ADDICUS

PRIVATE EQUITY IS INVESTING IN

Aesthetic Plastic Surgery Practices

The Aesthetic Meeting 2023

CAPITAL ADVISORS

Sid Sekhar | April 18, 2023

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OVERVIEW

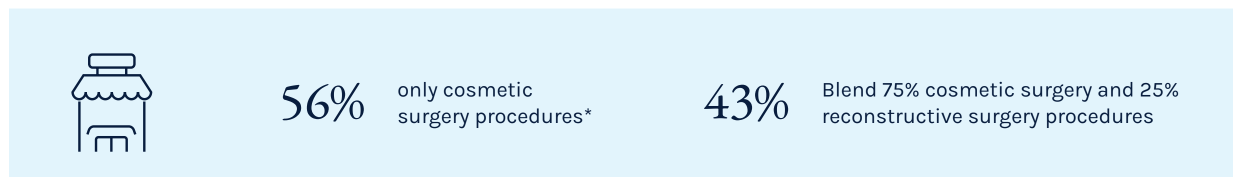
Aesthetic Plastic Surgery

$430,000
expected average salary

The cosmetic or aesthetic plastic surgery industry is ripe for consolidation as the market remains fragmented with numerous solo practitioners spread across the U.S. It comprises a wide range of procedures focused on enhancing the appearance of, versus reconstructing, various body parts. The demand for cosmetic surgery has experienced a recent wave for reasons such as being dissatisfied with appearance on video conferences, dubbed the "Zoom Boom," and a surplus of excess funds leftover from the coronavirus pandemic.

A high expected **average salary of approximately $430,000** and recent increase in the number of integrated plastic surgery residency program openings is a compelling reason as to why doctors choose plastic surgery as a specialty. Based on data from the San Francisco Match and National Resident Matching Program, the likelihood of an applicant to be accepted into an integrated plastic surgery residency program increased from **35% in 2010** to almost **73% in 2018**. Furthermore, demand for entry has remained steady. From 2010 to 2018, the number of integrated plastic surgery residency positions **increased by 142%**, and 194 spots were available in 2020.

Cosmetic surgeons typically have long careers, as demonstrated with an **average age of 49** as compared to an average age of 48 for surgeons overall. In addition, a simple majority of practitioners remain focused on cosmetic surgery. Based on 2022 data (practices focused to some degree on cosmetics), **56%** of cosmetic surgery practices perform only cosmetic surgery procedures. Conversely, **43%** of practices are a blend of **75%** cosmetic surgery and **25%** reconstructive surgery procedures.



Private equity groups spend significant time and resources monitoring the market before making any investments into cosmetic surgery providers. Trustworthy market size projections, juxtaposed with a fragmented industry marked by the primarily solo practitioners, provides a compelling opportunity for private equity groups to make significant investments.

*excluding reconstructive only practices

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$18.8
billion

Deal Scope & Structuring

As of 2021, the total U.S. Cosmetic Surgery and Procedure market is valued at $18.8 billion. Based on the amount of salary each surgeon is expected to earn per practice, which is a proxy for their revenue, private equity groups have already started to define their interest in the cosmetic surgery industry by wetting their feet in plastic surgery deals.

REPRESENTATIVE BUYERS

*The above private equity platforms are a sampling of buyers who are showing up in public research databases and other information mediums having transacted in Plastic Surgery. However, some of these transactions or strategies may be predominantly focused on related disciplines to cosmetic plastic surgery, such as those practices that are almost entirely reconstructive or may be predominantly dermatology with some plastics services.

Most private equity deals are leveraged buyouts, and buyers often pay 70% of the purchase price in cash to shareholders (less holdbacks and reserves that are specifically negotiated into the deal), with the remainder paid in the form of what is known as “management rollover equity” to physician partners who are staying with the practice or may be joining the practice as a partner.

Private equity groups are attracting plastic surgery targets by incentivizing their partner physician teams with significant rollover equity opportunities and granting them autonomy to continue practicing and operating their offices as desired (within reason and assuming performance remains constant or even improves). Through partnerships with practices, investors provide capital for expansion, acquisitions, and administrative support. After a private equity group acquires a practice, surgeons are expected to be paid in distributions pari passu, or equal to, to their rollover equity stake, in addition to a salary. It is not uncommon for surgeons to have opportunities for additional bonuses, including an initial earnout opportunity based upon certain performance or metrics after a deal is consummated.

Furthermore, as doctors should remain in leadership of their offices, they are also typically in charge of making all staffing and additional partner decisions. Therefore, it is expected that any new associate, staff, or extender contracts are steady replacements of current ones, and may include some grant of equity in the acquired entity or private equity platform.

Most private equity deals in this space are occurring for the first time in over a quarter century. Therefore, we believe that the market is still experiencing the first wave of sponsor acquisitions. We do not expect a true wave of secondary buyouts to occur until private equity saturates the space over the next five to seven years.

Economic Considerations

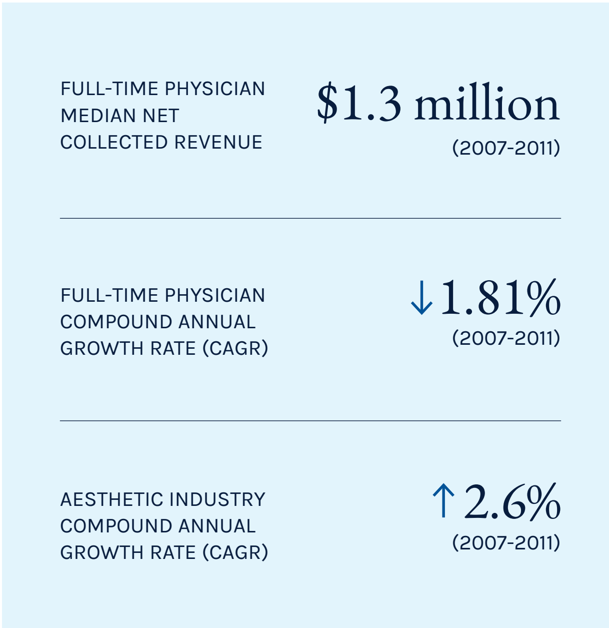
The current landscape is a pricing game. According to ASPS, the amount patients are willing to pay for cosmetic surgery procedures has increased, which should spur physicians to increase how much they are charging.

While patients are willing to spend "somewhat more" for procedures, fear of economic uncertainty is a pressure on patient interest. The June 2022 ASPS patient survey is supportive, in which the 45% of respondents — the largest group — reported patient interest in the face of economic uncertainty "staying the same." Thus, even if the amount patients are willing to pay has increased, interest in undergoing cosmetic surgery treatments has remained steady in the face of economic pressures.

Additionally, since the COVID-19 pandemic, there has been meaningful growth in demand for cosmetic procedures. Over three quarters of cosmetic practices have observed an increase in demand, and almost one quarter has reported their business has doubled. ASPS physician members also "agree" or "strongly agree" that patients are seeking combination procedures, supporting the notion that demand has increased. This is significant as the combination of heightened demand and consumer surplus powerfully supports expansion of total physician collections in the cosmetic surgery procedure industry.

DEMAND

As another uncertain economic cycle is navigated, we note the resiliency of the medical aesthetics industry through the Great Recession. Median Net Collected Revenue per Full-Time Physician in the industry was approximately the same in 2011 as in 2007, **$1.3 million**. However, the mean fell by a **1.81% compound annual growth rate (CAGR)** in the same period. While physician production trended negative to flat, total top-line revenue in the medical aesthetics industry grew by a **2.6% CAGR** from 2007 to 2011. This is because other sources of revenue, such as non-physician professional revenue service and retail sales revenue, grew during the period. In accompaniment, most major expense categories reduced in 2009, except for rent expenses, which slightly grew.



Lastly, it is no surprise that owners drew more money out of their practices in 2011 than in 2007 in absolute dollar terms. All else equal, diversification of revenue streams allowed aesthetics practices to continue operating profitably "through the cycle."

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How Are Practices Valued

Private equity groups typically determine the value of cosmetic surgery practices of interest based on a multiple of adjusted EBITDA, along with some consideration for the unique characteristics of the practice (location, quality and size of the facility, equipment/technology, patient/payor mix, upside potential, etc.). Adjusted EBITDA is an approachable proxy for free cash flow and stands for Earnings Before Interest, Taxes, Depreciation, and Amortization. It is easily calculated as follows:

Net Income (as it appears on your practice financials)
\+ **Owner Compensation & Owner Benefits** (health insurance, retirement contributions, auto, meals, etc.)
\+ **Associate Doctor Compensation**
\+ **Interest**
\+ **Depreciation**
\+ **Amortization**

Pre-Doctor Compensation EBITDA
– **Post-Closing Owner Doctor Compensation** (owner and non-owner doctors)

Adjusted EBITDA

In this calculation, owner and associate compensation is added back to EBITDA to produce pre-doc EBITDA. Subsequently, an adjustment to subtract "post-closing" owner compensation (usually negotiated between buyer and seller, generally based upon some base salary and possibly some percentage of collections associated with each doctor) is made, resulting in the base adjusted EBITDA that private equity groups will use to evaluate their potential acquisition target. Also, during the diligence process a good investment banker should work to ensure that numerous positive adjustments are made to net income adding back non-recurring items, anomalies, COVID adjustments, unrelated owner expenses, and things of the like to show net income in the most favorable light. Also, this professional should identify any exposures that may need to be addressed in the net income that could become negotiating points between buyer and seller.

Please note that practices generating **≤$1 million of pre-doc EBITDA** are not usually considered the most attractive deals for private equity groups. This is because there is not only a lower adjusted EBITDA after post-closing physician compensation is subtracted for private equity groups to earn, but also the purchase price isn't interesting enough for owners to be enticed to sell their practice. However, practices that generate **≥$1.5 million of adjusted EBITDA** net of physician compensation is the size range where we have observed deals occurring.

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Frequently Asked Questions

The following list is by no means exhaustive, but these encompass the most common questions we receive from sellers:

QUALITATIVE & QUANTITATIVE CONSIDERATIONS

Why should I consider selling my practice to a private equity group? The general strategy for private equity acquiring plastic surgery practices is to purchase various attractive practices that through centralized management, marketing, and other services can experience growth and synergy to drive additional cash flow beyond the original cash flow that existed at closing. Between growth in cash flow, efficiency, and scale of the group of practices, it is expected there will be a subsequent sale of the private equity platform where the sellers will experience tremendous upside in the transaction value of their rollover equity from the first transaction.

Could I endure having a "boss?" Many sellers have owned and operated their own practices for many years and are not used to having to answer to anyone other than their patients as a "boss." While generally private equity buyers want the practice to function largely the same as prior to the transaction, they may introduce certain services, technology, or other initiatives to drive efficiency that may be cumbersome or problematic. Further, while the buyer may be a little more hands off as long as the practice continues to perform, it is not uncommon for a practice performance to decline and for the buyer to get more hands on to protect and grow their investment. This situation could become a little more uncomfortable.

What is a reasonable "number?" Most sellers are not clear about what they need to gain from the transaction for it to make sense for them. There are a variety of reasons for this. Most notably, often clinical owners run various expenses through the practice and related entities for tax purposes but have lost visibility to their real personal expense load. Further, there are numerous elements, such as indemnity holdbacks, purchase price adjustments, fees, and post-closing compensation adjustments, that cause movements in cash proceeds to the seller. Additionally, there are other items that affect "net proceeds," such as net working capital adjustments, debt repayment, or other payments that perhaps weren't contemplated prior to the transaction or evolved late in the negotiation process. It would be wise to involve a financial professional to assist with projecting net proceeds and personal cash flow needs prior to getting too far down the road in entertaining a transaction.

Am I ready to go to market? Often sellers are not ready to go to market. Many plastic surgery practices consist of multiple entities so understanding revenue and cash flow may not be entirely clear. Additionally, many practices operate on cash basis and most buyers are going to want to perform a "cash to accrual conversion," to show revenue and cash flow on an "accrual basis." Further, as noted earlier, there are often clean-ups necessary to financials to normalize things, remove owner expenses, address anomalies, and potential pro-forma certain expected impacts or events that could drive additional shareholder value. It is wise to consider engaging a professional to assist in gaining an understanding of your normalized financials and adjusted EBITDA prior to going to the market unprepared.

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How should I consider taxes? Taxes are a huge consideration in a transaction with private equity. The earlier in a transaction a seller understands the tax implications with their particular practice setup, the better off they are. It is wise to have your CPA or other tax professional assess your structure and run detailed tax projections based on reasonable assumptions in the form of an asset sale. It is likely a meaningful portion of the purchase price may be treated as "ordinary income," and not as capital gain. This is particularly true for "cash basis" practices as they will have to pick up income for accounts receivable that has not yet been collected, as well as potentially trigger tax on supply inventories, fixed assets that have been largely or fully depreciated, etc. Further, the buyer may allocate purchase price to non-competes and other elements that may further drive ordinary income tax implications. Additionally, consider the structure of other future payments and the tax characteristics of those. It is wise to attempt to negotiate these tax issues as early in the process as possible. As the more the transaction process drags out, it is more and more difficult to get the buyer to accept changes that are favorable to the seller for tax purposes.

WHO IS YOUR BUYER & HOW ARE TRANSACTIONS GENERALLY STRUCTURED

How well do you know my buyers? Most private equity buyers are very good at developing relationships with potential sellers and gaining a level of trust. However, it is not uncommon for things to significantly change in the tenor of the relationship once the Letter of Intent (LOI) is signed. We often say that the power shifts to the buyer after the LOI is inked and, this phenomenon seems to continue to evolve throughout the process. It is not uncommon as a deal drags on through the late stages for the seller to experience "seller fatigue" and be more willing to give on seemingly small issues one by one. However, when you look at the number of "small issues" in aggregate, they can add up to be a meaningful or even significant change to deal terms. It is wise to do some substantial diligence on your potential buyer and interview a selection of previous sellers to learn about their experience to consider interviewing those sellers' law firms or investment bankers.

Do you know my buyer's strategy, capitalization, and track record? Almost without exception, a private equity buyer is going to finance a purchase transaction with some cash, bank and/or private debt, and "rollover equity" from the seller. First, it is wise to gain an understanding of the buyer's approach (could be relatively unique) to capitalization and their relative financial strength and banking relationships. Second, make sure and consider that the "rollover equity" in the transaction is exchanging your practice ownership for a portfolio or platform controlled by the private equity sponsor. The rollover equity is pinning your hopes to the effectiveness of the buyer's global strategy, commitment to the strategy, and financial strength. This setup presents considerable risk that the equity may or may not appreciate and could lose value completely if things were to go wrong. For this reason, in assessing personal needs from the transaction, it is wise for the seller to consider that the rollover equity may or may not have future value.

How are deals generally structured? Generally, a buyer will do an asset purchase of the clinical and non-clinical entities whereby they are purchasing "non-clinical assets" (A/R, certain non-clinical supplies and equipment, and goodwill). This purchase will consist of cash, holdbacks for indemnity and other reserves, and then some rollover equity in the new company or private equity platform company or holding company. Also, the clinical entity will continue to be owned by the physicians under generally a nominee/designee agreement where the private equity buyer has the proper controls, and all the cash flow is depleted from this entity between physician post-closing compensation and management fees paid to the buyer/platform entity/MSO.

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CLINICAL & MANAGEMENT

Who will direct clinical practice and patient care? Generally, there are prohibitions of clinical direction coming from anyone other than the doctors or a medical director, where applicable. In fact, most transactions, while structured as asset purchase transactions, focus on purchase of the non-clinical assets for the purpose of avoidance of getting into any type of clinical asset ownership or clinical management.

Who will direct day-to-day operations management? In most cases, the practice will stay mostly unchanged in terms of supervision of staff, hiring and firing decisions, supply and service orders, etc. The private equity buyer may offer suggestions for consolidation of certain services or contracts or providing services through a common back office, rather than having certain administrative overhead directly in the practice, and the buyer could force these issues. Where the buyer may exercise more control over the company is in situations where revenue and cash flow are sliding. However, keep in mind that the buyer wants to keep the medical providers happy and producing revenue and profit, so the healthcare provider does wield a certain amount of clout and control over the situation due to the fundamental nature of the company operating in a specialized healthcare field where practitioners are necessary to continue operations and are not easily replaceable.

QUALITY OF CARE & NEW PROVIDERS

Will patient care quality be impacted by a sale to a private equity group? This is certainly possible as the buyer does have a certain amount of control and can apply influence to providers in a variety of ways to drive revenue and profits. However, the clinical management and patient care is at the direction of the provider and/or medical director, and there are regulatory safeguards that provide some protection.

How can we recruit new physicians into a practice we do not own? This is a major concern for potential sellers entertaining private equity and an even larger concerns for upcoming graduates from plastic surgery programs and fellows coming into the market. There is definitely an impact in changing business model from entirely physician owned practices to private equity backed practices, and there is an impact to incoming physicians that would have normally been on an “earn in” or similar partner track. The theory promoted by private equity is that they will incentivize these new physicians with some granted equity and solid compensation that will get them ahead of the curve earlier. Also, the strategy is that these private equity-owned practices are some of the top performers in the industry. With professional management, they will be even more efficient and thus new incoming doctors will be better off overall. We will have to see how things play out whether this theory comes to fruition.

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OTHER CONSIDERATIONS

We generally advise plastic surgeons to separate their clinical practices from spa services to create better measurement and greater operating efficiencies, and we are seeing practices earning meaningful revenue from the spa services business line. Spa services are considered non-surgical, and some spa services may not even be considered health care services. In many states, such services can be delivered via non-MD professionals such as Nurse Practitioners (APRN's), Registered Nurses (RN), Physician Assistants (PA's), Aesthetic Specialists, or Medical Assistants. Treatments can include Age Management, Body Treatments, Botox, Chemical Peels, Coolsculpting, Dermal Fillers, Dysport, hCG Weight Loss, IPL Photofacial, Kybella, Laser Tattoo Removal, Laser Hair Removal, Make-up Treatments, Massage Treatments, Microblading, Microdermabrasion, Microneedling, Spider Veins, Skin Rejuvenation and Peels, vIVa Hydration, and Waxing Treatments.

Because spa services businesses have recurring revenue streams with less dependency on surgeons, they are likely to command higher multiples than clinical practices or hybrid practices. Furthermore, such businesses have different considerations related to taxes, disability, premature death, retirement accounts, fees and costs, uninsured and underinsured risks, exit and succession planning, revenue centers, and asset protection that enhance their attractiveness to private equity firms.

Summary

There is definitely an evolution of private equity activity in the plastic surgery space, including some activity in the cosmetic plastic surgery discipline, and we are starting to see the interest in this field increase. A transaction in the medical field (or really any professional services) is generally structured based upon historical earnings adjusted for post-closing professional compensation (a deduction against EBITDA) where a portion of the professional earnings is sold to the private equity platform, and then there is some meaningful management rollover equity. So, another way to think about it is the Adjusted EBITDA is sold for part cash and part equity in the new company (the equity rollover should be a "tax deferred" portion of the purchase price, whereas cash will likely be fully taxable).

One selling point that Private Equity firms will utilize as a positive feature of the deal is that in selling your practice you are converting your otherwise ordinary stream of income to capital gain at a lower tax rate. This can be true, but keep in mind certain parts of the transaction may still be ordinary income (purchase price may be allocated to accounts receivable, supplies, fixed assets, or non-competes) based upon purchase price allocation and many plastics practices being on cash basis tax accounting. Further, we believe it is important to have a trusted advisor who can provide projections and guidance on the financial impacts of the decision.

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Also, keep in mind, most of the Private Equity firms are going to be focused on higher producing practices that are generating post physician comp EBITDA of $1.5 Million or greater (not to say that lower EBITDA practices will not be sold). The reason investors are going to be looking at larger practices is to ensure they can pay the continuing physicians enough to keep them interested and still have meaningful EBITDA to sell and roll into equity. Obviously, the purchase price, in terms of cash, is all driven on EBITDA. Practices earning less than $1 Million in post physician EBITDA may see mid-single-digit purchase multiples and cash proceeds less than $5 Million, which will likely not entice a physician to part with their equity, take on a partner, and give up some level of meaningful management control.

Lastly, remember that in a transaction such as this, you are selling interest in your business and ceding actual control to a third-party investor, as well as rolling equity value from your practice into a new company, platform, or private equity firm. Based upon this, it is imperative to know who your potential partner is, understand their experience, and historical performance. Many sellers consider the value of their rollover equity at little to nothing as they don't know how things will pan out with the Private Equity firm's strategy and don't want to base their future financial success on the rollover equity having substantial value.

Much analysis should be done to ensure the cash proceeds and go-forward compensation needs to be meaningful enough to accomplish your desired financial objectives. As discussed earlier, it would be wise to engage a diligent financial advisor who can assist with projecting net proceeds after debt payoff, other liability settlement, taxes, etc. and further ensure that the expected future financial arrangements will satisfy your financial plan goals.

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