

# Private Equity and Urology

## An Emerging Model for Independent Practice



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### KEYWORDS

• Urology • Private equity • Consolidation • Health care

### KEY POINTS

- Urology practices motivated to remain independent are under mounting competitive and operational pressures, and large hospital systems continue to acquire physicians.
- Private equity can help independent urology practices grow and consolidate so that they can better implement best practices, unleash new revenue opportunities, and more effectively compete in the marketplace.
- Independent urology practices seeking private equity investment should carefully consider the benefits of private equity and understand the private equity transaction structure.

### EXECUTIVE SUMMARY

Driven by regulatory developments, market forces, and sweeping structural changes, consolidation has been a dominant trend in health care over more than a decade. From hospital systems to insurance providers to physician practices ranging from dermatology to ophthalmology to dentistry, all corners of health care are consolidating, with larger superregional and national players quickly becoming the norm, and urology is no exception.

Independent urology practices are under increasing competitive pressure, as hospitals seek to acquire more physicians to strengthen their own positions in the face of a changing marketplace and meet the needs of patients. In response, independent urology clinicians have formed regional groups that allow for greater economies of scale, better access to ancillary services, and more efficiency in navigating an increasingly complex reimbursement and regulatory landscape.

Now independent urology is at a critical inflection point as it transitions from a regional model

to a national model. A key factor in this stage of development is the use of private equity. By providing access to capital, as well as operational resources and business management expertise, private equity can act as a powerful lever. Urology practices that partner with private equity can better scale to compete with large hospital systems, while unlocking new growth opportunities, maintaining clinical excellence, and, critically, allowing physicians to retain ownership, the sine qua non of independence, with the added opportunity for equity appreciation.

Although some practice owners may still choose neither the hospital nor private equity route and would rather go it alone, this path is an increasingly difficult one to follow and is by no means a certain recipe for success. Now, more than ever, health care is a dynamic market, where there is no such thing as the status quo. With technology-enabled disruptors, the volatility of the payer market, and new care delivery models, there are few areas of certainty. Doing nothing to evolve is an active decision that also carries risk.

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In this article, the authors take a close look at the forces driving consolidation across the health care industry, and urology specifically, as well as the challenges that independent urology practices face. They also examine how private equity firms operate and what their position is in the urology marketplace. In addition, the authors explore the potential benefits of private equity investment, what firms look for in investment partners, how to prepare your organization for private equity investment, and the structure of a typical private equity-backed managed services organization (MSO).

**HEALTH CARE INDUSTRY CONSOLIDATION AND INDEPENDENT PHYSICIAN PRACTICES**

Over the past decade, the health care industry has undergone a wave of consolidation affecting nearly every type of organization and specialty, regardless of size. A recent study published in *Bloomberg Law*<sup>1</sup> (Fig. 1) found that health care consolidation across nearly all corners of the industry remained robust in 2019, with a total of 1588 deals closed or announced. Physician practice acquisition ranked second only to long-term care in the number of transactions conducted.

As a result, the health care landscape has been radically transformed, and the process is still underway.

One major factor accelerating consolidation over the past decade is the 2010 passage of the Affordable Care Act (ACA). The ACA had several far-reaching impacts, among them the increase of accountable care organizations (ACOs) under the Medicare program. The logic behind ACOs was that doctors, hospitals, and other health care providers that formed networks could better coordinate patient care and deliver that care more efficiently.

Although ACOs have not taken off as many proponents of the ACA legislation contemplated, and the number of Medicare ACOs has remained relatively flat,<sup>2</sup> they have nevertheless had a profound impact on health systems and the continued survival of independent medical practices. The drive toward ACOs served as a spark for further changes, including hospital systems buying physician practices to capture the legions of doctors needed to effectively serve newly covered lives.

According to Avalere Health and the Physicians Advisory Institute, between 2016 and 2018, hospitals acquired 8000 medical practices, while 14,000 physicians left private practice to work in hospitals.<sup>3</sup>

The hospital threat to independent physician practices comprises several interconnected factors that make it more challenging than ever for doctors to maintain autonomy. These factors include increasingly complex government

**Transaction Distribution - 2019**



**Fig. 1.** Health care consolidation across practice areas. IT, information technology; Mgmt., management; Svcs., services. (From Bloomberg Law. Published Jan. 27, 2020. Copyright 2020 by The Bureau of National Affairs, Inc. (800-372-1033) <<http://www.bloomberglaw.com>>; with permission.)

regulations and reimbursement rules, the prospect of financial buyouts from hospital systems, the potential lack of referrals from primary care doctors within hospitals' systems, and the threat that hospital networks may hire "their own" physicians if independent practitioners fail to fall in line and agree to be acquired.

However, hospital system growth is not the only threat to independence. Large insurance companies are also venturing into the provider side of health care. UnitedHealth Group's Optum division recently acquired Surgical Care Affiliates for \$2.3 billion,<sup>4</sup> establishing a base for Optimate's primary and specialty care division, which focuses on acquiring or partnering with private medical practices.

### THE EVOLUTION OF INDEPENDENT UROLOGY PRACTICES

Like practitioners across several other specialty areas, urologists wishing to maintain their independence in the post-ACA environment face increasing headwinds, which take many forms: administrative costs, reimbursement complexity, a lack of leverage in negotiations with large payers, competition in recruitment, and the need for increasingly sophisticated business services, including management, legal, accounting, information technology, and human resources.

The impact of these challenges has been dramatic, with 46% of urologists now employed by hospitals and institutions, whereas the percentage of urologists in private practice decreased by approximately 10% from 2015 to 2019, from 63% to 53%, according to the latest 2019 AUA census data.<sup>5</sup>

Today, 5118<sup>5</sup> urologists are either solo practitioners or part of independent single-specialty urology groups, but the market remains highly fragmented. According to Brighter Health Network, the 5 largest specialty urology groups in the country employ approximately 468 providers, including nurse practitioners, physicians' assistants, urogynecologists, and oncologists, representing 9% of the total. Moreover, only 7 practices nationally have more than 50 total providers (**Table 1**).<sup>6</sup>

This flight of urologists from private practices to hospital networks is taking place against the backdrop of a long-term evolution in the structure of independent urology practices that predates the ACA, is driven by several complex forces, and can be thought about in following 3 broad stages (**Fig. 2**).

#### **The Historic Practice Era**

Throughout the twentieth century and well into the early to mid-1990s, urology, like many other

**Table 1**  
**Largest specialty urology groups in United States**

Size Rank	Practice Name	Number of Urologists
1	Solaris Health Holdings	182
2	United Urology Group	161
3	21st Century Oncology	121
4	New Jersey Urology	119
5	Southern California Permanente Medical Group	99
6	Permanente Medical Group Inc	89
7	Advanced Urology Institute	68
8	Cleveland Clinic Foundation	64
9	University Of Pittsburgh Physicians	53
10	Uropartners	52
11	Georgia Urology	49
12	Mayo Clinic	49
13	North Shore-LIJ Medical	49
14	US Urology	47
15	Urology Clinics Of North Texas	43
16	Regents Of The University Of Michigan	41
17	Michigan Institute Of Urology	40
18	Michigan Healthcare Professionals	37
19	Minnesota Urology	36
20	Virginia Urology Center	33

Data from Medicare Data on Physician Practice and Specialty (MD-PPAS), individual group website provider count;2017.

specialty areas, was characterized by hundreds of small practices. These practices typically consisted of between 1 and 5 physicians focused on serving a limited, local market. During this period, which the authors call the "historic practice era," physician revenue was almost exclusively driven by the direct provision of evaluative or surgical care to patients.

#### **Emergence and Proliferation of Regional Leaders**

Beginning in the early 1990s, larger regional urology practices began to emerge. The market

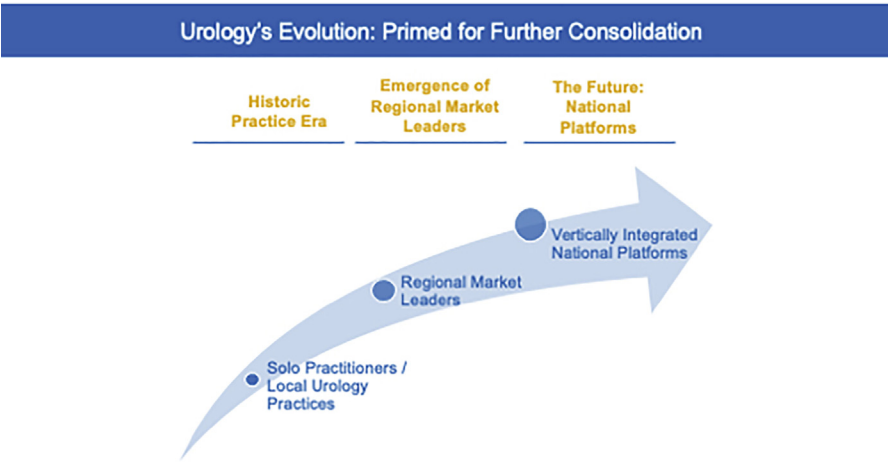


Fig. 2. Waves of consolidation in urology.

dynamics behind this shift are multifaceted. One important initial driver was the need for better negotiating power with payers as compensation for professional services decreased, and urologists saw that they were earning progressively lower revenues from their personal interactions with patients. To compensate, many independent practices sought new revenue streams through the addition of services unrelated to the direct provision of care. Beginning with capabilities such as ambulatory service centers (ASCs) and then progressing to imaging, laboratory, clinical research, radiation, and pharmacy, the last 3 decades have seen a steady increase in these and other ancillary services.

These more powerful regional practices came together primarily through mergers. A natural evolution of the formation of these regional leaders was the establishment of the nonprofit urology trade association Large Urology Group Practice Association (LUGPA), which has fostered increased interaction and networking among independent urology groups and further driven growth. As a result, the percentage of private practice urologists working in large groups consisting of 10 providers or more grew from 15% in 2015 to 32% in 2019.<sup>5</sup>

**The Future: National Urology Platforms**

As external pressures on independent practices have increased, this second stage has “primed the pump” for regional leaders to consider national consolidation and partnership to achieve greater scale.

The vision behind larger-scale *national* platforms is a linking of large regional groups that avoids the need to “reinvent the wheel” in each

geography and provides resources that smaller regional practices cannot access on their own. Factors driving urologists to consider the formation of national platforms include the following factors.

**Regulatory considerations**

For urologists, it has become increasingly difficult to manage the regulatory burden of administering a practice in a silo. The enactment of the Medicare Access and CHIP Reauthorization Act of 2015 and its MIPS program, the specter of emerging “alternative payment models” (including Centers for Medicare & Medicaid Services’ recently announced radiation oncology alternative payment model), and electronic records rules are just 3 examples of complex regulations that require time and resources to manage. The cumulative effect can be profound and takes physician attention away from building practices and serving patients.

**Operational efficiency**

National networks can accelerate the operational and quality-of-care benefits gained through sharing of best practices and centralizing costly back office and administrative functions, such as human resources, legal, accounting, revenue cycle management, and information technology. According to Medscape, urologists spend an average of 15.1 hours per week just on paperwork and administrative tasks.<sup>7</sup>

**Clinical burdens and subspecialization**

As the practice of medicine becomes more complicated and the volume of clinical information continues to expand, it has become harder for urologists to be good at everything. With national scale, urologists are better able to define clinical

pathways and best practices in subspecialty areas and disseminate that information out to the national network.

### **Revenue opportunities**

A national practice entity can provide the assistance needed for local practices to implement revenue enhancing ancillary revenue streams if they have not had the wherewithal to do so previously. Moreover, national scale may provide even sophisticated practices with an opportunity to unlock new revenue opportunities not previously accessible, such as leveraging proprietary practice data and other clinical resources, development of win-win value-based reimbursement models, as well as other sources not yet envisioned.

As the US health care system continues to rapidly evolve and the pressure on non-hospital-affiliated urology practices increases, national consolidation at scale may be the only way for urologists to compete while retaining their independence. However, these increased demands necessitate capital, expertise, and resources beyond the means of even large regional players, creating a natural entry point for private equity.

## **ENTER PRIVATE EQUITY**

With nearly \$600 billion raised in 2019,<sup>8</sup> across a broad range of industries and strategies, private equity firms play a critical role in the global economy and in investors' portfolios. At the beginning of 2020, Preqin estimated<sup>9</sup> that private equity investors were sitting on a record amount, \$1.45 trillion, in "dry powder," or cash available to invest.

To understand why private equity has grown to become such a major force in the global economy, it is important to understand how it works.

Private equity is often categorized as an "alternative investment." That is to say that it is an alternative to the stock and bond portfolios traditionally used by investors. Private equity seeks to earn returns that are better than what can be achieved in public equity markets through an expanded opportunity set of investments not typically available through public markets, legitimate access to nonpublic information before making an investment, a strong alignment of interests, and a greater degree of control and influence over investments. Over the past 30 years, US private equity has delivered greater average net returns compared with an alternative private-market performance benchmark using the S&P 500 as the proxy.<sup>10</sup>

Generally speaking, private equity firms raise pools of capital known as funds, from a variety of investors, commonly high-net-worth individuals

or families, corporate and public pensions, endowments, and foundations. These funds are structured as limited partnerships comprising the firm, known as the General Partner (GP), and the investors, known as Limited Partners (LPs).

It is the GP's job to identify quality companies with growth potential, invest in them, and grow their value. Achieving these goals can involve much more than just providing capital. GPs serve as advisors to portfolio company management, helping to streamline operations, develop productive leadership teams, and identify new avenues for growth.

Typically, after 3 to 7 years of ownership, the GP will seek to "exit" the company by taking the business public or selling it to another private equity firm or corporation. This exit distributes profits from the sale ("returns") to the investors in the private equity fund, the fund manager, any other investors in the company, and, in the case of physician practices, the physician shareholders.

Although all private equity firms follow this general approach, there are many variations based on size of investment, timing of investment, and other factors. For example, "venture capital" denotes firms making a greater number of less certain and relatively smaller investments in early-stage companies. "Growth equity" often designates a firm that takes minority stakes in mid-stage companies, and "buyout" most often refers to firms that purchase a majority stake of the businesses they invest in, through a combination of equity and debt financing.

Although the largest private equity firms can have funds of more than \$10 billion, most of the industry is composed of "middle market" firms managing funds with capital commitments between \$100 million and \$5 billion and focusing on transactions valued between \$25 million and \$1 billion.<sup>11</sup> According to PitchBook, in quarter 1 2020, 27 middle-market funds raised \$24.81 billion of capital.<sup>12</sup> Middle market buyout firms are those most likely to be interested in urology practice investments.

## **PRIVATE EQUITY IN HEALTH CARE**

In recent years, private equity has emerged as a major engine of growth across the health care landscape. According to Bain & Company's *Global Healthcare Private Equity and Corporate M&A Report 2020*,<sup>13</sup> more than \$79 billion was invested by private equity in the sector globally in 2019, the highest on record and a 5-fold increase over the previous 10 years. North American health care deal value in 2019 reached an all-time high of \$46.7 billion, whereas health



care deal volume increased from 149 in 2018 to 159 in 2019.<sup>13</sup>

Private equity’s interest in health care is due in part to the sector’s resiliency through macroeconomic cycles. The often inefficient, siloed, and fragmented nature of health delivery is also a natural match for private equity’s ability to enhance value by helping to streamline inefficiencies, develop productive leadership teams, improve operating models, and find new avenues for growth.

Another factor in private equity’s enduring interest in the health care sector is that it continues to exhibit viable paths to seek full or partial liquidity, so investment proceeds can be distributed to LPs. The ability to have a partial or full exit event is increasing. More than 100 health care private equity platforms are sold by 1 financial sponsor or private equity firm to another each year. Sixty percent of these exits are sales to larger private equity firms, whereas 5% to 10% are initial public offerings (Fig. 3).<sup>13</sup>

Furthermore, as Ernst & Young’s *May 2020 Health Global Capital Confidence Barometer*<sup>14</sup> underscores, the COVID-19 pandemic has amplified the need for health care industry improvements and the investment they require, with health care management teams’ expectations for mergers and acquisitions (M&A) in 2020 increasing to a 10-year high (Fig. 4).<sup>15</sup> Hospitals and health care providers, among the sectors most impacted by the pandemic, will need to be agile to reshape and reinvent themselves for the future, opening the door to strategic M&A.

The provider and related services segment has accounted for the greatest number of health care

private equity deals to date, with 96 in 2019, up from 84 in 2018 (Fig. 5).<sup>13</sup>

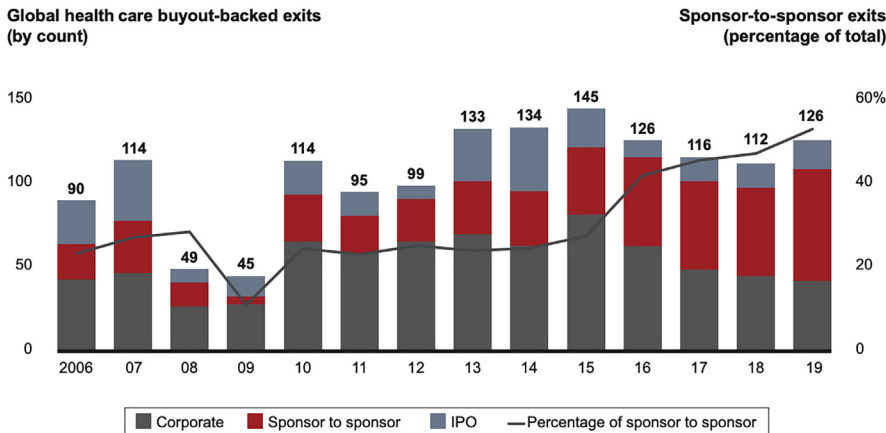
According to a February 2020 *The Journal of the American Medical Association (JAMA)* Study<sup>16</sup> of private equity medical group acquisitions between 2013 and 2016, the groups with the highest rates of private equity backing include anesthesiology (19.4%), multispecialty (19.4%), emergency medicine (12.1%), family practice (11.0%), and dermatology (9.9%). From 2015 to 2016, there was also an increase in the number of acquired cardiology, ophthalmology, radiology, and obstetrics/gynecology practices.

With the shift to value-based care, private equity firms are increasingly interested in specialties that both have independent private practices and present opportunities to consolidate regional markets and build industry leaders with defensible market positions (Fig. 6). The *JAMA* report cited above bears this out, showing the number of private equity deals with physician practices across specialties more than doubled between 2013 and 2016.<sup>16</sup>

PRIVATE EQUITY INTEREST IN UROLOGY

Given the context provided above, it should come as no surprise that private equity has turned its attention to urology in the United States, where the growth prospects are strong, and there are more than 13,000 practicing physicians as of 2019, 53% of whom are in private practice.<sup>5</sup>

Driven in large part by increases in longevity, the demand for urologic care has never been higher, as conditions such as prostate cancer, urinary incontinence, and benign prostatic hyperplasia



**Fig. 3.** Global private equity health care exits. Notes: Excludes spin-offs, add-ons, loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; deal values does not account for deals with undisclosed values. Sources: Dealogic; AVCI; Bain analysis. (Used with permission from Bain & Company.)

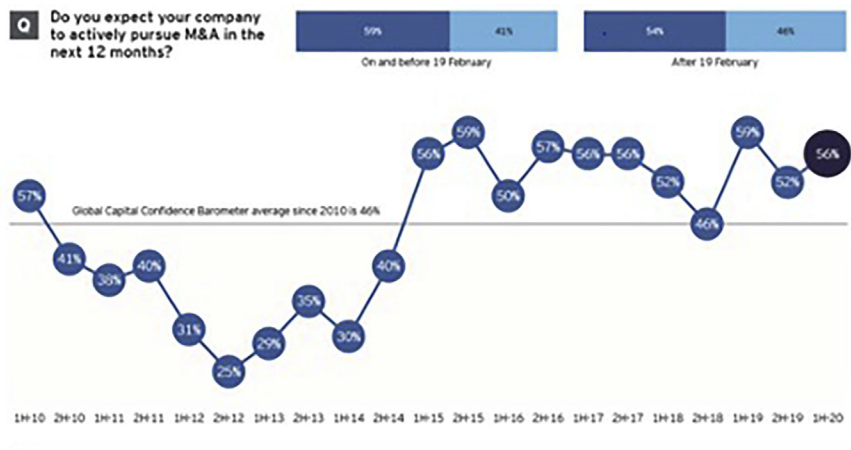


Fig. 4. Health care M&A expectations: 2020. (From EYGM Limited. © 2020 EYGM Limited. All Rights Reserved. <[https://assets.ey.com/content/dam/ey-sites/ey-com/en\\_gl/topics/ey-capital-confidence-barometer/pdfs/22/ey-22nd-global-capital-confidence-barometer-march-2020.pdf](https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/ey-capital-confidence-barometer/pdfs/22/ey-22nd-global-capital-confidence-barometer-march-2020.pdf)>; with permission.)

increase among the growing over-60 population. According to a recent Provident study,<sup>17</sup> this demand is currently on pace to outstrip the supply of urologists.

More than half of the practicing urologists in the United States, or 6175 urologists, are over the age of 55, with approximately just 300 graduating from residency programs each year. This gap between physician supply and patient demand ensures a steady stream of business for urologists and makes urology especially attractive for private equity.

Equally attractive for private equity investors are 2 important factors. First is the opportunity that

urology offers to consolidate a fragmented market. Second, urology offers the ability to add on ancillary services referenced above, along the continuum of patient care, creating diversified revenue streams.

Several private equity groups have partnered with leading platforms in the urology sector and are likely to continue to consolidate fragmented regional markets through add-on acquisitions. Examples include Audax Group’s 2016 investment in Chesapeake Urology; J.W. Childs Associates formation of Urology Management Associates with New Jersey Urology in 2018; NMS Capital’s funding of US Urology Partners in 2019; and Lee Equity

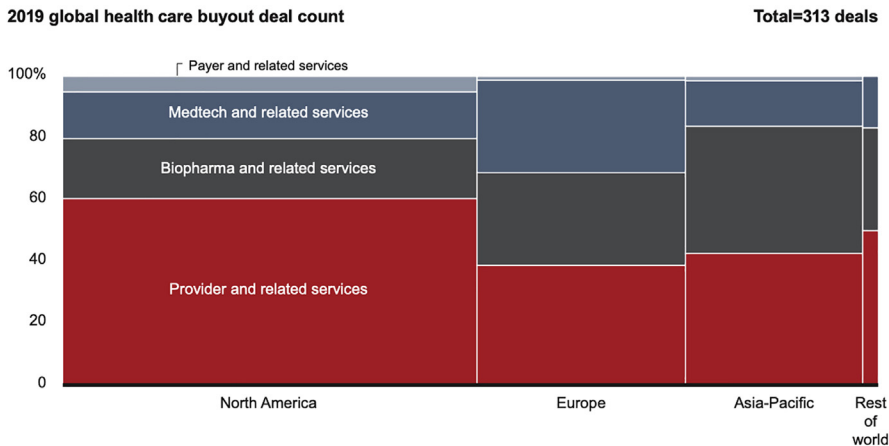


Fig. 5. 2019 global health care buyouts. Notes: Excludes spin-offs, add-ons, loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; deal values does not account for deals with undisclosed values; geography based on the location of targets. Sources: Dealogic; AVCJ; Bain analysis. (Used with permission from Bain & Company.)

Consolidation of Physician Practices Across Specialties

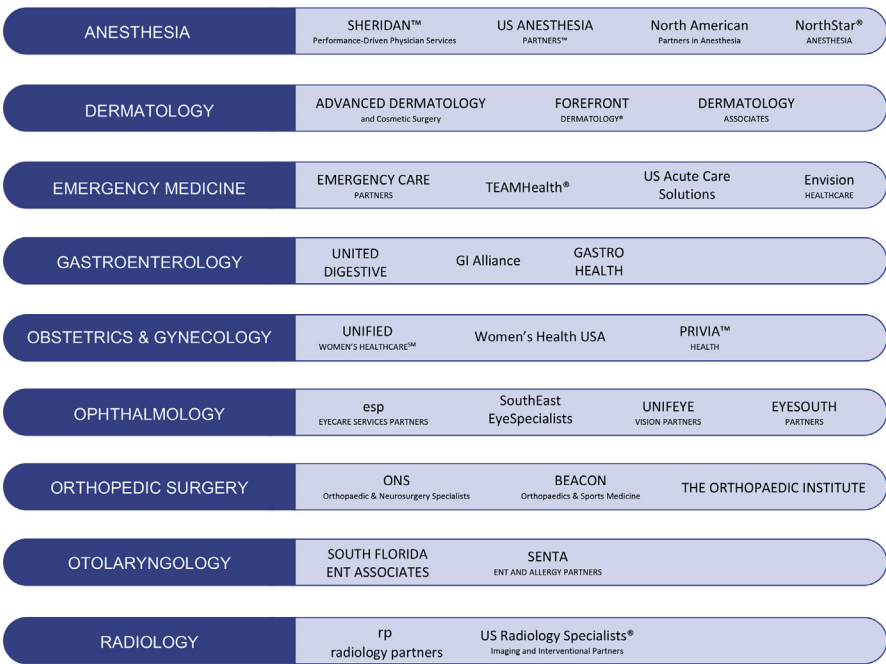


Fig. 6. Consolidation of physician practices.

Partners partnership with New York–based Integrated Medical Professionals and Cincinnati-based The Urology Group to form Solaris Health, a management services organization, in 2020.

POTENTIAL BENEFITS OF PARTNERING WITH PRIVATE EQUITY INVESTMENT

Whether pursuing an initial investment to create a new urology platform or joining an existing platform, there are many potential benefits to taking on private equity capital versus joining a hospital system.

Equity and Independence

First and foremost, a properly structured private equity agreement gives practice owners a significant equity stake in the business that, as discussed earlier, is a critical element of remaining an independent operator and something hospital systems cannot deliver.

Hand in hand with the financial interest, private equity creates a governance structure that preserves physician authority in areas of critical concern to them and ensures shared decision making between the private equity (PE) firm and physician shareholders. Governance structures vary in scope depending on the issues that are most critical to each practice, but may encompass

issues such as clinical authority, hours, location of practice, the addition of new doctors, and compensation. A good governance model is characterized by inclusivity and collaboration, with a common vision, collective leadership, localized decision making, and a patient-first mindset.

Liquidity and Future Upside

Many practice owners have a significant portion of their personal net worth tied up in their practice. Partnering with a private equity firm allows them to “take chips off the table” while retaining a significant equity stake that creates a new and potentially larger liquidity opportunity at the time of the private equity firm’s sale.

Addition of Services and Equipment

Urologists in private equity-backed independent group practices can gain access to the capital needed to develop and integrate facility-based services and add new technology in order to provide comprehensive care to patients. Such services may include ambulatory surgery centers, radiation therapy facilities, laboratory, and pharmacy.

Alleviating Administrative Burdens

Independent physicians work in a much nimbler organization, compared with their counterparts



within a health system. By partnering with a larger, privately held entity, physicians can enjoy the benefits of a management services organization that can handle administrative tasks, such as information technology, human resources/benefits, and operations management.

### ***Network and Operational Enhancements***

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Practice owners can also gain access to a private equity firm's network, creating opportunities for relationships with suppliers, vendors, and partners they would otherwise not be able to access. Private equity partners can also help improve management processes and financial controls and implement best practices that have proven successful with other providers.

### ***Legal Protections***

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Importantly, physicians who retain equity enjoy legal protections not available to physicians whose practices are purchased by hospital ownership groups. They benefit from having a stronger voice in policy, disciplinary, and management decisions. Moreover, once a first private equity deal is struck, the legal protections included as part of that transaction survive and must be honored by subsequent private equity investors, unless physicians agree to renegotiate terms.

### ***Lowering Payer Costs***

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Allowing physicians to be successful in private practice environments also drives down costs for payers. According to a 2016 study, the availability of ASCs reduces US health care costs by more than \$38 billion per year, driven by lower payments than hospital outpatient department (HOPD) prices for the identical procedure, regardless of market or payer. The study also found that migrating surgical procedures from HOPDs to ASCs could save as much as \$55 billion annually.<sup>18</sup>

## **EVALUATING AND PREPARING FOR PRIVATE EQUITY INVESTMENT**

Although the potential benefits of private equity are evident, it is not a step that should be taken without a great deal of forethought. Taking on any business partner changes the ownership dynamic, and that holds true with private equity. Practice owners should take the time to understand the motivations, perspectives, and methodologies of prospective private equity investors and build consensus with their stakeholders.

### ***Short- Versus Long-Term Perspective***

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Physicians need to understand a private equity firm's perspective on time horizon. Private equity firms typically have a 10-year investment time period but may make decisions to accelerate growth or otherwise optimize results to take advantage of market conditions conducive to a successful exit.

Practice owners should ask questions to fully understand the firm's philosophy on investment for long-term sustainable growth rather than short-term gains and weigh it against how they want to run and grow the business. It is critical to understand the firm's target investment horizon and how that might impact investment in the business over time.

### ***Performance Goals and Incentive Structures***

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Agreement upfront on whether performance metrics are achievable is a critical piece of a successful private equity partnership. This discussion may need to involve senior professionals in the company whose workload, range of responsibilities, and authority may be impacted by the change. Practice owners also need to have thorough knowledge of how and how frequently performance will be evaluated, what criteria will be used, and the consequences of missing agreed-upon targets.

### ***Alignment of Stakeholder Interests***

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Candid discussions to align stakeholder expectations are another critical element of successful private equity partnerships. Physicians should establish a clear understanding with private equity partners of how much they are expected to invest alongside the PE firm. Within the practice itself, it is also important to have transparent conversations about differing concerns and motivations across different classes of physicians, older and younger, partners and nonpartners, to ensure that the agreement is providing fairness and not disenfranchising any group.

### ***Impact on Quality of Care***

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Some in the industry have raised concerns about private equity's impact on the quality of care. A good private equity partner should be incentivized to build a sustainable, profitable business with a strong reputation. It is critical to partner with a firm that balances strategies to drive revenue growth and profitability with a commitment to making clinical excellence and patient care paramount.

Once the decision to pursue a private equity investment has been made, it is important to not be a passive participant. The private equity firm will conduct comprehensive due diligence, including legal and regulatory reviews and a detailed analysis of financials and performance metrics. The practice owner must take the same approach, taking a deep dive into the potential investor.

Ask for details on the firm's track record of prior performance in similar investments, what the keys to success were and what influenced their decision to sell. Sometimes failed investments can be even more enlightening. Understanding what went wrong and why, as well as the firm's efforts to save the investment and the lessons they took away from the experience, can tell you a good deal about their strategic approach and character.

Speaking with management teams the private equity team has worked with in the past can provide additional insight into how the firm supports management, their availability to the senior team, the tone and frequency of interaction, and their real commitment and contributions to the company's growth and value creation. Taking a thorough approach to evaluating your private equity partner will help ensure the collaborative and trusting partnership that is essential for success.

No practice owner should take on this burden alone. Trade associations, such as LUGPA, provide forums for private practice leaders to learn about the factors they should consider in deciding whether to partner with private equity.<sup>16</sup> In addition to consulting personal advisors, outside legal and financial counsel from firms specializing in these transactions is advisable, and some practice owners may retain an investment bank to manage interactions with interested firms.

A final consideration independent of firm selection is the timing of a deal process. Seeking investment when revenues are declining is unlikely to result in a positive outcome. Ideally, practice owners should begin a deal process when the practice has had strong and consistent, if not growing, financial results for a year or more. Macro events, such as the pandemic, should also be considered, but if the practice is otherwise strong, they should not be a reason not to pursue a deal.

## UNDERSTANDING THE PRIVATE EQUITY TRANSACTION

To better understand how a private equity transaction with a urology group works, it is important to be familiar with the typical private equity governance model as well as the financial structure of a typical deal. In the following discussion, the authors take a closer look at both.

## Governance

In order for urology practices to pursue a transaction with a private equity group while remaining compliant with state rules and regulations, a new Limited Liability Corporation needs to be created within the corporate structure to which nonclinical, operational assets are transferred; this is commonly known as an MSO.

Through a holding company, physicians retain ownership of the MSO. The private equity partner purchases shares in the holding company from the physicians and claims a fair market value management fee. Typically, the MSO will have a defined role in back office management and will be responsible for nonmedical business and administrative functions, as well as employment of support staff and development of ancillary services. In a healthy relationship, decision making between the MSO and member practices will be collaborative and shared.

Under a standard regional "add-on" platform model, practices are acquired and subsumed by founding practices. By contrast, a national PE-backed urology model creates a balanced system that can be thought of as a *consortium* of regional market-leading partners, governed at a national level by a board of directors that consists of a group CEO, representatives of the private equity partner, and physician leaders. The board is responsible for driving the group's overall growth strategy, reviewing and approving practice merger candidates, and budgeting and making MSO human capital decisions. When new practices join the national group, their existing leadership remains in place, and they work with the national board of directors to identify and realize synergies, both operational and clinical.

## Financial Transaction Structure

Unlike public companies, where profits may be distributed to shareholders in the form of dividends or equity growth, in private physician groups, money earned by the company is distributed back to the doctors on an annual basis, which means that there is no profit for a private equity firm to purchase. The first stage of a private equity transaction therefore involves creating an "artificial profit" by physicians reducing their take-home compensation to create EBITDA (earnings before interest, taxes, depreciation, and amortization), also called an income "rollback." The rollback is calculated based on the spread between market compensation and the current profits of the group.

Once the rollback has been created, the private equity firm purchases it at a multiple. The purchase

multiple may vary depending on the specialty (target groups in specialties that have already been somewhat consolidated may command lower multiples), the importance of the target group (whether it is intended to form the nucleus of a new venture, a “platform,” or is an “add-on” acquisition to an existing “platform”), and the growth potential of the target group.

The rollback, multiplied by the purchase multiple, becomes the *total enterprise value*. Physicians are beneficiaries of that value, both in the form of immediate cash proceeds and in retained “rollover equity” in the new company. Generally, the private equity firm will expect a meaningful portion of the enterprise value to be rolled into equity in the new enterprise, in order to align incentives for growth between the practice and the private equity company.

For physicians, part of the power of the transaction is the fact that cash proceeds are subject to capital gains tax treatment as opposed to ordinary income. Even assuming that a physician receives no subsequent return on the sale proceeds through further investment and takes no equity stake, the “delta” between capital gains and ordinary income gained by foregoing income and leveraging private equity provides an immediate economic value that might otherwise take the physician a decade to make up.

If one considers that cash proceeds, rather than lying dormant, are reinvested in traditional investment vehicles at a conservative rate of return, the value of the private equity transaction further expands. However, this does not yet factor in an additional important element, the equity stake. By retaining equity in the company, the physician can profit from subsequent transactions, the “second bite”.

The benefit of private equity can therefore be longer than 10 years if a reasonable investment return on the cash proceeds is assumed and can be 20 years or more with only 1 successful additional private equity transaction on top of this.

Furthermore, the new revenue streams that can be unlocked by through scale and the private equity partnership, such as ancillary services, big data, and others, create “income repair” that builds back the compensation physicians surrendered in the initial rollback. While in the immediate aftermath of the transaction physician compensation will be lower, these growth initiatives and cost-savings can fill the gap over time.

When one combines the financial impact of upfront cash, the value of investing those proceeds, the value of rollover equity in a subsequent private equity transaction, and income repair, the private equity model can result in income potential

that is in excess of traditional independent practice models over time.<sup>19</sup>

## SUMMARY

Throughout the history of urology, clinical excellence has been the foundation and hallmark of successful independent physician practices. By working with the right private equity partner to scale nationally, urologists can maintain high standards of patient care and access the resources needed to invest in growth.

Given the dynamic nature of the sector, it is incumbent on practice leaders to continuously evaluate new opportunities, keeping in mind that maintaining the status quo is a strategic choice not lacking risk. As urology continues to evolve and provides favorable market dynamics to attract investors, urologists should strongly consider the advantages that a private equity partner with aligned interests can bring to the table. These advantages include immediate and future economic value, balanced control, and the resources to compete in an increasingly challenging environment, while maintaining independence.

## DISCLOSURE

The authors are officers of Solaris Health Holdings. Solaris Health Holdings has received private equity investment from Lee Equity Partners.

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