WEIGHING THE POTENTIAL BENEFITS AND RISKS OF A TRANSACTION

By Steve Grassa

The dermatology sector has experienced an unprecedented amount of consolidation activity in recent years, primarily driven by private equity investment in the space. The recent wave of private investment began in 2011 when Advanced Dermatology & Cosmetic Surgery completed a recapitalization with private equity firm, Audax Group. Since that initial investment, over two dozen additional private equity groups have invested into the specialty, creating a competitive environment for acquisitions with attractive valuation structures and robust transaction volume. As a result, approximately 10% of dermatologists in the country practice medicine with an organization backed by private equity dollars. As institutional capital continues to flow into the sector, shareholders of business are constantly faced with weighing the potential benefits and risks of a transaction.

From a business perspective, many of our clients are opting to align with a financial or strategic partner for myriad reasons, including: accelerating the growth trajectory of their business; alleviating the administrative burden inherent in running a practice; risk mitigation; and / or using a transaction as a succession plan to eventually transition out of the business. For owners with a vision for growth, pursuing a transaction can help gain access to the capital and resources needed to execute on lofty growth initiatives, whether that be by way of a de novo-focused strategy or an acquisition-heavy strategy. For smaller businesses that are looking for ways to adapt to an ever-changing healthcare landscape, aligning with a larger entity can provide board level support, increased clout with payors, and the ability to leverage the resources and back office systems of a larger organization to better compete on a local level.

From a shareholder perspective, the benefits of pursuing a transaction are rooted in risk mitigation and equity appreciation. Transactions are typically structured such that shareholders receive cash proceeds at the consummation of the deal along with reinvested equity. The upfront liquidity allows shareholders to monetize their equity in a favorable market and take some "chips off the table" as a means of diversifying their wealth away from business and regulatory risk inherent in running a dermatology business. Aligning with a partner backed by institutional capital provides greater resources to focus on billing and compliance than an independent organization could achieve on its own. Additionally, post-transaction, any debt that is incurred by the practice is no longer personally guaranteed by the shareholders. In most transactions, shareholders are also expected to maintain equity into the new enterprise which is set to grow in value as the organization grows over time until a subsequent liquidity event is realized upon the private equity firm exiting its position to another financial buyer or strategic consolidator. The private equity model gives shareholders the opportunity to diversify risk across multiple geographies and markets by benefitting from the organic and acquisition-focused growth of other practices within the broader platform. In this model, equity interests are fully aligned across the entire shareholder base of the parent company.

Although there are many benefits to a partnership, there are certainly risks associated with pursuing a transaction of this nature. The main sources of risk stem from choosing the wrong partner or a misalignment of incentives. Since these transactions are structured as true partnerships, often lasting for three or more years, philosophical and cultural fit between the buyer and the seller is of the utmost importance. Groups that have different visions for growth, diverging views on clinical matters and limited experience working in physician services are often the ones that are less successful through these partnerships. In a field such as dermatology, where clinicians are the assets of the organization, it is critical to employ a model rooted in incentivizing physicians properly and retaining clinical autonomy.

An influx of capital and potential options come with risks and rewards – as a result it's very important to vet multiple partners based on philosophical fit and not just valuation to ensure that you find the right clinical and operational alignment post-close. Barring any recessionary or regulatory pressures, Provident expects transaction volumes to continue as established platforms with institutional backing continue to compete for add-on acquisitions. ■

Provident's Dermatology Industry Coverage team includes Managing Director Justin Hand, Vice President AJ Shekar and Analyst Steven Grassa.

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