By Shareef Mahdavi

Private equity: What you need to know

It's not coming to ophthalmology — it's already here.

Over the years, the value of an ophthalmic practice has been measured by its ability to grow, evaluating current performance against prior periods of services, revenue, active patients, locations and employees. Traditionally, this growth has been financed through debt (e.g., bank loans), the sale and subsequent lease-back of owned real estate (e.g., REITs), or through retained earnings. Those capital sources, however, are proving insufficient in today's environment in light of the increasing costs of an independent practice.

Rising costs, including overhead, is a prime reason that the number of large group practices has risen across all medical specialties, and equally attributable to the corresponding decline in the number of solo practitioner practices. Along with sharing expenses and overhead, groups can operate with greater efficiency than individuals. Larger groups have more power to negotiate better contracts and spread the risk of covered lives under capitation agreements. For example, just 10 years ago only 5% of cardiologists worked for somebody else. Now, two-thirds work for hospitals, according to Jim Palazzo, principal, Paragon Health Capital, an advisory to physicians exploring options for their practice.

While the ophthalmic profile is different than other specialties, those practices swept up in the merger and acquisition consolidation trend are attracting the attention of private equity (PE) firms. Having conducted numerous transactions in dermatology, anesthesiology and dentistry (among others), private equity professionals are actively courting large ophthalmic practices; advisory firms, including investment bankers, are involved in representing physician owners in negotiations.

Published data show that private equity purchases of medical practices are up over 100% in 2017 versus a year ago: PEHubWire, a subscription news bulletin for private equity professionals, describes transactions in ophthalmology "as having tremendous runway." While many ophthalmologists are hearing about recent deals and lofty valuations, just as many are curious why private equity firms are interested in ophthalmology.

My goal here is to help doctors and practices understand these dynamics and plan accordingly.

A BREAKDOWN OF PRIVATE EQUITY

Unlike venture capital firms, which fund early-stage companies, private equity firms invest in businesses that want to grow. There are different tiers of private equity; some do only multibillion dollar deals while other "boutique" firms exist to serve middle-market transactions that would encompass larger ophthalmic practices. Virtually all industry sectors have businesses owned by private equity firms; firms typically manage funds with capital from high net-worth investors seeking opportunities (and returns) not readily available to the public. The managers in these firms are charged with deploying this capital and providing significant returns to their shareholders, typically over a 5- to 10-year time horizon.

Unlike hospitals and health systems, whose acquisition prices are subject to fair market value (FMV) in order to comply with Stark and Anti-Kickback statutes, private equity has no such restrictions. They seek to form partnerships based on the strategic value of the practice, which is typically calculated by applying a multiple to a practice's EBITDA (earnings before interest, taxes, depreciation and amortization).

As a measure of practice profitability, the EBITDA is adjusted to account for the physicians' change in compensation after the transaction, which will shift in part to salary plus a productivity-based bonus. For practices that sell to private equity, this can create a meaningful liquidity event with a distribution; taxes may qualify for capital gains treatment rather than ordinary income.

In essence, the practice is rewarded today with a lump sum for earnings that are expected in the future. Those future earnings now belong to the new owners of the practice. Depending on the size and nature of the deal, physicians are often required to remain and retain an ownership percentage going forward.

MEDICAL PRACTICES AND MARKETPLACES

PE's interest in medical specialties began to catch on nearly a decade ago; today we have numerous "platform" companies that own dozens to hundreds of practices in a given specialty, consolidating back-office operations and creating leverage by being able to order supplies and equipment in much larger quantities. Similar to other specialties that serve an aging population, ophthalmology is increasingly attractive based on patient demographics, reimbursement rates and cash-pay procedures. In addition, ophthalmology's revenue sources include optical shops and ASCs that are physician-owned and generate income that can be included in the valuation.

What medical specialties share is a fragmented marketplace compared to many other industries; this is especially important in light of hospitals and health plans seeking to grow and create negotiating power for themselves. What PE sees is the opportunity to consolidate this marketplace and bring management expertise to the medical practice, and in doing so provide a financial return to shareholders.

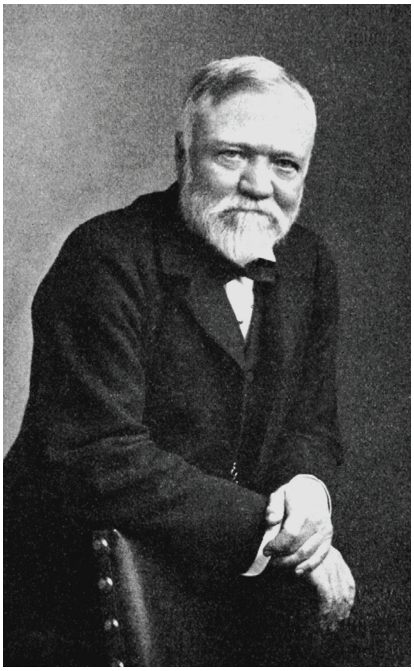
WHERE (HOW?) DOES EYE CARE FIT?

What's not clear yet is the impact on ophthalmology. One PE executive I spoke with believes ophthalmologists' collective memory around the failed promise of the PPMC (physician practice management companies) of the 1990s delayed private equity firms' ability to gain traction in the specialty. Those organizations, which included PRG and Vision21, promised greater efficiency, especially in back-office operations, by "rolling up" ophthalmic practices into a single entity. The payoff would come once the entities went public, making the stock that the doctors took in exchange for ownership very valuable. None of it happened.

"It was a stock play-and-attempt to roll-up disassociated practices," says Dan Chambers, CEO of Key-Whitman in Dallas. "The PPMC concept emerged years before today's communication infrastructure ... and the ability to network data across remote locations.[So] the model didn't work."

Fast forward to today. Seven to 10 major ophthalmic transactions were announced in the past year, with 20 or more in process, according to conversations with investment bankers involved in pending transactions. One key difference today is that doctors are being paid cash rather than stock. Another factor making private equity attractive is the value placed on the practice is far greater than what a young associate can pay to buy-in and eventually buy-out retiring physicians. "In those days, an older doctor could expect one to two times their annual income," notes Richard Lindstrom, MD. "Private equity firms are paying anywhere from four to eight times income once it's been normalized to account for salaries that need to be paid after a transaction."

J.P. Morgan's (L) 1901 acquisition of Carnegie Steel Company from Andrew Carnegie (R) and Henry Phipps for $480 million is considered the first true major buyout.



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Dr. Lindstrom, a founder and senior partner in Minnesota Eye Consultants, has first-hand experience with private equity firms. Minnesota Eye recently sold to Waud Capital, a private equity firm in Chicago. "We took two years to plan for this, and our entire group of physician partners had to agree at each step along the way. Fortunately, we had unanimous agreement, including among the younger doctors."

At the OCTANe conference held in June, Dr. Lindstrom noted his firm spoke with many private equity firms before deciding on Waud. Bruce Maller, president and CEO of BSM Consulting, said there must be alignment among the partner-owners, and that alignment must be focused on growing the business (see *A PE guide to the should-you and how-to*, page 15).

"We looked at multiple options for the practice," says Dr. Lindstrom. "Given the uncertainties of healthcare, especially with the prospect of single payer, capitation and the risk of not being able to grow revenue as we had in the past, we decided it was best to partner with someone else who could help and share in the risk as well as the rewards."

Waud Capital's intention is to have MEC act as a platform practice, meaning the management team and infrastructure in place can be used to acquire other practices. Those future acquisitions will help the new company – called United Vision Partners – grow, and those practices will benefit from centralized back-office functions.

THE ART OF THE DEAL

The path leading to a successful private equity transaction is long and arduous. Most practices do not have the revenue, income and infrastructure to serve as a platform. Options for smaller size practices include becoming a "bolt-on" acquisition to a platform or potentially merging with other smaller practices to create a platform. Those that meet the minimum requirements of a private equity investment will undergo a lengthy due diligence review that often includes a full replication of billing practices to ensure compliance. With the amount of money at stake, firms are highly conservative and want to make sure the practice is run correctly to avoid litigation down the road.

Once a transaction is completed, the private equity firm will seek to grow the platform and in the future sell to another entity. This entity could be a larger private equity firm (a standard event called "climbing the ladder") or a strategic buyer, such as a national health plan looking to vertically integrate. This future transaction is referred to as a "second bite at the apple," meaning that doctors' equity in the new organization can be monetized a second time; in theory, this process can repeat across decades. The goal is for the platform to grow both organically and via acquisition, using capital and expertise from its private equity partner along the way.

While the time between transactions typically takes five to 10 years, it can happen faster; this was the case with Katzen Eye Group of Baltimore, which sold to Varsity Health Care in 2014 and grew rapidly both in Baltimore and through practice acquisitions around the United States. "We benefited immediately from the business expertise brought by the private equity firm and found meaningful opportunities to improve how we run the practice," says medical director Brett Katzen, MD, whose father, Leeds Katzen, opened the practice in the 1960s. "We did a good job of integrating acquired practices, which attracted interest earlier than we anticipated; our doctors continue to be aligned as they have had the opportunity to invest and are excited about being owners in the new venture."

BUYER BEWARE

While private equity appears attractive, it is not without concerns. "Over time, doctors will ultimately realize 'I sold my practice' and no longer have the decision-making autonomy they once enjoyed," remarks Dr. Lindstrom. "Just like a marriage, it becomes a balancing act between getting what you want and compromising. While doctor goodwill will remain critical, the doctor is not the ultimate decision-maker regarding new equipment or practice expansion. Instead, he or she will be taking direction from a smart, well-trained MBA 20 to 30 years younger who will be more carefully evaluating decisions. It all sounds good until the new owner rejects a pet project."

"It's not a bed of roses," adds Mr. Chambers, who ran operations for PRG in its heyday. "While there's a clear opportunity here, PE transactions tend to create insecurity among employees and doctors. Even if the first transaction goes well, many doctors wonder, 'what's the next owner going to be like?'"

Dr. Lindstrom and Mr. Chambers consider access to covered lives as the critical issue for oph-

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thalmic practices moving forward. Mr. Chambers favors local and regional practice mergers over private equity. "There's definitely strength in numbers; merging with other practices creates better negotiating power. Once doctors sell to private equity, they have turned over control."

Cultural fit is also key to success when taking on private equity as a partner. "I had sought a capital partner for years to help alleviate the debt load we had taken," says Dr. Katzen. "Eventually, we found a partner who shared our vision and understood the value of a surgical practice that could grow, and would be patient with us along the way. It's been a great partnership."

Their advice to doctors considering private equity? "Swallow your pride and recognize that you can let an expert organize the business side of your practice," says Dr. Katzen. Adds Dr. Lindstrom: "The market is good right now because private equity firms are well capitalized and the stock market is strong. Like all markets, valuations will change over time. Later entrants won't likely get the same value, but they also won't have taken the risk of earlier adopters such as those selling now."

Private equity will likely consolidate only about 20% of the market, a ratio similar to what has taken place in anesthesiology and dermatology, says Bill Britton, managing partner at Cross Keys Capital, an investment firm specializing in medical practice transactions. There are other approaches to consolidation, including creating regional mega practices or selling to national chains such as United Healthcare. Other alternatives are emerging, including private bankers willing to loan to physicians at better rates and with more favorable terms than what is typically offered by a local bank. I've also met with private equity firms willing to be minority investors or equal partners, in part to address the fear of loss of control expressed by many successful ophthalmologists.

For the right practice — one that seeks to grow and wants outside capital and expertise to help — private equity can be the right solution. Going forward, a capital partner can help reduce future risk, especially in terms of changes in regulation and reimbursement. But this comes at a price, primarily in terms of loss of control and changes to practice culture.

Those practices considering transactions would be wise to get professional help from an investment bank, as the overall process and its required due diligence take a tremendous amount