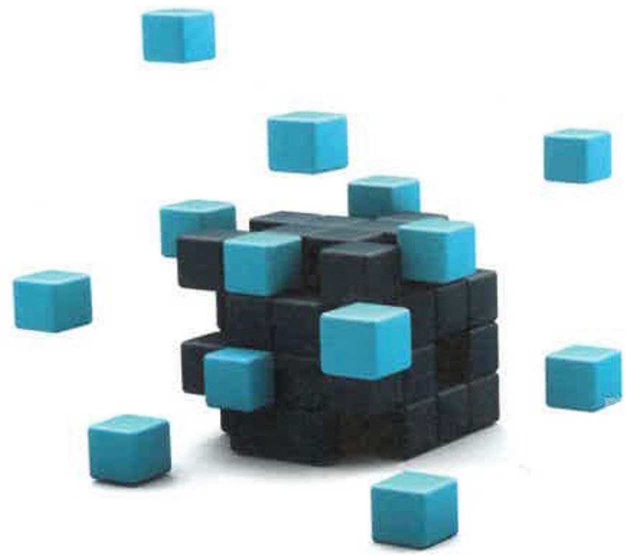
MIDDLE MARKET Growth

Private Capital Stitches up Physician Practice Space

Industry pressures and shifting attitudes drive consolidation

By Kathryn Mulligan



Private equity firms continue to flock to physician-run practices, a fragmented space where demographic and technological trends are converging, and one where sellers' expectations can make a deal vulnerable to failure if not managed properly.

Buying physician practices and consolidating them into larger platforms has been a private equity strategy for two decades, but in the last several years, PE involvement has extended to a wide-range of specialty areas—dermatology, ophthalmology, orthopedics and oncology, among others.

The physician practice management, or PPM, space appeals to PE investors looking to build regional or national businesses through add-on acquisitions. PE firms can help with marketing initiatives and brand awareness, and by reducing operating costs through back-office improvements. A larger organization may also have greater leverage with payers.

Dentistry was the specialty that reinvigorated interest in PPM investing about seven years ago, says Michael Cole, a managing director and health care industry leader in Alvarez & Marsal's Global Transaction Advisory Group. He attributes the appeal of dental practices, in part, to their retail-centric model, one that's easy to understand. "I think PE funds, maybe those that weren't traditional health care investors, they got it quickly," he says.

Dental care typically involves fewer government payers and less insurance involvement compared with many health care specialties, yielding a less complex revenue stream.

For Dana Soper, a serial health care entrepreneur, dentistry was an attractive market to enter because of its fragmented nature.

"A healthy dental practice can service 2,000 to 3,000 patients with a single practitioner," she says. "If you start putting those number together, you need a lot of dentists, so [the industry] is ripe for consolidation."

She and a partner co-founded Cordental Group, a dental support organization that affiliates and manages back-office functions for dental practices, with backing from private equity firm New Mainstream Capital. The company made its first acquisition in July 2017 and has since grown to 10 practice locations.

Despite the M&A activity in dentistry, only 7.4 percent of U.S. dentists were affiliated with a dental support organization as of 2017, according to the American Dental Association.

Up-and-Coming Specialties

Dermatology is another medical specialty where investors have been active, Cole says. It's one with a mismatch of supply and demand. There is a nationwide shortage of dermatologists, even as higher rates of skin cancer and other diseases have increased demand for services.

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Successful dermatology investments have led investors into other specialties. "The phrase we hear a lot is 'this sector is the new derm,'" Cole says.

Over the past six months, he's heard the "new derm" label applied regularly to orthopedics. As baby boomers age, the need for hip replacements, spinal surgery and other services has grown. That trend, coupled with technological advancements that enable more outpatient procedures, has spurred demand in the orthopedic space—and PE investment has followed.

Private capital can help companies enhance technological capabilities, build new revenue streams, and make acquisitions, says Ryan Buckley, a partner with investment bank Livingstone. "In an evolving landscape with competitors, hospitals and health systems, and payers—which in many respects are becoming providers as well—having the financial firepower that private equity investment brings is critical."

Buyer enthusiasm has driven up prices. For a large business, Cole says he's seeing valuation multiples in the 11x to 14x EBITDA range. Recently, an investment banker told an Alvarez client it would need to bid at 15x EBITDA to get to the next round of the auction for a platform-sized target. "It's funny, everyone keeps saying prices have to come down, but they haven't," he says.

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Sellers' Perspective

Fortunately for PE firms eyeing medical practices, many physicians are willing to sell, for reasons ranging from demographic shifts to changing industry dynamics.

One driver is succession planning for practitioners nearing retirement, says Frank Williamson, founder of Oaklyn Consulting. Changes in the health care industry are also playing a role, as increased reimbursement pressure and competition from larger providers have made it difficult to maintain an independent practice.

While innovation in health care has created opportunities for some practices, it has disrupted others. Williamson cites the impact of Invisalign on orthodontics. Unlike braces, a dentist can provide the teeth-straightening devices—a trained orthodontist isn't required. Such a threat to a practice's core scope might prompt a physician to consider an alternative career path. "That's going to cause someone to think: Rather than continuing to run my practice, am I better off taking an offer and taking what money I can and going and getting a job? Because that's going to be a whole lot easier," he says.

After a sale, a physician often becomes an employee of the new PE-owned business, and setting expectations up front is critical for a PPM acquisition to succeed, Williamson says. He encourages sellers to consider how much of their current earnings stem from being a practicing physician versus being the owner of a practice—and to compare those figures with the proceeds from the sale and their future salary as an employee. He suggests they also consider how much they value their social status. "They're going from 'I am one of the important partners in an important practice in the community.' That's different from 'I'm an employee in a big corporate practice group.'"

The first wave of physician practice roll-ups, in the mid 1990s, saw a number of failed investments, largely because of unrealistic expectations. "There were a lot of factors, but generally speaking, it was physicians not understanding economically what they had done, and frankly, just having a bit of sellers' remorse," Cole says.

He doesn't expect a similar outcome this time, in part because operating independently has become less viable for small practices. Regulatory pressure and third-party billing and collections have made it difficult to survive in today's health care industry. There is also a cultural shift underway. In the past, many new medical school graduates intended to own their own practices one day, but a number of young health care professionals today envision a different career path, says Soper. "It's true somewhat in the dental industry—they really come out expecting to go to work for somebody."

Those shifting industry dynamics have created an active M&A environment, which Cole has seen firsthand in Alvarez & Marsal's health care group. "Physician practice deals have been at least 70 percent of what we've been doing for the past three years," he says. "It has been a dominant part of our business."