Investors' Interest In Dermatology Is More Than Skin-Deep

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Incidences of skin cancer in the United States have increased over the past 30 years, especially among patients over the age of 60. As of 2014, 42 percent of dermatology patients were over the age of 60, and the U.S. Department of Health and Human Services estimates this percentage will continue to increase until 2030. As a result of this growing demand for dermatology services, the dermatology subsector is expected to grow to $13.1 billion by 2017. Unsurprisingly, the growing number of dermatology patients, coupled with the fact that skin cancer has become one of the most costly Medicare diagnoses (accounting for roughly $2.9 billion in Medicare charges annually), has increased the profitability of dermatology practices across the country.

Although dermatology practices have emerged as profitable health care businesses within the past decade, the dermatology subsector remains highly fragmented. It is estimated that the four largest dermatology practices in the United States each hold less than 2 percent of the market by revenue, and dermatologists account for only 1 percent of the U.S. physician population, but nearly 4 percent of the overall Medicare expenditures. As in other markets, fragmented health care subsectors provide opportunities for private equity investors to capitalize on economies of scale through consolidated management, billing, and in-office services. Private equity firms can also facilitate mergers that allow dermatology practices to realize the benefits of creating ancillary sources of income, utilizing more effective management teams, and implementing new technologies.

Unlike many subsectors of the health care industry, dermatology appears to have reached a point of stability for reimbursement due to recent policy changes by the Centers for Medicare and Medicaid Services. For example, in 2007, CMS implemented the Multiple Procedure Payment Reduction Policy, which reduced reimbursement by 50 percent for any subsequent surgical procedures performed during the same operative session by the same physician. This Multiple Procedure Payment Reduction Policy directly impacted a number of procedures performed by dermatology practices, such as Mohs surgeries, but also provided some clarity regarding CMS' reimbursement policies. CMS also recently reduced reimbursement rates for the technical component of in-office pathology services. Although these changes decreased dermatology practices' collections, they also reduced the likelihood reimbursement benchmarks will be altered in upcoming years, which may increase the attractiveness to private equity investment.

There have been a number of successful private equity investments in the dermatology subsector that have occurred since 2012. A few examples are as follows:

1) Advanced Dermatology and Cosmetic Surgery: In February 2012, Audax Group completed

its investment in Advanced Dermatology and Cosmetic Surgery. Through this investment, Audax Group affiliated with 53 dermatology clinics in Florida and Ohio, which provide numerous clinical, cosmetic and pathology services. Following the transaction, ACDS also provided billing, coding and management services for third-party dermatology practices. Just three years later, this platform now includes over 70 clinic sites nationwide.

2) Dermatology Associates of Tyler. In January 2013, Candescent Partners, a Boston-based private equity firm, announced it had acquired Dermatology Associates of Tyler. Dermatology Associates is a medical and cosmetic dermatology practice in Eastern Texas, which was formed by Dr. Lawrence Anderson in 1996. At the time of closing, Dermatology Associates consisted of 10 physicians and four offices, including a pathology laboratory and an ambulatory surgery center, and Dermatology Associates has continued to grow since closing.

3) Dermatology Associates of Wisconsin/Forefront Dermatology. In May 2014, Varsity Healthcare Partners, a health care-focused private equity firm, entered into a partnership with the shareholders of Dermatology Associates of Wisconsin/Forefront Dermatology, which at the time operated 40 dermatology clinics in the Midwest. In connection with the DAW transaction, Varsity Healthcare Partners formed Forefront Management Holdings, based in Manitowoc, Wisconsin, to provide practice management services to DAW focused on aggressive acquisition and growth. Now Forefront includes nearly 60 clinics in six states.

4) Anne Arundel Dermatology. In June 2015, New Mainstream Capital, a New York-based private equity firm, announced its partnership with Anne Arundel Dermatology PA. AAD is the largest dermatology provider in Maryland and provides dermatology services at 16 locations through more than 30 providers. Through this partnership, NMS invested in AAD Dermatology Management LLC to provide management services and additional capital to support AAD's further growth through de novo office openings and acquisitions.

Although there has been significant activity by private equity investors in the dermatology subsector, the marketplace remains highly fragmented and provides ample opportunity for additional investment. Future private equity investors should consider strategic approaches to the following challenges when investing in dermatology practices:

1) In-Office Laboratory Services. Increasingly, dermatology practices offer in-office pathology services to their patients by hiring in-house pathologists. Under in-office pathology arrangements, physicians often make referrals to their dermatology practice's in-office laboratory. The dermatology practice then bills and collects fees from private payors and federal health care programs for its professional pathology services. Prior to entering into an investment transaction, private equity firms should ensure the dermatology practice's pathology arrangements comply with the federal Stark Law and Anti-Kickback Statute.

Even referrals for pathology services to dermatologists' own group practice can implicate the federal Stark Law and Anti-Kickback Statute. However, dermatology practices can often fit their in-office pathology arrangements into the In-Office Ancillary Services Stark Law exception or Anti-Kickback safe harbor. Both the In-Office Ancillary Services exception and safe harbor require the arrangement to meet a number of complex elements, such as the Stark Law's group

practice definition. Failing to meet even one of the required elements can create risk in the transaction for both the dermatology practice and the private equity investor.

Note that since July 15, 2013, when the U.S. Government Accountability Office published a report stating that dermatology practices that bring dermapathology in-office bill more biopsies to Medicare than those who do not bring dermapathology in-office, in-office pathology arrangements have undergone increased scrutiny.

2) Reimbursement for Mohs Surgeries. Regulatory scrutiny has also increased surrounding Mohs procedures in recent years, particularly because the number of Mohs surgeries have increased more rapidly than the incidences of skin cancer. Private equity firms considering dermatology investments, especially those practices with a significant number of Mohs procedures, should be aware that there are specific concerns by payors when there is a high incidence of Mohs procedures on patients' trunks and extremities. Payors often believe skin cancer located on patients' trunks and extremities should be treated using less expensive procedures. Thus, private equity firms should confirm through due diligence that its dermatology target clearly and appropriately documents the medical necessity of any Mohs procedures, specifically noting the complexity, size or location of the patient's skin lesion(s).

3) Corporate Practice of Medicine. In many states, statutes and/or case law prohibit corporations from practicing medicine or employing physicians to provide professional medical services, including dermatological services. States' corporate practice of medicine doctrines often impact the structure of private equity investments in dermatology practices. Prior to an investment transaction, private equity firms should examine the applicable state's corporate practice of medicine restrictions and structure their investment in compliance with those restrictions. One common structure private equity firms utilize when investing in dermatology practices is a "MSO/PC structure," in which the private equity firm forms a management company to provide administrative, billing and coding services to the dermatology practice in return for a management fee. The viability of and controls permitted under this structure are largely dependent on the state in which the transaction occurs.

4) Licensure Concerns. As mentioned above, many dermatology practices provide a number of ancillary services to their patients, such as in-house laboratory services or laser procedures. Prior to performing these services, dermatology practices should ensure that its laboratory or other medical devices are in full compliance with applicable state-specific licensing requirements. For example, many states require laboratories to hold both a Clinical Laboratory Improvement Amendment Certificate and a state laboratory license. If a dermatology practice fails to hold all of its required licenses, it may not meet the required Medicare conditions for coverage, which could result in improper billing practices.

Clearly, private equity interest in dermatology practices is strong, and opportunities continue to exist for quality private equity investment despite regulatory challenges and other financial constrictions faced by many health care subsectors. However, as with any health care investment, investors should strategically approach regulatory issues and reimbursement pressures before moving forward with any investment in a dermatology practice.

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