The **Value** of the **Non-Equity Model** for Surgery Center Management

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SURGERY CENTER EXCELLENCE

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The Value of the Non-Equity Model for Surgery Center Management

Opening a new ambulatory surgery center (ASC) was considered a high-risk venture when ASCs first appeared on the scene. Hospitals frequently voiced strong opposition to the development of ASCs in their market. Patients were unsure about what a surgery center was and why it was an acceptable — if not preferable — alternative to receiving care at their local hospital.

With so much uncertainty, physicians interested in developing an ASC would often partner with a management and development (M&D) company. This partner would not only bring its M&D expertise to the facility, but it would assume ownership of a significant percentage of the ASC to help reduce the physicians' investment risk. This win-win model provided physicians with a lower investment and financial risk while benefitting from the expertise of the M&D partner; the M&D partner would receive a fee for its services and profit from its significant equity position in the surgery center.

CHANGE IN INDUSTRY, CHANGE IN NEED

The health care landscape has evolved and ASCs have cemented their place and importance in health care. They are recognized as effective, efficient, high-quality providers of care capable of maintaining positive cash flow. Now hospitals do not typically oppose new ASCs; in fact, a growing number are partnering with physicians on the development and ownership of surgery centers.

While an equity partnership between providers and M&D companies is still a viable model for many ASCs, it's no longer the necessity it once was, notes Robert Carrera, CEO and President of PINNACLE III, an ASC M&D company based in Denver, Colorado.

"With the abundance of surgery center expertise that now exists, a considerable change from the early days of the ASC industry, giving up a significant portion of equity to tap into that expertise and partner with someone who can really help your business is no longer a necessity," Carrera asserts.

Under the non-equity partnership model, a surgery center's owners can benefit from the professional management skills and experience an ASC M&D company brings into the relationship while retaining full ownership, adds Scott Thomas, Executive Vice President of PINNACLE III.

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>
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"We recognize many groups we work with now have the financial wherewithal to build centers and are therefore not interested in carving off equity pieces to an outside party that is not involved in the actual provision of care," Thomas says. "However, we've also found they often lack the expertise to clinically and operationally develop these centers. They need the expert help to take them through state licensure, Medicare certification and accreditation and, once they are operational, to guide them in the management and day-to-day operations of the facility."

Nonetheless, the value of the non-equity model may be challenged by ASC investors, Carrera notes. The basis for the argument against the model is that an M&D company partner without a substantial equity position in an ASC does not "have any skin in the game" because it lacks a financial interest in the surgery center's success.

"I would say the opposite is true — that being in a fee-for-service relationship is the ultimate skin in the game," Carrera counters. "Because our contracts can be canceled with a reasonable amount of notice, it's much easier to extricate us from the relationship than a partner who holds significant equity position in the center. It's very difficult to change those relationships and remove those organizations."

For the reasons identified by Carrera and Thomas and many others, the non-equity model is being embraced and sought after by more physicians and hospitals involved in ASC projects nationwide.

DR. CHRISTOPHER REISING OF PINE RIDGE SURGERY CENTER

Christopher Reising, MD, is a general surgeon and medical director for Pine Ridge Surgery Center in Wausau, Wisconsin. The ASC, which opened in late 2010, is a joint venture between local physicians and Aspirus Wausau Hospital.

PINNACLE III has been involved with the ASC since its beginnings. The company worked with the ASC's partners to determine the feasibility of the project. Once the business plan was approved, PINNACLE III's services were retained to assist in a number of areas including the design/build of the facility, setting up operating agreements, establishing payor contracts and securing Medicare certification. PINNACLE III has managed the ASC since it opened.

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> — *Dr. Christopher Reising*

"PINNACLE III's expertise is really in ASC operational management," Reising says. "They have specific trade knowledge that helps them to optimize our workflow, revenue cycle and efficiencies surrounding the provision of services. I think that's difficult to recreate on your own. At the end of the day, I find the value they bring in these areas optimizes the shareholders' return on investment."

PINNACLE III does not hold an equity stake in the facility, a model that Reising indicates serves the ASC well. "From a business standpoint, the value PINNACLE III brings to the table is their facilitation of managing operations. The moment they're not able to do that effectively is the moment they're not needed anymore. There is definitely a feeling that they are working for us. They are providing a service and are very service-oriented. I think that's important."

"The business model of non-equity management is always going to be focused around the M&D company's management expertise that the partners can't bring themselves," Reising continues. "A question I would have if I were involved in a joint venture with a management company holding an equity position is if I'm paying for management services, what else does this company bring to the table to justify its ownership? With a non-equity model, you retain the freedom of not having the M&D company as a shareholder and tied to the ASC's corporate structure in a legally binding way."

While Reising recognizes a management firm which is also an equity shareholder may have an added incentive to produce positive results because of the financial benefits it would receive from the success of the ASC, he finds the potential challenges that may come with such an arrangement a concern.

"We're very much a local business, so if we had somebody with an equity position working a long distance from us, they may not share our culture and values," Dr. Reising says. "We have the flexibility to treat our employees in a manner we deem appropriate. I can see arguments over that if you have a non-local owner who may not necessarily be interested in the families you're working with but wants to influence staffing ratios, salaries and benefit structure to improving the bottom line while sacrificing a healthy community and friendly work environment."

BILL MUNSON OF BOULDER COMMUNITY HOSPITAL

Bill Munson is Vice President and Chief Financial Officer of Boulder Community Hospital in Boulder, Colorado. He serves on the board of three hospital-physician joint-venture ASCs. PINNACLE III serves as the manager of two of the surgery centers but does not have an equity stake in either.

Munson prefers the non-equity model for many different reasons, including long-term flexibility.

"I prefer when the provider owners have all the governance and decision-making authority, and are not required to consult an outside third party for a perspective," Munson says. "When a management company is an equity owner, it has a say in the way the ASC is run and the decisions that are made. Should the ASC choose to change its direction or alter the facility's management structure, that becomes very difficult because the management company is an owner."

The high degree of uncertainty and volatility in health care makes having this flexibility even more important, he notes. "In today's health care environment, change is happening at an accelerated rate. I think it's much more difficult today with any business venture to say 'I know this is going to be the way I want the model to work 5 to 10 years from now.' At some point the model could become prohibited or certain owners in the business may align with different providers. There may be a better model that comes along that would incentivize you to abandon your current model."

"I think it's to the benefit of providers to have as much agility and flexibility as they can based on the uncertainties that are ahead of us in health care," Munson continues. "What I have observed when a management company has equity is it becomes an impediment when the provider-owners want to change the direction of the ASC. If they want to change in a direction that is not to the advantage of the management company, they're usually blocked from moving ahead with the change. They've lost their ability to independently make a decision about the facility's future."

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The non-equity model also brings with it many benefits for the short-term success of the ASC, he says. "The management company's incentive is to provide good management services and help the ASC be successful. If they don't do a good job of that, you have the option to get out of the contract and find someone else to do a better job. The model incentivizes them to make appropriate business decisions."

"I do not think a management company with equity has a greater incentive for the ASC to be successful. I view management companies under each ownership model as being equally incentivized," he says. "If a company is an owner and not successfully managing the center, its income will suffer. If it's not an owner and not successfully managing the center, it's going to get fired and that income goes away. The difference is the ability to remove the management company's involvement in the center."

"Ownership models typically come with lots of strings attached; they're structured to protect the management company because they put equity into the business," Munson continues. "In my mind, putting equity in brings certain rights and obligations with it that can encumber the ASC. I certainly like the arms-length relationship with a management company much more than having them joined at the hip from a governance perspective."

ROBERT ERICKSON OF ST. FRANCIS HEALTH CENTER

Robert Erickson is President and Chief Executive Officer of St. Francis Health Center in Topeka, Kansas. About eight years ago, when he was with a different organization, Erickson was involved in a physician/hospital joint-venture ASC in northern Wisconsin. The partners selected PINNACLE III as the surgery center's M&D company in part because of the non-equity model, he says.

"One of the reasons we chose them was because they were one of the few development companies at that time that did not demand equity ownership in any type of venture moving forward," Erickson recalls. "We felt, in an environment where we foresaw revenues shrinking and reimbursement shrinking, equity was precious. My hospital didn't need additional capital to do the project. The physicians didn't need capital. We weren't looking for a capital partner. We needed expertise. We didn't have the internal expertise to develop the ASC from scratch with the physicians and then to manage it efficiently, effectively and from a quality perspective," he says.

Erickson relays a non-equity partner at that time could also help in other areas critical to the joint venture's success. "In the not too distant past, you almost had an adversarial relationship between health care systems and independent physicians. Their financial incentives were misaligned and there were often cultural differences. Companies that did not require an ownership stake could come in and essentially serve as a buffer between health systems and physicians in terms of trust and relationship."

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>
> — *Robert Erickson*

"Physicians are really at risk for this personally — it's their money, unlike a health system that is spending its profits," he continues. "Utilizing the services of a non-equity management company gives the physicians confidence knowing there's a neutral party with expertise that can make objective decisions in the best interests of the venture."

Erickson believes a management company does not need an equity stake in an ASC as motivation to work hard for the facility. "Even without equity, PINNACLE III wanted to do everything it could to make that facility a profitable, well-run, high-quality ASC. Their reputation is built on delivering those results. We were also looking at developing other ventures throughout the state, and by building that trust and credibility with a high-performing center, PINNACLE III would obviously be in line for a bigger relationship with us than just one freestanding ASC in northern Wisconsin."

He says he expects the non-equity model to only grow in popularity in the future. “With all of the changes in health care, giving up equity ownership and control of the facility, especially as we’re called on to be more integrated under Accountable Care Organization-type models, is becoming very difficult. But if a company can bring expertise, credibility and good management skills, as well as that ability to enhance and further relationships, there’s real value there and people are willing to pay well for it.”

PRESSURE TO PERFORM

While the insight from these three leaders demonstrates how the non-equity model has benefitted PINNACLE III’s partners, it is a model that has benefitted and continues to benefit PINNACLE III as well.

“We’ve been able to increase our client base because of our willingness to embrace that model,” Thomas says. “A number of current and long-standing clients told us up front they weren’t interested in having an equity partner. I think that mentality has become more prevalent, especially with hospital/physician joint ventures.”

He points to the structure of PINNACLE III’s agreements with its ASC partners as a vital reason for the company’s ongoing success. “Our agreements are structured so a client can terminate an agreement with 120 days notice. That’s a pretty short notice and it puts the burden on us to do the job we’ve been hired to do. I think it keeps the incentives appropriately aligned and, for us, it has worked well. Our clients have opted to repeatedly renew their agreements with us.”

Another reason for PINNACLE III’s success is the size of the company, Carrera says. “We don’t have 200 centers and we’re not publicly traded or backed by a venture capitalist, so every single client we have is incredibly meaningful to us. There’s a considerable amount of skin in the game when you have 10 to 20 centers as opposed to 100 to 200 centers. Making sure each of those centers is successful is a far greater piece of our income than it is for larger groups that typically require large pieces of equity.”

EARNING AN EQUITY POSITION

While the company has found great success with the non-equity model, PINNACLE III is not opposed to the equity model, and the company has purchased a small ownership stake in a number of the ASCs it manages. “As our partners develop trust and value us as a resource in those partnerships, sometimes that will lead to small minority positions for us,” Carrera says.

“We have a flexible model where we’re willing to accept new clients as a development and/or management partner without equity, but we also are willing to participate if they desire to have us as an equity partner,” Thomas adds. “We have a few situations where we were invited to participate in ownership, and I’m sure it’s because of the job that our teams do at these centers. We developed a level of trust with the owners and they were comfortable inviting us to participate.”

Just don’t look for PINNACLE III to seek much more than a small ownership position in its ASC partners. “Taking a large piece of equity out of the hands of the people who really drive the business — the physicians and, when applicable, a hospital partner — is something we think is a bad business prospect for the providers involved in the project,” Carrera says. “The physicians really drive these centers, and as much equity as possible needs to be in their hands.”

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