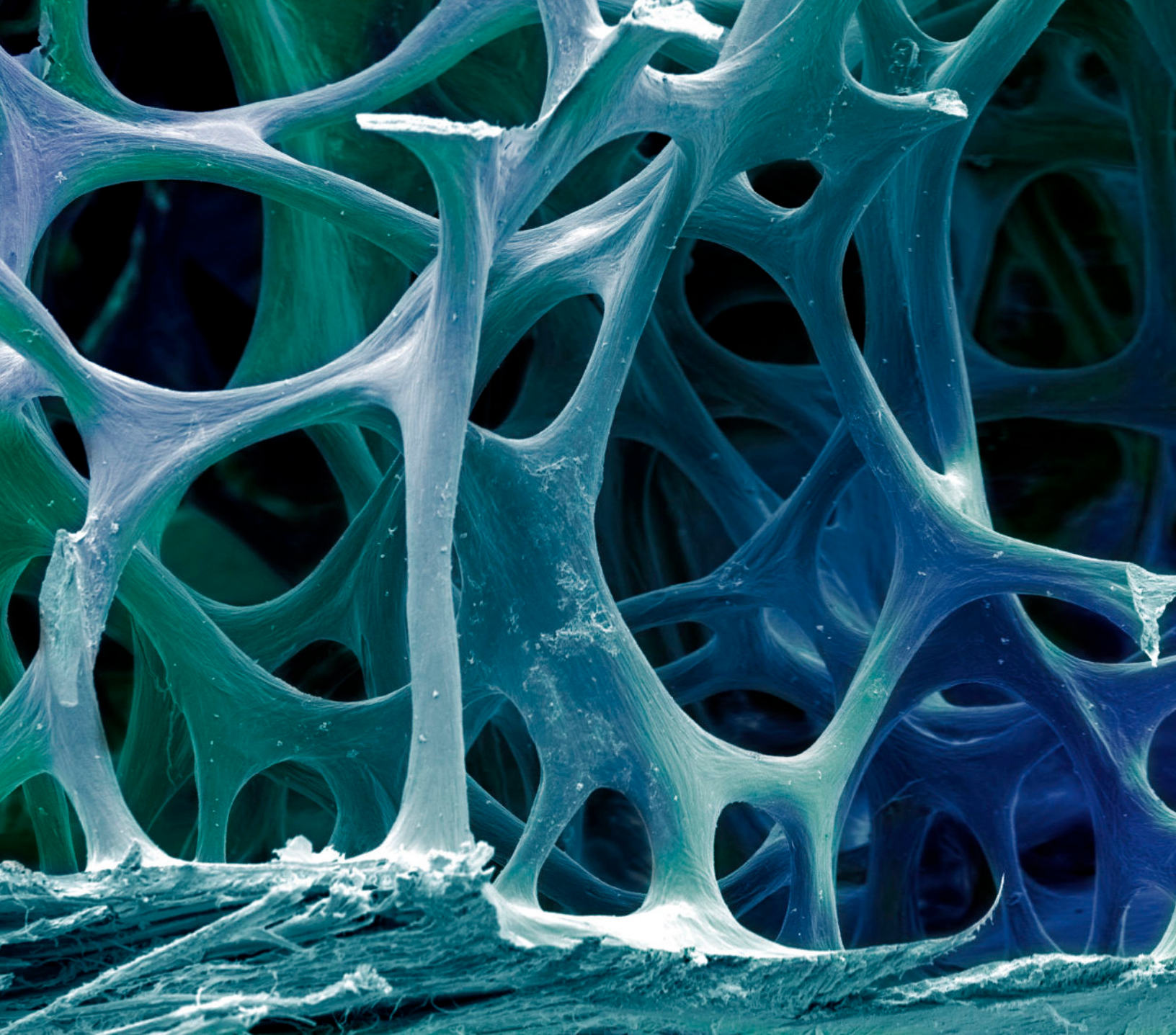




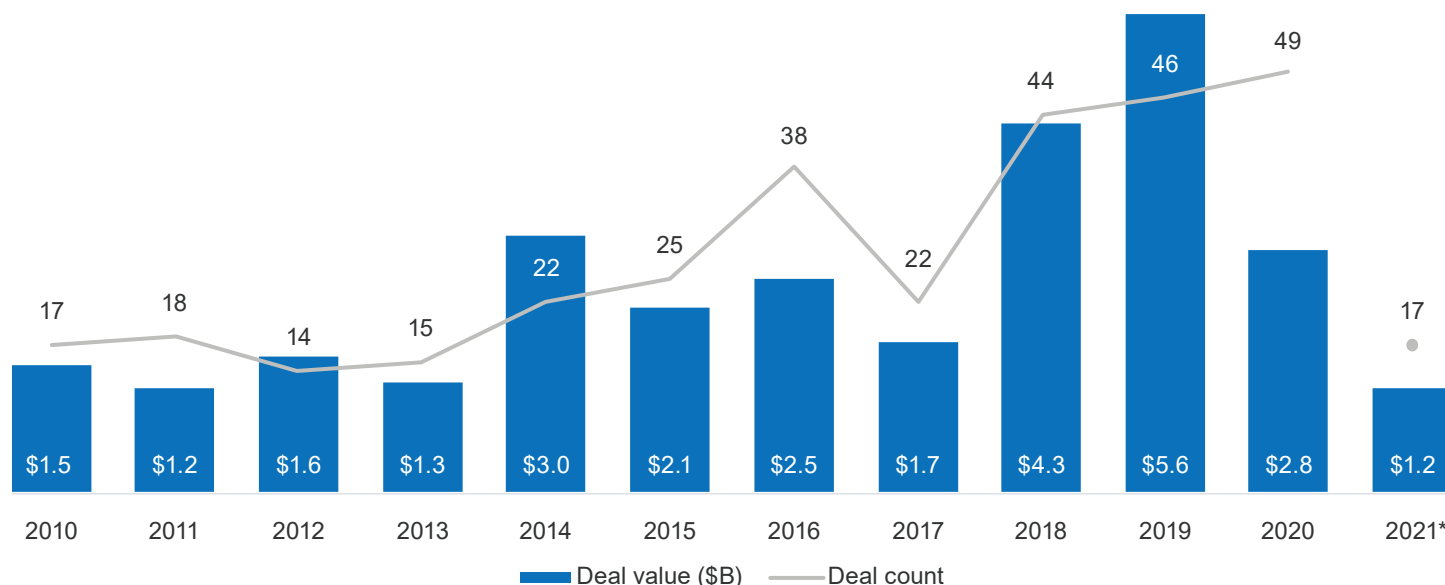
EPSTEIN
BECKER
GREEN

Private Equity Driving Consolidation Across Orthopedic Healthcare

Data provided by  PitchBook®

Transaction volume pushes to new heights

US PE activity in orthopedic healthcare



Source: PitchBook | Geography: US | *As of May 25, 2021

From gastroenterology and oncology to urology and dermatology, financial sponsors have spurred innovation and fueled consolidation across the US healthcare landscape. In 2020, private equity (PE) deals in healthcare generated \$79.2 billion in value—some 14% of all capital committed—across 735 transactions, or 17% of all deal volume in the US. Niche areas of the space, comprising not just healthcare services but also devices & supplies, technology systems, pharmaceuticals, and biotechnology, represent attractive rollup opportunities. As a bonus, healthcare generally weathers macro-level downturns better than most industries.

As a result, a growing number of fund managers have jumped on the abundant investment prospects across healthcare sectors. And orthopedic healthcare has been no exception—rather, it has lately emerged as a bellwether of PE's appetite for physician-led clinical practices.

Despite the disruption wrought by the COVID-19 pandemic, 49 orthopedic transactions closed in 2020—topping the record set in 2019—across no less than \$2.8 billion¹ in aggregate deal value. With the back half of 2021 yet to play out, financial sponsors have completed an additional 17 deals generating another

\$1.2 billion in overall value. The customary push to close ongoing transactions by year's end should propel 2021 to a new high for deal volume, if not value.

The professionalized corporate infrastructure PE partnerships bring can greatly improve the overall financial performance of a medical group, negotiating more lucrative managed care contracts with payors. Such a centralized management team can also obviate the need for duplicative mid-level and back-office staff at each office.

1: Extrapolated because of undisclosed deal sizes.



Vector Medical Group, LLC conducts project management, client leadership insights, and market research for industry, community-based medical groups, health systems, and associations. Vector Medical Group is the preeminent leader in creating synergies between investors and healthcare provider groups with seamless, strategic, trademarked solutions. As an intersection between investors and healthcare leaders, we work to integrate with any health industry business at any facet of its life cycle. We work with C-Suite executives and senior leadership to drive business performance and outcomes based on combining healthcare and shareholder value. Our global experience allows us to assist organizations with change management and affords shareholders streamlined solutions across all departments. **With over 20 years' experience and an unprecedented lens of the insight across the ever-changing healthcare marketplace, there is no better option than Vector Medical Group.**

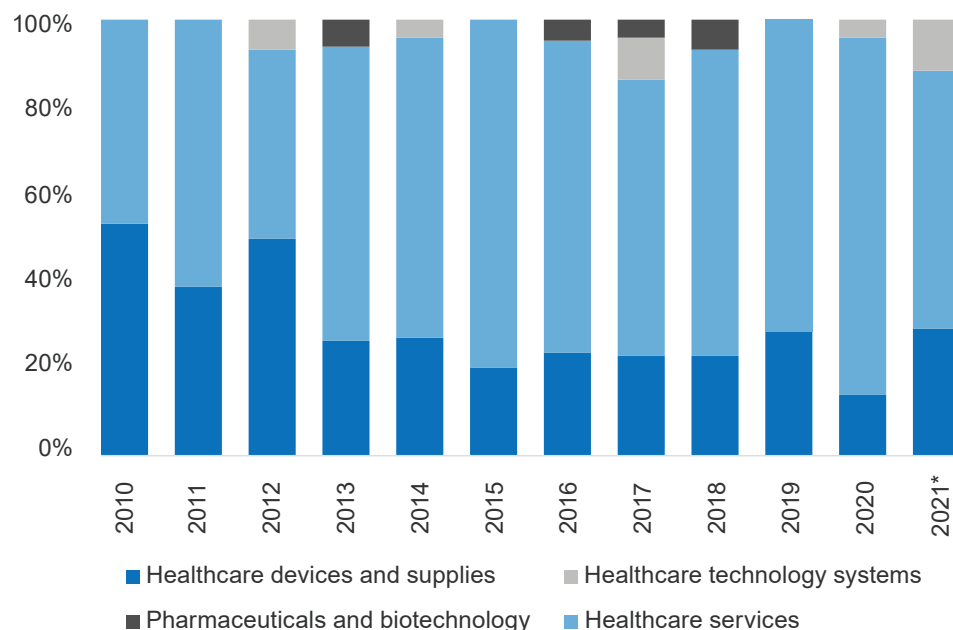
Financial sponsors targeting the healthcare space look to leverage multiple ancillary service opportunities as additional profit centers, and orthopedic practices can offer the widest variety of ancillary services to their patients, including:

- Ambulatory surgery centers
- Physical and other therapies (such as occupational or hand therapy)
- Multiple imaging modalities (including MRI, CT, ultrasound, X-ray, bone densitometry)
- Durable medical equipment
- Prosthetics and orthotics
- Injections (such as for pain management, biologics)
- Orthopedic urgent care centers
- Occupational health centers

PE-backed platforms continue to expand through new as well as add-on acquisitions, and over the past several years, existing orthopedic platforms have increasingly moved across state lines. Meanwhile, new orthopedic platforms are staking claims in specific regions across the US. For example, last July, Ohio-based Beacon Orthopaedics & Sports Medicine, a Revelstoke Capital Partners portfolio company turned national management services organization (MSO),

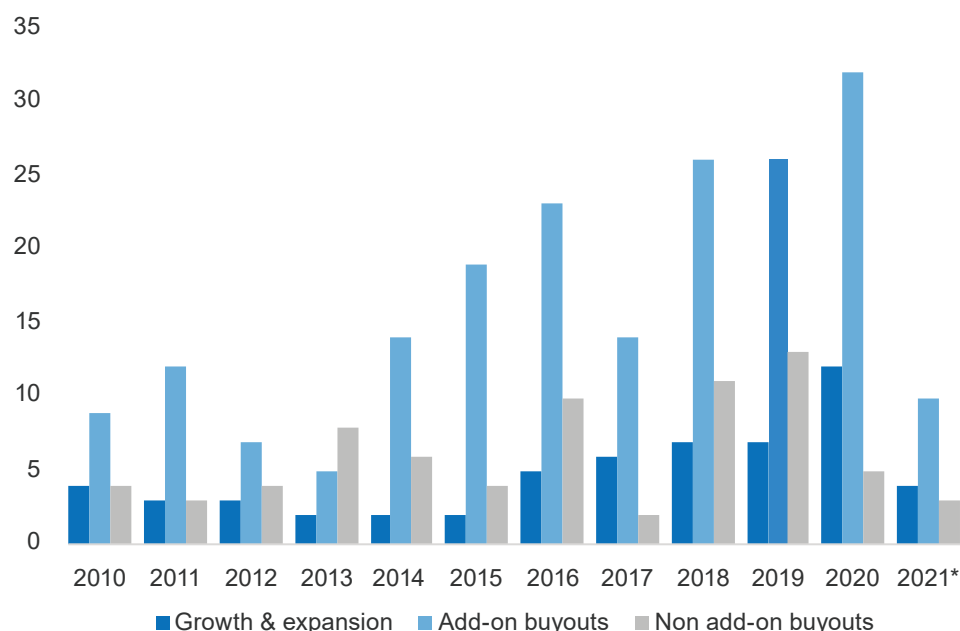
According to the Association of Orthopaedic Surgeons, just 12% of orthopedic surgeons operate solo private practices, per 2018 survey data, while full-time orthopedists are between 40 and 59 years old.

US PE activity (#) in orthopedic healthcare by industry group



Source: PitchBook | Geography: US | *As of May 25, 2021

US PE activity (#) in orthopedic healthcare by type



Source: PitchBook | Geography: US | *As of May 25, 2021

acquired Reconstructive Orthopaedics & Sports Medicine in Cincinnati.

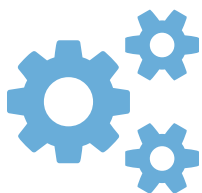
Such moves can capture economies of scale that could secure lucrative multiples at auction. Likewise, returns continue to drive home the message that PE can add real value in the healthcare market. Going forward, the tailwinds for orthopedic healthcare include an aging population and back-pain-related issues stemming from lifetimes of inactivity and obesity in the US. These factors are likely to persist and should encourage further PE dealmaking across the space for the foreseeable future.

Selected orthopedic practice mergers completed YTD in 2021:

- Phoenix-based The CORE Institute merged with Advanced Foot and Ankle Specialists, a six-physician group in Howell and Dexter, MI., expanding its presence in the state.
- Seven orthopedic practices in New Jersey merged to form Ortho Alliance NJ.
- Cincinnati-based Wellington Orthopaedic & Sports Medicine merged with OrthoCincy Orthopaedics & Sports Medicine to form OrthoCincy Wellington Orthopaedics & Sports Medicine.
- Six orthopedic groups in Texas merged to form OrthoLoneStar.
- Longmont, CO.-based Front Range Orthopedics & Spine merged with Fort Collins, CO.-based Orthopaedic & Spine Center of the Rockies.
- Leawood, KS.-based Orthopaedic and Sports Medicine Consultants, and Dickson-Diveley Orthopaedics merged March 1.

PE firms are focused on the continued tailwinds from migration to outpatient procedures, most recently knee and hip replacements. They are focused on future growth as well as rebounding from pandemic-depressed markets. There is an expected rebound recovery for lost procedures in H2 2021 and 2022. PE groups expect consolidation because of operational challenges faced by private practice physicians.

Key trends to watch in 2021



Enabling technology:

Orthopedic robots drive revenue not only for device companies, but also for hospitals reliant on highly profitable joint replacement and spine surgeries.



Mergers and acquisitions:

As the pandemic depresses asset prices, resource-rich companies are increasingly aggressive in small acquisitions to expand their portfolio or market access.



ASCs:

Joint replacement and spine companies are highly focused on positioning themselves to leverage the shift of producers to ASCs.

*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 using a combination of keywords and a primary industry code tag of healthcare to identify companies within the orthopedics space.

Q&A with Dana Jacoby and Gary Herschman

In this series, we've chronicled how PE firms have grabbed a growing share of overall dealmaking in healthcare. What do financial sponsors find so appealing about the orthopedic space and which opportunity sets are unique to this corner of the market?

Financial sponsors find the orthopedic space very appealing due to a variety of factors:

- Hospitals lost an estimated \$10.9 to \$11.9 billion in reimbursement and \$2.6 to \$3.5 billion in net income due to canceled elective musculoskeletal surgery during 8 weeks of the COVID-19 pandemic.¹ Orthopedic practices, which spend more than \$33,000 per month per surgeon to maintain overhead in addition to ancillary, medical malpractice, and capital expenditures, also experienced a financial loss with the pandemic.²
- The physician services subsector within the musculoskeletal space is extremely fragmented, with multiple medium and small orthopedic practices in most major regions throughout the country.
- Demand for orthopedic services has grown consistently over the years and is expected to rise at an even faster pace over the next decade as baby boomers aging through retirement require substantial orthopedic care.
- Large orthopedic practices offer a wide range of subspecialty care, including sports medicine, joint replacement, pain management, bone cancer treatment, or physical therapy.

What are the chief investment risks and related challenges for both buyers and sellers involved in transactions across ortho?

Sellers in the orthopedic services sector face many of the same challenges as in other physician specialties, as well as some unique issues. Some of the unique challenges include:

- Because certain orthopedic subspecialists are highly compensated, it can be more challenging to “normalize” (i.e., reduce) their pay in a manner that is acceptable to investors, who do not want too large of a reduction in provider compensation for fear of not being aligned with physician productivity post-closing. As a result, there is a wide disparity in collections—and therefore compensation—among physicians in many orthopedic groups. This, in turn, results in major differences among physician owners with respect to the proceeds they receive in a partnership transaction with investors. Such financial differences can cause tension among the shareholders of a group, making it difficult to achieve consensus on proceeding with the deal. Although such disparities can be addressed in various ways, if the practice is a corporation, the options for doing so may be extremely limited depending on various factors.
- Orthopedic groups also face many other challenges that are common to all physician group deals, such as (i) structuring transaction terms so that early-, mid- and late-career shareholders are all treated fairly and are appropriately incentivized and aligned moving forward; (ii) including terms that align the interests of existing associate physicians; (iii) ensuring that post-closing the group can still be competitive in recruiting highly talented



Dana L. Jacoby
CEO
Vector Medical Group



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

orthopedic physician associates and other clinicians (e.g., mid-levels, PTs); (iv) making specific commitments to other aspects of growth, such as new offices and expanded ancillary services; (v) finding a partner that is a good “cultural fit” with the group with respect to management and governance and who will not interfere with clinical aspects of the practice.

How are financial sponsors achieving efficiencies through scale by rolling up a number of physician-led ortho practices?

Being part of a larger organization with many physicians throughout a state (or many states) allows physicians to substantially benefit from economies of scale and other practice enhancements, such as:

- Migrating to an advanced EMR system that provides advantages regarding clinical care and population health, as well as turbocharged revenue cycle capabilities. These advanced EMR systems are inordinately expensive for a mid-sized or large practice (and not even considered by small groups) but can cost-efficiently be acquired and operated by consolidated groups with dozens of

2: “Economic Implications of Decreased Elective Orthopaedic and Musculoskeletal Surgery Volume During the Coronavirus Disease 2019 Pandemic,” *International Orthopaedics*, Matthew J. Best, et al., July 17, 2020.

3: “Economic Impacts of the COVID-19 Crisis: An Orthopaedic Perspective,” *Journal of Bone and Joint Surgery*, Anoushiravani AA, et al., April 21, 2020.

physicians across many offices. These systems also provide crucial data to better position the practice to succeed in bundled payment and other value-based reimbursement programs, which are becoming more prevalent.

- Real cost savings in a variety of high-end purchases like health insurance, malpractice insurance, major imaging equipment, biologics, website & other marketing, population health, capabilities, data analytics, and care management staff.
- Benefits of an experienced senior management team, including a complete C-suite, a managed care executive, a human resources executive, a compliance officer, and many more.

The professionalized corporate infrastructure PE partnerships bring can greatly improve the overall financial performance of a medical group, negotiating more lucrative managed care contracts with payors. Such a centralized management team can also obviate the need for duplicative mid-level and back-office staff at each office.

What do you see on the horizon for dealmaking in ortho as the back half of 2021 unfolds?

The COVID-19 pandemic brought unprecedented disruption to orthopedics in 2020. Despite these challenges, the industry recovered quickly. As a result, we have seen three trends playing a crucial role as we move into the back-half of 2021:

1. Enabling technology: Orthopedic robots drive revenue not only for device companies, but also for hospitals reliant on highly profitable joint replacement and spine surgeries. With ASC evolution, the growth of orthopedic robotic surgeries will continue to flourish.
2. M&A: As the pandemic depressed asset prices and group resources, revenue-rich companies have become increasingly aggressive toward small orthopedic acquisitions to expand their platforms or access new markets.
3. ASCs: Joint replacement and spine companies are highly focused on positioning themselves to leverage the shift of high-volume surgeons to ASCs.

There are various pros and cons of orthopedic groups “partnering” with a financial sponsor vs. corporate acquirer. The following summarizes some of these key differences.

Hospitals:

The biggest upside of becoming part of a hospital or health system is that they are large organizations in the local region serving the same population as the group. The downsides are: (i) they often do not value practices as highly as financial sponsors, as the terms they offer must be fair market value to comply with the Stark and anti-kickback laws (because physicians can refer patients into them), as well as legal restrictions on tax-exempt organizations; (ii) many hospitals are not adept at managing physician practices and instead focus on filling beds, providing tertiary healthcare services, and negotiating rates for these high-end services; and (iii) in some markets, physicians do not trust hospital executives and, even if they do, they are concerned about the next management team given their frequent turnover.

Payors and National Healthcare Companies:

Physician groups are increasingly being approached by payors and their affiliates, as well as national healthcare companies. Although these “buyers” oftentimes offer competitive financial terms, many of them do not offer “rollover” equity, which allows physicians to benefit from the growth and increased value of the organization (e.g., through “exit” transactions in the future). Although these buyers are very experienced in population health, data analytics, and value-based reimbursement programs, many physicians don’t want to be aligned with payors due to their heavy-handed dealings with physicians over the years.

Financial Sponsors (PE firms):

Financial sponsors usually provide the highest valuations and financial terms to physician groups, while providing “rollover equity” to ensure strong alignment of financial interests among the investors and physicians. One of the other key pros of PE partnerships can also be one of the major cons, however. Although sponsors usually exit within three to seven years, which can be very lucrative to physicians holding rollover equity, this inevitable change in the financial partner presents some level of uncertainty as to when or, even more so, who the new investor will be. On the flip side, the next investor will be valuing the platform at a higher level that it likely won’t change much and will instead focus on investing in additional growth. Moreover, it won’t want to upset the platform’s physician partners, who will always be the key drivers of the company’s ongoing value and success.