McGUIREWOODS

Private Equity in Healthcare – An Updated Review of Selected Niche Investment Areas

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Private equity investment in healthcare has continued to evolve since McGuireWoods examined various niche investment areas last year. This article provides updated observations and insights on key investment niches, many of which were discussed in the 2018 article. It also provides some initial thoughts on the market as a whole.

This analysis covers 19 niche investments areas, with a note indicating whether there is steady (i.e., roughly equal) or more private equity interest in that sector, as compared to the last several years. None of the sectors examined in this article has experienced significantly less investment in recent years. The specific investment areas discussed are as follows:

1. Orthopedics (more)
2. Urology (more)
3. Women's Health (more)
4. Gastroenterology (more)
5. Podiatry (more)
6. Ear, Nose and Throat (more)
7. Other Hospital-Based Specialties (more)
8. Healthcare IT and Tech-Enabled Provider Solutions (more)
9. Oncology (more)
10. Physical Therapy/Occupational Therapy/Speech Language Pathology (steady to more)
11. Anesthesiology and Pain (steady)
12. Behavioral Health (steady)
13. Ophthalmology and Optometry (more)
14. Dental Practice Management (steady)
15. Dermatology (steady)
16. Compounding and Specialty Pharmacy (steady)
17. Veterinary Services (steady)
18. Laboratory Businesses (steady)
19. Urgent Care (steady)

Overall, the pattern of provider consolidation continues to lead private equity interest, with expansion into some new sectors, as well as investors branching out into subspecialties of some already-established areas of investment. In some sectors (e.g., dental practice management and dermatology), larger platforms have led the investment expansion, while in other sectors (e.g., physical therapy/occupational therapy/speech language pathology, as well as ophthalmology and optometry), private equity firms have struggled to find enough platforms of scale to meet investment demand. Balancing out (and perhaps hedging) the continued interest in provider consolidation, there has been increasing interest in the orthopedic and health IT and tech-enabled provider solutions sector (e.g., telemedicine and remote monitoring).

Note the following key, initial observations that apply generally to each of the niche investment areas that are described in greater detail throughout this article:

1. **Valuations remain high**. A modest lowering of valuations could actually draw out more investor interest as many investors remain cautious at these levels.
2. **Consolidation continues**. There does not appear to be any slowing of the provider consolidation trend, in both existing and newly explored sectors.
3. **The investment community has its eye on larger buyers**. The investor community is keenly watching the larger buyers moving into the market. It is important for the industry that these investors do well, as the size and return expectations of the larger investors take some pressure off of mirroring the growth rate of larger-market funds.

I. 2018 Healthcare Investment Overview

Throughout 2018, consolidation and competition remained prevalent themes in the healthcare investment market. While overall M&A deal volume stayed fairly flat in 2018, M&A activity in the healthcare industry continued to grow, with an overall increase of 20 percent in deal volume and a 50 percent growth in deal value, according to the annual Bain & Company's Global Healthcare Private Equity and Corporate M&A Report (referred to herein as the "Bain Report").[1] Competition between financial sponsors and corporate acquirers continued to push valuations higher, and 2018 saw yet another peak in healthcare investment activity due, in large part, to the rise in multi-billion dollar "mega deals."

Additionally, the number of deals involving retail health companies, which are defined as companies that operate free-standing, health-related outlets like dental clinics or urgent-care facilities, has continued to grow globally, supporting a trend in evidence since 2012.[2] Interest in retail health has expanded beyond a niche set of investors. Success stories have drawn more investment interest into the healthcare industry, which, inevitably, puts upward pressure on multiples. As a result, in addition to the established investment areas, some investors are seeking opportunities in newer niche sectors, as described further below.

II. Investment Areas

1. Orthopedics (more)

Orthopedic care is one of the fastest-growing segments of the healthcare industry, with orthopedic conditions generating more than 137 million visits to providers on an annual basis. Unlike its industry peers, however, the orthopedic sector remains largely untouched by outside investment, and such fragmentation is garnering a compelling interest from private equity, which is only expected to increase in coming years.

Due to utilization of numerous ancillary service lines — including imaging, physical therapy, durable medical equipment and ambulatory surgical centers (ASCs) — orthopedic practices often offer investors the ability to gain additional revenue and serve as a "one-stop-shop" for patients, facilitating access to care and consumer convenience. Orthopedic practices have long invested in many of these ancillaries, including ASCs, which provide an attractive alternative to hospitals for certain types of surgical procedures, especially given the increased emphasis on moving cases to outpatient venues. Indeed, the Centers for Medicare & Medicaid Services (CMS) proposes to allow certain knee replacement surgeries in the ASC setting in coming years, following a trend that commercial payors started years ago. Orthopedic procedures often are accompanied by numerous advantages shared by other attractive healthcare subsectors, as insurers generally reimburse orthopedic procedures well, and providers often offer elective procedures, which are generally self-pay and not subject to discounts by insurers.

Investment in orthopedic practices also poses unique challenges. Investment in the orthopedic space is costly, with very high EBITDA multiples. Furthermore, many orthopedic practices have numerous well-paid partners who are used to working independently, often with entrenched "eat-what-you-kill" compensation models. Notwithstanding, investors rationalize these challenges with the organic growth possibilities and opportunities for strategic tuck-in transactions.

The orthopedic space is positioned for a surge of transactions in the coming years. 2018 saw numerous orthopedic investments, including but not limited to Atlantic Street Capital's partnership with OrthoBethesda, a full-service orthopedic provider in the Washington, D.C., area, and OrthoIllinois and Associates in Orthopaedic Surgery joining forces. 2019 is shaping up for even more activity. In July 2019, Revelstoke Capital Partners and Beacon Orthopaedics and Sports Medicine Ltd. announced the launch of a national management services organization, and Kohlberg & Company invested in Connecticut-based Orthopaedic Neurosurgery Specialists.

2. Urology (more)

Like orthopedics, but unlike some other physician specialties, urologists have long remained independent due, in part, to steady, profitable ancillary services opportunities. For example, similar to orthopedic providers, urology practices will often own ASCs and provide lithotripsy, pathology, imaging, radiation oncology, high-intensity focused ultrasound and brachytherapy services. Of course, groups must have a certain level of scale for these service offerings to make financial and operational sense.

In addition to management expertise, private equity funds have helped make available cash and debt for capital investments that otherwise would be difficult for small physician groups to complete. However, only a few serious private equity-backed platforms are currently active using the single-specialty approach within

[1] *See generally* Bain & Company Inc., *Global Healthcare Private Equity and Corporate M&A Report 2019* (2019).
[2] *See id.*

this market. Alternatively, some private equity-backed oncology and other multispecialty practices include urology. In August 2018, JW Childs Associates and New Jersey Urology formed Urology Management Associates. Most recently, in December 2018, New MainStream Capital formed U.S. Urology Partners with its investment in Central Ohio Urology Group (COUG). COUG was founded in 2004 and has over 20 urologists in approximately 16 locations throughout Ohio.

Despite new private equity activity in the space, a number of large, independent urology practices remain unaffiliated. For example, Integrated Medical Professionals in the New York area has over 100 providers and 48 locations, posing the potential for future investment and consolidation.

3. Women's Health (more)

Investment in women's health has been on an upswing in recent years due to a variety of factors. The industry now encompasses much more than traditional obstetrics and gynecological care and has expanded to keep pace with the aging population as well as the younger generation of women, who are seeking more preventative, routine care. The women's health sector has expanded options for both a broader age range of women as well as offerings for a broader range of medical conditions that occur throughout women's lives.

The National Center for Biotechnology Information reports that 81 percent of gynecological and obstetric care in the United States is provided to women ages 18 to 44, during which time, routine preventive care, obstetrical care, breast health, sexually transmitted infection treatment and immunizations are the focal points.[3] However, in the United States, the fastest-growing cohort of the female population is those aged 65 and over. Some researchers estimate that this group of females is expected to grow by 81 percent by 2050. This phenomenon has led to an increased focus on conditions associated with aging, such as menopause and osteoporosis.

Separately, the U.S. fertility business has grown dramatically, most dominantly amongst millennials. But, this growth is not only due to the well-known trend in the rising age of women giving birth for the first time, rather, the fertility business boom is also due to sophisticated marketing, more expendable income, additional service options (such as egg banking, genetic testing and advanced fertility treatments), and a younger generation willing to spend money on early fertility testing (e.g., ovarian health screenings and other diagnostic tests geared toward alerting women earlier of fertility issues they may be able to address). And, of course, demand has led to broader insurance coverage for treatment. Some industry experts estimate that, over the next several years, the already $5 billion U.S. fertility business will experience a 1-2 percent increase in year-over-year demand.

For these reasons, we have seen great enthusiasm from investors in this subsector over the past several years. Investments include Sverica Capital's investments in women's health platform Women's Health USA and fertility business In Vitro Sciences, Lee Equity's investment in Prelude Fertility, TA Associates' investment in Colorado Center for Reproductive Medicine and MTS Investors' investment in Ovation Fertility. Investor interest in this subsector is expected to continue into 2020 and beyond.

4. Gastroenterology (more)

The industry is beginning to see a convergence of several different business models within gastroenterology (GI). First, GI groups are increasingly either merging or consolidating into private equity-backed integrated care platforms. However, many gastroenterologists are still independent. In fact, in a significant number of states, there are no gastroenterology practices with more than 20 physicians. Next, endoscopy centers continue to evolve on the facility side of the business and reach over into practice management. Finally, ancillary services providers, like anesthesia groups and pathology labs, are continuing to consolidate amongst themselves as well.

GI is another physician specialty that has enjoyed profitable ancillary service lines, such as ASCs, endoscopy suites, anesthesia and pathology. GI has a lot of the same dynamics as orthopedics (which, as stated above, is rapidly gaining investor interest), with significant ancillary services, a diverse payor mix (heavy Medicare, significant commercial and some elective/cash-pay opportunities), and well-paid partners who are used to working independently with often entrenched "eat-what-you-kill" compensation models.

[3] R. Chakrabarti, T.M. Dall, et. al., *Estimated Demand for Women's Health Services by 2020*, JOURNAL OF WOMEN'S HEALTH (July 22, 2013).

There has been a very recent, highly pronounced acceleration in GI deal-making, with several significant, recent transactions, including Frazier Healthcare Partners' 2018 acquisition of Atlanta Gastroenterology Associates — a practice with 60 locations, almost 100 physicians and 14 endoscopy centers — to form United Digestive. Other recent transactions include Waud Capital's November 2018 partnering with Texas Digestive Disease Consultants to create The GI Alliance. The GI Alliance quickly followed on with the acquisition of Illinois Gastroenterology Group in July 2019. Finally, in May 2019, Amulet Capital's acquisition of Regional GI, Main Line Gastroenterology and Digestive Disease Associates resulted in the creation of US Digestive Health. The surviving company will constitute the seventh-largest GI physician group in the U.S.

Taking a different approach, Physicians Endoscopy and Capital Digestive Care announced a strategic partnership, forming a platform to offer practice management solutions to gastroenterologists who wish to remain independent but be a part of a larger practice. The traditional business model of Physicians Endoscopy focused on ASCs and endoscopy centers, and this transaction represents the convergence between the facilities and practice management sides of the business.

5. Podiatry (more)

Podiatry is one of the subsectors that is quickly gaining investor interest, presenting a unique opportunity for leverage as a "first-mover" in the space. Still largely untouched by outside investment and merger activity, the podiatry market remains highly fragmented, leaving significant room for consolidation.

Investor interest in this subsector is likely attributable to the rise in "super-groups," as well as the increased aging population and incidences of diabetes and obesity, conditions that often exacerbate health conditions that require podiatric care. Additionally, podiatric specialists have focused on developing new regenerative medicine technologies and a plethora of elective services, presenting additional growth and income opportunities for investors. Within the sector, solo practice margins are being challenged, making private equity investment an attractive alternative for providers as well. An understanding of this space, as well as how to expand podiatry practices to include ancillary services such as ASCs, will be an important component investors should bring to the table when evaluating and selecting target acquisitions.

While in the past podiatry lagged behind other healthcare specialties in which private equity investment was focused, today's investors are showing an increased interest in acquiring podiatric practices, as demonstrated by Albaron Partners LP's 2019 partnership with Great Lakes Foot & Ankle Institute and NMS Capital's 2018 involvement with Foot & Ankle Specialists of the Mid-Atlantic to form US Foot & Ankle Specialists. Expect such investments to continue and increase over the coming years.

6. Ear, Nose and Throat (more)

As the steady march of multi-location provider consolidation moves into increasingly more specialized and smaller practice areas, it is no surprise that ear, nose and throat (ENT) practices are joining the wave. We heard quite a bit about ENT (and the related area of allergy treatments) but did not see many private equity deals until recently.

ENT practices cover a broad array of services that can have varying degrees of ancillary services and ASC support, with practices that have heavier ancillary services being more attractive targets for investment. At the same time, smaller practices that are not able to leverage ancillary services and ASC ownership on their own pose opportunities for bolt-on activity and the ability to expand into those ancillary services lines upon joining a larger overall practice. Once a larger platform is established, the playbook looks similar to other sectors, with smaller practices finding it difficult to compete with the payor-contracting leverage and efficient administrative support of the larger consolidators. Many platforms are able to fold in smaller, single or double provider practices without an acquisition. The targets find their enhanced economics in the larger platform materially better even with a portion of the net cash flow running to the private equity sponsor.

It is unclear if the more specialized pure-play subsectors, like allergy treatment, have the same dynamics as the broader ENT practices. Allergy treatment, for example, includes limited ancillary service lines, resulting in a growth strategy that requires a lot of lower margin acquisitions to reach critical mass. Overall, expect ENT practice consolidation to increase as larger platforms materialize. A notable, recent transaction was Shore Capital's and an Atlanta practice's May 2019 formation of Southern ENT and Allergy Partners.

7. Other Hospital-Based Specialties (more)

The industry is seeing continued investment in hospital-based specialties, such as emergency medicine, internal medicine, hospitalist services, general surgery, radiology and pathology. Cost, quality and location pressures are forcing hospitals to provide healthcare services through lower-cost providers at lower-cost locations. This, in turn, creates opportunities for large hospital-based specialty groups to serve as low-cost outsource providers to hospitals.

In general, and in contrast to outpatient practices, hospital-based specialty groups have low overhead requirements because the hospital client provides the physicians with necessary equipment to practice. Often these hospital-based specialty groups remain private, but utilize long-term contracts with hospitals to achieve cost efficiencies. Further, large hospital-based specialty groups can present different value propositions for physicians. For example, some physicians join these groups solely as employed professionals who can obtain schedule flexibility and other work-life balance benefits. Other physicians may hold rollover equity and have the ability to participate in governance and practice growth.

Billions of dollars were invested in physician services organizations providing hospital-based specialties in 2017, and since that point, investment in hospital-based specialties and physician services organizations has continued. Likewise, 2018 saw increased investment in hospital-based specialties in the areas of emergency medicine and hospitalist services, anesthesiology services, radiology/tele-radiology services and pediatric services. Investment in this sector will likely rise as hospitals continue to manage the ongoing shift toward value-based care, recruiting and staffing challenges, and increased operating costs, especially in areas that have experienced a surge of investment, such as obstetrics and gynecology.

8. Healthcare IT and Tech-Enabled Provider Solutions (more)

The healthcare industry has traditionally straggled behind other industries when it comes to technology and digitalization. As a result, investors have been hesitant to invest in healthcare technology companies beyond the historic involvement in electronic medical records (EMR) technology companies.

However, due to recent pressure for innovation, investment in healthcare technological companies shows immense interest and all-time-high investment activity. Healthcare IT investment has expanded toward billing solutions, data analytics and patient engagement opportunities. Provider and related-services acquisitions continue to grow, which are heavily driven by large deals in the healthcare IT space that are focused on solutions for providers. At the same time, this sector faces high EBITDA multiples and incredible competition for deals.

Though this subsector offers great opportunities for investors, it is also heavily regulated, and investors must consider and manage state telemedicine laws, fraud and abuse laws, HIPAA and state data privacy laws, licensing requirements, and other legal considerations. Cybersecurity considerations and patient privacy issues remain one of the leading areas of diligence for healthcare technology investors in this sector because there has been a significant rise in healthcare data targeting.

IT solutions focused on payor services also remain a desirable area for investors, particularly with respect to solutions that facilitate the transition from fee-for-service models to value-based care. For example, as noted in the Bain Report for 2016, 2017 and 2018, payor healthcare IT assets drew significant interest in those years, propelled, in part, by the priority many private equity firms have placed on making IT investments across industries, including healthcare. Notable deals in this space include Veritas Capital Partner's acquisition of GE's revenue-cycle, ambulatory care and workforce management software unit in July 2018 for over $1 billion and Vertitas' subsequent strategic acquisition of athenahealth (an RCM and EMR software vendor), which together led to Veritas' reorganization of the two entities to combine the healthcare IT assets of both platforms under the athenahealth umbrella.

Patient engagement, including with respect to payments, continues to emerge as a trend across both the provider and payor transaction landscape. Data analytics and healthcare IT opportunities focused on improving outcomes and reducing costs for providers and payors also remain desirable investment opportunities in this highly competitive space. In 2019, Francisco Partners acquired Qualcomm Life (now Capsule Technologists), a leading global provider of medical device connectivity solutions for hospitals and providers, and in 2018, Best Buy acquired GreatCall Inc., the largest provider of connected health and personal emergency response services for senior citizens, from GTCR, a leading private equity firm.

9. Oncology (more)

The oncology space is growing, and patient volume is on the rise — up 20 percent since 2013 — and is only expected to grow. Simultaneously, the industry is also undergoing significant operational changes in terms of treatment and payment norms. With the increase in patient volume, oncology practices are experiencing significant growth in specific areas, including treatment for breast cancer, lung cancer, colon cancer and leukemia. Similarly, practices are diversifying the methods of delivering services to patients, with an increased emphasis on patient access and care through ancillary lines such as telemedicine and outpatient infusion care. Managed care organizations are, increasingly, willing to reimburse for these ancillary services. And, as cancer treatments become increasingly more targeted, and the individualized patient treatment regime more and more important, many practices are focusing on smaller subspecialties within the oncology space — such as urologic, gynecologic and dermatologic — and such growth and specialization is expected to continue.

Diagnoses and treatments are provided in hospitals, physician offices, free-standing radiation oncology centers and free-standing infusion centers. Investors interested in the space must understand the healthcare regulatory implications as well as the business opportunities and challenges associated with a myriad of different ownership structures (including joint venture models that are unique for the oncology space) and a full array of delivery-of-care models.

Both oncology practices and potential investors must be flexible about developments in reimbursement in the future. CMS is urging both commercial and governmental payors away from fee-for-service and toward alternative payment models. However, approximately 50 percent of oncology practices received significant reimbursement from APMs in 2017, and that percentage is only expected to rise. Investors should continue to monitor these developments in reimbursement as they consider investment opportunities in the oncology space.

The past several years have seen an increase in investor interest and investments. In 2018, General Atlantic invested $200 million in a startup (OnOncology) that focused on supporting the entire continuum of cancer care treatment, and Pharos Capital Group announced that it acquired an Indiana oncology practice in connection with launching its own new venture, Verdi Oncology. In 2019, Integrated Oncology Network, a portfolio company recapitalized by Silver Oak Services Partners in October 2018, announced its acquisition of e+CancerCare, which operates outpatient cancer care centers across 10 states.

10. Physical Therapy/Occupational Therapy/Speech Language Pathology (steady to more)

Physical therapy, occupational therapy and speech language pathology are seeing modest growth, due in part to the aging population as well as the move to value-based care. The older population suffers mobility issues, which necessitate physical therapy, and this population faces a broad scope of speech, language, swallowing and voice issues that are often treated by speech-language pathologists after strokes and dementia. As payors are moving to value-based care, patients are often required to attempt therapy before a surgical or medical alternative will be approved for reimbursement.

Meanwhile, these subsectors remain highly fragmented. Research and Markets[4] estimates that the 50 largest therapy companies comprise less than 25 percent of the market. Investors favorably view these subsectors to drive scale through consolidation. Although many platforms build *de novo* locations, as opening a facility often costs between $100,000 and $170,000 and begins providing a return on investment within two years of opening.

Regulatory and policy tailwinds are also driving interest in this space. Only 10 years ago, Medicare began to pay speech language pathologists in private practice for the first time. These three services are also typically considered part of the Affordable Care Act's essential health benefit mandates. Furthermore, Congress recently repealed therapy caps to allow Medicare beneficiaries to access additional therapy services. Of course, focus on these regulatory changes also carries risk, as Medicare and other payors are conducting more targeted reviews for medical necessity instead of relying on a cap. These changes may make it difficult for providers to remain independent due to the increased cost of doing business in a compliant manner.

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[4] *U.S. Physical Therapy Clinics Report 2019: Industry Analysis Examines the $34.5 Billion Outpatient Physical and Occupational Centers Market*, BUS. WIRE (June 28, 2019), *available at* https://www.businesswire.com/news/home/20190628005120/en/U.S.-Physical-Therapy-Clinics-Report-2019-Industry.

Two of the largest national therapy players are owned by public companies — U.S. Physical Therapy and Select Medical. Some commentators anticipate that additional "top-five" players, like Athletico and ATI, will go public after executing significant growth to capitalize on that consolidation. Some recent, notable transactions suggest another consolidation wave could come after prior waves paused. These transactions include Sheridan Capital Partner's 2018 investment in Empower Physical Therapy and Revelstoke Capital Partners' Upstream Rehabilitation acquisition of Drayer Physical Therapy (becoming the third-largest physical therapy provider in the U.S). April 2019 brought investments in speech-language pathology, including Ridgemont Equity Partners' partnership with The Speech Pathology Group, and occupational therapy, including U.S. Physical Therapy's acquisition of Briotix Health. Expect investment in these subsectors to continue in 2019 and beyond.

11. Anesthesiology and Pain (steady)

Investment in the anesthesia/pain sector ran hot and cold for many years, but investor interest seems to have evened out, and we view this currently as a steady subsector. Separately, anesthesia is also an important part of some multispecialty and single-specialty practice models, with many platforms bringing anesthesia in-house to control quality and access.

As with investment in the laboratory, imaging and a few other diagnostic and therapy sectors, the anesthesia industry is much more heavily reliant on referrals within the provider community rather than direct patient relationships. This dynamic makes the structure of referral relationships especially important from a business standpoint but also creates an environment of intense regulatory scrutiny, as government regulators and litigants have closely analyzed these referral relationships over the last several years. Such regulatory pressures have forced many companies to modify the structures of their referral relationships. Notwithstanding, such scrutiny does not seem to have slowed the aggressive acquisition strategy of several active buyers, including but not limited to large consolidators like US Anesthesia Partners, Mednax and Vancouver-based CRH. Additionally, American Securities invested in North American Partners in Anesthesia, and Cranemere purchased NorthStar Anesthesia from TPG Capital.

Similarly, pain management practices are often components of a larger anesthesia group or free-standing groups, in either case typically performing a wide range of procedures in office-based surgical suites, ASCs and/or even, in some cases, physician-owned hospitals. These high-volume procedures tend to be fairly lucrative, particularly when the physicians have invested in the facility and are receiving both their professional fees and a share of the facility fees. As with anesthesia practices, there are sensitive regulatory issues to understand, one of which is the significant public attention on opioid addiction. Among the recent investments in the focused pain-management space, American Discovery Capital invested in Midwest-based Center for Pain Institute, NexPhase invested in Gulf Coast Pain Institute, Commonview Capital created Pain Specialists of America through the combination of two Austin Texas practices, and Avista Capital invested in National Spine & Pain Centers.

Private equity investment in these subsectors is likely to steadily continue throughout 2020 and beyond, as larger platforms become more realistic buyers of a longer list of smaller platforms, mirroring trends that have repeated across numerous sectors.

12. Behavioral Health (steady)

The behavioral health sector is a broad umbrella, encompassing a wide range of providers, such as inpatient psych hospitals, substance-abuse rehab facilities, methadone clinics, inpatient and outpatient eating-disorder programs, and autism and educational therapy, among others. Many subsectors in the behavioral health industry have the potential for significant growth in the future. While there are still some limitations on how care is provided and reimbursed, the market is currently trending toward increased reimbursement for services provided to a rapidly expanding patient base.

Mental-health parity also continues to fuel interest and investment in the sector, and increased reimbursement for providers of mental health and substance-use disorder services is a factor that has driven interest in the behavioral healthcare market. There continues to be strong interest in business strategies that bring together several different types of treatment to a specific target population or demographic (such as autism care, senior care or more comprehensive programs aimed at Medicaid-covered populations).

Overall, there has been active investment activity in the addiction, eating disorders, autism therapy and outpatient rehabilitation programs. In particular, the national opioid crisis is causing the market to experience a significant uptick in the number of new opioid treatment facility companies, with private equity companies seizing the opportunity to enter the industry. Many of these service lines also have a laboratory or monitoring component, an area in which extra caution is warranted. Interest in lab service businesses in the behavioral health sector was seen in Five Arrows Capital Partners' equity recapitalization of Averhealth in July 2019.

Additional recent and notable transactions include New York-based private equity firm Blue Wolf Capital Partners' announcement of the acquisition of RHA Health Services, and Anthem Inc.'s acquisition of Beacon Health Options from Bain Capital Private Equity and Diamond Castle Holdings to create one of the most comprehensive behavioral health networks in the country.

13. Ophthalmology and Optometry (more)

With acquisition activity accelerating, the vision space remains ripe for investment. Despite the vision space remaining highly fragmented with tremendous room for consolidation, it is estimated that independent practices still perform 68 percent of all patient eye-care services. Accordingly, investments of scale are often highly competitive, and the industry is seeing existing platforms actively adding to regional footprints, such as CEI Vision Partners, Eye Health America, SightMD and Spectrum Vision Partners.

Given the numerous advantageous market-dynamic considerations at play, such as the increased demand for vision services (both medical and cosmetic) and the high-volume ancillary business lines that many vision practices offer, investment in this sector is only expected to grow. In addition to the lucrative ancillary services, vision practices can often diversify from a reimbursement perspective by providing premium eye-care service offerings, such as LASIK, premium intraocular lens and dry-eye treatments, all of which can have a significant cash-pay component.

The retina subspecialty has seen an increased demand for investment from private equity. Retina practices present attractive investment opportunities, but such investments are often costly and can present risk due to the competitive landscape. The high demand is likely due to the unique dynamics of this subspecialty, including but not limited to injectable drugs, such as those used to treat wet age-related macular degeneration (e.g., Lucentis, Eyelea and Avastin), which are highly profitable, as well as complementary to more standard ophthalmologists and cataract surgeons. Some ophthalmology platforms have also considered ways to increase care integration by acquiring optometry and optical businesses, within their platforms, or structuring relationships with optometrists in their community.

Physician alignment remains the key to success for investors. As is the case in numerous other sectors, the number of retiring ophthalmologists is outpacing the number of physicians who are beginning their careers in this space, which creates competition for recruitment of talent. This landscape puts additional pressure on investors to develop innovative incentive and alignment strategies that reach beyond compensation, and include, for example, involvement in committees, research platform development and alternative work arrangements.

14. Dental Practice Management (steady)

Private equity investment in the dental service organization (DSO) sector has remained strong, with several new platforms coming to market in the past year. The focus seems to have shifted, in earnest, away from the larger platform transactions (although we still see a few), toward a more intense consolidation effort with smaller add-on transactions. Investment activity has largely been fueled by fragmentation in the industry (still greater than 85 percent by most estimates), a relatively favorable commercial payor environment as compared to other sectors, inelastic demand and shortages of quality dentists in some markets.

DSOs have commanded some of the highest valuation multiples over the past several years and remain a relatively pricey investment, especially at the upper end of the market. One valuation challenge relates to the pricing expectations of the selling owners of smaller practices. Seeing the valuations at the higher end of the market, small practice owners have increased their purchase price expectations, making it more difficult to execute a consolidation strategy predicated, in part reducing the overall multiple paid for the platform's assets, in the aggregate.

Some notable transactions in 2019 alone include Bain Capital's investment in Texas-based Rodeo Dental & Orthodontics; CORDENTAL Group Management's (a portfolio company of NMS Capital) strategic partnership with Dubuque, Iowa-based AppleWhite Dental; Surge Private Equity's investment in Access Dental and Lacosta Dental in Texas; and The Guardian Life Insurance Company selling its DSO to Western Dental Services (a portfolio company of New Mountain Capital LLC). Notably, recent dental transactions have not been limited to the provider world. Planet DDS, known for its practice management software Denticon, recently received a growth capital investment from Level Equity.

One other notable trend is experimentation in moving away from single-specialty DSOs and toward a true multispecialty approach. Again, these models are still emerging but involve pediatric DSOs adding orthodontics, orthodontic DSOs adding oral surgeons, and general dentistry DSOs adding pediatrics and periodontics, for example.

Lastly, investors considering a move in this sector should be aware that forming a DSO does not, by itself, create any value. McGuireWoods previously hosted a webinar with PlanetDDS on the topic "Should You Form a DSO?" A recording is available upon request.[5]

15. Dermatology (steady)

The dermatology industry remains a highly fragmented market, and the multi-site, multi-unit structure of group practices is ideal for pursuing buy and build strategies.

Investors considering dermatology opportunities should give thought to the various market dynamics at play. For example, revenue from minimally or non-invasive cash-pay cosmetic procedures allows for direct-to-consumer marketing, while at the same time, the medical dermatology side of the sector provides a solid foundation for recurring cash flow. Additionally, dermatology, like other segments, utilizes numerous lines of ancillary services — including but not limited to labs, clinical trials and ASCs — making them attractive to investors as an opportunity to gain additional revenue by serving as a "one-stop-shop" for patients. Investors must also consider certain other market conditions that affect not only the dermatology sector, but other specialties as well, such as physician shortages, which place a burden on investor-led practices to recruit and retain physicians. To combat this, some platforms are experimenting with thoughtful incentives — such as clinical research opportunities, loan forgiveness programs and other compensation models — to support providers and align incentives between physicians and investors.

Scale is key, not only in terms of geographic reach, but the number of providers. Achieving a certain level of scale affords the ability to bring ancillary services and specialty service lines (such as MOHs surgeries) in-house. With that said, investors have struggled to find platforms of scale (i.e., platforms with the infrastructure or centralized functions needed to support bolt-on transactions). Given the benefits that investment in dermatology can bring, however, many investors are demonstrating a willingness to consolidate without a true "platform" as a starting point.

2018 saw significant investment activity in the dermatology space, with notable transactions, such as Gryphon Investors' majority investment in Water's Edge Dermatology, a leading provider of comprehensive dermatology services in Florida and Platinum Dermatology Partners' (backed by Sterling Partners) acquisition of Center for Dermatology & Plastic Surgery, an Arizona-based dermatology practice. Already in 2019, there has been a flurry of investment, with Susquehanna Private Capital LLC announcing its investment in Skin & Cancer Associates, a large provider of dermatology in Florida, and Anne Arundel Dermatology Management announcing its acquisition of Laser Skin & Vein Center of Virginia, a dermatology practice spanning three states.

16. Compounding and Specialty Pharmacy (steady)

The compounding pharmacy market, estimated at approximately $8.5 billion dollars in 2017 and expected to grow to $12.5 billion by 2024, has recently seen several key trends affecting investment, particularly, market consolidation and non-traditional market participants. Vertical consolidation of the pharmacy and drug delivery sector, as well as the entrance of non-traditional players into this sector, is likely to accelerate disruption of the status quo in the drug delivery supply chain. Throughout 2018, there was significant consolidation in the pharmacy and drug supply chain sector, with non-traditional combinations between insurers and pharmacy benefit managers taking center stage. This vertical consolidation is expected to continue and will likely translate into other large market participants entering the pharmacy space.

The compounding pharmacy sector also presents evolving regulatory challenges and has been a focal point for oversight and regulation by not only the Food and Drug Administration, but state laws as well. The driving forces behind much of this regulation have been rebates and expanded transparency. When approaching a

[5] *See also* Ben Petitto, Lauralee Lawley and Bart Walker, *Should You Form a Dental Services Organization*, DENTISTRY TODAY (Apr. 16, 2019), *available at* https://www.dentistrytoday.com/news/todays-dental-news/item/4672-should-you-form-a-dental-services-organization.

pharmacy as a potential acquisition, investors therefore should conduct careful diligence around rebates, sterile compounding practices and other compliance issues.

We have not seen as much by way of private equity investment in this subsector; however, in August 2019, Equistone Partners Europe agreed to buy a majority of Omnicare, a pharmaceutical wholesaler that operates throughout Germany and distributes finished medicinal products to compounding pharmacies. The healthcare industry will, indeed, continue to keep its eyes on this sector and potential investments in the same.

17. Veterinary Services (steady)

Private equity interest in the veterinary-services sector has remained steady over the last several years, and we see no reason for the interest and deal volume to slow. Investors have been attracted to increasing trends in pet ownership and an ongoing willingness of pet owners to prioritize spending on pet health and pet products, with dedicated consumers in all wealth classes devoting a large portion of disposable income to pet care. This sector is, overall, considered an area with decent returns and lower business and regulatory risk, given it is predominantly a cash-based business with much less regulatory oversight on ownership structures than businesses involving human medicine. Beyond the core veterinary office-based business line, the additional ancillary business lines of lab, grooming, pharmaceutical, DME, cremation, urgent care, hospitals and therapeutic products provide expansion opportunities that are attractive to investors. Finally, the limited number of strategic buyers and a more recession-resistant market are additional factors that have private equity firms flocking to the space. Expect investors to continue to pursue opportunities in pet health-related businesses, such as pet health biotech and devices, over-the-counter health products and pet food manufacturers.

In terms of recent veterinary investments, Mars Incorporated paid $9.1 billion for VCA Inc. and its 800 animal hospitals, its animal diagnostic imaging company and its doggy day care and overnight camp franchise. OMERS Private Equity acquired a minority stake in National Veterinary Associates, the largest independent owner-operator of veterinary hospitals, pet boarding and daycare centers. A sampling of other notable investments includes Latticework Capital's investment in American Veterinary Group; Cressey & Company's investment in People, Pets & Vets; and Tyree & D'Angelo's investment in Heartland Veterinary Partners.

Thus far, investor interest has focused more dominantly on the small-animal market, which has more of a retail feel. As the space becomes more consolidated and competition for attractive investment increases, it will be interesting to see if some investors turn toward large-animal opportunities.

18. Laboratory Businesses (steady)

Investors continue to show steady interest in laboratory businesses, but those opportunities tend to be focused on niche approaches, rather than broad, generalist toxicology or pathology labs, as large providers, such as Quest and LabCorp, continue to dominate the laboratory subsector. The lab industry continues to experience downward pressure on reimbursement, forcing providers to find more creative business models to maintain margins and market share. In addition, larger groups are looking to bring lab services in-house, when possible.

Because the lab sector is heavily regulated and the regulatory scrutiny of lab arrangements has heightened in recent years, a thoughtful and relatively sophisticated analysis of structuring considerations is necessary to avoid inadvertent legal problems. In fact, in May 2018, three individuals were ordered to pay $114 million to the federal government for illegally providing physicians remuneration in exchange for referrals to two blood-testing laboratories: Health Diagnostics Laboratory Inc. in Virginia and Singulex Inc. in California. Also, in January 2017, UnitedHealth Group Inc. filed suit against Texas-based Next Health LLC, alleging that the company had defrauded United over several years through an illegal physician referral scheme. This suit remains active.

Federal prosecutors also remain focused on prosecuting laboratories' illegal financial relationships. For example, in July 2019, the owner of Allegiance Medical Laboratory and AMS Medical Laboratory was sentenced to 30 months in prison and was ordered to pay $3.4 million in connection with the owner's provision of illegal kickbacks for referrals to laboratories.

Investors must scrutinize, more than ever, laboratories' relationships with marketing and sales representatives when doing due diligence on a company. In October 2018, Congress enacted the Eliminating Kickbacks in Recovery Act of 2018 (or EKRA), an all-payor statute that is much broader than the federal Anti-Kickback

Statute (AKS) and effectively eliminates the safe harbors to the AKS that laboratories historically relied upon when structuring compensation arrangements with sales representatives for marketing services.

Despite the regulatory challenges and reimbursement pressures facing the laboratory industry, private equity interest in laboratory businesses remains strong. For example, in 2017, Avista Capital Partners acquired Miraca Life Sciences, a large, independent laboratory that provides subspecialty anatomic pathology services. Specialty/niche pathology and esoteric/genetic testing seem to show the most promise, due to the increasing awareness of rare and complex diseases, growing opportunities toward personalized medicine and the expanding market for genetic testing services.

19. Urgent Care (steady)

The urgent-care industry continues to grow, adding 300 to 600 locations each year and gathering speed as the business changes from an "after-hours alternative" to many patients' initial access to the healthcare system. Particularly, retail urgent care offers extended hours, convenient treatment locations and shorter wait times for consumers. At the same time, we are seeing fewer deals in this sector than immediately following the recession. Nevertheless, some large platforms have done well in the space, such as American Family Care, CityMD, Concentra, Optum's MedExpress and MD. However, in April 2019, FastMed and NextCare terminated a pending merger agreement after competition concerns were raised. For investment models that have succeeded, staffing models are critical, with many successful platforms relying on non-physician personnel — such as nurses, nurse practitioners and physician's assistants — further keeping their operational costs down.

In many regions, hospitals and health systems are prime investors, deploying urgent-care centers to: (i) introduce healthy patients to their provider network, (ii) keep patients out of emergency rooms and (iii) defend against competitors in their backyard. However, for many health systems, rapid deployment of urgent-care centers is not a core skill. Accordingly, many hospitals and health systems are partnering with urgent-care companies on joint-venture models. While there are plenty of examples of successful partnerships, private equity investors must find good, strategic partners as larger health systems may be willing to take losses in the urgent-care space, viewing such locations as an opportunity to reinforce their system's footprint.

We are seeing more specialty urgent-care operations. Pediatric urgent care was an early focus, and more efforts are being made in that space, including PM Pediatrics, Night Lite Pediatrics and Urgent Care Pediatrics. We are also seeing orthopedic and maternity-specific urgent-care centers, often created by large groups to serve their existing patients. Similarly, many urgent-care centers are expanding their services into other service lines, including, for example, behavioral health, dermatology and weight management.

We anticipate another wave of consolidation to occur in the coming years, entrenching key, dominant regional players, as early investors exit the space. Many recent investments seek to create regional strength, such as Great Point Partners' portfolio company Little Spurs Pediatric Urgent Care acquiring All Children's Pediatric Urgent Care in Dallas-Fort Worth in July 2019. Some other recent notable transactions include Shore Capital Partner's SouthStar Urgent Care partnering with AHS Walk-In Clinic in July 2019; HCA Healthcare's CareNow Urgent Care acquiring 24 MedSpring urgent-care clinics in Texas in July 2019; and in December 2018, a hospital-urgent-care joint venture, Dignity Health in San Francisco and GoHealth Urgent Care, purchasing six urgent-care centers. Recent urgent-care transactions have not been limited to the provider world. In May 2019, Warburg Pincus merged DocuTAP and Practice Velocity, two leaders in the on-demand healthcare and urgent-care space, using the name Experity.