Parsing the "Fine Print" in Private Equity Acquisitions

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It only takes a few major market events for the snowball effect to begin.

- *Dateline 2014.* Katzen Eye Group sells interest to private equity firm, Varsity Partners, and form EyeCare Service Partners.
- *Dateline 2017.* Varsity Partners sells its majority interest in EyeCare Service Partners to another private equity firm, Harvest Partners, LP.
- *Dateline 2017.* Waud Capital announces its partnership/buy-in of Minnesota Eye Consultants. Sterling Partners announces its investment in Michigan-based Grand Rapids Ophthalmology. HIG Capital announces its investment in two major competitors in Arizona—Barnet Dulaney Perkins and Southwestern Eye Center.

Such important market news naturally piques the interest and curiosity of physicians. If administrators have not yet heard questions about selling to private equity groups (PEGs), it won't be long until they must be prepared to help their owners consider selling to such an investor. This article is designed to help administrators understand the evolving world of private equity (PE) and eyecare.

UNDERSTANDING PEGS AND THEIR INTEREST IN EYECARE

PEGs are interested in healthcare opportunities, and eyecare practices in particular, for these reasons:

1. Medical practices—and eyecare in particular—have been fragmented. Consolidating the market will allow for better purchasing, shared expenses, and potentially increased profits. A PEG has the capital available to acquire existing practices and businesses that can be folded into the larger operating entity.
2. It's a growing market. The aging population is demanding more healthcare services.
3. Adding service lines to a practice, particularly cash service lines, is something investors can do by providing the capital necessary for ancillary services such as ambulatory surgery centers, optical, cosmetic lines, hearing services, etc.
4. Ophthalmology, optometry, and optical are seen as relatively stable specialties with a good mix of insurance and cash-pay business.

UNDERSTANDING OPPORTUNITIES MOST VALUABLE TO PEGS

The key thing to understand: Most PEGs are not "operators." They are not looking to come in and improve operations of a practice or participate in a turnaround. They prefer to find organizations that have a sound business foundation. This includes financial strength, quality leadership, solid IT infrastructures, well-known and respected medical providers, and a strong strategic vision. If a practice has not yet created a management services organization (MSO), the equity partner will most likely venture with the practice to create this platform, which will be the conduit between the PEG and the medical corporation. Most PEGs will look first to the practice's current CEO/leadership team to head up MSO operations.

Private equity groups are looking for high returns—in the 15–20% range over 5–10 years. Thus, practice owners need to understand that investors are looking for growth-minded partners who will drive returns in a relatively short period of time. PE investors believe they can increase earnings in a practice by offering available capital for expansion, new technology, consolidation (acquisitions of other groups), and new business development.

Generally, here are the key elements of interest that compel PEGs to invest in a practice:

- A diversified operating model, including practices with multi-subspecialties, optical, and ambulatory surgery centers.
- A regional presence with multiple locations, a good reputation, and a substantial market share.
- A proven growth strategy and capacity to handle growth.
- Strong provider relationships.
- Strong payer relationships and access to patients.
- Strong leaders and business infrastructure that will easily handle integrating new services and practice mergers.

- Reasonable operating overhead and sound financials.

Once a PEG acquires a regional leader, the group turns its interest and focus to opportunities for consolidation.

UNDERSTANDING THE PROS AND CONS OF A PE OPPORTUNITY

Every business decision—from the financial implications to the long-term strategic benefits or risks to the practice—deserves thoughtful consideration. Here are five considerations to explore with your owners as you vet a PE opportunity.

Cash up front vs. cash over time. Practice owners are receiving large sums of money — in the range of six to 10 times a multiple of profits (after provider compensation). This is especially attractive to physicians who are nearing retirement and will get a bigger buyout than available in their current agreements. While physicians will have a salary for the work they do, additional earnings that they currently enjoy as business owners are now owned by someone else. Although some physician owners may receive equity shares in the new MSO, this is not always the case. Therefore, younger physicians are typically not as interested in these types of deals where they have to give up long-term profits and may feel a loss of control. Ideally, the new partnership will increase earnings enough for both physicians and investors to make their desired income, but that is not always the perception.

Restrictive covenants. Private equity firms need to protect their investment, and one of the ways to do so is to restrict physicians in the practice from being able to become a direct competitor. Physicians need to understand that if they desire to leave in 3–4 years, they will have to move their families to an area outside the market area restriction.

Management responsibilities. Many physicians are excited to focus their attention on providing medical care to patients rather than worrying about business affairs. In a PE scenario, the business can thrive while physicians keep their attention on providing the best possible patient care.

Cycles of ownership/change of culture. When selecting a PE partner, practices must ensure alignment of patient care and other critical business philosophies, which are foundational to the culture of the practice. If the practice culture changes too dramatically, the practitioners may be dissatisfied in their daily work environment. Even when a thorough due-diligence process assures aligned strategies and cultural fit of your new PE partner, there is no guarantee that alignment will remain. It is important to remember that the PEG likely will sell its investment in 5–10 years and the practitioners may have little say in determining the new business partner.

Exit strategy. For physicians looking for an exit strategy, the sale to a PEG is extremely interesting. For smaller practices that can be merged into a larger practice, it is an ideal situation for both the PE-owned MSO and the soon-to-retire physician(s). However, large practices looking to be the foundational practice in a region need to realize that PEGs are not interested in physicians who want to slow down and retire quickly. They need the business to grow rapidly and will need your help recruiting and training the next generation of physicians.

UNDERSTANDING THE EFFECTS ON AN ADMINISTRATOR

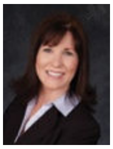
Most practices hire investment bankers to represent the practice to potential buyers and negotiate the sale. Still, the process is stressful for practice administrators who need to provide reports and participate in multiple meetings. In general, one good thing for administrators is that they should not fear they will be displaced by the PEG that brings in its own management team; it is usually not the case. While administrators may have a different role working in the MSO structure, most will have a continuing role.

POSITION YOUR PRACTICE

Whether you need to do your research to evaluate a possible sale to a PEG or you need to position your practice to compete with a PE-owned competitor, administrators would do well to focus time and attention on

1. Strengthening business operations.
2. Solidifying financial position and governance (clean/clear entity divisions, operations, and financial statements).
3. Strengthening payer contracts and regional presence.
4. Developing an MSO and networking/contracting structure.
5. Diversifying operations (more cash pay).

Private equity opportunities are real and alive in the market. Proactive administrators will need to closely and regularly monitor these trends and serve as a valuable resource to help their physician owners make sound decisions that will impact future practice success.



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