Provident Perspectives: Investment and Market Trends in Workers Compensation Ancillary Services

Merger and acquisition activity in the Workers Comp Ancillary Services space has persisted despite the challenges presented by COVID-19

Provident Healthcare Partners

Executive Summary: Focus on Cost Containment Poised to Drive M&A Activity across Workers Compensation

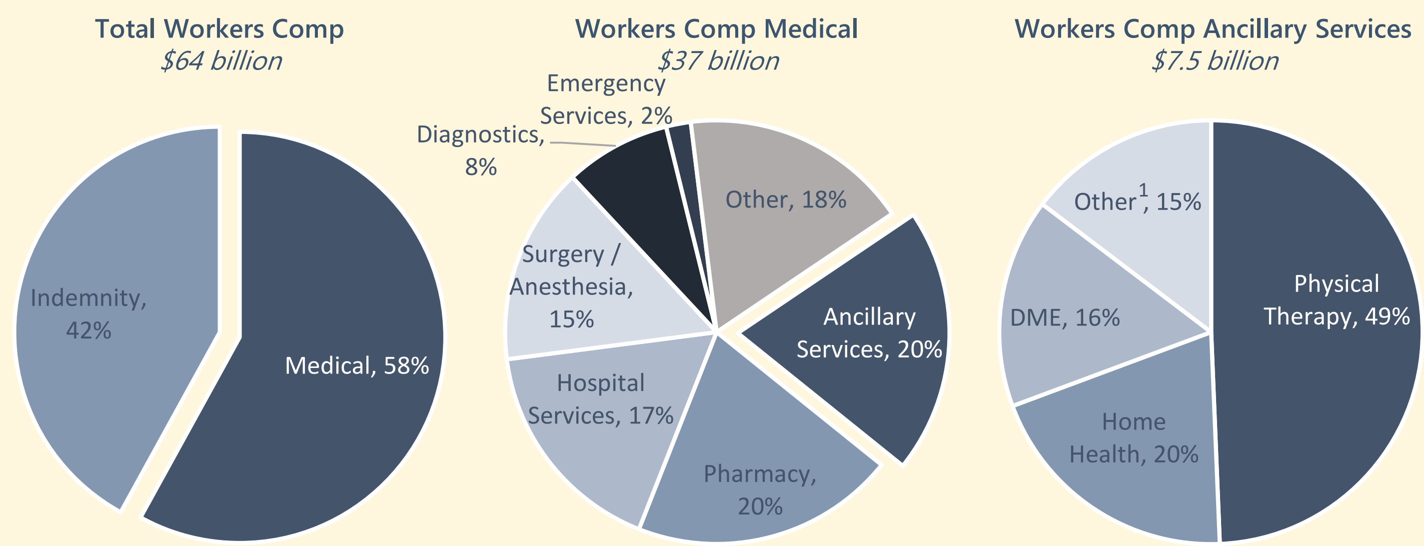
The Workers Compensation (WC) industry has grown to approximately $64 billion spread across two sub-segments: Indemnity and Medical. The Indemnity segment covers employee reimbursement for lost wages while recovering from a work-related injury. The Medical segment, comprising 58% of the total WC market, or $37 billion, covers all expenses associated with patient recovery from a work-related injury. WC Ancillary Services fall into this bucket, comprising $7.5 billion (~20%) of the total WC Medical segment *(Figure 1)*. The WC industry is mature, placing a greater emphasis on scale and cost preservation to protect margins in a competitive environment.

Ancillary Services represent a diverse and growing portion of the WC market. The scope of services provided to patients is broad, ranging from Durable Medical Equipment (DME), home care, physical therapy, prosthetics / orthotics, transportation, home modification, and translation services. These services tend to be highly specialized. Providers of these services offer a substantial value-add both to patients and workers compensation payors in the form of a streamlined care experience and cost containment.

The prevalence of ancillary service providers to the workers comp industry has grown over time. Generally, there are little financial incentives for claimants to avoid expensive medications or procedures when recovering from their ailments. As the amount of medical expenditures as a percentage of total workers comp payments has increased, payors have refined their focus on providing cost-effective care to patients, particularly those with long-term disabilities and high acuity conditions.

This demand for cost containment capabilities has been a strong driver of consolidation across the industry. M&A activity in the space has been primarily led by strategic acquirers with private equity backing. These consolidators have benefitted from the realization of cost synergies, service line diversification, and expansion of their core customer base and catchment areas. In an industry that has been driven by providing cost effective care and a streamlined patient experience, inorganic growth through M&A presents a strong opportunity for businesses to evolve into end-to-end providers that are well-positioned to navigate these dynamics.

Figure 1:Workers Compensation Industry Breakdown



Source: NASI

[1] Includes Prosthetics, Orthotics, Translation, Transportation, Home Modification, and other ancillary services

Key Trends and Observations

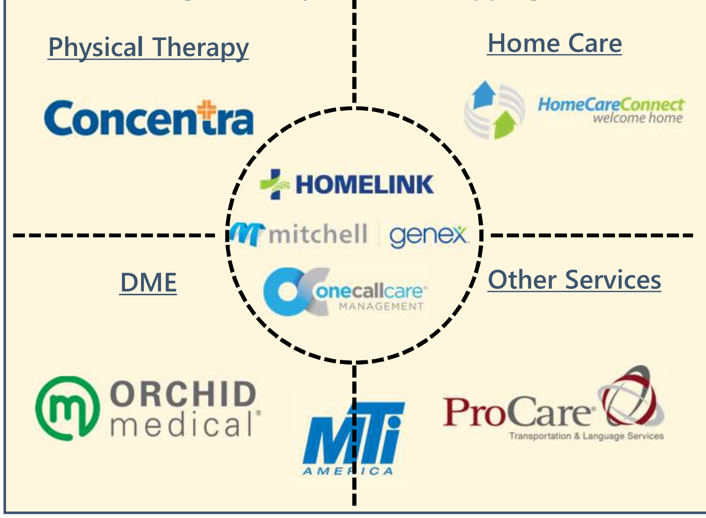
Two-tiered market structure dominated by a handful of large players…

The workers compensation ancillary service provider market is highlighted by a select group with strong competitive positions and large market share, coupled with a vast array of smaller, "mom & pop" providers with expertise in a particular sub-vertical, geographic market, or type of claim. The largest companies in the space include One Call, Mitchell | Genex, Paradigm, MedRisk, VGM Homelink, and Optum Workers Comp *(Figure 2)*. With VGM & Optum the lone exceptions, these companies are all backed by large private equity investors who provide capital resources and strategic guidance to pursue acquisitive transactions, introduce new service lines, and expand into untapped geographic markets, consistent with the typical private equity playbook. These businesses have been the primary drivers of consolidation activity in the sector over past 5-10 years.

…paired with a strong presence of smaller, more specialized businesses

Despite the concentration of large players at the top-end of the market, there remains a sizeable presence of mid-sized providers operating in targeted sub-sectors across the lower & middle markets. These businesses, generally founder owned & operated, have had success establishing footholds in their respective sub-sectors due to a focus on customer service and in-depth subject matter expertise, a task which can become more difficult as organizations grow in size and scope. This dichotomy creates an interesting dynamic within the WC ancillary service market, as businesses with vastly different amounts of capital & organizational resources are operating alongside one another.

Figure 2: Key Provider Mapping



Competitive advantages and areas of differentiation

Given the contrast in market share and total capitalization between the operators across the WC ancillary services space, it's critical for smaller businesses to carve out competitive advantages in their specific sub-sectors. While larger providers, such as One Call, boast the vast resources and full spectrum of services of a large organization that has grown and refined its strategy through several rounds of private equity ownership, lower & middle market providers have created value using alternative methods.

Two key methods that businesses have effectively deployed are data integration and adopting lower-cost operating models. Effective data integration allows businesses clear lines of sight into the various costs, trends, and providers that are impacting financial performance. Organizations without strong capabilities in this area tend to lack the ability to self-identify areas for improvement and continued growth across the enterprise. Further, businesses employing lower-cost models to preserve margins and effectively contain costs gain a competitive advantage over other industry participants. For instance, one claim can pass through several layers of third-party administrators and suppliers, with added costs tacked on at each level as those businesses take a profit. Those businesses that can streamline processes and eliminate unnecessary providers can operate with lower overhead and effectively control costs, preserving gross margins and improving patient care.

High level volume drivers show positive long-term trends

Until the recent impacts of COVID-19, discussed below, WC ancillary services providers had benefitted from industry tailwinds such as rising employment levels, an increased number of jobs covered by workers compensation insurance *(Figure 3),* an aging US population, and a workforce susceptible to injury and chronic ailments, all of which demonstrate a direct relationship with workers compensation claim volume. Further, increases in the severity of cases and utilization of ancillary services such as home care and physical therapy have resulted in an uptick in revenues for ancillary service providers. These tailwinds have buoyed operators in the industry and provided a compelling thesis for those seeking to expand their footprint via M&A.

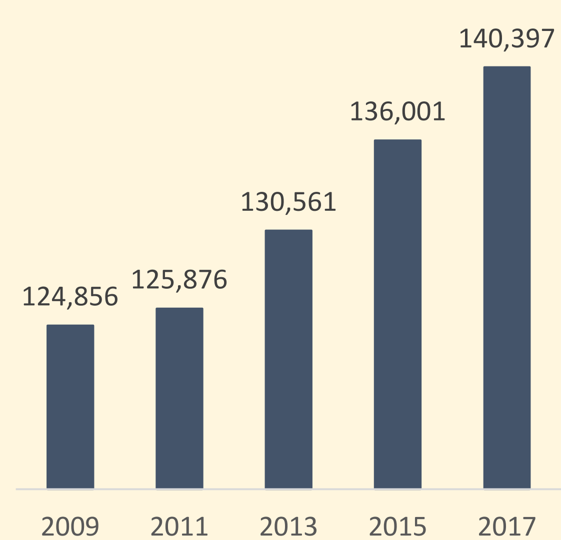
However, COVID-19 will continue to make an impact on the industry

WC ancillary service provider revenue streams are driven largely by claim volume, a function of employment levels, particularly in service-oriented industries where the likelihood of injury is substantially higher. The spike in unemployment levels induced by the pandemic has driven down claim volumes nationwide. For instance, from Jan 2020 – Jun 2020, California reported a 28.8% YoY decline in total claims, despite accounting for workers who had contracted COVID-19 submitting claims.

While the industry at large was negatively impacted by the pandemic, certain service lines held up better than others. Non-elective areas such as DME and home care were relatively unaffected, while physical therapy and transportation were hit harder due to the non-emergency nature of those services. However, those service lines that initially experienced a strong pullback have begun to rebound. As COVID-19 cases subside, this recovery is projected to continue.

While COVID-19 presents a unique challenge to ancillary service providers, operators who have service line diversity and efficient operating models can lean on those strengths, preserving top-line revenues and profit margins, to effectively weather this downturn and ultimately emerge in an advantageous position relative to competitors.

Figure 3: Increase in Employees Covered by WC Insurance over time (000's)



Source: Insurance Information Institute, California Workers Compensation Institute, NASI

Consequences for M&A Activity

M&A activity driven by desire for increased scale and cross-selling opportunities

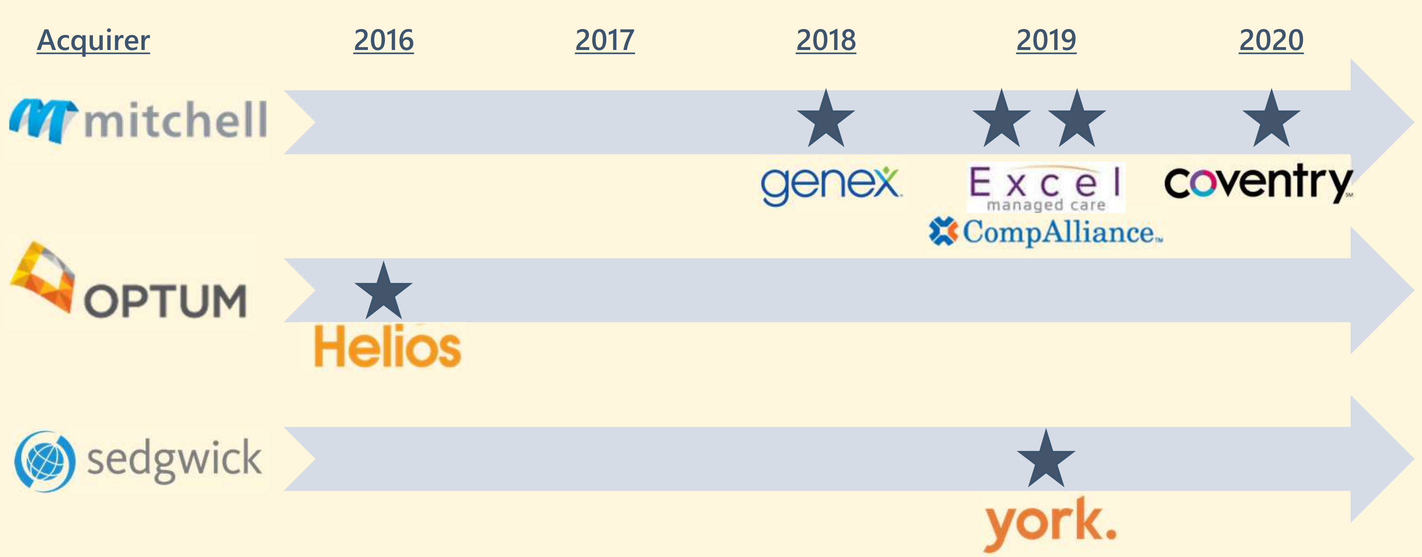
As mentioned, consolidation activity across the sector has been primarily driven by large, private equity backed businesses with the scale and capital resources to aggressively pursue inorganic growth opportunities, as well as other sizeable and well-resourced businesses such as Optum and VGM Homelink.

One large catalyst for M&A activity across the space has been the introduction and implementation of the Affordable Care Act (ACA) in 2010. This legislation asserted pressure on insurers to more effectively control healthcare costs, which prompted those companies to seek out lower cost options in the workers comp ancillary benefits provider universe. The wave of consolidation that followed allowed ancillary service providers to achieve greater scale and therefore offer more attractive prices to these insurers, meeting their demand for lower cost alternatives. This strategy has proven to be an effective way for businesses to scale, and in doing so, reducing their fixed expense profile through negotiating more favorable contracts with suppliers and streamlining back-office operational costs.

Along with reducing costs due to increased economies of scale, inorganic growth through M&A allows providers to deepen their presence in existing markets and expand into adjacent service lines. This has allowed them to leverage their existing customer bases for cross-selling opportunities across related ancillary services, and to diversify their revenue streams across products and claim types. Those characteristics have proven to be valuable as providers have navigated the challenges presented by COVID-19.

WC patients and payors alike value a provider who can provide the full continuum of cost containment services, prompting businesses to continue their push into adjacent service lines. For many providers operating in the lower to middle market, targeting a strategic partnership through an M&A transaction with a larger strategic player in the space has proven to be an effective method to gain scale, diversify service lines, drive operational efficiencies, and enter new relationships with carriers. Provident expects those trends to continue over the coming 12-18 months.

Figure 4: Timeline of Key WC Ancillary Services Transactions



Current M&A Environment & Valuations

Consolidation across the sector has ticked up over past 18-24 months

Recent M&A activity in the sector has been headlined by a few notable transactions *(Figures 5-6)*. In August 2020, Stone Point Capital-backed Mitchell | Genex acquired Coventry Workers' Comp Services (WCS) from CVS / Aetna in a transaction valued at an estimated $850 million. Coventry WCS is a market leading provider of care and cost containment programs across WC and auto insurance carriers. The transaction will effectively double the size of Mitchell | Genex's ancillary services network, while adding Coventry's sought-after PPO network to the Mitchell | Genex platform. This transaction is the latest in a flurry of M&A activity since the merger of Mitchell International and Genex in November 2018. The combined entity recently acquired two medical case management providers; CompAlliance (Dec 2019) and Excel Managed Care (Jan 2019) further solidifying their position as an end-to-end WC services provider. These transactions effectively illustrate a broader trend of consolidation to gain scale, operational efficiency, and service line revenue diversity. Mitchell | Genex expects to target additional tuck-in opportunities to further augment the growth of the business.

While M&A activity has been largely driven by PE-backed platform companies, there has been additional consolidation activity from other industry players. VGM Homelink, a 420+ member ESOP, purchased the WC ancillary service business of myMatrixx in October 2016. The transaction allowed both Homelink and myMatrixx to focus on their core businesses of ancillary benefit administration and pharmacy benefit management services, respectively.

Valuation multiples are compelling, but have varied significantly

M&A transactions are typically priced off a multiple of a Company's adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA), a proxy for the true earnings of the business in a given year. Adjusted EBITDA multiples for WC ancillary service businesses have been compelling in recently completed transactions, reaching into the low-to-mid teens for the largest entities in the space, allowing shareholders to take some chips off the table at strong valuations. Premium valuation multiples are based on myriad factors including size, growth trajectory, profitability, and customer concentration mix. The right combination of these factors can drive a premium valuation multiple in a competitive sale process to a private equity or strategic buyer.

Figure 4: Select Private Equity-backed Workers Compensation Ancillary Services Platforms

Investment Date	PE Firm	Platform Company
October 2019	GSO Capital Partners, KKR	One Call
September 2018	OMERS Private Equity	Paradigm
September 2018	The Carlyle Group	Sedgwick Claims Management
April 2018	Stone Point Capital	Mitchell | Genex
December 2017	The Carlyle Group	MedRisk

Figure 5: Select Non-PE Backed Consolidators

Company	Ownership Type	Notable Acquisitions
VGM Homelink	Employee Owned	MyMatrixx (Oct 2016)
Optum	Publicly Owned Subsidiary	Helios (Jan 2016)

Conclusion – Provident's Perspective

Following the implementation of the Affordable Care Act, the pressure for insurers to find new avenues to cost reductions became paramount. In turn, WC ancillary service providers positioned themselves as low cost providers to workers comp carriers, meeting the newly created demand criteria introduced by the ACA. This led to a continued wave of M&A across the WC ancillary services landscape, as providers at the top of the market utilized the private equity capital at their disposal to grow their scale, expand service line offerings, and achieve enhanced operational efficiency through streamlining back-office operations. In a fragmented market, this allowed those companies with aggressive inorganic growth strategies to quickly grow market share.

As the industry continues to evolve, firms can uncover new avenues to reduce costs such as investments in data analytics, implementing low-cost operating models, and streamlining back office functions will be well-positioned for success. This playbook has been consistently deployed by market participants across the capitalization spectrum, allowing smaller, more nimble organizations to gain solid footholds in the fragmented landscape dominated by a handful of sizeable competitors.

Strategic and private equity buyers have begun to capitalize on these trends in recent years, as M&A activity in the sector has experienced a noticeable increase. Provident anticipates this trend will continue, providing opportunities for both buyers and sellers to capitalize on prevailing industry tailwinds while protecting against COVID-19 induced challenges.

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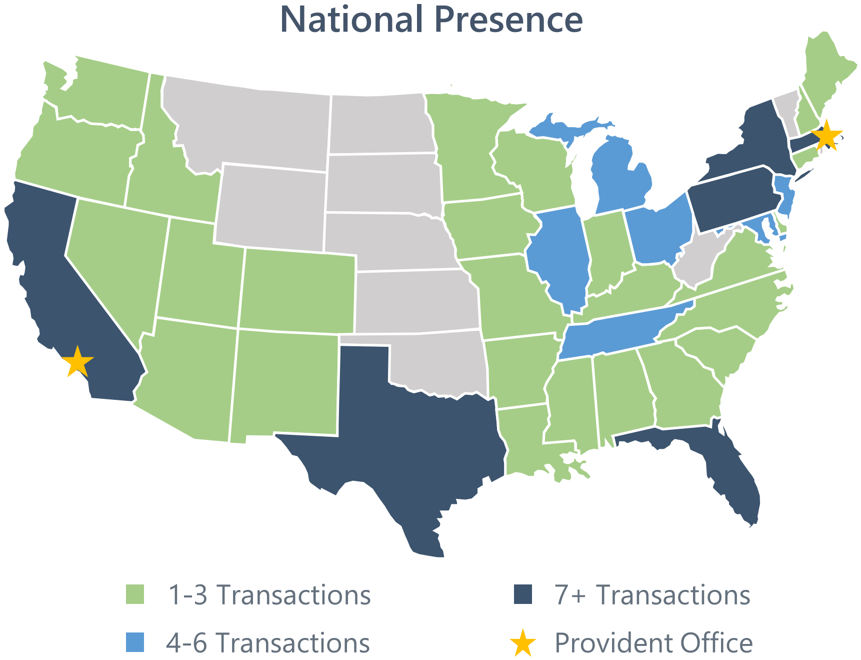
Provident Healthcare Partner's investment banking team works with privately owned healthcare companies to provide advisory services related to mergers and acquisitions. Prior to formal engagement, Provident works with companies to provide the upfront education to shareholders necessary to understand the economics, structure, and motivation of a transaction. Following the education process, if formally engaged, Provident leverages their extensive knowledge of the buyer universe to find the most compatible partner and drive valuations for a company's previously illiquid stock. Driving the entire transaction process, Provident facilitates and assists with deal structuring, negotiations, exit planning/processing, counseling amongst shareholders, and due diligence.

National Presence



21+	Years of Healthcare Investment Banking
140+	Healthcare Deals Closed
12-15	Landmark Deals Per Year
26	Banking Professionals

Note: The above map represents states where Provident clients were headquartered. Provident has successfully closed transactions with clients operating in 45 states and Puerto Rico.

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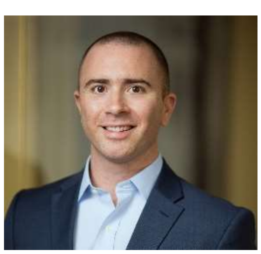

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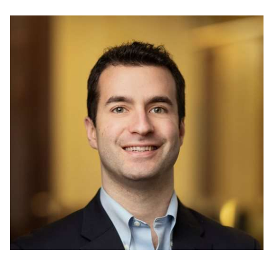

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Provident is the leading investment banking firm specializing in merger and acquisition advisory, strategic planning, and capital formation for middle-market and emerging growth healthcare companies.

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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