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Dealmaker's Corner: Acquisitions in the Booming Dermatology Practice Sector

This is the third article in a series in which Polsinelli health-care principal Paul A. Gomez and other dealmakers will discuss legal issues arising in health-care sector mergers and acquisitions.



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Introduction

Find a subsector in health care that is highly fragmented, offers multiple revenue streams, and has sustainable margins beyond that of many other medical specialties and you will be sure to find buyers in a race to consolidate the industry. In the final quarter of 2017, acquisitions and consolidation in the dermatology practice sector remains intense, led primarily by private equity firms looking to enter the sector and/or expand their respective geographic footprints. Other potential buyers, including other medical practices and health systems are also active in this space, but the average deal size is generally smaller when compared with private equity deals. With the dermatology sector projected to grow to \$16.1 billion by 2021, most observers are expecting acquisitions of dermatology practices to continue at brisk pace for the foreseeable future.

This article focuses on the factors driving private equity capital into the market; discusses the fragmented and relatively limited supply of dermatology practices; buyers' motivations, key aspects of the due diligence process, and approaches to valuation; and provides some practical tips for successfully concluding the sale of a dermatology practice to a private equity buyer. Although the focus of this article is primarily on recent large-scale consolidation of the dermatology sector by private equity firms, it should also apply in several respects to hospitals, health systems and physician groups that are considering such transactions. Although different deal structures may be available to the parties, depending upon transaction terms, applicable laws and regulations, and what jurisdiction(s) the deal is in, this article assumes that the deal structure is an asset purchase. For information on physician practice asset purchase acquisition deal terms and concerns, much of which also pertains to dermatology practice asset purchase acquisitions, please refer to our [previous article](#) in this series published in Bloomberg BNA Health Law Reporter.

Factors Drawing in Private Equity Funding

Market Fragmentation

According to an article published by QuintilesIMS approximately two years ago, 10,223 of the 13,847 dermatologists in the United States practiced in offices with five or fewer physicians. Further illustrating this fragmentation, 12,129 of the 13,847, or 87.6%, of all dermatologists worked in offices with ten or fewer physicians and approximately one-third of dermatologists continue to practice as solo practitioners. Current estimates indicate that the United States has approximately 4,000 dermatology practices.

In light of relative fragmentation in this sector, many private equity buyers (and other potential purchasers) are attracted to dermatology practices in part due to the promise of benefits that may be achieved over time through economies of scale associated with acquisition and consolidation. This includes consolidation of office and business functions such as billing and collections, scheduling, vendor services, and payer contract negotiations. Private equity investors hope that greater economies of scale and less fragmentation will lead to less redundancy and lower input costs, with greater consolidation contributing to more favorable payer and vendor arrangements. In theory, holding all else equal, consolidated dermatology practices should lead to more profitable practices and greater revenue. The trick, of course, is holding all else equal in a sector and industry that currently lives and breathes constant change on every front.

Multiple Sources of Revenue

Medical and Surgical

Per a survey published by the American Academy of Dermatology (AAD), approximately 65% of dermatology services focus on non-surgical medical treatment, while another 25% involve surgery, and about 10% focus on cosmetic dermatology. Reimbursement for common dermatology procedures, both medical and surgical tends to be relatively favorable. Having multiple sources of revenue, a portion of which is non-clinical has several potential benefits to a buyer, the primary benefit being that of a diverse revenue stream that may reduce the risk of an investment in the venture. For example, the number of cosmetic dermatology services and procedures may fall with a downturn in the economy, but Mohs surgery, used to treat skin cancers, may increase with the aging of the population. However, as further discussed below, care must be taken regarding certain related compliance and due diligence issues.

Cosmetic Products and Services

Cosmetic dermatology offers the practice and the buyer a unique opportunity to generate revenue from high margin cosmetic procedures and products including, without limitation, botox injections, liposuction, or through skin-care products and services.

Cosmetic dermatology is generally paid out-of-pocket by the patient. As a result, revenue derived from such products and services tends to be highly correlated with consumer discretionary income in relative terms, which itself tends to be highly correlated with the state of the national economy. When the economy is strong, a dermatology practice can realize additional revenue from the provision of these products and services. However, when the economy takes a downturn and such revenue may decline, the practice may still maintain more steady sources of revenue from other clinical and surgical dermatology procedures which have historically shown less correlation to discretionary income levels or national economic conditions.

Dermatology Laboratory

With increasing frequency, dermatology practices have in-office pathology laboratories which not only offer great convenience to their patients by offering more services in a consolidated location, but also provide them with an additional revenue stream. These laboratories are often staffed by a dermatologist either through direct employment by the practice, if there is sufficient volume, or through a contractual arrangement with another provider or practice (e.g., independent contractor agreement or outsourced to another party under contract). For those with sufficient revenue to cover staffing, supplies, and expenses, value can be enhanced. However, "value" is often a reflection of an investor's ability to put cash in his or her pocket. Therefore, income, as stated on the practice's income statement, is only the starting point in assessing value, as one must also consider the cash outlay necessary to repair and replace the equipment needed to generate laboratory revenue, income, and cash flow.

In considering all of the foregoing, and as discussed in more detail below, dermatology practices and potential private equity suitors must take care to ensure that business arrangements are structured carefully to minimize risk exposure under the Stark Law, Anti-Kickback law and other health-care fraud and abuse laws.

High Margin Subsector

The ability of dermatology practices to utilize physician assistants and to offer cosmetic dermatological services and products has helped many of these practices maintain earning margins, before interest, taxes, depreciation, and amortization (or EBITDA), beyond 20 percent.

Appropriate utilization of mid-level support provides operating leverage to a dermatology practice. As the mid-level's compensation is often a fixed salary with some incentive compensation component, every dollar of reimbursement in excess of this largely fixed level compensation falls directly down to the practice's bottom line having a favorable impact on EBITDA margins.

Cosmetic dermatological services generally offer revenue opportunities more favorable on a per procedure basis than most clinical dermatological services. Cosmetic products typically do not require as much utilization of provider time and related costs, further contributing to favorable margins.

More Insureds

With the passage of the Patient Protection and Affordable Care Act (PPACA), approximately 20 million people gained insurance coverage. This is having a favorable impact on the number of patients visiting dermatologists for preventative and non-elective procedures.

Favorable Demographic Trends

With the graying of American well underway, the number of patients seeking treatment for dermatological diseases that are positively correlated with age (e.g., skin cancer) is also growing at a rapid pace. It is estimated that there will be approximately 54 million Americans over the age of 65 by 2019. According to the U.S. Census Bureau, the percentage of our population that is 65 and over is expected to double from current levels by 2060. These demographic trends, among other factors, continue to boost demand for dermatological services and consequently volume, revenue, and profitability.

Strong Economy, Low Interest Rates, Cheap Capital

Generally, when the economy is strong, interest rates begin to rise via manipulation of the Federal Funds Rate by the Federal Reserve. As interest rates rise, access to funds becomes more expensive and consumers tend to borrow (i.e., spend) less. However, for some time now, interest rates have been very low concurrent with a strengthening national economy, which is having multiplicative effects on the dermatology sector.

Demand for cosmetic procedures increases as consumers have access to lower interest rate financing as some patients finance elective procedures through national healthcare financing companies or directly through the practice itself. A strengthening economy should lead to increased discretionary income, increasing demand for cosmetic procedures. Further, as private equity firms have abundant access to capital, one can expect this capital to be put to work creating increased demand for practices and their respective ability to invest in the support, technology, and capital investments needed to bolster and improve health-care quality and financial performance delivered by these practices. All of these factors are leading to larger transactions at increasing multiples of EBITDA.

Factors Driving Physicians to Sell

Money Talks

Perhaps one of the strongest motivational factors driving supply, is demand. As mentioned earlier, a relatively strong economy, plenty of liquidity available to private equity firms, and investors demanding returns is putting a lot of capital to work. Given that the supply of attractive targets for these private equity buyers are relatively fixed in nature, and demand for these practices is growing, multiples are increasing for practices that represent an acquisition target for these buyers. Moreover, the number of dermatologists (and physicians, generally), which has not grown in proportion to demand for their services, is not expected to increase any time soon. As multiples increase, deals get done, sellers talk to potential sellers, and word of the latest multiple turns a potential seller into a motivated seller. Put more simply, money talks.

State of the National Economy

For many of the same reasons that a strong economy generates demand for dermatology practices, it also has an impact on supply. With a strong economy comes an increase in discretionary income leading to an increase in cosmetic dermatology procedures leading many physicians to conclude that they should strike while the iron is hot and margins are strong. There was a correlative effect during the "Great Recession" when many dermatologists were impacted adversely not only by a dip in revenue from elective procedures, but also a decline in retirement portfolios (affecting the broader population as well), contributing to many remaining on the sidelines and delaying retirement that may have previously been on the near horizon.

Practitioners Want to Practice

As the health-care industry moves from volume to value-based payment models where high quality patient care must not only be achieved, but also documented and reported in compliance with multiple standards and requirements imposed by both law and contract, the administrative burden on physicians is increasing at unprecedented rates. Increasing numbers of physicians and group practices are finding the costs of investing in resources to handle this additional administrative burden (in addition to all other manner of business and office administration functions) to be unsustainable and causing them to divert far too much time away from focusing on the treatment of patients. Many physicians are opting to sell their respective practices in an effort to offload these administrative and business operations tasks to the buyer so that they can devote more time and energy to practicing medicine. The current uncertain health-care regulatory and payment environment may also be contributing to more physicians opting to sell their practices to a larger partner in an effort to shield them from unpredictable conditions, both economic and political.

Greater Access to New Equipment

Consolidators like well-funded private equity investors are able to leverage their relationships and resources to invest in and acquire expensive capital equipment at lower costs and with more favorable terms than a dermatologist in private practice and make possible the kind of equipment and other capital investments that many dermatology practices may not be able to pursue on their own. Obtaining access to this equipment creates a competitive advantage for these entities by allowing them to offer cutting-edge procedures and services, and improve quality of care and results.

Certain Legal Compliance and Due Diligence Concerns

Like physician practice acquisitions more generally, dermatology practice acquisitions typically involve several material potential legal compliance risks. These include, without limitation, risks posed by the federal Anti-Kickback Statute (state corollaries as well), the Stark Law (and state corollaries), the federal False Claims Act (and state corollaries), prohibitions on the corporate practice of medicine, licensing and certification, and antitrust. A more detailed discussion of these issues as they relate to physician practice acquisitions generally can be found in our [previous article](#).

However, below are certain related and additional legal compliance and due diligence issues that are specific to dermatology practice acquisitions.

Dermatology Laboratory—Compliance and Payment

If the practice targeted for acquisition has already established a dermapathology laboratory, it is critical to understand whether the laboratory is operating in compliance with the Stark Law, by meeting the in-office ancillary exception, and the Anti-Kickback Statute. Compliance with applicable state corollaries to both of these federal statutes should be assessed as well. Further, consideration should also be given to whether the laboratory is operating in compliance with federal and state anti-markup laws.

Dermatology practices with a captive pathology laboratory usually do so with the intention that, in addition to offering additional laboratory services to patients in a more convenient fashion, sparing them the need to travel to a different location for such services, the dermatology practice will be able to submit claims and collect payment for both the technical laboratory component and the professional pathology services component of the overall laboratory services. However, such arrangements that run afoul of the federal Anti-Kickback Statute or the Stark Law may result in violations that quickly add up to hundreds of thousands or millions of dollars in liability for improper payments and monetary penalties, disruption of an important revenue stream for the practice, and potential criminal liability in the case of the Anti-Kickback Statute.

Dermatology practices may be able to structure such an arrangement to comply with the in-office ancillary services exception under the Stark Law and/or an available safe harbor under the Anti-kickback statute. Compliance with the aforementioned exception requires careful structuring and documentation to ensure that the dermatology group and pathologists who read the laboratory tests operate as a "group practice" and that the laboratory and related services take place either in the same building (but not necessarily the same exact location or space) or a centralized building used by the group practice for provision of some or all of the group's clinical laboratory services or other DHS, as applicable. Billing for the services must also comply with billing requirements to ensure that billing is in connection with the right individual or group practice entity billing number.

Care must be taken to also examine such arrangements for compliance with Medicare and applicable state "anti-markup" rules and regulations, because in some cases, it may be permissible for the group practice to bill for ancillary services, but it may be limited in how much it can bill for such services, potentially exposing the group practice to payment liability and negatively affecting assumptions and predictions that support estimates of anticipated practice revenue.

Licensing

As discussed above, dermatology practices may have several service lines and streams of revenue, which may include procedures involving laser equipment and/or an in-office laboratory. Care must be taken to ensure that all required material licenses, certifications, permits, or accreditations are obtained to use the equipment and to offer, provide, and bill for such services in a compliant manner. Although some certifications or accreditations may be conferred by a federal agency, many are state-specific, so it is important to review and adhere to licensing and approval requirements of the state where the practice is located.

Staffing, Supervision and Scope of Licensure

As dermatology is a practice that often employs a diverse staffing mix of physicians, physician assistants, nurse practitioners, registered nurses, aestheticians, and administrative staff, among others, buyers should work with appropriate advisors to understand staffing ratios, compensation relative to market, capacity constraints, whether supervision protocols are being followed, and whether any incident-to-billing activities are conducted in compliance with the appropriate rules and regulations. Careful review should be given to ensure that mid-level practitioners are providing services that are appropriate and consistent with the scope of their respective professional licenses. Again, these requirements, including supervision rules and scope of licensure issues can vary significantly from state to state.

Coding Audit

Prospective buyers should review reports from the seller's billing system in order to review billing codes (i.e., CPT codes), with modifiers, units, charges, adjustments, and collections related to all payers (or at least, the most significant ones). These reports should be pulled as of the date of service so that the buyer and its advisors have the ability to analyze the practice's volume, procedure mix, collections ratios, payer mix, and productivity of each of the practice's providers and the practice as a whole by assessing work RVUs and collections. This analysis of work RVUs and collections on a per provider basis will also help the buyer assess the reasonableness of provider compensation on a historical and ongoing basis. Analysis should be performed with regard to use of appropriate coding procedures, training, and internal compliance audits to help assess the practice's billing compliance posture. This helps to understand not only potential related compliance risk but also to assess the strength of earnings reports and projections for future revenues. Buyers may consider having the legal counsel engage a qualified coding specialist to conduct the audit and review while preserving legal privilege protections.

Mohs Surgery (Support, Documentation, and Payment)

Mohs surgery has become more common in connection with dermatology practices but increased scrutiny has also accompanied this rise in use. Some of this scrutiny derives from findings that the rate of increase in use of Mohs surgery has outpaced the increase in incidence of skin cancer. In other instances, some payers are more apt to dispute use of Mohs surgery when treating skin cancer on certain parts of the body as opposed to others, the position taken sometimes being that less expensive procedures would have been sufficient. As a result, buyers, perhaps concurrent with the coding audit referred to above, should engage an appropriate expert (or perhaps have legal counsel engage such expert, as discussed above) to assess the

rate at which Mohs surgeries are performed (are they high compared to the average?) and the strength of the dermatology practice's compliance posture regarding appropriate documentation of medical necessity of the procedures.

Valuing the Business

Standard of Value

To the extent a transaction is subject to federal and/or state regulations requiring that the purchase price be consistent with fair market value, valuation experts will assist in providing a range of fair market value for the assets transferred per the terms of proposed asset purchase agreement.

Fair market value is defined in the Business Valuation Standards of the American Society of Appraisers as:

"The amount at which property would change hands between a willing seller and a willing buyer when neither is under compulsion and when both have reasonable knowledge of the relevant facts."

In the instance where Stark Law and the Anti-Kickback Statute applies:

"Fair Market Value means the value in arm's-length transactions, consistent with the general market value. 'General Market Value' means the price that an asset would bring as the results of a bona fide bargaining between well-informed buyers and sellers who are not otherwise in a position to generate business for the other party, or the compensation that would be included in a service agreement as the result of a bona fide bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party, on the date of acquisition of the asset or at the time of the service agreement."

This standard is further defined and interpreted in Internal Revenue Service [Revenue Ruling 59-60](#), in guidelines published by the United States Treasury, and further refined in numerous court decisions.

Fair market value cannot consider synergies that a specific buyer may bring to the table, or downstream revenue that the practice may generate for the buyer. Counsel will provide guidance on whether this standard of value applies to the transaction as in many private equity transactions, the fair market value standard does not apply and the price at which the parties consummate a transaction is arrived at by the amount buyers are willing to pay and the amount sellers are willing to accept. While the remainder of this section applies to transactions subject to fair market value, much of the content will also apply to private equity transactions not subject to such standard of value as most, if not all, investors are utilizing similar valuation approaches.

Valuation Approaches

In determining fair market value, an appraiser will rely on either a cost approach, an income approach, or a market approach. Within each approach there are several different methods that can be employed to value the practice. The cost approach is often referred to as the floor in a valuation given that the most common method of the cost approach, the net asset method, results in the fair market value of a practice's net assets, or assets less liabilities. Very little current market data exists related to fair market value indications for dermatology practice transactions, thus precluding the use of the market approach on many occasions. Therefore, a method under the income approach, the discounted cash flow method, is most often employed in opining on the fair market value of a dermatology practice since these types of practices generally produce positive cash flow.

The discounted cash flow method utilizes projected cash flow (i.e., prospective income adjusted for capital expenses, taxes, and working capital requirements) and relies on an appraiser's risk assessment of the practice. Value is correlated to risk. As the risk profile of a dermatology practice decreases due to any of the factors identified in this article (e.g., diversified revenue stream and is in compliance with all laws and regulations), the value of the practice will typically increase. When a transaction is subject to fair market value, an appraiser will need to consider each area of risk identified in this article to adequately quantify the applicable discount rate. In instances where the transaction is not subject to the fair market value standard, care should still be taken by the buyer and seller to consider the same areas of risk identified herein to properly develop an offer or know whether the offer is fair and that an appropriate discount rate is being used.

In addition to the forgoing, it should be noted that the discounted cash flow method can be applied in two different ways, one resulting in the fair market value of the entity's equity (i.e., assets less liabilities) the other resulting in the fair market value of the entity's equity and debt (commonly referred to as invested capital). In either scenario, the resulting value serves as the starting point from which to begin including and excluding any assets or liabilities that will or will not be included in the transaction. All too often the results of the discounted cash flow method are provided and relied upon as the indication of fair market value to be relied upon in negotiating a fair market value purchase price. Doing so, unless by accident, will not provide an apples to apples comparison between the asset purchase agreement and the valuation opinion, thus rendering the opinion of very little use for compliance purposes.

Financial and Operational Analysis

When valuing any physician practice, an appraiser generally relies upon several years of historical income statements, balance sheets, statements of cash flow, and billing/volume reports. Historical income statements are often reported on a cash basis derived from the timing of cash collections and expense payments. These do not reflect the time period in which revenue was earned and expenses were incurred, so the financial statements are typically adjusted to accrual basis to gain a better understanding of the actual month-to-month and year-to-year operations of the practice. Date of service billing statements are analyzed for a variety of purposes from projecting revenue, validating reported income on other documents, projecting compensation, assessing risk associated with the practice's payer mix and procedure mix.

It is very common for a dermatology practice to track revenue in its billing system from elective procedures and products. These items are generally paid out of pocket by the patient and generally do not have an assigned CPT code. Therefore, the practice will create their own five-digit alpha-numeric code and utilize the billing system's functionality for revenue tracking purposes. To the untrained eye the code may appear to be an actual CPT code, but in practice is generally referred to as a "dummy code." The practice usually maintains a crosswalk document that is useful in determining the proper classification of the procedure or product sale that is then either projected or excluded from the projection dependent upon the terms of the proposed transaction.

Tips for Success

The following are certain brief practical tips to help both the buyer and seller navigate and close the deal, and to help increase chances that the transaction will be considered a success by both parties over the long term.

Tip 1—Determine whether or not there is a business cultural fit between the parties.

Both buyer and seller should use the early stages of talks about a transaction and due diligence to assess whether there are sufficient levels of shared business culture, shared vision and trust. To the degree there is a fit on these levels, likelihood that the parties will be pleased with the day-to-day, post-transaction, and integration processes will improve. Parties with shared culture, trust, and mutual respect have a much better chance of overcoming obstacles (both seen and unforeseen) and forging acceptable compromises both during the deal and afterward. This may also lead to a higher probability of a favorable secondary liquidity event for all parties vested in the deal.

Tip 2—Determine the level of autonomy the seller physicians will have in operating the practice post-transaction and be clear about roles and governance.

Clinical autonomy generally contributes significantly to a physician's happiness in their day-to-day practice of medicine. To the extent this is expected to change in any way post-transaction, this should be communicated early in the negotiation process to avoid any deal-breakers down the road. The same guidance applies to the role a physician will play post-transaction on both a clinical and non-clinical level. State law and applicable prohibitions on the corporate practice of medicine may also play a critical role in addressing these matters.

Tip 3—Discuss and agree upon the amount of skin in the game required and the expected time horizon to the next liquidity event.

Communication related to the timeline of the secondary liquidity event and potential compensation at stake should happen as early on as practical given the differences in the risk-tolerance and value placed upon work-life balance among sellers. Many times a physician approaches a potential sale as an opportunity to mitigate risk and increase the proportion of time available for non-work pursuits, so expectations should be addressed clearly and early.

Tip 4—Selling the practice begins far before going to market (tip directed to seller physician practice).

A seller can do many things, as discussed herein, to help lower the risk level of an investment in its practice, potentially leading to a higher multiple and transaction price, and to otherwise help facilitate a transaction that will proceed all the way through to a successful closing. Pre-market compliance and coding audits (which should be conducted under the direction of legal counsel) can help to identify key actual or potential legal compliance and/or payment matters that can be addressed (or start to be addressed) prior to engaging in serious discussions with potential buyers and can help identify areas of weakness in compliance plans and billing functions that can then be improved. Corporate documents, employment contracts, shareholder agreements, payer agreements, leases, key vendor agreements and other documents and policies should be reviewed to ensure that appropriate consultations, consents, and approvals are obtained in a timely fashion and in order to avoid unwelcome surprises down the road as the transaction moves toward closing. All of this involves a high-level of commitment and sufficient resources (monetary, time, staff, and otherwise) from the seller, its owners, and its personnel. Sellers should move toward getting ready to go to market and to entering into a transaction with their eyes wide open about this and prepare themselves for the burdens this will entail while continuing to operate the practice and treat patients in the meantime.

Tip 5—Time kills all deals—commit to a deal timeframe and benchmarks.

Parties should establish and agree upon a reasonable, but prompt, time frame and benchmarks for completing the transaction. Doing so can help provide reassurance for both parties that the other party is committed and will devote the necessary time and resources to get to a successful closing. Failing to take this important step can lead to transactions that languish and drag on too long, inevitably giving the parties additional time to conceive of new issues that may place the deal in jeopardy, to consider other potential partners, or to simply lose interest in the deal.

Tip 6—Align with health-care counsel and advisors early on in the process.

Those with knowledge of the health-care industry and familiarity with the dermatology sector can bring valued added services to the entire process. Buyers and sellers can save time and resources, avoid potential monetary penalties post-transaction, increase the efficiency of the due diligence and valuation processes, and capture the value of all assets specific to a dermatology practice by engaging those with intimate knowledge of the regulatory and financial considerations pertaining to the nuanced dermatology sector early in the process.

Conclusion

There are several important factors driving interest in acquiring and selling dermatology practices. These include demographics, economic factors, favorable reimbursement, and diversified payment streams, fragmented markets and opportunities for increased value of the practice that can arise from consolidation, economies of scale and further strategic investment in the practice. Acquisitions in the dermatology practice sector should remain very active for the foreseeable future.

As parties continue to pursue dermatology practice deals, care should be taken to ensure that both legal compliance risks and assumptions about payment streams and financial growth, which are often closely bound together, are assessed with appropriate rigor and far enough in advance of the targeted closing date. Awareness of, and response to, common legal and financial risk areas, as well as other common deal pitfalls can help to reduce such risk, facilitate appropriate solutions and help lead toward carefully targeted and successful acquisitions.