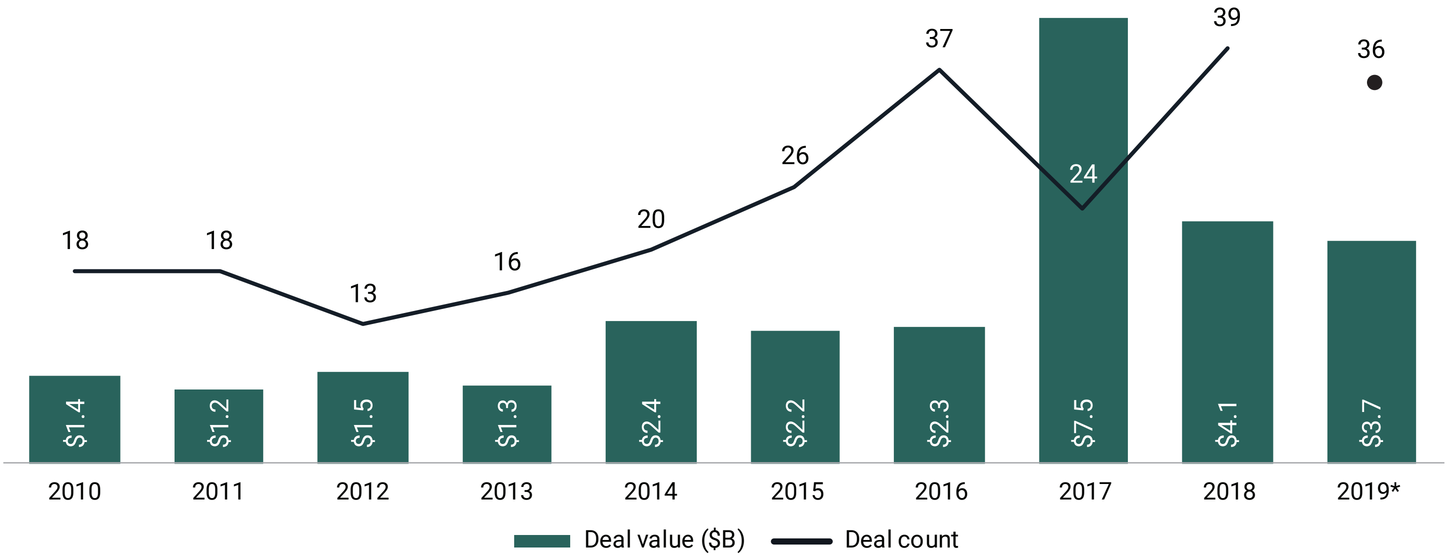
Breaking Down PE's Push Into Orthopedics

Data provided by PitchBook

2019 Could See New High In Volume

Orthopedic healthcare PE deal activity



Source: PitchBook | **Geography:** US
*As of November 1, 2019

Healthcare has long been underpinned by private equity (PE). This is evidenced by its attractive consolidation opportunities, resilience during recessions and increasing numbers of fund managers flocking to the sector. Niche areas such as behavioral health and dermatology have seen an uptick in investment activity, with fund managers conducting rollups of fragmented practices across multiple geographies. Now, however, a new segment is experiencing a surge of PE deal making: orthopedics.

39 orthopedic transactions closed in 2018, a high for the 2010s, across no less than $4.1 billion (extrapolated because of unknown deal sizes) in aggregate deal value. Moreover, 2016 saw nearly the same volume, while with two months left in the year, 2019 has already seen 36 deals close. A customary push to close transactions by year's end could even result in this year seeing a new high.

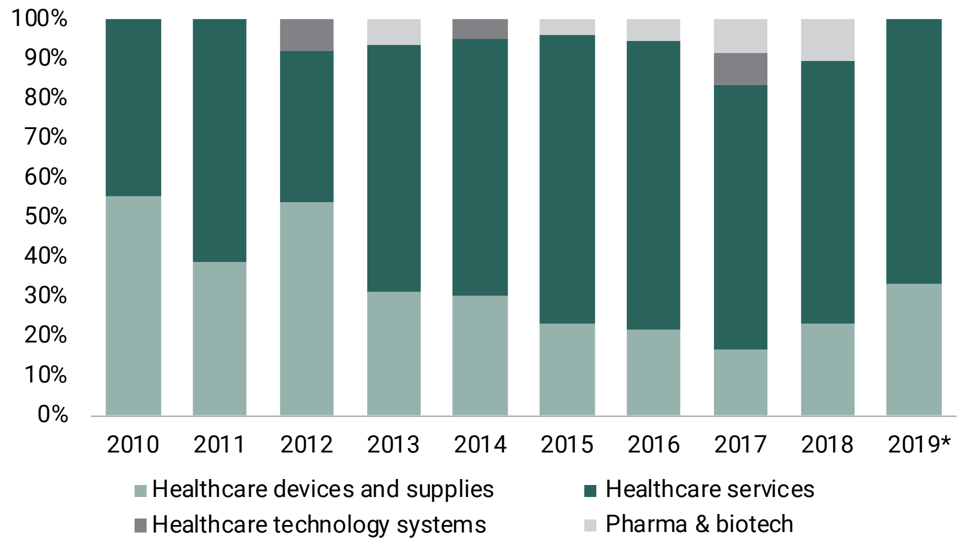
Orthopedic surgeons, who have historically scowled at PE, are starting to soften toward PE opportunities as macro trends threaten to cut into their profit through bundled payments, Medicare cuts and lower overall payor reimbursement rates.

Many factors can be attributed to the swell in orthopedic deal volume. Here is a summary of leading market indicators:

- Aging demographics will generate strong and growing demand for orthopedic services for the foreseeable future.
- Significant fragmentation offers multiple opportunities for rollups.
- Reimbursement for common procedures is well accommodated by multiple insurers, and elective procedures paid out of pocket by patients can provide an attractive source of cash flows (not subject to insurers' discounts).
- A significant shift to outpatient clinics and ambulatory surgery centers has not only enabled orthopedic practices' growth but also provides additional investment opportunities for PE firms looking to up their exposure even more.
- Ongoing consolidation within the orthopedics industry, given a favorable tailwind of retiring physician owners, offers entry points for PE firms at different sizes and scales of businesses across the market.

The creation of scale and infrastructure in present-day orthopedic groups can be expensive and may come out of the partner physician's pockets or revenues upfront versus being deferred over a long period of time.

Orthopedic healthcare PE deals (#) by industry group



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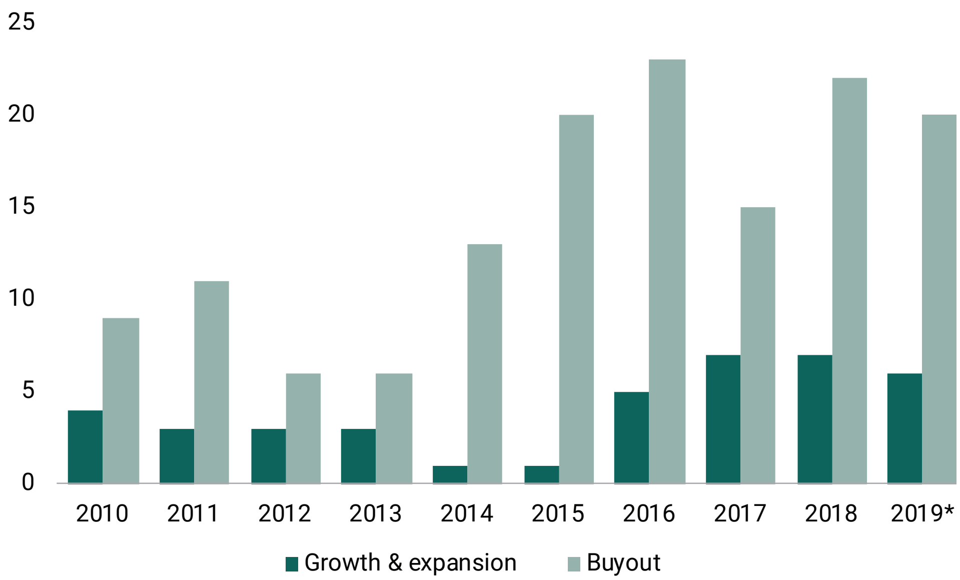
Orthopedic healthcare PE deals (#) by type



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There is a tremendous opportunity to assist physicians in what is currently a chaotic market. Bundled payments, cuts in reimbursement, ASC patient volume influx, the elderly population and advances in technology all offer significant opportunities and subsequent revenues as they advance into the orthopedic arena.

- Although complex and packed with legal nuances, lucrative ancillary services businesses often are proximate to orthopedic practices if not always under common ownership, thus proffering additional investment opportunities.

- Regulatory agencies are moving quickly to publish policy frameworks around innovations in the space (for example, regenerative medicine) in a sign that a favorable regulatory climate will persist.

These factors are likely to remain intact and encourage further PE deal making in the space in the future. There will still be hurdles, especially for brand-new firms in the space, as multiple legal and regulatory risks must be considered, not to mention the customary operational and infrastructural challenges, when entering a buyout of orthopedic practices. However, the future looks bright for healthy levels of PE activity across orthopedics in general.

Most active PE investors in orthopedics (2004-2019)*

Investor name	Deal count
Ivy Rehab Physical Therapy	16
Waud Capital Partners	16
ATI Physical Therapy	13
KRG Capital Partners	11
Great Point Partners	10
Professional Physical Therapy	9
TPG Capital	8
Gryphon Investors	7
Water Street Healthcare Partners	7

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Methodology

All datasets are sourced from PitchBook, and all traditional healthcare industry codes correspond to existing industry codes for healthcare in the PitchBook Platform. The orthopedics-specific data was derived by utilizing a combination of keywords and a primary industry code tag of healthcare to identify companies within the orthopedics space.

Key Trends Shaping M&A And PE Activity In Orthopedics

What is the broader backdrop to why orthopedics is now primed for M&A in general, and more specifically, private equity activity?

Orthopedic groups have a history predicated on a breadth of ancillary services coupled with increasing outpatient surgical volumes. More recently, these trends have included an aging physician and elderly patient population. Because of these historical and current market conditions, there is a significant opportunity for M&A, as well as PE-led consolidation. With many years of M&A activity in other areas such as dental, dermatology and ophthalmology, PE groups and orthopedic leaders are seeing orthopedic groups as the next physician practice management (PPM) space.

Traditionally, orthopedic surgeons have been among some of the highest paid physicians across medicine. As a result of high compensation and profitable ancillaries, orthopedic groups have had little incentive to sell or merge their operations until recently. As the evolution of service-based payments and fee-for-service reimbursements creates a landscape revolving around patient health outcomes, and as commercial payers scale and strengthen, many orthopedists are facing rate pressures along with rising administrative and regulatory compliance costs. These challenges, hinged on capital and operational costs, are cause for opportunity in the M&A and PE arena.

Orthopedics is also becoming a lucrative specialty for PE. The number of joint replacements and orthopedic surgery offerings will increase substantially over the next decade due to the aging population and improved technological solutions. Currently, more than one million joint replacements are performed each year, according to data from the Centers for Disease Control and Prevention's National Center for Health Statistics, compared to nearly 693,000 total knee replacements and nearly 311,000 total hip replacements in hospitals for patients over 45 years of age in 2010. The numbers have continued an upward trend over the past decade, and will grow exponentially going forward, creating ample opportunity in the orthopedic space as healthcare evolves.

How are PE firms approaching the unique hurdles of the orthopedics space?

The aging population and the demand for quality orthopedic practices require specific services and volume production. There has been a sizable increase in hip and knee replacements and the movement of those surgeries to less expensive outpatient settings and ambulatory surgery centers (ASCs). Many orthopedic groups are unprepared for this volume of patients and the subsequent surgeries they could require. Groups are aiming to add ASCs, ancillary and complementary service offerings and women/men's health centers, but the volume is surpassing the maturation of their current business models, culture and infrastructure.

The growth in orthopedics has also evolved as the number of procedures that the Centers for Medicare & Medicaid Services (CMS) now allows to be done in an outpatient setting has increased. In addition, the fear attached to falling reimbursement rates is substantial for orthopedic group leaders. Most orthopedic groups are not addressing this issue proactively; rather,

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they are addressing the problem as an afterthought once it begins to hit their practice revenues.

In response to these unique hurdles, many private orthopedic practices have been developing alternative facilities with a variety of complementary patient services such as physician therapy, urgent care, women's and men's health clinics and other service offerings.

Most recently, and in the more mature orthopedic transactions, I have been asked to provide deliverables such as "culture and leadership training and metrics," "efficiency analyses" and "partner alignment strategies." These topics indicate that we are beginning to proactively address many hurdles, but in most mergers and/or PE transactions, they still exist.

Can you outline the key investment risks and related challenges for both buyers and sellers in orthopedics?

The biggest risks I see in recent buyer and seller deal flow is the inability to predict reimbursement degradation and cultural alignment across merged entities, as well as the focus on revenues or EBITDA versus the overall patient care and clinical pathway adherence. In addition, a lack of understanding of both buyers and sellers as it relates to predictive versus actual margins has been a challenge in predicting productive deal and transaction outcomes. Many of us who have been in healthcare for a long time can see some of these risks and challenges, so we are more comfortable with change management and physician or provider behavior metrics than a new entity or buyer might be.

Many buyers and sellers are using historical dentistry or dermatology models to predict how orthopedic surgeons and their practices will evolve. This methodology can be inherently flawed, and some of the proverbial "second bites of the apple" are not as forthcoming as originally predicted in boardroom modeling. Surgery-oriented practices have a particular culture and leadership model, which is why some of the early-acquired specialties believe that rollups are not good guideposts for surgery-centric practice M&A.

Lastly, I find there is a tremendous opportunity to assist physicians in what is currently a chaotic market. Bundled payments, cuts in reimbursement, ASC patient volume influx, the elderly population and advances in technology all offer significant opportunities and subsequent revenues as they advance into the orthopedic arena. With that said, while there is opportunity in chaos, there can be a lot of confusion. Our physician leaders, healthcare C-suite executives and staff are running patient-centric care facilities with dynamic outcomes and systems predicated on historical patient care models. As a result, there is a reluctance to change or adopt new KPIs or metrics without logical cause. Buyers and sellers run the risk of not understanding the true dynamics of change management in orthopedic surgery practices, specialty medicine or surgical mindsets and may not get the most effective return on their investment.

How is the orthopedics space evolving from traditional modes, especially given current pressures to reduce costs and increased utilization of technologies such as 3D printing and telemedicine? What other key technical advances are helping transform the space?

3D printing devices:
The orthopedic 3D printing market is estimated to register a CAGR of almost 26% by 2023, so this technology is beginning to increase in relevancy; however, few orthopedic groups are currently utilizing the technology due to high costs and the inability to adopt newer technologies.

3D printing may find an increasing application in the development of customized surgical implants as the technology and orthopedic groups evolve. As 3D printing can quickly produce customized surgical implants, it can solve important problems in orthopedics. For example, traditional implants are often unsatisfactory for a significant number of patients, and physicians may have to order multiple implants to create the right fit during a surgery. 3D printing may be an effective solution, providing customized implants that can be designed to fit precisely into anatomical defects or malformations without physicians needing to order a litany of implants and discard unused materials. Medical implants can be fabricated from high-quality and biocompatible materials, and their durability may offer greater longevity to the patient and surgeon.

Opioid prescription:
Orthopedic surgeons are the third-highest prescribers of opioid medications in the US, making the opioid crisis another recent challenge/opportunity for orthopedic groups. Pain management after common procedures should be a priority for orthopedic surgeons, but opioids and other pain medications should also be carefully tracked to insure accurate and appropriate care. The opioid crisis has offered an opportunity for orthopedic groups to home in on their prescribing technology and care modeling to ensure safety and quality tracking in their patient guidelines and consultations.

Robotic surgery:
Computer-assisted surgery (CAS) has offered another advancement for orthopedic groups. CAS can have a multitude of definitions, ranging from computer-assisted navigation married to fully automated robotic systems, to semi-active robot-assisted technologies coupled with surgical simulation systems and technologies. The evolution of computer-assisted surgery has been growing substantially over the past few years and should continue to increase as orthopedic groups evolve.

CAS surgeries have had implant and suture placement benefits, faster recoveries and earlier discharges from the hospital or outpatient facilities. While early results demonstrated promise in patient care and outcomes, more long-term studies and better training are needed to illustrate substantial benefits and cost-effectiveness to warrant widespread adoption.

Artificial intelligence (AI):
AI is starting to play a role in areas such as computer-assisted surgery and radiography in orthopedics. Recent studies indicate that some AI programs can be as accurate as orthopedic surgeons in evaluating patient care and fractures, and could provide greater potential for surgeons to make accurate diagnoses. A key advantage of AI technology is its ability to leverage large amounts of data to create an informed decision. While AI will likely never become a true replacement for orthopedic surgeons, it is being discussed as the "next new frontier" in orthopedic and surgery groups.