

Editorial

"In My Experience...The Current State of Private Equity in Orthopaedics"

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The authors review their experience concerning the current state of private equity in orthopaedics.

Over the last 15 years, private equity investors have become very interested in physician practice management at large, the provision of care has long been ripe for consolidation and investment in necessary best practices on the business side. The wave of investment began with more of the retail specialties such as dermatology, ophthalmology, dental. As time has gone on, the investor community has become more informed about the provision of care and is currently using that knowledge to explore investments in some of the higher acuity, surgically-driven specialties.

Orthopedics came into view in say 2016-2017, with the HopCo platform, built on the Core Institute, a value-based care driven strategy created in partnership with Frazier Healthcare Partners. In 2019, just three years after its formation, HopCo received a \$400M co-investment from Linden Capital Partners and Audax Private Equity. Since that time, we have seen 15+ platforms form around orthopedic strategies and overall musculoskeletal care.

Private equity firms have a few goals when investing in orthopedics, one being capital for growth. That's sort of the obvious one. If you're a physician who wants to build an ASC, or you might want to invest in a new MRI, depending on the size, scale and sophistication of your group, those projects take resources, time, and capital. Oftentimes, that capital might require a personal guarantee. From the physician standpoint, you're saying, "Do I want to put myself financially at risk for these expansion projects or is it possible to perhaps get a partner who can provide some capital, and some expertise in developing new ancillaries and service lines?" Private equity can supply the capital for these practice enhancements.

One of the less tangible benefits to associating with private equity and where private equity sees opportunities, really lies in the back-office resources. If you are an independent practice in orthopedics, you've typically been able to generate good revenues on a per-physician basis, so we see larger groups who have successfully made their own investments in back office operations. But for many groups, as you think about making a hire to run your recruiting function or to run your RCM and billing and improve that piece of your business, or if you're looking at perhaps payor contracting opportunities and bringing someone in who is 100% dedicated to that effort, you want to make sure that you have enough revenue to spread those costs over, so scale in terms of number of providers is key. One way to create such scale is to partner with private equity, aggregate multiple groups, and use the resulting income to make some investments in your practice from a resource perspective.

One of the biggest challenges across most specialties at the moment is the provider shortage. Provider recruitment is huge right now and is something that every one of our physician group clients at PGP sees as critical when considering private equity or strategic partners to help gain an edge. Maybe it's bringing in a residency or fellowship program to your practice and using that as a source for doctors and even mid-levels where appropriate. In addition to recruiting, maybe it's looking at what are we paying for billing? What are we collecting on our charges? Is there improvement to be had there?

All of these resources are things that private equity can and does bring to bear in all of physician practice management, but in particular in orthopedics. That was really the thesis

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behind a lot of these platforms that have formed. So, what does this term I used, "Platform" mean in the context of private equity in physician practice?

A platform in physician practice management and in orthopedics in particular, can take many forms. A private equity firm makes investments in businesses, and in this case in physician practices and in orthopedic groups. What that really means is, they're traditionally taking a controlling stake in the group through a restructuring of the economic model that exists in the group. In orthopedics, most groups today are on what I would call a net income model, which means that the physicians within the group are paid effectively the revenue that they generate less the cost incurred to generate that revenue. They take home their relative profit within their group as compensation, spreading incremental income from ancillaries, facilities, and extenders across the partners of the group. Given this paradigm, the income statement for those groups traditionally would show zero net income or zero profit (known as "EBITDA" in the context of a transaction). What a platform and what private equity is doing is, they are converting a physician practice to an investor model by effectively shaving off a certain percentage of profitability that is the excess created by the group and sending it to the management services organization ("MSO") to build the business side and drive overall growth. So, if you're a group who has an MRI or you have mid-levels or an ASC, you're likely able to generate for yourself a higher-than-market compensation relative to an employed physician producing at an equivalent level. The other important factor to consider when thinking about lowering your compensation to create this EBITDA is the concept of "income repair" which is the idea that as growth happens, there should be opportunities to recapture the income you gave up. The residual income becomes what is referred to as EBITDA, which is really a proxy for the profit of the practice. The term EBITDA actually means Earnings Before Income Tax Depreciation, and Amortization. That EBITDA is what you're in effect selling in a transaction with private equity.

Private equity firms want to help feed growth with investment and board advisory; they have no interest in managing the day-to-day of any practice and want to leave clinical decision making to the providers and their staff.. Moreover, a MSO is created that partners with the private equity firm and the practice to run all aspects of the practice in a professional way. This MSO is responsible for all aspects of the operations of the practice and the "MSO" is what is commonly referred to as the "platform." The goal of the platform is to professionalize operations and produce residual income from the practice, above and beyond the physician salaries, investing those profits in growth, adding additional practices to benefit from the infrastructure. Private Equity will evaluate investment opportunities and essentially say, "We have found a group that we can build around." We have found a group that has a certain level of, first of all, profitability, but second of all, maybe some infrastructure, and maybe even a non-clinical management team, where they're saying this is a great starting point for us. Let's buy this practice or make an investment in

this practice. Then let's go look to grow it through organic growth opportunities, ancillaries, recruiting, even margin expansion opportunities that come with scale like saving on supply or benefit costs; as well as inorganically, by acquiring additional high performing groups.

Practices can start their own platform or sign on to an existing platform. Traditionally, as mentioned earlier, the platform is acting as the management service organization, MSO, providing all the back-office support to the group, and the second, third, 10th groups who affiliate with the MSO keep their name and their local branding since, after all, healthcare is local. For purposes of patient interaction, the patients would not necessarily know that you were part of the platform, but you're able to tap into the platform resources.

The other meaningful and complex component of orthopedics is the opportunity to pursue value-based care in the form of bundles or other arrangements with payors. That capability and the ability to take on risk requires a certain level of analytical wherewithal, a certain level of understanding of how the payors work, certain self-introspection on where are we in terms of quality, and can we be successful in a risk-based or value-based payer paradigm?

All of those question marks are things that private equity sees as opportunities and orthopedic surgeons see as benefits to a partnership with private equity. As these platforms have formed, I think we've seen some trends in which certain ones have been more successful than others. For example, the regionally dense platforms seem to be the ones performing the best today. Those platforms who have dots all over the map, I think are looking to re-shift their focus to gain density in the markets that they're in, versus having more markets across the country. You've even seen some of the platforms, at least one in particular in the Northeast who had a presence previously in on the west coast and decided to divest that asset in the hopes of creating more regional density where they had scale already.

Now that we have a good sense of the benefits that these platforms can bring, we are seeing more orthopedic surgeons who have remained independent, maybe they have friends who partnered with a platform, and they're starting to see those benefits and starting to explore the private equity world.

This trend in the orthopedic community moving towards more adoption of private equity comes with more understanding of the value that private equity brings to the table, with more exploratory conversations starting to happen in the market. Because when you are well paid and you can use investments you've already made and roll that cashflow or distributions from your ASC into new investments, new clinics, funding guarantees as you hire physicians, things like that, you've been able to grow to a certain point on your own. But now that the model is starting to prove itself out, I think groups are getting more and more open to affiliations with private equity. I think from the pure private equity standpoint, those firms that haven't yet made their investment in private equity but still want to, there's still a number of private equity firms looking for a platform in orthopedics.

There are quite a few orthopedic platforms already. Some commonly known platforms include Spire Orthopedic Partners, Growth Ortho, HOPCO, Aligned Orthopedic Partners, United Musculoskeletal Partners, Orthopedic Services Management ("OSM"), Ortho Nebraska, and US Orthopedic Partners (see [market map](#)). These are some names of the platforms that you might hear in the market that exist today. So those platforms are really the management interface between the private equity firm and the practice. The platform exists to serve the individual practices who choose to affiliate with said platform.

For completeness, there is a fourth player in the private equity equation, with the first three being the practice, the private equity firm, and the MSO/Platform. This is the investment banker, which is what we do at PGP. The investment banker is the exclusive and trusted advisor to a physician group in pursuit or exploration of one of these transactions that we're talking about. We work to understand your goals and represent your best interests as you identify and negotiate with private equity.

By and large, investment bankers in this space are representing the sellers, the physicians who are looking to explore opportunities with private equity and use what we call a "process," which includes building a model around the practice that reflects the adjusted compensation model we discussed earlier along with any pro forma opportunities to capture ongoing growth initiatives in the practice, writing what we call the "book," which includes a series of data points and information about the practice's capabilities and what they could be, growth opportunities, market participants that could be add-on acquisitions, so on and so forth. The investment banker frames up the opportunity for the private equity market in a way they are used to seeing opportunities and then runs a process to use competition to hopefully determine the best outcome for a physician group seeking a private equity or strategic partner.

At our firm, Physician Growth Partners, we are focused first on finding cultural and operational fit, as well as ensuring physicians and their teams maintain clinical autonomy post-transaction. In our view, no investor should be telling a doctor how to treat their patients. The MSO will have or establish a local clinical governance board, involving multiple physicians to ensure clinical decision making lies with the physicians. The MSO will also have a governing board that helps steer the trajectory for the platform itself on the business side. We at PGP strive to align interests on all sides of the coin with a goal towards alignment of culture and philosophy toward growth. Economics are certainly part of any transaction involving a seller of any business and private equity, but no partnership is worth pursuing if cultural, operational and clinical needs aren't met. When we call our clients two years after they close a transaction, we are looking to hear that they'd do it over again and again. Those are the partnerships that last and end up

being successful on the economic side with "second bites at the apple", etcetera.

With private equity consolidation going on in many specialties across healthcare, and notably orthopedics, it can seem confusing on how to get started with private equity if you are an independent practice, no matter if you have 5 physicians or 50+. I think there's a couple ways that this traditionally happens, or at least the bug is planted in the physician's ear. One is, "I heard that my friend did a private equity deal with his or her practice and a private equity firm, and they created a new platform or they joined an existing platform. I wonder if I should explore that?" That's a route that we see quite often. Another route is the physician receives inbound information or interest of some sort from an existing platform or private equity firm or even a news article. It may be an investment banker reaching out or an article like this. Regardless, it's important to remember that there can be multiple groups interested in a given practice and every group needs to explore their options, not necessarily taking the first offer that comes in. For a number of reasons, you may have more options than you realize. It is important to understand that you should know the state of your practice and what your practice should yield in terms of valuation, as a starting point.

Concerning what types of groups that private equity is looking for, there's really no bottom end in terms of qualification. What matters is whether you'd prefer to be the platform or to partner with an existing platform, your options there will largely be dictated by the scale of your practice today. The beauty of partnering with an existing platform is that they want to add physician scale and apply their resources to as many physicians as they can. So, if you're a two or three doc group or a twenty-doctor group, there's traditionally going to be interest so long as there's a platform in or adjacent to your market. They won't establish a new beachhead in a market if you don't have a certain amount of scale. So that's really the deciding factor. If there are one or multiple platforms in your market, there's really no lower bound on whether they would be interested in acquiring your practice.

In summary, in the current physician practice management (PPM) private equity landscape in orthopedics, I think we're probably bottom of the second inning or top of the third. It's early in orthopedics still. There's still a lot of independent groups and a lot of consolidation to be had.

What we do know is that the independent practice of medicine, specifically helping people restore their mobility and function, is harder today than it was yesterday, and it'll be harder tomorrow than it is today for a variety of factors. Private equity and strategic partnerships provide an avenue to help groups better compete in an ever-more-challenging market where scale is a tool to better combat headwinds.

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