Mergers and Acquisitions
By Bart Holl, Provident Healthcare

The U.S. dermatology market is a growing and fragmented industry with both macroeconomic drivers and secular trends prompting investment interest and consolidation. Regulatory changes and reimbursement uncertainty have also spurred consolidation as practices seek alliances and partnerships to mitigate future risks that could impede financial and operational stability. As private practices contemplate merger and acquisition strategies, it is important to identify and evaluate strategic alternatives, their impact on shareholders and administration, and why they may be beneficial to the practice and the patient.

Market Overview and Factors Driving Consolidation

Overall demand for dermatology services and consequential investment interest is driven by a few prominent industry themes including favorable demographic trends, increased patient/public skin awareness, and advancements in research and technology. Current estimates place the U.S. dermatology market at $10.6 billion while maintaining an average annual revenue growth rate of 3.2% over the past five years. This growth has been significantly driven by improved skin health awareness. On a yearly basis, there are more individuals reporting skin cancer (2 million in total) than breast, lung, prostate, and colon cancer combined. Accordingly, surgical procedures have also increased – the approximate number of melanoma diagnoses for 2013 was 76,690, up from 47,700 in 2000 (a 61% increase). Mohs cases have also increased over 400% in the past 15 years. Unfortunately, demand far exceeds accessible care, as a stagnant residency training capacity for incoming dermatologists is causing a nationwide shortage of physicians.

The framework of the dermatology industry is conducive to investment interest and activity as strong growth drivers provide the groundwork for optimistic future returns; however, equally as influential is the high fragmentation within the market. This has resulted in heightened levels of consolidation amongst both solo and multi-physician practices. As larger providers continue to compete for market share and hospital systems and multi-specialty groups strategically acquire groups to address medical staff shortages, consolidation will likely persist. The increasing prevalence of heightened regulatory mandates and rising costs has also motivated physicians to make the transition to an employee as opposed to an employer, or to seek partnerships with financial institutions that can help alleviate the nuances associated with running a practice.

Strategic Options and Implications

Before discussing some of the strategic options available to private practices, it is important to consider the most obvious path of continuing business as it currently stands and remaining independent, as it can also bring to light some of the key benefits to pursuing a transaction. First and foremost, remaining independent allows for both physicians and administrators to practice with operational freedom, and the flexibility to govern the practice as they please. Additionally, the ownership structure remains constant, keeping current, and potentially soon-to-be, shareholders at ease with equity holding expectations. On the other hand, remaining independent also has its impairments, which primarily stem from limited access to both financial and operational resources that can have substantial impact on the overall success of the group. Without these supplementary support lines to help deal with hurdles, such as the adoption of an EMR or transition to ICD-10, there is substantial shareholder wealth at risk should these endeavors go awry, with no safety net available. The uncontrollable impacts of economic downturn, legal exposure, and regulatory changes can be overwhelming and, combined with the risk of losing market share to competitors, can be a major financial threat.

Through our experience with physician and practice management transactions, the decision to explore a process typically originates from career timing of practicing physician shareholders. A properly planned exit strategy can offer physicians the chance to transition out of the practice at a fair monetary value, while also avoiding an abrupt close of operations, potentially leaving employees searching for alternatives.

Moreover, if a complete exit is not desired, a merger can also allow for increased work schedule flexibility and greater stability regarding compensation. Today's compensation structure within hospitals or multi-specialty clinics can also be flexible and measured by productivity, quality, and efficiency. Combining these motivators with the potential deterrents of remaining independent and assuming the timing is right to explore a transaction, there are two typical paths available to practices – a strategic merger/sale or recapitalization with a financial sponsor.

When considering a 100% sale of the business where all shares are acquired by an outside entity, there are typically three viable options: a larger provider, a hospital system, or a multi-specialty practice. This exit option can be beneficial to both shareholders and administrators. In addition to the large upfront payment achieved through the sale of the practice, a merger can offer greater administrative and financial resources such as additional personnel and access to technology and capital. As such, strategic partnerships can alleviate the pressures of reimbursement uncertainty and competition-based pricing pressure that can impact financial performance. With the right partner, additional operational synergies can also be achieved on the clinical level as the coordination of patient care becomes more streamlined through service diversification.

An alternative option, which is typically geared towards growing and already established groups, is partnering with a private equity firm. The focus of this strategy is to offer additional capital and management expertise to grow the organization past its current means. Private equity firms typically look to acquire a majority stake in a practice to form a true partnership with the group. Since a majority of shares are sold, equity holders and management experience an initial liquidity event commensurate with the value of the practice, and also have the opportunity to roll equity into the newly formed organization. Similar to the benefits of a 100% sale, a private equity sponsor helps mitigate risk through diversification of net worth, access to additional financial and operational support, and a large network of industry contacts to help ensure growth in the upcoming years. The mentality behind a private equity transaction is future growth - both physician shareholders and administrators can benefit from such a partnership as equity value grows during the holding period of the investment.

As is the case with any strategic decision, crucially important is positioning the practice appropriately to ensure an optimal outcome as well as setting goals or milestones in order to meet expectations. Navigating a transaction is not an easy task, and utilizing the support of outside advisors and counsel can greatly alleviate the pressures of directing a merger or acquisition to successful completion, while also ensuring a superior value is achieved in the process. As there continues to be changes in law, reimbursement, and the overall structure of the delivery of care, physician group consolidation will undoubtedly continue. These transactions will inevitably become more complex and finding the right partner will become more challenging. A well-planned transaction process, however, can be beneficial to all parties involved and can ensure that long-term value is created.

Bart Holl *is an Analyst at Provident Healthcare Partners and his primary responsibilities include conducting in-depth research and analysis of targeted healthcare sectors to identify growth trends and other factors driving merger and acquisition activity in the marketplace. At Provident, he covers multiple sectors within healthcare services with a significant focus on dermatology and assisting these practices through strategic growth opportunities. He also has extensive experience working within healthcare information technology, home health and hospice, as well as radiology. Prior to joining Provident, he worked as an Analyst in the Private Markets group at New England Pensions Consultants (NEPC), a full-service investment consulting firm based out of Cambridge, MA. He is a graduate of Boston University's School of Management with a Bachelor of Science in Finance and Entrepreneurship.*

Originally in July/August 2014
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