Investment and Consolidation within Dermatology

The dermatology sector continues to draw interest from private equity investors as well as existing platforms. A favorable growth backdrop paired with fragmentation within the sector has created an environment ripe for consolidation.

Provident Healthcare Partners

INTRODUCTION

Dermatology has been one of the fastest growing subsectors within physician services in recent years. The $13 billion market is expected to grow at 5.8% to upwards of $16 billion through 2019, making it the second-fastest-growing provider specialty, trailing only Physical Therapy, in terms of top line revenue growth. Volume growth of this nature, coupled with significant fragmentation in the marketplace, has created a robust investment and acquisition environment, as evidenced by more than 30 transactions executed over the last 24 months. We are expecting this trend to continue as practices continue to draw interest from the private equity community, as well as from private equity backed consolidators.

Due to the significant fragmentation and scarcity of larger practices in the sector, private equity groups are increasingly coming downstream to act on their investment theses. Strategic consolidation has also gained traction due to the absence of larger practices as private equity backed platforms have executed add-on acquisition strategies in order to realize synergies, expand into new geographies and accelerate growth. Scalable companies with robust infrastructure, fitting the platform mold, have commanded some of the highest multiples within healthcare services due to pent-up demand and the ability to quickly expand.

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Provident Dermatology Deal Team

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Source: IBIS World

CONSOLIDATION DRIVERS

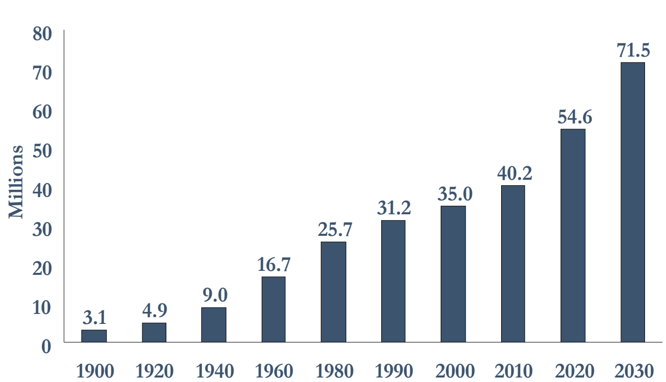
There are a number of factors driving consolidation in the dermatology space. Volume-based growth trends, favorable reimbursement structure and fragmentation within the sector have made dermatology practices attractive investment and acquisition targets for both private equity firms and strategic consolidators.

TOP LINE VOLUME GROWTH

Demographic tailwinds continue to drive volume growth as the population ages and lives longer. Patients older than 60 years old account for 40% of industry revenues and by 2030, the 65+ demographic is expected to more than double in size from 30 million to 71.5 million people.

An increase in skin cancer, due to an aging population, along with an increased awareness for skin health has contributed meaningfully to growth as well. According to the American Cancer Society, there have been more instances of skin cancer than breast, prostate, lung and colon cancer combined.

U.S. Population Growth – Age 65 and Over



FRAGMENTED SECTOR

The fragmented nature of the dermatology sector has created an environment ripe for consolidation. 40% of dermatology practices are solo practices, while 73% have less than five physicians. Moreover, the four largest practices within the dermatology sector comprise less than 2% of market share.

Fragmentation and scarcity of larger practices has caused a rise in add-on acquisitions. Advanced Dermatology & Cosmetic Surgery, formerly backed by Audax Group, executed 40 add-on acquisitions over the course of their five year holding period. Advanced Dermatology & Cosmetic Surgery has since then traded financial partners, having been acquired by Harvest Partners in May of 2016. U.S. Dermatology Partners, which was recently acquired by ABRY Partners from Candescent Partners, has already executed five add-on acquisitions this year.

> “The four largest practices within the dermatology sector comprise less than 2% of market share.”

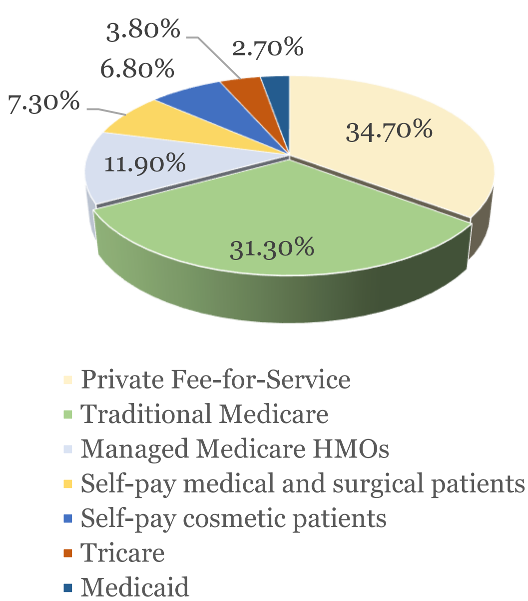
Sources: US Administration on Aging, American Cancer Society, AADA Profile Survey, Law360.com

CONSOLIDATION DRIVERS

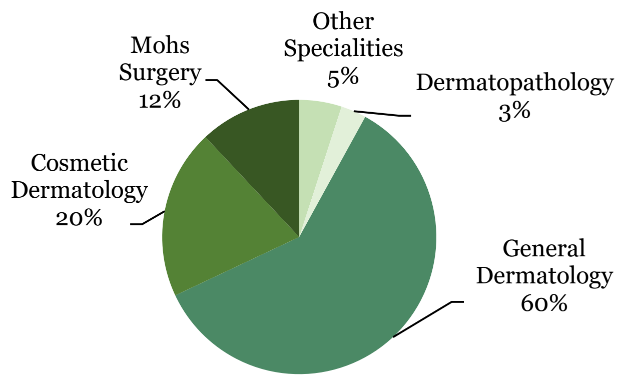
REIMBURSEMENT STRUCTURE

In addition to volume-based growth trends, the dermatology sector also boasts reimbursement stability and favorable payor dynamics. Medical and surgical procedures are typically well reimbursed as private fee for service payors comprise the largest percentage of revenue (35%) within the sector.

Dermatology also includes an elective, private pay component, which serves as an attractive cash pay, ancillary revenue stream. Medical dermatology accounts for 60% of volume but cosmetic dermatology has started to gain some traction due to the increasing social acceptance for cosmetic procedures and a rise in disposable income



Cosmetic services now comprise 20% of industry revenue, partially mitigating the reimbursement risk inherent in healthcare services. Additionally, federal funding for Medicare and Medicaid is expected to increase at an average annual rate of 5.3% for the next 5 years. Medicare projections, an attractive payor mix and favorable reimbursement structure all point to signs of steady future revenue streams within the sector.



> "Medicare projections, an attractive payor mix and favorable reimbursement structure all point to signs of steady future revenue streams within the sector."

Sources: Skincancer.org, IBIS World

PRIVATE EQUITY INVESTMENT

PRIVATE EQUITY INTEREST

Private equity interest has expeditiously grown over the last 48 months in healthcare services. The combination of capital overhang (capital overhang represents roughly 3x the amount of capital called in the previous year) and inexpensive debt, coupled with recession resistant volume growth in healthcare services has led to increased demand for leading providers.

Private equity interest mainly lies with groups of size and scale with centralized back office functions and robust infrastructure in place (billing, collections, IT, EMR). Private equity groups have historically paid a premium for practices that are easily scalable through executing an add-on acquisition strategy.

Aside from infrastructure and scalability, groups typically look for practices that are able to generate ancillary revenue streams through high margin surgical services such as Mohs surgeries and dermatopathology. Cosmetic dermatology is another sought-after service line due to its mitigation of reimbursement risk and cross-selling potential.

Platform	Private Equity Group
Advanced Dermatology & Cosmetic Surgery "The Dermatologist Will See You Now!"	HP Harvest Partners
Forefront Dermatology	OMERS
United Skin Specialists	TB Tonka Bay
qdp QualDerm Partners	Cressey & Company
Anne Arundel Dermatology	New MainStream Capital
Schweiger Dermatology	LLR partners
Riverchase Dermatology and Cosmetic Surgery	GTCR
DermOne Dermatology	Westwind Investors, LP
U.S. Dermatology partners	ABRY Partners
West Dermatology	EEF Enhanced Equity Funds

Source: Prequin

PRIVATE EQUITY INVESTMENT

PRIVATE EQUITY EXITS

The private equity partnership model has proven over the last 48 months to be successful in dermatology as evidenced by the amount of private equity-backed dermatology exits in 2016 alone. Five of the largest practices have traded financial partners over the last year, demonstrating the ability of groups to quickly scale a platform business and realize a significant return on investment. We expect this trend to continue as other private equity firms aim to replicate these successes, along with their own investment successes in similar physician service sectors.

Audax Group, for example, invested in Advanced Dermatology & Cosmetic Surgery as their platform investment in October of 2011. Over the course of 5 years they were able to grow the company's EBITDA through both organic and inorganic growth intiatives. The company added 90 clinics and expanded into 11 more states through 40 add-on acquisitions. They recently exited their position, selling to Harvest Partners in May of 2016, having generated an above market return on investment.

Platform Investment	Initial Private Equity Investment	Subsequent Private Equity Investment
Advanced Dermatology & Cosmetic Surgery	Audax Group (2012)	Harvest Partners (2016)
Riverchase Dermatology	Prairie Capital (2012)	GTCR (2016)
Dermatology Associates	Candescent Partners (2012)	ABRY Partners (2016)
Forefront Dermatology	Varsity Healthcare Partners (2012)	OMERS (2016)
Schweiger Dermatology	SV Life Sciences (2015)	LLR Partners (2016)

CONCLUDING THOUGHTS

Dermatology has undergone a tremendous amount of consolidation in recent years but very much remains a fragmented sector. M&A is an intriguing proposition not only from an investor's standpoint, but also from a business owner's standpoint as well. Independent practices are increasingly opting to build scale or align with large providers to increase negotiating leverage with payors and alleviate the administrative burden that comes with the Affordable Care Act, Meaningful Use and the transition to value based care. With M&A considerations strong from both the sellers' and buyers' perspective, we are expecting consolidation to continue to take form in dermatology.

Provident

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