Volume #10: Shifting Demographics Areas of Interest

In our previous four Strategy Reports, we dove into the most impactful manifestations that we saw rising from our four *Factors of Influence*, including *Rising Conflicts, Lower Energy Prices, the Modernization of Things, and Shifting Demographics*. This report marks the beginning of the transition to the next stage in the strategy report series, where we will examine the areas of interest arising from the manifestations of each *Factor of Influence*. In this report, we will focus on the areas of interest that are relevant to 3RC resulting from the manifestations of *Shifting Demographics*, which will further guide our investment strategy and outbound sourcing efforts.

The table below serves as a visual outline of the key areas of interest that we will take a closer look at throughout the following pages of this report. We are tracking several sub-verticals that will continue to shape 3RC's thematic lens and will lead our search to uncover the most compelling investment opportunities for our investors.

Factor of Influence	Manifestations	Areas of Interest
Shifting Demographics	Increased demand for health products and services	• Elderly and disabled services • Home care providers • Behavioral Health • Nursing care facilities
	Heightened demand for pet care services	• Pet grooming and boarding
	Changing consumer preferences	• Intelligent vending & logistics

Increased Demand for Health Products & Services

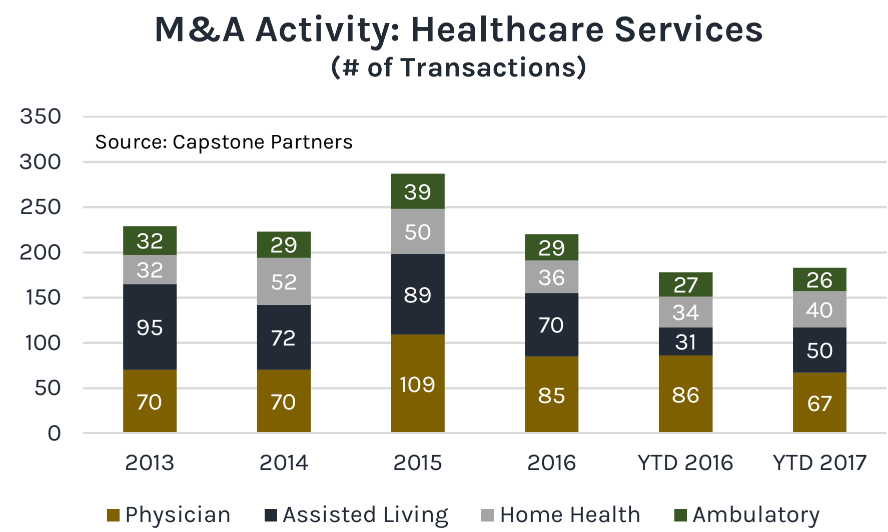
The Baby Boomers are having a massive impact on a variety of end markets, but 3RC believes that their impact will be felt the most in the coming years in the Health Services sector. The majority of Baby Boomers will be older than 65 by 2027, which is the segment of life where we see a significant increase in healthcare spending (as much as a 40% increase).[i] Overall health will fall as the average age of this population continues to rise, elevating demand for healthcare services.

After analyzing this trend in detail and carefully considering the risks associated with investing in the healthcare space, 3RC has filtered out four specific sub-verticals of interest: Elderly & Disabled Services, Home Care Providers, Behavioral Health, and Nursing Care Facilities. Each of these areas will be examined in further detail below, including analysis of the market trends and qualities that differentiate firms.

Elderly & Disabled Services:

The elderly & disabled services market encompasses transportation, relocation, concierge, and additional social assistance services for the elderly. In 2016, the annual revenue for this industry was $50.7B and has an estimated annual growth of 7.7% through 2022.[ii] The supplemental elderly services market will experience growth in tandem, with a projected global CAGR of 7.4% from 2016-2024.[iii] Aging populations within the United States is the primary driver of these hefty growth projections, as demand accelerates as more elderly enter the market and live longer lives.

Currently, the industry is heavily fragmented which stems from low barriers of entry and the growth stage of the sector encouraging new entrants in the market in the coming years. Differentiation is critical for companies in this space to defend against new entrants and obtain new clients. The firms that offer a wide range of services across the spectrum of care or are experts in a specific area of care are projected to be the most successful in building defensibility. Additionally, retaining high-quality, empathetic employees is a critical factor for long-term business viability.



Federal government funding is a key factor for the industry. In 2016, the federal government awarded over 1,100 contracts to approximately 240 companies which totaled $20.5B in expenditure. Operators will continue to compete for these contracts and further government funding in the future, and those that are able to differentiate will likely be successful in these efforts.

The fragmentation in the elderly & disabled services industry has led to some consolidation. In the first three quarters of 2017, 183 transactions have been closed in the healthcare services industry which is more than the 178 transactions closed during the same time period in 2016.[iv] 3RC will focus closely on companies with a differentiated offering to uncover the most promising opportunities in the elderly & disabled services industry.

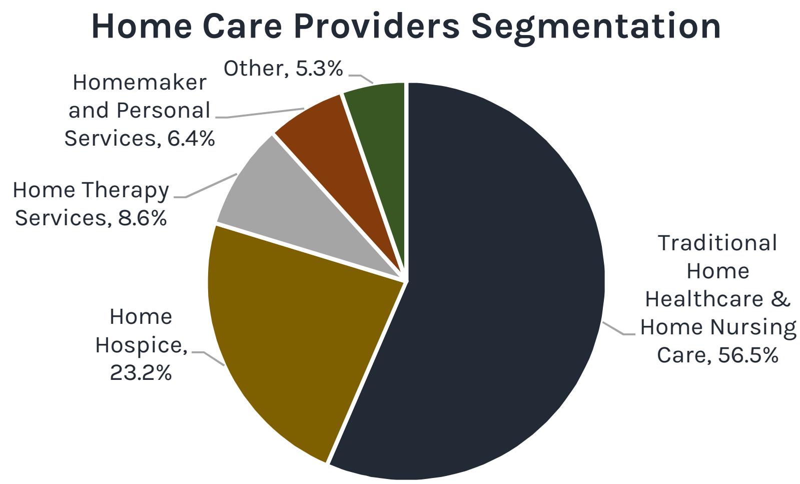
Home Care Providers:

The home care providers market provides both medical and non-medical services in the residences of patients, and includes nursing, companion, and physical therapy solutions. In 2016, the annual revenue for this industry was $92.5B and has an estimated annual growth rate of 6.1% through 2022.[v] Companies in this segment are primarily sole proprietorships, with 90% of industry operators maintaining no employees on payroll but only accounting for 10% of annual industry revenue. The aging population has increased demand for home care service, which is an alternative to long-term care, hospital visits, and assistance from family. Home care is actually seen as the preferable solution from the patient's perspective, as "90 percent of seniors want to stay at home" instead of repeatedly making hospital visits. At least half of these individuals will require daily assistance.[vi]

Home care has been increasingly adopting technological solutions for the elderly. One such solution is remote monitoring. Best Buy recently joined the ranks of firms that are adapting to this switch, and sells an "entry-level package of gear for $389.96" while also providing "a monitoring service for $29 a month."[vii] While this may initially appear to be a large price to pay, it is dwarfed by the $3,500 that would be paid monthly to live in an assisted-living facility. Despite the cost-efficiency of remote monitoring and the fact that 75% of caregivers want to use technology, only 7% currently make use of technology's capabilities.[viii] The remote monitoring market will not be ignored by 3RC, as the $50B industry is having a massive impact among established companies by providing a consistent flow of information and communication.

A large portion of industry revenue is generated from government healthcare programs, primarily Medicare and Medicaid. Estimates for 2017 indicate that Medicare and Medicaid will account for 39%

and 37% of expenditures respectively. Continuation of strong funding for these programs is critical for the long-term success of the industry, and adjustments could have a major impact on the home care provider segment.



One success factor for home care companies is their ability to partner with relevant care providers in tangential spaces. For example, a home care provider that specializes in Alzheimer's and Dementia hospice care services could strategically partner with an industry operator specializing in diabetic and congested heart failure patients. This would help companies ensure that they are capable of providing care to patients that have a wide range of disorders and reduce the churn rate of those patients. This could also lead to a natural acquisition opportunity and would have clear cost synergies through the elimination of repetitive administrative responsibilities, which implies that multiple expansion is possible in this space.

The home care industry is fragmented and, due to the high growth rates, will likely become more fragmented in the coming years. This creates a unique environment for 3RC, and identifying companies within this space that are prepared to capture this growth will provide a unique opportunity to create substantial returns. Additionally, an acquisition of a home care provider by an adjacent industry operator could increase the likelihood of outsized returns – for example, acquiring a home care provider as an add-on acquisition to a nursing care facility. The long-term care M&A market has experienced the influence of home care, as transaction volume in the long-term care sector decreased by 6% during 2016.[ix] This further solidifies the importance of home care providers in the health care spectrum and shows how they have been accelerating industry shifts. 3RC will be closely examining the market to identify companies that are utilizing the capabilities of technology and are positioned for growth to filter investment opportunities.

Behavioral Health:
The behavioral health market encompasses residential care and treatment for patients that have a variety of behavioral issues, including alcoholism, mental illness, and drug addiction. In 2016, the annual revenue for mental health and substance abuse centers was $18.7B (90% of the overall behavioral healthcare market) and is projected to grow at a steady 2.4% for the next five years.[x] In recent years, awareness and an improved understanding of treatment for these disorders has combined to fuel industry-wide growth. The ACA, or Affordable Care Act, defined mental health and substance abuse benefits to be essential and required coverage for those services. Companies that supply this industry with the unique materials required for treating behavioral health patients will experience similar growth, along with tangential businesses that service these centers.

There are a few specific areas that are expected to undertake a significant portion of the growth within this sector, including those that provide care for underserved and growing populations and focus on unique geographic areas that are prepared for increased services.[xi] Businesses also have the advantage of reduced capital expenditure requirements in this space, as there is little infrastructure investment involved.

Underserved and Growing Populations:

The aging Baby Boomer market has not been receiving adequate care and, as shown previously, is steadily growing as the average age increases. Current data suggests that over 2.5 million seniors are struggling with alcohol or drug problems throughout the United States.[xii] Moreover, they are " hospitalized just as often for alcohol-related problems as they are for heart attacks," showing the impact and necessity of these services.[xiii] These individuals often are in nursing homes as well, with half of the elderly in nursing homes having issues related to alcohol.

Behavioral health companies that are able to work in tandem with other care providers, including nursing homes, that service the elderly market should be able to capture additional market share by providing easier access to care.

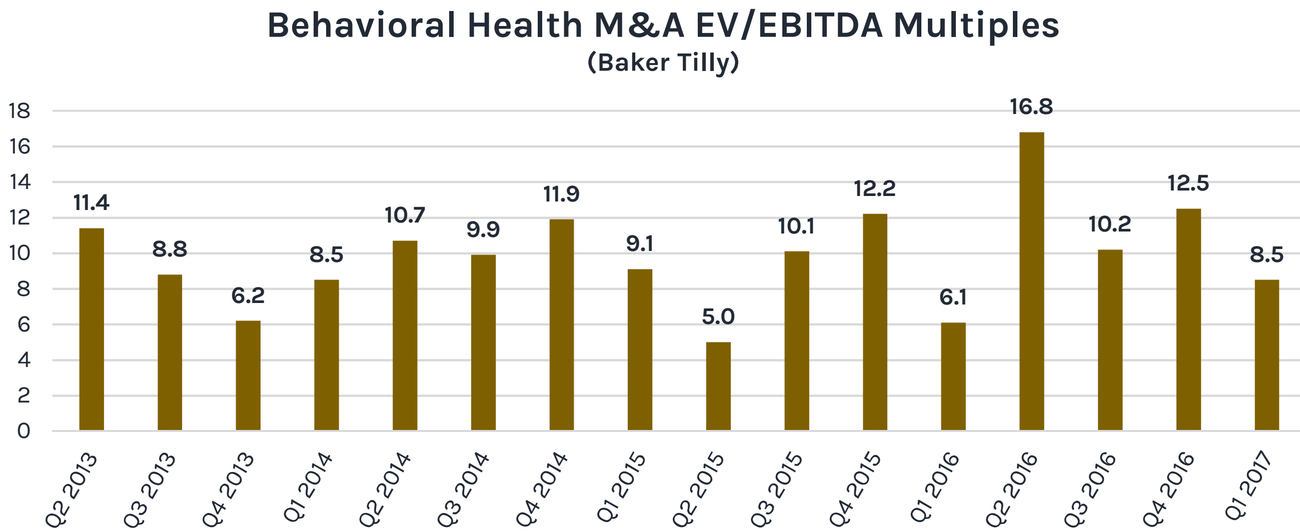
The pediatric population is experiencing a similar dynamic which has primed the segment for expansion. Only 10% of demand for pediatric behavioral health is being filled by the current system, illustrating the massive span of this service gap.[xiv] This divide could continue to grow in upcoming years as children are increasingly being enrolled in Medicaid programs across the nation. Firms that uniquely position themselves in the market could find ways to partner with schools or provide counseling through telehealth technology.

Geographic Optimization:

Reimbursement is often on a state-by-state basis, and adequate funding is not always available. In certain geographic locations, the market is already saturated with firms that are capable of providing the services that are demanded, but the in-person nature of the work emphasizes the importance of the local population. This is due to the fact that the market has historically been limited by travel distance of patients, as each center attracts patients from a certain radius.

Additionally, certain states have been more successful in securing and utilizing innovation grants to improve behavioral healthcare as well as implementing regulations that encourage further industry development. Autism services provides a great example, where "38 states have already enacted autism insurance reform laws that include coverage for autism services and an additional seven states are pursuing reform."[xv]

The behavioral health industry has historically been fragmented with no firm providing over 1% of total revenue, though consolidation is occurring and is projected to continue in the coming years. In 2016 there were 48 M&A transactions in the industry and through Q3 2017, there have already been 27 additional deals.[xvi] While strategic acquirers dominate the space, PE has made a significant impact with 179 M&A deals between 2005 and 2014.[xvii] EV/EBITDA multiples appear to be within range of 3RC, could potentially show expansion after being acquired by a strategic buyer, and have oscillated between 6-10x in the past two years.[xviii] 3RC will focus closely on the factors detailed above to uncover the most promising companies in the behavior health industry.



Nursing Care Facilities:

The nursing care facilities market provides extended care for patients that require daily, non-hospital assistance. Facility operators can focus on providing the social aspects and benefits for senior or the medical assistance aspect, but many offer both types of benefits to their residents. In 2016, the annual revenue for this industry was $128.7B and has an estimated annual growth rate of 3.7% through 2022.[xix] As the baby boomers age, demand will flow into nursing care facilities and bed count will increase as a result, driving growth. Despite this, 3RC believes that the nursing care facilities sector provides enticing investment opportunities in both the facilities themselves and tangential companies that operate along the supply chain.

Government expenditure also plays a large role in the nursing care facilities industry. In previous years, reduced government funding via Medicare and Medicaid reimbursement has impaired the ability for operators to translate high growth rates to the bottom line. However, government spending also manifests through contracts and in 2016, an estimated $506M was spent directly on nursing care facilities through awarding 7,000 contracts to over 1,300 different operators. As the aging population continues to impact the industry, the ability to attract government spending could be a unique success variable.

One factor that will determine how much of this growth can be captured by nursing care facilities is the ability to provide a higher-level of care for residents. Patients that are post-acute are more profitable for facility operators, primarily stemming from the amplified attention that is required for these patients which increases the probability of Medicare reimbursement.[xx] Moreover, managing and maintaining high occupancy rates, particularly within these higher-value patients, will ensure a strong and consistent revenue stream.

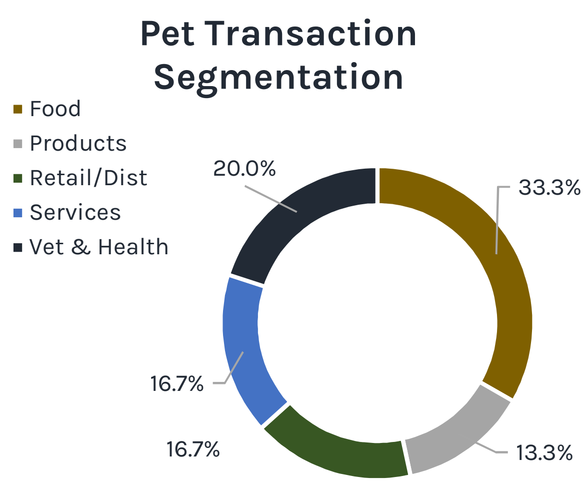
Nursing care facilities are also serviced by a wide variety of additional companies that provide the materials and staff required for operations. Companies that staff and provide nurses will receive more attention in the coming years as demand increases. Furthermore, due to the importance of preserving a high-quality employee base, the ability to source nurses that work well with patients is a cornerstone to success. Additional companies that provide food, medical supplies, and maintenance services will grow and are additional areas of interest for 3RC.

Many senior care facilities operate through a franchise model, which accounted for $3.2B of the industry and has an expected growth rate of 12.8% through 2021 following strong growth of 11.7% from 2011-2016.[xxi] Franchises offer unique benefits and provide entrepreneurs with the ability to function with an established brand and reliable methods. As demand in the market grows, franchises could arise as a solution to quickly increase the overall quantity of beds.

The projected growth rate in this market has made it an acquisition target for many firms, which has been reflected in the price-per-bed metric. In 2016, the price per bed reached $99,200 which is 15% higher than 2015 levels.[xxii] Acquisitions did not fall as a result, with 337 acquisitions in 2016 totaling $14.4B. Acquisition value has decreased, however, in 2017 and total transaction value during the second quarter was 45% less than 2016. 3RC will continue to closely watch this industry as it evolves and adapts to unique growth factors.

Heightened Need for Pet Care & Products

The Baby Boomers and Millennials have aligned through their combined interest in pets, which has provided the pet care and products sector with the opportunity to grow. Their unique alignment through the significance of pets in their lives has enabled a variety of companies to differentiate their products and services. The pet industry offers unique dynamics, including the fact that it is " recession resistant as pet owners tend not to cut back on pet food spending during an economic downturn.[xxiii]



3RC examined this tendency closely and determined that the most relevant sub-vertical is the Pet Grooming & Boarding industry. This area will be examined in detail below, and will elaborate on the specific aspects that makes firms unique.

Pet Grooming & Boarding:

The Pet Grooming & Boarding market includes guard dog and obedience training, boarding, animal shelters, and various grooming services. In 2016 the industry achieved $7.6B in revenue and is projected to grow at a rate of 7% over the next five years, continuing the solid growth that doubled the industry over the past ten years.[xxiv] This growth has largely been driven by the "humanization of pets" trend that has encouraged increased spending and quality of care across the pet ownership spectrum.[xxv]

A critical factor in analyzing this industry is determining how to create differentiation among various pet services firms. Barriers to entry are extremely low for the industry, and there are no companies that account for over 5% of market share and 95.5% of enterprises having less than 20 employees.[xxvi] What has determined success historically has been location to the end market, workforce capabilities, marketing efforts, and regulatory compliance.

Moving forward, different factors may help differentiate certain firms from the pack. Due to the wide variety of pet services that can be offered to customers, businesses that are capable of providing specialized services and obtaining unique skills will be able to attract a wider range of business. High-quality and knowledgeable employees will become increasingly important, as it can be difficult to hire individuals who have the niche skill set that the industry requires. Additional external competition is expected to come from technology-enabled services, though businesses that can integrate technology to provide higher-quality services could obtain greater market share.

As discussed, the historical fragmentation in the industry and overall capital availability has prompted an increase in M&A transactions in the past years. Businesses typically have at least $1-2M EBITDA or approximately $15M in sales before they are considered as acquisition targets for PE firms.[xxvii] Strategic buyers, however, still account for the majority of transactions, and were responsible for 88% of transactions in 2015.[xxviii] Once companies reach this level, there is significant competition to win these deals which has elevated multiples. Despite this, EV/EBITDA multiples for companies under $100M in revenue have been between 5.5-6.0x in the past three years and show potential for expansion as larger companies had a range of 7.8-9.0x over the same time period.

EV/EBITDA Multiples By Transaction Size
(Brooks, Houghton & Company)

Changing Consumer Preferences

In the *Shifting Demographics Manifestation* report, it was made clear that consumer preferences were shifting toward experience-based spending and customization. This trend was most prevalent within Millennials, who are entering their peak spending years and are fueling the personal consumption segment of the economy. After that analysis, it is difficult to understand exactly which products these trends could impact favorably, though what is certain is that the preferences are frequently shifting and inconsistent. The way that the consumers are making purchases has shown a distinct push, however, and indicates that the space has potential for 3RC.

Thus, 3RC aims to carefully examine investments with the tailwind of changing consumer preferences to ensure that the exposure is not based on fleeting and uncertain demand. 3RC is unlikely to make a subjective guess on what Millennials will demand in the coming years, but rather how the purchases will be made in the future based on thorough market analysis. One of the sub-verticals that appears promising is the intelligent vending space, which is discussed in further detail below.

Intelligent Vending:
In 2016, the vending machine operators market received $6.7B but maintained a low profit margin and only brought in $335.1M in profit.[xxix] In an attempt to boost profitability, expand product offering capabilities, and continue to grow top-line revenue, firms have been integrating technology at an increasing rate. These integrations have led to a new set of devices called intelligent vending machines, which integrate " LCD/touch-screen displays, cashless payment, telemetry…and anti-theft/anti-vandal cameras."[xxx]

As retail continues to fight against the headwind of e-commerce, intelligent vending has emerged as a solution. A vending machine is always accessible, and "has become a symbol of the world's quest for convenience, operating 24 hours around the clock, 7 days a week."[xxxi] Millennials and the broader consumer base, as shown through accelerated shipping provided by Amazon, are willing to pay for this convenience.

Vending companies and retailers, through the use of intelligent vending machines, have been able to expand their product offerings beyond food and drink. Cashless payment methods have increased sales per transaction, "especially for high-end products like smartphones and portable media players.[xxxii] Moreover, vending storefronts have started to materialize, and pools of vending machines operate like a robot-store, marketing various products, including music, books, movies, video games, perfumes and telephones and also provide services, such as mobile recharge, travel agency, insurance and ticket sales for events." [xxxiii]

This also opens the door to a variety of tangential service companies. In fact, "over half of the intelligent vending machine shipments will be retrofits, primarily adding a small LCD display and/or a card reader."[xxxiv] This means that "system integrators retrofit the machine by installing pre-qualified kits from vendors specializing in this field." Additionally, marketing companies that produce and support high-quality, touchscreen-enabled video will receive businesses by providing vending companies with unique solutions.

As the vending industry continues to evolve and adapt to the shifting purchasing preferences of consumers, 3RC believes that there is significant opportunity for investments. By operating within the buying methods of customers, vending companies steer clear of many product-specific risks that would drastically increase investment variability. As 3RC examines investments in this sector we will center our focus on the capabilities of the technology that is integrated and tangential service companies that operate in the field.

The manifestations of the *Shifting Demographics* Factor of Influence have created three specific industries of interest for 3RC. Following the investigation and analysis conducted in this report, 3RC is prepared to uncover the most promising investments that relate to these trends. In the next volume of the Strategy Report series, 3RC will examine and discuss the most relevant Areas of Interest resulting from the manifestations of *Rising Conflicts.*

[i] U.S. Centers for Medicare and Medicaid Services
[ii] IBISWorld
[iii] IBISWorld
[iv] Capstone Partners
[v] IBISWorld
[vi] UnitedHealthcare Retiree Solutions
[vii] Bloomberg Businessweek
[viii] AARP
[ix] Irving Levin Associates
[x] IBISWorld
[xi] Behavioral Health Executive
[xii] University of Pennsylvania Health System
[xiii] University of Pennsylvania Health System
[xiv] AHP Healthcare Solutions
[xv] Behavioral Health Executive
[xvi] Capstone Partners
[xvii] Braff Group
[xviii] Baker Tilly
[xix] IBISWorld
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[xxii] Long Term Care Provider
[xxiii] Brooks, Houghton & Company
[xxiv] IBISWorld
[xxv] Brooks, Houghton & Company
[xxvi] IBISWorld
[xxvii] MHT Partners
[xxviii] Peakstone Group
[xxix] IBISWorld
[xxx] Intel
[xxxi] Frost & Sullivan
[xxxii] Intel
[xxxiii] Frost & Sullivan
[xxxiv] Frost & Sullivan