Reprinted from
September/October 2007
Vol. 2007 No. 5

BECKER'S ASC Review
PRACTICAL BUSINESS AND LEGAL GUIDANCE FOR AMBULATORY SURGERY CENTERS

Establishing an ASC – The Building Blocks for Success

By Kenneth Hancock
and Catherine Kowalski

The number of ASCs continues to grow as a result of the demand by the key participants in the industry – physicians, patients and payers. The high levels of patient satisfaction, physician efficiency and lower costs are all associated with this innovative model. More and more physicians are choosing to develop their own ASCs. Because development is so complex, physicians should be well-informed of all of the moving parts involved, and should learn what type of professionals they should enlist to assist them throughout the project. With the right information and the right support team in place, physicians can successfully build and own their own ASCs.

Establishing the Partnership

Number of physicians. The number of physicians (at least eight to 10 who are committed and ready to proceed) and proper planning are crucial determinants in initiating a project. A physician leader must emerge as the catalyst to drive the organization forward.

Case volume. It's vital to accurately analyze the surgical case volume. Determine the universe of surgical cases by physician and always calculate the net case transfer to the ASC, factoring in issues that discount volume including insurance contracts, regulatory, politics, convenience, scheduling and surgeon behavior. For a conservative analysis, consider 50 percent of the surgical case universe.

Specialty mix. A new ASC project must have the right mix of surgeons whether the project is single or multi-specialty. A dominant sub-specialty thread such as orthopedics, pain, ENT, ophthalmology, GI or general surgery will give the project its best opportunity for success.

Reimbursement. It is imperative that you have a plan for reimbursement and insurance contracting before starting construction of the facility. The business may have a strong number of surgical cases but if you cannot get paid for the work performed, it is a potentially devastating blow to cash collections.

Partnership Formation

Syndication. Seek appropriate legal counsel to best determine the process for syndication, the binding of the partnership. A private placement memorandum will describe the project in detail covering all aspects of the business including the strategic plan, financial projections, project scope, operating agreement, management agreement, development agreement, and investment opportunity and risks associated with the investment. Depending on the size of the partnership, legal counsel may advise hiring a securities group to properly syndicate the transaction.

Partnership options. Seek legal counsel to guide the partnership in selecting the appropriate legal structure such as a limited liability company or limited partnership.

Types of ownership. Physicians may own ASCs entirely or may partner with a hospital or corporation in some combination. There are positives and negatives to consider with all approaches:

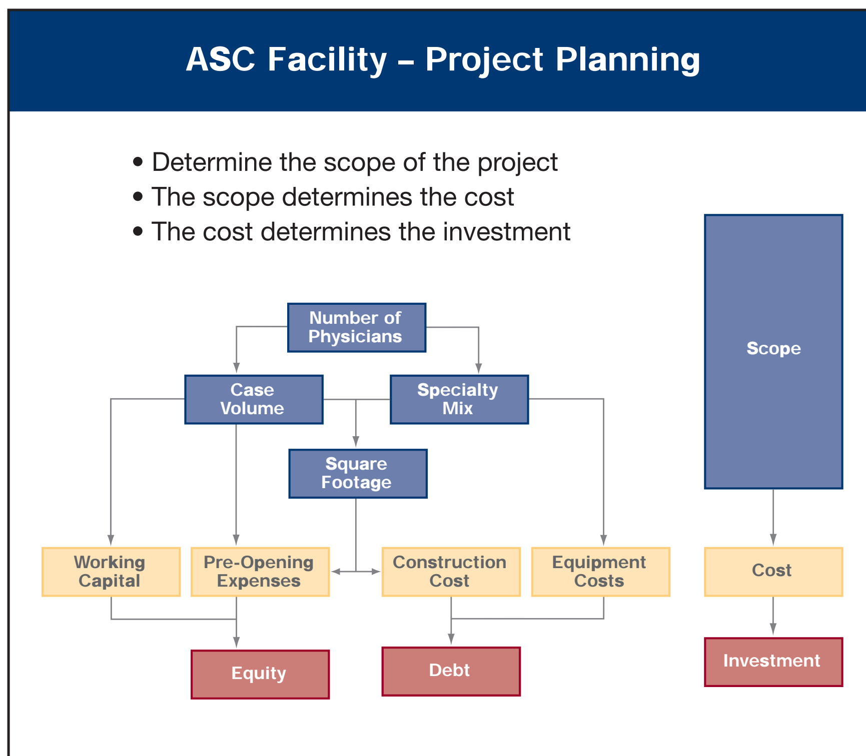
- **All-physician.** Physicians are busy being physicians and their administrators are busy running practices, so who develops and operates the ASC? Physicians will often hire consultants to navigate development and initial setup. A drawback of consultants is that, once the ASC is operational, they move on, leaving the physicians to find dedicated management or run the facility themselves.

- **Hospital and physician.** The overarching benefit of this model is that

you have a partner with whom to share the risk: The community hospital usually has capital and is able to secure insurance contracts at attractive rates. The challenge is that many physicians simply don't trust hospital management, so the trust factor must be weighed when diluting ownership, because most hospitals want a structure that allows the hospital majority ownership in the ASC. According to 2004 data, hospitals have ownership interest in 21 percent of all ASCs.[1]

• **Corporation and physician.** There are approximately 30 companies in the business of partnering with physicians to develop, own and manage surgery centers. Of the 4,500 Medicare-certified ASCs operating in the United States, only 837, or less than 20 percent, are owned and managed by multi-facility chains.[2] In this model, physicians benefit from having a strong capital partner to ensure their return on investment is based on the success of an excellent plan and well-run business. Corporate partners have experience recruiting, budgeting, financial analysis, human resources, technology, clinical benchmarking and marketing, which can let physicians focus on surgery instead of on the business. The aligned incentives of ownership work well in many partnerships.

• **Three-way partnership.** Popularized by USPI and Baylor, this model combines the interests of physicians, hospital and a corporate partner. The advantage of this model is that the two parties that typically don't trust each other have an independent partner to operate the business in everyone's best interests. This model can eliminate tension between the physicians and hospital, adds a strong capital partner and provides the ASC with insurance contracts. Meanwhile, the day-to-day operations are driven by an independent corporate partner and access to hospital volumes is strong. The caveat is the hospital must have evolved its strategy to the point that allows such a joint-venture.



Defining Project Scope

Here are some of the critical points related to the cost of a project and the investments required.

• **Project scope.** Be careful to not overbuild a facility beyond its capacity – it's perhaps the No. 1 reason for failure. It's easy to overbuild, which creates undue stress on the financial performance of the ASC. It's better to under-build initially and plan future expansion.

• **Surgical case volume.** What is the net projected case count of all procedure types? This information defines the scope of the facility and determines the net revenue.

• **Equity.** Ensure that enough cash is committed to the project; a lack of cash in the crucial start-up phase is a common problem. It's easy to miscalculate cash needs and be forced to initiate capital calls from the partnership to meet cash needs in the first 12 months to keep the project running.

• **Debt.** Obtain a commitment for financing before starting the project. Rates may vary between sources, so shop around. Non-recourse financing is always contingent on the strength of the financial projections for the business, the number of committed physician partners, the equity raised by the partners, the business plan, and the experience level of the partners, management and likelihood of successful execution. Expect guarantees on tenant improvements and equipment, and try to negotiate a structure that eliminates guarantees after cash flow objectives are met in the first 24 months.

• **Cost to build.** Usually running about $1 million per OR, a small, single-specialty center with two surgical suites ranges from $2 million to $3 million, with larger-multispecialty ASCs costing $4 million to $8 million. Typically, the majority of the costs associated with development, including

the tenant improvements and surgical equipment may be leveraged with debt. The need for equity is isolated to working capital – typically four to eight months' operating expenses totaling $1 million to $1.5 million. The investment ranges from $10,000 to $15,000 for a 1 percent interest in the partnership plus assumption of pro-rata debt dependent on debt structure.

Real Estate

Consider a real estate partnership separate from the operating entity, as this affords the partnership another investment opportunity and eliminates costs that would be capitalized by the operating entity. The real estate partnership becomes the landlord – capturing land improvements, shell building and a tenant improvement allowance of $40 per square foot – and structures an operating lease with the operating entity. The real estate investors may be the same or different partners from the operating entity; they will receive a fair market value return and may someday take advantage of appreciation in the real estate asset by selling the entity.

Financing

It's vital that you detail the amount of capital required to successfully deliver the facility and run operations for five years, including costs associated with real estate, construction, equipment and working capital.

- **Real estate.** The real estate entity is responsible for the land purchase and improvements such as site grading, water, sewer, fees and permits. In addition, this entity is responsible for the shell building, which typically costs $60 to $80 per square foot and provides some allowance for tenant improvements, usually $20 to $40 per square foot. The real estate partnership will execute a fair market value lease with the operating entity, typically with a 10-year term that covers the investment plus a reasonable return on investment.

- **Equipment costs.** It's well worth the fees to seek an equipment planning professional or firm with significant ASC experience to properly plan, select, warehouse and install the equipment. Plan to spend between $450,000 and $600,000 per OR for all equipment needs.

- **Working capital.** Don't go into a project without enough cash. It's important to have four to eight months of operating expenses covered. This need is established in the budget but typically ranges from $1 to $1.5 million dollars in cash available to cover the initial start-up and ramp-up of the business.

A proper plan lets the partnership leverage the tenant improvements and equipment with debt, but must invest cash to cover the working capital needed pre- and post-opening. There are plenty of banks and specialty ASC financers; be sure to use one familiar with the needs of the physician ownership model.

Construction

Work with an architect who has significant experience in designing ASCs. Check references and one or two centers in the architect's portfolio. An experienced architect will be know mechanical, electrical and plumbing design engineers necessary to properly designing a facility. The real estate partnership chooses the contractor to construct the shell building. The construction firm should also have significant ASC experience. Check references and the experience level of the project manager; this is not a time for rookies.

Operations

Develop a detailed pre-opening checklist that includes all milestones, specific tasks, completion dates and accountability assignments to team members.

- **Human resources/staffing.** Build a ramp-up strategy around volume to help manage labor costs during start-up. Bring on the administrator or top tier employees early to assist with the growing task list, adding other employees as opening approaches. Design initial staffing around a condensed schedule, opening only enough days to accommodate early volume, then expand to run a full schedule as volume dictates. The best way to manage early and ongoing labor costs is to establish a plan to staff the appropriately-sized facility to accommodate anticipated volume.

- **Licensing.** Early planning is your best friend. Gather appropriate information from all investors during the initial stage and submitting all your licensing applications promptly will help eliminate any last minute delays. When applicable, many ASCs choose to obtain deemed status through the Joint Commission or AAAHC while waiting for the state to complete their survey.

- **Managed care.** Knowing which contracts to establish and successfully negotiating these contracts are key to ensuring your ASC receives the best reimbursements possible. Vital strategies include establishing a relationship with your main contact, anticipating your costs and consistently negotiating. Plan carefully, be persistent, understand your leverage and don't be afraid to tout the ASC's benefits (such as lower costs and high quality/ reputations of physicians).

- **Supply costs and management.** A strong GPO/supplier relationship will ensure your ASC opens and operates with the necessary inventory. Define your process around procedure standardization and utilization of a preference card system to make supply cost management easier and more effective.

- **IT systems.** Determine ahead of time the data points you want to retrieve from an IT system so you can ensure appropriate utilization. Carefully review the support history of products you're considering and talk candidly with other clients using the different systems. The system you choose must be user-friendly and provide data lets you track performance.

- **Measurement of performance.** To know if your ASC is running efficiently, you need to collect solid data, then analyze it based on your targets. Develop benchmarks based on your budget, industry averages or historical data from your management company. Consistently track your progress in labor costs per case, staffing hours per case, supply cost per case and days in A/R.

As the certificate of occupancy date approaches, the number of items to be completed frequently becomes cumbersome, so having a plan helps eliminate unnecessary and costly last-minute delays. There are six key operations to focus on after opening.

Successful Development

Developing and owning an ASC requires commitment, capital and a comprehensive plan. By understanding all the building blocks to success, physicians can better set and meet their expectations and achieve their ultimate goal of ASC ownership. ■

Mr. Hancock is the president and chief development officer of Meridian Surgical Partners and Ms. Kowalski is the executive vice president and chief operating officer of Meridian.

Sources:
1. *2004 ASC Salary and Benefits Survey*, Federated Ambulatory Surgery Association, 2004.
2. Informed Healthcare Media, LLC, 2006.

Meridian Surgical Partners aligns with physicians in the acquisition, development and management of multi-specialty ambulatory surgery centers and surgical facilities. Meridian acquires interests in established physician-owned surgical facilities, as well as, partners with physicians seeking to grow their businesses locally through the development of new surgical facilities.

615-301-8140 | www.meridiansurg.com