The Dermatology Market: A Tidal Wave of Private Equity Investment

A beginner's guide to the complex world of mergers and acquisitions.

BY CLINT BUNDY

Over the past seven years, there has been an explosion in acquisition and investment activity in the dermatology market. The acquisition and investment trend in dermatology has been driven by financial investment funds known as private equity groups. As Jack Resnick, MD stated in a January 2018 *JAMA Dermatology* article, "Consolidation of practices fueled by private equity investments has begun to transform dermatology."[1] Furthermore, the demand from private equity buyers continues to surge, resulting in a barrage of phone calls and emails from private equity groups to practice owners from California to New York requesting meetings. While opinions can vary among dermatologists on the attributes of private equity groups, one thing is clear: these investors are a force in the dermatology market and are here to stay.

Private equity groups are funds of money, managed by finance and operating professionals, that are usually focused on acquiring a majority ownership position in private companies. The original practice owners and/or management team usually retain a minority equity interest. After an initial, or platform, investment in the dermatology market, the private equity group and its physician partners then seek to accelerate the growth of the practice though various means. This could include enhancing services of the practice, adding new locations and completing "tuck in" acquisitions of other dermatology practices. After an investment period of three to seven years, the private equity group and its physician partners aim to sell the practice and receive back two to five times the amount of equity that it originally placed into a transaction.

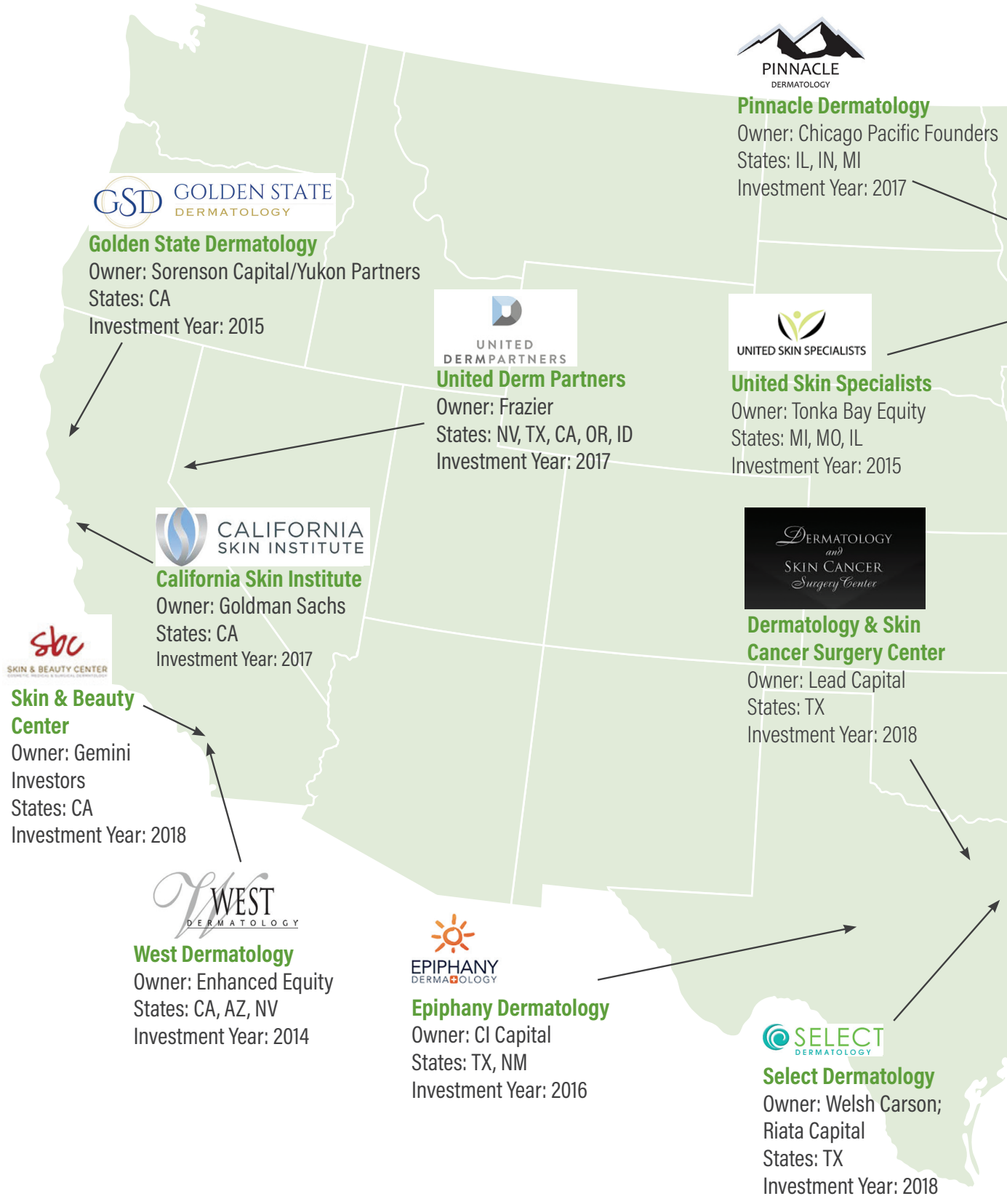
There has been a rush of private equity capital into the dermatology market over the past seven years. In 2011, there was only one private equity investor in the dermatology market, yet by 2018 there were more than 30 private equity groups active in the segment.[2] From January to July 8, 2018, there were 36 transactions in the dermatology market, almost all of which involved a private equity group.[2] While this market evolution has created some cause for concern in the community, many dermatologists have been intrigued and receptive to this trend. Clifford Perlis, MD states that private equity investment into dermatology practices, "Adds value to practices, creates more practice options, enhances advocacy, and better manages the complexity" of practices.[3]

A MARKET PERSPECTIVE

There are a number of reasons for this explosion of private equity capital into the dermatology market:

Growth Market. The dermatology market is a $16 billion market that is expected to grow at a 2.3 percent compounded annual growth rate through 2021.[4] These attractive market characteristics are a natural pull for return-driven investors focused on growing markets.

Durable Market. Private equity groups, focused on protecting their capital, gravitate towards recession-insulated industries. These investors understand that the dermatology market weathers recessions better than many other industries. Tom Ferkovic, Managing Director with Medic Management, a medical management and operational consulting firm, stated that during the depths of the Great Recession, "Well-run, disciplined dermatology practices that understood their market advantage were not hurt" by the economic downturn. Furthermore, Mr. Ferkovic noted that, "Unlike other medical specialties, dermatology has multiple product lines and revenue sources. If one of the revenue lines, such as cosmetic, shrinks [due to a recessionary climate],



Golden State Dermatology
Owner: Sorenson Capital/Yukon Partners
States: CA
Investment Year: 2015

Pinnacle Dermatology
Owner: Chicago Pacific Founders
States: IL, IN, MI
Investment Year: 2017

United Derm Partners
Owner: Frazier
States: NV, TX, CA, OR, ID
Investment Year: 2017

United Skin Specialists
Owner: Tonka Bay Equity
States: MI, MO, IL
Investment Year: 2015

California Skin Institute
Owner: Goldman Sachs
States: CA
Investment Year: 2017

Dermatology & Skin Cancer Surgery Center
Owner: Lead Capital
States: TX
Investment Year: 2018

Skin & Beauty Center
Owner: Gemini Investors
States: CA
Investment Year: 2018

West Dermatology
Owner: Enhanced Equity
States: CA, AZ, NV
Investment Year: 2014

Epiphany Dermatology
Owner: CI Capital
States: TX, NM
Investment Year: 2016

Select Dermatology
Owner: Welsh Carson; Riata Capital
States: TX
Investment Year: 2018

Summit Dermatology Partners
States: IN
Investment Year: 2018

Dermatologists of Central States
Owner: Sheridan Capital
States: OH
Investment Year: 2016

Adult and Pediatric Dermatology
Owner: Waud Capital
Sates: MA, NH
Investment Year: 2017

Northeast Dermatology Associates
Owner: OTPP, Century Equity
States: MA, ME, NH
Investment Year: 2017

Tricenna
Owner: The Riverside Company
States: NJ, NY
Investment Year: 2016

NavaDerm
Owner: BelHealth Investment Partners
States: NJ, NY
Investment Year: 2018

Forefront Dermatology
Owner: OMERS
States: WI, IA, IN, KY, MI, OH, VA, MD, NC
Investment Year: 2016

Schweiger Dermatology Group
Owner:LLR Partners, LNK Partners
States: NY, NJ, PA
Investment Year: 2016, 2018

Anne Arundel Dermatology
Owner: New Mainstream Capital
States: MD, VA, TN
Investment Year: 2018

Platinum Dermatology Partners
Owner: Sterling Partners
States: TX, AZ
Investment Year: 2016

QualDerm Partners
Owner: Cressey/Apple Tree
States: NC, VA, OH, TN
Investment Year: 2013, 2016

Sona Dermatology & MedSpa
Owner: Pharos Capital
States: NC, AR, DC, MD, TX, VA
Investment Year: 2016

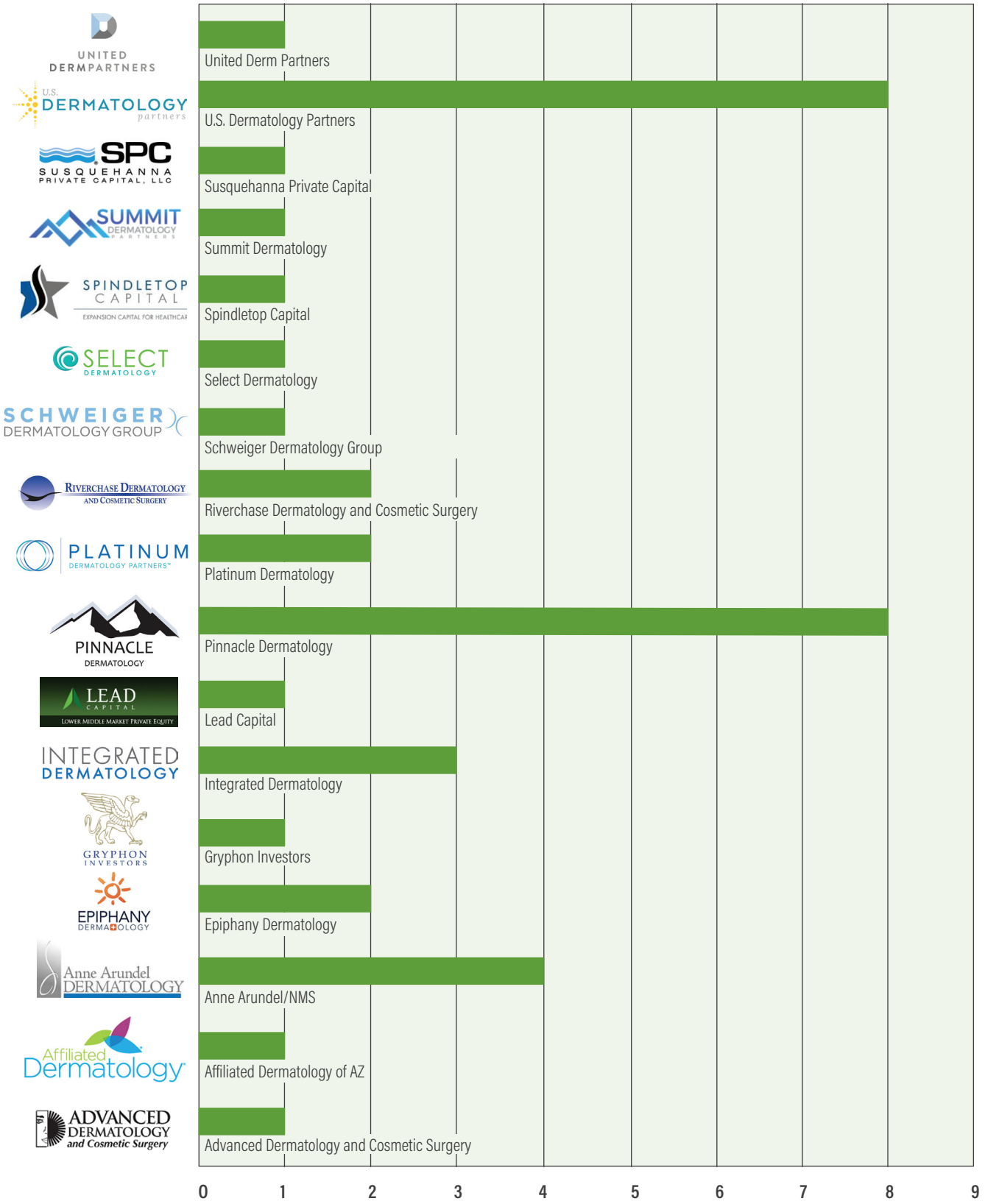
Advanced Dermatology and Cosmetic Surgery
Owner: Harvest Partners
States: 14
Investment Year: 2016

DermCare
Owner: Gemini Investors
States: FL
Investment Year: 2017

Skin & Cancer Associates
Owner: Susquehanna Private Capital
States: FL
Investment Year: 2018

Riverchase Dermatology
Owner: GTCR
States: FL
Investment Year: 2018

Year-to-Date July 2018* Mergers & Acquisitions Buyer Activity: Dermatology Market



*As of July 9, 2018. Note. With the exception of Affiliated Dermatology of AZ and Integrated Dermatology, all of the above transactions involve either private equity groups or private equity-backed platforms.

other lines, such as medical dermatology, will still maintain a strong pipeline due to the lack of available appointment slots." Between 2007 and 2009, the dermatology market grew at approximately a 2.1 percent compounded annual growth rate while the US GDP decreased 4.3 percent from Q4 2007 to Q2 2009.[4,5]

Consolidation Opportunity. There are more than 11,000 dermatology practices in the United States, and approximately one-third of those practices are owned and operated by solo practitioners, and 41 percent are single-specialty group practices.[1,4] Furthermore, the three largest dermatology players only represent approximately 3.3 percent of the dermatology market.[4] As practices are acquired and consolidated, owners and providers can gain efficiencies. These efficiencies, or synergies, can be gained through better vendor pricing for supply costs, increased reimbursement rates obtained through improved negotiating leverage with insurance payors, cross-selling of services, and sharing of administrative resources. These combination benefits often lead to higher profits, which then result in higher valuations for dermatology owners.

Recurring Revenue. The buyer's market places a heavy premium on businesses that have repeatable customers and revenue. To that end, a buyer will focus on practice attributes, such as attrition rate of patients, backlog of patient appointments, history of procedures per patient, and frequency that the average patient visits the facility. Andrew Henoch, a Managing Director with Alvarez & Marsal's Transaction Advisory Group, states, "Many dermatology practices are innovating to increase their top-line opportunities. Specifically, we've seen dermatology practices pursue service-line expansion into repeatable offerings such as cosmetics, cosmeceuticals and other elective procedures. In addition, practices are also seeking vertical integrations of dermatopathology lab and more highly acute oncology-based service offerings. These factors, coupled with an aging and expanding patient-base in the US, create compelling investment opportunities for private equity sponsors."

THE PRACTITIONER'S PERSPECTIVE

So why are dermatologists increasingly either selling a majority or 100 percent equity position in their practices? Reasons include:

Regulations. The regulatory environment continues to place more burdens on dermatologists. The independent physician group especially bears the administrative and resource training brunt. Michael Sherling, Co-founder of Modernizing Medicine, stated that that "The percentage of dermatologists reporting symptoms of burnout is skyrocketing: from 31.8 percent in 2011 to 56.5 percent in 2014."[6] He added that, "A major cause of burnout is loss of autonomy over how physicians spend

their time, which is at least in part due to large amounts of documentation burden."[6]

Bart Walker, a healthcare and M&A legal specialist with McGuire Woods, an international law firm, provided additional insights. Mr. Walker stated that, "Fraud and abuse statutes governing compensation methodologies and ancillary investments, licensing and reporting obligations imposed by state regulatory authorities, and regulations governing permissible uses of patient health information have continued to become more complex over the past five to 10 years." Furthermore, he added that, "Large group practices, whether backed by outside investors or grown organically through physician investment, can provide the necessary resources to understand and comply with these increasingly complex regulatory schemes."

Focus On the Patients. In the book *Good to Great*, author Jim Collins defined the hedgehog concept as where a, "Hedgehog reduces all challenges and dilemmas to simple…indeed almost simplistic…hedgehog ideas. For a hedgehog, anything that does not somehow relate to the hedgehog idea holds no relevance."[7] Many dermatologists are embracing the hedgehog concept by shedding as many business and administrative duties as possible in order to focus almost exclusively on patient service delivery. As a part of a sale, the physician relies on the new owner to institute a structure and team to manage these non-clinical aspects of the operations after the close of a transaction.

Personal Financial Goals. In a practice sale that could generate an attractive all-cash payment for a dermatologist, sellers can quickly bolster their retirement nest egg. In addition, dermatologists can obtain an attractive compensation agreement from the new owners, allowing them to continue to share in the production that the dermatologist generates. Finally, under a private equity structure, physicians have the opportunity to retain or earn equity in the dermatology practice. The dermatologist then has the ability to receive a "second bite of the apple" when a resale of the practice occurs in the future.

OPPORTUNITIES AND RISKS

While the influx of capital into the dermatology market can offer dermatologists many advantages, including cash offers for their businesses and partners to support them on growth, there can be risks. This could include enhanced pressures on dermatologists to grow the practices, loss of decision-making control for the dermatologist, and the risk of too much debt being placed on a practice as a result of an acquisition, which could lead to bankruptcy. In addition, there are voices within the dermatology community that are concerned that "investor-owned conglomerates" could create too much of a business-like atmosphere and commoditize "the treatment of patients."[1] While it is too early to tell the outcome, the presence of private equity in the dermatology market will certainly have an impact on the industry.

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For each physician owner, there is an analysis to complete that weighs the benefits and costs of a sale to a private equity group, or a private equity-backed dermatology platform, before pursuing a course of action. Regardless of one's decision, private equity groups are expected to be an ever-present option for dermatologists for the foreseeable future. ■

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