Private Healthcare Investor

Healthcare: Still a safe haven following the ACA?

In the second of a two-part series, Constitution Capital Partners' Robert Hatch highlights that while healthcare has earned its reputation as a shelter sector, in the wake of a massive regulatory overhaul, potential hazards may exist.

If there is one certainty in healthcare, it's that spending in the sector should grow steadily for decades to come. An ageing Baby Boomer population and increasing life expectancies together create a long-term tailwind that investors have recognised for years.

If there is one uncertainty, however, it's how the Affordable Care Act may affect healthcare's standing as a shelter sector during an economic slowdown even amid the projected spending growth.

The ACA has, for instance, triggered a major transformation of the healthcare industry and so far unleashed a wave of M&A, as payers and providers seek to reduce costs, enhance operational efficiencies, and improve the quality of care. The focus in this new, more patient-centric healthcare model has placed far more emphasis on the value of care delivered. And both strategic buyers and PE investors have been actively seeking deals that can help address these new demands.

In 2015, private equity firms closed on more than 500 new healthcare investments, worth a combined $66 billion, according to PitchBook. If one sector stood out from the rest it was healthcare services, as sponsors tallied $44 billion worth of transactions in this segment alone.

For private equity, the popularity of the services segment is due to a couple of factors. These investments help address one of the most pressing needs for long-term capital within healthcare. Additionally, the transformation currently underway within the services segment lends itself to the PE model for driving growth.

In part triggered by ACA's focus on costs, care is moving from the traditional physician's office and hospital settings to far less expensive acute-care facilities or outpatient clinics.

In many respects, this is classic terrain for PE's buy-and-build strategies that add scale, create back-office efficiencies, and drive multiple expansion. This is particularly true for small- and mid-market firms. Recently, we've also witnessed a number of rollups focused on dental, dermatology, radiology and anesthesiology practices, in addition to ongoing interest in home-health agencies, inpatient rehab and skilled-nursing facilities.

The value add of private equity has been well documented, but in healthcare and the services segment in particular the effect can be even more pronounced. For instance, through either augmenting or bringing in the right management team, and complementing these executives with a highly-qualified board, private equity investors can help professionalise these assets with executives who can quickly scale a business and drive profitable growth.

Many healthcare-focused PE firms also come into these investments with a thorough understanding of the opportunities available and already have a strategy to target new verticals or fill in the white space of a given region. In addition, many GPs have navigated the regulatory demands of the sector and witnessed the evolution prior to the ACA and then following its implementation. Experienced sponsors, in this regard, will bring the kind of clarity that only comes with having done it before.

Beyond addressing an obvious market need, the risk profile of the services segment is far more befitting PE, as are other "healthcare light" areas of the market, a term Bain & Co. uses to describe areas of the market with less exposure to development or reimbursement risk.

This is especially true during an election season when the political rhetoric has taken dead aim at healthcare costs. Hillary Clinton, for one, has made drug costs a key focus of her campaign and she has repeatedly touted plans to eliminate certain tax breaks for the pharmaceutical companies, regulate increases in research spending, and force the industry to adopt lower prices.

Medical devices carry similar uncertainty. While the 2.3% excise tax – part of the sweeping ACA legislation – was temporarily suspended, cuts in Medicare reimbursements and uncertainty around the new bundled pricing model (versus "fee-for- service") are both areas of concern for device makers.

Even healthcare IT, while it promises to lower costs and improve clinical outcomes, has so far been a bit slow on the uptake. An Accenture survey last year, for instance, found that 58% of US doctors find electronic health records systems hard to use, while roughly 70% claim that healthcare IT has decreased the amount of time they can spend with patients.

So given all of these concerns, we anticipate that private equity firms will continue to focus on the healthcare light areas of the market, segments such as services or managed care that are focused on cost containment and feature limited reimbursement exposure.

One other factor worth noting is that while healthcare has historically outperformed during periods of economic unrest, the popularity of the sector among dealmakers in the wake of the ACA's implementation means that assets are by no means considered inexpensive today. As one healthcare investor remarked at a March private equity conference at Harvard Business School, "Assets in the small- and middle-market are being priced to perfection."

Put another way, success for GPs today requires that investors not only "buy right" but also take care to minimise risks and ensure that they're coming in with a strategy to add material value post close. That has been the recipe for success over time, and while the ACA may make the risks more pronounced, those GPs that understand the sector and where they fit within it will be able to capitalise on the ongoing evolution of the industry and the promise for growth in the years to come.

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