FOLEY

FOLEY & LARDNER LLP

Health Care Law Today Podcast
Episode 8: What's Ahead for Provider-Focused Health Care Investing?

Please note that the interview copy below is not verbatim. We do our best to provide you with a summary of what is covered during the show. Thank you for your consideration, and enjoy the show!

In this episode, Foley Partner Roger Strode sits down with John Riddle (Managing Director of Brown Gibbons Lang & Company) and Dan Davidson (Managing Director of Coker Capital Advisors) to discuss the expected trends in provider-focused investing in the physician and behavioral health spaces in 2020.

Roger Strode

My name is Roger Strode. I'm a partner of the national Health Care Practice at Foley & Lardner and I work out of our Chicago office. Over the course of my career, I have provided counsel to buyers and sellers in health care businesses, including investors in, and sellers of, things like physician practices and ambulatory surgery centers. I do work in physical therapy, hospital M&A, imaging centers, and the like. And I hesitate to say this, but I've been in practice approximately 30 years—it's actually more than 30 years, but I'm sticking with 30!

The focus of today's podcast is expected trends in health care private equity investing over the next 12 months. For those of you listening that are engaged in some aspect of the space, you're fully aware of the torrid pace at which these investments have taken place. If you look at 2018 statistics alone, there were almost 800 transactions, with about $100 billion in value on those transactions.

With all this investing, there are questions that began to arise around private equity investing in health care. One of the questions is whether or not this pace of investment and the returns expected by investors are good for patient care. Are these investments causing

increases in costs? Are all these deals going to be successful and what happens if these deals fail? And furthermore, members of Congress are beginning to probe investors, looking at issues like surprise billing, as an example.

Today's discussion is going to center on provider-focused investing in the physician and behavioral health spaces, both of which have been really, very hot. We've seen an awful lot of this at Foley & Lardner and I know those of you listening out there have probably seen an awful lot of it as well. In connection with this discussion today, I'm delighted to be joined by two guys who are good friends of mine—and with whom I've had the pleasure to work over the past decade in all manner of transactions.

My first guest is John Riddle. John is Managing Director of Brown Gibbons Lang (BGL) and he's charged with running BGL's health and life sciences business. John's a graduate of the University of Chicago. My second guest is my friend Dan Davidson. Based in Atlanta, he's Managing Director at Coker Capital Advisors. Coker most recently became a division of Fifth Third Bank. Dan is a proud Clemson Tiger and Dan, I'm sorry about the fate of your boys this year. Both John and Dan have deep experience in the purchase and sale of a wide variety of health care businesses.

As I mentioned, my team and I have worked alongside both BGL and Coker at numerous times and I'm continually impressed with the knowledge of each of them, their professionalism, and their client services. So it's a real pleasure to have each of them here today. Gentlemen, welcome to Health Care Law Today.

Dan Davidson

Thank you.

John Riddle

Thanks, Roger.

Roger Strode

Before we start, I'm going to throw it back to each one of you, both John and Dan. Can you give us a little introduction to your backgrounds and a little bit on—John on the BGL business, and then Dan on the Coker business. So John, take it away.

John Riddle

Brown Gibbons Lang is an investment bank based in Chicago. We are one of the larger middle market advisory firms in the U.S. and covers a number of industries. We have a significant team dedicated to the health care and life sciences industry. With health care among the sectors we are active in, we have a team that specializes, as Roger indicated, in advising physician practices and the many related inventory services that doctors are

involved in. For my part, I have been an investment banker now for better than 30 years and have worked across the health care landscape advising providers, diagnostic, and device companies, many life science companies, and a wide variety of health care IT and outsourcing businesses.

Roger Strode

Dan, if you could take a couple of minutes and tell us a little bit about yourself and Coker Capital.

Dan Davidson

Thanks so much for having me on today, Roger, and further to your comment, Coker Capital Advisors was founded in 2009 and we formally partnered with Fifth Third Securities in February of 2018. So that's just two years ago now. Our firm is also an investment bank, and we have a dedicated team of 25 experienced professionals that focus exclusively on providing advisory services to health care clients, primarily in the services industry.

We have six partners that have over 100 years of combined experience, and have executed over 250 deals with an aggregate value in excess of $65 billion. I am looking forward to sharing some of the insights that we've learned over the years. In terms of my background, yes, I am a Clemson Tiger, and I'm also not as old as you gentlemen, because I only have 25 years of investment banking experience, all of that focused on the health care industry.

Roger Strode

As I've said before, we at Foley & Lardner have had the opportunity to work with both John and his team, and Dan and his team, and have greatly enjoy it. I'd like to jump into a few questions for each one of you today.

John, given the amount of work that you and BGL do in the physician practice recapitalization space, can you give us about five minutes on what you expect to see in this space over the next year? And maybe you can focus on acquisitions, possibly some restructurings, as we've seen some deals that haven't done well. I think the audience out there would really like to hear what you have to say on this.

John Riddle

The way we think about this sector, it's a bit of a tale of two, or three, or four cities, and really dependent upon the particular physician specialty or model. The multi-site retail specialties—where there's been just a ton of heat and activity—we view as really just continuing to consolidate at a steady pace across all the many sectors like dental, dermatology, and ophthalmology that have been in consolidation for a number of years.

Interestingly, we are starting to see increasing activity in the complex disease specialties such as orthopedics and gastro. There's definitely a great promise there but they're very different businesses than the retail multi-site specialties in that they tend to be more localized, dense delivery systems and much more complex—a bit of a managed care and payer overlay to those specialties. Within the third group are facility-based specialties such as anesthesia and emergency department management.

We're seeing a fairly demonstrated pullback from consolidation, or the frenetic consolidation pace that we see in the past five years, as the large consolidators themselves start to regroup. So we expect to see that sector generally cool down here for a year or two. Trend-wise, we see the consolidators in each specialty, along with the investors and lenders, getting more discipline, frankly, in the way that they value a target practice. Particularly related to giving credit to certain pro form adjustments to revenues and earnings that they've been more than willing to provide full credit for. And thus provide, really, fulsome valuations in the past. Three years ago, investors were extremely aggressive. Today, that initial exuberance has really settled down into more of a rational approach to valuation in transactions relative to the acquisition activity with the larger consolidations, or several of the original platforms within the retail specialties are going to be sold this year, in 2020, by their private equity investor.

Perfect example. There is a recent transaction announced by Enhanced Equity on their dermatology platform, West Dermatology, which is one of the larger dermatology groups. It was recently sold from Enhance to Sun Capital. We expect to see a number of groups follow suit in 2020. At some point, we'll see the individual consolidators themselves begin to merge within these specialties, although I think we're probably a few years away from seeing that happen in any meaningful way. Roger, you asked the question around restructuring in places where things haven't gone so well. The good news is that, except for the rare exception, the investment activity within the physician practice landscape has been very successful. Frankly, it's the rare exception where companies haven't performed or where investment returns for the equity investors haven't met expectations. So it continues to hold the attention of the broad investment market. We don't see that slowing down for the next several years.

Roger Strode

John, in terms of one of the more complex disease states that you mentioned—both gastroenterology and orthopedics—I know we've seen an awful lot of interest, especially in orthopedics. Can you tell us why those deals are going to be tougher or more complex to get done? Obviously, you've got very complex practices. What I'm seeing is, again, an awful lot of interest, but not as many deals getting done. Is that just the nature of the beast with these types of practices?

John Riddle

I think it is a couple of things, Roger. First of all, they're very different, as I said, than the retail specialties which the practice of dermatology, for example, functions not too dissimilar from any other retail business in America. They have a storefront, they have a footprint—standardized footprint—and they have a model of delivering care. Each clinical occasion is essentially, in successful practice, very close in the way they operate and deliver care to the other one that's down the street, around the corner, or in a town one stop over.

So it's very much about standardization and then just replicating the unit of operations. The operational complexity is not that great. Within orthopedics, for example, it's multi-specialty, it's within orthopedics, its site of service could be in the hospital, it could be at the ambulatory surgery center, and it could be in the clinic. There are a lot of different disciplines that are going into delivering care to, for example, a joint surgery, including physical therapy and durable medical equipment.

Perhaps drugs, they're getting into even behavioral and dietary. Another big difference is that dermatology generally doesn't compete with a local health care system because they don't drive any volume into a hospital whereas an orthopedic group is in direct competition with the local health systems and they could be collaborating with them. They're just very complex. The other thing I would say in terms of volume, if you look at each one of these retail specialties, a lot of the consolidation activity was catalyzed by some kind of reimbursement cut.

In dermatology, they had a huge cut to the lab and a huge cut to one of their core surgical procedures, and you have these very profitable small practices that get a bit nervous. Maybe I should look for a big brother to align with rather than continue to retain independence? Whereas orthopedics really hasn't suffered that kind of a hit to revenues yet. I guarantee you when that happens—and it will happen, in our view—it will probably push position owners to get more aggressive, more receptive to consolidation.

Roger Strode

Dan, I'd like to switch gears here for a minute and talk to you specifically about an area that Coker in general, and I know you personally, have developed quite a reputation for, and that is in recaps and buyouts of behavioral health organizations, including autism centers and the like. I would really like to hear—and I know our audience would appreciate—your perspective on the next 12 months or so in this space and maybe focusing on what some of the drivers of this activity are.

Dan Davidson

Behavioral health covers a range of issues, but today I'm going to address the fundamentals of the autism industry, and what we can expect going forward. But first, a

little bit of history on the term autism. Autism was initially used to describe schizophrenic patients in the early 1900s. Later, in 1940, a German scientist named Hans Asperger, reported cases of milder forms of autism which are now known as Asperger syndrome, and it's mostly boys that were highly intelligent but had trouble with social interactions.

The movie *Rain Man* from the 1980s was important for raising public awareness for the disorder. Today, the DSM–5 folds all of the subcategories into conditions under one umbrella of a diagnosis called Autism Spectrum Disorder, or ASD. So, as we're talking about today, autism has attracted a significant amount of attention from private equity investors who are seeking to leverage some very compelling dynamics in the industry such as the significant fragmentation, which is really just a lot of very small mom and pops and pure plays with a few diversified players out there as well.

No one really has a competitive advantage or a dominant position within the market. Investors are also trying to address the supply/demand imbalance, which is created by the increase in incidence of the number of children that have been diagnosed. So to put that into perspective - back in 2000, one in every 150 children were diagnosed with autism. Astonishingly, today that number is one in every 40. Another aspect is the attractive reimbursement environment, coupled with strong patient advocacy and growing funding sources, greater utilization due to awareness and earlier diagnosis.

Last, but not least, highly profitable unit economics. Roger, the characteristics that make for an attractive investment are no surprise. Number one, an experienced and talented executive team. That is very, very important. As it is with all companies. Also high quality clinical programs that have tailored treatment plans to meet individual needs both for the home and the center based settings. Next would be geographic diversity, and a replicable market entry strategy and de novo model. Also, demonstrated ability to integrate and add on acquisitions.

A payer focus strategy on in-network contracting, which provides rate stability, and unit economics in the top quartile of the industry, are also what investors seek. And lastly, I would say metric-driven clinical outcomes. That's very important for obvious reasons, but that folds back into the payer discussion. So where does the industry go from here? Looking back, there have been roughly, I was able to count about 150 transactions over the last 20 years in the autism sector. The vast majority of those were private equity sponsored transactions.

Going forward, I would expect the consolidation to continue roughly at or near the same pace due to the fundamentals I mentioned previously. Given the number of platforms in existence today, the external factors such as availability and cost of debt and other non-

economic factors, I expect we will see some pressure on valuation over the next 12 months.

Roger Strode

So I take it Dan that you don't see at Coker—and you in particular—any slowdown in this growth over the next 12 months?

Dan Davidson

Across the behavioral health spectrum, we don't see a slowdown, but within certain pockets there's definitely a slowdown. So if you're an out of network substance abuse provider, you've had a very difficult time collecting and those companies are seeing a tremendous amount of pressure. And some are actually not able to collect on the services that they're providing. So we've seen a number of companies that are failing because of that.

Roger Strode

That's pretty fascinating and that really leads me to my next round of questions for you on this issue of valuations and valuation growth. And yet, Dan, what you're seeing in autism, John, I take it, you've seen actually a pullback. You mentioned earlier that there's more investor discipline being applied to the valuation of deals. I've got two questions. The first question is, John, in the pullback that you're seeing, when we were seeing some of these platform companies, physician platform companies going at 13 and 14 times, trailing 12 months earnings or are on a pro forma basis, potentially even more, because all the credit that they were giving on a pro forma basis. What is causing the pullback in valuation and causing the investor discipline? Is it a supply and demand thing? Or is it that they've seen some of these platforms stumble because there was too much credit given and the prices were too high so that it was impacting returns? What do you think it is that's causing that pullback that you're seeing?

John Riddle

The pullback is really more on the earnings credit side than it is on the multiple. We are seeing multiples hold in terms of the assigned relative pricing statistics when you really dig into the numbers and how the transaction is being valued. The big change is on the earnings credit side. We were getting credit and really all bankers were getting, and sellers were getting credit for pretty aggressive forward looking revenue and earnings adjustments into a seller performance. So looking forward, and annualizing a new provider two years forward and seeing relative to reported earnings as much as 50%, 100% increases in the pro forma EBITDA that was then being valued at a multiple.

You'd get some pretty significant actual trailing multiples in some of these transactions. The issue with that is some groups have worked out because, in fact, they were growing that fast and they just grew through and grew into the multiple. Others, if it doesn't show up, if the earnings and revenues don't show up, and the transaction is done, on with bank debt

and significant leverage. That practice gets upside down, and equity investors have to put more money in for the most part, particularly in the front end of this consolidation wave.

These companies have worked out just because it's been early enough and has been nice growth. You asked a question, have there been some challenges? Yes, for sure. For the most part, these groups have done very well, what you would expect at the front end of a consolidation wave within these highly fragmented sectors. There have been a couple of groups that have had some challenges and a perfect example of that is what's going on with one of the larger consolidators, US Dermatology Partners, which is based in Dallas, and was formed initially through the merger of two good sized practices: one in North Texas and one in Kansas City. Very good practices with excellent clinicians and their great reputation was taken through an auction and transition from the initial private equity fund to its current owner. And then really just kept running and successfully closing acquisitions and now have really grown a pretty significant practice.

But along the way, they haven't been as disciplined in putting in common informatics across all the practices, and getting their data and systems to a single platform which is really important when you're mounting up against multiple-site, multiple-state. They certainly overpaid in our view on the entry there. That's a situation where a tremendous amount of performer credit was given and paid for and leveraged against. If you talk to some of the clinicians, frankly, US Derm has fallen a bit short on developing a consistent, physician-friendly environment. That's really important to get right when you're talking about professional services business, businesses like this, in that you've got to have physicians all pulling in the same direction and feeling like the strategy makes their life better. Today they have some dissatisfaction among a number of their key physicians.

They are going to need to figure out a way to solve that, I'm sure they will. In the physician practice universal release, the keys to success are basic blocking and tackling. First, you have to partner with doctors who have a common culture and practice philosophy and are committed to practicing and growing the business. You absolutely have to implement a common set of informatics for all the practices and EMR and practice management software and find a way to manage the practice that creates value for the physician partner while continuing to deliver high quality care to patients and a value proposition to the payer. So, where you see these things going wrong, it's when they don't tend to their knitting and certainly the pressure of overpaying up front can lead to some distress in the platform.

Roger Strode

Interesting stuff. Dan, in the behavioral health space, when you mentioned earlier substance use, disorder clinics that are out of network. A lot of pull back and slow down there. They're not getting paid. When you see deals stutter and sputter, why is it? Is it again that they've overpaid? Did they hit payer headwinds? Is it legislative? So when these deals go bad or they stumble, what do you look at as the reason for that?

Dan Davidson

Roger, there's a lot of perceptible headwinds that have led to some of the challenges you're alluding to. I would characterize those as follows, that decline and out of network rate admissions is one. That, followed by low reimbursement rates by the insurance provider, which also leads to a decline in length of stay by the patients and aggressive utilization by the payers. So the payers are not only trying to reduce the length of stay, but also sometimes those that need treatment are not able to get the treatment that they need. Other things that impact are what you would expect, and what John had suggested on physician services as well, which are high valuations and pro forma earnings that don't work out.

Roger Strode

Gentlemen, thank you for your time and your expertise today. For those of you listening, you got some real inside baseball on what's going to go on in health care private equity investing over the next 12 months. Thanks to everybody for their time today. And thanks to you out there listening to this podcast.