Understanding and evaluating deal considerations in the dermatology sector

An update for private equity investors

The dermatology sector is highly fragmented and has provided opportunities for private equity investors to capitalize on economies of scale, creating an attractive investment platform for buy and build strategies. However, the regulatory, financial, and tax issues surrounding dermatology practices can be complex and daunting as these practices potentially have elements of lab testing, in-office and ASC-based surgery, cosmetics and other services all under the same roof. This issue explores certain financial and tax issues that private equity investors should consider when evaluating investments in dermatology clinics.

Financial and operational considerations

Health care reform and MACRA impact on reimbursement—Health care reform poses significant challenges to the specialty of Dermatology, including narrowing Medicare Advantage networks and changing reimbursement patterns, including the impacts of the Medicare Access and CHIP Reauthorization ACT (MACRA). This new legislation repeals the Sustainable Growth Rate (SGR) formula for physician payments and sets updates to the Medicare Physician Fee Schedule for future periods. MACRA offers significant financial incentives for health care professionals to participate in risk-bearing, coordinated care models and to move away from the fee-for-service system. Investors should consider and evaluate the preparedness of dermatology clinics for new reporting requirements and performance standards in addition to potential financial impacts of future positive or negative payment adjustments. The Department of Health and Human Services estimates that by 2019, 99% of Dermatologists will be in a Merit-Based Incentive Payment System (MIPS). Of these dermatologists, 42% will have a negative payment adjustments under the MIPS program and approximately 58% will have a positive payment adjustment.[i]

In addition to financial implications, MACRA has other significant ramifications, including the public disclosure of physician quality scores, which can impact reputation and the operational requirements to adhere to the law. One example is the requirement for more robust clinical data capabilities (data governance, capture, collection, validation and reporting), which underscores the necessity to have consistent and complete coding practices.

Billing & Coding—As with any other specialty, the billing and coding practices of a physician on patient claims are paramount to correct reimbursement. Investors should consider a billing and coding analysis during diligence as there is significant potential for punitive financial and regulatory consequences related to improper compliance. An analysis during diligence would compare charges by dermatologists to CMS data for physicians of the same specialty to reveal outliers. When evaluation and management (E/M) codes are billed with a procedure, it is critical to confirm that the office visit is separately identifiable from the procedure performed. It may be required to denote that on the day a procedure or service identified by a CPT code was performed, the patient's condition required a significant, separately identifiable E/M service beyond the usual preoperative and postoperative care associated with the procedure that was performed. A significant, separately identifiable E/M service is substantiated by documentation that satisfies the relevant criteria for the respective E/M service to be reported. The circumstances may be reported by adding modifier 25 to the appropriate level of E/M service. However, the services performed that are routine to assess the patient prior or subsequent to a procedure are not separately billable and Modifier 25 cannot be utilized. Dermatologists are particularly vulnerable to issues with Modifier 25 and often bill an E/M code in addition to a procedure in instances in which CMS would not consider the evaluation to be separable from the procedure.

Revenue cycle—Dermatology services are typically reimbursed on a fee-for-service basis from commercial and government payers for medically necessary procedures and from private payers or individual patients for elective procedures and retail cosmetics. Each payer contract differs and can require varying degrees of patient responsibility. The resulting complexities result in variations between gross amounts charged and contractual rates agreed to with insurers or patients. Significant judgment can be required to estimate future expected cash collection and the value of accounts receivable. Investors should consider performing additional procedures related to accounts receivable and the revenue cycle to assess whether historical accounts receivable estimates have been realized through subsequent cash receipt and whether historical trends indicate current accounts receivable may be collectible. The ultimate realizeability of the collections can have a significant impact on historical or projected earnings. Understanding historical billing and collection experience is typically a key focus of the dermatology due diligence process.

Owner and provider compensation—Dermatologists may own a portion of the practice and therefore extract profits of the business through increased salaries or equity distributions. During due diligence, a pro forma adjustment should be considered for owner and other provider compensation commensurate with established post-transaction employee agreements. Additionally, investors may consider unpaid bonuses or accrued compensation in excess of pro forma run rates to be debt-like in nature. Investors should also have a comprehensive understanding of the contractual relationships between practitioners and third parties as there may be continuing obligations or regulatory and financial ramifications. Finally, providers may receive compensation based on a percentage of revenue or cash collections and therefore an adjustment to revenue may necessitate a corresponding adjustment to provider compensation run rate.

Unaudited Financial Statements—As many dermatology practices are smaller in nature and may not have significant debt, the dermatology practice may not be subject to a financial statement audit. Investors should be aware that if a company is unaudited, there is a risk that a financial statement audit may result in adjustments to the financial results of the

i Department of Health and Human Services, Federal Register Proposed Rules Volume 81, Volume 89, May 9, 2016, p. 212

company. To evaluate the cash flows of the company, Investors should consider performing a proof of cash flows during financial due diligence by comparing revenues recorded on the income statement to monthly cash inflows on bank statements.

Cash basis/modified cash basis accounting—Due to being smaller in scale, many dermatology practices operate on a cash basis or modified cash basis of accounting. Investors should consider utilizing accrual basis financial information to inform analysis and investment decisions as the timing of cash flows may not accurately depict the economic reality of the current state of the business. During the financial diligence process, the conversion from a cash basis of accounting to an accrual basis of accounting can require additional information and time from management.

De novo analysis—Dermatology practices are often comprised of several locations with centralized back office support. However, products and services may differ at each location such as retail cosmetics, Mohs surgery or dermatopathology offered only at a single location. Investors should consider performing a same-store analysis to identify outperforming or underperforming locations with the awareness that certain expenses may be allocated differently to each location. Additionally, a de novo analysis will help determine time to profitability for each location and inform investor models as to start-up loss expectations. Investors should analyze organic and acquired growth trends to support target projections.

Dermatopathology and in-house lab considerations—Achieving a certain level of scale may afford the ability to bring pathology lab services in-house and allow for additional ancillary revenue streams. However, when considering bringing pathology services in-house, or evaluating dermatology clinics that perform lab services, investors should consider that there are certain dominant players who often have exclusive arrangements with numerous payers.

Tax considerations

Tax structuring—Certain states require dermatology practices to be owned by medical professionals who are duly licensed or otherwise legally authorized to render professional medical services. This requirement is often referred to as the corporate practice of medicine doctrine. To comply with the corporate practice of medicine doctrine, investors may need to form legal entity/ownership structures, whereby a private equity-owned management company and the existing dermatology practice operate under the governance of various agreements. The formation of these structures, the ongoing operations, and the exit from these structures can have adverse tax implications for both buyers and sellers if not carefully structured and reported.

Independent contractors—Dermatology practices may treat certain professionals as independent contractors. The proper classification of an individual as an independent contractor vs. an employee is highly dependent on the facts and circumstances. Dermatology practices that misclassify certain individuals as independent contractors may be subject to income tax withholding exposure and payroll tax exposure, which could be sizable depending on the number of independent contractors and the lengthy statutes of limitations. Underpayment of payroll taxes could also impact a dermatology practice's quality of earnings.

Tax accounting methods—As described above, many dermatology practices utilize the cash method of accounting for tax purposes. Depending on the tax structure that investors pursue, dermatology practices may be required to report taxable income using the accrual basis of accounting during post-closing tax periods. The conversion from the cash basis of accounting to the accrual basis of accounting may trigger taxable income, creating adverse tax implications for buyers and/or sellers. As such, investors should address these tax implications in the letter of intent so that the parties clearly understand who is responsible for the taxable income that may have been deferred as a result of the cash basis of accounting. Additionally, if required to use the accrual basis of accounting for tax purposes, the dermatology practice will need procedures in place to substantiate its revenue recognition generally based on contractual reimbursement rates at the time of services and billings. If the dermatology practice has not historically implemented such procedures, additional post-acquisition system implementation costs may be required.

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