Private Healthcare Investor

Healthcare: The past informs the future

In the first of a two-part series, Robert Hatch of Constitution Capital Partners explores some key takeaways for investors through analyzing over 1,000 healthcare buyouts, dating back to 1987.

A stalling global economy, tighter credit conditions and declining profit margins are forcing many investors to prepare for a cyclical downturn.

Just as recessions tend to influence fashion, a deceleration in the economy will almost always influence general partners and the areas of the market that demand their attention. And even if healthcare never really went out of fashion among PE investors, the shifting sentiment in the public markets means that the sector is back in vogue for GPs. The question, however, is: what have they learned since the last downturn?

Healthcare's reputation as a safe haven is indeed well earned. According to our internal database of investments, which captures 1,018 healthcare buyouts dating back to 1987, the best vintage years for the sector coincide with either outright recessionary environments or periods of waning optimism.

For instance, with the exception of 1995, the year after the Clinton healthcare plan died, the two best years for PE investments in the sector were in 2001 and 2003, when GPs active in the sector produced return multiples significantly above the average. The year of the stock market crash, 1987, also registered as the fourth most profitable year for healthcare LBOs.

With growth becoming harder to find and the economic cycle maturing, the unabated spending in the US healthcare market makes the space an obvious destination for investors. The Affordable Care Act (ACA), while it has led to margin pressure with its focus on cost containment, has served to drive volumes higher thanks to a substantial reduction in uninsured patients.

But just as GPs realise healthcare offers an uncorrelated and attractive source of growth, the space is not without pitfalls. When looking through the lens of what hasn't worked, it becomes clear that the areas that have proven to be the most successful are those segments within healthcare that best lend themselves to the value-creation PE traditionally brings to the table.

Out of the 1,018 healthcare buyouts in our database spanning across the industry, 532 of the deals represent realised investments. While most would be considered successful, with over a quarter returning more than 4x equity, 95 of the realised investments resulted in losses for limited partners. So exactly what were the lessons learned?

One out of every four of the money-losing deals came from the pharmaceuticals sector, while healthcare technology represented 20% of the failed investments. And even as biotech failures weren't among the most common, the losses in the segment were the most spectacular, with a loss ratio – dividing the total losses by total realised deals – that equated to 35 percent. The loss ratios also tended to skew higher for deals with equity commitments of $10 million and below.

The takeaways support the idea that the biggest threats facing investors in healthcare revolve around development risk, whether it's the time required or uncertainty involved in commercialising earlier-stage treatments or resistance in driving adoption of new technology and IT processes. This is reflected by the larger loss ratios for the deals with smaller equity commitments. Moreover, deals employing higher leverage take on even more risk in healthcare, where regulations and government intervention can have a sudden and tremendous impact on cash flows.

It is also why it's so critical for GPs to understand the revenue model of the businesses they're backing and ultimately who is paying for the service, be it the patient, the government or the insurance company.

Indeed, reimbursement risk remains one of the biggest threats for LBOs, particularly as the ACA has re-oriented the reimbursement system to focus not on the volume of services provided but rather on the value of the care. Not to be overlooked, the higher deductibles that have accompanied the implementation of ACA have also had an effect on elective procedures, as patients more closely scrutinise out-of-pocket costs and may choose to bypass certain treatments altogether.

But even as the money-losing investments can help inform future strategy, it's the consistency and success of firms in the sector that drive ongoing GP interest. Since we've been tracking healthcare buyouts, these investments – at least those in our database – have produced a median realised return of 3.3x invested equity.

Pharmaceuticals, which yielded the most money-losing investments, at the same time had the highest average return, at 5.5x equity, highlighting the high risk / high reward opportunity of the segment. Healthcare Services and Managed Healthcare, which seeks to reduce costs and improve the quality of care, were also among the top performing sectors, with average returns in excess of 4x equity.

We continue to see opportunities in the sector, particularly as the spending in the space will create a tailwind for years to come. The challenge for investors, even those well versed on where historic returns have come from, will be the changing dynamics introduced by ACA. This is a topic that we'll address in the second part of this two-part series on healthcare investing.

Robert Hatch is a partner of Constitution Capital Partners.

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