The Evolving M&A Landscape in the Physical Therapy Sector

Following years of private equity investment, the physical therapy industry continues to see steady consolidation as market fragmentation persists.

INTRODUCTION

Despite an increase in consolidation over the last decade, the outpatient physical therapy industry remains highly fragmented and vast compared to other healthcare services sectors experiencing investment and consolidation activity led by private equity investors. There are over 200,000 licensed physical therapists in the U.S. spread across more than 16,000 outpatient clinics, with no single provider owning more than 10% market share in the outpatient industry, according to U.S. Physical Therapy's May 2018 Investor Presentation. Comparatively, other healthcare verticals in the midst of significant consolidation, such as dental practice management and behavioral health, employ approximately 190,000 and 140,000 providers, respectively[1], and highly sought-after areas for investment in the physician services industry, such as dermatology and ophthalmology, contain less than 30,000 doctors per subspecialty nationally. Though the aforementioned investment areas differ from physical therapy, the investment theses from private equity investors have comparable components across each of these outpatient healthcare services areas.

The size of the physical therapy industry, favorable macroeconomic tailwinds, and a practice environment ripe for consolidation have led to a steady trend of merger and acquisition activity across the United States. Between 2012 and 2016, 12 private equity groups made initial platform investments in outpatient physical therapy practices. The entrance of new private equity groups, however, slowed in 2017 as industry transaction activity shifted more heavily towards add-on transactions as private equity-backed groups actively acquired independent or private equity-owned competitors, a trend that is expected to continue moving forward.

PROVIDENT HEALTHCARE PARTNERS

120+	Healthcare Deals Closed
40+	Practice Managements Transactions Closed
12-15	Landmark Deals Per Year
24	Banking Professionals

- Investment banking services delivered exclusively to companies in the high-growth healthcare industry
- An established track record as one of the most active healthcare investment banks in the country
- Has emerged as a leading advisor to outpatient providers across the dental, physical therapy, and physician services industries
- Experienced advisors to serve the complexities of varied shareholder motivations
- Focus on sell-side mandates resulting in the best long-term partnerships

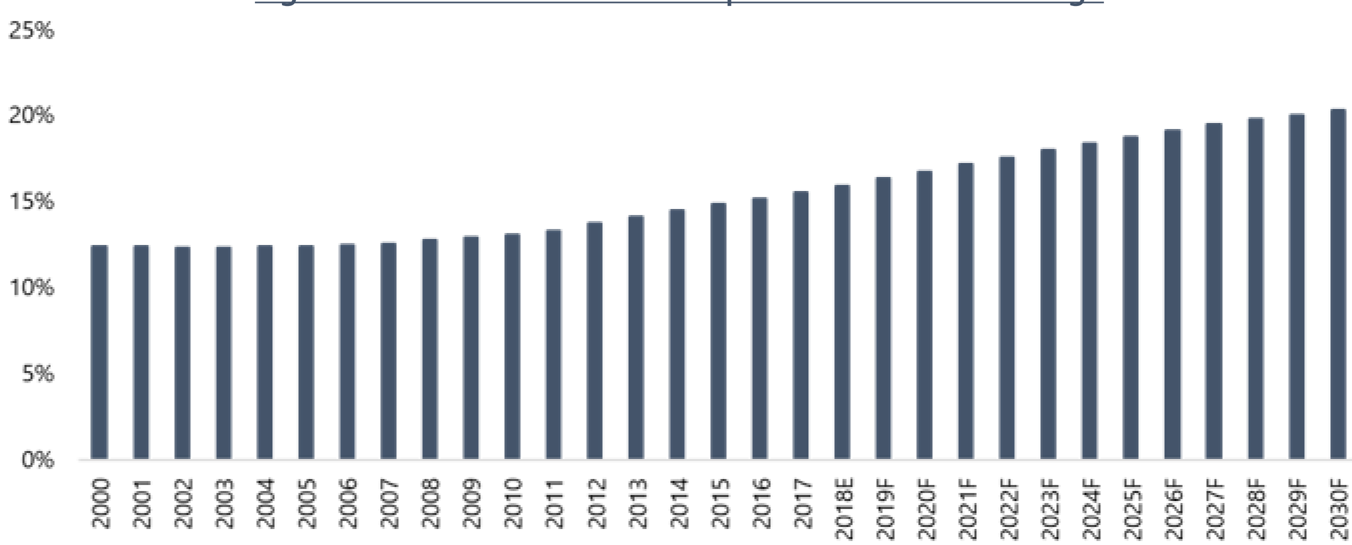
[1] *Sources: American Dental Association Workforce Statistics, Association of American Medical Colleges, and American Psychological Association*

PHYSICAL THERAPY INDUSTRY TAILWINDS CONTINUE TO ATTRACT HEALTHCARE INVESTORS

Private equity investment in physical therapy has been a trend for over 20 years. The first publicly-announced private equity recapitalization of a physical therapy practice was in 1995; Summit Partners ("Summit"), a private equity group with a reputation for making the first investments in healthcare sectors, completed a majority recapitalization of Rehab Management Systems, a Florida-based provider of physical therapy services with seven freestanding locations. Many other private equity groups have followed with investments of their own; since the beginning of 2010, 23 private equity groups have recapitalized physical therapy practices, with 10 of those practices receiving institutional capital backing for the first time.

The increase in activity over the last decade is driven by a number of industry tailwinds, including the shift to value-based care and the favorable demographics in the U.S. population. Increased demand for physical therapy services has caused the industry to grow roughly 2.8% annually over the last five years to reach a current market size of over $30 billion[2]. Demand for physical therapy services is expected to continue to rise given the increasingly active and aging population. Figure 1 below highlights the expected aging trend of American citizens through 2030, per the Organization for Economic Co-operation and Development. Adults over the age of 65 account for 34% of all physical therapy patients, and this percentage will grow as the population continues to age and life expectancy increases.

Figure 1: Percent of American Population >65 Years of Age



[2] *Source: IBISWorld*

PHYSICAL THERAPY INDUSTRY TAILWINDS CONTINUE TO ATTRACT HEALTHCARE INVESTORS (CONT.)

Furthermore, the physical therapy industry is well-positioned in the eyes of investors under value-based payment structures. The low cost and strong clinical outcomes of physical therapy services in the outpatient setting is an ideal fit for the current healthcare landscape where payors and provider networks are seeking high quality, cost-effective care for its patient population. While the effect of the Merit-based Incentive Payment System ("MIPS") remains to be seen in physical therapy until eligible providers begin reporting in 2019, MIPS implementation currently ongoing across the broader physician services industry has proven to be a driver of practice investment in healthcare technology to capture outcomes data, and it has provided a level of uncertainty regarding future reimbursement penalties and bonuses. Private equity consolidators have been leveraging this demand for capital and reimbursement uncertainty to drive consolidation in many of these areas, which Provident expects to further buoy consolidation in physical therapy in the future. Despite some immediate uncertainty, the long-term positive outlook for physical therapy under new payment models, as the payor system shifts away from fee-for-service, is expected to continue to drive interest from healthcare investors.

Additionally, private equity groups are attracted to the physical therapy industry given its fragmentation. There are an estimated 16,000 to 18,000 outpatient physical therapy clinics in the United States, and despite years of private equity-led consolidation, no single provider accounts for more than 5% of total industry revenue or 10% of market share by number of clinics[3]. Heavy fragmentation within the sector provides the opportunity for practices with capital to increase size and scale rapidly through acquisitions, or leverage brand equity and marketing strategies to compete through de novo clinic openings.

The large supply of small practices and limited number of consolidators in many U.S. markets presents a strong arbitrage opportunity for investors seeking accretive add-on acquisitions at attractive valuations.

The supply-demand imbalance of limited independent platform-sized physical therapy groups compared to the number of investors seeking portfolio companies in the sector has caused some changes to the traditional platform investment model. In mid-2017, GPB Capital formed the physical therapy platform Alliance Physical Therapy ("Alliance PT") through simultaneously acquiring majority stakes in four independent practices in separate states across the U.S. GPB leveraged operating partners to develop a management infrastructure and build the platform rather than the traditional model of investing into a well-established entity with strong executives. Alliance PT has since completed four add-on acquisitions, most notably adding the U.S. operations of Agility Health; the platform's success could influence other investors to consider entering the physical therapy market in a similarly unconventional manner.

The large supply of smaller practices and the significant amount of capital deployed in the sector has resulted in a surge of add-on acquisition activity. Private equity-backed platforms made 72 publicly announced add-on acquisitions over the last three years, up drastically from 22 publicly-announced add-ons during the three years prior. With only one publicly-announced platform investment in 2017, it's clear that industry transaction volume is shifting more heavily to add-on deals versus new platform investments. The rapid increase in these acquisitions correlates with the number of new platforms to emerge since 2010, with most investors utilizing a similar roll-up strategy.

[3]Source: US Physical Therapy Investor Presentation

ANALYZING THE PT INDUSTRY PRIVATE EQUITY ACTIVITY

The level of fragmentation in the physical therapy market presents a strong opportunity for investors looking for add-ons, but conversely creates a challenge to find organizations of scale that have yet to pursue a partnership with an institutional investor. As highlighted in Table 1 below, many of the largest outpatient organizations have taken advantage of favorable valuations in the market post-recession as a result of low interest rates and have already pursued a partnership with an investor.

Table 1: Notable Industry Private Equity Activity Since 2004

	Private Equity Investor			Exit Transaction	
Portfolio Company	**Year**	**Investor**	**Years Held before Exit**	**Year**	**Buyer**
Agility Health (U.S. Operations)	N/A	Publicly Traded (TSX)	N/A	2018	Alliance Physical Therapy
FYZICAL	2018	New Harbor Capital	N/A	N/A	N/A
Alliance Physical Therapy	2017	GPB Capital	N/A	N/A	N/A
CORA Health Services	2016	Gryphon Investors	N/A	N/A	N/A
Excel Orthopedic Rehabilitation	2016	Caymus Equity	N/A	N/A	N/A
360 PT Management	2015	Celerity Partners	N/A	N/A	N/A
MOTION PT Holdings	2015	Pharos Capital Group	N/A	N/A	N/A
Athletico Physical Therapy	2014	Harvest Partners	2	2016	BDT Capital Partners
Results Physiotherapy	2014	Sterling Partners	N/A	N/A	N/A
Phoenix Rehabilitation and Health Services	2013	3 Rivers Capital	N/A	N/A	N/A
Pivot Physical Therapy	2013	InTandem Capital	N/A	N/A	N/A
PT Solutions	2013	New Harbor Capital	5	2018	Lindsay Goldberg
Drayer Physical Therapy Institute	2012	Goldman Sachs Merchant Banking Division	6	2018	Upstream Rehabilitation
Physiotherapy Associates	2012	Court Square Capital Partners	4	2016	Select Medical Holdings
ATI Physical Therapy	2012	KRG Capital Partners	4	2016	Advent International
Michigan Rehabilitation Specialists/Excel Rehabilitation Services	2012	Shore Capital	1	2013	ATI Physical Therapy
Physical Rehabilitation Network	2012	Silver Oaks Capital	N/A	N/A	N/A
Professional Physical Therapy	2011	Great Point Partners	5	2016	Thomas H. Lee Partners
Accelerated Rehabilitation Centers	2011	OMERS Private Equity	3	2014	Athletico Physical Therapy
ATI Physical Therapy	2010	GTCR	2	2012	KRG Capital Partners
Drayer Physical Therapy Institute	2008	Linden Capital Partners	4	2012	Goldman Sachs Merchant Banking Division
Accelerated Rehabilitation Centers	2008	Gryphon Investors	3	2011	OMERS Private Equity
Ivy Rehab Network	2007	Ivy Capital Partners	9	2016	Waud Capital Partners
Physiotherapy Associates	2007	Water Street Healthcare Partners	5	2012	Court Square Capital Partners
Dynamic Physical Therapy	2006	Lake Capital	11	2017	Pivot Physical Therapy
ATI Physical Therapy	2005	KRG Capital Partners	5	2010	GTCR
Upstream Rehabilitation	2004	Charterhouse Equity Partners	11	2015	Revelstoke Capital Partners

ANALYZING THE PT INDUSTRY PRIVATE EQUITY ACTIVITY (CONT.)

Successful prior exits and the previous returns realized by investors have resulted in repeat private equity entrants into the outpatient market, a rare occurrence in the healthcare services industry. KRG Capital Partners originally invested in ATI Physical Therapy in 2005 and grew the practice to 88 locations before selling its position to GTCR five years later. In 2012, KRG repurchased ATI Physical Therapy, which operated 188 clinics at the time, and subsequently exited four years later to a larger private equity group, Advent International, at a valuation of well over $1 billion. Additionally, Gryphon Investors leveraged its successful three year investment in Accelerated Rehabilitation Centers, which it exited to OMERS Private Equity in 2011, to pursue a more recent partnership with CORA Health Services in 2016. And most recently, New Harbor Capital remained invested in the physical therapy market with its recapitalization of FYZICAL and exit from PT Solutions.

As illustrated in Table 2, the average investment window for private equity firms in the industry has been five years, with the majority of groups pursuing a secondary transaction with a larger private equity firm entering the sector for the first time (64.7%). This more common exit strategy and timeline has allowed platforms to continue their same growth strategies with new capital partners that provide more significant resources, while mitigating the integration risk inherent in merging two large organizations. The outliers to this strategy include Shore Capital's one year investment in two Michigan-based platforms, which caught the attention of ATI Physical Therapy and resulted in a quick exit for Shore in 2013. Conversely, both Charterhouse Equity Partners and Lake Capital held their investments for 11 years before a secondary transaction with a financial buyer and strategic buyer, respectively.

A number of platform investments made between 2012 and 2014 are approaching or have recently reached the end of a typical holding period for a private equity firm. Most recently, New Harbor Capital exited its position in PT Solutions to Lindsay Goldberg after an approximately five year holding period. Similarly, Goldman Sachs Merchant Banking Division sold the majority of its physical therapy platform, Drayer Physical Therapy Institute, to Upstream Rehabilitation, a portfolio company of private equity group Revelstoke Capital Partners. Physical Rehabilitation Network, acquired by Silver Oaks Capital in April 2012, and Pivot Physical Therapy, recapitalized by InTandem Capital and CI Capital in 2013, are two logical candidates to pursue partnerships with new investor groups or strategic entities in 2018 or 2019.

Table 2: Key PE Industry Statistics

Key Statistics	
Average Investor Holding Period	5 years
Percentage of Exits to Financial Buyer	64.7%
Groups Approaching Potential Exit	4

*Data through Q3 2017

CONCLUDING THOUGHTS

There have already been four notable physical therapy transactions so far in 2018, indicating that market consolidation is not slowing down. In addition to the Drayer Physical Therapy deal, New Harbor Capital, which solid its majority stake in PT Solutions to Lindsay Goldberg in June 2018, made a majority investment in FYZICAL, a physical therapy franchisor with 265 locations in 36 states. Also, Agility Health sold its U.S. operations, a total of 84 clinics and 36 hospital contracts, to Alliance Physical Therapy. With backing from GPB Capital, Alliance PT is the most recently formed physical therapy platform, and this landmark acquisition solidifies their status as a major player in the physical therapy market.

Looking ahead, Provident expects the physical therapy market to remain an area of high interest to investors. Strong add-on acquisition activity and platform investments over the past few years echo investor confidence in physical therapy services, and a series of landmark deals in the last 12 months only strengthens that confidence. While add-on transaction activity will likely outpace new investors entering the industry, the opportunity to be a platform still exists in today's market for sizeable practices with 10 or more clinics. Members of the Provident Healthcare Partners physical therapy coverage team, including Eric Major, Vice President, and Scott Davis, Vice President, would be happy to elaborate on any of the insights in this article and to answer other inquiries regarding healthcare services. They can be reached at (617) 742-9800.

Provident

Provident is the leading investment banking firm specializing in merger and acquisition advisory, strategic planning, and capital formation for middle-market and emerging growth healthcare companies.

The firm has a vast network of senior industry relationships, a thorough knowledge of market sectors and specialties, and unsurpassed experience and insight into the investment banking process.

Boston:
260 Franklin Street, 16th Floor
Boston, Massachusetts 02110
617-742-9800

Los Angeles:
315 S. Beverly Drive, Suite 504
Beverly Hills, California 90212
310-359-6600