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FOCUS ON FRAGMENTATION WHITEPAPER

Trends in Healthcare Services

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Introduction

"Healthcare has traditionally been a very local business," says Dexter Braff, President of The Braff Group. "People have their personal relationships with their caregivers, so size doesn't necessarily provide a lot of competitive advantage.

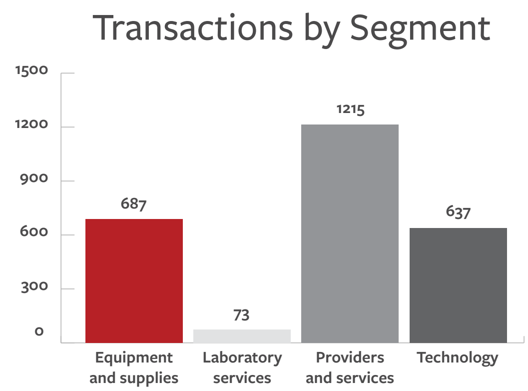
"It may not be the most efficient model," he says, but it's the model that has developed.

Today, a confluence of forces are driving the industry as a whole toward consolidation. According to data compiled by SDR Ventures, an Axial member, the total transaction value in the United States healthcare industry increased 262%, from $93.5 billion in 2014 to $245.3 billion in 2015. In Q4 2015, forty-five percent of buyers were strategic and 55 percent financial.

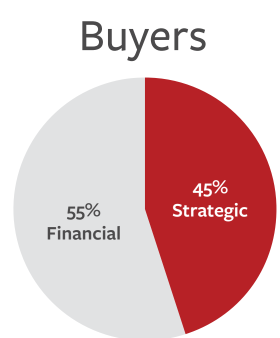
According to Duff and Phelps, the average LTM revenue and LTM EBITDA multiples for the healthcare services industry as of February 2016 were 1.93x and 11.7x.

According to Accenture, there are five major driving factors behind healthcare M&A: "Healthcare providers are making these acquisitions to gain economies of scale; shift from volume-based to value-based care; address local market characteristics to remain competitive; better appeal to consumer wants and needs; and expand their digital health and e-health capabilities."

This whitepaper delves into one particularly active healthcare subsector: healthcare services. According to SDR Ventures, 1215 of the 3000 total healthcare transactions in 2015, or 40 percent, fell under "providers and services." The other categories identified were equipment and supplies, technology, and laboratory services.



Data from SDR Ventures



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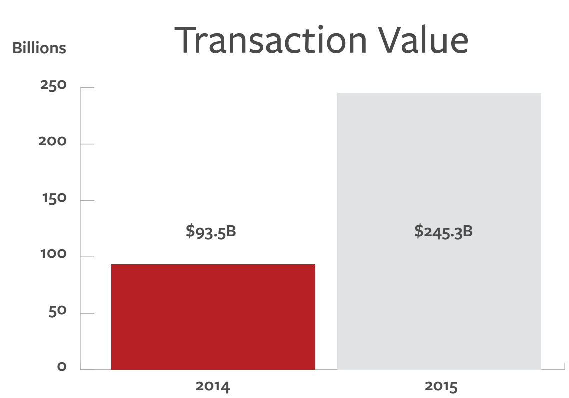


Data from SDR Ventures

Deals Driving Efficiency

Sterling Partners, an Axial member, completed an investment last year in Surgical Solutions, a Kentucky-based provider of support and equipment for surgical procedures. Says Whitney Krutulis, Director of Business Development at Sterling Partners, "The founders had already built a great business providing a unique, niche service, but they knew they needed a partner to help take the business to the next level. We recognized the staying power of the company's services, which deliver quality and value to patients at a lower cost to the system."

Says Kim Vender Moffat, Principal at Sterling Partners, "Surgical Solutions meets the pressing need of hospital administrators to find new ways to save money while promoting 'physician-friendly' facilities and delivering the highest quality of care. The company drives efficiency, as well as professional – doctors and nurses – and patient satisfaction. We partnered with the founder and his team to take what they had built and help them further scale that service while not losing focus of the company's founding mission and service orientation."

As interest in consolidation increases, healthcare specialists and generalist advisors alike are turning to online networks to identify buyers and investors that might be a good fit for their clients' needs. According to Axial data, 21 percent of healthcare services deals brought to the network were represented by advisors specializing in healthcare, with the remaining brought directly by generalist advisors or CEOs themselves.

The Triple Aim

In the ongoing quest to improve U.S. healthcare, what the Institute for Healthcare Improvement (IHI) calls "the triple aim" has emerged. The IHI defines the triple aim as "improving the patient experience of care (including quality and satisfaction); improving the health of populations; and reducing the per capita cost of health care."

This philosophy has driven healthcare reform — and in turn, growing consolidation. Before the passage of the Affordable Healthcare Act (ACA) in 2010, healthcare providers operated under a traditional fee-for-service, volume-based payment methodology. But the ACA has begun to disrupt this model, promoting a new pay-for-performance paradigm that takes into account both quality and efficiency. Providers who improve quality and reduce cost can receive a share of overall savings.

These policy shifts have incited a move toward clinical integration, as individual providers come together to establish more cost-effective and efficient continuums of care for patients and create a platform for negotiating managed care agreements with Medicare and commercial payers. Under evolving healthcare payment methodologies, payments for multiple related services are bundled, to incentivize the system as a whole to promote cost-saving practices. These larger, integrated organizations are also better equipped to collect, analyze, and improve upon efficiency and quality data.

Subsectors on the Rise

Every healthcare services sector will be affected by the driving factors behind consolidation in 2016 and beyond. Several sectors in particular are ripe for M&A activity.

Hospice and Home Healthcare

America's aging population is "an obvious factor" in the increased utilization of hospice and home healthcare, says The Braff Group's Braff. But he says the rise of hospice and home healthcare is also a function of a shift to "population management, where the idea is to find the best outcomes in the least costly settings." Home health and hospice "deliver on that substantially... Accountable care organizations get paid for reducing the average fees per services cost within the population they're serving. They're motivated to push into less costly settings rather than serving patients in hospitals — that's often going to be home health and hospice."

As healthcare dollars get more scarce, the incentives increase for multiple providers — e.g., a hospital and a hospice provider — to integrate to reduce cost and maintain quality.

Dental

Says Paul Barrett, Senior Associate of BelHealth Investment Partners, an Axial member, dentistry is a prime example of an "industry where there has been a lot of PE activity over the last five years in creating dental practice management companies and consolidating individual practices; however, 88% of dentists and orthodontists are solo or two-dentist practices. So despite some consolidation in the industry, it is still highly fragmented and there is still a lot of opportunity to build large organizations from all the individual practices."

"Dentistry has undergone a complete transformation in the last decade."

“Attractive indusry dynamics coupled with a highly fragmented sector is attracting strong PE investment in physical therapy.”

Dental service organizations, or DSOs, which provide business support to dental practices, are on the rise. Alex Giannini, CEO of Blackford Dental, a DSO, says that dentistry has undergone a complete metamorphosis in the last decade. “In the early 2000s, 3% of all dentists were in a group practice and today it’s estimated to be almost 15-18%.” According to The Dental Alliance, practices using the DSO model are growing at over 18%, compared to 5% industry growth. The aim of DSOs is to provide affordable, efficient, and effective care to patients and reduce per-patient cost.

“Blackford is purely a business partner,” says Alex. “We’re there to support the dentists by providing back-office support, marketing, compliance, IT, and procurement.” Doctors can spend more time taking care of the patient — creating a happy, recurring customer base and a predictable flow of revenue and referrals.

Physical Therapy

According to Axial member Capstone Partners’ Q1 2016 report, “attractive industry dynamics coupled with a highly fragmented sector is also attracting strong PE investment” in physical therapy. “Publicly traded players are receiving robust valuations including U.S. Physical Therapy (12.4x EBITDA) and Select Medical (10.8x), which provides the currency and impetus to make accretive acquisitions of privately held businesses,” reports Capstone Partners, and “fiscal 2015 was another record setting year with the number of announced transactions totaling 118 (CapIQ).”

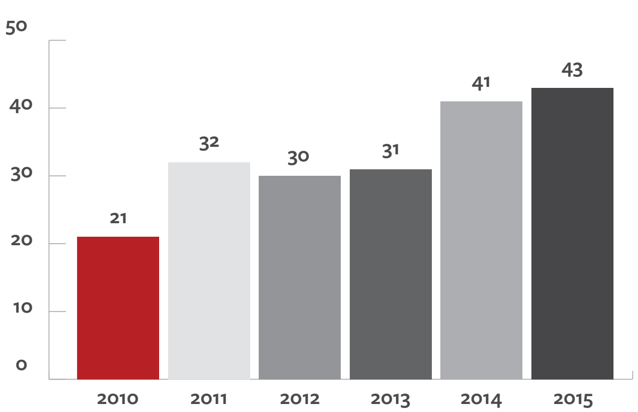
Like other healthcare services industries, notes Capstone Partners, “the industry is benefiting from an aging population intent on maintaining an active lifestyle as well as commercial carriers and government health programs emphasizing patient outcomes and value-based medicine. There is a growing recognition among stakeholders that PT is an effective yet affordable treatment option that can minimize the need for surgery and medication.”

According to Capstone, “the outpatient rehabilitation sector is highly fragmented with the three largest players controlling only 8.3% of the market share and 13.1% of the facility base. While there are a few national companies, the industry predominantly consists of small to medium regional providers with annual revenue of slightly over $1 million per center.”

Behavioral Healthcare

Braff points to behavioral healthcare — including addiction and substance abuse services, autism services, and mental health facilities — as the top area of growth within the healthcare services industry. This growth comes in part because of The Paul Wellstone and Pete Domenici Mental Health Parity and Addiction Equity Act of 2008 which was expanded further under healthcare reform. Braff explains that this "new legislation requires that insurance providers for the most part have to reimburse mental health services on par with medical services, so the reimbursement opportunity for mental health services has increased."

M&A Activity: Behavioral Healthcare



Data from Capstone Partners

In addition to regulation, Capstone Partners points to five main factors as industry drivers:

- Increased exposure to drugs and alcohol
- Development of new treatments and programs
- Healthcare reform and affordability
- Growth in private insurance
- Increased awareness

According to The Health Care M&A Report, Q4 2015 saw 71% more M&A activity in behavioral healthcare acquisitions than the same time in 2014, with 12 transactions announced. The Health Care M&A Report editor Lisa Phillips says that "increased interest in this once sleepy market" is because of changes in insurance and reimbursement policies rather than necessarily increased demand. As health care policy steps into the spotlight during the 2016 presidential race, interest in the sector is expected to increase further.

Urgent Care

Braff says that "urgent care — providers of the ubiquitous 'doc in a box' — is undergoing a substantial amount of expansion."

The Journal of Urgent Care Medicine agrees, calling urgent care "a highly fragmented industry considered ripe for consolidation… high valuations, oversaturated markets, changing buyer and seller expectations, and structural changes attributable to the Patient Protection and Affordable Care Act will influence urgent care deal-making in coming years.

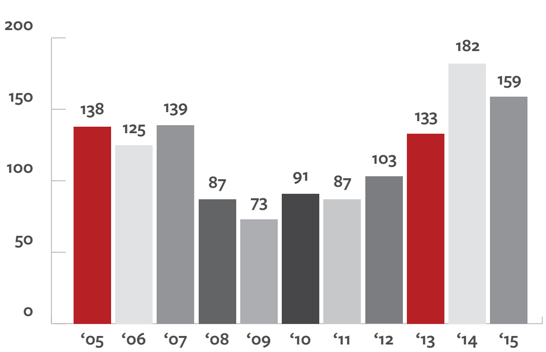
Large billion-dollar plus deals like last year's acquisitions of Concentra and MedExpress centers "have raised the expectations of some owners seeking an exit strategy," the publication reports.

Healthcare Staffing

Healthcare staffing is a $11.1 billion dollar industry in the U.S. and is anticipated to grow 7% through 2016, [according to Harris Williams & Co](). "The healthcare staffing market remains substantially fragmented, with the top ten participants commanding approximately 40 percent of the market" and no firm holding more than a 10 percent market share, the report notes. As "mounting regulatory and economic pressures are forcing hospitals to increase the focus on cost efficiency and reduced readmissions rates," the opportunities for consolidation grow.

[Capstone Partner's Q1 2016 report agrees](), noting that "with the Affordable Care Act expanding insurance coverage, millions of baby boomers moving into their senior years, a large cohort of physicians and nurses retiring, and increasingly complex patient care, providers are unable to meet their dire need for clinicians and allied healthcare professionals and are increasingly turning to outsourced staffing companies." Deal volume remained steady in the sector from 2014 to 2015, with 19 deals in 2015 and 20 in 2014.

M&A Activity: Healthcare Staffing

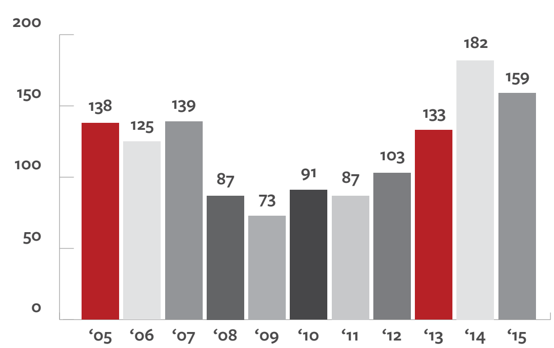


Data from Capstone Partners

Physician Practices

The 2015 Healthcare Services Acquisition Report notes there was nearly $3.2 billion spent on physician groups last year. Physician groups are joining hospitals, being acquired by private equity groups, and consolidating into larger group practices. In addition to the more recent ACA, the Stark Laws, limiting physician referrals to practices with which the physician has a financial relationship, have increasingly driven consolidation since the first law's passage in 1989. The law, which contains an exception for group practices, has encouraged physicians to band together under one practice to enable legal referrals.

M&A Activity: Physician Practices



Data from Capstone Partners

[According to Accenture](), though horizontal healthcare M&A — e.g., hospitals acquiring other hospitals — hasn't delivered on promised value in recent years, "vertical M&A — when a hospital acquires a payer or a non-acute care provider (e.g., retail clinic or physician practice) — has significantly increased."

[Reports Modern Healthcare](), private equity firms investing in physician practices "see an opportunity in being early participants in value-based care.... The niche is well-suited for private equity firms, which feed on uncertainty." PE groups, which seek out savvy practices ahead of the curve on value-based care, might eventually sell these practices to insurers or health systems.

Veterinary Services

Like human healthcare, veterinary services is increasingly primed for M&A activity. Gino Volpacchio, Chairman and CEO of PetVet Care Centers, an Axial member, attributes the trend to a number of factors, including a high demand for services, lack of insurance regulations or requirements, and clients' high level of care of emotional attachment to their pets.

According to Capstone Partners, M&A activity in the pet and animal care industry increased 30% from 2014 to 2015. Of 61 transactions in 2015, 53 were completed by strategic acquirers and eight by financial buyers. Volpacchio says he is seeing a growing number of private equity firms in addition to corporate buyers in the industry.

Mercer Capital reports that as of December 2014, there were approximately 65,000 veterinarians in private practice in the United States. Says Volpacchio, "you have a demographic where sellers are getting older, and either looking to exit or not particularly fond of taking care of the business side of things." In a previous generation, he says, "doctors would pick an associate, and the associate would buy him out," but that model isn't applicable today.

"Lifestyle is very important" to many vets, says Volpacchio. According to Mercer Capital, larger practices "offer consistent work hours and an increased client base," and provide the opportunity for specialists to merge "in order to combine market bases or purchasing power."

How to Approach Healthcare Services

As a CEO

As M&A in healthcare services industry increases, more and more founders and CEOs are looking to transact at the highest possible valuation, to the right buyer or investor.

Engaging an advisor with experience in the space can ensure the best possible outcome. Chad Elms recently sold 60 percent of his company, Momentum Physical Therapy and Sports Rehab, for $7.2 million to U.S. Physical Therapy Inc. The company engaged Martin Healthcare Advisors (MHA), whom he connected with on Axial. As a result, says Elms, "our buyout offer increased almost twofold from where we had started the process... We would have ended up much worse financially had we saved the fee and chose to go at it on our own."

As an Advisor

As an advisor, selling one's expertise to healthcare services CEOs "is a long-term process, because it's so fragmented. You have to create opportunities to make yourself known to a large number of prospective companies," says Braff. For The Braff Group, "that's a function of a multi-pronged strategy that we have invested heavily in over a long period of time." Braff says theirs is a "market-immersion strategy. We have very narrow silos, but we go very deep."

If you're a generalist advisor looking to break into the space, consider identifying a few target areas of interest and dialing in on your target audience through inbound and outbound marketing, events, and other business development activities.

Braff cites strategies including:

- Advertising
- Direct marketing
- Proprietary writing
- Industry-specific newsletters
- Presentations at national and regional conferences
- Presence at trade shows
- Using a CRM to maintain a dynamic database of potential companies
- Using Axial to reaching out to potential buyers outside main network
- SEO

"Healthcare is a unique animal," says Braff. "Human services businesses are hard to run. They're not commodity businesses... you're constantly dealing with people, and people don't always fit into routine procedures." He cites regulation, compliance exposure, and third-party reimbursement as additional challenges.

At the same time, "that enables healthcare services to often generate higher margins than other business segments. There are rewards for taking on the risk."

As a Capital Provider

"We actively network and search for healthcare specialists," says BelHealth's Barrett. "They are terrific resources in helping us source deals. Our firm was founded by former healthcare entrepreneurs and executives... so we leverage their long-standing relationships. We also go to events and leverage Axial's huge network to find advisors that have not yet heard of BelHealth so we can be on their radar."

Says Barrett, "driving proprietary deal flow is a critical part of our strategy so finding regional and local healthcare advisors is very important to our group." However, "our ideal sourcing scenario is to get a direct introduction to a CEO or founder and begin a dialogue. It saves us an enormous amount of time if we are able to speak with a funder and come to a quick decision on whether we want to move forward or not."

Building relationships with generalist advisors is important too. On Axial, 79 percent of healthcare services deals were brought to the network by generalist advisors, vs. 21 percent by healthcare specialists.

There are also unique due diligence considerations for healthcare buyers, as Healthcare Law Insights outlines, including:

- Anti-kickback laws
- Stark Laws
- Compliance policies
- State Corporate Practice of Medicine restrictions
- Antitrust laws
- Civil Monetary Penalty Laws and False Claims Act
- HIPAA
- Licensing and certification considerations