on the upswing following a few months of slowed activity resulting from the pandemic."

"It has become a good market," reflects Chad Beste, a partner within The BDO Center for Healthcare Excellence & Innovation in Rosemont, Ill. "I didn't think I would say that two months ago! But the volume of activity we're seeing across the country is very significant."

Medical practice volume "took a significant hit," admits Amel Hammad, managing director of Conway Mackenzie, part of Riveron Consulting in Dallas. "If there are no patients, then you don't have any revenue. But we're starting to see things normalizing. And we're starting to see which specialties are able to come back quickly versus those who are kind of still in a little bit of a rut."

Cash on hand

You may wonder how this could be. The pandemic and ensuing public health emergency (PHE) have not only clobbered the U.S. economy, but also greatly reduced traffic and earnings at practices, according to a recent AMA survey (*PBN 11/5/20*). Why would anyone want to buy a practice now?

One reason is that investment capital, unlike revenue, is not lost in downturns; it's either invested differently or returned to the banks. "A number of very successful private equity firms have developed new funds and they want to invest the money raised," Beste says. "And oftentimes —if they don't spend it in a certain time, it may need to be returned to the investors."

"Access to capital opened up early in the pandemic and has continued to open up," says Meindl, co-author of the VMG report. "All of that capital has not been deployed as buyers continue to determine whether they should spend it on M&A, or if they need to maintain higher capital reserves in case of a second wave."

There's another reason why you may see purchases heating up soon: The incoming Democratic administration. "Sellers have been looking at this and seeing that there's a very good chance, especially with the Biden presidency, that tax rates are going to go up next year," Beste says. "So they've been motivated to try to get a transaction done before any changes to the tax law."

But is now the time?

The question is whether potential sellers want to get on the block now or wait for more favorable conditions. Here analysts are less sanguine. Hammad thinks that unless you have a good reason to go to market now, you might want to wait for the market to firm up — which in her estimation could take four or five years.

The reason she thinks so is because she doesn't believe COVID-19 was the sole cause of the practice sector's tough times, but the precipitating event of an inevitable market downturn. "From my perspective, I believe that multiples were slightly inflated prior to the pandemic," Hammad says. A multiple is a metric used for valuation purposes; a common equity multiple would be the ratio of investment returns, i.e., earnings within a defined period, to payment.
"And as a restructuring professional, I think the economy was definitely inflated, too," Hammad adds.

The Trump economy, with its "favorable tax policies and interest rates," had kept the health care balloon aloft, Hammad believes, and "stock market increases were due to the feeling that the economy would continue to grow, not based on examining the economic cycle and how these fiscal policies would impact the economy at the time they were instituted."

COVID burst that bubble, Hammad says, so while you may find a buyer now, "you're not going to get that inflated multiple that you would have prior to COVID."

Other experts see a quicker return to action. "I'm not too sure that I think that investors are going to wait five years to deal," Meindl says. "I think there are going to be a lot of investors who jump in pretty quick now, whether they make the returns they want to make or not. I think a lot of people see this is an opportunity. It's high risk, high reward."

Winners and losers

Nonetheless, while some analysts are bullish, they also recognize that not every practice will make out well on the market at the moment. While immediate earning potential is not the sole or even the primary attraction of a practice to buyers, those having a hard time are not necessarily inviting targets.

Beste sees a difference among specific practice factors. "Specialties with a more elective nature" that have been "slower to recover" in the pandemic, may see less interest. Take gastroenterology, for example. "If nothing hurts, if I don't have [colon cancer] in my family, I don't feel I need to get a colonoscopy done in the next month or three months, I can wait a year," Beste says. The same for dentistry: "It's just very easy to go another six months without a cleaning, versus needing a hip replacement."

Primary care, on the other hand, continues to do well, especially as value-based medicine remains an industry watchword. "I'd say primary care is typically the tip of the spear for risk sharing-arrangements," Meindl says. "These risk-sharing arrangements have been coming down the road for quite some time, but we're now starting to see that shift in transaction activity from ophthalmology, which was hot last year, to primary care, which is becoming more hot this year."

"If there is a health care sector that gets hurt in a second wave of the virus, I would expect all that private capital to rotate among different health care sectors," Meindl adds.

Beware the MAC

Something that may affect your sales picture is a tendency among sellers to ask you to reduce some of their risk. Buyers and sellers often seek to "de-risk" their transactions in a volatile environment, Meindl says. In the current market, buyers may push harder for terms that protect them if something goes badly wrong — like a new COVID-19 wave decimating the value of their investment.

Thus you may find your potential buyers demanding a stiff material adverse clause (MAC) that gives them the right to walk out on a deal. Given that these negotiation can take many months, that could leave the seller out on a limb.

"Buyers are comfortable with valuations, but they don't want to buy an earning stream that would potentially get disrupted by a second wave of coronavirus," Meindl says. "So it really is putting a lot of pressure on buyers and sellers to cover some items in that diligence period in the reps and warranties."

Resources

VMG Health M&A Report May 2020: *http://info.vmghealth.com/2020-healthcare-ma-report-before-and-after-covid-19-trends-expectations*

"Health-Care M&A Deals in Q3 Impacted by Covid-19; Election Could Shape Q4," Bloomberg Health Law & Business News, Oct. 30, 2020: *https://news.bloomberglaw.com/health-law-and-business/health-care-m-a-deals-in-q3-impacted-by-covid-19-election-could-shape-q4*

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