



Physician Hospital Organizations as Financial Investments

**Hospital and physician owners of PHO's profit from aligning
execution of strategic objectives with shareholder value.**

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Introduction

Through the continued, though slowed, period of healthcare provider consolidation that began in the late 1990's, Physician Hospital Organizations (PHO) have emerged as a way for physicians and hospitals to increase the efficiency of regional healthcare systems to benefit healthcare providers, payors, and patients without eliminating physician practice ownership. To date, substantial attention has been paid to the services offered by PHO's and the potential for anti-competitive characteristics to do more harm than good. But as a business entity, little attention has been paid to how PHO's benefit shareholders; or the business risks faced by PHO's and their shareholders. The following discussion investigates PHO's from the shareholder value perspective and draws upon industry research and our experience with clients that have successfully delivered value to shareholders. Our experience in the industry has shown us that PHO's take many forms, but this discussion is limited to characteristics that we believe represent the direction in which the industry is headed, and the value drivers and risks that will be central to understanding the value of a PHO.

What are PHO's?

PHO's are formed with the goal of centralizing contract management with managed care payors such as private health insurers, HMO's, and PPO's. Centralized contract management presumably results in a direct benefit of higher reimbursement rates that collective negotiations bring. Besides the obvious benefit of strength in numbers, PHO's aim to achieve more profitable contracts with payors by increasing the efficiency of member providers. By increasing efficiencies, payors benefit from fewer costs associated with reimbursements for un-needed tests, unnecessary office visits, and preventable re-admittances. PHO's achieve credibility with payors by demonstrating through performance-measurement and reporting that hospital and physician members have adopted best practices. Ideally, more credibility translates into better bargaining power.

While many PHO's began by offering not only contracting services, but also Receivables and Payroll management, many of the organizations have streamlined operations by adopting contract management as a core competency, and providing consultative services to bring member hospitals and physician practices up to best practices. They consult with member providers to incorporate payor-accepted performance benchmarks set by programs such as the National Committee for Quality Assurance (NCQA) and the CMS Physician Quality Reporting Initiative (PQRI); implement the integrative information systems that enable the gathering and aggregation of provider performance; and communicate that information to both member providers and payors.

PHO's are joint ventures with a shareholder base consisting of physicians and hospitals. The shareholder base also makes up a substantial portion of the clientele. Hospitals benefit most from greater strategic alignment with the member physician practices that make up the network. The physicians benefit from greater negotiating power, less time spent on managerial tasks, and centralized credentialing. As shareholders of the PHO, physicians and hospitals share the benefits of pay for performance incentives, *and* share the risks of missing out on a portion of their reimbursements due to underperformance. Collectively, the PHO member-providers risk losing credibility with payors as a result of not achieving network-wide strategic alignment, which will eventually cause the PHO to dissolve.

How do they Work?

Member providers allow the PHO to withhold a percentage of payor reimbursements and are paid up to 100% of their withholdings if they meet performance standards set by the PHO and agreed upon by payors. Providers that do not meet performance standards risk not receiving the full amount of their

contribution to withholdings. The withholdings that are not paid out to providers are returned to the payors. A provider also risks being kicked out of the PHO for non-compliance, which usually involves failure to adapt to performance measures, or consistent under-performance.

In return for the services they provide to providers, PHO's most commonly receive an administrative fee equivalent to a percentage of provider withholdings. The administrative fee represents the largest share of revenue for PHO's – thus, contract management is the most substantial source of benefit and risk to shareholders.

There is a common misperception surrounding valuation of PHO's that they can be classified as businesses that offer healthcare services and that they can be compared to physician offices or ambulatory surgical centers on either an operational or financial basis. In our experience, PHO's are more similar to management services companies, such as a trust management company, than healthcare services organizations. If they are viewed as management services organizations, traditional methods of valuation based on discounted future benefits to shareholders fit PHO's remarkably well and the risks to PHO shareholders can be accurately quantified and attributed.

Value Creation in a PHO

Similar to any other going-concern business, PHO's are an investment that should provide return to shareholders who take on the risks of ownership. An argument can be made that shareholder value should come second to benefits provided to patients. However, the PHO model is highly conducive to alignment of shareholder and stakeholder benefits, assuming the objective of the PHO is to provide services that increase the efficiency of the healthcare system.

Benefits to Shareholders

The benefit to shareholders of PHO's is the amount of Free Cash Flow to Equity (FCFE) that is generated by the business. Since the business is not usually Fixed-Asset intensive and is not reliant on Long Term Debt for capitalization, FCFE is most dependent on profitability and management of Adjusted Working Capital. One could base the benefit stream on Cash Flow from Operations, which is Free Cash Flow to Equity before Capital Expenditures and Long Term Debt, but in order to take into account the possibility of acquisition of fixed assets (such as buildings), and the use of debt in capitalization, it is more advisable to instead use FCFE as the benefit stream.

From the shareholder perspective, management of PHO's should focus on increasing Net Income, and managing Working Capital to increase cash flow. Management of Working Capital is largely dependent on the efficient collection and dispersal of provider withholdings. Incidentally, a major benefit to shareholders is the return the company can achieve on cash invested in short-term investments. The more quickly cash is collected and the longer the company can hold cash from withholdings, the more shareholders realize the benefits of invested cash.

Profitability is mainly dependent on management's ability to control expenses. The most significant expense for PHO's is wages and salaries. However, an emerging expense for PHO's is the cost of services that it provides to members. Interestingly, internal research has found that these costs have typically risen year over year as the integration of practices initiated by PHO's have relied more and more on the development of systems and the implementation of more advanced technology. While PHO's have traditionally been more profitable than the average management services company, it is conceivable that as more services are offered, expenses could rise to meet those of comparable management services companies.

Shareholder Risks

In a discussion of valuation, it is important not only to discuss the benefits but also the risks that shareholders in PHO's face. Although some risks have been implied in the preceding paragraphs, a

thorough examination is required to understand and justify the rate at which benefits should be capitalized to determine the value of PHO's.

A PHO's main risk is associated with payor contracts. As revenue is derived from provider withholdings, a decrease in contracts would significantly detract from profitability. It is for this reason that the valuator should examine fluctuations in withholdings, and also the concentration of withholdings attributable to top payors. In analyzing PHO's financial statements, contract risk will be borne out in fluctuations of Net Income, Asset Efficiency, and Leverage. Another risk has to do with the investment of a PHO's cash balances. To explore this risk, fluctuations in interest income should be examined. While some interest income risk can be explained by market conditions, the fluctuation in interest income is heavily impacted by management's decisions regarding how the cash should be invested. Cash investment risk will be borne out in fluctuations of Net Income.

As previously mentioned, the value of a PHO is equivalent to the benefit provided to shareholders discounted by total shareholder risk. Following the preceding discussion, value is equal to Free Cash Flow to Equity divided by total investment risk. The components of that risk are the Risk Free Rate, Market Risk, and Company-Specific Risk. The Risk-Free Rate and Market Risk are common to all business on the date of the valuation, but the company-specific risk premium is unique to the PHO being valued. Having previously determined the risk factors most common to PHO's and how they affect trends in Net Income, Asset Efficiency, and Leverage, the quantification of those risks represents the risk specific to the company. The inter-relatedness of those measures of risk prevent the valuator from simply summing their variations. In order to fully capture the company specific risk in a number, the valuator should employ the quantified variability (standard deviation) in Return on Equity. The reason for this is that Return on Equity can be decomposed into three parts: Net Income, Asset Efficiency, and Leverage. The product of those three variables equals Return on Equity, and thus the inter-relatedness of the risk factors unique to the company are encompassed in the fluctuation in ROE over time.

Capitalizing the PHO's FCFE by its total risk as described in the method above is not only accurate but fully defensible if it is justified by a thorough statistical analysis. The PHO business model is unique, but less so than one might conclude at first glance. Regardless of how the PHO is classified, it is a business that should serve shareholder objectives. PHO's can and should be valued using proven going-concern valuation methodologies.

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