

# FOCUS

Investment Banking

## Healthcare Team

# PRIVATE EQUITY INVESTMENT AND CONSOLIDATION STRATEGIES IN DERMATOLOGY



## Investment Banking and Advisory Services

FOCUS Investment Banking LLC is a leading Investment Bank with specialized healthcare services expertise, concentrating on providing highly tailored services to middle market and larger organizations in this sector:

- Mergers & Acquisitions Advisory
- Corporate Development Consulting
- Strategic Partnering & Alliances
- Capital Financing, Debt & Equity
- Corporate Valuations

April 2020

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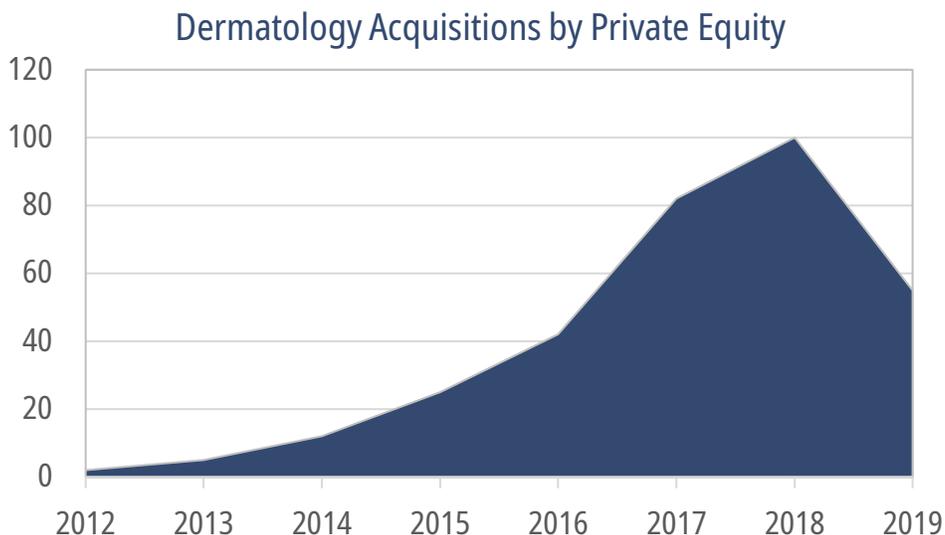
# COVID-19

## Impact on Specialty Practice Consolidation Across America

As of this writing, most of the specialty practices and ASCs we work with are nearly or completely shut-down due to elective procedure bans and shelter-in-place orders. Amid this struggle, we see several positive factors for our current and potential clients:

1. There is inherent demand for specialty medical services. Investors understand this and have confidence businesses will recover.
2. It appears excellent short-term financing options will be available very soon, including a generous "CARES Act" loan program from the Small Business Administration. We believe these loans will help practices meet their ongoing expense burden at very low interest rates, with possible forgiveness of the principal.
3. We are confident investors will give sellers "credit" for the COVID-19 shutdown – adjusting financial performance or looking at other periods when valuing a practice or ASC.
4. Deals continue to move ahead. Though many are paused, some are still closing now. We expect a return to normal deal volume once more is known about the COVID-19 timeline, and especially once normal clinical operations resume.
5. The potentially lucrative "window of opportunity" has not closed. However, we believe transactions closing at the end of 2020 and in the first half of 2021 will have sell-side teams who started preparing during the crisis so that they are ready to act at the right time.

Graphically, consolidations typically follow an acquisition curve that progresses through five stages; Emergence, Growth, Peak, Decline, End. The Dermatology consolidation curve from 2012-2019 is shown below.



# Physician Owner Specialization

## Our Services .. New Highs in 2019

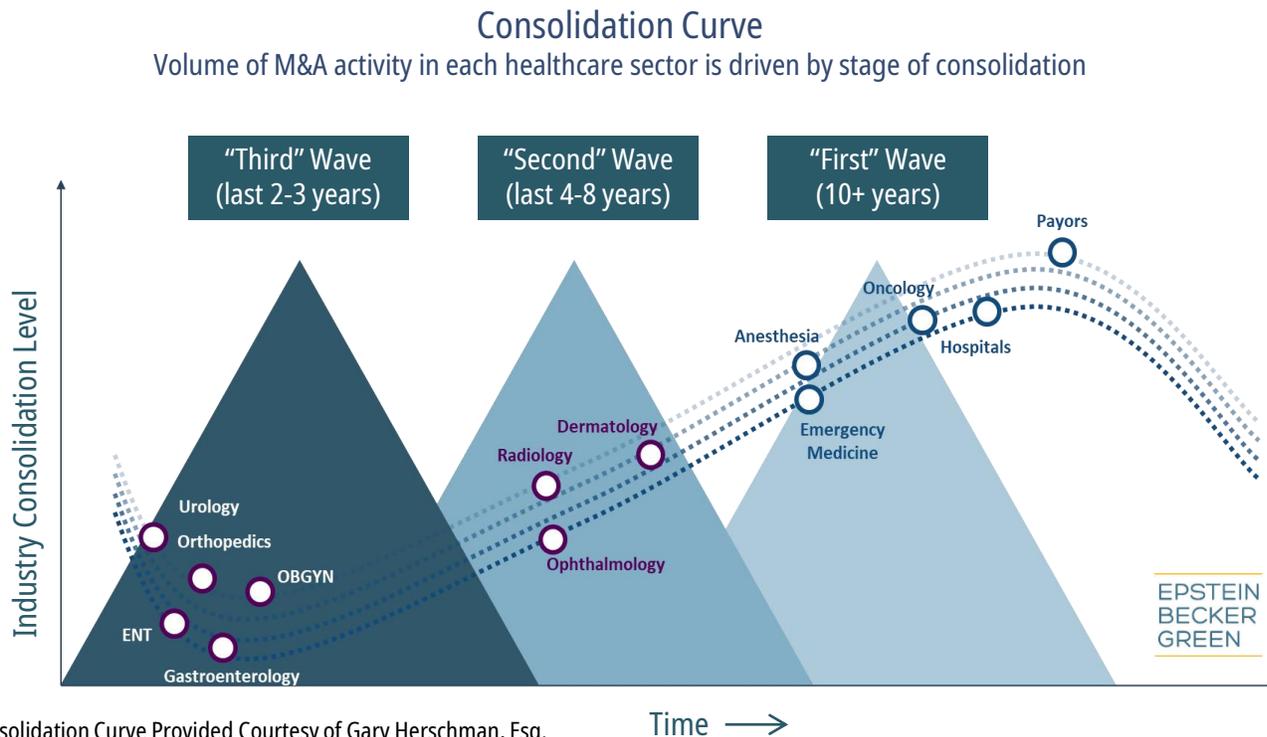
FOCUS Healthcare specializes in investment banking services focused on mergers & acquisitions involving clinicians. We represent physician groups in transactions with private equity and ASC management company investors across the United States. The demand for our services hit new highs in 2019. Since July of 2019, we have had seven successful closings and have eight additional businesses under Letter of Intent as we begin 2020.

We are a leading expert on this market and its participants. This White Paper is designed to share those insights with you – physician owners with valuable practices and ASCs contemplating their own transactions with private equity.

As former operators, we understand the unique attributes of specialty practices and surgery centers. We invest our time and money in the best data available and our partners constantly track transaction activity, conduct independent research, and analyze critical issues. We represent physicians every day and leverage the resulting experience and relationships to benefit our clients.

## We Specialize in Second and Third Wave PPM

We focus on the emerging second and third wave sectors across the full spectrum of physician practices.



Consolidation Curve Provided Courtesy of Gary Herschman, Esq.  
Epstein Becker & Green, P.C.

# Recent Transactions

Our services are designed to provide exceptional investment banking services to specialty practices and ASCs across a wide range of practice specialties.

Since July of 2019 we have closed transactions for nine clinical businesses and have six businesses under LOI.

## Transactions Closed

# 05

Specialty  
Medical  
Practice  
Closings



# 04

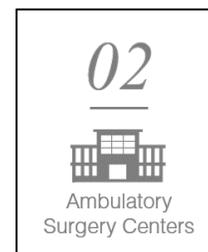
Ambulatory  
Surgery Center  
Closings



## Transactions In Progress – 2020 Close Anticipated

# 06

Businesses  
Under Letter  
of Intent



# Consolidation Strategies Underway in Ophthalmology

## The PPM Management Company Strategy

The predominant private equity acquisition strategy is best defined as “Platform-Growth”. Executing this strategy with success requires the acquisition of a large practice or practices which act as a foundation. Those platforms are expanded through “Add-On” acquisitions of medium and small practices and ASCs within a geographic region.



We consider large practice acquisitions to be the key driver of market expansion and a primary indicator of future investment in medium and small practices in a geographic area. A platform practice is defined by a variety of factors, determined in part by the buyer’s preferences. Our market analysis simplifies this and considers the acquisition of practices with ten or more physicians. We feel this is a strong indicator of overall platform acquisition activity.

## The Physician-Owned Area Consolidation

We are seeing an increasing number of physician-owned practices combine to form larger practices to reap the rewards of increased market coverage, expansion of services, consolidated investment and operating cost efficiencies. This approach can create the most lucrative selling opportunity for physician owners.

Physicians pursuing this strategy are aware of the potential to sell to private equity in the future at favorable multiples. However, the challenge of running a practice while pursuing consolidation is very demanding and prohibitive for most physicians.

We offer specialized services for groups pursuing this strategy. These include strategic consulting, transaction advisory, and unique financing solutions. Please contact us for more information.

## The Participation Investment Strategy

A handful of players are engaged in what we call a “Participation” strategy – one with less emphasis on geographic density. They seek to acquire strong practices with less regard to geography and are often willing to enter a new area through a smaller acquisition.

# Differing Views on PE-Backed Consolidation

## Raising Questions

Private investment in dermatology has become a key topic in the journals, at conferences, and among physicians. Some physicians and researchers have raised questions about whether private investors will really be able to improve the practice of dermatology. Will they be able to help doctors see more patients, provide better care, live better lives, and navigate the coming shift in payment structures? Or will they simply create unwieldy organizations with misaligned incentives? We believe it is in physicians' best interest to pursue a serious fact-based evaluation of their own before dismissing this opportunity.

## A Better Model

Many have compared and contrasted the current investment environment to that in the 1990's, centering on the concept of "physician practice management companies" like PhyCor. Those firms were focused on cost containment through centralization, moving critical functions to an off-site location and leaving physicians and core personnel in the practice to see patients. In a way, investors were paid before doctors (via management fees) rather than vice-versa. These companies grew too quickly, incentives were misaligned, local knowledge and management skill was wasted, and the venture ultimately failed.

PE investors learned this lesson and are now taking a fundamentally different approach. Their transaction models feature short- and long-term performance incentives for physicians and leverage local knowledge, relationships, and expertise to grow. Instead of a manager, the investor is a growth partner looking to provide strategic guidance and inject capital when needed. Indeed, we believe large and well-capitalized organizations are likely best suited to take advantage of the shift to value-based payment systems. And under the employment model, physicians are paid first via a compensation formula.

Another core objective is perpetuating practices. Investors are developing sophisticated recruiting systems and offering attractive work environments for young physicians, usually with some sort of equity purchase option down the road. These structures can provide a combination of upside and stability, without the personal debt load often associated with partnership buy-ins.

In sum, the current round of PE consolidation can represent an attractive opportunity for the right dermatology physician owner.

# The End Goal for Private Equity and Physician Sellers

## Improved Patient Care, Revenue Growth, Profit Improvement

In order to gain a return on their investment, PE firms look to improve operations and grow their portfolio companies through organic and inorganic initiatives, ideally driving a much higher valuation and EBITDA multiple when the portfolio company is sold (usually in 5-7 years).

Principal areas for organic growth include referral networks, physician recruiting, contract negotiations and revenue cycle and cost containment initiatives. They will also invest in practices via capital improvement projects - perhaps additional offices, new technology or construction of a surgery center. Each investment will present unique opportunities, such as combining multiple practices under a single umbrella for reimbursement purposes. Investors will leverage their size, financial resources, and human capital expertise to achieve desired growth outcomes.

Inorganic growth comes through the acquisition of gastroenterology practices, ambulatory surgery centers, and other complementary businesses. Investors provide capital and leverage physician knowledge and relationships to identify and pursue appropriate opportunities.

## Physician Autonomy

Importantly, most physicians will be surprised by how hands-off these investors are when it comes to day-to-day practice operations. They are rarely, if ever, interested in physician schedules and local management issues, believing instead that these things are best handled by the physicians themselves and their local management teams. This emphasis on growth and improvement rather than operational change means that physicians can continue to focus on their patients while a well-funded partner works to grow and perpetuate their practice.

## Successful Recapitalization at Higher Multiples

Many firms offer physician sellers the opportunity to “roll over” equity into the acquiring company, thus investing along side its other physicians and the PE firm. That equity may be sold in later transactions at a higher value (or EBITDA multiple). This strategy allows physicians to participate in the gains private equity firms achieve.

# Example of a Successful Recapitalization

## Partners Group Buys FFL's EyeCare Partners for \$2.2 Billion

A highly successful ophthalmology recapitalization just occurred in December of 2019 when Partners Group Holding AG acquired EyeCare Partners, adding one of the largest U.S. ophthalmology and optometry services groups to its portfolio of healthcare investments.



Details of these transactions are usually highly confidential but reports on this transaction provide an impressive real-world example for dermatology physician owners.

## \$2.2 Billion ... About 16x EBITDA

At the time of the transaction, EyeCare Partners was reportedly valued at \$2.2 billion including debt. At that valuation, the transaction carried a multiple of about 16x based on EyeCare Partners reported adjusted EBITDA of approximately \$135 million.

## Roll-Over Equity Participation

EyeCare Partners management team and physician partners with roll-over equity continued to maintain a substantial equity stake in the recapitalized company.

## Organic Growth Achieved

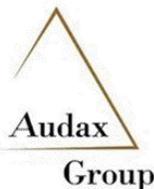
FFL made its first optometry investment in 2015 and grew to include significant ophthalmology acquisitions in Missouri, Illinois, Alabama, Kentucky, Kansas and Michigan. During that time, the company's revenue grew at a compounded growth rate of 65% by making over 60 strategic acquisitions and expanding its locations from 63 to more than 450 locations across thirteen states. ECP also focused on recruitment and investment in clinical technologies to foster growth.

## Inorganic Growth Achieved

FFL Partners pursued inorganic growth initiatives to implement a fully integrated model that delivered patient and process improvements in scheduling, billing and treatment coordination. A built-in referral system was created between ECP's optometrists and ophthalmologists to maximize care, outcomes and efficiency. In addition, a single source of medical records and data contributed to cost reductions.

According to PE Hub (December 16, 2019), "Partners Group claims victory for FFL's EyeCare Partners in \$2.2 bln deal"

# Dermatology Recapitalizations To-Date

Date	Practice Mgmt. Company	Recapitalized PE Investor	Initial PE Investor	Investment / Valuation
October 2019				Not Disclosed
March 2018				Not Disclosed
October 2016				Not Disclosed
May 2016				\$300 Million+ 15x EBITDA*
May 2016				Not Disclosed
April 2016				\$35 Million Financing**
January 2016				\$450 Million+ 13X EBITDA***

\*The Wall Street Journal (May 18, 2016), "ABRY Partners to Buy Candescend Partners' Dermatology Associates of Tyler for Over \$300 Million"

\*\*Private Equity Wire (April 14, 2016), "Schweiger Dermatology Group Secures USD35m in fundraising round led by LLR Partners"

\*\*\*Private Equity News (January 13, 2016), "OMERS Buys Varsity-Backed Forefront Management for more than \$450m"

# Private Equity Investors in Dermatology

Private equity firms usually create a subsidiary Practice Management Company within their portfolios to acquire and manage dermatology practices and surgery centers. Most transactions include equity ownership in the parent management company. The current list of PE investors / management companies are shown below.

 Waud Capital	⇒	 Adult & Pediatric Dermatology, PC	 Cressey & Company	⇒	 qdp   QUALDERM PARTNERS
 HP HARVEST PARTNERS	⇒	 ADVANCED DERMATOLOGY and Cosmetic Surgery	 GTCR	⇒	 RIVERCHASE DERMATOLOGY AND COSMETIC SURGERY
 NMS CAPITAL	⇒	 Anne Arundel DERMATOLOGY	 SPINDLETOP CAPITAL	⇒	 SANOVA DERMATOLOGY
 Goldman Sachs	⇒	 CALIFORNIA SKIN INSTITUTE	 LLR	⇒	 SCHWEIGER DERMATOLOGY GROUP
 TYREE & D'ANGELO PARTNERS	⇒	 DERMATOLOGY MEDICAL PARTNERS	 WCAS	⇒	 SELECT DERMATOLOGY
 HILDRED CAPITAL MANAGEMENT	⇒	 dermcare MANAGEMENT	 SPC SUSQUEHANNA PRIVATE CAPITAL, LLC	⇒	 Skin and Cancer Associates
 SHERIDAN CAPITAL PARTNERS	⇒	 DOCS DERMATOLOGISTS OF CENTRAL STATES	 PHAROS CAPITAL GROUP, LLC	⇒	 sōna DERMATOLOGY & MEDSPA
 CI CAPITAL PARTNERS	⇒	 EPIPHANY DERMA+OLOGY	 ALPINE	⇒	 SUMMIT DERMATOLOGY PARTNERS
 OMERS	⇒	 FOREFRONT DERMATOLOGY	 Riverside	⇒	 tricenna
 H.I.G. CAPITAL	⇒	 MedPro Advantage LLC	 FRAZIER HEALTHCARE PARTNERS	⇒	 UNITED DERMPARTNERS
 BH BELHEALTH Investment Partners	⇒	 NVA NAVADERM	 TB TONKA BAY	⇒	 UNITED SKIN SPECIALISTS
 ONTARIO TEACHERS' PENSION PLAN / CENTURY EQUITY PARTNERS	⇒	 PhyNet DERMATOLOGY	 ABRY PARTNERS	⇒	 U.S. DERMATOLOGY partners
 CHICAGO PACIFIC FOUNDERS	⇒	 PINNACLE DERMATOLOGY	 ArmoryCapital	⇒	 VitalSkin DERMATOLOGY
 STERLING PARTNERS	⇒	 PLATINUM DERMATOLOGY PARTNERS	 GRYPHON INVESTORS	⇒	 WATER'S EDGE DERMATOLOGY
 LEAD CAPITAL	⇒	 PREFERRED DERMATOLOGY	 ENHANCED HEALTHCARE PARTNERS	⇒	 WEST DERMATOLOGY

# PPM Dashboard

Definition: A dashboard is a graphical user interface that provides at-a-glance views of key performance indicators (KPIs) to provide a clearer understanding of business or market activity.

The following key performance indicators help provide an unbiased numeric view of the marketplace. It is a useful tool that brings data into the quest to understand complicated market dynamics.

We use this data in context with other input we receive in our day-to-day dealings. Properly designed, a dashboard can provide a numeric picture of market strength and direction.

## Mixed Signals – Possible Market Restructuring

Since the third quarter of 2018, our dashboard has signaled a mixed picture. Expansion – new PE firm entry and new geographic area expansion. Decline – an increasing number of PE firms making no acquisitions in the last six months and a significant drop in acquisitions. We believe the market may be moving toward a PE player restructuring where some of the current investor pool merge. We also expect companies that have been unable to grow at their desired pace to combine with larger, more successful enterprises. Further, we see a coming resurgence of acquisition activity as physicians evaluate this unique selling opportunity post COVID-19.

Key items of note in the latest quarter -

- Armory Capital's VitalSkin enters dermatology signaling continued growth opportunity.
- 80% of participating PE firms had no acquisitions in the last six months (24 of 30).
- Total acquisitions in the quarter was the lowest since the 4<sup>th</sup> quarter of 2014.

	2017				2018				2019				2020
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Number of New PE Firms Entering Dermatology PPM Sector	3	1	0	2	2	4	1	0	0	0	1	0	1
Total Acquisitions	24	16	24	18	31	26	21	22	15	13	19	8	3
Platform (5+) Acquisitions	4	2	8	2	7	7	5	2	4	0	3	2	0
Add-on Acquisitions	20	14	16	16	24	19	16	20	11	13	16	6	3
Number of New Geographic Areas (NGA) Entered	4	4	7	4	3	1	2	5	2	0	2	4	0
Number of Firms Closing an Acquisition in the Qtr.	11	10	11	14	14	15	11	11	7	9	11	5	2
Number of Firms Invested with No Acquisition in the Last 6 Months	4	4	5	4	6	8	10	13	16	16	14	17	24
Management Company Recapitalizations	Note: There were 5 successful recapitalizations in 2016				1							1	

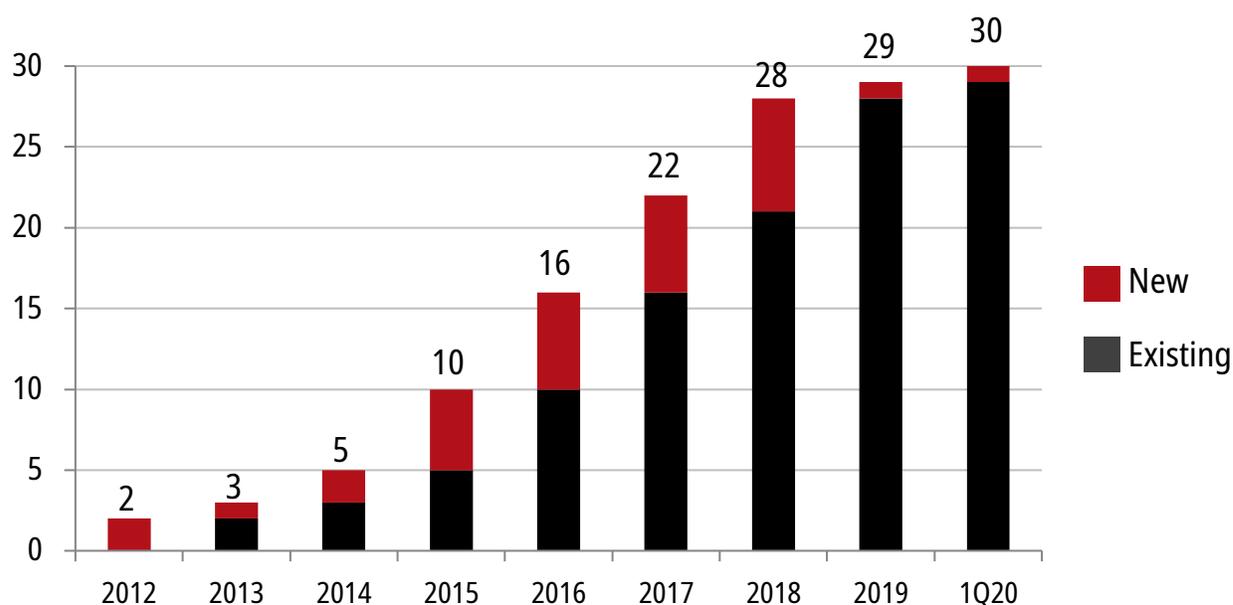
Note: Data Scorecard data is based on publicly available records and information provided to us by acquiring firms with authorization to publish.

# History of Participating Private Equity Investors

For any business, entering a new market is a big decision. The key drivers to that decision are saturation and profit potential. When a market has high profit potential and low competitor saturation, new entries are attracted.

The number of private equity firms actively investing in dermatology practices increased dramatically from five to twenty-eight during the four-year period from 2015-2018. Then, after three quarters of no new entries, two new firms entered ... one in the third quarter of 2019 and another in the first quarter of 2020. These new entries are an indication that investors see continued opportunity in dermatology.

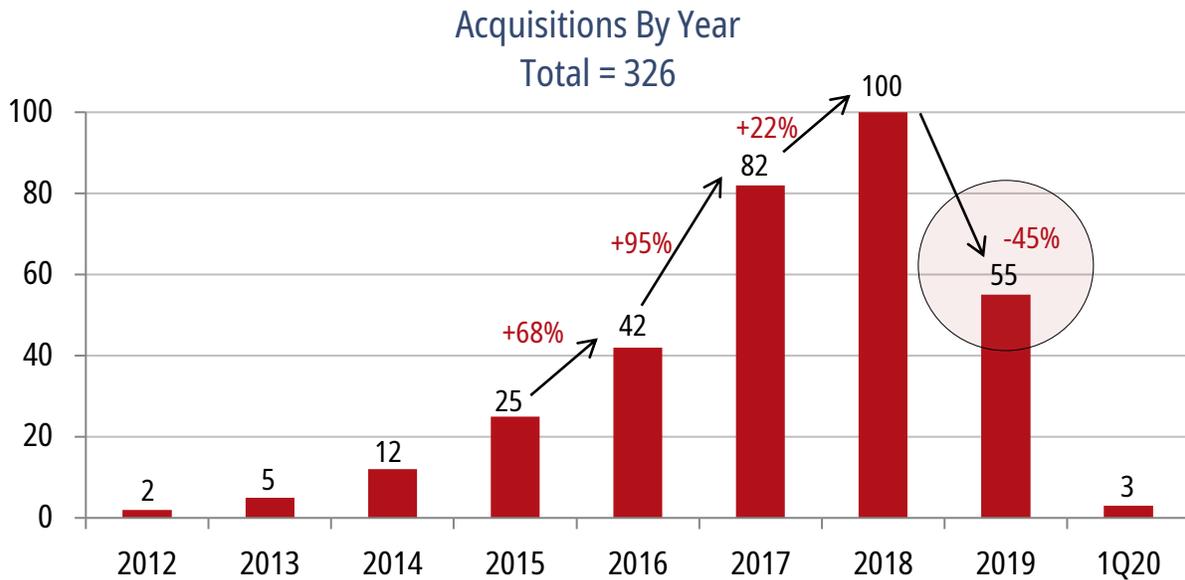
### PE Firms Investing in Dermatology



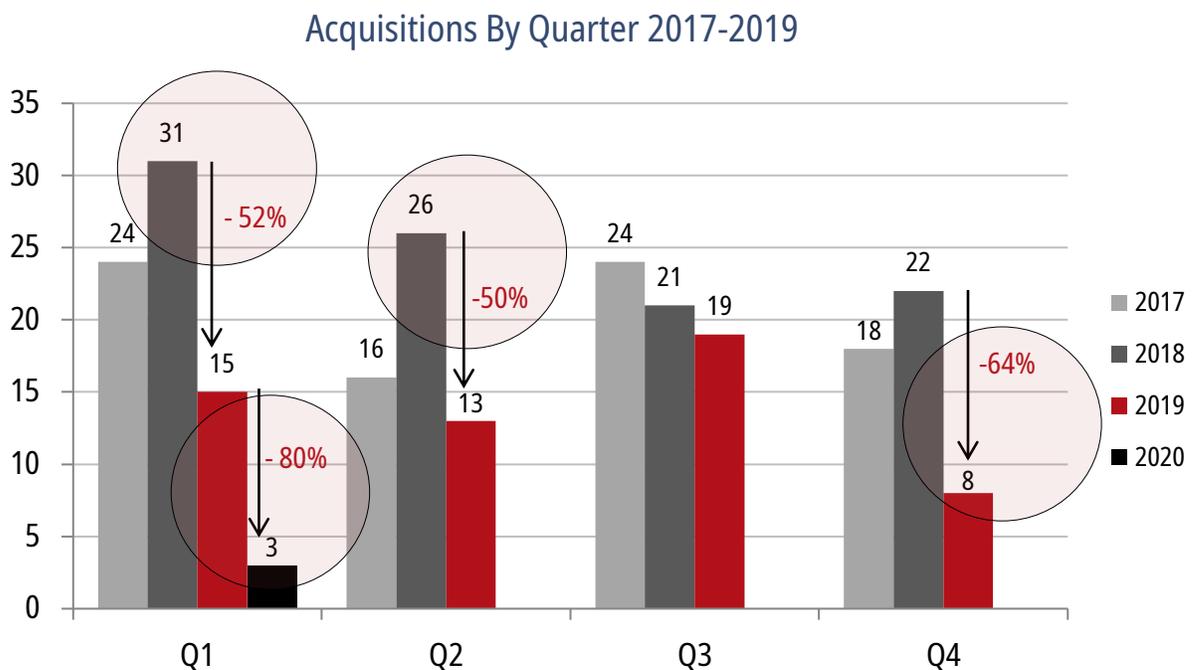
Note: 2018 includes Westwind Investors, LP exited through sale to LLR/Schweiger March 2018

# Recent Declines are Inconsistent with Market Opportunity

After six years of strong acquisition growth, 2019 saw a 45% drop in dermatology transactions. That has continued into the first quarter of 2020.



We believe this represents a more mature consolidation phase for dermatology. Though PE firms continue to seek partner transactions, most early adopters have transacted while others are waiting for the right consideration point. We believe this lower volume and continued high buyer demand is likely to create favorable selling opportunities for physician owners post COVID-19.

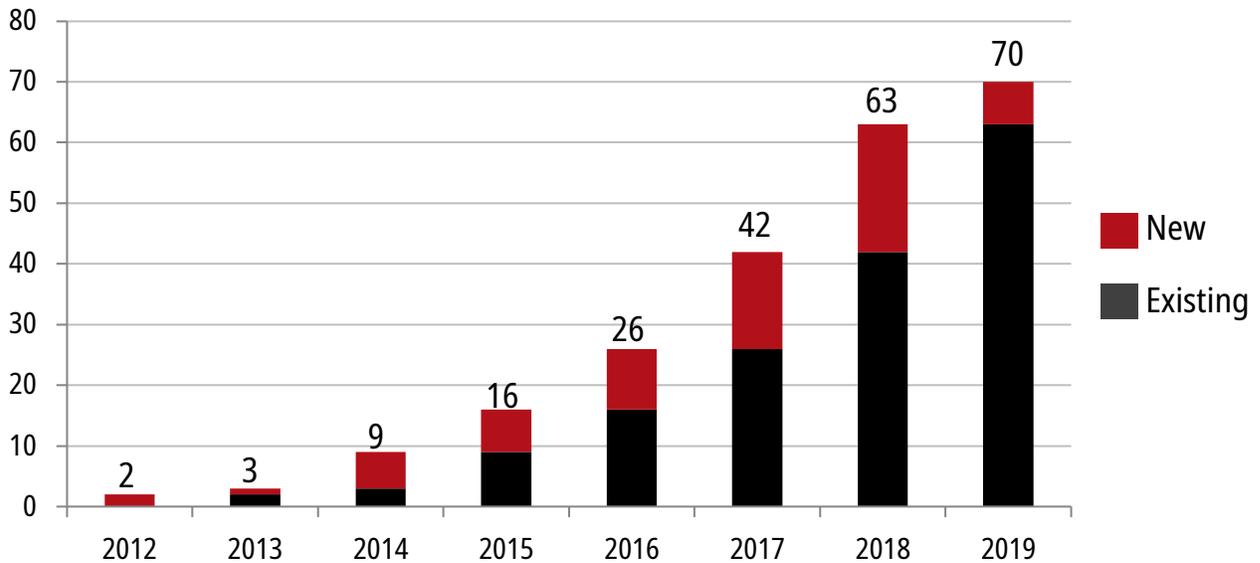


# Geographic Expansion Transitions to Add-ons

The graphs below provide a clear visual representation of the evolution of acquisition practice size as the consolidation progresses over time. Early phase acquisitions focus on large platform practices (5+ MDs) to create a strong foundation upon which to build network expansion.

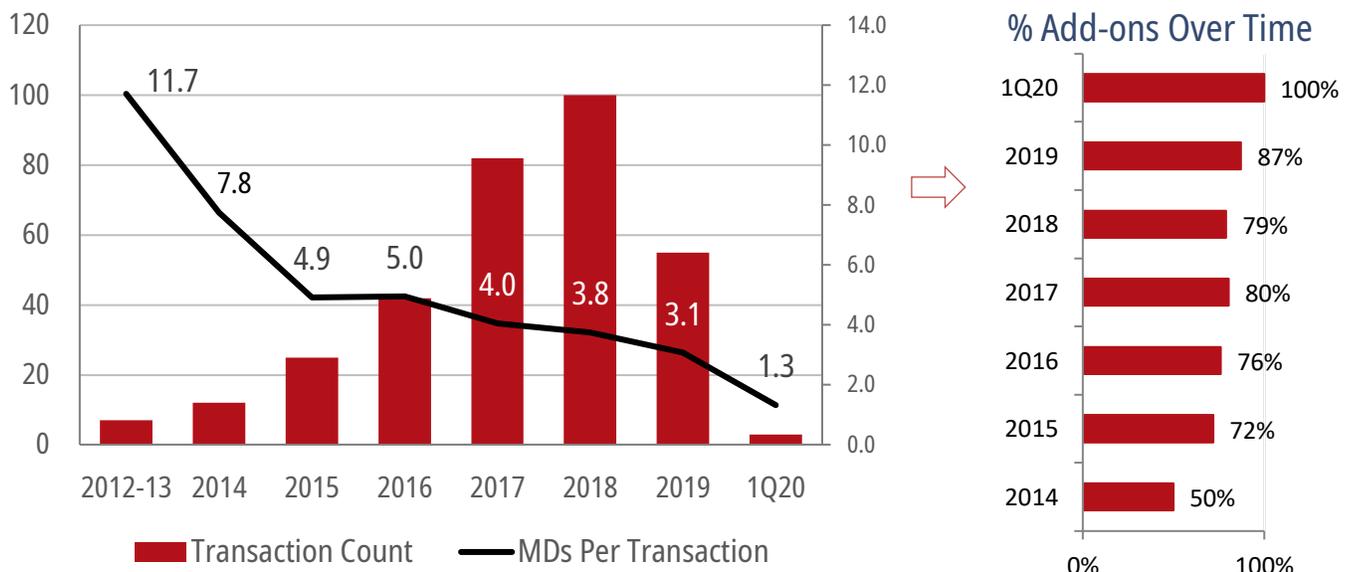
In 2019, the acquisition of large practices slowed while the pace of add-on acquisitions grew.

### Acquisitions of 5+ Physician Practices



As the consolidation develops, two actions are taking place ... 1) new geographic areas are pursued through large platform acquisition and 2) add-ons are pursued to build a wider geographic network.

As a result, the average practice size of transactions falls consistently as the consolidation across the U.S. progresses.



# Significant Potential for Further Consolidation

Based on our detailed tracking and analysis, the dermatology market is only 11.5% consolidated as of this publication.

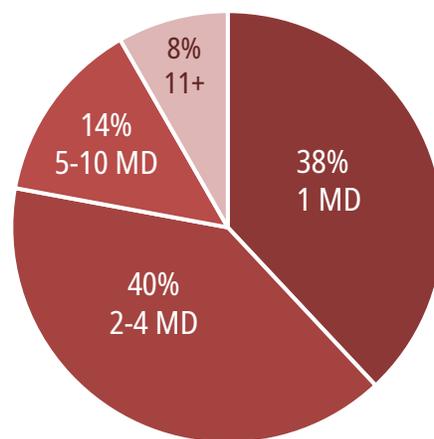
Excellent supply and demand fundamentals, new geographies, and dermatology's relative independence from hospitals suggest private equity will remain interested. Couple that with today's higher risks and costs of practicing medicine, compelling financial components, and a more physician-friendly model, we expect continued consolidation.

Although there is a wide spectrum of practices with their own individual characteristics across the U.S., based on our experience we find their characteristics tend to cluster based on one simple factor ... the number of active MDs. This may seem overly simplistic, but it is a good tool to help us understand the market dynamics at work.

As such we have identified four key physician clusters:

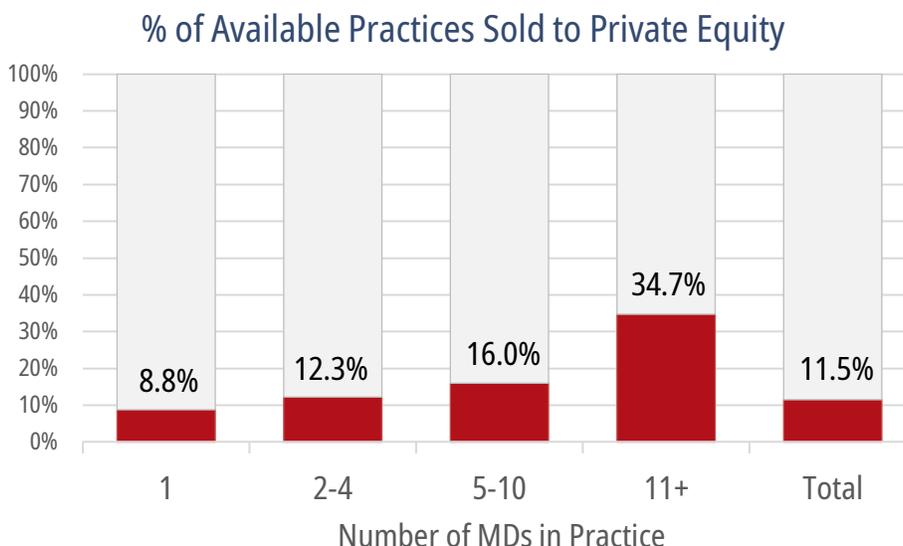
1. Single Physician Practices
2. Practices with 2-4 Physicians
3. Practices with 5-10 Physicians
4. Practices with Over 10 Physicians

Practices with 2-4 physicians account for the highest percent of acquisitions (40%) followed by single physician practices at 38%. The higher MD practice clusters are at 14% and 8%.



## Consolidation Actualization Varies by Practice Size

As would be expected, the larger practices are lower in number and have been acquired at a higher rate. As a result, almost 35% of practices with 10 or more physicians have closed a transaction with private equity.



# Geographic Targeting and Development

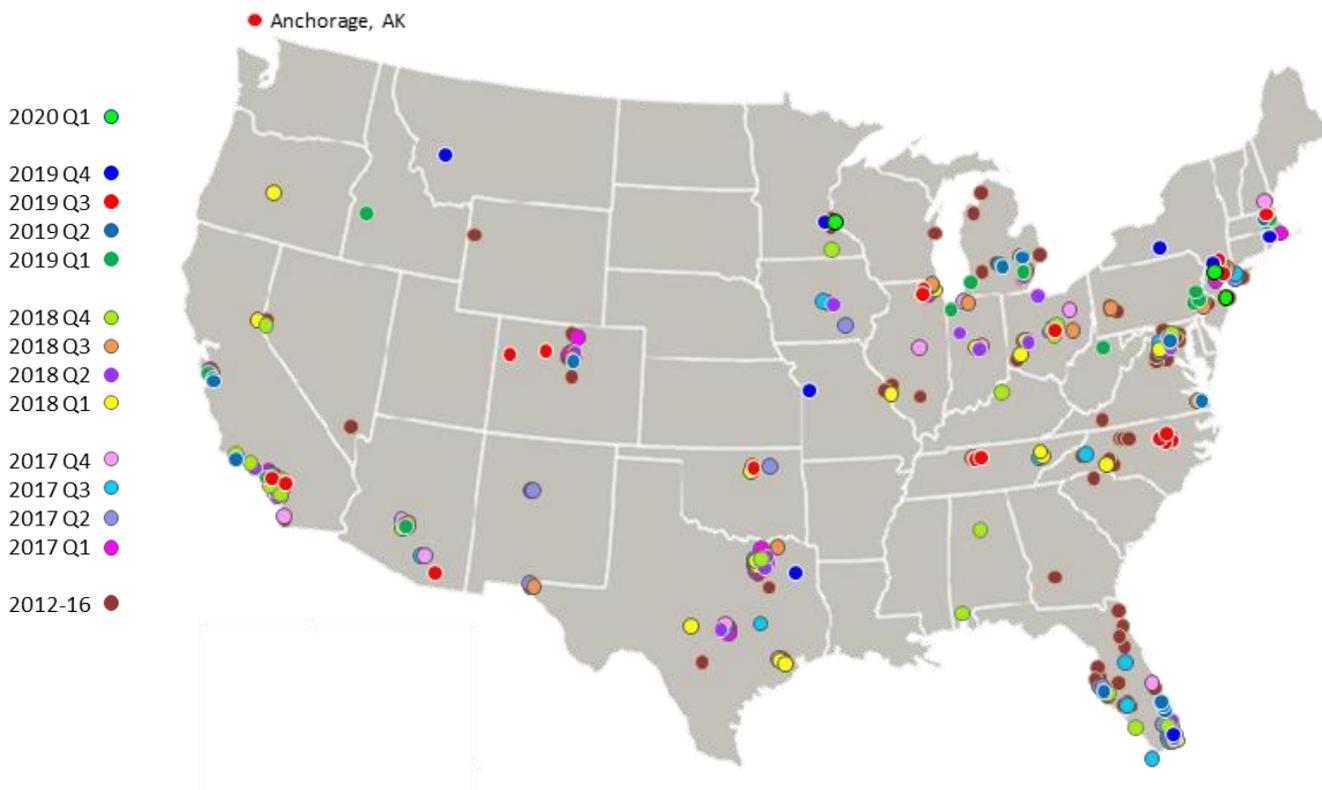
Eight years of consolidation activity has resulted in a wide spread of PE-backed practices across the United States. The heaviest concentration is focused in:

- Southwest Florida
- Florida's Central Gulf Coast
- Washington DC
- New York City
- Dallas / Ft Worth
- Los Angeles
- Chicago
- Denver

Over the last four quarters, private equity has entered six New Geographic Areas (NGAs) through acquisition:

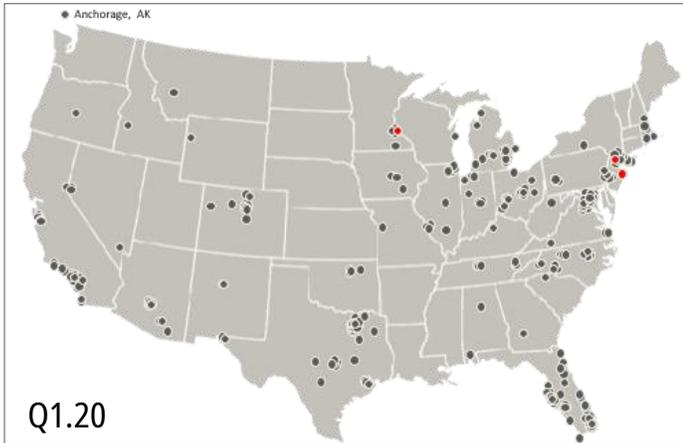
- Anchorage, Alaska
- Grand Junction, Colorado
- Kansas City, Kansas
- Tyler, Texas
- Elmira, New York
- Butte, Montana

## Dermatology Practice & ASC Acquisitions 2012 – Q1 2020



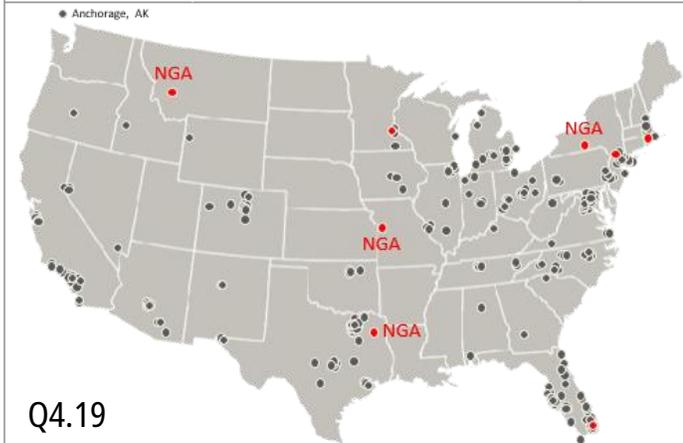
This map provides a visual summary of private equity / dermatology consolidation activity beginning in 2012. Each dot represents a practice acquisition. Multi-location practices are shown with only one dot.

# Geographic Investment Highlights by Quarter



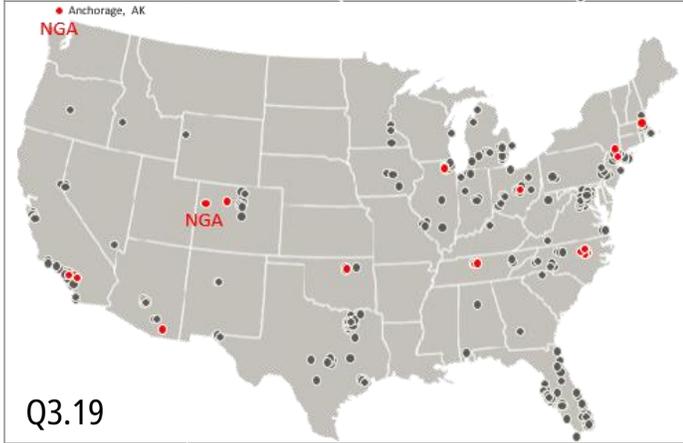
Q1.20

- Armory Capital enters dermatology with the announcement of VitalSkin
- No New Geographic Areas entered this quarter
- Schweiger Dermatology makes its first entry into New Jersey with two acquisitions
- Pinnacle Dermatology adds a second practice to its Minneapolis presence



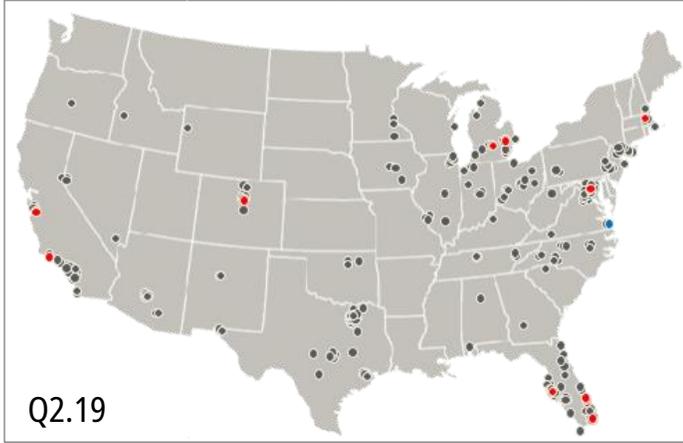
Q4.19

- Four New Geographic Areas (NGA) Entered
  - Kansas City, Kansas
  - Tyler, Texas
  - Elmira, New York
  - Butte, Montana
- Epiphany Dermatology makes three acquisitions in Texas, Montana and Kansas
- Six PE firms make eight total acquisitions



Q3.19

- HIG Capital enters dermatology
- Two New Geographic Areas (NGA) Entered
  - Anchorage, Alaska
  - Grand Junction, Colorado
- Eleven PE firms make nineteen acquisitions
- Anne Arundel Dermatology makes four acquisitions in North Carolina



Q2.19

- No New Geographic Areas (NGA) Entered
- Nine PE firms make thirteen acquisitions
- Five acquisitions made in Florida
- Three acquisitions made in California
- Two acquisitions made in Michigan

# Opportunity Areas: Open Geographies

This map shows the concentration of “available” practices that have not sold to private equity.

With only 11.5% of physician-owned dermatology practices reaching a transaction to-date, several key geographies have experienced a relatively low level of investment, yet they offer compelling opportunities.

## Upper Midwest to Northeast

The core area stretching from Illinois to Massachusetts is relatively open. Yet, many opportunities exist here including ASC acquisitions in non-CON states. Hospital dominance can make some of these markets more challenging.

## Southeast / Mid Atlantic

Climate, demographics and practice availability make this area a prime opportunity with a high concentration of dermatology practices. 88% of those practices are available.

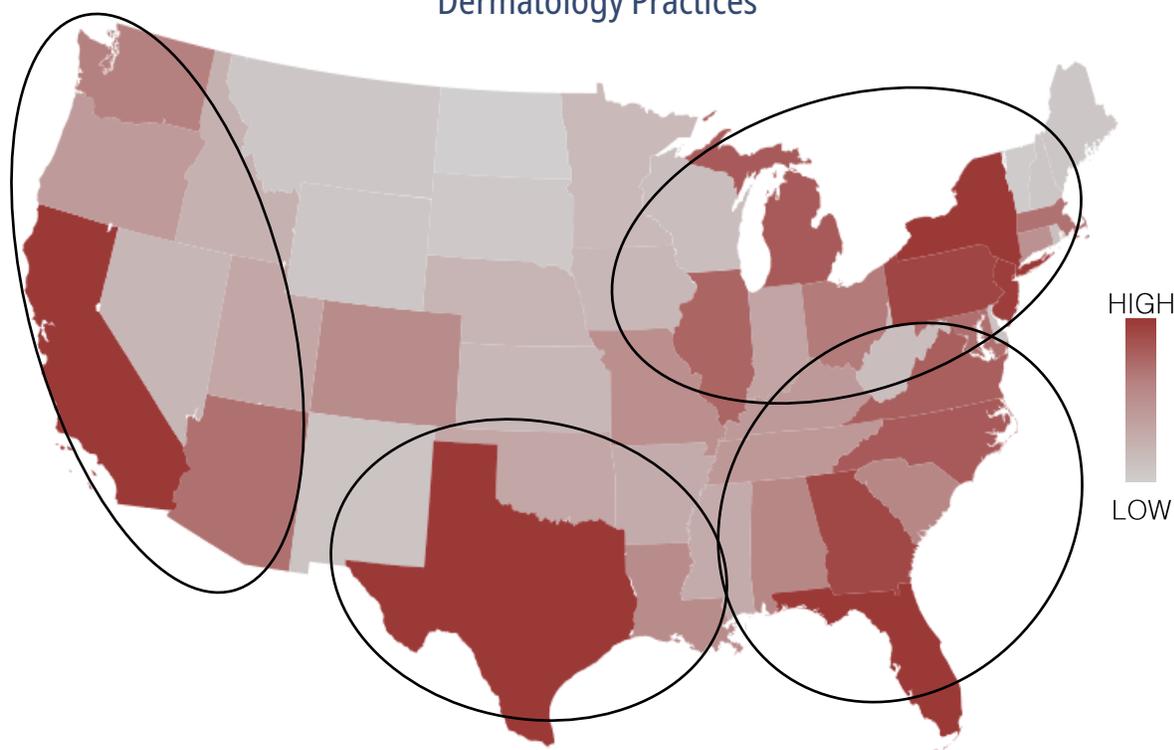
## Texas, Louisiana, Oklahoma

Large, highly populated, and fast-growing, these states represent an excellent opportunity market. Texas alone has over 200 available practices.

## Northern California and the Pacific Northwest

An investor could be very successful in Arizona and California up through the Pacific Northwest. California has the highest number of dermatology practices in the United States, and they are only 8% consolidated to-date.

Concentration of Physician-Owned  
Dermatology Practices



# Key Takeaways

1. Excellent supply and demand fundamentals, new geographies, and dermatology's relative independence from hospitals suggest private equity will continue to seek partner transactions.
2. Physician-owners considering a sale to private equity would be wise to act now given the maturity of the consolidation and the fact that transactions typically take 9-12 months to complete.
3. We are confident investors will give sellers "credit" for the COVID-19 shutdown – adjusting financial performance or looking at other periods when valuing a practice or ASC.
4. Deals continue to move ahead. Though many are paused, some are still closing now. We expect a return to normal deal volume once more is known about the COVID-19 timeline, and especially once normal clinical operations resume. We are advising physicians looking for a 2021 sale to begin the process now.
5. Since the third quarter of 2018, our dashboard has signaled a mixed picture of consolidation activity with some KPIs exhibiting expansion while others are more stagnant. We believe a few PE-backed companies will consolidate, and that there will be a resurgence of acquisition activity as physicians evaluate their selling opportunity post COVID-19.
6. There is a significant level of "anti-private equity consolidation" rhetoric permeating the dermatology vertical and likely reducing sale consideration. We strongly recommend that physician owners pursue a serious fact-based evaluation before dismissing this potentially lucrative window of opportunity.
7. Based on our detailed tracking and analysis, the dermatology market is only 11.5% consolidated as of this publication. Several key geographies have experienced a relatively low level of investment, yet offer compelling transaction opportunities:
  - Upper Midwest to Northeast
  - Southeast / Mid Atlantic
  - Texas, Louisiana, Oklahoma
  - Northern California and the Pacific Northwest

# Contact

To learn more about our healthcare investment banking services or to discuss your specific situation with no obligation please feel free to call:

Eric Yetter  
FOCUS Managing Director and Healthcare Team Leader  
Direct: 615-477-4741

We are happy to share our knowledge and help you understand your options. All conversations are strictly confidential.

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