

## Business Case Studies

# Private Equity Partnerships in Orthopedic Groups: Current State and Key Considerations

Gary Herschman<sup>1 a</sup>, Hector Torres<sup>2 b</sup>

<sup>1</sup> Member, Healthcare and Life Sciences Practice, Epstein Becker & Green PC, <sup>2</sup> Managing Director, Co-Leader of Healthcare Investment Banking, FocalPoint Partners, LLC

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advantageous pathway for independent orthopedic groups to bolster their financial strength and better position themselves to weather the post-COVID-19 storm.

### CURRENT CLIMATE OF THE U.S. PHYSICIAN GROUP INDUSTRY

Over the past several years, M&A transaction activity within the U.S. physician group sector has accelerated in large part due to the proliferation of new market entrants - namely, private equity groups and vertically integrated healthcare companies. As a result, physician group M&A

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<sup>a</sup> GARY W. HERSCHMAN is a Member of the Firm in the Health Care and Life Sciences practice, in the Newark and New York offices of Epstein Becker Green. He serves on the firm's Board of Directors, and also on its National Health Care and Life Sciences Steering Committee. Prior to joining the firm, Mr. Herschman was Co-Chair of the Health Care Practice Group of a large regional law firm.

Mr. Herschman represents a diverse group of health care clients, including health systems, hospitals, large physician groups, nursing homes, long-term care facilities, ambulatory surgery centers, home health companies, private equity and other investment funds specializing in health care companies, ambulance companies, dialysis companies, imaging centers, medical marijuana/cannabis providers, specialty care networks, management services organizations (MSOs), and other health care businesses.

Mr. Herschman advises and assists health care providers in strategically positioning themselves in the rapidly changing health care marketplace. This includes advising clients in regard to consolidations, affiliations, mergers and acquisitions, as well as, joint ventures, physician alignment, clinically integrated networks, ACOs, MSOs, IPAs, PHOs, and population health contracts. Mr. Herschman also advises health care clients on regulatory compliance (federal and state), Stark, fraud and abuse, corporate compliance, HIPAA, government investigations, and civil and administrative health care litigation.

Mr. Herschman is a frequent speaker at local and national conferences on a variety of cutting-edge health care law issues, with a focus on strategic transactions for physician groups, hospital consolidations, affiliations and acquisitions, hospital-physician alignment transactions, the formation of ACOs and CINs, regulatory compliance issues (Stark, fraud and abuse, etc.), major clinical and facility joint ventures, recent government enforcement initiatives, reducing whistleblower exposure, and conducting "Stark" audits of hospital-physician arrangements. He also has authored many articles on current health care law issues published in local and national publications.

In addition, Mr. Herschman serves as Chair of the Fraud & Abuse Practice Group of the American Health Lawyers Association, and is a member of the Editorial Boards of Bloomberg Law's Health Law & Business and Health Care Compliance Association's Compliance Today.

<sup>b</sup> Hector M. Torres is a Managing Director and co-head of the Healthcare Investment Banking practice of FocalPoint Partners, LLC, a leading global investment banking and financial advisory services firm with offices in Los Angeles, Chicago, New York and Shanghai. With over 16 years of experience providing investment banking and financial advisory services to healthcare organizations nationwide, he has completed more than 25 M&A transactions with a cumulative value of more than \$2.8 billion in the last six years alone. His clients include large physician practices and groups, national and multi-regional health systems, academic medical centers, health insurers, non-acute care providers, medical device companies and capital providers to healthcare entities.

transactions have been occurring at a rapid pace, with 219 transactions announced in 2019, up 21.7% from 180 transactions in 2018; and growing at a compounded annual growth rate of approximately 29.6% since 2014 (see [Figure A](#)).

Even though there was slowdown in activity in the 2<sup>nd</sup> Quarter of 2020 due to the COVID pandemic, many industry experts believe the immense financial and operational pressures facing independent physician groups will result in increased levels of transaction activity in the second half of 2020, and beyond.

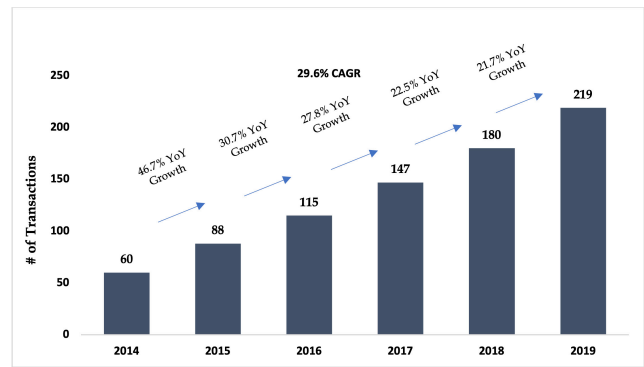
Concurrently, private equity's growing interest in the physician group sector stems from an investment thesis driven by themes highlighted in [Figure C](#) below. Despite the recent economic upheaval, the demand for physician group investments by private equity will remain robust. Conversely, the many secular challenges faced by independent physician groups will be amplified due to diminished, or in some instances temporarily non-existing, clinical revenues resulting from COVID-19's shelter-in-place protocols. These converging factors are projected to sustain, or potentially accelerate the level of private equity investment in physician groups.

## THE ANATOMY OF A PRIVATE EQUITY PARTNERSHIP

While variability exists from one partnership transaction to another, private equity firms usually seek to acquire a controlling interest in an orthopedic group by "buying out" a majority interest from the existing physician owners. Physician owners often continue to own a minority ownership interest via "roll-over equity" in the partnership investment platform. Thus, they share with the private equity investor in upside value appreciation post-transaction. This typically results in physician owners receiving a large upfront tax-advantaged payment (i.e. long-term capital gains) in exchange for the transfer of practice assets, and yielding business aspects of the practice, – but not relinquishing any control over the medical and clinical aspects of the practice.

Notably, in regard to the tax-advantaged nature of the purchase price payment referenced above – at lower, long-term capital gains, tax rates – it is possible that if tax laws change following the 2020 election, this beneficial aspect of a transaction could be reduced or eliminated. For this reason, many medical groups are actively assessing a potential transaction before the end of 2020 (or in early 2021).

There are essentially two types of investments that private equity firms make in physician groups. The first is called a platform investment, and this is typically the firm's initial investment in a single-specialty independent physician group that has a well-functioning infrastructure in place. For example, a private equity firm will go out in the market and find a large independent orthopedic group and make that acquisition its first investment in the orthopedic sector. The private equity firm will then use this platform – with a professional business infrastructure (including senior management team, effective revenue cycle, EMR/IT systems, virtual care capabilities, human resources function, managed care expertise, compliance program, etc.) – as the vehicle to make the second type of investment, called a bolt-on, or add-on investment. These usually involve acquisitions of smaller, independent orthopedic practices either in the same geographic region, or elsewhere, which can efficiently and seamlessly benefit from the platform's professional business infrastructure. This general deal struc-



**Figure A: U.S. Physician Group Total M&A Transactions by Year**

Source: <https://news.bloomberglaw.com/health-law-and-business/insight-health-care-consolidation-strong-in-2019-expect-even-stronger-2020>.

1. Lack of liquidity and working capital to fund ongoing clinical and non-clinical practice operations in the COVID-19 environment
2. Professional infrastructure and substantial capital to better weather future pandemics and/or economic slowdowns
3. Uncertainty regarding the "new normal" for medical practice following the pandemic.
4. Uncertain reimbursement environment and future regulatory changes
5. Continued consolidation by new market entrants (i.e. private equity) resulting in larger and more well-capitalized competitors
6. Acquisition of independent primary care referral sources by local hospitals, regional multispecialty groups and national companies (e.g., Optum) which also employ specialists (including orthopedics)
7. Shift from fee-for-service to value-based payment structure, population health and risk programs
8. Expertise in direct contracting with self-insured employers, as that model of healthcare delivery and reimbursement continues to grow;
9. Greater need for strategic working capital to invest in information technology, advanced data analytics, EMR, virtual care platforms, and new/expanded ancillary services; and
10. Shift from legacy hospital-based/inpatient setting of care to ambulatory/outpatient setting

**Figure B: 10 Key Operational Challenges Facing Independent Physician Groups**

- ✓ Highly fragmented industry ripe for consolidation resulting in opportunity to quickly realize sizeable investment returns from a growth-oriented strategy
- ✓ Supply/demand imbalance from an aging population and associated growing demand for clinical services relative to the number of clinical providers available and/or coming online
- ✓ Growth in healthcare spending and the associated essential service nature of clinical services result in the sector economic sustainability
- ✓ Shift to outpatient/ambulatory setting of care leading to increased opportunities to participate in high-margin procedures and other ancillary services with strong reimbursement trends

**Figure C: Drivers of Private Equity Physician Group Investment Thesis**

ture is unlikely to change in a post-COVID-19 environment, and as previously indicated, may even accelerate as smaller groups seek to partner with professionally managed, well-capitalized regional and/or national private equity-backed organizations.

## PRIVATE EQUITY DEMAND FOR ORTHOPEDIC GROUPS FORECASTED TO REMAIN STRONG

Private equity investment in orthopedic groups will be further supported by growth in the number of private equity firms seeking to invest capital within the clinical specialty. The demand for orthopedic treatment is continuing to increase nationwide, with inpatient and outpatient surgeries generating \$110 billion in revenue annually. At the same time, many physicians are experiencing increased financial pressures in the current healthcare environment. [Figure D](#) below provide a representative overview of the private equity partnerships that have been formed with orthopedics groups most recently.

The recent investment by private equity firms FFL Partners and The Thurston Group in U.S. Orthopedic Partners (“USOP”), announced in September 2020, serves as yet another case study of a strategic partnership between private equity and a platform orthopedic group. USOP is a full-service, integrated orthopedic care platform that provides the full continuum of musculoskeletal treatment to patients in the Southeastern U.S. Supported by diversified orthopedic sub-specialties, an ultramodern ambulatory surgery center, fellowship training programs and comprehensive suite of ancillary services, USOP will be a complete provider for patients seeking high quality, value-based surgical care. This example of a private equity investment in USOP is intended to help empower growth-minded physicians with a vision for providing best in class musculoskeletal care, while reducing back-office and administrative burdens. This approach will catalyze the expansion of USOP’s regional footprint in the Southeast through acquisitions of complementary physician practices to meet the strong demand for high quality treatment in the region.

### WHAT DOES PRIVATE EQUITY BRING TO THE TABLE?

At the highest level, private equity firms provide physician owners with liquidity, working capital and management expertise in both operational efficiencies and growth via acquisitions/partnerships with orthopedic groups. Many orthopedic groups can greatly benefit from private equity firms by:

- Monetizing the value of the medical practice versus the *status quo*, which usually means that upon retirement, relocation, death or disability, physician owners receive a nominal payment under their existing buy-sell agreements. Monetization in a private equity partnership includes all three of the following:
  - an initial upfront purchase price based on the “market value” of the practice;
  - a buy-out of physician owners’ rollover equity at fair market value upon unexpected events (such as death and disability), as well as upon retirement and relocation (after a certain minimum time period, such as 5 years), ; and
  - additional purchase price for all or part of their rollover equity when the PE investor “exits” via a sale of its interest in the practice to another, usually larger investor or healthcare organization.
- Helping realize cost savings through the consolidation and optimization of back-office functions and ongoing investment in areas, such as EMR, virtual

Private Equity Partner	Orthopedic Group	Transaction Completion Date
Initial: Frazier & Princeton Ventures Now: Audax Group & Linden Capital Partners	HOPCo/The CORE Institute	January 2017 (initial investment by Frazier & Princeton Ventures) August 2019 (partial exit, with investment from Audax & Linden Capital Partners)
Candescent Partners	Southeastern Spine Institute	April 2017
Varsity Healthcare Partners	The Orthopedic Institute	November 2017
Atlantic Street Capital	OrthoBethesda	September 2018
Lorient Capital	Atlantic Neurosurgical Specialists	October 2018
Revelstoke Capital Partners	Beacon Orthopaedics & Sports Medicine	July 2019
Kohlberg & Co.	Orthopaedic & Neurosurgery Specialists	July 2019
FFL Partners & The Thurston Group	U.S. Orthopedic Partners	September 2020

Figure D - Representative Private Equity/Orthopedic Group Partnership Transactions



 <p><b>Pros</b></p>	<ul style="list-style-type: none"> <li>✓ Upfront liquidity event in the form of tax-advantaged purchase price</li> <li>✓ Strong potential for tax-deferred “roll-over” equity participation</li> <li>✓ Incentive and alignment mechanisms for practice physicians post-transaction</li> <li>✓ Cost savings and operational efficiencies through back office consolidation</li> <li>✓ Improved performance through better practice infrastructure, access to capital and private equity management expertise</li> </ul>
 <p><b>Cons</b></p>	<ul style="list-style-type: none"> <li>✓ Loss of ownership and control of business aspects of practice</li> <li>✓ “Normalization” (reduction) in compensation to physician owners based on personal productivity</li> <li>✓ Strategic decision-making may be influenced by investment timeline and related priorities</li> <li>✓ Uncertainty related to long-term ownership</li> <li>✓ Partnership exploration and execution process can be time-consuming, burdensome, and distracting</li> </ul>

Figure E - Private Equity/Orthopedic Group Partnerships Pros and Cons

care platforms, data analytics, managed care contracting, value-based reimbursement programs, and practice infrastructure (such as lowering costs via economies of scale in group purchasing of health benefits, malpractice insurance, expensive equipment and supplies, etc.);

- Providing capital and resources to support growth, improve infrastructure, and optimally manage the burden of administrative functions.

### STRATEGIC OPTIONS - THE PROS AND CONS OF PRIVATE EQUITY PARTNERSHIPS

It is of critical importance for independent orthopedic groups to consider the benefits and potential risks of a private equity partnership. [Figure E](#) below provides a framework for orthopedic groups considering a potential private equity partnership.

A partnership with a private equity investor/platform can be an appealing option for orthopedic groups, but physicians must also understand the overall goals of private equity. While all of the medical, clinical and patient care aspects

of the practice will remain within the sphere of influence of the physicians in a private equity partnership, physicians may have very little influence on the business aspects of the practice. Business-related initiatives – such as the streamlining of administrative tasks, pursuit of economies of scale for purchasing, onboarding of new vendors, and installing new leadership teams within the practice – are all examples of areas in which the private equity investor will lead decision-making.

Further, understanding the transactional nature of private equity is an important consideration. Physicians who enter partnerships with private equity will typically receive a large upfront tax-advantaged purchase price and retain only a minority equity ownership interest in the practice's business platform post-transaction. As a result, if the private equity firm is successful and the platform is sold several years later, the physicians will have limited input regarding how and when this secondary transaction is structured and to whom the practice's business platform is ultimately sold. Buyers of the platform down the road may include health systems, "strategic practice consolidator organizations", national healthcare companies or other (usually larger) private equity firms. Again, the final decision as to whom the platform is sold will be made by current private equity partner.

Lastly, gaining comfort with private equity's motivations is paramount. Private equity firms are profit-minded investors that deploy a "bottom line" financial performance approach to the management of their investment. Private equity firms are typically seeking to rapidly develop scale within a clinical specialty, in order to build a larger, more valuable medical practice support enterprise which can then later be sold at an outsized profit.

## PRIVATE EQUITY DUE DILIGENCE OF ORTHOPEDIC GROUPS

Orthopedic groups should understand that before a private equity firm invests tens of millions of dollars (or more) in a partnership, it will conduct comprehensive—upside down, inside out—due diligence, and will incur an average of \$3-4 million on due diligence and other transaction expenses. This extensive diligence is time-consuming and can at times be distracting to the group's physicians and management team. The top 12 areas that a private equity will scrutinize include:

1. All financial books and records, and in considering "value," investors will have their accountants assess the practice's "EBITDA" (i.e. free cash flow) on a "GAAP" basis, which entails an extensive process of recasting financial figures from cash basis to accrual basis accounting (and which assessment is commonly referred to as a "Quality of Earnings Report" or "QofE");
2. Coding, medical record documentation, and billing & collection practices of the group, with a careful eye towards identifying any aggressive billing or coding trends that could later be challenged by Medicare or commercial payors and result in demands for recoupment;
3. Human resources and benefit programs, policies, and procedures to assess any potential employment and benefits-related exposure;
4. Any existing or past governmental or payor investigations and audits;
5. Any existing or prior litigation or disputes (commer-

cial, employment-related, or otherwise) that could result in exposure;

6. Diversity of payor mix, the preference being in-network participation with multiple payors (and non-reliance on any one managed care entity for a large percentage of its revenues);
7. All professional services agreements that provide revenue to the group (e.g., on call, medical directorships, clinical coverage, etc.), and related federal and state fraud and abuse compliance;
8. All debt and financing arrangements, including capital leases, and the terms of key real estate leases;
9. The group's corporate documents and shareholder and operating agreements reflecting governance, distribution, and buy-sell terms, as well as ownership structure of ASCs and other ancillary services;
10. Employment agreements for clinicians, including compensation and restrictive covenant provisions;
11. The practice's information systems, and any related cybersecurity and HIPAA/privacy breaches; and
12. Whether the group has a robust and documented corporate compliance program.

Orthopedic groups exploring private equity partnerships also need to conduct their own diligence on the private equity firms making partnership proposals. Investment bankers typically assist groups in this "reverse due diligence" by investigating each investor's prior experience with other physician groups. It is also imperative for a group's physicians to meet (preferably in-person or virtually) with other physicians who have partnered with a particular private equity firm, in order to obtain a first-hand account of what it's like to partner with the investor – for example, the organization's culture, whether it lived up to its promises during the transaction process, the benefits actually experienced/enjoyed from the platform's infrastructure, whether it truly is "hands-off" with respect to clinical matters, etc.

## KEY PROTECTIVE PROVISIONS FOR PHYSICIANS IN PRIVATE EQUITY AGREEMENTS

In a partnership transaction with private equity, there are many contractual terms that are important to focus on to protect the interests of physicians both in the short- and long-term. The top 12 contractual protections that are most important include:

1. Structuring the purchase price to maximize long-term capital gains treatment;
2. Other terms that materially impact purchase price, include understanding that most valuations (offers) from investors are based on the "enterprise value" of the entire group, not just the percentage being purchased, after (a) paying off all debts, and (b) is subject to having normalized "net working capital" at closing (cash and collectible accounts receivable), and to the extent of a deficiency (or overage) having a corresponding deduction (or increase) from net proceeds at closing;
3. Whether "tail policies" for professional liability insurance and directors and officer's liability insurance are required at closing, and how the cost of same is apportioned;
4. Ensuring that the rollover equity component of the purchase price consists of the same class of security as the investor (with identical financial rights), with

- customary dilution protections, and with board representation for “platform” and other large groups;
5. Post-closing employment agreements, including the term (e.g., 5 years), the specifics of compensation and bonuses (mostly based on personal productivity), and having fair (and narrow) termination provisions;
  6. Reasonable restrictive covenants, including: (a) geographically, preferably based only on a physician’s primary office location(s); (b) customary carve-outs for teaching, consulting, inventions, books, expert witness work, directorships and other outside positions; and (c) a timeframe, which usually is 5 years from the closing (under the purchase agreement), plus during the term of employment and for 1-2 years thereafter;
  7. Terms regarding the physicians’ post-closing indemnification obligation to the investor (i.e., to reimburse it for pre-closing liabilities and any breaches of their contractual representations), including how long representations and warranties “survive” beyond the closing, the maximum (or “cap”) on exposure, the “basket” (or deductible) amount, and potentially having the investor obtain “representation & warranty” insurance to substantially limit this potential exposure;
  8. How much of the purchase price is “escrowed” to be used to satisfy any indemnity obligations which arise, which depends on various factors and for how long (usually 12-24 months), and staggering the terms of the release of such escrowed funds (e.g., 1/3 every 6 months, etc.);
  9. What decisions require consent of the group’s “local leader” or “managing physician”, such as: hiring new physicians, terminating physicians, opening new offices, changing a physician’s primary office, terminating a key office lease, changing clinical protocols, etc.;
  10. Triggers for buyouts of a physician’s rollover equity, and calculation of the purchase price (which could vary depending on the trigger);
  11. The terms pursuant to which senior management (executives) of the group at closing, and current and future associate physicians thereafter, obtain equity in the platform entity; and
  12. The management and advisory fees (if any) that the investor is paid at closing, and more importantly, on an ongoing basis for management, entering subsequent add-on transactions, raising additional capital and/or financings, and sale of the platform (or otherwise).

## KEY QUESTIONS FOR ORTHOPEDIC GROUPS CONSIDERING PRIVATE EQUITY

With the broad spectrum of private equity options available to orthopedic groups today, physicians should develop guiding principles upon which the merits of a potential partnership can be measured. This approach helps validate whether private equity may be a good fit for your group, defines the characteristics of the optimal partner, and identifies the most important partnership terms.

Key questions to consider when contemplating a private equity partnership include:

### WHAT ARE MY PRACTICE’S GOALS AND OBJECTIVES?

Knowing what goals and objectives are most important to

you and your physician partners will validate whether private equity is a strong fit. For example: (a) is monetizing the value of physician ownership in the practice important? (b) is the growth of the practice a strategic imperative? and (c) is access to working capital, resources, and related support an absolute necessity for the group’s long-term survival and success?

### WHAT ARE THE NUANCES AND IMPERATIVES RELATED TO MY SPECIFIC LOCAL/REGIONAL MARKET?

Local market trends and priorities inform the need or desire for orthopedic groups to partner with private equity. For instance, a private equity partnership may be the right vehicle to provide the capital needed to achieve: (a) the ability to effectively compete with a large hospital system or multi-specialty group (especially if due to acquisitions of primary care physicians, there are fewer independent primary care referral sources in the community); (b) the need to lower operating costs; and (c) the need for substantial investment to improve practice infrastructure (EMR, virtual care, population health, etc.).

### HOW MUCH NON-CLINICAL AUTONOMY IS MY PRACTICE WILLING TO GIVE UP?

While physicians who partner with private equity will always continue to have the authority and responsibility to engage in the practice of medicine, how willing and to what degree is your practice able to surrender non-clinical and business/operational control? Many physicians today want to be freed from the administrative burdens of operating their practice so that they can focus entirely on the delivery of clinical care. Business-related changes, such as consolidation of back-office operations and related infrastructure, are just a few examples of areas in the private equity firm’s sphere of influence. Knowing upfront how much non-clinical autonomy your practice can live with is an important factor in the overall suitability of a private equity partnership.

### WHAT ARE THE POTENTIAL RISKS AND AREAS OF EXPOSURE WITHIN MY PRACTICE THAT COULD IMPACT ITS VALUE IN A POSSIBLE TRANSACTION?

Prior to considering a partnership with private equity, be sure to undertake a thorough review of the operational, financial, clinical, legal, and regulatory aspects of your practice. Any areas of risk or exposure could result in a material negative impact on the valuation of your practice, the structure of the partnership and/or the likelihood of the partnership transaction closing. Taking time up front to ensure your “house is in order” will avoid a reduction in the value of your practice (and if any such lower value is unacceptable, avoid wasting a lot of time and resources in the exploration process).

### WHAT IS THE CURRENT AND FUTURE IMPACT OF COVID-19 ON MY PRACTICE?

While private equity partnerships with orthopedic groups will remain buoyant, practice leadership teams and physician shareholders alike should prepare to address COVID-19’s impact on both historical and projected financial performance. While having been severely impacted by the COVID-19 crisis will not necessarily rule out the pos-

sibility of a private equity partnership, having undertaken measures, such as securing Federal relief aid funding and rapidly deploying telehealth medicine capabilities are just two examples of important elements that private equity investors will analyze when measuring the strength of your practice. Most importantly, investors will want to understand your practice's ability to recapture lost patient volume and revenue resulting from COVID-19, and how quickly patient volume and revenues likely will ramp back up to pre-pandemic levels.

## IS PRIVATE EQUITY THE RIGHT CHOICE FOR MY ORTHOPEDIC GROUP?

The top five factors orthopedic groups should consider when contemplating a private equity partnership include:

1. The importance of "monetizing" the value of historical physician ownership relative to forgoing non-clinical business/operational autonomy;
2. Local and regional market risks impacting the practice within the context of the changing reimbursement and regulatory programs, and increasing uncertainty in the post-COVID-19 healthcare industry environment;
3. The desire to increase the practice's operational performance and efficiency;
4. The need for working capital to invest and support practice infrastructure and growth (including the addition of more physicians, office locations, ancillary services, EMR, virtual care, etc.); and
5. The overall cultural fit, track record and orthopedic sector expertise of the potential private equity partner organization.

Before concluding whether private equity is right for your group, thoroughly explore the pros and cons based on the circumstances and characteristics of your practice. For orthopedic groups with a stated goal of monetizing practice ownership, attaining the benefits of scale and growing the value of the enterprise, private equity will remain an attractive option for the rest of 2020 and in 2021 (and, depending on various factors, possibly thereafter).

## ABOUT THE AUTHORS:

**Gary W. Herschman, Member, Healthcare and Life Sciences Practice**

*Epstein, Becker & Green, P.C.*

Gary W. Herschman is a member of Epstein, Becker & Green, P.C.'s Health Care and Life Sciences practice, and serves on the firm's Board of Directors in addition to its National Health Care and Life Sciences Steering Committee. Gary is a healthcare attorney who focuses on mergers and acquisitions and other strategic transactions. This primarily includes advising physician groups (including orthopedic groups and many other specialty practices) across the country on private equity partnerships, consolidations, merger and affiliations, as well as JVs, hospital-physician alignment, PSAs, Co-management, clinically integrated networks, ACOs, MSOs, IPAs, PHOs, and population health contracts. Gary also advises healthcare clients on regulatory compliance (federal and state), Stark, fraud and abuse, corporate compliance, HIPAA, government investigations, and civil and administrative healthcare litigation.

**Hector M. Torres, Managing Director, Co-Leader of Healthcare Investment Banking**

*FocalPoint Partners, LLC*

Hector M. Torres is a Managing Director and co-head of the Healthcare Investment Banking practice of FocalPoint Partners, LLC, a leading global investment banking and financial advisory services firm with offices in Los Angeles, Chicago, New York and Shanghai. With over 16 years of experience providing investment banking and financial advisory services to healthcare organizations nationwide, he has completed more than 25 M&A transactions with a cumulative value of more than \$2.8 billion in the last six years alone. His clients include large physician practices and groups, national and multi-regional health systems, academic medical centers, health insurers, non-acute care providers, medical device companies and capital providers to healthcare entities.

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