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The Effects of COVID-19 on Private Equity in Healthcare – A Review of Selected Niche Investment Areas

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At the beginning of 2020, it appeared that the slow but steady drumbeat of provider consolidation would continue on its natural course. Then, COVID-19 struck. Non-emergent procedures were largely shut down. The health and economic security of the nation were gravely at risk. Early spring to summer saw much acquisition activity canceled or deferred as provider-based businesses dealt with furloughs, credit facility defaults and endless stresses. Looking back at the distress, it has become apparent that the pandemic was more of an accelerant of pre-existing issues and opportunities than a true change in the prognosis of the healthcare sector. Stronger companies survived, even flourished, and struggling companies faced existential crisis. As 2021 begins, the majority of providers have rallied, vaccines are in distribution and, while the end of the tunnel is still far away, there is a light.

The natural acquisition demand of healthcare services as an asset class for investment has resulted in pent-up capital designed to be invested. That demand is evident as pricing multiples have stayed high even though valuation is difficult when the last 12 months' EBITDA is a difficult measure of future expectations due to COVID-19. The general outlook of 2021 activity is that investment will be strong. The sectors will vary as discussed below, but macro level recovery will be a rising tide. That, at least, is the hope.

In the meantime, private equity investment in healthcare has continued to evolve. This annual McGuireWoods article includes observations and insights on the key investment niches that have been areas of private investment focus over the last several years.

This analysis covers 22 niche investments areas, with a note indicating whether the industry should expect steady (i.e., roughly equal), less or more private equity interest in that sector, as compared to the last several years. The specific investment areas discussed are as follows:

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

18. Laboratory Businesses (more)
19. Urgent Care (more)
20. Hospitals (less)
21. ASCs (steady)
22. Cardiology (steady)

II. Investment Areas

1. Orthopedics (steady to 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 prior to the COVID-19 pandemic. Private equity investment in this space is surging, and deals are highly competitive. That said, the orthopedic market is still highly fragmented, and such fragmentation is garnering a compelling interest, which is expected only to continue 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 payor and patient emphasis on moving appropriate cases (including some partial and total joints) to outpatient sites of service, which are historically lower-cost for the payor and patient.

Investment in orthopedic practices poses unique challenges. Investments in the orthopedic space typically involve higher upfront purchase prices, with very high EBITDA multiples. Further, many orthopedic practices have numerous well-paid partners who are used to working independently, often with entrenched "eat-what-you-kill" compensation models. Given these dynamics, physician alignment models are critically important. Expense allocation should ensure that individual decisions impact compensation, while group overhead is fairly allocated. Physicians who are driving platform growth generally want to be compensated accordingly. Therefore, the physician profit and expense distribution methodology is a key factor in the success of a PE-backed physician group, as are incentives for driving add-on transactions and physician recruiting. Certain PE-backed orthopedic platforms may also be well positioned to lead the market in value-based care. This is due in part to having well-developed IT infrastructure and large-scale operations. A lead provider in the value-based orthopedic care market is Healthcare Outcomes Performance Company (HOPCo), a vertically integrated provider of musculoskeletal care services, and Audax portfolio company. In 2020, HOPCo acquired Stryker's Performance Solutions' extensive value-based care business.

With numerous states halting elective procedures during the early days of the COVID-19 pandemic, orthopedic practices suffered an immediate revenue hit, and the uncertainties of the pandemic definitely slowed transactions in 2020. But, by late summer, with the loosening of state mandates, the industry's flex toward telehealth and the role of high-deductible health plans driving year-end care, orthopedic practices have largely rebounded and investor interest is expected to continue. Recent transactions in 2020 alone include Beacon Orthopaedics' addition of seven physicians formerly with OrthoCincy and Reconstructive Orthopaedics & Sports Medicine, private equity firm Cobepa's closure of a growth equity investment in Laurel, Maryland-based Precision Orthopedics and FFL Partners formed U.S. Orthopedic Partners (USOP), a new orthopedic health services organization.

2. Urology (steady)

Private equity investment in urology practices has increased over the last year. 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 through their practice entities. Of course, oncology groups must have a certain level of scale to develop these service offerings in a structure that makes financial and operational sense. In many situations, the desire to achieve this scale encourages consolidation of small to mid-size urology practices. In addition to management expertise, private equity funds have helped make available cash and debt for capital investments that otherwise would make it difficult for small physician groups to compete.

Similar to orthopedics, the specialty is seeing increased demand due to the aging population and low supply of physicians. With respect to COVID-19, urology practices saw a significant decline in elective procedures during the earlier months of COVID-19. This decline has, however, largely stabilized, and many urology practices were refocusing on potential transactions during the end of 2020 and continuing into early 2021.

In January 2020, Lee Equity Partners formed Solaris Health (Solaris) in Fort Lauderdale to own and manage urology practices. Solaris was established to bring together New York-based Integrated Medical Professionals (IMP) and Cincinnati-based the Urology Group (TUG). In October 2020, Gauge Capital partnered with Urology Austin, to form a new urology platform, Urology America. Despite new private equity activity in the space, a number of large, independent urology practices remain unaffiliated.

3. Women's Health (steady)

The women's health and fertility industry continues to produce attractive opportunities for private equity investment as a result of its availability for associated ancillary services, significant technological advances and new openings to negotiate with payors for a greater share in the produced cost savings. As the focus toward access and individualized care increases, the industry is expected to continue to drive interest for investment.

Grand View Research Inc. reports that the global women's health market size is expected to reach $47.8 billion by 2027. This growth is attributable to many factors, including an increased awareness of women's health and women's unique risk for diseases, new end-users of fertility treatments and reproductive services, and enthusiasm for new innovative technologies in the space.

In 2020, investment in the women's health and fertility industry expanded into more than an investment into traditional obstetrics and gynecological (OB/GYN) care. The industry offers a diverse catalog of treatment and service options in addition to traditional OB/GYN care including genomics and genetics, egg-freezing services, alternative and preventative treatments, fertility treatments and laboratory services, drugs, and more.

There is also growing enthusiasm by investors for several new subsectors of the women's health market, some of which are pandemic-driven. First, the market in female-focused health products (aka "femtech") has continued to garner more attention, with Forbes estimating that femtech will be a $50 billion industry by 2025. The last few years have demonstrated that more same-sex couples and women over the age of 40 are interested in having children. Therefore, the demand for specialized fertility treatments and care, advanced drugs, technologies, products and innovations is high. This demand is exemplified, for example, by Elvie (a company known for developing a silent breast pump), which announced in 2019 that it raised $42 million in its third private financing round in connection with four new femtech products, which was led by IPGL, a private equity firm based in London.

Second, the COVID-19 pandemic emphasizes the true demand for new virtual and telehealth technology for an industry historically rooted in in-person visits and care. During 2020, patients required obstetric services via telehealth. The shift toward sustainable, virtual platforms and crucial, yet safe, telehealth treatments in the women's healthcare sector could offer value-add opportunities for investors.

Finally, interest in the four primary subspecialties of women's health (gynecologic oncology, reproductive endocrinology and infertility, maternal fetal medicine, and pelvic and reconstructive surgery) have garnered increased interest for a variety of reasons, including from larger OB/GYN practices interested in structuring more value-based care reimbursement demanding some degree of risk-bearing for such subspecialty care. 2020 saw multiple such subspecialist practices come to market; expect this particular trend to continue.

The enthusiasm from investors for women's health and fertility investments is evidenced by new closings even during the pandemic. In June 2020, Seven Hills Women's Health Centers, a leader in women's healthcare, joined Axia Women's Health, a portfolio company of Audax Private Equity. In addition, in September 2020, Women's Care Enterprises, a leading comprehensive women's health platform, partnered with Complete Women Care, a portfolio company of Lindsay Goldberg, a private investment firm. Sverica Capital's Women's Health USA and In Vitro Sciences platforms also closed several acquisitions throughout 2020.

4. **Gastroenterology (steady)**

Prior to the COVID-19 pandemic, investor interest in the gastroenterology (GI) industry was on the rise. After several decades of investor interest in single-specialty GI surgery centers, the 2016 investment by Audax in Gastro Health created one of the first PE-backed GI practice platforms. Thereafter, between 2018 and early 2020, there were several significant transactions, including Frazier Healthcare Partners' 2018 acquisition of Atlanta Gastroenterology Associates to form United Digestive; Waud Capital's November 2018 acquisition of Texas Digestive Disease Consultants to create The GI Alliance; Amulet Capital's May 2019 acquisition of three Pennsylvania practices to create US Digestive Health; and the August 2019 creation of Physicians Endoscopy Practice Solutions (PEPS) by Physicians Endoscopy and Capital Digestive Care. And, of course, most of these GI practice platforms have deployed a growth strategy through various-sized add-on acquisitions as well, and the still very-fragmented GI industry made investor interest continue to rise prior to the COVID-19 pandemic.

While the industry has definitely been subject to reimbursement pressures for many years, investors have been attracted to the fairly steady and profitable ancillary service lines, such as ASCs, in-office 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.

But, the pandemic hit the GI industry much like it hit other surgical specialties that were forced to cancel elective procedures and flex toward telehealth**.** Procedural volume was significantly and negatively impacted in the early months of the pandemic, but volumes have largely returned to near-normal levels. Seeing improved volumes, investor activity has resumed for deals of all sizes, with late 2020 seeing closings of significant size in the GI sector; thus, the GI sector can be viewed as involving steady investor interest, with the potential for increasing interest depending on how the industry continues to evolve.

5. Podiatry (steady to more)

With an estimated 75 percent of Americans experiencing foot or ankle problems, podiatry is seeing an uptick in investor interest, presenting a unique opportunity for leverage as an "early mover" in the space. The podiatry market remains highly fragmented, leaving significant room for consolidation; however, the space currently has limited platforms of scale that can serve as a significant first investment for a fund looking to get into this space, with some estimates indicating that there are only about 30 U.S. podiatry platforms with more than 10 podiatrists in total. Notwithstanding, once a platform is established, given diminishing margins, small to solo podiatry practices are looking to private equity with increased interest as a way to achieve economies of scale.

Investor interest in this subsector is likely attributable to the growing rise in "super groups" (i.e., podiatry practices with more than 30 practitioners) 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 service lines such as ASCs, will be an important component investors should bring to the table when evaluating and selecting target acquisitions.

COVID-19 kept many patients out of podiatric offices due to stay-at-home orders and elective procedure bans; however, some clinics began offering tele-podiatry for foot ulcer management, a trend that may continue after the pandemic, especially for low-risk patients.

In the past, the podiatry space lagged behind other healthcare specialties in which private equity investment was focused, but today's investors are showing an increased interest in acquiring podiatric practices, as demonstrated by VSS Capital Partners' October 2020 investment in Podiatry Growth Partners, and NMS Capital's Foot and Ankle Specialists of the Mid-Atlantic continuing to roll up practices.

6. Ear, Nose and Throat (steady)

As in other sectors with heavy surgical and elective procedure volume, ear, nose and throat (ENT) practices have been impacted by COVID-19. Recent studies of surgical volume by ENT practitioners noted a sharp downturn in cases through the midpoint of 2020. Despite fewer elective procedures for a portion of the year, ENT investments remained relatively steady compared to other subspecialties. Particularly, ENT practice consolidation into large platforms continues to occur and potential platform targets continue to join the market. Private equity deals included Shore Capital's Southern Ear, Nose, Throat & Allergy Partners completing three affiliations in fall 2020.

Traditionally, ENT practices cover a broad array of services that can have varying degrees of ancillary services and ASC utilization—including lab, diagnostics and medication—with practices that have heavier ancillary services being more attractive targets for investment. This fact remained true during 2020, but potential buyers have expressed skepticism regarding the performance of ancillary service lines and elective procedures during the COVID-19 pandemic. Smaller practices that are not able to leverage ancillary services and ASC ownership have proven somewhat less attractive to buyers in 2020. However, in the coming year, expect their attractiveness to rebound because they will pose opportunities for bolt-on activity and the ability to expand into those ancillary services lines upon joining a larger overall practice.

It is unclear if sub-subspecialties, like allergy treatment, will continue to attract attention in 2021, similar to more integrated ENT practices. Allergy treatment, for example, saw less consolidation in 2020, which may be due to the limited ancillary service lines and high numbers of elective treatments impacted by COVID-19. As patients become more comfortable seeking elective treatment, interest in this sub-subspecialty may rebound.

7. Other Hospital-Based Specialties (steady)

All of the hospital-based specialties have been hard-hit by the COVID-19 pandemic—no one can deny that. However, on a more extended timeline, cost and physician coverage challenges continue to drive investment in alternative or outsourced models of care for hospital-based specialties. Many tertiary markets are seeing severe physician shortages, particularly with specialists and subspecialists in hospital-based specialties. Within outsourced emergency physician services, TeamHealth Holdings Inc.(purchased by Blackstone in 2017 for $3 billion), together with one other market participant, collectively own an approximately 30 percent market share. Overall, hospital visits have been hit hard by the COVID pandemic, and many of the related physician practice management companies have felt the effects even if such effects will be limited to the duration of the pandemic. Similarly, Fitch Ratings recently downgraded Team Health's rating from "B-" to "CCC+." Team Health currently has approximately $4 billion of debt. Fitch noted that it does not expect recovery to pre-COVID-19 levels in 2021 due to "… weakness in emergency department (ED) patient volumes and ongoing commercial payor contract disputes." Stability at the larger platform level bodes well for private equity consolidation at smaller levels, as having a viable upstream buyer market is critical to the proposition of consolidation at every level.

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. One of the key challenges is the "life cycle" of physician groups once partnered with an outsourced company (i.e., once the original founding physicians begin to cycle through retirement and new physicians are added to the group, organizations struggle to replicate some of the economic benefits of private practice ownership). This has led many sponsors to explore alternative and increasingly esoteric compensation models and equity-like structures in an effort to more closely align local and organizational interests. Many of the more creative models require serious thought around the associated healthcare regulatory complexities.

Certain hospital-based specialties have seen movement toward technology-enabled solutions (even before the COVID-19 pandemic) which has now accelerated. For example, radiology has experienced growth in "nighthawk" radiology services and technology-enabled remote image reading capabilities. Historically, payors have been a little wary of embracing telehealth solutions, especially at the same reimbursement rate, with the concern being that the ease of delivery would create material increases in utilization. The pandemic has created a necessity of telehealth delivery of services that has helped assuage those concerns as the expanded use of telehealth has not seemed to result in overutilization. Given this experience and the inherent cost-saving potential, expect these telehealth applications to continue to be a growth area.

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

Historically, the healthcare industry lagged behind others in investments involving technology and digitalization, with investors somewhat leery of healthcare IT

(HCIT) companies. Recent years, however, have seen a shift. The HCIT sector is becoming competitive and ripe for investment. Due to COVID-19, expect this demand to continue as now, perhaps more than ever, the industry and consumers are pushing for increased innovation.

In recent years, the HCIT sector began experiencing all-time-high interest and investment activity. Although overall deal activity in the sector held steady between 2018 and 2019, 2019 brought a surge of competition for innovative HCIT deals in a range of sectors. Bain & Company reports that the total disclosed value in HCIT hit a record $17.5 billion in 2019, compared to $8.6 billion in 2018. Investment in the HCIT space throughout 2019 was competitive across its many subsectors, from Warburg Pincus' investment in Qualifacts, one of the largest software-as-a-service (SAAS) EHR providers for behavioral health, to Golden Gate Capital's investment in Ensemble Health Partners, a national revenue cycle management provider, to Francisco Partners' acquisition of Qualcomm Life (now Capsule Technologists), a leading global provider of medical device connectivity solutions for hospitals and providers.

In comparison to certain other niche areas, HCIT and tech-enabled provider solutions is a sector well-positioned to weather effects of the COVID-19 pandemic as the industry as a whole craves solutions for problems exacerbated by the coronavirus. In fact, Mercom Capital Group reports that in Q1 of 2020 alone, funding for digital health companies, including private equity and corporate venture capital, reached a record $3.6 billion, with telemedicine as one of the most-funded categories of HCIT. Private equity deals have continued to emerge during the pandemic, such as Accel-KKR's recent majority equity investment in Surgical Information Systems, an industry leader for business/clinical surgical software for ASCs.

Though this subsector offers great opportunities for investors, it is also heavily regulated. Investors must consider and manage state and federal telemedicine laws, state and federal fraud and abuse laws, HIPAA and state data privacy laws, licensing requirements and other legal considerations. Investors willing to understand and learn how to navigate this subsector despite applicable federal and state laws may see better-than-average returns on their HCIT and tech-enabled provider solutions than other sectors. Expect to see investment in this sector increase as the industry continues to search for pioneering ways to facilitate improved patient experiences, tech-enabled solutions, personalized treatment modalities and more.

9. Oncology (steady)

Long before the COVID-19 pandemic, the oncology space was growing, and patient volume was on the rise—up 20 percent in the five-year period between 2013 and 2018. This rise is only expected to grow. In fact, a 2014 study by the American Society of Clinical Oncologists (ASCO) predicted an increase in demand for medical and radiation oncologists of more than 20 percent by. In addition to growing demand, the fragmentation in the industry is very attractive to investors. According to the 2017 Medicare Physician Compare data, more than 2,200 oncology practices nationwide represented more than 12,000 clinicians, with 76 percent of practices employing fewer than five clinicians. Thus, investors have seen a real opportunity for the same type of consolidation with economies of scale that has been available in other high-volume yet fragmented physician specialties, such as dental and dermatology.

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, such as treatment for breast cancer, lung cancer, colon cancer and leukemia. Similarly, practices are diversifying their methods for 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. As cancer treatment becomes increasingly more targeted, and the individualization of the patient treatment regime becomes 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. The Centers for Medicare & Medicaid Services (CMS) is urging both commercial and governmental payors away from fee-for-service reimbursement and toward alternative payment models. However, approximately 50 percent of oncology practices received significant reimbursement from alternative payment models in 2017, and that percentage is expected only 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 private equity interest in the oncology space. In 2017, Tahoe Investment Group acquired a controlling stake in Alliance Oncology. In 2018, General Atlantic invested $200 million in startup OneOncology, which is 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.

The short-term impact of the COVID-19 pandemic on the industry was material, due in large part to clinicians' modification of the vulnerable patient population's treatment schedules, with materially more missed treatment in the first six months of the pandemic than in normal times and with those missed treatments not expected to be "made up" (whereas many elective procedures in other specialties were simply delayed). But, the long-term impact is less clear, and most industry experts expect a return to normal volumes. Given the other attractive features of the industry, investor interest likely will remain steady.

10. Physical Therapy/Occupational Therapy/Speech Language Pathology (less)

Physical therapy, occupational therapy and speech language pathology are expected to see less growth compared to recent years, due, in part, to possible Medicare reimbursement hits. Although growth may decelerate, investors remain attracted to these subsectors as a result of the highly fragmented market, which remains ripe for consolidation, significant growth potential related to a renewed emphasis for value-based care and the valuable role physical therapy, occupational therapy and speech language pathology play in a patient's treatment.

In August 2020, CMSreleased its proposed Medicare Part B fee schedule, which could result in an up to 9 percent reduction in reimbursement for physical therapy and occupational therapy. It is unclear how the proposed fee schedule will impact speech language pathology, but a reduction in Medicare reimbursement is expected in this subsector as well. Although there is some skepticism regarding whether the rate cuts will actually take effect, fee reductions of this magnitude would be a heavy hit to these subsectors. In addition, the COVID-19 pandemic has already caused significant financial ramifications for providers of non-COVID-19-related therapy services. However, investors are expected to use the reimbursement uncertainty as leverage when pursuing acquisitions in this space.

Despite threats of lower Medicare reimbursement, patients' demand for services from physical therapy, occupational therapy and speech language pathology providers is on the rise. With hospitals discharging patients earlier, an aging population and the need for alternatives to opioids, the physical therapy, occupational therapy and speech language pathology subsectors remain necessary and integral players in the healthcare industry. As the movement toward value-based care continues, these subsectors' positions in the market also attract investors due to the relatively lower cost of care, compared to alternatives. Therapy providers focused on achieving high scores through the Merit-Based Incentive Payment System (MIPS) likely remain hot targets for investors as they will be in the best position if, and when, the Medicare rate cuts become effective.

These subsectors are also highly fragmented compared to other healthcare service sectors and remain attractive to investors seeking to achieve the benefits of scale with consolidation. According to U.S. Physical Therapy Inc.'s August 2020 Investor Presentation, there is no outpatient rehabilitation provider in the United States with greater than a 10 percent market share. Some recent, notable transactions evidence that investors are expected to continue to capitalize on the heavy fragmentation of these industries. Some of these transactions include Pine Tree Equity IV LP's early 2020 acquisition of Kids Speech, Physical & Occupational Therapy Inc. (Kids S.P.O.T.) and the June 2020 investment of PHOENIX Rehabilitation & Health Services, a portfolio company of Audax Private

Equity, in CACC Physical Therapy. Although the rate at which acquisitions occur may slow, expect investment in these subsectors to continue in 2021 and beyond.

11. Anesthesiology and Pain (steady to less)

After a few years of varied interest, investment in the anesthesia and pain sector became fairly steady in the years leading up to the COVID-19 pandemic, particularly given that separate and apart from anesthesia as a standalone practice, the specialty 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 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 and 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 large consolidators like US Anesthesia Partners, Mednax and Vancouver-based CRH. Additionally, Cranemere purchased NorthStar Anesthesia from TPG Capital

Anesthesia demands are largely dictated by demands in other specialties, with anesthesiologists and CRNAs supplying much-needed services to other specialties. Thus, in the early days of the pandemic, when states were shutting down elective procedures, anesthesia practices focusing primarily on outpatient procedures were badly hit while those with more inpatient-focused practices saw less impact. Given the loosening of elective procedure bans, some anesthesia groups are seeing a recovery, yet some industry experts have expressed concern over slightly longer-term effects of the pandemic, such as an inability to train new anesthesiologists, anesthesia supply-chain hiccups and a focus on lower levels of anesthesia when possible, which will have an impact on anesthesia revenues. For these reasons, investor interest likely will be steady to slightly less in the near future.

Finally, separate and apart from traditional anesthesia business lines, pain management practices are often components of a larger anesthesia group and are occasionally also free-standing groups. Pain management professionals typically perform 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.

12. Behavioral Health (more)

The behavioral health sector encompasses a wide range of providers, such as inpatient psychiatric hospitals, substance-abuse rehabilitation facilities, methadone clinics, inpatient and outpatient eating-disorder programs, and autism and educational therapy, among others. While some limitations exist on how care is provided and reimbursed, the market is continually trending toward increased reimbursement for services provided to a rapidly expanding patient base. Given this, many subsectors in the behavioral health industry continue to experience significant growth.

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 disorder, autism therapy and outpatient rehabilitation programs. Notable transactions in these subsectors prior to the COVID-19 pandemic include Golden Gate Capital's 2019 acquisition of Invo Holdings, a childhood behavioral health services and autism provider, and Ridgemont Equity Partners' 2019 strategic partnership with The Speech Pathology Group (SPG) and formation of Autism Intervention Services, a management services organization that will continue to foster and support SPG's growth.

During COVID-19, certain behavioral health providers successfully transitioned to providing services via telehealth (such as mental-health therapy providers), while other subsectors have struggled with the facility shutdowns that have swept the nation (such as autism care providers). Substance-use disorder service providers continue to experience the effects of the national opioid crisis, and demand for services continues at a steady pace. Providers are deploying social distancing, quarantining and remote visitation to accommodate a continued demand for services in the midst of the pandemic. Behavioral health transactions have continued to close since March 2020, including New Capital Partners' November 2020 investment in DotComTherapy and Pharos Capital Group LLC's December 2020 acquisition of Catalyst Behavioral Solutions. In light of steady, ongoing interest in the behavioral health sector, combined with behavioral health's ability to efficiently and effectively transition to a post-COVID-19 model, the behavioral health sector can be viewed as an area with increasing investor interest.

13. Ophthalmology and Optometry (steady)

Private equity acquisitions in the vision sector have continued accelerating over recent years, and investor interest is likely to remain steady in 2020 and beyond. Notwithstanding recent years' investments and estimates that there are upwards of 30 investors in the current market, the vision space remains fragmented, providing room for further consolidation. With this, however, comes highly competitive bidding processes as established platforms look to actively expand their regional footprints.

Due to the increasing aging population and interest from the younger generation in cosmetic procedures such as LASIK, the demand for ophthalmology and optometry services is growing; however, the number of ophthalmologists is not. Retiring ophthalmologists continue to outpace younger physicians beginning their careers in this space, which leads to increased productivity per physician and an attractive investment opportunity for funds; however, physician alignment thus remains tantamount, with investors focusing on promoting younger physicians into leadership positions earlier in their careers to align incentives and focus engagement.

The vision space offers lucrative ancillary services that can be leveraged, including the use and ownership of ASCs and retail, two areas that have become increasingly attractive to investors. In addition, vision practices are often able to diversify from a reimbursement perspective through providing premium eye-care service offerings, such as premium intraocular lens and dry-eye treatments, all of which can have significant cash-pay components. As evidenced by Webster Equity Partners' March 2020 formation of Retina Consultants of America, a physician management services organization consortium of five retina subspecialty practices across the United States, the retina subspecialty also continues to see increased demand due to its unique and profitable dynamics (e.g., injectable drugs).

Although steady investment in the vision space is expected to continue, similar to other subspecialties that have a heavier focus on elective and/or surgical treatment options, COVID-19 has hit the ophthalmology and optometry industry in a negative way. Notwithstanding, volumes are returning to near-normal levels, and investor activity is picking back up. The past several months alone have seen increased deal activity, especially among existing platforms, such as EyeSouth Partners' affiliation with Medical Center Ophthalmology Associates, Omni Group Partners' strategic partnership with Eye Care Northwest P.A., and Total Vision Partners' acquisition of Foothill Optometric Group. Strategic portfolio investments have also been picking back up, as evidenced by Leonard Green & Partners' October 2020 strategic investment in Eyesmart Express. Expect to continue to see a flurry of PE activity throughout the next several years, followed by a period of consolidation. Investors should identify targets willing to invest in their infrastructure and management team as well as those with a healthy mix of providers who will continue to grow and lead the business to future success.

14. Dental Practice Management (steady)

Large swaths of the dental sector were shuttered during the early stages of the COVID-19 pandemic. The economic impact was not evenly spread. Rather, depending on geography, some practices were completely closed for multiple weeks (or even months), while others suffered relatively little interruption. Most dental practices were able to reopen in due course with appropriate safeguards. Dentists were also aided by the CARES Act funding specifically designated for dental providers and many also took advantage of the Paycheck Protection

Program. Through Q3, most have reported returns to approximately 80 percent of pre-COVID-19 patient volumes.

Still, fragmentation and opportunities remain in the industry. At the end of the day, dentistry enjoys relatively favorable reimbursement rates, inelastic demand and shortages of quality dentists in some markets. In addition, even though the consolidation wave in dentistry has been going on for two decades and de novo store openings can hit saturation points in some markets, the sheer size of the dental market and its continued relative fragmentation make dental consolidation an attractive investment thesis.

There has been at least one high-profile bankruptcy in this space, with Benevis filing under Chapter 11 and ultimately selling to New Mountain Capital. Anecdotally, at least a few other platforms have shown signs of distress. Expect this trend to continue, given the relatively high levels of debt on some of the DSOs. For those that survive, this sector should continue to have numerous opportunities, including a large number of solo and small practices newly motivated to join forces in case they have to weather another economic, political or social storm.

15. Dermatology (steady)

The dermatology sector has experienced significant private equity investment each year since 2011, with Modern Healthcare reporting 184 acquisitions by private equity firms of dermatology practices from May 2012 through May 2018; however, 2019 experienced a decrease in the total amount of acquisitions in the space. 2020 is likely to experience a steady investment trajectory in line with 2019 due to a variety of factors outlined below. Despite the significant disruption the dermatology industry experienced due to the COVID-19 pandemic, the dermatology market is likely to see a steady amount of add-on acquisitions to current platforms and stable growth in 2020.

Dermatology is an attractive market for investors due to its growth potential, its diversified revenue streams, its effective use of low-cost midlevel providers, and its offering of revenue-boosting ancillary services (e.g., cosmetic services, pathology and clinical trials). Other factors, such as the substantial aging population in the United States, coupled with the growing emphasis on early detection and prevention with respect to skin diseases, make the dermatology industry attractive to investors.

Partnering remains an attractive opportunity for dermatologists as their practices' overhead expenses skyrocket and compliance with regulatory regimes continues to place a burden on offices; however, some dermatologists may be waiting to see whether the promised success stories of investors in this space actually occur. The dermatology market offers a strong opportunity for new investors, but an even greater opportunity for current investors in the space. Investors currently in the dermatology space looking to acquire new dermatology platforms or complete add-on acquisitions may have a less-challenging experience demonstrating to potential selling dermatologists how investment in a practice can decrease costs, increase patient care and alleviate administrative burdens for the practicing providers. Investors seeking to enter the dermatology space can still capitalize on this opportunity, especially if investors are, or have been, involved with other successful platforms in different specialties. To combat certain dermatologists' negativity toward private equity investment in this space, investors must consider the cultural fit of the partnership to ensure retention of platform physicians long term and participation in equity models for the physicians to create an excitement toward growth and production.

Although investment in the dermatology sector is expected to be steady throughout 2020, the industry is not at a saturation point. Some notable transactions have occurred in the dermatology space in 2020. Prior to the COVID-19 pandemic, Sun Capital Partners Inc., a private investment firm, announced that its affiliate acquired West Dermatology, a leading clinical, cosmetic and research dermatology platform with more than 55 practice locations throughout Arizona, California and Nevada in February 2020. At the height of the COVID-19 pandemic, in June 2020, Pinnacle Dermatology acquired Lehman Advanced Dermatology in Tennessee and just recently, in October 2020, Ridgemont Equity Partners announced the acquisition of Anne Arundel Dermatology Management, a provider of medical, surgical and cosmetic dermatological services in the mid-Atlantic and Southeastern states with more than 70 clinics. Investor interest in this subsector is expected to steadily continue into 2021 and beyond.

16. Compounding and Specialty Pharmacy (steady to more)

Vertical consolidation of the pharmacy and drug delivery sector persevered in 2020, with combinations of insurers, pharmacies, pharmacy benefit managers and private equity funds continuing. Expect vertical consolidation in this subsector to drive even more large market participants to enter the pharmacy space. The industry saw evidence of this trend in Welsh, Carson, Anderston & Stowe's investment in Shields Health, a specialty pharmacy and in Humana's investment in Enclara Healthcare (a hospice pharmacy and benefit management provider). Expect the shifting consumer landscape from in-person pharmacy services to mail-order and home-delivery pharmacy services to drive investment interest in the compounding and specialty sector beyond 2020.

The compounding pharmacy sector presents evolving regulatory challenges and has been a focal point for oversight and regulation by not only the U.S. Food and Drug Administration, but also state governmental agencies. Rebates and expanded transparency are just two of the driving forces behind much of the recent, increased regulation in this sector. The U.S. Supreme Court recently decided in *Rutledge v. Pharmaceutical Care Management Association* that pharmacy benefit managers are not exempt from state regulation. When approaching a pharmacy or pharmacy benefit manager as a potential acquisition, investors therefore should conduct careful diligence around rebates, sterile compounding practices and other compliance issues, taking into account that states have definitive authority to enact even more stringent laws affecting the industry.

17. Veterinary Services (steady)

Private equity interest in the veterinary-services sector has remained steady for the past several years and is unlikely to slow, even due to COVID-19. The U.S. pet industry is booming. In 2019 alone, estimates showed the U.S. spent $95.7 billion on pet care, up from the approximately $90.5 billion spent in 2018. Investors view these upward trends as enticing, and the veterinary space has seen increased competition, though it still remains heavily fragmented, with estimates that nearly 90 percent of the veterinary market remains independent.

The veterinary sector is, overall, an area with decent returns and lower regulatory risk given it is predominantly a cash-based business with less regulatory oversight on ownership structures and operations than businesses involving human medicine. Beyond the core veterinary office-based business line, additional ancillary business lines such as lab, grooming, pharmaceutical, DME, cremation, urgent care, hospitals and therapeutic products provide expansion opportunities that are attractive to investors. Similar to other sectors, veterinary providers are also turning to telehealth applications, providing yet another ancillary business line and opportunity for growth. For these reasons, investors have shown an increased appetite in investment over the past several years, from Harvest Partners and Oak Hill Capital Partners' 2017 recapitalization of VetCor, to Partners Group's 2019 purchase of Blue River PetCare, a network with more than 300 veterinarians across 23 states.

Although deal activity may have slowed in the beginning months of the COVID-19 pandemic, the veterinary and pet-care industry have demonstrated they can weather the effects of the pandemic and remain poised for future investment. In the first half of 2020, pet adoptions across the country skyrocketed as the United States sheltered in place due to lockdowns. As the pandemic progressed and the veterinary sector continued to prove it is a more recession-resistant market, private equity deals in the veterinary space have continued on an upward trajectory. In April 2020, TSG Consumer Partners announced its acquisition of a majority ownership interest in Pathway Vet Alliance, an operator of more than 270 veterinary hospitals and 86 veterinary clinics throughout the United States. Additionally, in September 2020, Trilantic North America purchased a minority share in Rarebreed Veterinary Partners, an operator of 17 veterinary clinics in the Northeast.

Overall, 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.

18. Laboratory Businesses (more)

As an obvious starting place, any lab involved in COVID-19 testing has seen a rush on demand unlike almost anything witnessed before or in other sectors. As just one example, consider Thompson Street Capital Partners' July 2020 sale of Analytical Lab Group, a microbiology and viral lab that offers COVID-19 testing services.

While the societal importance of meeting the demand for COVID-19 testing goes without question, the impact on laboratory businesses from a valuation or future prospects perspective is a bit more difficult to ascertain. Typical valuations based on trailing performance are obviously rough attempts to gauge the trajectory of future growth. Anomalies in performance related to COVID-19 (positive or negative) make that difficult for many sectors. For COVID-19-related lab businesses, this effect is greatly amplified. In light of those dynamics, most valuations are relegated to pre-COVID-19 performance with some boost for the anticipated tail-out of COVID-19 impact. There is also a bit more room to utilize earnouts in the laboratory sector to bridge the gap between buyer and seller valuation expectations, which is a mechanism typically not available in other sectors in the healthcare industry where there is referring physician ownership because of the Stark Law. On balance, expect the COVID-19-related impact on future prospects of labs to be muted by the relatively short life span of related testing, such that the prior assessment of steady growth in this subset of lab business appears to be the prescription for 2021 as well, even if such assessment appears counterintuitive.

The pathology lab segment has some competing influences. For example, the ability to build and grow pathology lab businesses in local markets that have historically been very segmented continues to be a viable buy and build strategy. However, the competing influence of vertical integration of providers does pose headwinds in locally affected markets. Part of the value proposition and clinical efficiency benefit of provider consolidation is the ability to retain ancillary services work that smaller providers do not have the capacity to provide within their practice. A smaller dermatology practice, for example, may not have the wherewithal to build an in-office ancillary lab. The same practice that is acquired by a larger regional practice will immediately have in-office lab capabilities that could affect historic referral patterns to an outside reference lab. These competing currents lead to a more measured expectation for growth in this segment with a particular focus on local competitive and referral dynamics.

19. Urgent Care (more)

Like other healthcare subspecialties, urgent care centers faced significant challenges due to the COVID-19 pandemic. Nearly two-thirds of centers reported operational impacts from the pandemic (such as closures or staff quarantines), according to the *Journal of Urgent Care Medicine* (May 2020). Even centers that remained open saw fewer visits as patients faced community spread. At the same time, commercial payors often reimburse urgent care centers using a flat, global rate per visit, which did not increase to cover costs from the additional necessary PPE expenses or increased payroll costs of staff hazard pay.

Despite these headwinds, the urgent care industry continued its impressive expansion in 2020, growing to nearly 10,000 locations (doubling in the last decade), and remains a desirable subsector for investment. The urgent care subspecialty is in an advantageous position as consumers shift from using these centers as an “after-hours alternative” to an initial point to the healthcare system, enjoying convenient treatment locations and shorter wait times. The Urgent Care Association (UCA) estimates that nearly 23 percent of primary care visits and 12.6 percent of outpatient visits in 2019 occurred in these centers.

The pandemic also encouraged shifts to increased telemedicine services by urgent care centers. Even before the COVID-19 pandemic, HealthCare Appraisers surveyed professionals familiar with urgent care transactions and noted that telemedicine was the most desirable ancillary service line. That interest went into overdrive during the pandemic with 85 percent of centers responding to UCA in May 2020 that they were providing telemedicine services, up from 29 percent in 2019. Experity, a software provider for the subsector, launched a telemedicine platform in the first quarter of 2020 over half a year before its planned launch. Similarly, Concentra, an occupational medicine and urgent care provider, extended access to its workers' compensation telemedicine platform to 38 states. Finally, Urgent Care Partners, a manager for hospital-owned urgent care centers, acquired Merchant Medicine in July 2020 to provide telemedicine and related on-demand consumer-driven healthcare.

Entering 2021, the urgent care industry may continue to see changes related to the COVID-19 pandemic. Along with retail-based convenient care clinics (typically less acute subspecialty care than urgent care), urgent care centers are positioned to help facilitate vaccine deployment. Standard vaccinations are already part of many patient visits. As the Convenient Care Association and the UCA pointed out recently, this trust can be leveraged as the nation launches a COVID-19 vaccination strategy with nearly 80 percent of the U.S. population living within 10 minutes of an existing urgent care clinic.

Based on the foregoing trends, acquisitions in 2020 were steady compared to preceding years (likely being a larger share of overall transactions in 2020, which is expected to continue in 2021). In many regions, hospitals and health systems are prime acquirers as a front door to their systems. Such transactions include the Georgia-based Piedmont Healthcare joint venture with WellStreet Urgent Care, and the University of Maryland Medical System acquiring nine urgent care sites. Similarly, HonorHealth formed a partnership with FastMed Urgent Care with 30-plus centers in Arizona. Investors also sought good partners, including Warburg Pincus's CityMD acquisition of Urgent Care Now in New Jersey, CHR Healthcare's Peachtree Immediate Care acquisition of St. Francis Urgent Care in Georgia and Trinity Hunt Partners' partnership with MainStreet Family Urgent Care in Alabama.

20. Hospitals (less)

Historically, hospitals have been not only extremely active sellers but also popular acquirers of physician practices and their associated ancillary businesses. However, in 2020, hospitals were among the healthcare entities hardest hit by COVID-19. Regardless of geography, most facets of hospitals' management have become entrenched in planning for and responding to COVID-19. The attention these tasks consumed reduced the number of hospital acquirers and sellers in the marketplace. With respect to physician practice acquisitions, this lack of participation by hospitals in the market provided additional opportunities for private equity firms to grow their portfolios to the extent they had available capital.

The current acquisition challenges hospitals and health systems face are primarily linked to the limited bandwidth necessary to complete transactions and financial performance as a result of COVID-19. As has been widely publicized, hospitals have spent most of 2020 actively triaging clinical strategies and expanding care for COVID-19 patients. Little time was spent on preparation for sales or seeking acquisition targets. Additionally, widely reported data show that hospitals have seen record-low operating margins in 2020 due to the resources required for

COVID-19 responses. This decline in financial performance has made hospitals a less-attractive target for investors and hindered hospitals from acting as acquirers in the current market.

Despite the challenges noted above, some development teams at hospitals are still actively exploring joint ventures and acquisitions. Hospital acquisitions have not stalled in 2020. In fact, Kaufman Hall's M&A Quarterly Report identified 14 transactions involving hospitals and health systems during the second quarter of 2020. This amount was a decrease from the previous quarter, but it was not a significant reduction from 2019. In the last quarter of 2020 and into 2021, expect hospitals with liquidity to resume acquisitions as planning for COVID-19 levels. Also, expect distressed hospitals to become attractive targets for financial and strategic acquirers.

21. ASCs (steady)

For an extended period of time over the last 15 years, there was very little net growth in the number of Medicare-certified surgery centers and the total number of procedures performed at those centers. For such a period of time, there were around 5,600-plus Medicare-certified surgery centers. Now, there is growth again, often fueled by private equity-driven efforts directly aimed at surgery centers and aimed at practices where surgery centers are a key ancillary service.

Some of the largest surgery center chains are part of publicly traded firms, such as HCA Healthcare and United Surgical Partners International, an affiliate of Tenet Healthcare. Others, such as Surgery Partners, Physicians Endoscopy, and Covenant Surgical Partners, have private equity partners. Finally, Surgical Care Affiliates is an affiliate of Optum.

A great deal of surgery center interest currently comes through private equity funds buying practice management platforms and surgical practices. Surgery centers are also benefiting as lower-cost alternatives to hospitals with lower infection risk generally.

The four main specialties that drive surgery center volumes are ophthalmology, gastroenterology, orthopedics and pain management. More recently, there has been substantial growth in surgery centers in three types of procedures: cardiovascular procedures, total joint replacements and spine procedures.

Surgery centers were partially locked down during the early months of COVID-19, primarily due to the ban on elective procedures in many states. Notwithstanding the initial lockdown and slowdowns, surgery center volumes largely recovered in the final quarters for 2020, expect that investment will continue at steady levels in 2021.

22. Cardiology (steady)

Like orthopedics and other subspecialties with highly compensated physicians, cardiologists have traditionally remained independent due, in part, to profitable ancillary service line opportunities. Historic cardiovascular acquisitions were executed primarily by hospitals, which makes sense given the significant inpatient aspects of most cardiovascular practices. However, recent years have seen hospitals shy away from acquisitions of cardiology practices and move toward professional services arrangements. This trend was even more pronounced in 2020 as hospital resources were absorbed in responding to the challenges of COVID-19. This change presented an opportunity for private equity to enter into transactions with cardiology groups.

Despite COVID-19's impact on the credit markets, investor interest in cardiology has remained strong. Private equity investors continue to recognize the fragmentation in the cardiology market, which provides for growth and consolidation opportunities. Investors also find cardiology attractive because the average life span in the United States continues to increase, which drives the continued need for cardiac care and increases the potential patient population. Finally, investors recognize that cardiology is uniquely positioned to take advantage of alternative payment models, due to the ancillary services involved in the subspecialty. This facet of target businesses provides opportunities for increased upside in investments, if cardiology practices can evidence superior quality care for lower costs.

Despite private equity's relatively new interest in this space, a significant number of transactions have occurred in 2019 and 2020. One of the most notable transactions in the past two years was Comvest Partners' and Athyrium Capital Management's acquisition of Sunset Cardiology, through its multispecialty portfolio company, IMC Health Medical Centers.