DJIConsulting

Unpacking the Drivers of Dermatology Dealmaking

Data provided by

PitchBook

PE buyers are driving the bulk of M&A in dermatology

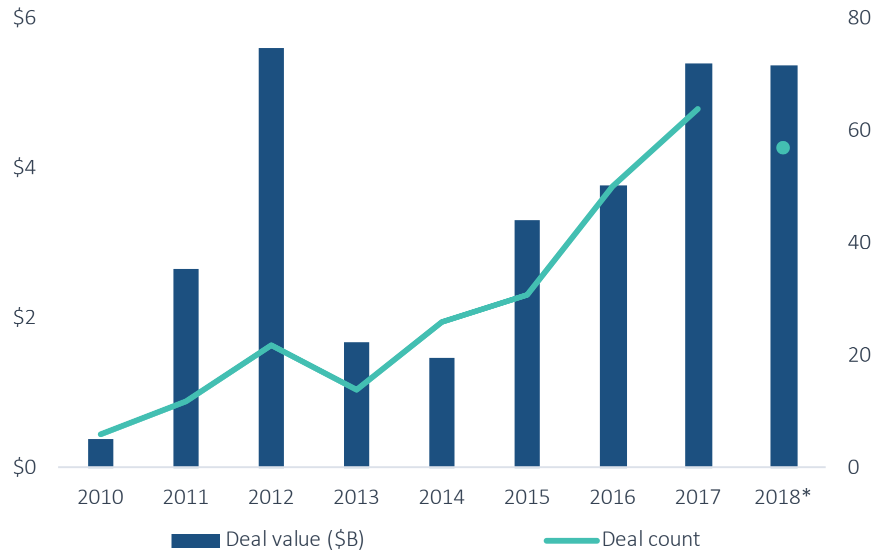
The acceleration in dermatology M&A within the US over the past five years has been striking. Deal value in 2018 may just barely eclipse the prior high of $5.6 billion, while volume is almost sure to reach a new high of 60+ transactions. What has been driving this intensified acceleration?

"Dermatology is a $16 billion market that is expected to grow at a 2.3% compounded annual growth rate (CAGR) through 2021[1]," says Dana Jacoby, founder of DJI Consulting. "There are more than 11,000 dermatologists in practice in the US[2]—approximately one-third of which are solo practitioners, and 41% single-specialty group practices."

Given that level of fragmentation and positive growth forecast, it makes sense that consolidation across the spectrum was highly likely, driven by both strategic and financial acquirers. Unlike broader healthcare segments, or the general healthcare landscape, however, much of this aggregate deal value has been driven by private equity sponsors. Not only that, but also volume.

Consolidation in dermatology drives M&A to new highs

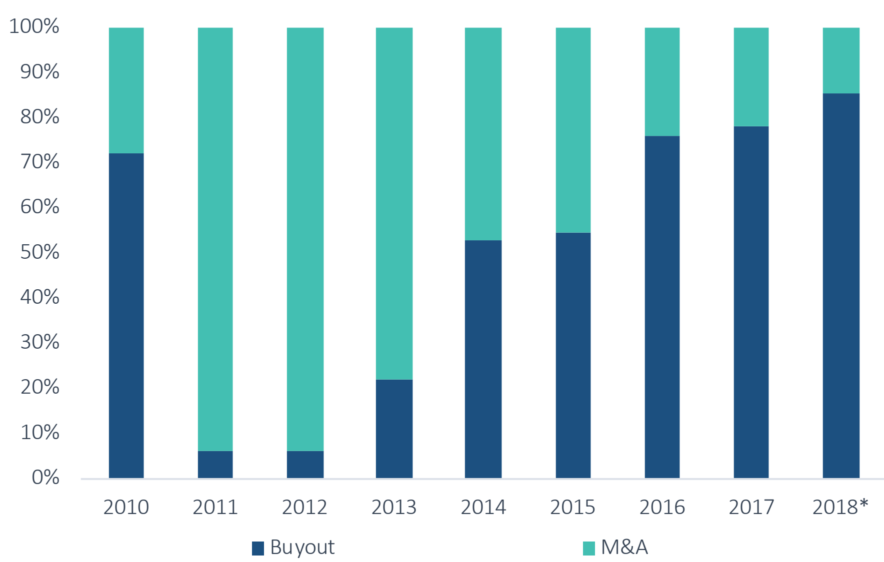
US M&A activity in dermatology



Source: PitchBook
*As of November 27, 2018

PE buyers have grown to account for a vast majority of all deal value

US M&A activity ($) by type in dermatology



Source: PitchBook
*As of November 27, 2018

1: "Dermatology Practice Consolidation Fueled by Private Equity Investment, Potential Consequences for the Specialty and Patients," JAMA Dermatology, Jack Resneck, November 21, 2017

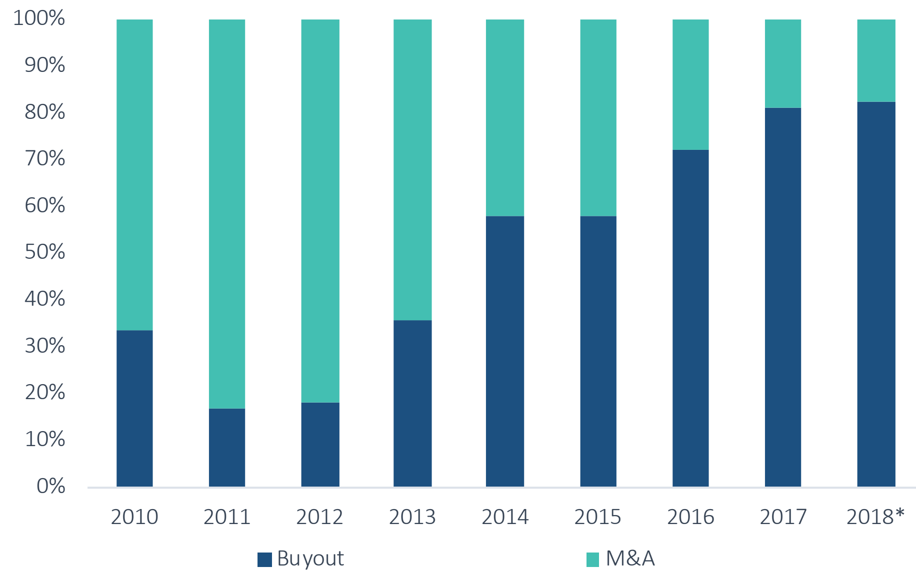
2: "IBISWorld Industry Report 0d4168: Dermatologists in the US," IBISWorld, Kelsey Oliver, December 2016

Of the 57 dermatology deals in 2018 to date, 47 have been buyouts, the second-highest tally on record. The rate of growth in PE buyers' activity across dermatology is all the more impressive when isolated, as in the chart below. According to Jacoby, the drivers behind PE's avid interest in dermatology are numerous, but principal among them are fragmentation and the cash pay or ancillary retail element.

"Last but not least," Jacoby adds, "high productivity and revenue levels for dermatologists offer unique opportunities to complement revenue streams with lab, pathology and other cash pay service lines."

The bulk of volume has shifted to PE sponsors

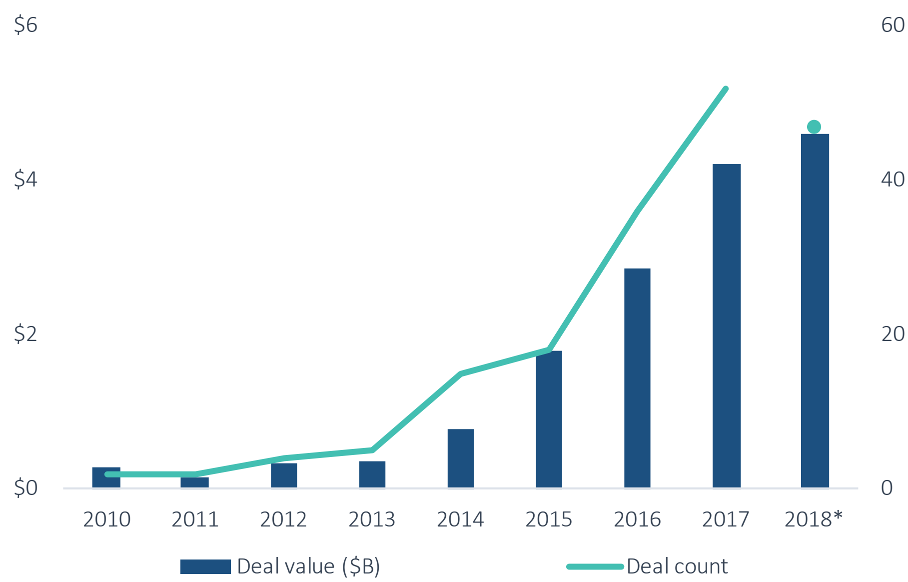
US M&A activity (#) by type in dermatology



Source: PitchBook
*As of November 27, 2018

By the close of the year, PE buying in dermatology will have grown in almost a linear rate for three straight years

US buyout activity in dermatology

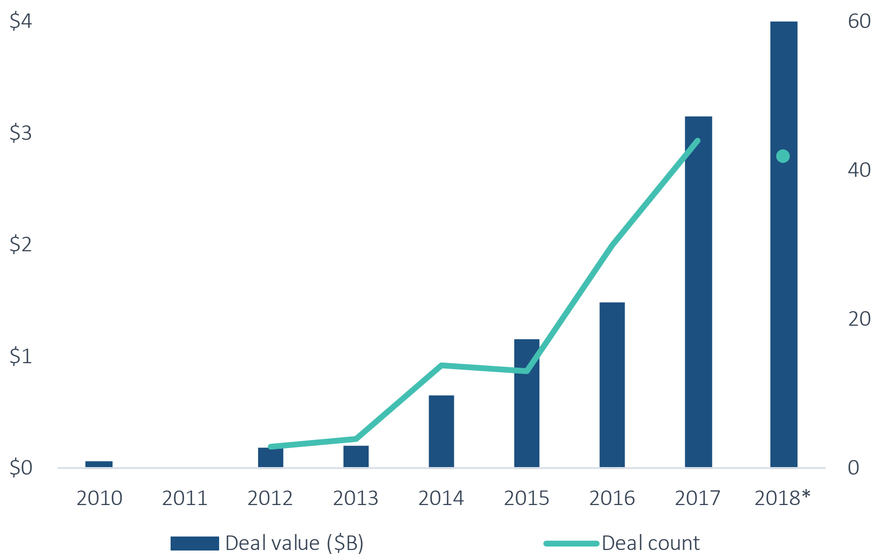


Source: PitchBook
*As of November 27, 2018

Methodology

The dermatology dealmaking data was generated using a custom list of keywords in order to identify appropriate companies within the PitchBook Platform. Otherwise, customary PitchBook reports' methodologies for M&A and PE transaction classification was utilized.

The allure of add-ons has driven much of PE dealmaking
US add-on activity in dermatology



Source: PitchBook
*As of November 27, 2018

Diving deeper into PE activity also yields the not-too-surprising finding that add-ons have accounted for the vast bulk of all PE transactions within dermatology. Quite popular as a way to mitigate initial buyout multiples in a pricey dealmaking environment, add-ons also lend themselves to the type of fragmentation observed in dermatology. It is much easier for a platform buyout to be closed at a potentially lofty price if multiple add-ons can already be lined up in order to establish a commanding presence in a given region, or in a particular niche. The degree to which add-ons have been the approach of choice for PE in dermatology is extreme relative to other segments, however.

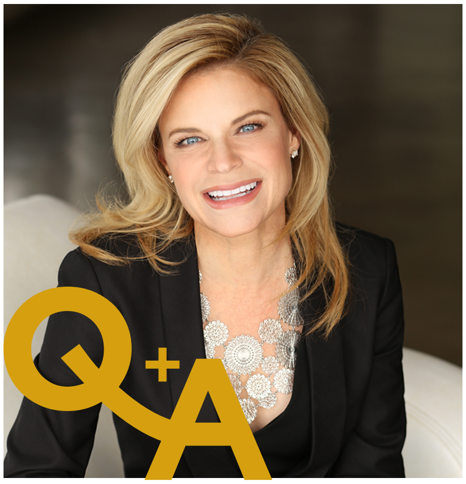
Add-ons' prevalence is depicting in some of the top transactions within dermatology
Select transactions in dermatology in US

Company	Deal Size ($M)	Close date	Deal type	Location
Dermatology and Skin Surgery Center	$50.7	July 25, 2017	Add-on	Battle Creek, MI
Miramar Labs	$34	July 25, 2017	M&A	Santa Clara, CA
Skinvisible	$10	June 30, 2018	M&A	Las Vegas, NV
Moberg Pharma North America	$4.25	April 27, 2018	M&A	Cedar Knolls, NJ
Townsend Clinic	N/A	January 9, 2017	Add-on	Austin, TX

Source: PitchBook
*As of November 27, 2018

About DJI Consulting

DJI Consulting is at the intersection of strategy, implementation and creativity. We help medical practices, hospitals and health systems re-imagine their business models so they can maximize profits and reshape how work is done using current technological advances. As a healthcare consulting firm with 15 years of experience in the industry, we've acquired deep insight into departments as diverse as sales, operations and management. We work with C-Suite executives and senior leadership to drive business performance and outcomes based healthcare and shareholder value.



Dana Jacoby of DJI discusses the drivers of dermatology dealmaking

What are the primary drivers, in your view, of the popularity of M&A within dermatology in the US?

The dermatology market is a $16 billion market that is expected to grow at a 2.3% CAGR through 2021. As practices have been acquired and consolidated, owners and providers have been able to recognize efficiencies and operational synergies.

For example, better vendor pricing for supply costs and supply chain management, increased reimbursement rates (negotiating leverage with insurance payors), cross-selling of services, the buildout of ancillary revenue streams, real estate and asset consolidation, and sharing of full-time equivalents and/or billing/administrative resources all have offered previously unrecognized growth and revenues across dermatology group footprints. A combination of these types of benefits

We are living through a truly transformative period in healthcare.

can lead to higher profits, which then should result in higher valuations and revenues for dermatology owners.

M&A and consolidation have been driven by evolving reform and chaos within the US and healthcare industry. Over the past decade, there has been uncertainty for private practice physicians, due to shifting market conditions and changes in payor methodologies and reimbursement models. For many groups merging with another practice (with either the same or a different specialty), this lends itself to perceived advantages.

Unsustainable levels of spending are driving the shift to value-based care and the search for more effective and affordable solutions. New technologies are launching that have empowered and educated patients. This “empowerment” has shifted control away from healthcare professionals and has created a new algorithm in the comprehensive delivery of care. In addition, patients now view access to healthcare and healthcare providers as their right. This is occurring at a time when the US government has recognized that societal wellness can be an economic asset for the populations it serves. Finally, in the past few years, healthcare entities and organizations have had to adapt to new regulations while simultaneously focusing on objectives to grow and maintain quality, positive patient experience and profitability.

The confluence of all these changes, adopting technology/innovation, increased spending, and adaptation to new regulations has dramatically disrupted how healthcare is designed and delivered in the US with an emphasis on certain sectors such as dermatology.

How does dermatology differ from other healthcare segments?

Dermatology has multiple product lines and revenue sources. This makes dermatology a unique investment opportunity and quantifies it as markedly different from other community-based specialties. Many dermatology practices are innovating to increase their top-line opportunities, while restructuring to control their bottom-line expenses. In the past year, I’ve seen dermatology practices pursue service-line expansion into repeatable, year-over-year offerings such as cosmetics, cosmeceuticals, skincare lines, and other elective procedures. In addition, practices are also working to develop vertical integrations of dermatopathology lab offerings and other more technical service offerings. These factors, coupled with shifting healthcare market conditions, create compelling investment opportunities for PE sponsors.

From 2007 to 2009, the dermatology market grew at approximately a 2.1% CAGR while US GDP decreased 4.3%.[3]

3: “Opinions Clash Over Private Equity’s Effect on Dermatology,” Dermatology News, Mitchel Zoler, March 27, 2018

What are the most popular concerns your dermatology clients bring to you, from items concerning dealmaking to business practices?

Investors are understandably interested in a positive return on their investment. Whether it is the dermatology client, managing partners, or practicing MDs, they want to know how to maximize patient care while maintaining profitability and security.

Dermatology clients are aware that the process of consolidating practices and selling practices at a profit may lead to financial disruption, leaving dermatologists without security around their business models, services, and/or revenues. Dermatologists who are considering a sale of their private practice to strategic and/ or equity partners voice concerns about a loss of autonomy, including decisions about staffing levels, overall governance, compensation changes/ structures, and/or smaller expenditure control around such things as capital equipment purchases.

Dermatologists also voice concerns that investors who purchase may seek to increase profits by hiring physician assistants to work in unsupervised satellite settings. There are also concerns about redirecting dermatopathology specimens and Mohs surgery referrals to other entities within the consolidated group. Most of my clients want to maintain some facet of control and have concerns about eliminating opportunities for dermatologists to recommend and select the best route for each patient they oversee. While the initial sale of the private practice may result in a large cash payout for the partner, concerns arise that it may not transcend to staff physicians who will likely receive lower compensation in coming years under a process or "normalization" of physician payment. There are also concerns about how a physician will have to contend with noncompete clauses and/or legal fees if he or she leaves the purchased practice or is terminated. There are a lot of concerns regarding both M&A and/or buyer/seller arrangements. The bottom line is they all revolve around the fear of the unknown, loss of autonomy, and/or loss of control.

Dermatology remains highly fragmented relative to other fields, with roughly only 5% of the industry consolidated.

Much of dermatology M&A is accounted for by PE buyouts. What are the key factors that stand out about the transactions and companies that are involved with PE fund managers in the dermatology industry?

During the last 12 months, there has been strong M&A activity for both platform practices and add-ons, and analysts expect to see continued add-on growth.[4] Many dermatology practices are becoming more sophisticated in their discussions and understanding of investment strategies. As a result, it is becoming more difficult for investors to differentiate themselves to dermatologists looking for investment partners. As the deal flow, education and conversations have increased, the noise in the marketplace has also grown.

Dermatologists provide a plethora of services and procedures, such as biopsies, which test for skin cancers and other diseases. They can also provide and promote company-branded products to patients, offer new services, refer to in-house specialists, and process lab tests on site, all of which serve as revenue streams. In certain geographies, dermatology offices offer a continuum of care that is highly-profitable and can be an excellent opportunity for the culturally appropriate strategic or PE buyer. Effective use of midlevel providers can also be an attractive opportunity in increasing the revenue and growth of a dermatology practice. Midlevel providers can be used to effectively provide appropriate services. As a caveat, PE firms should be aware that different states may require certain ratios of physicians to midlevels or may have additional supervision requirements.

Negotiating favorable contract terms with payors (as a result of growing platforms obtaining more leverage) can also be of benefit to the PE firms or other buyers. In complement, the presence of larger, diversified practices may also result in the prevention of cuts to reimbursement rates by payors. One key element is the increased ability of the personnel brought in by investors to better negotiate with these large payors, as these personnel are often professional individuals experienced in such negotiations. In short, many groups now have payor care teams or departments rather than a small group of people handling their negotiations or contracts.

4: "Investment and Consolidation within Dermatology," Provident Healthcare Partners, May 2018