Provident Perspectives: Private Equity Investment in Orthopedics

Orthopedics is a sector ripe for consolidation. Favorable industry tailwinds and significant fragmentation in the market has set the stage for a wave of M&A activity driven by private equity investment in the marketplace.

Provident Healthcare Partners

PROVIDENT'S PERSPECTIVE

As the leading middle-market merger and acquisition advisory firm within physician services, Provident possesses unique insight into the current trends facing the practice management industry and how these trends will likely drive future consolidation activity. Provident also has a reputation for representing early-movers in specific physician specialties through landmark transactions with private equity firms. Past examples of these recapitalizations include Women's Health Care Group of PA with Audax Group, National Spine & Pain Center with Sentinel Capital Partners, Katzen Eye Group with Varsity Healthcare Partners, and most recently Southeastern Spine Institute with Candescent Partners. Given the significant interest from the private equity community in Southeastern Spine Institute, Provident predicts orthopedics will be the next physician services sector to undergo significant investment and consolidation.

SSI Southeastern Spine Institute and Ambulatory Surgery Center

Has been recapitalized by

Candescent Partners

The Spine Center at The Center for Pain Management

Has been recapitalized by

Sentinel Capital Partners

Katzen Eye Group

Has been recapitalized by

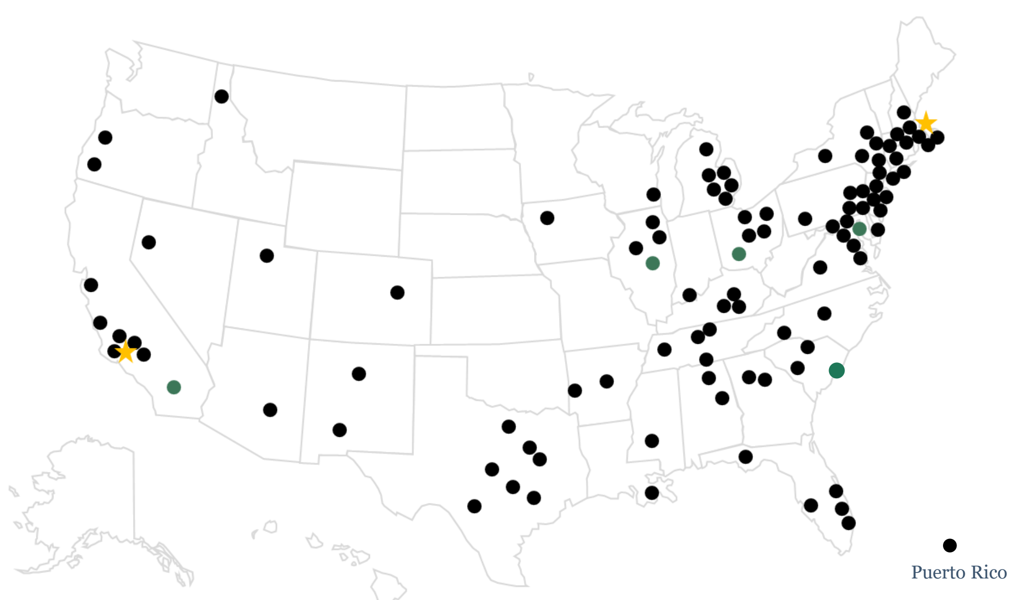
Varsity Healthcare Partners

Women's | Health Care Group of PA

Has been recapitalized by

Audax Group

NATIONAL PRESENCE



Recently Completed Transaction

Deals Closed – Past 5 Years

Office Location

100+	Deals Closed
$13B+	Aggregate Transaction Value
15-20	Landmark Deals Per Year
30+	Deal Professionals

INTRODUCTION

The orthopedic space represents one of the few physician specialties to remain relatively untouched by outside investment. In fact, the industry saw its first majority recapitalization by a private equity group when Provident represented the shareholders of Southeastern Spine Institute through their recapitalization with Candescent Partners in April of 2017. While private equity investment is commonplace in most other specialties including dermatology, ophthalmology, and pain management, it remains a relative unknown in orthopedics. Although the space has yet to see significant outside investment, there are a number of factors that make orthopedics a highly attractive opportunity for private equity groups. Given the wide breadth of ancillary services offerings, increasing outpatient surgical volume, aging population, and the growing importance of orthopedics to overall healthcare, there is significant opportunity in space for private equity led consolidation.

Each year the Centers for Medicare and Medicaid approve more procedures to be done in an outpatient setting. This trend has allowed private orthopedic practices to shed ties with local health systems and create platforms with a broad array of services such as physical therapy, urgent care, x-ray, MRI, pain management, DME, and more. Coupled with the growing demand for orthopedic services from an aging population, the space is one of the fastest growing in healthcare.

As falling reimbursement puts pressure on smaller practices, many will understand that to remain viable in the new healthcare environment, they must partner with a larger organization. Traditionally the only potential partner for private practices has been the local health system. Provident believes that private equity presents an additional, more favorable option for practices looking to gain size and scale to remain competitive in the current reimbursement environment.

Provident also believes there are a number of similarities in orthopedics to other specialties that have seen considerable private equity investment. Due to these factors and the favorable industry tailwinds, Provident believes that the orthopedic space will be the next space to experience a considerable amount of outside investment.

Practices that are educated on the private equity model and the benefits that these outside investors can bring to a practice will be positioned to benefit most from this coming industry shift.

"Given the wide breadth of ancillary services offerings, increasing outpatient surgical volume, aging population, and the growing importance of orthopedics to overall healthcare, there is significant opportunity in space for private equity led consolidation."

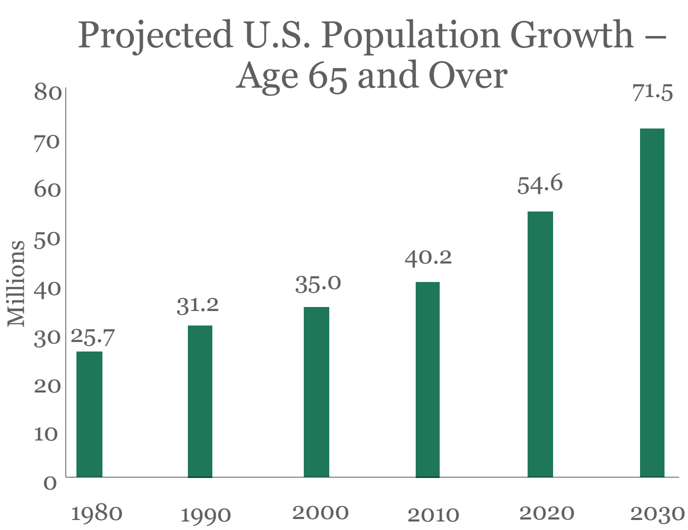
Robert Aprill, Associate
Provident Healthcare Partners

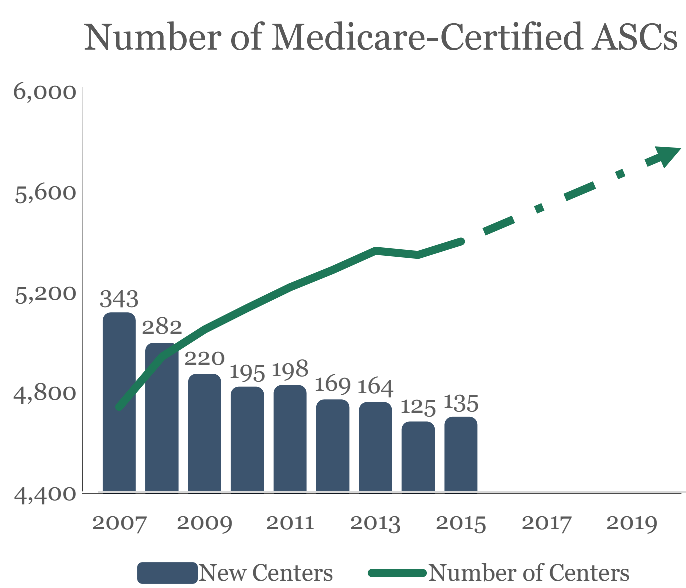
ORTHOPEDIC MACROECONOMIC TRENDS

Provident believes there are several key industry drivers fueling growth in the space. A growing and aging U.S. population will lead to an increased demand for orthopedic procedures. The number of U.S. citizens ages 65 and over is projected to more than double 2000 level by 2030 (an increase from 35 million to 71.5 million). This, in conjunction with the rise in poor joint health caused by obesity and age-related conditions, has created one of the fastest growing areas of need in healthcare. It is estimated that 60 million people suffer from chronic musculoskeletal pain, resulting in over $100 billion in medical expenditures per year. Due the continuing rise in life expectancy in the U.S. increasing, demand for orthopedic services will only continue to grow.

In addition to a growing market, outpatient orthopedic services continues to benefit from a loosening regulatory environment. Each year the Centers for Medicare and Medicaid approve additional procedures to be done in an outpatient setting. Over the past decade, patients, payors, and hospitals have begun to realize the numerous benefits of shifting care to an outpatient setting. Medicare reimbursement to hospitals has grown at an average annual rate of 1.5% for inpatient and 6% for outpatient services since 2005. Lower cost per case, improved technology, patient preference, 23-hour stay programs, and significant improvements in anesthesia and postsurgical pain management have shifted a significant portion of orthopedic procedures to outpatient settings. Physician-owned practices have been the biggest beneficiary of this industry transformation.

Provident believes that the orthopedic industry will continue to benefit from favorable macroeconomic and societal trends for the foreseeable future.



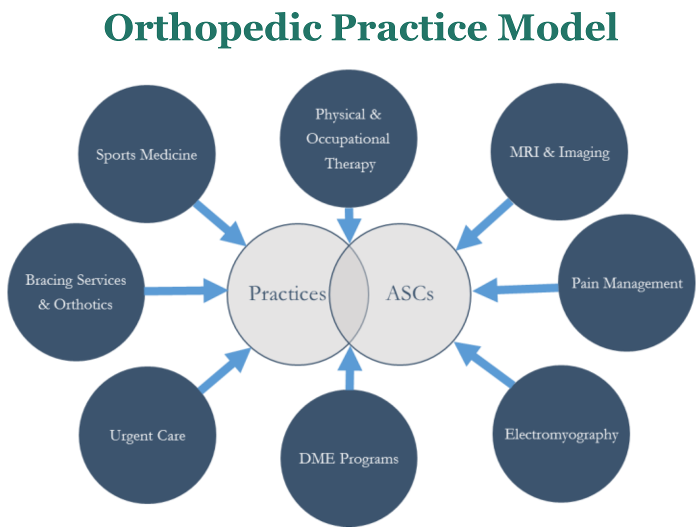


**Source: Sg2 Health Care Intelligence, Becker's, www.medpac.gov*

PRIVATE EQUITY APPROACH TO ORTHOPEDICS

While nearly every other specialty has experienced some level of private equity investment (i.e. dermatology, ophthalmology, pain management, etc.), the orthopedic specialty has remained relatively untouched. While we have seen several years of cash-less consolidations with practices merging in an effort to negotiate more favorable payor rates, outside investment into the space has remained all but non-existent. There are several shifts taking place within the industry that have made it more closely resemble specialties with a long history of private equity involvement. An increasing number of procedures are being done in outpatient/ASC settings, allowing for private practices to sever long standing ties to the local hospital and their surrounding health system. With the shift away from the hospital has come the need for practices to offer more service lines. The model of 'one-stop shop' has created a drastic shift in the industry. Ancillaries such as x-ray, MRI, physical therapy, occupational therapy, orthotics, sports medicine, walk-in clinics, etc. not only provide a more patient centric experience, but have created alternative revenue streams that have bolstered a practices bottom line.

Orthopedics has traditionally experienced some of the most favorable reimbursement rates of any specialty. As rates across healthcare have fallen, orthopedics has seen this once favorable environment start to slip away. Practices are seeing that the future viability of their business hinges on size and scale. The ability to negotiate rates with major payors will determine the future of private practices. Although there are a few regional providers in the space (Centers for Advanced Orthopedics, OrthoCarolina, and OrthoIndy etc.) the number of multi-state providers is minimal. The vast majority of the



industry is comprised of small (1-5 provider) practices. As smaller providers feel the pinch of falling reimbursement, they understand to stay viable in the future they will need to make a change. For many of them the only option may be joining the local health system. The majority of private practitioners have no interest in becoming an employee of a hospital, and would view joining a private equity-backed private practice as a much more favorable option.

Private equity groups will look to make an investment in a orthopedic group that have a strong management team, a breadth of ancillary service offerings, and a strong community presence. Using this group as a 'platform', they will grow the partnership by leveraging the current reimbursement environment to make acquisitions of high quality, smaller practices in strategic geographic markets. In addition, where acquisitions don't make sense, they will open de novo locations, including ASC's, to meet patient needs. Lastly, a private equity group would work with practice management to determine what ancillary services should be added to which locations to ensure each practice location can satisfy patient demand.

CONSOLIDATION TRENDS IN PARALLEL SPECIALTIES

Driven largely by the regulatory environment, reimbursement pressures, and extreme fragmentation, physician services organizations across a wide range of specialties have found that the best way to stay competitive in the modern healthcare environment is to gain size and scale. Private equity has been a key driver of the consolidation occurring within healthcare through implementing a "buy and build" or "roll-up" investment strategy in fragmented sectors. The strategy starts by partnering with an established "platform" organization that possesses talented management, a strategic vision, and a base infrastructure to scale the business. Following further internal investment, organizations aligned with a private equity firm will then look to perform "add-on" acquisitions of smaller physician groups at lower valuations than the platform investment received.

The practice of increasing enterprise value through acquiring smaller organizations is known as "multiple arbitrage". As the platform organization grows, its value increases in tandem with each subsequent addition to the platform. A return is realized through a subsequent transaction, at which point the organization can see a higher exit multiple because of the premium that is typically paid for the larger entity upon exit. In addition, each add-on acquisition that was performed is subsequently exited as part of the platform organization at the higher valuation. The opportunity to implement this buy and build investment strategy as a first-mover in the fragmented orthopedic market is what makes partnering with a private equity partner an attractive option for groups that possess the qualities of a platform organization.

Sample Overview of Multiple Arbitrage

Company	Valuation Range	Rationale	EBITDA	Multiple	EV
Private Equity Platform Investment	7x - 9x	• Regional dominance • Established infrastructure	$5M	8x	$40M
Add-On Acquisition	4x - 6x	• First-mover advantage ensures less competition	$2M	5.0x	$10M
Combined Organization	10x - 12x +	• Value of add-on is enhanced as the organization benefits from premium demanded for the platform company • Combined organization leverages the infrastructure and regional dominance of platform • Synergies from centralizing back-office functions and increased leverage with payors enhance the EBITDA of the combined organization	$7M + $500K in synergies = $7.5M	10.0x	$75M

PRIVATE EQUITY GROWTH STRATEGY - CASE STUDY

Platform Transaction Overview – May 2014

- Market leader in patient centric eye care in Central Maryland
- Vertically integrated ophthalmology and optical services
- Four clinical locations and an outpatient surgery center (Dulaney Eye Institute)

- Private equity firm focused on originating, acquiring and growing market-leading healthcare provider platforms with locations in Los Angeles, CA and Stamford, CT
- Principals bring extensive healthcare expertise and experience

Add-On Acquisitions

Source: PitchBook

Growth Overview – May '14 to Present

Operating Metric	Katzen Eye Group 2014	EyeCare Service Partners 2017
Physicians	30	114
Clinics	4	44
Surgery Centers	1	5
States	1	5
Service Lines	Ophthalmology, Optical	Ophthalmology, Optometry, Optical

Katzen Eye Group's management team sought to replicate the company's regional success on a national level through a private equity partnership. Provident organized a transaction process focused on 25 private equity firms and 10 strategic buyers. Katzen garnered significant interest as many of the equity sponsors involved saw the opportunity to leverage experience with other outpatient healthcare sectors to the fragmented eye care sector. Varsity Healthcare Partners was ultimately selected due to their ability to finance Katzen's acquisition pipeline, deep expertise in the ophthalmology space, and focus on Katzen as one of their only portfolio companies. Katzen was restructured and a national holding company, EyeCare Services Partners Holdings, LLC (ESP), was established. Varsity immediately bolstered existing senior management by bringing in a national CEO, Michael Fricke, formerly of Sante Pediatric Services, with the primary owner preferring a transition into the Chief Medical Officer role. In addition to a new CEO and VP of Business Development, Varsity has helped the organization make investments in IT infrastructure to execute a rapid growth strategy based on identifying and acquiring the highest-quality ophthalmology and optometry practices in attractive markets across the U.S. With a first-mover advantage in the market as one of the only ophthalmology practice consolidators, ESP has been able to evaluate dozens of potential opportunities (through investment banks as well as their own organic outreach) and has selectively chosen to partner with groups in specific markets. The organization has moved into four new states through acquisitions, since the initial investment by Varsity in May of 2014

ORTHOPEDIC PRIVATE EQUITY DEAL - CASE STUDY

Candescent Partners Acquires the Southeastern Spine Institute

Transaction Summary:

The Southeastern Spine Institute (SSI) was a single location practice in Mount Pleasant, South Carolina when they engaged Provident to help them find a private equity partner. The Practice had been serving the Charleston Community for over 20 years and felt with the assistance of an experienced private equity group, they could expand their services to the surrounding communities and states. When SSI began working with Provident, they had grown into the largest spine practice in the state of South Carolina, occupying a 41,000 sq/ft facility. In tandem to working with Provident, SSI was in the process of building a brand new state-of-the-art facility that will be over 70,000 sq/ft when completed in 2018. While the Practice had many years of consistent growth, the shareholders felt that a private equity partner would allow them to amplify their growth trajectory and assist them in expanding from their single location to several that could capture an unmet patient need in the surrounding area and states. Provident ran a broad process that saw significant interest from the private equity community. Ultimately the shareholders at SSI felt that Candescent Partners was the best partner as they brought the highest level of industry knowledge and a proven track record of successful investments in the physician services space. Prior to their partnership with SSI, Candescent partners had successful investments in eye care, dermatology, dental, and home health. In addition, the SSI shareholders had been seeking a CEO prior to engaging with Provident. In tandem with the closing of the transaction, Candescent Partners helped SSI successfully conduct a national search for a CEO with extensive experience growing a physician practice through acquisitions. SSI and Candescent will look to grow through a combination of acquisitions, de novo expansion, and bolstering of ancillary service offerings.

Client:

SOUTHEASTERN SPINE INSTITUTE AND AMBULATORY SURGERY CENTER

- The leading medical practice in the State of South Carolina specializing in spine care.
- Located in Mount Pleasant, SC in a 41,000 sq/ft facility.
- The practice has onsite MRI, X-ray, diagnostics, non-surgical treatment rooms, block suites, in-house pharmacy, and physical therapy.

Investor:

CANDESCENT PARTNERS

- A Boston-based private equity group that specializes in acquisition, growth, and recapitalizations of lower middle market companies in the healthcare services space.
- Founded in 2008 by Steve Jenks and Sandy McGrath.
- Invests in business with EBITDA's between \$2 - \$8 million and enterprise values between \$10 and \$75 million.

CONCLUDING THOUGHTS

While it is impossible to predict the future, trends and past experience within other specialties leads Provident to expect that mergers and acquisitions will become increasingly prevalent within orthopedics. The private equity community is aggressively looking for platform ready groups in the space. As trends within the sector continue to favor large providers with scale, strong management, strategic vision, and access to capital, the Southeastern Spine Institute's partnership with Candescent Partners will surely be the first of many in a wave of outside investment into the orthopedic space. To the extent that it is of interest, members of the Provident team would be happy to elaborate on any of these trends & provide specific insights on healthcare niches, specialties, and industry verticals. Please contact us at (617) 742-9800 for additional information.

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.

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