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DISSECTING THE POTENTIAL ADVANTAGES AND PITFALLS OF

PRIVATE EQUITY



Leaders from all sides of a private equity deal provide valuable insights and factors to consider before signing a deal.

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PRIVATE EQUITY STATE OF THE UNION

BY STEPHEN DAILY

After a 25-year hiatus, private equity (PE) investment has returned to the eye care market in a big way. During the past 3 years, PE has targeted ophthalmology as an attractive investment due largely to appealing secular growth, an aging US population, cash pay services, and diversification of offerings.

During the 1990s, ophthalmology was in the midst of the physician practice management company (PPMC) phenomenon. In comparison, today's PE companies are better equipped to manage the obstacles that might have been mismanaged by PPMCs in the past. PE capital is flowing into large, more established practices first, and seems destined to continue its outreach in the highly fragmented eye care space.

In an effort to connect physicians with the premier authorities in private equity, Bryn Mawr Communications hosted the inaugural Private Equity Live symposium in late October, prior

to the annual American Academy of Ophthalmology meeting in Chicago.

With the influx of investment money flowing into the ophthalmic space, the goal of Private Equity Live was to address the many questions practitioners have about business principals not taught in residency, including how to: (1) evaluate your earnings before interest, taxes, depreciation, and amortization (EBITDA); (2) leverage your real estate; and (3) keep employees and partners engaged/motivated after a deal. The event also provided networking opportunities among physicians, private equity firms, and investors.

The inaugural Private Equity Live event began with a "State of the Union" address by health care consulting veteran Bruce Maller, the founder and CEO of BSM Consulting, a health care consulting firm that provides support for all facets of practice management. Founded in 1978, BSM Consulting currently has 17 sharehold-

ers and 60 employees with offices in Phoenix; Incline Village, Nevada; Orem, Utah; and Duncanville, Texas.

NOW AND THEN

Mr. Maller kicked off the symposium by providing the audience an overview of the current wave of market consolidation and compared it to the PPMC deals of the '90s.

"The wave—and it really is a wave—of consolidation is really not like anything that I have seen in my career," Mr. Maller said. "Some of us were here during the middle 1990s, when there was a fair amount of consolidation activity and, of course, everybody kind of knows if you were around, the outcome was not particularly positive."

SO WHAT IS DIFFERENT TODAY?

"To put it simply, this time around there is actual cash," Mr. Maller explained. "In the 1990s, many of the deals were trading equity for equity or stock for stock. ... We were all going



"TO PUT IT SIMPLY, THIS TIME AROUND THERE IS ACTUAL CASH. IN THE 1990S, MANY OF THE DEALS WERE TRADING EQUITY FOR EQUITY OR STOCK FOR STOCK. ... WE WERE ALL GOING TO BET ON THE OUTCOME THAT WE WERE GOING TO BUILD THIS AMAZING BUSINESS, AND WE WERE ALL GOING TO MAKE A LOT OF MONEY WHEN WE TAKE THAT ENTITY PUBLIC OR WE TRADE IT OUT AND SELL IT OUT TO SOMEBODY ELSE. THAT IS NOT THE WAY IT WORKS TODAY. THERE IS ACTUALLY CASH."

-Bruce Maller, CEO, BSM Consulting

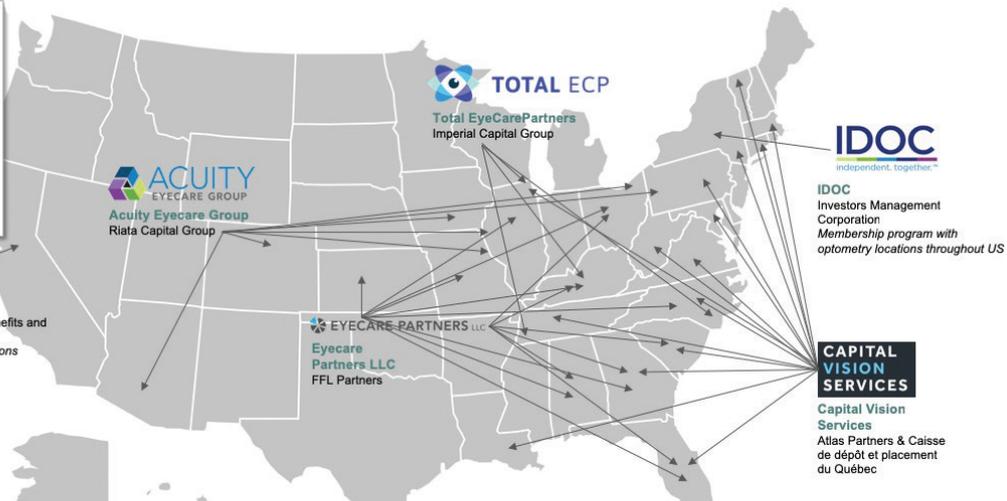
Figure 1

Condolidation Activity-Ophthalmology



- Large multi-location practices:
- Capital Vision Services (365 Locations in 15 States)
 - Eyecare Partners LLC (Est. 240+ Locations in 9 States)
 - IDOC (Optometric Alliance of 3,000 Member ODs)
 - VSP (Optometric network of over 4,600 independent optometrists and retail chains)

vsp
VSP Vision Care
Not-for-profit vision benefits and services company
Network provider locations throughout US



* Map does not include all optometric consolidation activity, but instead gives an overview of major private equity activity in recent years.

Figure 2

Condolidation Activity-Optometry

to bet on the outcome that we were going to build this amazing business, and we were all going to make a lot of money when we take that entity public or we trade it out and sell it out to somebody else. That is not the way it works today. There is actually cash.”

Learning from mistakes of the past, Mr. Maller said that today’s investors are more nuanced in terms of running a business. In addition, purchase terms are different, as well as how the deals get structured.

“One of the big aspects that I see is that investors today are bringing greater structure, order, and discipline from

a governing standpoint,” Mr. Maller said. “They set up better governance, they oversee more effectively, and they bring more discipline.”

“They are smart enough to know what they don’t know and are the first ones to say, ‘We are going to rely upon you.’ Or ‘together, we are going to hire talent into our organization to help in building and strengthening infrastructure.’”

CONSOLIDATION ACTIVITY - OPTHALMOLOGY

Based on research provided by BSM, there have been PE transactions in 45

states in recent years, with approximately 22 management company platforms. Providers involved in acquisitions include more than 850 MDs/DOs and more than 400 optometrists in platform activity (Figures 1 and 2).

Mr. Maller noted that consolidation is not just limited to ophthalmology; there is similar activity taking place in optometry, albeit not to the same degree. The margins in optometry are typically not as good, making it tougher for the business model to work, he said.

He also pointed out that prior to the wave of PE investment in ophthalmology, there was an influx of PE dol-

lars in dermatology. The dermatology space can be used as a comparative benchmark, Mr. Maller said, because like ophthalmology, it is an insular specialty with strong demographic trends. Many of the same companies now investing in the eye care space were previously investing in the dermatology space, and the investment opportunities look strikingly similar in some ways to the ophthalmic space.

Mr. Maller said that the demographic trends of the ophthalmic space are very attractive, providing a “bull market” for investment opportunities. He added that a combination of increasing eye disease diagnoses, the emergence of new technology, and the allure of ambulatory surgery centers (ASCs) that provide cash pay services have provided a growing stream of cash flow.

“The most important reason why any practice should think about doing something (with PE) is because you want a partner that is going to help you execute a growth plan,” he said. “That is at the very essence of why and how you need to think (when) doing these kinds of deals.”

Mr. Maller said while all PE investors want control, with the ultimate goal of increasing cash flow, the deal structures and long-term strategy of PE firms vary substantially. Therefore, it’s crucial for any practice to know the motivation of the PE partner.

“Deal structure varies; their motivation can be very, very different,” Mr. Maller explained. “That investor who looks at your practice and surgery center and says, ‘Hey, we want to be here for the duration,’ meaning we want to buy an asset, build it, grow it, keep it, hold it. (That investor) thinks very differently than (an) investor who says, ‘Hey, I want to buy this asset, I want to build up the cash flows, but I have got investors over here that I need to satisfy, and the only way I do that is to flip or turn or sell that asset in a period of time.’”

Therefore, sellers need to educate themselves on what makes PE firms different and know their motivation,

so they can align themselves with the best strategy for their business.

TYPES OF CONSOLIDATION AND FACTORS TO CONSIDER

During the opening session of the Private Equity Live event, Mr. Maller also outlined the different types of consolidation in the eye care space and the metrics in which the private equity market will value a business.

When determining valuation, investors look at whether a practice is a “platform” or a “tuck-in.” A platform is based on the quality and integrity of the infrastructure, personnel, IT systems, and ability to scale-up the business.

“Can you bolt on additional practices and operate them efficiently and drive efficiencies to the bottom line?” Mr. Maller asked. “You may or may not be in that category. But the platform practices, because they are more mature and more sophisticated, are going to likely command a higher price point from a valuation standpoint versus that practice that is folded in or acquired by an existing platform.”

Mr. Maller also discussed how the main metric in which the PE market will value your business is based on adjusted EBITDA.

“Once you get to a number, a buyer assigns a multiple to that, and the multiple has everything to do with the buyer’s expected rate of return and how (it) views the asset that you have available to sell,” he said. “And there are many factors that impact the multiple.”

Mr. Maller outlined other factors that are important for investors and sellers to consider, providing the following commentary on them:

- **Due diligence.** “I want to buy you, (so) we sign some letter, which is nonbinding, and now I am going to go in and look at everything you do, and how you do everything you do, to determine if you really are who we hope you are.”
- **Purchase terms.** “How much is cash? How much of the cash that we receive is potentially going to be rolled over into equity in the

successor company? That rollover equity becomes an important part of every deal that practices contemplate. It’s very important to know the value of the equity, and (if) that equity going to go up in value over time. It is variable.”

- **Tax considerations.** “You want to optimize from an after-tax return perspective—the proceeds. These are complex issues and require intense work from legal, accounting, and regulatory (personnel) to make sure that you are managing that appropriately.”
- **Allocation of money among partners.** “Do we have to divide the money equally? Is there any opportunity for disparate allocations of sales proceeds? Complex issues, again, that you need counsel for.”
- **Terms of employment.** “I am going to go work for somebody—what is it going to look like post-closing? How am I going to get paid? What are my benefits? What about those associates who work for us, how are they going to be affected by this transaction?”
- **Real estate.** “We own the building. Do we sell it? Do we keep it? Do we lease it? Do we do a sale lease-back? All kinds of considerations one needs to think about.”

Mr. Maller concluded his presentation by saying he believes consolidation in the eye care space will continue. This could cause disruptions to referral channels, and potential out-migration on the payer-contract side. Still, he believes many markets will be unaffected by PE consolidation, and that practices can still be successful even if not part of a PE-backed platform. He advised all practice owners to continue educating themselves, reassess their vision, values, and long-term goals, and evaluate capital needs to execute a plan.

STEPHEN DAILY

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ANATOMY OF A DEAL

BY MATT OWENS, ESQ., AND NAOMI HARTMAN, ESQ.

During the Private Equity Live Symposium, we provided an overview of private equity (PE) transactions in the eye care space. Most notably, the discussion focused on how these transactions are structured, who the key players are, the stages of a transaction, and the key issues that are presented in these deals.

For various reasons, including prohibitions in some states regarding the corporate practice of medicine, PE firms (and similar financial investors, collectively, “financial partners”) will often structure transactions with physician practices through a management services organization or “MSO” model. In this model, an MSO holds the nonclinical assets of the practice and enters into a management agreement with the practice to manage the day-to-day operations. Meanwhile, the practice retains authority over the clinical aspects of the business. In a transaction using the MSO model, if the financial partner does not already have an existing MSO in place, then the physician practice and the new financial partner will form an MSO into which the financial partner then invests. After the transaction, the practice—which at this point is generally referred to as a “captive practice”—remains owned by one or more physicians, while the MSO is generally majority owned by the financial partner, with the former practice owners owning a minority “rollover” interest in the MSO. In some instances, the financial partner’s MSO may already have a captive practice that it manages, in which case, a physician practice looking to transact may have all of its clinical assets and operations moved into the existing captive practice.

In any practice management

transaction with a financial partner, there are various parties that will be involved:

- **Physician Owners:** The owners of the practice who are looking to transact.
- **Financial Partner:** The PE firm or similar financial investor that is looking to invest in the business of the practice.
- **Investment Bankers:** Financial advisor that assists the physician owners in all stages of the transaction, from the marketing of the practice to finding the right financial partner (as well as maximizing the value of the transaction).
- **Lawyers:** Legal advisors that assist in all stages of the transaction, from ensuring the structure of the deal is tax efficient and compliant from a regulatory perspective, to ensuring that the physician owners protect the value created in the transaction.
- **Accountants/Tax Professionals/Wealth Managers:** Additional financial advisors that help physician owners with tax structuring and asset protection in connection with these types of transactions.

It is critical that physicians who may be considering a transaction with a new financial partner consult with their advisors early in the process. Advisors will help to guide physicians through the transaction, ensure no key issues slip through the cracks, and minimize missed opportunities throughout the process. Often, these deals are transformational in nature and represent a once-in-a-lifetime opportunity. As with anything this important, selling physicians must have proper advisors in place to ensure value is maximized, assets

are protected, and the transaction is structured and consummated in compliance with law.

Most practice management transactions follow similar paths, and include many of the same stages (though no two deals are the same and each can certainly take on a life, and path, of its own):

- **Internal Discussions:** It is absolutely essential before proceeding down this path that all owners of the practice reach consensus on whether they want a transaction and how they see the process unfolding.
- **Hiring of Advisors:** For significant transactions like these, it is always best to engage advisors early in the process.
- **Marketing and NDAs:** Once the practice has decided to pursue a transaction (and often after the practice has hired an investment bank), the practice will begin the process of marketing itself to potential financial partners. These partners will sign nondisclosure agreements and then receive access to financial information and other key items of information about the practice to decide if they wish to pursue a transaction.
- **Initial Due Diligence (“The Dating Stage”):** A subset of financial partners that received initial information will seek additional information about the practice and may want to meet with management and the physician owners to get a better feel for the business. This is not only a time for financial partners to do initial due diligence on the practice, but also an opportunity for the practice to do its own due diligence on the potential financial partners.



STAGES OF A DEAL

- Internal Discussions and Hiring Advisors
- Marketing and NDAs
- Initial Due Diligence/The Dating Stage
- Letter of Intent
- More Extensive Due Diligence and QofE
- Agreement Negotiations
- Closing/Transition

- **Letter of Intent:** Eventually, the practice will likely sign a letter of intent with its preferred financial partner, signaling its willingness to negotiate exclusively with that one financial partner for some period of time as the parties work to get a deal completed based on high level terms set out in the letter of intent.
- **Continued Due Diligence/Quality of Earnings:** The preferred financial partner will then conduct more extensive legal and financial due diligence on the practice and will most likely want to perform its own “Quality of Earnings” review to ensure the valuation agreed to in the letter of intent is supportable.
- **Agreement Negotiations:** All parties, with the help of legal counsel, will negotiate the key transaction documents, which generally will include, at a minimum, a purchase agreement, employment agreements for the selling physicians, and agreements related to the terms and conditions of the rollover equity that will be received by the selling physicians.

- **Closing/Transition:** After all documents have been fully negotiated and all issues resolved, the parties will close the transaction, wire funds, and start working together on the new partnership.

Throughout these stages of a transaction, there are several key issues that selling physicians need to navigate:

- **Valuation:** Valuation is often the first—and most important—issue that physicians focus on. If there are multiple owners, as noted above, it is important they reach consensus at the outset on what the minimum valuation is that all physicians require before transacting. Part of the valuation analysis includes determining how much annual post-closing compensation each physician owner will want (because the more post-closing compensation an owner wants to retain, the lower the upfront valuation will be).
- **Tax Structure:** Physician owners must be sure not to look at valuation in a vacuum—it is just as important to determine how the physician’s sale proceeds from the transaction will be taxed. The goal is to structure the transaction

as tax efficiently as possible (eg, capital gains instead of ordinary income). The tax outcome will be impacted by the existing legal structure of the practice, how the transaction is structured, and how the rollover equity will be issued, among other issues. Tax needs to be front of mind from the outset, as it can have significant implications on the transaction.

- **Rollover Equity:** Closely related to valuation, because rollover equity frequently represents a large portion of the overall sale proceeds received by the selling physician, are the terms and conditions of the rollover equity (eg, the equity in the MSO that selling physicians will receive as part of the transaction). It is not just a question of what percent of the sale proceeds will be payable in equity, but also a question of what the terms will be of that equity. Two significant questions to get answered at the outset of a transaction are: (1) will the equity received by the selling physicians be the same class of equity held by the financial partner (in terms of economics, etc.), or will the financial partner have a senior, or

preferred, security; and (2) what governance rights will the selling physicians have in the MSO in which they own rollover equity.

- **Noncompetes:** The financial partner will require that all selling physicians enter into noncompetition and related restrictive covenants. This will likely include, at a minimum, a sale of business noncompete for a period of years following the closing, as well as a new employment noncompete that lasts for the period of employment plus some tail period (depending on state laws with respect to physician noncompetes). Selling physicians should determine how important this issue will be to them before getting too far down the road with a transaction.
- **Employment Agreements:** Generally, the selling physicians will be required to enter into new employment agreements with the captive practice. For some selling

physicians, this may be the first time they have had to negotiate the terms of their employment. Employment agreements will raise several important issues, including whether a specific work schedule will be required, whether certain outside activities will be permitted (hospital call, expert witness work, etc.), how compensation will be measured and calculated, and the terms of restrictive covenants, among other issues.

- **Associate Physicians:** Frequently, practices that are pursuing a transaction with a new financial partner must address how to treat an associate physician who may be up for partnership (or already in the middle of the partnership buy-in process). This is a delicate issue, and one that requires careful thought and consideration as the practice balances doing what is right by the associate physician and the existing physician owners who may have been partners for many years.

- **Real Estate:** To the extent physician owners also own some of the real estate that is leased and used by the practice, the financial partner may require negotiation of a new lease (as they rarely look to acquire the actual real estate). Not only must the leases be on fair market terms, but physician owners will need to ensure that certain terms of the leases that are important to them as landlord (length of term, triple net, etc.) are not materially changed.

There continues to be significant interest in practice management transactions, and many practices in the eye care space are pursuing (or have pursued) transactions with financial partners. The summary above is just that—only a high-level summary of some of the many issues and aspects of these transactions. These are complicated transactions, but when done right, they can lead to successful partnerships and exciting opportunities for physician owners.

WHAT IMPACTS YOUR VALUATION?

BY BRUCE MALLER

Within the context of private equity (PE) transactions, the determination of value is normally based on a multiple of EBITDA (earnings before interest, taxes, depreciation, and amortization). EBITDA is often used to describe the “free cash flow” of a business. Free cash flow is the amount of cash available for capital expenditures, debt service, and distribution to the owners of a business. It is calculated by subtracting from revenue the cost of goods sold and operating expenses of the business, including a market rate of compensation to the selling physicians.

When using a “multiple of EBITDA” valuation method, the buyer assumes they will be acquiring the business free and clear of any encumbrances. To the extent there is debt on the balance sheet at the time of closing, the seller is normally required to pay off the debt out of the sales proceeds.

The multiple applied to the adjusted EBITDA corresponds to the buyer’s expected rate of return on capital invested in the transaction. Generally, there is good faith negotiation between the buyer and seller on the purchase multiple as well as other deal terms.

In arriving at EBITDA, it is common to eliminate one-time gains or losses,

as well as nonrecurring revenue and expenses. As noted, the compensation of the selling physician(s) is “normalized” to a rate of pay likely to be paid to the physicians postclosing. This is normally a percentage of professional collections in the range of 30% to 35%. The following is a list of additional items that are typically adjusted in arriving at the EBITDA.

- Excess or below market rent paid to shareholders/related entities
- Excess or deficient owners’ compensation
- Personal travel and entertainment
- Above market fees paid to a related entity

CONSIDERED IT, SERIOUSLY CONSIDERED IT ... DECIDED AGAINST IT

As part of the PE Live symposium, Robert J. Weinstock, MD, provided a first-hand account of the process behind considering a partnership with a PE firm.

Dr. Weinstock is a partner and the Director of Cataract and Refractive Surgery at The Eye Institute of West Florida, a 45-year-old family owned and operated specialty ophthalmology practice in Tampa, Florida. The institute has six locations, a surgery center, aesthetic center, two optical centers, and a retail store. It employs about 300 people, including 35 providers and eight partner physicians.

When the PE activity in ophthalmology started to take off, Dr. Weinstock decided to explore all possibilities, committed to engage in a full vetting process to see if such a deal would benefit the practice and its partners.

Dr. Weinstock said the prospect of partnering with a PE firm that could provide management services was appealing to him as his practice is transitioning from a “mom-and-pop” organization to a more corporate type of culture.

“[The practice] has grown tremendously. We need more management, capital for growth, and quite frankly, we need help in operations,” Dr. Weinstock said. “We believe there are economies of scale, and opportunities for cost savings by consolidating back-office processes, such as human resources and billing, across a group of practices.”

Dr. Weinstock engaged in an 18-month endeavor to evaluate all prospects of partnering with a PE firm.

Based on what he learned during the process, Dr. Weinstock identified several potential pros and cons of doing a deal with a PE firm.

PROS

- **Access to new capital growth.** “We have growing debt because, as we all know, every time you expand your practice, buy a new piece of equipment, or open a new satellite, you go to the bank and borrow money. [Partnership with PE] would allow us to grow without continuously borrowing money.”
- **Management and financial support.** “We are in a continual state of rapid growth and expansion, which requires a lot of capital and a lot of management time on my part and the other partners’ time. Management becomes challenging and we are doctors, not necessarily business people.”
- **Marketplace insulation.** “Become the big provider in the community and have all the patients flow to you and not be carved out of insurance plans.”
- **Financial divestment for the partners.** “There is a good tax benefit for capital gains when you sell the entity, versus ordinary income on a going-forward basis as an owner-employee of your practice.”

- **Sale proceeds, immediate and delayed.** “There is immediate cash upfront as you sell some of the EBITDA (earnings before interest, taxes, depreciation, and amortization), and then there is the option for the second bite.”

CONS

- **Loss of control of practice.** “You need to ask yourself questions such as, ‘What is the board going to look like? What is the leadership going to be? What if I want to buy a new femtosecond laser or I want to buy a VisuMax laser (Zeiss)? What if I want to grow the practice, take more time off, redecorate, hire additional help...how are these decisions made? Will you be able to make these decisions or are you going to have a team of people make these decisions?’”
- **Change in practice culture.**
- **Concern of next owner and the second bite.** “Concerns of whether this next bite will really happen and whether you are going to see that at any point in time.”
- **Quality-of-life issues around becoming an employee.** “Many of us are self-employed. It is quite a change to be an employee. In some of the contracts, there are some sticking points about being an employee. How much vacation time do you get? What about other income through consulting and other work that you may do?”
- **Distribution of proceeds.** “If you sell a partnership and you have equal partners on paper, those proceeds will be distributed equally by law, but we all know in certain practices there are some partners who contribute more than others. There are different aspects of the practice like the optical, or the surgery center, or other arenas in cosmetics where some of the partners can gain access to the EBITDA and the profits unequally, but when you sell it, it has to be distributed equally. So that creates potential challenges in large partnerships.”
- **Risk of the second bite.** “When/if there is another sale, how will the proceeds be distributed? What happens if you are not happy after a year or two with the next owner? Do you have to pick up and move your whole family to another state to practice?”

Dr. Weinstock concluded by advising practices that are considering partnering with PE to have a good legal firm, and to set up noncompete clauses as an added protection.

“Ultimately we passed on the deal. We decided to continue to grow our practice, which we have been doing,” Dr. Weinstock said. “We have good EBITDA, like most of you, so we have value. We decided to do what PE wanted to do: acquire smaller practices and acquire optometric practices and grow our practice organically. We also want to look at other partnership models where some of the PE risks are mitigated.”

Valuation Considerations



Adjusted EBITDA

Multiple of Earnings

What impacts the multiple?



- Litigation expenses, payments, or recoveries
- Extraordinary one-time casualty expenses, ie, hurricane
- Any one-time expenses incurred in conjunction with the sale

transaction. This would include legal, accounting, or consulting fees
 Although there are several other methods of valuing a business, the multiple of EBITDA approach is the

most common within the context of the sale of physician practices and surgery centers to PE buyers.

For selling physicians, it is important to engage experienced professionals to assist in performing these calculations. Most often, physicians only get one opportunity to put their best foot forward and to project the best possible picture of practice performance, within the context of a sale. Suffice it to say, buyers will perform a significant amount of due diligence to “prove” that the assumptions provided by the seller are reasonable. This is a normal part of the deal process. Selling physicians should not be offended if a buyer disagrees with certain assumptions included in the EBITDA analysis. Normally, selling physicians are provided ample opportunity to support their argument.

REGULATORY DUE DILIGENCE: TOP REGULATORY ISSUES THAT YOU DON'T REALIZE YOU HAVE

BY STEPHEN DAILY

In a session dealing with the important, yet sometimes overlooked, issue of regulatory due diligence, Alan Reider, Esq., Senior Counsel, Arnold & Porter, in Washington DC, shared his advice on the top regulatory issues that many practices may have—even if they didn't realize it.

Mr. Reider explained the main differences between corporate due diligence and regulatory due diligence as it relates to the health care field. Traditionally, when you had a transaction, due diligence focused on corporate issues, such as making sure that the corporation was appropriately registered with the state, making sure tax returns are filed, etc. But in the health care field, there are completely different types of due diligence to address.

“We are dealing with the question as to whether you are structured correctly from a regulatory perspective and whether your ownership is appropriate from a regulatory perspective,” Mr. Reider said. “You are going to have to lay yourself bare before your private equity (PE) partner or potential partner to make sure that they are comfortable that you are doing everything right. And depending upon what they find, that could have a significant impact on the transaction.”

Regulatory due diligence requires that a practice provide documentation about its structure, ownership, operations, and relationships with referral sources and vendors. After all, PE partners like a clean slate, Mr. Reider said, and this could lead to several actions

that a practice may not anticipate prior to a deal.

For example, during the due diligence process, the PE partner may find problems with the way a practice is doing business or improper billing procedures, which could lead to a repayment to patients and/or third-party payers. It could also lead to a practice making a voluntary disclosure of a Stark law violation to CMS.

“That is going to cost you more than just the overpayment,” Mr. Reider warned.

Even worse, a practice may be obligated to make a voluntary disclosure to the Office of the Inspector General or Department of Justice relating to false claims or a violation of the Anti-Kickback statute.

“These are the kinds of problems that arise in the context of this due diligence and you want to make sure you take care of them before that happens so you are not confronted with that problem,” Mr. Reider said.

There are important financial implications that could result from the regulatory due diligence process as well. Concerns from the buyers could affect the calculation of a practice’s EBITDA, which ultimately could lead to a reduction in the purchase price.

“We have seen deals collapse because of regulatory problems. Either the practice is not willing to make the change or not willing to make the disclosure, disagrees with the conclusion of the PE folks, or the PE folks said, ‘We did not know what we were getting into. We are out of here,’” Mr. Reider said.

To address the potential pitfalls of the due diligence process, Mr. Reider highlighted some of the more common issues that arise. He also provided advice for practices about things to know before they even begin the process of partnering with a PR firm or signing a letter-of-intent.

“When you have the folks from the PE firm coming to your practice, you

Impact of Finding Non-Compliance in Due Diligence

Note: the following are not mutually exclusive:

- Prospective correction of the problem
- Repayment to patients and/or third party payers relating to improper billing
- Voluntary disclosure to CMS relating to Stark law violations
- Voluntary disclosure to the Office of the Inspector General or Department of Justice relating to false claims or violation of the Anti-Kickback statute
- Reduction in the EBITDA calculation resulting in reduction in purchase price
- Collapse of the transaction

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want to minimize, if not eliminate, the possibility that they are going to find a problem that is going to either require you to change your practice or require you to repay money,” he said.

STARK LAW

The Stark Law, which Mr. Reider described as “one of the most complex technical rules in the health care industry,” has been the single biggest issue Arnold & Porter has seen when dealing with PE deals.

The Stark Law has a provision relating to productivity-based compensation for physicians. When it comes to eye care practices, risks arise in connection with the provision of certain diagnostic testing, such as OCT

and A-Scans, in which the physicians personally perform the professional component (the interpretation), but not the technical component (which is generally performed by the technician). If the physician’s compensation is based on the global revenue rather than the professional component only, the Stark law has been violated.

“This is the single most common problem we have seen on the regulatory front, so you need to be sensitive to that,” Mr. Reider said. “Obviously, it is an easy fix. You just carve out the technical component and put it in a separate pool and you don’t pay individual physicians based on that productivity, but you’ve got to fix it ahead of time.”

Another significant issue that arises in



“YOU ARE GOING TO HAVE TO LAY YOURSELF BARE BEFORE YOUR PRIVATE EQUITY PARTNER OR POTENTIAL PARTNER TO MAKE SURE THAT THEY ARE COMFORTABLE THAT YOU ARE DOING EVERYTHING RIGHT. AND DEPENDING UPON WHAT THEY FIND, THAT COULD HAVE A SIGNIFICANT IMPACT ON THE TRANSACTION.”

-Alan Reider, Esq.

many medical specialties is the administration of outpatient drugs. However, because most ophthalmologists personally administer outpatient drugs (such as anti-VEGF injections), it is usually not a problem with the Stark Law.

PAYMENT TO PHYSICIAN PARTNERS

Another issue that arises during the due diligence process is payment to physician partners. Mr. Reider pointed out that most physician practices are structured so that all partners have an identical interest in the equity of the practice. And most physicians in a practice are compensated based on some form of productivity formula, which often results in significant variation in compensation among partners.

This structure works and is typically not a problem. However, when a PE transaction is under consideration, distribution of cash can become an issue.

Mr. Reider said, upon closing of a deal with a PE company, the initial payment to the physician is based on each physician's pro rata share of the equity in the practice, not productivity. As a result, the significant upfront cash payment will be shared equally by all partners regardless of their respective contribution to the value of the practice.

"We have seen some practices where the major producers are saying, 'Wait a minute. Let me get this straight. I am responsible for 50% of this very large dollar amount we are about to get, and I am going to get 10% of it? Something is wrong there,'" Mr. Reider said.

INDEPENDENT CONTRACTOR AGREEMENTS

Another common issue practices would be wise to be aware of is independent contractor agreements with physicians, or leases with referral sources, that don't meet safe harbors.

Many practices enter into contracts with other physicians who perform services with the practice on a part-time or full-time basis. Some practices also lease space, equipment, or staff to or from other practitioners who are

referral sources. Because these practices reflect both a financial and a referral relationship, the Anti-Kickback Statute is implicated.

"The good news is that the government understands there are many perfectly legitimate deals out there that should not violate the law, so they developed safe harbors," Mr. Reider said.

The US Office of Inspector General has published guidance, in the form of safe harbor regulations, that provide protection from prosecution in such cases as long as all of the criteria are followed.

Mr. Reider said that even if an agreement does not follow all of the criteria of a safe harbor, the agreement may still be legal. But it is helpful for practices to adhere to the safe harbor criteria, if possible.

"When you are having a PE firm come in and write a check for many millions of dollars, they are going to want to minimize any potential risk," he said. "You should be in a safe harbor. This is an easy fix. You shouldn't have to worry about this potential problem. But again, we have seen a couple of deals stumble, not collapse, but it has caused some anxiety, and they have had to reform these agreements."

PHYSICIAN CONSULTING AGREEMENTS WITH INDUSTRY

Physician consulting agreements with industry, including advisory board participation, performing clinical trials, and providing consulting services, are generally viewed as a positive and welcome by PE groups as they enhance the reputation of the physician. However, Mr. Reider said the consulting has to be done properly and can sometimes trigger anti-kickback concerns.

However, similar to independent contract agreements, there are safe harbor criteria that protect these arrangements as long as guidelines are followed. As with most elements of PE deals, documentation is crucially important. The major problem is the lack of documen-

tation of the work performed and the scope of the service provided, generally in the form of time spent.

"If a PE firm comes in and you say, 'Hey, I am a KOL for this manufacturer.' That's terrific. They may say, 'Let's see what your contract says. Let's see how much you got paid and what did you do for that?' And if you can't show that last part, that's going to be a potential problem," Mr. Reider said. "We have worked with a number of practices where we have literally created a grid so the physician could document the hours that he or she has spent, and the work that he or she did."

Failure to validate with documentation the scope and amount of work performed raises questions about the fair market value of the payment made to the physician, Mr. Reider said.

EDUCATIONAL PROGRAMS

Many practices provide education programs to local optometric groups. While ostensibly these programs are to promote high quality patient care, Mr. Reider pointed out that they may be viewed as providing something of value in order to induce referrals, thus triggering an anti-kickback concern.

Mr. Reider advised the audience to ask themselves several questions when dealing with these types of education programs:

- Is the program open to all ODs or limited to referral sources?
- Does a program provide collateral benefits like a meal, and if it is a meal, what kind of a meal is it (eg, pizza or surf and turf)?
- Is it a program held locally or is it at a resort with golf and a variety of other activities?
- Does a program offer continuing education and if it does, do you charge for it?

"My belief is that a reasonable program with no significant collateral benefit should be fine, and there are number of PE folks with whom we have talked to who agree with me," Mr. Reider said. "There are others who



don't want to have anything at all. So again, it's something to be sensitive to. Make sure that if you have these programs, you make them rational and reasonable."

Mr. Reider also advised audience members to be mindful of gifts and other benefits if they are intended specifically for referral sources. Even small gifts, such as a holiday wreath, to an optometric referral source could present unneeded scrutiny.

"The way to deal with it is to make no distinctions (for your gifts) and make it not limited to referral sources," he said. "PE will almost certainly cut down on any of the programs that are not reasonable and some will not let you do it all."

BILLING AND CODING ISSUES

Mr. Reider said billing and coding can be the single biggest issue a practice will need to confront when considering a deal with a PE firm. Any due diligence will include a comprehensive

billing and coding audit by an independent billing and coding consultant. If the consultant takes issue with how the practice has billed for services, or the extent to which the documentation supports the medical necessity of the services billed, it will issue a report identifying a potential overpayment.

So what could happen as a result?

Mr. Reider outlined several possible outcomes.

- The practice is able to convince the PE firm that no action is required (an unlikely scenario)
- The practice and PE firm agree that despite the finding, the practice need only make a change prospectively, although the practice likely will be required to indemnify the PE firm relating to the historical conduct
- The practice must make a refund of the overpayment and may have to perform a more extensive retroactive audit over a longer period of

time to determine the full extent of the overpayment

- The overpayment results in a reduction in the valuation of the practice
- The billing and coding issues are so severe that the PE firm withdraws

"The overpayment reduction, if it is significant, could affect your EBITDA and it could affect the price of the deal. If it's a real problem, it could tank the deal," Mr. Reider warned.

Mr. Reider closed his presentation by giving one final piece of advice to practices considering partnering with PE.

"My advice is very simple: Do your due diligence before the PE firm does it for you. You are going to make that process go more smoothly. You are going to be able to decide how you want to deal with the problems that arise. You will present to PE firm as a practice that is sensitive to compliance issues and you will hopefully avoid being surprised."

SHOULD I HOLD OR SELL THE REAL ESTATE?

BY JACK CHAPMAN, MD, AND COLLIN HART, MBA

Real estate has been a great investment vehicle, but as I considered a transition in my ophthalmology practice, I contemplated whether I should I hold or sell the real estate.

I ASKED MYSELF A FEW QUALIFYING QUESTIONS:

Question #1: Are our associates able/willing to shoulder the debt/payment of buying into the real estate?

For our practice, the answer was “no.” Our younger physicians were interested in the employed model, one with more predictability, less commitment, and thus without the risk/reward of owning a building.

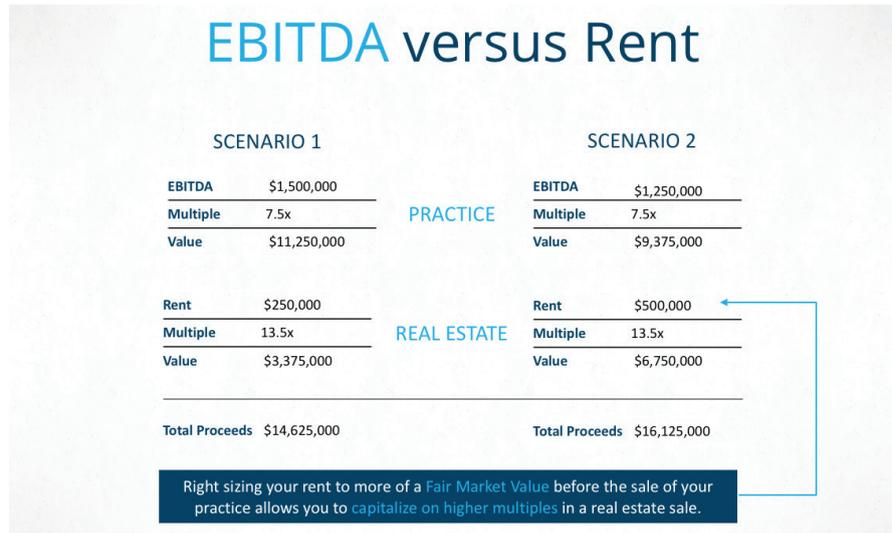
Question #2: Is it an investment you want to continue holding as you transition?

I was developing my succession plan for the practice; the same held true for our flagship practice/ASC location that we built 10 years before. The continuous cashflow would be attractive, but could I receive a lump sum today without the worry of being a landlord or facing a future recession?

Question #3: Is the value significant?

The appraised value of our property wasn't quite as attractive as we hoped, but as we further explored our options, we were turned on to the idea of a sale and leaseback. This allowed us to sell our real estate at the highest possible price, while continuing to operate long-term in our facility without interruption.

We worked with a specialist in the field to help us advantageously structure and execute the real estate trans-



action, seamlessly interfacing with our new private equity partner.

Enter, Collin Hart of ERE Healthcare Real Estate Advisors.

Physicians always ask us about the keys to success in a sale and leaseback transaction, so we've highlighted three that were instrumental in our success with Dr. Chapman's transaction.

THREE KEYS TO SUCCESS

#1: Partnership conversations

It's critical that members of your partnership are on the same page in terms of objectives. Are they also a partner in your building, how long will each of you continue to practice, do you have similar financial objectives?

#2: Proper determination of rent

While most of our clients have historically paid themselves rent, that rent may have been set arbitrarily, depending on their financial and tax planning goals. When selling and leasing back

your facility, it's important to right-size your rent to more of a fair market value. While this might decrease your EBITDA slightly, you'll more than make up for it in a real estate sale (Figure).

If your practice is being valued at 7.5x EBITDA, your real estate will be valued closer to 13.5x annual rent, so shifting some of your earnings to a slightly higher rental rate could serve you well.

#3: A controlled transaction process

Just as you might use an investment banker to find a practice partner, a specialized real estate advisor can help maximize the value of your real estate. Proper underwriting and marketing will help attract the most buyer interest, increasing demand and competition, resulting in the highest likelihood of your real estate sale actually going through.

Whichever path you choose, being armed with the right considerations will help you avoid missteps. ■



As part of a Q&A panel with private equity and platform executives, Chris Moore, President of Century Vision Global (CVG), spoke about the state of private equity (PE) as it pertains to eye care and shared the unique business model of CVG.

“Like PE companies, we are actively acquiring eye care practices. But life after the transaction is where we are really different (Table),” Mr. Moore said. “We are not motivated by short-term value creation, which allows us to partner responsibly with practices for the future.”

CVG has acquired and partnered with more than 150 doctors nationwide and has never sold a practice. This gives physician-entrepreneurs the flexibility to partner with a capital partner without compromising the culture of the business, Mr. Moore said. CVG provides eye care practices with the capital, resources, partnerships and relationships they need to help doctors reach their goals—whether the goal is a new satellite location, updated technology, expanded services, or a pathway toward retirement.

“CVG invests in growth-hungry entrepreneurial doctors who are looking to build upon the legacies they have already created,” he said.

Another distinguishing characteristic of CVG is that it only partners with eye care practices, Mr. Moore said, while many traditional PE firms are just entering the ophthalmology space.



“It’s dangerous to lump all equity groups together. There are some good PE groups out there and those groups can create structures that work for all parties,” Mr. Moore said. “However, I think it is important to realize that there are dozens of PE deals that have been done in eye care, but only a handful have included the ‘second bite’ when physicians realize the value of any remaining equity they have left in the deal.”

Mr. Moore said the take-home message for doctors who are considering a partner is to fully understand the different options available to them.

“It’s very early in the game for our industry. Take your time, keep learning, and let things develop and mature,” Mr. Moore said. “Stay on the sidelines as long as you need to and develop your own plan for the future. You’ll find the right partner that can help secure your legacy when the time is right.”

For more information, contact Chris.Moore@cvgloballlc.com

Century Vision Global vs. Private Equity

KEY FACTORS	TRADITIONAL PRIVATE EQUITY	CENTURY VISION GLOBAL
Expected sale in 3-5 years	Yes	No
Depends on outside investors	Yes	No
Future exit multiple guarantee	No	Yes
Owner's exclusive focus on eye care	No	Yes
Dilutive to doctors as growth occurs	Yes	No
Model conducive to younger doctors	No	Yes
Geographic control	Sometimes	Always
Future commitment known	No	Yes

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Cross Keys Capital (CKC) has advised on more than \$3 billion in transactions with more than 60 of them being physician practices. They have completed deals all across the country, and they have have ophthalmology clients in most areas of the United States.

For more information, contact

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- Managing Director Jeanne Proia
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The ERE Healthcare Real Estate Advisors team (ERE) is led by real estate veterans with more than 70 years of combined experience. They have collectively advised on 184 real estate transactions nationwide, totaling more than \$1.3 billion in asset value.

For more information, contact

- Managing Director Collin Hart
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Eye Health America (EHA) is focused on eyecare partnerships in the Southeast United States. Led by an experienced team of eye care industry leaders with more than 100 years of combined practice management experience, EHA partners with best-in-class eye care practices and ambulatory surgery centers in the Southeast to provide superior clinical care to the region.

For more information, contact

- EHA Chief Development Officer Philip Isham, COE, OCS,
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EyeSouth (ES) has completed eight affiliations as of early 2019, including the initial formation of EyeSouth Partners through Shore Capital Partner's (Shore) investment in Georgia Eye Partners in early 2017. ES focuses on the Southeast region, including Georgia, Florida, Alabama, Tennessee, South Carolina, North Carolina, Mississippi, Louisiana, and may consider other surrounding states on a case-by-case basis.

For more information, contact

- Vice-President of Business Development & Strategy
Charlie Shreve, Charlie.shreve@eyesouthpartners.com;
404-953-4095



Unifeye Vision Partners (UVP) provides management and support services to ophthalmology and optometry practices, as well as single-specialty eye surgery centers. UVP operates through a network of 51 providers, 11 clinical locations, and five ambulatory surgery centers.

For more information, contact

- Sami Abbasi, Chief Executive Officer
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Vision Integrated Partners (VIP) has completed six deals in Northern California and Florida. The company is a physician-centric national eye care platform formed to accelerate regional growth strategies by providing access to capital, professional management expertise, and analytical tools to maximize operational performance.

For more information, contact

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Full company profiles can be found online at crstoday.com