

Privcap/ Briefing

Context for Private Capital Investment

Q1 2013

The Healthcare Opportunity

An executive summary of the Privcap thought-leadership series on private equity investing in America's dynamic healthcare sector



Plus:

*Expert Q&A with Tammy Hill, Managing Partner,
Transaction Advisory Services, McGladrey*

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The Healthcare Opportunity

Key Findings

1. Management and execution are critical in an uncertain healthcare environment
2. Reimbursement and “government” risks are hard to measure—and fatal if miscalculated
3. Some healthcare sectors should be avoided altogether
4. Companies that provide cost-saving care and products are best bets
5. Regularly update due diligence to reflect the changing environment

The Panelists



James Elrod
Managing Director
Vestar Capital Partners



Tammy Hill
Managing Partner
Transaction Advisory Services
McGladrey



Sherrill Neff
Founding Partner
Quaker Partners

1. Management and execution are critical in today's uncertain healthcare environment

The healthcare industry is volatile. Technology is constantly and rapidly evolving, and government efforts at reform have injected additional uncertainty into the market. In this environment, highly skilled management teams are critical.

“It used to be an old saw,” says James Elrod of Vestar Capital Partners. “Give me an A management team and

a C business any day.’ We all used to pay lip service to it, but it’s really true. To hear the CEO’s or the entrepreneur’s plan on how they’re going to build out the team to realize the opportunity is much more important than it used to be because of the changing landscape. To have confidence that this person has the vision to do that is really important these days.”

Private equity firms don’t want to buy a company and watch the management team retire to a beach somewhere. They need the team to stay on, execute the plan, and drive success.

“That’s absolutely true in the deals we see,” said Tammy Hill of McGladrey. “Most of the entrepreneurs in the healthcare sector, as opposed to an older industry like



Deal Flow Today

Many observers thought deals would surge after the Supreme Court upheld most of the Affordable Care Act, but there has yet to be a sizable increase. The deals getting done are mostly in the middle market, noted Tammy Hill, partner at McGladrey.

“Most of what we see are one-off deals where the buyers are pursuing smaller niche players who are geographically concentrated,” she said. “It’s not a situation where the deal flow is coming from big investment banks and they’re bringing it to a lot of buyers. It’s people going after the players because of the expertise they have and the operating partners that they team up with.”

A defining feature on the seller side of today’s market is management teams more interested in growing than in cashing out. They’re even willing to leave equity on the table to make it happen. “For someone who’s started a company and they don’t have the capital to expand geographically, the opportunity is just right. Sometimes it’s a requirement to leave a little bit of equity on the table, but sometimes it’s also a desire on their part to, ‘Hey, come help me grow this.’”

manufacturing, these are relatively young entrepreneurs, and our clients aren’t interested in seeing them go away. Part of the investment they’re making is in the management team, the toplevel of management.”

2. Reimbursement and “government” risks are hard to measure and fatal if miscalculated

Healthcare investing has always involved uncertainty around reimbursement, regulation, and other “government” risks—politicians doing things that are hard to foresee. All the participants agreed that government risk is now at an all-time high, not only because the White House is pushing through reform but because the government is such a dominant force in healthcare regulation and payment.

“Almost all the products that come through our companies have to deal with the Food and Drug Administration,” said Sherrill Neff of Quaker Partners. “And for the past five years, since the Vioxx blowup, the entire attention of the agency has been shifted to the safety end of the pendulum.”

Once a product is approved, a company has to figure out the reimbursement end of the equation, and here again the government plays a heavyweight role. Neff pointed out that the federal government now provides 45 cents out of every healthcare dollar spent—and predicted that spending would be very difficult.

“Our experience has been that you’re pushed into the consulting world, maybe with former administrators, et cetera, to give you a sense of what it was like when they were there,” he said. “But it’s a new game, and I’m not sure that anybody’s crystal ball, in terms of the next two or three years on the federal level, is going to be worth a lot.”

3. Some healthcare sectors should be avoided altogether

All three participants said that there are some sectors of healthcare where the risks make investment unwise. Elrod said that capital-intensive services in the target zone for reimbursement cutbacks don’t look good for

the next three to five years, even if they're services that are in demand.

"Nursing homes would be an example," he noted. "Very much a needed service, but with the reimbursement focus that they've experienced recently and the cost of admission—where you're kind of a genius if you have 93 percent occupancy and struggling if you have 89 percent occupancy—means it's just not an equation where it makes sense."

Neff said there are areas of therapeutics his firm "absolutely avoids," including large-market drugs that require extensive patient-safety data and clinical trials, and "me too" products like stents.

Tammy Hill said clients of McGladrey are steering clear of companies whose profits depend on long treatments that historically have not had good outcomes. "It's more about the innovation and how can you improve the outcomes, how can you get people out of the hospital."

4. Companies that provide cost-saving care and products are best bets

The most urgent issue in U.S. healthcare is cost. This logically makes companies with products and services that cut costs attractive investments. "One of the themes that we're quite focused on as investors right now is how to tackle significant problems in medical care or medical delivery with solutions that are both cost-effective and result in better quality," Neff said.

He gave an example, a recent Quaker Partners investment called NovaSom. The company sells an in-home device for diagnosing sleep apnea, a condition that affects some 28 million Americans and is linked to a wide range of very expensive, very serious medical conditions, from cancer to heart disease.

People who suspect they suffer from sleep apnea have traditionally checked into a clinic run by a hospital to spend the night hooked up to an array of electrodes and sensors. It's uncomfortable and expensive—anywhere from \$1,500 to \$3,000 per night—preventing more patients from getting tested.



Sherrill Neff

Diligence Is a Two-Way Street

In the past, private equity firms have simply chosen the companies they want to acquire. These days, however, healthcare companies are being choosy as well.

"Entrepreneurs who have the ability to be selective, which are the ones we all want, spend a lot of their time doing due diligence on us and deciding whether it's a marriage they want," said Sherrill Neff, founding partner at Quaker Partners. "It's very important to be able to show them the strategic relationships we can bring that will help grow their business and set the stage for exits down the road, our ability to help them recruit teams, et cetera. That's very, very important to them."

He noted that CEOs and management teams are doing a lot of investigating up front to determine whether or not a particular private equity firm is a good fit. "They check with other CEOs to see how we've behaved in other companies. And we frequently find a CEO who will have a desire to focus on one of two or three partners as the board member and may have anecdotal evidence that you don't want a fourth partner as the board member. And so there's a lot of testing and probing on the part of the CEOs."

NovaSom appeals to payers because it cuts costs and helps more people get diagnosed for sleep apnea before the disorder leads to more serious and expensive conditions. NovaSom appeals to patients because they don't have to spend the night in a hospital bed. "We can put into patients' hands something that's less costly for the payers—and they can significantly increase their volume without increasing their overall cost and get more people on appropriate treatment," Neff said. "That's typical of a theme that we're trying to address."



Public vs. Private

It's the ultimate question for every growing company: go public or get acquired? It's especially relevant for healthcare companies, which are seeing strong multiples on the private-sale side but may also be tempted to try their luck in the public market.

Jim Elrod, managing director at Vestar Capital Partners, said that with a choppy and unpredictable IPO market, private equity acquisition is still the preferred exit.

"The problem we face today is that the public market is an on-again, off-again experience and pretty unreliable in terms of when the gates are going to be open," he said.

"That has driven more transactions into the hands of private equity."

5. Regularly update due diligence to reflect the changing environment

Due diligence is a vital step prior to any investment. But the areas of concern change over time. What was diligence a few years ago could be negligence today. In an industry shifting as quickly as healthcare, private equity partners must constantly update their list of red flags.

Elrod said Vestar now pays particularly close attention to organizational details. "One of the items we look at is not whether the entrepreneur or the CEO has simply a vision for where the business could go but whether they've got the organizational chart plotted out on what they need to do to make the investment thesis come to fruition."

Hill said several high-profile cases of payments fraud in the past decade have forced much closer scrutiny of reimbursement, especially government reimbursement. "In a situation where the up-front diligence would start to point out potential problems on the billing or the collection side, it would most likely be a deal killer."

Neff agreed that reimbursement must be an area of concern in any healthcare investment. He said Quaker Partners has walked away from several seemingly attractive deals recently because the reimbursement now enjoyed by those companies was "too good to be true."

"In one case, since we turned down the deal, other people invested, and it has in fact proved out the way we suspected it would."

He agreed that GPs these days must be able to find companies that create value and, just as important, to dodge those deals that will destroy value. "We make all our partners take dancing lessons." ♦

Expert Q&A

with Tammy Hill, Partner
Transaction Advisory Services
McGladrey



What challenges do private equity firms face investing in the many sub-industries within the healthcare sector?

There are so many regulatory issues and other factors that affect those industries that private equity groups are looking everywhere they can to, number one, confirm their investment thesis, but also, in many cases, help them, once they've done acquisitions—how to grow, how to be more cost-effective, looking for the right add-on acquisitions. All of the things that are going to make that investment successful.

How does McGladrey support private equity investments in the healthcare sector?

We have a consulting practice, and also audit and tax, with a fairly good-size number of people within McGladrey that specialize in and literally spend 100 percent of their time in the healthcare area. These professionals exclusively serve healthcare sectors such as classic hospitals and physician practices, and also some of the one-off sectors like ambulatory surgical centers, equipment and service providers, and other kinds of providers.

Series / The Healthcare Opportunity



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- ↗ Healthcare Thesis: Two GPs Share Deal Details
- ↗ What's Driving Healthcare Deal Flow?
- ↗ Healthcare Due Diligence and Dealbreakers
- ↗ Expert Q&A with Tammy Hill of McGladrey

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