



Understanding and evaluating deal considerations in the urgent care sector

An update for private equity investors

This issue explores certain strategic, financial, and tax issues that private equity investors should consider when evaluating investments in urgent care clinics.

Strategic considerations

Health care reform impact—Health care reform has had a significant impact on the urgent care industry, and it is expected to drive additional revenue opportunities for urgent care clinics. The continued shift towards higher patient responsibility for medical costs under The Affordable Care Act is forcing consumers away from more expensive hospital emergency departments toward lower cost urgent care clinics. Furthermore, the increase in the number of insured patients has resulted in increased

utilization of traditional primary care physicians by newly insured patients. This increased demand on primary care physicians has created additional delays in seeking care in traditional care settings such as emergency rooms or physician offices. Urgent care clinics offer similar services to traditional primary care practices, and they are designed to accommodate 'drop-in' patients who cannot or will not wait in long lines at the emergency department or until their traditional primary care physician has availability for an appointment. These

trends are likely to drive additional volume to urgent care clinics.

Role within the care continuum—

Urgent care clinics have the potential to contribute to the reduction in health care costs and increase patient satisfaction by providing an alternative to the expensive emergency room and increasing the convenience and accessibility of care. However, most urgent care clinics operate on a standalone basis with a fee-for-service model and without significant coordination of care with other health

care providers. With the continued shift toward value based care models and providers accepting some or all of the risk of patient health costs, urgent care centers will need to become more integrated within the care continuum to succeed. Clinics that can effectively work with payers or other health care providers to coordinate care for patients, drive down costs and increase quality are likely to succeed. Urgent care business models that do not adapt to the new health care delivery models will likely face challenges.

Financial and Tax Considerations

Revenue cycle—Urgent care clinics are typically reimbursed on a fee-for-service basis from commercial and government payors. Understanding historical billing and collection practices is a key focus of the urgent care clinic due diligence process. The revenue cycle for urgent care clinics is complex, as there are variations between gross amounts charged and contractual rates with insurers. Significant judgment is required to estimate future expected cash collection and the value of accounts receivable. Changes in historical trends related to payor mix, including a trend towards increased patient responsibility, and timing of collections may affect the accuracy of estimates of collectability, resulting in a financial impact to EBITDA and working capital.

Urgent care clinics often have higher rates of uninsured patients due to the clinic's perceived lower cost. Uninsured patients and insured patients with higher responsibility for co-pays and deductibles increase the collection risk of accounts receivable. Investors should consider performing additional procedures related to accounts receivable to assess whether historical accounts receivable estimates have been realized through subsequent cash receipt and whether historical trends indicate current accounts receivable are collectible.

Revenue recognition from a tax perspective should also be assessed. Contractual allowances and bad debt reserves that are based simply on estimates may not be currently deductible for tax purposes. As such, certain urgent care clinics may have unrecorded book-to-tax differences attributable to revenue recognition that could result in pre-closing cash tax exposures (see also Cash Basis Considerations, below).

Professional liability insurance

—Urgent care clinics are often insured for professional liability risk (medical malpractice risk) on a “claims-made” basis. While this coverage provides for lower annual cash premiums, it provides coverage for only the claims-made or reported during the current accident year. Urgent care clinics that are insured under claims-made policies should also account for the exposure related to incurred, but not reported (IBNR) claims. Investors should consider the impact of the changes in the estimated IBNR claim liability on the historical quality of earnings, as such estimates are often determined based on a complex actuarial analysis which utilizes sensitive assumptions. Buyers often require the selling shareholders to acquire, at the selling shareholders' expense, a “tail-policy” to mitigate the historical insurance exposure.

Retail considerations—The urgent care market is highly fragmented with some of the largest urgent care organizations offering only sporadic national coverage. Investors should consider analyzing same store sales, which can help identify performance metrics by location. Additionally, a vintage analysis can be used to analyze the timing of when de novo practices transition from start-up to profitability, understand historical trends, and assist in the development of future expectations. Under a retail model, investors should analyze a target's

growth and operations by assessing base, de novo, and acquired entities' growth trends.

Staffing model—Urgent care clinics commonly employ or contract with emergency or family practice physicians and then supplement staffing with various assistants, technicians, and registered nurses. Certain clinics rely on physician extenders, such as physician assistants and nurse practitioners, to reduce costs associated with physicians. Consideration should be given to the staffing structure of the clinic and to any regulatory compliance requirements that may arise from both the employment and/or contracting of physicians and the use of physician extenders. Consideration should also be given to whether individuals are properly classified as independent contractors, if applicable, as opposed to employees. If such individuals are misclassified as independent contractors, payroll tax exposure may exist.

Billing and coding assessments

—Improper billing of Medicare and Medicaid can result in significant fines and penalties. Additionally, if proper billing and coding requirements are not followed, revenue may be misstated, which can also impact the quality of earnings. Performing a billing and coding assessment is a critical step during diligence. This typically includes selecting a sample of patient records and their related billing documents to assess whether the company has documented evidence of services being performed and has billed correctly for those services.

Cash basis considerations—Many urgent care clinics use a cash basis of accounting, and are not subjected to a financial statement audit. When performing financial analysis and developing a financial model, investors should consider utilizing accrual basis

financial information, as there could be significant timing issues in the receipt or disbursement of cash that do not reflect the economics of transactions. Additionally, upon exit of the investment, accrual basis financial statements may be required. Investors should tailor due diligence to include cash to accrual adjustments. In instances where companies are not subjected to a financial statement audit, investors should be aware that due diligence procedures may not identify material misstatements that audit procedures could identify, and financial results may be subject to adjustment upon completion of an audit.

Urgent care clinics may also utilize the cash method of accounting for tax purposes. Depending on the acquisition structure and choice of acquisition entity that investors employ, these clinics may be required to report taxable income using the accrual basis of accounting during post-closing tax periods. The conversion from the cash basis of accounting to the accrual basis of accounting may trigger taxable income, creating adverse tax implications for buyers and/or sellers. As such, investors should address these tax implications in the letter of intent so that the parties clearly understand who is responsible for the taxable income that may have been deferred as a result of the cash basis of accounting. Additionally, if required to use the accrual basis of accounting for tax purposes, the urgent care clinic will need procedures in place to substantiate its revenue recognition generally based on

contractual reimbursement rates at the time of services and billings. If the clinic has not historically implemented such procedures, additional post-acquisition system implementation costs may be required.

Ownership structure—Certain states require urgent care clinics to be owned by medical professionals who are duly licensed or otherwise legally authorized to render professional medical services. This requirement is often referred to as the corporate practice of medicine doctrine. To comply with the corporate practice of medicine doctrine, investors may need to form legal entity and ownership structures, whereby a private equity-owned management company and the existing urgent care practice operate under the governance of various agreements to assign and allocate economics. The formation of these structures, the ongoing operations, and the exit from these structures may have adverse tax implications for both buyers and sellers if not carefully structured and reported.

From a financial accounting perspective, due diligence procedures should be designed to understand the ownership structure, including any non-controlling interests, and the financial impact related to the consolidation of any variable interest entities. These ownership structures can be complex and may not be reflected in unaudited financial statements. Additionally, investors should

understand the contractual relationship between the physicians, the urgent care clinics, and any related entities, as these relationships may have financial and regulatory ramifications that could impact deal value.

Prior acquisitions—Certain urgent care clinics have previously acquired assets or practices from other parties, including doctors themselves. Consideration should also be given to the pro forma impacts of recently acquired entities as changes in payor contracting, payor mix and cost structure can lead to variations in pre-acquisition and post-acquisition earnings.

Often, tax due diligence has not been conducted in connection with these acquisitions, and the acquiring practices may receive varying degrees of contractual protection for pre-closing tax matters. As such, it is important to understand the practice's prior acquisitions, analyze the nature and extent of any tax indemnification provisions, and evaluate whether such tax indemnification provisions will carryover in a contemplated transaction. Furthermore, it is important to understand whether sales and use taxes and transfer taxes in connection with these acquisitions had been remitted to the applicable tax authorities depending on the form of the acquisitions. Otherwise, any unpaid sales/use taxes and transfer taxes may be inherited by investors in contemplated transactions.

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