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WHITE PAPER

Orthopedic Research

Physician Compensation and PPM Transaction Structures

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Physician Practice Management (PPM) transactions involve acquiring and optimizing medical practices, as it is typical in musculoskeletal care. Physicians sell a stake for financial backing and operational support, improving efficiency while focusing on patient care.

What are PPM Transactions?

PPM Transaction Structure:

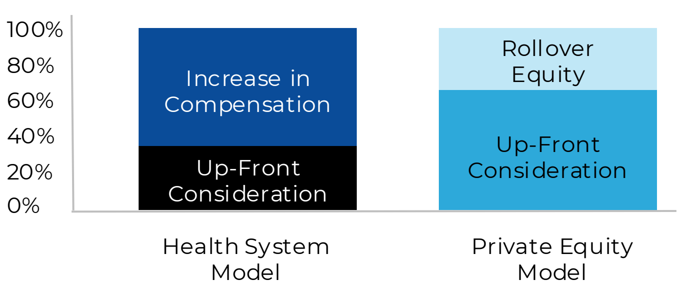
Physicians sign agreements to sell a minor portion of future earnings. These deals typically include:

- **Equity Participation:** Physicians retain ownership while receiving upfront capital.
- **Revenue Sharing:** Compensation (comp.) tied to practice revenue, aligning physician and management incentives.
- **Operational Support:** Management firms handle administrative functions, allowing physicians to focus on clinical care.

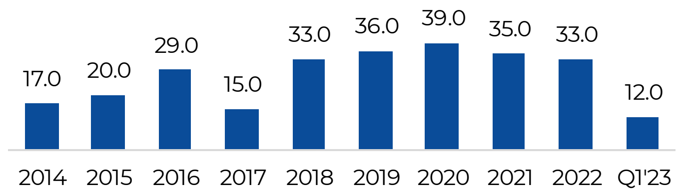
How Capital Sponsors (such as Private Equity) Support Orthopedic Practices:

- **Capital for Expansion:** Sponsor funds support ASCs, new equipment, and reduce financial risks for physicians.
- **Back-Office Efficiency:** Investment enhances hiring, revenue cycle management, and payer contracting, improving scalability.

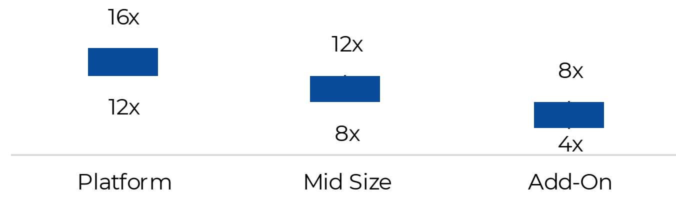
Transaction Structure



Private Equity Acquisitions of Orthopedic Practices



EBITDA Multiple Range



Physician Compensation in PPM Transaction

The capital sponsor model contrasts with the hospital/health system approach in several ways:

- **Upfront Payout:** Sellers receive a large initial payout, with 20–40% rolled into equity within the platform.
- **Scrape:** To account for EBITDA, total cash comp. is reduced—a process typically called 'scrape.'
- **Goodwill Considerations:** Private Equity deals often tie purchase price to physicians' personal goodwill, impacting taxes and requiring valuation.

Private Equity Transactions

Private Equity interest in consolidating physician practices remains strong, especially in orthopedics. Despite active PPM platforms, the market remains fragmented, offering continued transaction opportunities.

Scrape

A scrape limits or adjusts physician comp. post-acquisition to align with market salaries. This allows acquirers to aggregate excess pay, ensuring financial alignment with EBITDA targets.

1. https://journaloei.scholasticahq.com/article/120356-in-my-experience-the-current-state-of-private-equity-in-orthopaedics
2. https://healthcareappraisers.com/industry-outlook-orthopedic-practices-and-ancillary-services/
3. https://vmghealth.com/thought-leadership/blog/how-post-transaction-physician-compensation-structure-affects-fair-market-value-of-physician-practices/

Physician Compensation Structure in a PPM

Impact on Valuation:

Pre- vs. Post-Transaction: Shareholder physicians typically retain all earnings pre-transaction. Post-transaction, comp. adjusts, impacting EBITDA and practice valuation.

Inverse Relationship: Higher comp. = lower earnings available for sale → lower valuation.

Common Comp. Forms:

- **Salaries:** Base pay and productivity bonuses.
- **Benefits and Payroll Taxes:** Insurance, PTO, 401(k), and payroll taxes.
- **Discretionary Expenses:** Car, phone, and travel.
- **Other Comp.:** Profit sharing, cash balance plans, and other pension plans.

Physician Comp. & Transaction Impact:

- Comp. structures vary widely.
- Many shareholder physicians take all practice earnings, making post-transaction comp. key in determining monetizable earnings.
- Factors such as productivity, reimbursement rates, and expense management influence available comp.

The Valuation Process

Practice Valuation Process:

Valuation depends on market conditions, regulations, and reimbursement policies. Goodwill may be considered, though professional goodwill is often excluded.

Valuation is primarily done using three approaches, with EBITDA as a core metric:

- **Income**: Discounts future earnings.
- **Market**: Uses EBITDA multiples based on comparable transactions.
- **Cost**: Values tangible and intangible assets, especially for low-earning practices.

Comp.'s Effect on Valuation:

- High comp lowers cash flow and valuation; low comp increases both.
- Aligning comp. with market norms ensures stability post-transaction.

Conclusion:

- Practices have flexibility in service offerings and comp. models.
- Understanding the link between post-transaction comp. and fair market value is crucial for buyers and sellers.

Market Approach Scenarios

	Scenario 1	Scenario 2	Scenario 3
EBITDA (A)	$2,000,000	$2,000,000	$2,000,000
No. of Physicians (B)	3	3	3
Individual Physician Comp. (C)	$4,000,000	$4,000,000	$4,000,000
Total Physician Comp. (D = B*C)	$12,000,000	$12,000,000	$12,000,000
Pre-Comp. EBITDAPC* (E = A+D)	$14,000,000	$14,000,000	$14,000,000
Percentage of Comp. Purchased ("Scrape")	20%	30%	40%
Purchased Comp. ("Scrape") (F)	$2,400,000	$3,600,000	$4,800,000
Post-Scrape Comp. (G = D – F)	$9,600,000	$8,400,000	$7,200,000
Sellable EBITDA (H = E - G)	$4,400,000	$5,600,000	$6,800,000
EBITDA Multiple (I)	7.0x	7.0x	7.0x
Implied Valuation Indication (J = H * I)	**$30,800,000**	**$39,200,000**	**$47,600,000**

Excessive physician comp. can reduce valuation multiples, whereas under comp. may cause attrition or lead partners to add expenses, lowering valuation.

1. https://vmghealth.com/thought-leadership/blog/how-post-transaction-physician-compensation-structure-affects-fair-market-value-of-physician-practices/
2. https://www.appraisaleconomics.com/wp-content/uploads/2018/12/Medical-Valuation-PDF-.pdf
3. *EBITDAPC = EBITDA before Physician Owner Compensation

Pros and Cons of Sharing Compensation with a Capital Sponsor

Pros

Immediate Financial Gain: One of the primary advantages of selling a larger portion of comp., often referred to as a 'scrape,' is the immediate financial benefit it provides to physician owners. By agreeing to reduce their comp.—typically from 20% to 40%—physicians can enhance the practice's earnings before interest, taxes, depreciation, and amortization (EBITDA). This increase in EBITDA can significantly boost the practice's valuation during a transaction, allowing physicians to receive a higher purchase price when selling their practice to private equity firms or other management service organizations (MSOs) and receive an advantageous tax treatment for the proceeds (capital gains).

Potential for Higher Transactional Proceeds: The financial structure of many physician practice management transactions is designed to reward physicians for their willingness to scrape comp.. By lowering their earnings temporarily, physicians can create a more attractive financial profile for potential buyers, which can lead to higher transactional proceeds. The selling price is often based on a multiple of the normalized historical EBITDA, meaning that a well-executed scrape can lead to a substantial increase in the final sale price of the practice.

Cons

Long-Term Financial Implication: While scraping comp. may yield immediate benefits, it can have significant long-term financial implications. Physicians who agree to lower their pay may face reduced income during the period leading up to a second sale, which could affect their personal financial stability. Furthermore, if the practice's performance does not improve as anticipated post-transaction, physicians may find themselves in a less-than-ideal income scenario due to their initial decision to scrape, though the upfront capital provides a mitigant here.

Possible Negative Impact on Practice Growth: As discussed, long-term financial stability can also be jeopardized if physicians are unable to maintain their previous income levels after the transaction. Additionally, if the practice's growth does not meet expectations, the anticipated benefits of increased EBITDA may not materialize, leading to dissatisfaction among physician owners and newer physicians joining the group. This situation can be exacerbated by factors such as market fluctuations or changes in patient volume that affect overall practice profitability.

1. https://www.ecgmc.com/insights/article/3016/unlocking-value-the-role-of-personal-goodwill-in-physician-practice-deals
2. https://healthcareappraisers.com/personal-goodwill-a-common-multi-million-dollar-component-in-physician-practice-transactions/
3. https://www.healio.com/news/orthopedics/20230828/consider-operational-financial-structures-before-private-equity-investment
4. https://www.foley.com/insights/publications/2023/01/physician-recapitalization-transactions-issues/

Multiple scraping scenario's

Scenario 1

Equal ownership equal value

Scenario Breakdown: In this case, post-transaction comp. for physician owners is equal because their pre-transaction comp. was also the same. However, in a different scenario where pre-transaction comp. varied based on individual productivity, the post-transaction arrangement could differ as well.

Physician	Pre-Transaction Compensation	Pre-Transaction Ownership Percentage	Compensation Scrape at 30% (Synthetic EBITDA)	Value Contribution at 10x the EBITDA
A	$500,000	25%	$150,000.0	$1,500,000.0
B	$500,000	25%	$150,000.0	$1,500,000.0
C	$500,000	25%	$150,000.0	$1,500,000.0
D	$500,000	25%	$150,000.0	$1,500,000.0

Scenario 2

Equal ownership, unequal value

Scenario Breakdown: In this case, the selling physicians equally own the practice; their value contributions differ due to varying pre-transaction comp. Sale proceeds must be allocated based on ownership to qualify for tax benefits, but exceeding this allocation triggers taxation as ordinary income, potentially causing conflict among higher contributors. To address this, physicians may sell personal goodwill separately to receive proceeds aligned with their contributions while maintaining tax efficiency.

Selling Personal Goodwill: Personal goodwill is an intangible asset unique to each individual, reflecting the reputation a physician has cultivated over the years with patients, colleagues, and the community.

Physician	Pre-Transaction Compensation	Pre-Transaction Ownership Percentage	Compensation Scrape at 30% (Synthetic EBITDA)	Value Contribution at 10x the EBITDA
A	$800,000	33.3%	$200,000.0	$2,000,000.0
B	$6,00,000	33.3%	$1,50,500.0	$1,505,000.0
C	$7,00,000	33.3%	$1,75,000.0	$1,750,000.0

1. https://www.ecgmc.com/insights/article/3016/unlocking-value-the-role-of-personal-goodwill-in-physician-practice-deals

Factors Influencing Decision to Scrape

Financial & Strategic Incentives:

- **Immediate Financial Gain**: Physicians receive substantial upfront payments when selling to private equity, taxed at lower capital gain rates compared to annual income. This financial windfall allows for risk reduction and diversified reinvestment.
- **Financial Risk Diversification**: Selling shifts financial risks—such as market fluctuations, healthcare policy changes, and operational disruptions—to private equity, which can be particularly appealing for physicians nearing retirement.
- **Growth & Equity Upside**: Many physicians retain a portion of equity in the new entity, benefiting from future growth as private equity firms scale operations and drive higher valuations.

Operational & Competitive Factors:

- **Reduced Administrative Burden:** Private equity acquirers take over practice management, regulatory compliance, and operational responsibilities, enabling physicians to focus on clinical care.
- **Market Pressures & Economic Trends:** Rising education and practice costs make independent ownership less viable, leading many physicians to prefer employment over ownership. This shift increases private equity's attractiveness as a buyer.
- **Regulatory Challenges:** Compliance with complex laws such as Stark and Anti-Kickback regulations makes private practice ownership less financially viable. Private equity-backed entities often have the resources to navigate these challenges.

Post-Transaction Considerations:

- **Physician Comp. & Sustainability:** Comp. adjustments tied to EBITDA reductions must align with regional cost-of-living standards to ensure financial stability and job satisfaction.
- **Retention & Incentive Risks:** Poorly structured post-transaction incentives can lead to dissatisfaction, productivity declines, and physician turnover, impacting long-term practice stability.
- **Market Comparisons:** Buyers must benchmark transaction terms—including valuation and comp.—against industry standards to avoid overpayment or unsustainable agreements.

Growth Opportunities & Risk Factors:

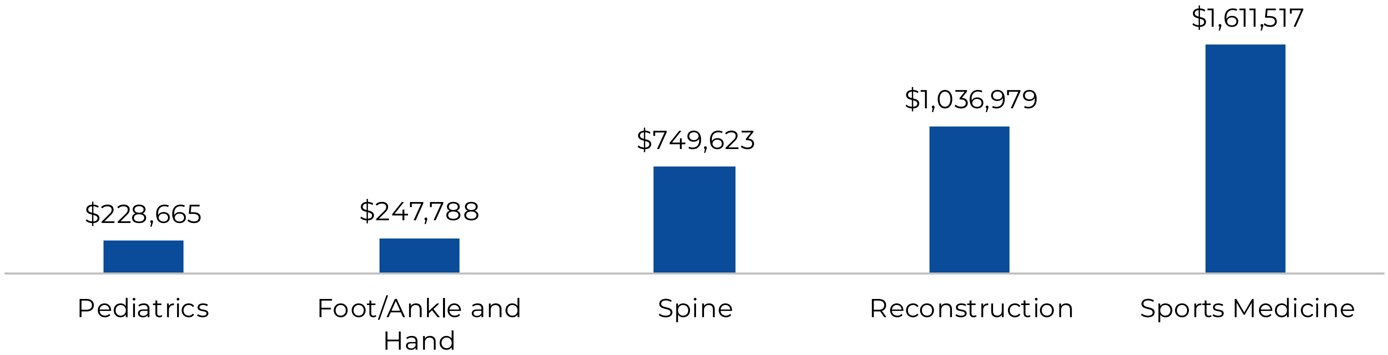
- **Expansion Potential:** Practices in high-growth specialties (e.g., dermatology, ophthalmology, gastroenterology, orthopedics, and musculoskeletal care) command higher valuations due to scalability.
- **Young Physician Base:** A younger team ensures long-term growth potential by increasing patient load and practice sustainability.
- **Ancillary Services:** Comprehensive services (e.g., imaging, diagnostics, and surgery) increase patient volume and transaction attractiveness.
- **Operational Risk:** Challenges like getting teams to work well together and handing over admin tasks can add risk—especially for practices that depend on just a few top-performing doctors.

1. https://edgepoint.com/our-insight/physician-focus-should-i-sell-my-practice-to-private-equity
2. https://www.healthcarebusinesstoday.com/demystifying-valuation-and-deal-structuring-in-physician-practice-acquisitions-ebitda-vs-ebpc/
3. https://vmghealth.com/insights/blog/valuing-a-practice-in-a-physician-practice-management-context-its-all-about-salary-sustainability-and-succession/
4. https://pubmed.ncbi.nlm.nih.gov/35977319/#&gid=article-figures&pid=figure-2-uid-1

Orthopedic Physician Compensation by Region

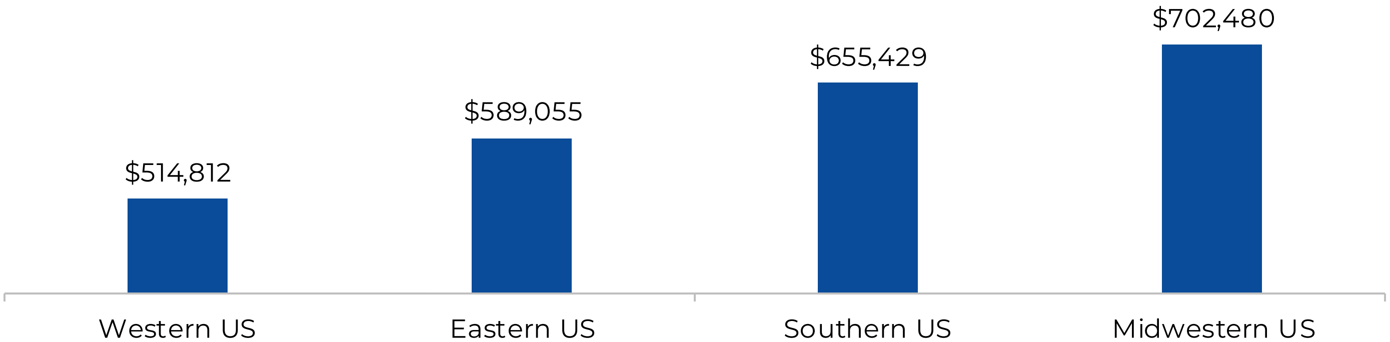
Post-transaction comp. of an orthopedic physician depends upon several factors, such as experience, practice setting, geographic location, and subspecialty. Overall salaries of physicians in the US increased by 3% between 2023 and 2024, in which orthopedics secured the top spot with the highest-paid medical specialty. Here is a classification of salaries earned by orthopedic surgeons by subspecialty and region.

Average Base Pay of Orthopedic Surgeon by Subspecialty



Income levels differ among orthopedic subspecialties, with spine surgeons, reconstruction, and sports medicine specialists typically earning higher base salaries due to the complexity and high demand for their skills.

Average Basic Pay of Orthopedic Surgeon by Region



Practice location significantly affects salaries, with states such as New York and California offering higher pay than places such as Alabama or Arkansas. However, less populated areas may provide competitive comp. and incentives due to a shortage of specialists. Interestingly, smaller metro areas sometimes offer higher salaries than larger cities, as demand and the local supply of orthopedic surgeons can make these areas a strategic choice for maximizing income.

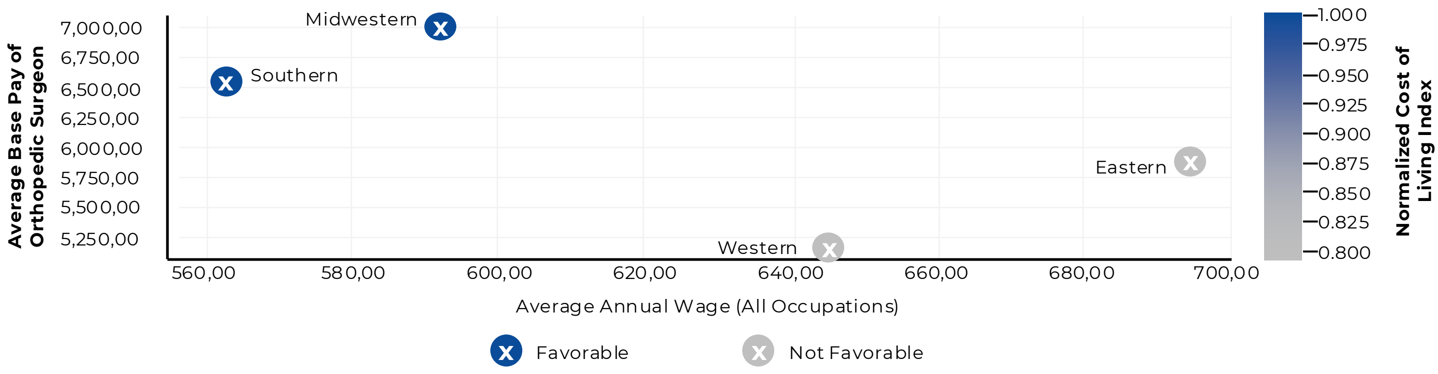
1. https://www.caliberhealth.com/blog/how-much-do-orthopedic-surgeons-make
2. https://physiciansthrive.com/orthopedic-surgeon-salary/
3. https://journals.lww.com/jbjsoa/fulltext/2021/12000/disparities_among_industry_s_highly_compensated.25.aspx

How Cost of Living Plays a Crucial Role

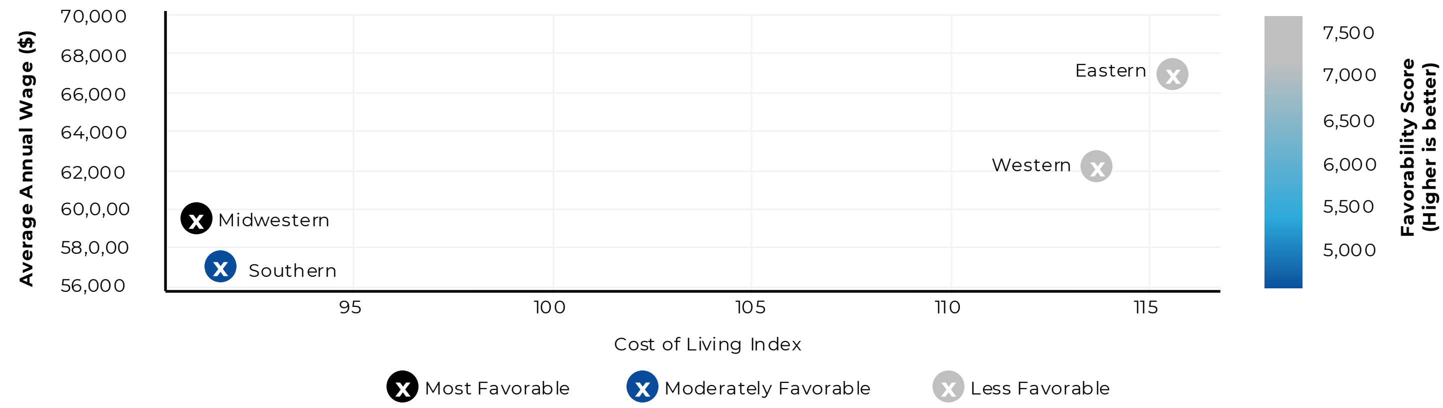
While comp. structures vary by specialty and region, understanding the cost of living is equally crucial in evaluating income. High-paying regions such as New York or California often have elevated living costs, which can diminish the purchasing power of higher salaries. Conversely, areas with lower comp. may offer greater affordability, balancing overall financial well-being. This interplay between income and living costs is a key factor for professionals when choosing where to practice.

While selling out a physician practice, it is advisable to consider the regional cost of living scenario to be analyzed very carefully. As regions such as Midwestern US states with a high cost of living, where the average base pay of an orthopedic surgeon is $700k, giving up a larger share of the earnings will have a major impact on future earnings. Therefore, understanding multiple factors while selling off is important.

Regional Income vs. Regional Cost of Living Impact on Orthopedic Salaries



Regional Income vs. Regional Cost of Living



For orthopedic professionals seeking the best financial and lifestyle advantages, the Midwestern region is the most attractive option. While the Western and Eastern regions provide decent wages, their high cost of living reduces overall benefits. The Southern region remains a viable alternative with moderate favorability.

1. https://www.patriotsoftware.com/blog/accounting/average-cost-living-by-state/
2. https://worldpopulationreview.com/state-rankings/cost-of-living-index-by-state

Conclusion

As private equity interest in orthopedic practices continues to surge, physician groups must carefully evaluate the financial, operational, and strategic implications of entering a Physician Practice Management (PPM) transaction. These deals offer immediate capital, operational relief, and potential equity upside, but they also introduce long-term considerations around comp., valuation, and sustainability.

A key determinant of transaction success lies in understanding the interplay between post-transaction physician comp. and practice valuation. Reducing comp. (scraping) can temporarily boost EBITDA and increase sale proceeds, but if not carefully calibrated, it may undermine physician satisfaction, retention, and long-term financial stability.

Valuation is further influenced by regional income variations, cost of living, practice infrastructure, and the presence of ancillary services. Orthopedic subspecialties and geography play a significant role in comp. norms, making it essential for practices to benchmark income levels and understand local economic contexts before structuring a deal.

For orthopedic groups considering a capital partner, aligning financial incentives, tax efficiency, and comp. sustainability is critical. Practices that thoughtfully navigate these variables—balancing immediate returns with future viability—will be best positioned to unlock value, scale operations, and thrive in a rapidly consolidating healthcare environment.

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