HEALTHCARE SECTOR NEWSLETTER

Physical Therapy: A Booming & Rapidly Evolving Sector

FALL 2016

Livingstone

Introduction

Outpatient physical therapy is experiencing a decade-long M&A frenzy with no signs of abating. In the last 12 months alone, six physical therapy platforms have transacted, 35+ private practices have been acquired, and at least five sizable physical therapy platforms have launched sale processes.

With this significant activity altering the physical therapy landscape – combined with private practices being inundated with in-bound interest from prospective buyers – this newsletter aims to serve as an educational resource regarding the current state of the physical therapy M&A market. Also included herein is a feature on the implications to the physical therapy sector of value-based care and bundled payments.

Livingstone has had a front row seat to industry consolidation, advising on over a dozen sale or refinancing transactions with private practices, strategic buyers, and private equity investors. There has been neither a more compelling nor lucrative time to: (i) take chips off the table while also becoming an industry consolidator through a private equity recapitalization; (ii) pursue a full sale to a strategic buyer; or (iii) fund growth through debt financing. If strategic alternatives are being considered, Livingstone is available to advise through this critical process.

Market Landscape

Physical therapy consolidation has been underway for 10+ years, yet immense fragmentation persists. Of the 18,000+ outpatient clinics, the 15 largest public or private equity-backed platforms own ~3,550 clinics or just 20% share, with no company owning more than 6% of clinics. Beyond the large consolidators, the number of companies with more than 12 clinics approximates only 100 companies, who collectively own approximately 2,300 clinics. This market landscape results in 12,000+ clinics spread across thousands of private practices nationwide.

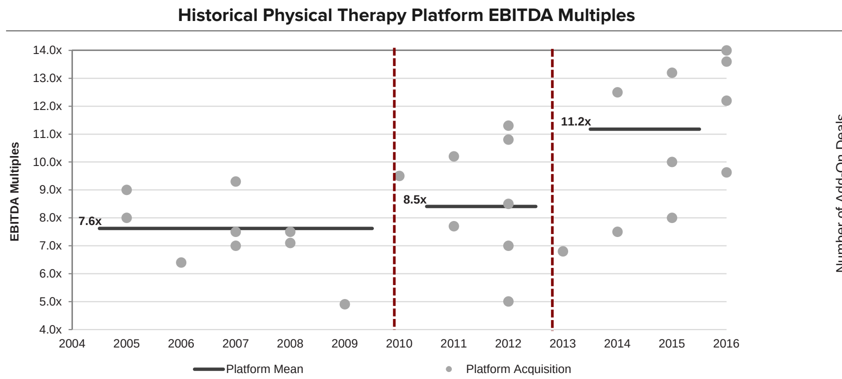
Top 15 Physical Therapy Platforms by Clinic Count

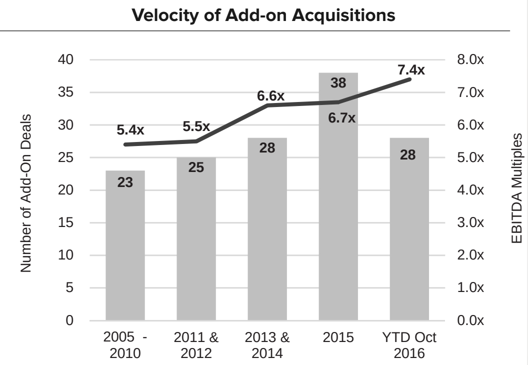
1	Select Medical Corporation	Public	1,000+	37 states
2	ATI Physical Therapy	Advent International	600+	25 states
3	USPh	Public	500+	42 states
4	Athletico Physical Therapy	BDT Capital	~350	9 states
5	Upstream Rehabilitation	Revelstoke Capital Partners	~250	11 states
6	Drayer	Goldman Sachs	130+	15 states
7	Pivot Physical Therapy	CI Capital Partners	120+	7 states
8	results physiotherapy	Sterling Partners	100+	9 states
9	Professional Physical Therapy	Great Point Partners	100+	3 states
10	PT Solutions	New Harbor	100+	8 states
11	CORA	Gryphon	100+	3 states
12	Phoenix	3 Rivers Capital	60+	4 states
13	MotionPT		50+	5 states
14	IvyRehab Physical Therapy	Waud Capital	40+	5 states
15	Dynamic	Lake Capital	~40	3 states

Source: Livingstone proprietary research

Lofty Valuations

The landscape has never been more favorable for practices interested in M&A. A decade ago, sellers could look to just a handful of acquirers. Today, the range of financing alternatives and number of prospective capital partners has dramatically expanded. The influx of private equity into physical therapy has led to the development of over 15 strategic buyers that are voraciously pursuing acquisitions and partnerships. The prevalence of these PE-backed consolidators – supported by favorable industry tailwinds, a stable reimbursement environment, strong operating performance, and robust debt markets – has created an ideal environment for sellers. This dynamic continues to drive higher valuations, seller optionality, better deal terms and higher certainty to close. Valuation, most often measured as a multiple of adjusted pre-tax earnings, has increased by 25% to 50%.





Source: Livingstone proprietary research

The chart above demonstrates the dramatic rise in valuations for platform physical therapy transactions. This dynamic has resulted in a "rising tide lifts all boats" environment for smaller physical therapy providers interested in M&A. Indicatively, the average multiple for add-on acquisitions in 2015 and YTD 2016 has been 6.7x and 7.4x, respectively, representing a meaningful increase from the 5.4x average multiple for add-on acquisitions between the 2005 and 2010 period. Further, the velocity of add-on M&A activity has also increased, with 65 announced add-on acquisitions since 2015 compared to 53 reported deals between 2011 and 2014 and 23 reported deals between 2005 and 2010.

Platform Physical Therapy Transactions, 2005-2016

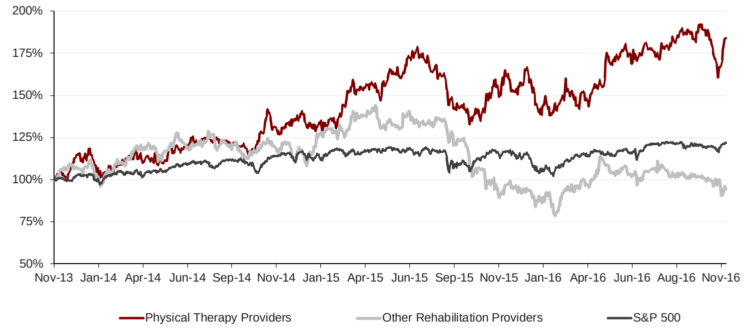
Avg EBITDA Multiple	($ in millions) Date	Target	Buyer
11.2x 2014 - 2016	Nov-16	Athletico Physical Therapy	BDT Capital Partners
	Jul-16	CORA Health Services, Inc.	Gryphon Investors
	May-16	Ivy Rehab Network Inc	Waud Capital Partners
	Mar-16	ATI Physical Therapy	Advent International
	Jan-16	Physiotherapy Associates Holdings, Inc.	Select Medical Holdings (NYSE: SEM)
	Dec-15	Upstream Rehabilitation, Inc.	Revelstoke Capital Partners
	Jun-15	Physiotherapy, Rehab and Medical Assessments division of Centric Health (TSX: CHH)	Audax Private Equity
	Aug-15	360 Physical Therapy	Gemini Investors & Celerity Partners
	Jun-15	Metro Athletic Medicine & Fitness ("MSM") and Sports Therapy and Rehabilitation	MOTION Physical Therapy (Pharos Capital)
	Mar-15	Physical Therapy Central, PT Development, TexPTS, F	Confluent Health
	Nov-14	Accelerated Rehabilitation Centers, Ltd.	Athletico Ltd. (Harvest Partners)
	Oct-14	Results Physiotherapy	Sterling Partners
	May-14	Athletico Ltd.	Harvest Partners
	Feb-14	Maryland Sportscare and Rehab (Pivot Physical Therapy)	CI Capital Partners / InTandem Capital
8.5x 2011 - 2013	Dec-13	PT Solutions Holdings, LLC	New Harbor Capital Management
	Oct-13	PHOENIX Rehabilitation	3 Rivers Capital
	Dec-12	ATI Holdings, LLC	KRG Capital Partners
	Jul-12	Drayer Physical Therapy Institute	GS Capital Partners.
	May-12	Excel Rehabilitation Services Inc. and Michigan Rehabilitation Specialists, Inc.	Shore Capital Partners
	Apr-12	Physical Rehabilitation Network ("PRN")	Silver Oak Service Partners
	Mar-12	Physiotherapy Associates, Inc.	Court Square Capital Partners
	Nov-11	Professional Orthopedic and Sport Physical Therapy	Great Point Partners
	Jul-11	Accelerated Rehabilitation Centers	OMERS Private Equity
	Jan-11	CBI Health Group	OMERS Private Equity
7.6x 2005 - 2010	Mar-10	ATI Holdings, LLC	GTCR Golder Rauner, LLC
	Aug-09	Advanced Physical Therapy PC	Cardinal Equity Partners
	Aug-08	Drayer Physical Therapy Institute LLC	Linden LLC
	Apr-08	Accelerated Health Systems, LLC and OccuSport Physical Therapy	Gryphon Investors
	Jun-07	Benchmark Medical, Inc.	Physiotherapy Associates, Inc.
	Jun-07	Physiotherapy Associates, Inc.	Water Street Healthcare Partners
	May-07	HealthSouth Corporation, Outpatient Rehabilitation Divis	Select Medical Corp.
	May-06	Dynamic Physical Therapy	PhysioHealth Inc. (Lake Capital)
	Mar-06	CBI Health	Callisto Capital
	Nov-05	Athletic and Therapeutic Institute (ATI Physical Therapy)	KRG Capital Partners
	Feb-05	Select Medical Corp.	Thoma Cressey Bravo and Welsh, Carson

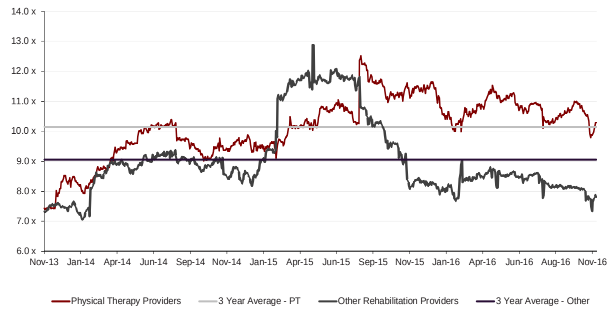
Source: Livingstone proprietary research. Livingstone maintains in-depth knowledge of nearly all platform acquisitions and welcomes the opportunity to discuss M&A landscape in more detail.

The stock performance of the two publicly-held outpatient physical therapy platforms – Select Medical and US Physical Therapy – has risen in a similar fashion as the private market valuations for physical therapy platforms. In the last 18 months, the average EBITDA multiple for these public companies has expanded to 12.9x from a three year average of 10.1x.

Comparable Public Companies

($ in millions)				Trailing Twelve Month (TTM)			Margins (%)		3 Year % Growth		EV as a Multiple of		
Company Name	Market Cap	Net Debt	Enterprise Value	Revenue	Gross Profit	EBITDA	Gross	EBITDA	Revenue	EBITDA	TTM Revenue	TTM EBITDA	Debt/ EBITDA
Physical Therapy Providers													
Select Medical Holdings Corporation	$1,661	$2,607	$4,605	$4,211	$738	$452	17.5%	10.7%	12.8%	6.2%	**1.1x**	**10.2x**	5.9x
US Physical Therapy Inc.	779	27	806	348	85	51	24.4%	14.8%	11.2%	11.4%	**2.3x**	**15.7x**	0.8x
Mean	**$1,220**	**$1,317**	**$2,705**	**$2,280**	**$412**	**$252**	**20.9%**	**12.8%**	**12.0%**	**8.8%**	**1.7x**	**12.9x**	**3.4x**
Median	**$1,220**	**$1,317**	**$2,705**	**$2,280**	**$412**	**$252**	**20.9%**	**12.8%**	**12.0%**	**8.8%**	**1.7x**	**12.9x**	**3.4x**
Other Rehabilitation Providers													
HEALTHSOUTH Corp.	$3,633	$2,934	$6,864	$3,576	$1,501	$817	42.0%	22.8%	17.1%	1,442.5%	**1.9x**	**8.4x**	3.7x
Kindred Healthcare Inc.	558	3,107	3,888	7,255	3,142	550	43.3%	7.6%	14.5%	16.1%	**0.5x**	**7.1x**	6.1x
Mean	**$2,095**	**$3,021**	**$5,376**	**$5,415**	**$2,321**	**$683**	**42.6%**	**15.2%**	**15.8%**	**729.3%**	**1.2x**	**7.7x**	**4.9x**
Median	**$2,095**	**$3,021**	**$5,376**	**$5,415**	**$2,321**	**$683**	**42.6%**	**15.2%**	**15.8%**	**729.3%**	**1.2x**	**7.7x**	**4.9x**



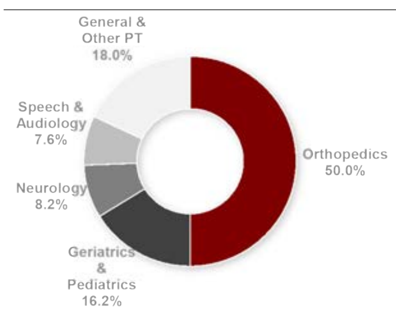


Large Industry with Favorable Tailwinds

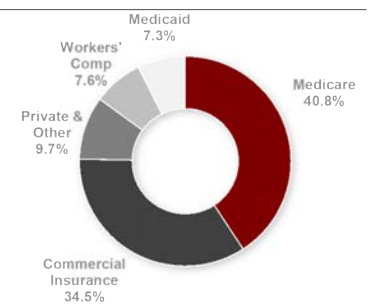
Outpatient physical therapy is a $29 billion industry, which has grown 3.8% annually since 2007 and is projected to grow 1.7% annually through 2021. Long-term industry growth is supported by multiple tailwinds including an aging and increasingly active population, the need for cost-effective and preventative treatment, the continued inpatient-to-outpatient migration, improved patient access, and greater healthcare consumerism driving a retail focus of healthcare services. Under the new model of healthcare delivery, with greater emphasis on cost containment, quality and value of care, the outpatient physical therapy industry is positioned to benefit from healthcare reform.

Industry Growth, 2007-2021

Industry Segmentation



Payor Segmentation



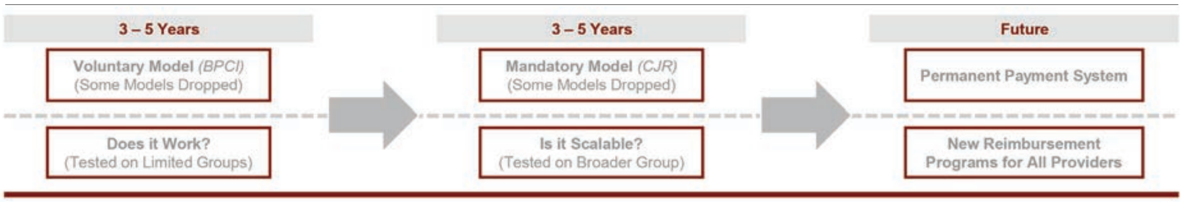
Source: IBIS World

Implications of Value-Based Care and Bundled Payments

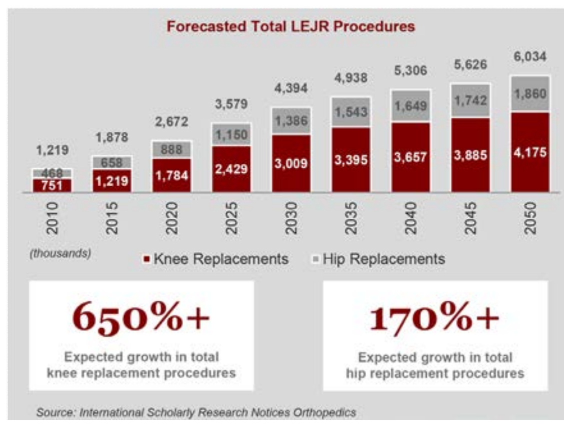
Medicare enrollment will increase by 1+ million beneficiaries per year through 2030, resulting in 81.5 million enrollees by 2030 (up from 47.7 million in 2010). This basic demographic trend positions Medicare as a rapidly growing health insurer, thereby shifting unsustainable costs to the Federal government. To combat this reality, CMS has implemented transformative changes to reimbursement and healthcare delivery, with the goal of transitioning 50%+ of all Medicare reimbursement to alternative payment methodologies by 2018.

One of CMS' first steps, in 2013, was the Bundled Payments for Care Improvement ("BPCI") initiative, a *voluntary* test program across ~50 clinical episodes *to determine if medical bundling works*. This on-going program revealed that bundling certain episodes, such as lower extremity joint replacements, results in superior outcomes at reduced cost through the redesign of clinical pathways and better care coordination. As such, in November 2015, CMS issued its final rule for the April 2016 launch of Comprehensive Care for Joint Replacement ("CJR"), which is CMS' *mandatory* test program for 800 hospitals across 67 MSAs nationwide *to determine if medical bundling can be scaled*. Once CMS determines that bundling can be scaled, this new reimbursement model will become a permanent payment system, resulting in innumerable changes to all healthcare providers, including physical therapy operators.

Implementation Cycle of New Reimbursement Models



Why were lower extremity joints selected as the first mandatory bundling program? Hip and knee replacements are the most common inpatient surgeries for Medicare beneficiaries and are expected to grow in procedure volume by 650% (knee) and 170% (hip) by 2050. These procedures often require lengthy recovery and rehabilitation within the post-acute continuum (inpatient rehab, skilled nursing, home health, and physical therapy, collectively known as the "PAC" network), which has been scrutinized for over utilization and excessive, unnecessary spending. Under fee-for-service reimbursement, each PAC provider has been incentivized to drive patient volume and utilization with limited incentive to optimize patient outcomes.



Indicatively, while post-acute care constitutes 40% of the cost of a Medicare lower joint episode (surgery, hospitalization, and post-acute recovery), the PAC network represents ~70% of episode cost variance. The average cost of a Medicare lower joint ranges from $16,500 to $33,000 across geographic areas with quality and cost of procedures varying greatly among providers. The nearby chart highlights the typical cost of each aspect of the PAC network if utilized in the episode.

Estimated Costs Along the Post-Acute Care Continuum

What does bundling mean to physical therapy providers? CMS, through bundling, is incentivizing the (i) reduction or elimination of medically unnecessary treatment and utilization, (ii) reduction of the length of stay through alternative care pathways and/or shifting of care to lower cost settings, and (iii) altering of pre-operative care protocols to optimize quality, efficiency and patient outcomes. Physical therapy providers should expect: (i) an expansion in episode volume; (ii) patient populations to gravitate toward a higher percentage of Medicare beneficiaries; (iii) reimbursement pressures from Medicare, which will then be followed by commercial and other payors; and (iv) shorter lengths of stay as utilization continues to be scrutinized. Payors and their episode care managers will seek to continue narrowing PAC networks with a focus on PT providers with the highest quality rankings. This, in turn, will place greater emphasis on clinical documentation and result in heightened administrative burdens to private practices.

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Tom's Two Cents

As enterprise values in the physical therapy space hit all-time highs so too have leverage levels. Lenders are following private equity funds into the stratosphere and regularly lending up to 60% of enterprise value. Therefore, if a physical therapy business trades at or above 10x EBITDA, lenders are comfortable applying leverage up to 6.0x for businesses with EBITDA exceeding $20 million. For businesses closer to $10 million of EBITDA lenders generally support up to 55% of the enterprise value, which again is still strong support from the lending community.

Debt Multiples for Physical Therapy Transactions

	<$10 million EBITDA	$10 - $20 million EBITDA	> $20 million EBITDA
Cash Flow Lending			
Total Leverage (x EBITDA)	4.00x - 4.50x	4.75x - 5.50x	5.50x - 6.00x
All-in Pricing	L + 900 - 1000	L + 750 - 850	L + 600 -700
Equity Contribution	50%	40% - 45%	35% - 40.0%

This data should not be surprising as other sectors of the economy are also enjoying deep market clearing support from the debt markets. With that said, what makes the physical therapy space unique is that lenders are supporting EBITDA add-backs such as "run-rate" EBITDA for recently opened ("de novo") clinics. This type of run-rate adjustment has been around for a while but is now being more accepted by the lending community for operators with strong track records. One area where the lenders do focus is the payor mix component of the revenue stream. Whereas businesses that generate a majority of "in-network" revenue receive broad support, similar to the equity story, businesses that have a concentration of "out-of-network" payors receive a discount to the enterprise value lenders are willing to risk. Livingstone believes the overall surplus of debt capital chasing middle market deals will continue, allowing the robust M&A market to maintain its torrid pace for the foreseeable future.

The Power of Private Equity

Livingstone's advisory work in physical therapy includes representing on the formation of three of the 11 largest private equity-backed physical therapy platforms. These platforms include ATI Physical Therapy (in 2005), PT Solutions (in 2013), and MOTION Physical Therapy (in 2015). In addition to providing partial liquidity to company ownership, private equity supports portfolio companies with growth capital for de novo development and add-on acquisitions, add-on acquisition identification and integration, capital structure guidance, operational / business building expertise, and broad strategic leadership, among other value.

	Footprint, Timing, and Partner of First Private Equity Deal					Platform Today	
Livingstone	ATI Physical Therapy	13 Clinics 3 States	2005	KRG Capital Partners	11 years with PE	600+ Clinics 25 States	46x+ Clinic Growth
Livingstone	PT Solutions	32 Clinics 6 States	2013	New Harbor	3 years with PE	100+ Clinics 8 States	3x+ Clinic Growth
Livingstone	MotionPT Management	9 Clinics 1 State	2015	Pharos	1 year with PE	50+ Clinics 5 States	5x+ Clinic Growth
Select Other PE Platforms	Drayer	40 Clinics 7 States	2008	Linden	8 years with PE	130+ Clinics 15 States	3x+ Clinic Growth
Select Other PE Platforms	Professional Physical Therapy	10 Clinics 1 State	2011	Great Point Partners	5 years with PE	100+ Clinics 3 States	10x+ Clinic Growth
Select Other PE Platforms	Athletico Physical Therapy	83 Clinics 3 States	2014	Harvest Partners	2 years with PE	350+ Clinics 9 States	4x+ Clinic Growth

No Better Time than the Present

Based on our experience, capital continues to flow freely into the physical therapy sector. There is a surplus of private equity capital that must be deployed, debt providers that are aggressively supporting higher than normal leverage levels, and many strategic buyers with an eye toward M&A to spur growth. This leads Livingstone to believe that companies with strong management, defensible geographic positions, high quality clinical care, and attractive cash flow generation will continue to attract buyer and investor interest. Therefore, whether your business is currently a buyer, seller, or capital seeker, funding is readily available to finance your future endeavors.

Livingstone's Healthcare Expertise

Livingstone is among the most active advisors to the physical therapy industry, closing over a dozen deals including 6+ since 2014. Livingstone's healthcare team, which comprises over 10 dedicated professionals globally, has completed 30+ transactions, totaling in excess of $1 billion in transaction value, since 2010. In the last 12 months, Livingstone has closed seven healthcare sell-side transactions at an average purchase multiple of over 10x annual earnings. The healthcare team has particular expertise in the areas of multi-unit outpatient healthcare, post-acute care providers, physician practice management, outsourced services, and medical products and distribution.

Metro Sportsmed Physical & Occupational Therapy / Sports Therapy and Rehabilitation Star Physical Therapy
has merged to form
Motion PT Management
and recapitalized by
Pharos

ATI Physical Therapy
has acquired
mattsmith Physical Therapy

Infinity HomeCare
a portfolio company of
HealthEdge Investment Partners
has been sold to
Amedisys

ATI Physical Therapy
has acquired
Triumph Physical Therapy

ATI Physical Therapy
has acquired
Monroe Physical Therapy For Injuries, Accidents & Illness

New Harbor Capital
has acquired
PT Solutions Physical Therapy

Orthopædics
has been sold to
Cadence Health

GTCR
has acquired
ATI Physical Therapy
a portfolio company of
KRG Capital Partners

We welcome the oppportunity to speak with you further about your strategic objectives and the broader marketplace:

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