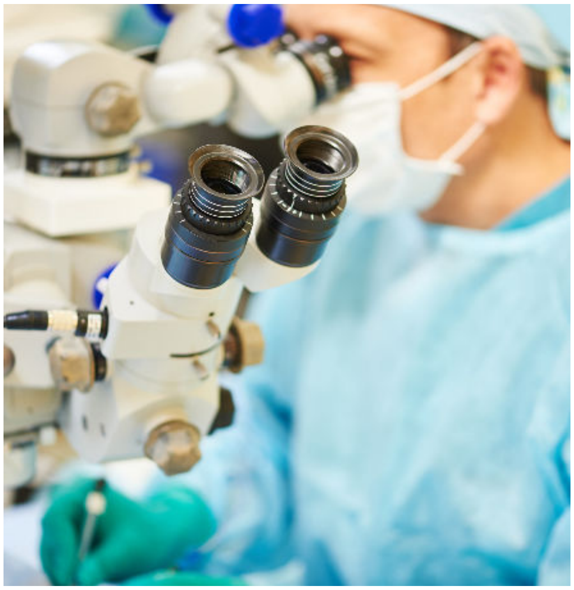

Ophthalmology 2024 Update: Entering a Mature Stage

By Eric Yetter

Summary

Private equity's investments in ophthalmology are entering a new, more mature lifecycle phase. We expect continued transaction volume, though with a smaller average deal size. We also expect many platform recapitalizations once private equity groups and lenders become comfortable with the interest rate environment.

Introduction

Beginning around 2016, innovative PE groups began acquiring large ophthalmology practices and formed Physician Practice Management ("PPM") companies around them. These organizations were designed to acquire, operate, and grow ophthalmology practices. The goal was to make these PPM organizations "investable", which has come to mean the following:

1. The PPM organizations are stable – procedure volumes are consistent and provider rosters experience low turnover. When a provider does leave, a new one can be recruited at a similar cost.
2. Cash flow, including revenue cycle and purchasing, is well managed.
3. Provider autonomy is preserved, especially clinically but also in day-to-day operations and scheduling.
4. The company has identified growth opportunities and demonstrates "same store" growth, including some or all the following:
   a. Growing provider rosters (adding additional physicians or optometrists)
   b. Adding new lines of service (for example, adding retina services to an anterior segment practice, or adding cosmetic services)
   c. Optimizing site of care delivery (for example, moving surgical cases from a hospital operating room to a more efficient ambulatory surgery center)

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d. Increasing reimbursement (for example, negotiating better reimbursement rates from insurance companies)
e. Decreasing costs (for example, negotiating lower prices on lens implants and other devices through the purchasing power of a larger organization)
c. Introducing operational efficiencies that either a) save money, or more likely, b) allow providers to see more patients (for example, introducing a new practice management or electronic medical records system that helps providers use their time more efficiently)
d. Increasing patient volume (for example, implementing a marketing program either to referral sources or directly to patients)

We believe ophthalmology PPM organizations that meet the above criteria will be the most highly valued in the marketplace. Equally important, they will enjoy more interest from both physician sellers and newly trained providers seeking employment, further accelerating their growth and value.

Current Landscape

There are approximately 35 private equity-backed ophthalmology PPM organizations today, with significant variance in size and activity. A typical ophthalmology PPM was founded in 2018 and has completed ten total acquisitions since (and thus, is now partnered with ten practices). The typical ophthalmology PPM is also regionally focused. For example, all affiliated practices are in the Southeastern US.

There are many exceptions on either side of the normal curve. Some PPMs have gotten very large, with partnerships across a broad geographic area and valuations likely north of $1B. Others have stayed small, only acquiring a handful of practices within a smaller geographic area. These PPM companies may be worth under $100M.

Certain areas of the United States have seen much greater PPM activity – notably the Southeast (including Texas), Eastern Midwest, and Mid-Atlantic regions (including, by our definition, New York and Pennsylvania). By contrast, the New England, West, Mountain, and Western Midwest regions have experienced generally lower partnership volumes, though activity is still significant. We believe over 400 total transactions have occurred, though it is difficult to account for all activity.

The Deal Environment in 2024

Transaction volumes in 2023 and 2024 have remained significant, though down from their peaks in 2019 and immediately after COVID-19. There are two key factors contributing to the deal environment in ophthalmology, which in some ways, are different from the larger market.

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1. "Platform Creation" transactions are very rare. We believe this is largely due to the specialty reaching a more mature stage where there are many players in the market. In our conversations, many investors feel that ophthalmology has gotten "crowded" (which makes sense, since Dermatology reached a similar "peak" in PPM count around 35 organizations). We have found that the number of PPMs in a specialty generally track with white space is available (how many independent practices there are). For example, there are many more dental PPMs than there are in ophthalmology, and many more ophthalmology PPMs than there are in Urology (where there are fewer practices to acquire).
2. "Exits" – where private equity firms sell a PPM company from their portfolio – have also been very limited. We believe this is largely due to the interest rate environment, which is in line with private equity and larger transactions across the marketplace. Investors tell us that they are waiting for more clarity on rates before going to market. The reasoning is simply that, with lower interest rates, a buyer will be able to pay more for the PPM asset as their cost of capital is lower and lending requirements are more flexible. Importantly, interest rates seem to affect these larger transactions ($100M to $1B+) much more than transactions for individual practices. The impact on individual practice transactions has been minimal.
3. "Add On" transactions have decreased somewhat, but steady volume continues. We believe this is mostly due to a maturing of the specialty as it relates to PPM. A more typical pace has set in since the flurry of initial ophthalmology acquisition activity quieted down. The PPMs themselves generally take one of three views:
   a. Some PPM organizations are "on hold" and not acquiring practices this year. They are focused on operational improvements and are getting ready to go to market themselves.
   b. Other PPMs (the majority, in our opinion) are still aggressively seeking acquisitions. They believe keeping up that trajectory is the best way to demonstrate future value to investors as they prepare to go to market.
   c. A third group (e.g., EyeSouth Partners, EyeCare Partners, Vision Innovation Partners) have already experienced recapitalizations and are young in their new sponsor's portfolio. We also see them being aggressive about acquisitions.

Our Expectations in 2024 and 2025

Generally, many of the largest and most desirable ophthalmology practices have gone to market and been acquired. There are others waiting to sell for various reasons, but they will do so at a steadier rate driven by their owners' objectives. This is similar to the 30-plus year-old market for ambulatory surgery centers. ASC transaction volumes reflect owners' desire to sell, or new centers being built and perfected, and then reaching a point where a transaction becomes desirable. Among our current client base, we generally see strong practices that have "reached the right time for them". They are looking for the ideal partner with the best valuation and terms possible. We think that profile represents most of the market for independent ophthalmology practices going forward.

Many of these deals include between $1M and $3M in transaction EBITDA, with larger practices being somewhat rare. We also believe PPMs do occasionally acquire practices with less than $1M in EBITDA, though such transactions remain less common.

Waiting to Recapitalize

We expect many PPM recapitalizations (the sale of a PPM company from one investor group to another) in 2025, assuming more clarity around interest rates arrives beforehand. Most ophthalmology PPM organizations are still with their founding private equity sponsor. And among them, most are at the end of the sponsor's desired hold period (typically 5 to 7 years). Most ophthalmology PPMs were formed in 2018 and 2019 and are now towards the end of that hold period.

In the interim, we expect a steady flow of add-on acquisitions driven by opportunistic physician sellers. These physicians are often completed by a buyer who is already active in the region. But we have observed significant interest from PPM organizations who are looking to expand their footprint through a large enough acquisition. This often takes place in adjacent states or regions.

We are seeing strong valuations in our own sell-side auctions, likely driven by competition among the existing PPMs as they seek to show continued inorganic growth.

Notable Trends in the Ophthalmology PPM Market

We have had multiple ophthalmology transactions on the market at a given time since 2017. As the industry has matured, we have observed the following trends:

- A general focus on ophthalmology vs. optometry. We have not seen many new optometry-focused organizations created outside the handful of existing, major players. Ophthalmology PPM organizations do tend to be more focused on adding optometry providers vs. acquiring practices.
- Almost all ophthalmology PPMs have gotten comfortable with retina, and now seek to acquire retina practices. More groups are now looking to add oculoplastics and other sub-specialties.
- Private equity firms and PPM operators are highly focused on physician alignment and view it as critical to their stability and worth. We have seen several items result:
    - A slight increase in post-transaction compensation, from an initial rate at 30% of net professional collections (for non-retina physicians) to the current observed average at 35%
    - Additional vesting requirements for rollover equity, often dependent on some sustained performance metric. If the sellers significantly underperform post-transaction, they can lose their rollover equity (an ownership interest in the larger PPM company)
    - Some buyers have introduced seller notes as a small part of their deal structures, which can also include a requirement for sustained performance.

- Higher interest rates have led to a more restrictive lender environment. For add-on transactions in ophthalmology, this often means buyers need “firmer” numbers to support a transaction. Lenders are scrutinizing pro-forma items and financial adjustments more closely. In our transactions, we work with expert transaction accounts to complete a very tight quality of earnings analysis whenever possible.
- Rollover equity (ownership in the larger PPM company) has settled in the 20-30% range. For example, a $10M transaction might be paid as $8M in cash and the remaining $2M as an ownership interest in the buyer PPM organization.
- Buyers may introduce an earnout, sometimes called a “contingent payment”, to bridge a valuation gap, especially when part of the financial structure is based on future performance. For example, the selling practice may get an additional payment if it hires a new physician within a year of the transaction closing.

Conclusion

Ophthalmology PPM is entering a more mature phase, categorized by steady transaction volumes. We believe that increased certainty around interest rates will trigger many recapitalizations, which will have a downstream effect on add-on deals. Provided those recapitalizations are successful, many conservative physicians may become more comfortable with the PPM model. The benefit of more physicians practicing with PPMs for a longer period could offer additional assurance around clinical autonomy and operational competence. This may make younger doctors more attracted to PPMs, facilitating growth, and creating additional long-term stability.

2024 remains a very attractive time for individual ophthalmology practices to explore a transaction with private equity. First, the effect of interest rates on individual practice sales has been limited. Second, most buyers desire to show continued growth and a robust acquisition pipeline prior to their own sales. Those factors have caused valuations to remain highly attractive, and many opportunistic physicians are looking at a sale process in 2024.

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