Value Your Practice: Current Investment Trends in Ophthalmology

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Financial Disclosures and Affiliations

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Valuing Practices: Trends and Considerations

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Traditional Valuation Method

• Valuation of asset components (less debt)
  o Fixed (“hard”) assets: via (re-depreciation) formula or appraisal
  o Accounts Receivable: via formula
  o Goodwill: via formula (% of annual revenue or X of annual earnings)

• Distinguished from global enterprise methods
  o Discounted cash flow method
  o Capitalized earnings method
Traditional Valuation Method

• Why?
  ○ Need to know sub asset values
    ▪ Partnership buy-ins:
      ▫ Some asset values historically tied to out-of-pocket “stock” purchase (hard asset value) and some paid “pre-tax” via income adjustments (AR and “goodwill”)
      ▫ Many groups no longer recognize “goodwill” value
    ▪ Practice sales:
      ▫ Receivables typically retained
  ○ Customary
Valuation Method Used by PE Companies

• **Capitalized earnings**
  - Multiple times “EBITDA” (less debt)
  - Earnings Before Interest, Taxes, Depreciation and Amortization
    - Taxes = income taxes (not employment or other taxes)
    - Distinguishing “earnings” distributions from compensation
      - Substitute all distributions and compensation paid to owners with compensation the owners will be paid under the “deal”
  - Enterprise valuation method
    - Receivables included and purchased
Should Method Matter?

• Methods will produce varying results
  o Most appraisers use various methods and average the results
  o All methods require subjectivity, to some degree
  o Methods, if correctly applied, should NOT produce WILDLY different results
Why Are PE Valuations Significantly Higher

• PE Companies tend to use higher capitalization rates (i.e., higher multipliers)
  o Historically, doctor-to-doctor purchase prices have been significantly lower than company-to-doctor prices (for practice and ASC purchases)
  o Parallel markets
Trends

• Practices charging associates buy-ins based on PE valuations

• Although “goodwill” recognition remains predominant in ophthalmology, long trend toward lesser or no goodwill recognition continues
  o Desire of groups to grow in size and number of owners
  o Greater competition
  o Erosion of physician non-compete laws
Recent Case Law of Interest


• Shareholder dissent case.

• In a shareholder appraisal case, the Colorado Court of Appeals court rejected the shareholder’s argument that the Practice’s value was tied to price offered by the PE firm. Instead, it ruled that the market value was a lower value determined by the practice’s selected appraiser (using more traditional method). Other factors contributed to PE firm’s offered price: Agreement for lengthy employment terms, reduction of compensation, etc.

• Court did agree with shareholder that his employment non-compete should be unenforceable because of the practice’s sale to PE.
Medical Real Estate Valuation and Sales

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Buying and Selling of Medical Practice Real Estate

Typical Scenario

• Many young ophthalmologists who join a private practice expect to become partners

• Buy-in based on value of equipment, furniture, accounts receivable, goodwill

• New partner in the medical practice may be offered partnership in the medical practice real estate entity
Does the New Doctor Have an Interest in Owning or the Senior Doctor in Selling the Real Estate?

New: Pros of Ownership
- Nest egg for retirement

New: Cons of Ownership
- May require significant cash outlay or personal debt
- May feel investment not a good one

Senior: Pros of Selling
- Creates a sense of true partnership

Senior: Cons of Selling
- Less control and financial benefit
Establishing the Value and Payment

Valuation

• Recent purchase price
• Purchase price + COL increases
• Formal Commercial Appraisal:
  1) Replacement Cost
  2) Direct Sales Comparison
  3) Income Capitalization

How will the New Partner Buy In?

• Pay up front (cash or bank loan)
• Sign note with the current partners
• Existing partners refinance mortgage as close to 100% financing as possible

And Senior Partner be Bought Out?

• Automatic at time leaves practice? At what price?
What if interest rates are rising?
And you want to promote ownership in the real estate but don’t want to (entirely) refinance?

**Scenario**

- Assume Eye LLC is appraised at $2M
- Balance with Bank = $500K
- Equity = $1.5M; 4 current partners do not wish to refinance
- New partner buy-in = $1.5M/5=$300K
- New partner can’t afford this buy-in
And you want to continue promote ownership in the real estate but don’t want to refinance?

Option

• Keep first (lower interest note) and continue to pay down
• Appraise property; establish equity
• Current equity frozen for current partners
• New partner buys in at zero or some value (e.g. 3x annual LLC profit distribution/5)
• When building later sold, initial equity shared only by original partners; remaining gain shared by all

Example

• Eye LLC is worth $2M with debt of $500K
• Equity is $1.5M; 4 current partners
• New partner pays no (or some) price
• If building sold in 2 years for $2.2M and debt is $400K, equity of $1.8M would be shared as follows: First $1.5M would be shared among original 4 partners; remaining $300K would be shared among all 5 partners
Selling the Real Estate to a Commercial Investor

- Commercial Real Estate Investors see strong Fundamentals in the Medical Real Estate Market
- Certain retail properties seen as more risky real estate investments (e.g. Sears, Best Buy, malls in general, etc.)

Strong Demographic Drivers in Healthcare/Ophthalmology

Source: U.S. Census Bureau
“Slumping Shares of Mall Operators and Shopping Centers Have Badly Trailed the Broader Market”

Source: WSJ, October 16, 2018
“Real Estate Investors Piling Into Medical Offices”: WSJ July 24, 2018

- Competition for high quality medical office buildings (MOB’s) is intense
- Hospitals less desirable than MOB’s as investments
- Stability of this asset class is appealing to investors

Note: Figure for 2Q 2018 is preliminary. Source: Real Capital Analytics
How Much is My Property Worth?

The Formula

Property Valuation $\times$ Cap Rate = Annual Rent

*Lower Cap Rate (the investor's return) results in higher property valuation*
Commercial Investors: Sale-Leaseback

Calculating Building Value

Years of Lease: 15
Total Square Footage: 9,210
Triple Net Lease: $24.50/SF
Net Operating Income: $225,645
Cap Rate (Investor’s Return): 6.50%
Valuation: $3,471,462
Summary: Real Estate Valuation and Sales

• Real estate equity valuations and sales require careful consideration by potential new partners and current owners.

• Rising interest rates may require some “work arounds” to promote buy ins that are fair to new and current owners.

• Valuations of medical real estate by commercial investors are currently relatively high.
Solo/small practice in the era of private equity investment and other consolidation models in healthcare

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Practices in my area are being purchased. I am in a solo/small practice. What will happen to me?
I think I’ve seen this before? Vision 21 (1990’s)

- Are today’s consolidation/private equity models fail-safe?
  - Investors require ROI, not better patient care
  - Solo practice model requires personalized, quality patient care and quantitative ROI is the byproduct.
Solo/Small Practice
IN THE ERA OF CONSOLIDATION/PRIVATE EQUITY

• Consolidation and private equity offers:
  o Expert management team
  o Economies of scale
  o Contract negotiation leverage
  o Marketing expertise in discretionary services
    ▪ Not always aligned with doctors’ professional objective
    ▪ Not always aligned with patients’ absolute health needs.
Solo/Small Practice
IN THE ERA OF CONSOLIDATION/ PRIVATE EQUITY

• Small practice offers
  o Local community knowledge
  o Can better manage patient experience in the office
  o More personal feeling than large corporate practice
  o More control over your own destiny
  o Ability to quickly “pivot” in response to constant changes in healthcare industry.
Solo/Small Practice
IN THE ERA OF CONSOLIDATION/PRIVATE EQUITY

How does a solo/small practice thrive?

• Prioritize your professional brand
• Social media strategy - deploy, monitor, respond
• Maximize patient experience from check-in to check-out
• Every staff member is equally important - respect and appreciation results in productivity, efficiencies and savings that show up on your P&L
Solo/Small Practice

IN THE ERA OF CONSOLIDATION/PRIVATE EQUITY

What I’ve done:

- Start-up costs minimized by shopping secondary market for equipment and furniture
- Select the “right” EHR - SaaS model minimizes IT and upgrade cost, cloud based
- My voice is the recorded auto-attendant - patients appreciate the personal touch
- Office decor (paint, counter-tops, wall art, flooring) can convey calmness and distinguish practice from sterile, stressful decor of most medical offices
- Leverage technology for workflow efficiencies, patient engagement & education…and most importantly communication. I automate appointment reminders, birthday greetings, patient portal, etc.
- Doctors MUST code - reduces claim rejections and billing staffing needs
- LEAN
Solo/small practice
In the era of consolidation/private equity