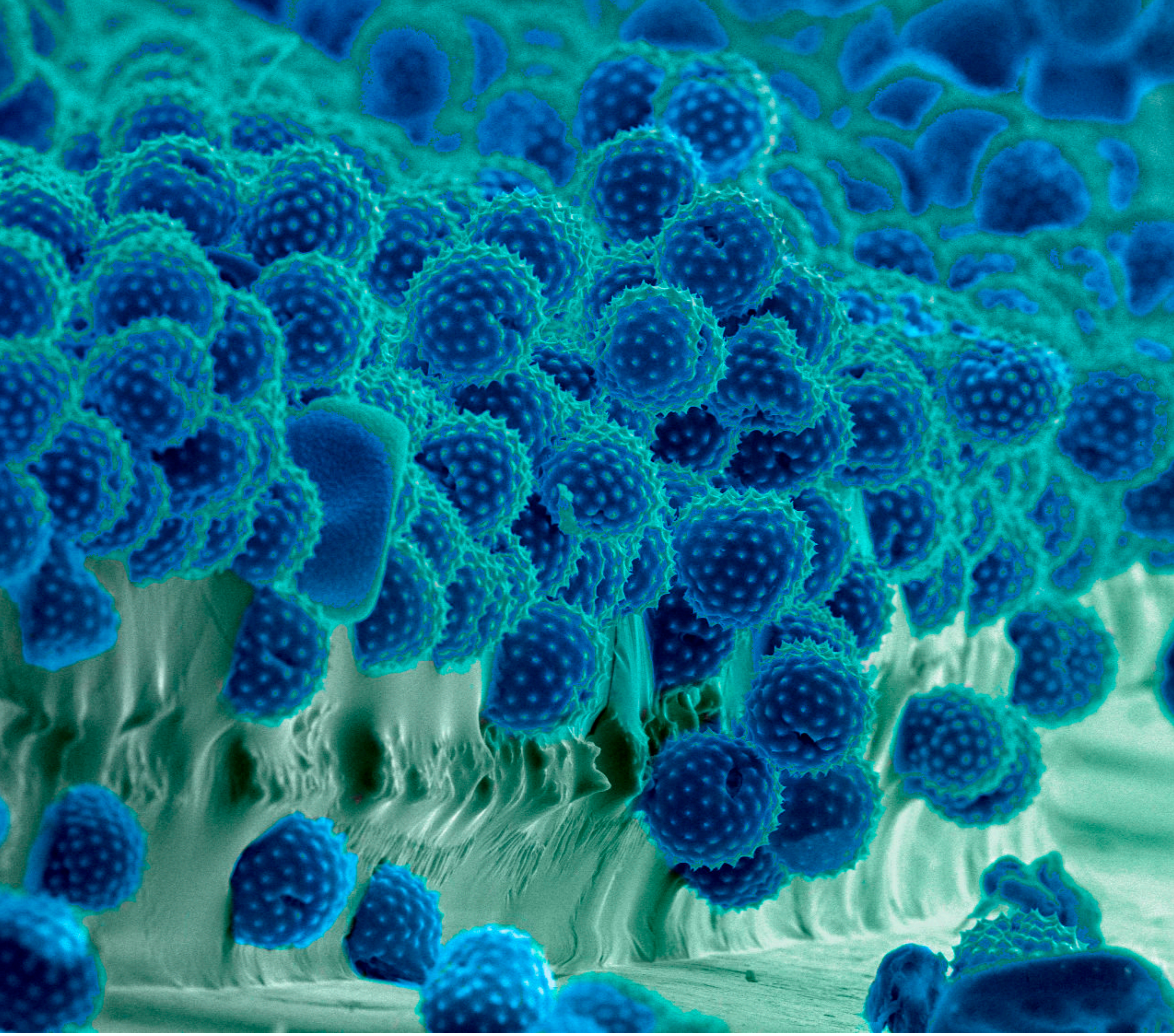
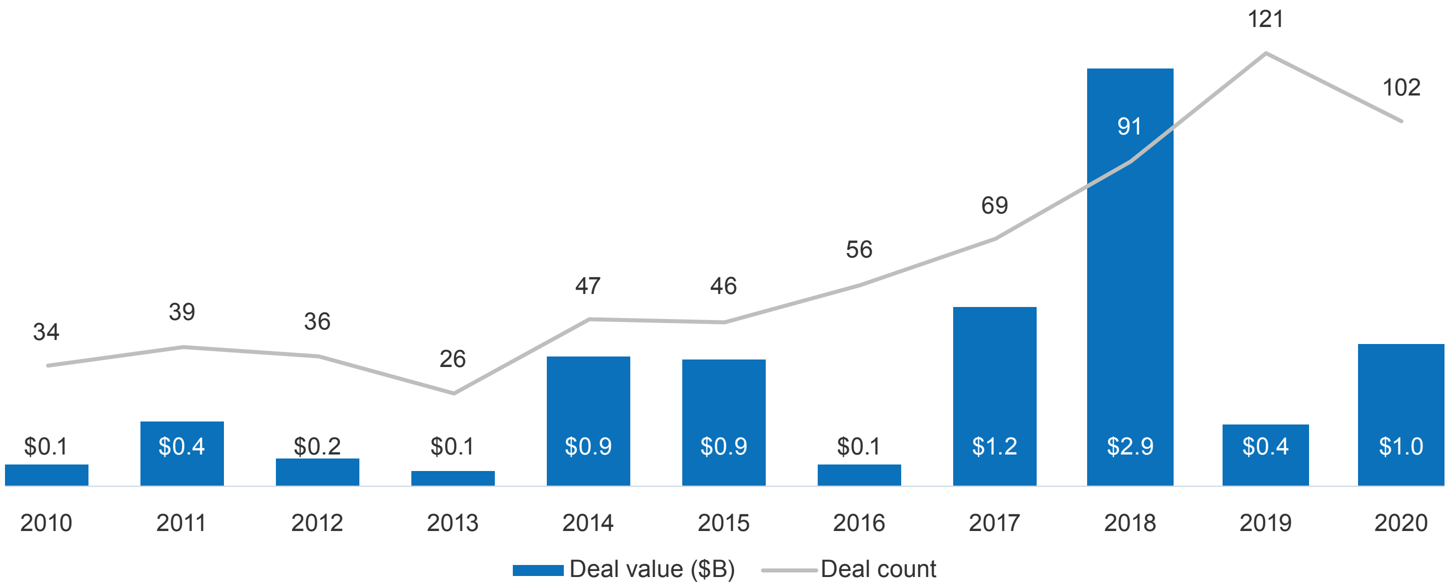


PE Poised to Expand Investment in ENT/Allergy

Data provided by PitchBook

Financial sponsors target ENT/allergy platforms at accelerating pace

US ENT/allergy deal activity



Source: PitchBook | Geography: US

A small but growing number of financial sponsors have targeted the ear, nose, throat, and allergy (ENT/allergy) space since 2015. For independent physicians, this group of private equity firms has emerged as an alternative to hospital groups and insurance companies tucking in specialty clinical practices across the US. Between 2010 and 2020, completed PE deals, comprising not only buyouts and add-on transactions, but also growth equity investments in this sector,* have expanded at a compound annual rate of 12%, climbing from 34 deals closed a decade ago to a record 121 transactions completed in 2019. Although the arrival of COVID-19 caused financial sponsors to pull back slightly in 2020, the fewer but larger deals done in ENT/allergy still produced an uptick in disclosed value year-over-year (YoY).

While the pandemic forced some to scale back M&A ambitions early on, activity in this sector surged in the back half of the year, jumping from a low of 19 deals completed in Q2 to 34 in Q3 and a staggering 54 transactions to close out 2020. The recent enthusiasm from PE firms for physician-led practices in the space has already helped push completed M&A, including acquisitions involving larger healthcare systems and hospitals, to 16 deals as of March 10. In January, Florida's largest ENT/allergy group, South Florida ENT Associates (SFENTA), announced a deal with Texas ENT Specialists (TENTS) to form a combined entity comprising 60 ENT centers. The deal was backed by Boston-based Audax Private Equity, a leading financial sponsor across several specialty healthcare services sectors.

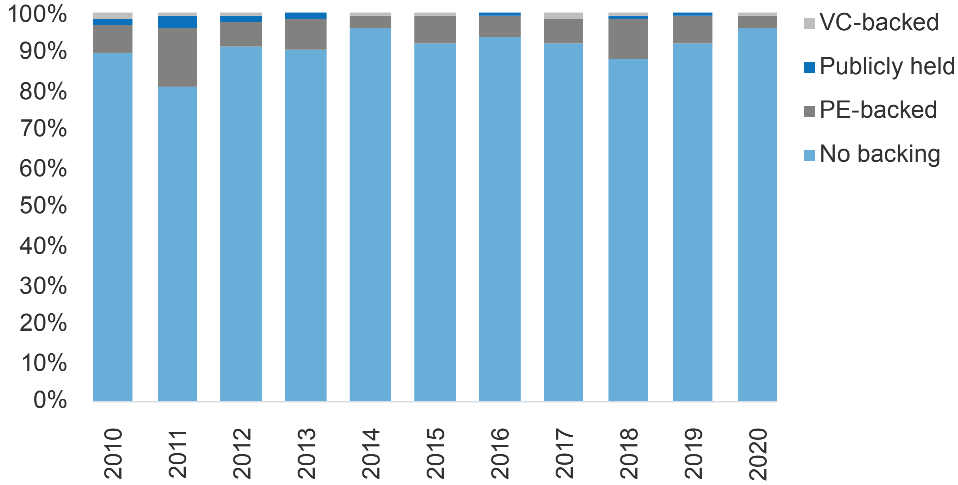
The stated rationale for the transaction is characteristic of recent financial-sponsor-driven consolidation activity across the

ENT/allergy practice space—namely, to deepen regional concentration and pursue opportunities in additional markets. By the end of February, SFENTA also announced the formation of Elevate ENT Partners, a new management service organization (MSO) backed by Audax to provide independent physicians with an alternative platform to those offered by hospital groups and insurance companies, with its sights set on leveraging this network to acquire other practice groups across the US.

At less than 1% consolidated to date, according to a recent estimate, there's also no shortage of dealmaking opportunities in ENT/allergy for PE firms such as Audax, Shore Capital Partners, and others to explore. It also remains an under-capitalized market, with few targets in the space having any institutional backing at time of acquisition.

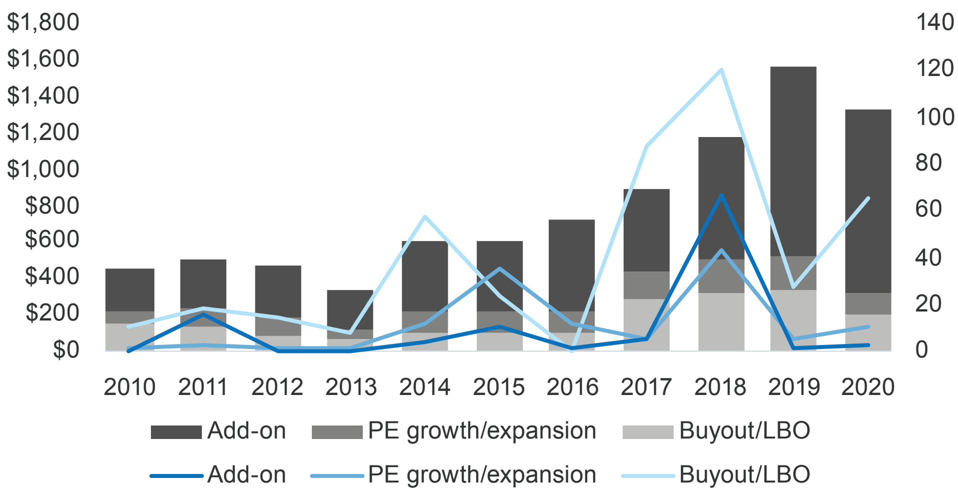
The formation of Elevate ENT Partners on the heels of SFENTA's deal with TENTS illustrates the rise of leading MSOs that serve independent partner groups, a leading example of which is Minnesota-based ENT Partners. In 2018, the group received a round of growth investment from Candescent Partners, its only disclosed funding from a financial sponsor since its founding in 1977. By the end of 2020, ENT Partners had already purchased Illinois-based providers Arlington ENT and Specialty Care Institute. Such add-on activity has become a driving force in PE dealmaking of late.

US ENT/allergy M&A deals (#) by backing at time of acquisition



Source: PitchBook | Geography: US

US ENT/allergy PE deal activity by type



Source: PitchBook | Geography: US

Meanwhile, challenges on the ground continue to complicate maintaining an independent practice. However, these situate the ENT/allergy space as one in which PE firms can drive further consolidation in a manner that preserves much that makes independent practice appealing to physicians, who reported "bureaucratic tasks" as a top cause of burnout in a recent Medscape survey,[1] while still achieving economies of scale. The benefits of a corporate infrastructure with expertise in managing ENT/allergy practices include both substantial cost savings and enhanced revenue opportunities such as:

- Savvy managed-care contracting executives with experience in

1: "Most ENTs Remained Happy Through 2020; a Third Reported Burnout: 7 Insights," ASC Review, Carly Behm, March 1, 2021.

negotiating favorable rates, including both fee-for-service and valued-based reimbursement programs

- Experienced finance teams, including billing, collection, call center, and scheduling, all of which increase revenue cycle and profitability
- Seasoned human resources and employee benefits personnel to manage dozens (or hundreds) of staff, benefits, and policies/procedures
- Reduced operating costs through group purchasing advantages (discounts) in areas such as health and professional liability insurance, as well as clinical purchasing, including medical equipment, testing supplies, and medications.
- Centralized compliance and legal functions across all offices
- Common and cost-efficient information systems, EMR, IT-support, data analytics, and population health teams
- Beneficial mass marketing initiatives through websites, social media, and other outlets

Historically, economies of scale have only been available to large providers or insurers, which has upended competition. However, financial sponsors can help recruit specialists who are willing to invest in and maintain a smaller practice despite heavy pressure for talent from larger hospitals and healthcare systems. Nonetheless, low patient volume and heavy reliance on government payers remain perennial challenges for independent practices, particularly in rural areas of the US.

Top Investors in US ENT/allergy deals, 2010-2020

Investor name	Investment count
Shore Capital Partners	31
Welsh, Carson, Anderson & Stowe	28
Audax Group	26
Webster Equity Partners	18
Enhanced Healthcare Partners	16

Source: PitchBook | Geography: US

Correcting for these downsides to independence while allowing seller physicians to maintain many of the upsides to independent practice represents a unique value proposition that financial sponsors can offer. Likewise, financial sponsors can benefit rural areas. The COVID-19 vaccine rollout has illustrated just how concentrated care is in urban centers. PE has an advantage here in its ability to reach rural areas via buy-and-build strategies that combine complementary care offerings with back-office support. The knock-on effects—beyond reducing the tasks that physicians find taxing—include savings on common procedures for patients. Indeed, the average cost of more common ENT procedures such as tonsil removal in an outpatient setting are often half the charge for the same procedure in a conventional hospital setting.

PE firms, sitting on record levels of dry powder and extensive experience operating in the middle-market, will continue to target independent physician-led clinical practices in the ENT/allergy space and beyond for investment. After more than a year of negative patient growth brought on by COVID-19, the number of independent practices looking to merge with or acquire other practices via external financing should only increase.

24 million

Estimated number of people with asthma in the US, including more than 6 million children, according to the American College of Allergy, Asthma & Immunology[2]

15%

Occurrence of seasonal allergic rhinitis (i.e., hay fever) in children, historically in the South and Southeast of the US, according to the Asthma and Allergy Foundation of America[3]

2: "Allergy Facts," ACAAI, January 9, 2018.
3: "2021 Allergy Capitals: The Most Challenging Places to Live with Allergies," AAFA, 2021.

*Methodology

Ear, nose, throat, and allergy practice dealmaking data was generated using a custom list of keywords, including but not limited to sinusitis and sleep apnea, to curate a list of appropriate companies within the PitchBook Platform's coverage of the larger healthcare services industry. In addition, where appropriate, transactions also involving practices offering parallel services to common ENT procedures have been included in this sector such as ASCs, sleep disorder clinics, and allergy testing providers. Customary PitchBook reports' methodologies for M&A transactions and PE deal flow have been used, with M&A value based on reported or disclosed figures, with no estimation used to assess the value of transactions for which the actual deal size is unknown. Therefore, annualized deal values reflect disclosure and transparency requirements for private transactions and, as result, may in some instances reflect aggregate sums lower than those realized on a per transaction basis.

Q&A with Dana Jacoby and Gary Herschman

PE firms have already dialed up the pace of overall dealmaking in healthcare since the start of 2021. What do financial sponsors find so appealing about where ENT/allergy in particular fits within the wider physician practice space?

There are several reasons why private equity sponsors find ENT/allergy attractive targets for investment. For a start, the sector is extremely fragmented. There are approximately 10,600 ENT/allergy physicians' practices, with 53.8% operating in physician practice groups vs. hospitals or health systems. Moreover, many of the ENT groups across the country remain small and independent at fewer than 25 physicians, while 54.3% of the practices are single-specialty ENT—meaning they are not aligned with a multi-specialty practice for support or infrastructure. These conditions present enormous opportunities for smaller groups to consolidate and substantially improve their financial performance by benefiting from the many economies of scale of a larger corporate infrastructure. As a result, financial sponsors have been targeting physician specialties that utilize (or can utilize) multiple ancillary services, and ENT/allergy practices offer several ancillary opportunities: ambulatory surgery centers (ASC), allergy testing, audiology testing, hearing aids, sleep disorder clinics, and ENT pediatric centers, to name a few.

But PE firms are targeting ENTs for additional reasons such as achieving increased expertise in negotiating with payors, creating more sophisticated economies of scale to support the high fixed costs of practice (e.g., investments in medical equipment and infrastructure builds), and increasing their patient referral bases. Consolidation generally takes place in private practices as they are acquired by a private equity firm or merge organically. ENT is still considered "white space" by many investors because the physicians have remained fragmented and solo rather than merging practices toward consolidation.

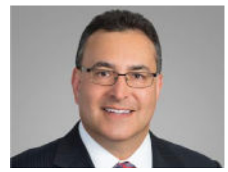
What are the unique investment risks and related challenges for both buyers and sellers involved in transactions across ENT/allergy?

PE acquisition of practices may benefit ENT physicians in multiple ways. For example, PE financing may increase access to capital. This capital may assist with equipment expenditures and technology buildouts. Investor-supported ENT practices with PE partnerships may be able to pursue market-desirable services (e.g., robotic surgery systems for the treatment of obstructive sleep apnea) that would be too expensive for a single practice. PE firms can scale, simplify, or reduce administrative burdens and operations, allowing ENT physicians to focus on patient care models and minimize business stresses. Smaller ENT practices that are contemplating a sale may find an investor platform to be attractive as they navigate the post-pandemic changes required in healthcare.

PE firms and ENTs alike may also have an opportunity to increase ASC procedural volume and buildouts. ENTs perform nearly one-eighth of all ASC procedures, which makes them a high-target specialty for ambulatory surgery buildouts. And ENT procedures performed at ASCs are highly profitable (mean case net revenue of $2,543), particularly compared with other high-volume ASC specialties such as ophthalmic procedures (mean case net revenue $1,442).

How should a prospective seller assess the relative advantages of exiting to a financial sponsor versus a corporate acquirer in ENT/allergy?

Dana L. Jacoby
CEO
Vector Medical Group



Gary W. Herschman
Board of Directors /
Member of the Firm
Epstein Becker Green

Financial sponsors are the most entrepreneurial-driven consolidation model, and arguably the best type of transaction to maximum total valuation, via 1) a tax-advantaged upfront cash purchase price, plus 2) rollover equity to align financial incentives with investors and allow physicians to share in future upside appreciation, which can be extremely lucrative. Both considerations are very important if one of the primary objectives of physicians is to "monetize" the value of their medical practices while positioning themselves to be successful going forward considering the continuing changes and uncertainty in the healthcare system. Equally important, sponsors usually allow the physicians full autonomy with respect to clinical aspects of the practice going forward.

The main downside of financial sponsors is that their investment horizon historically has been three to seven years, and the average of five years has recently inched downward. Even though "second bite" transactions can be lucrative, there is some uncertainty regarding the physicians' next partner when the initial sponsor exits to another larger sponsor or national company. Nevertheless, the next partner likely will be vetted extensively by existing investors (including physicians holding rollover equity) and vice versa, to ensure that vision and culture remain consistent with that of the physicians.

What other market dynamics are driving the recent growth in dealmaking activity across the ENT/allergy space, and what do you envision as the lasting impact of COVID-19 on these trends?

Many ENT practices are "top loaded" with aging physicians. On the other hand, there generally is a lack of desire among newly trained physicians to manage the business aspects of physician groups in light of the increasingly competitive, complicated, and changing landscape of medical practice. Likewise, the aging US population creates an increasing demand for all types of physician specialties and services, which has spurred a shift to outpatient care and population-health & value-based care initiatives, all of which require enhanced IT systems, data analytics, and clinical integration programs.

What else do you see on the horizon for deal making in ENT/Allergy involving PE?

In the wake of COVID-19, more physician groups than ever are exploring strategic options, including practice sales and investor partnerships. Most physicians suffered financial downturns over the course of between three and six months (or more) from closed and/or reduced practice operations. Federal stimulus, such as PPP, helped them navigate the pandemic to some extent, but physicians who were part of larger organizations, with substantial corporate infrastructure and capital, were better able to weather these difficult times. As a result, many physician groups that previously vowed to remain independent are now actively exploring the pros and cons of partnerships and are transacting. This has catapulted forward a good number of medical practice transactions at the end of 2020 and the outset of 2021. This spike in physician group deal activity is expected to continue throughout 2021 and into 2022. But these transactions are not right for every group, and some will continue to stay the course as independent practices.

Financial sponsor or corporate acquirer?

Regarding financial sponsors versus "corporate acquirers," the answer may depend on whether the corporate buyer is a hospital, national healthcare company, or other large specialty or multi-specialty physician group.

Hospitals as buyers:

Although not true across-the-board, most hospitals do not value physician groups as highly as financial sponsors due to "fair market value" limitations under fraud & abuse laws (because the physicians refer to the hospitals), as well as rules governing tax-exempt organizations (for nonprofit hospitals).

- *Hospital deals do not involve a rollover equity opportunity (for long-term financial benefit).*

Many physicians know their hospitals from working in the community for so long, which can either be an advantage or a disadvantage:

- *Some physicians do not trust the motives of hospital executives, who are viewed as trying to maintain the status quo of physicians in the community (so that they are not acquired by others) and mainly focusing on negotiating beneficial inpatient hospital rates.*
- *Other physicians may see comfort or refuge in becoming part of their local health system based on how they have partnered together in the past as well as the health system's focus on caring for local communities.*

Large groups (single or multi-specialty) as buyers:

There are potential upsides and downsides to a medical practice being acquired by a larger physician group. The upsides include:

- *Knowing that you continue to be part of a physician-owned and managed group, as opposed to a hospital, investor, or large healthcare company*
- *Potentially being purchased in the future at a much larger valuation*

The downsides include:

- *Receiving a lower valuation upon joining the group, and sometimes no payment—being "absorbed" into the group instead*
- *Lacking control over a future decision to no longer remain independent*

National healthcare companies as buyers:

National healthcare companies (such as Optum, Envision, etc.) usually provide practice valuations (purchase prices) that are very competitive with those of financial sponsors.

- *National companies generally purchase 100% of a practice without rollover equity, which provides an opportunity for physicians to benefit in future upside appreciation of the company.*
- *Large healthcare companies commonly implement incentive plans that reward productivity via bonuses and/or the grant of options or equity.*