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U.S. Research Report

Healthcare Services

Q4 2021

Healthcare Finance Trends: The Rise of Private Equity Investment

Defining Private Equity

In general terms, private equity (PE) primarily refers to investment funds, usually in the form of limited partnerships, that buy and restructure companies. As the name suggests, PE funds are not publicly traded. The term private equity also encompasses hedge funds, closed-end funds and unit investment trusts.

Private-equity investments are mostly made by a PE firm, venture capital (VC) or angel investor. Although their strategies vary, all forms of PE investment provide working capital to a target company to support expansion, product development and restructuring activities.

The most common PE investment strategies include leveraged buyouts, VC, growth capital, distressed investments and mezzanine capital. Whereas leveraged buyouts mostly involve gaining majority control of an existing firm, VC investments mainly target younger, emerging companies without obtaining majority control. In addition, as the name suggests, leveraged buyouts make considerable use of debt finance to acquire companies.

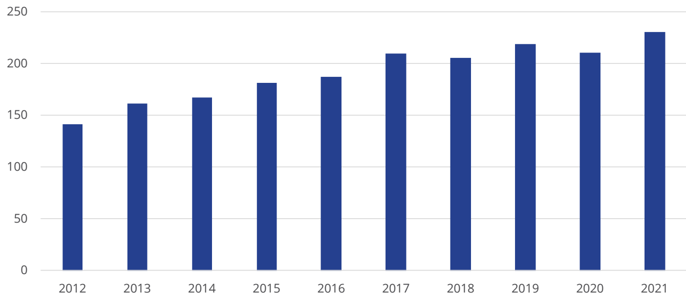
In addition to acquiring or funding companies, PE investment also can target certain asset classes and activities, most notably real estate, in the form of Real Estate Investment Trusts (REITs), infrastructure and utilities.

The size of the PE industry in the U.S. is estimated at $230.6 billion of revenue as of July 2021 across 12,503 businesses. Total value growth is forecast to be 9.4% in 2021, which would bring the five-year annual growth rate to 4.3%. Growth over the next five years through 2026 is expected to exceed this pace posting a 5.5% annualized rate, which would take total PE revenue to $301.1 billion.

Key Findings

- *Healthcare businesses have become increasingly attractive to private equity (PE) investors. Growth in PE investment in healthcare has been outpacing broader PE deal activity since 2009.*
- *Investors are attracted to healthcare due to the constancy of demand, which is rising further as the U.S. population ages.*
- *Healthcare is viewed as being more recession-resistant than most other asset classes with long-term performance potential and limited volatility.*
- *The COVID-19 pandemic further heightened investor interest due to its exponential impact on demand for healthcare services and therapies.*
- *The annual PE healthcare deal total rose to 2,360 in 2020 - the highest annual total on record. 2021 is on track to post a similar performance.*
- *Acquisitions of healthcare service providers, particularly physician practices, remain the dominant focus for PE investors.*
- *Urgent care was one of the earliest healthcare services to attract PE funds, but interest looks to have peaked.*
- *Look for PE investors in healthcare to come under increasing scrutiny. It is critical that the quality of service and outcomes are sustained and improved upon, without passing on notably higher costs to clients.*

U.S. Private Equity: Total Revenue ($ billion)



Source: IBISWorld.com

Private equity funds and hedge funds dominate the PE industry accounting for 49.1% and 45% respectively of current industry revenue. The remaining share is comprised of closed-end funds (4.6%) and unit investment trusts (1.3%).

In terms of investor composition, pension funds account for one-third of PE holdings, followed by high net-worth individuals/managers at 14.9% and insurance companies, which have a 12.3% share.

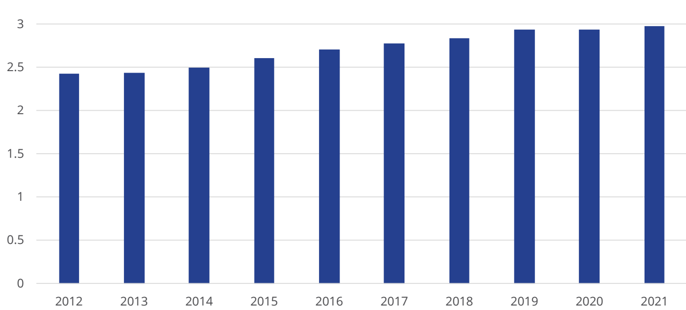
Four states lead the PE landscape: California, New York, Florida and Texas. Driven by technology firms and start-ups in Silicon Valley, California alone accounts for 20.4% of industry funds. New York follows with an 8.3% share.

The Healthcare Industry: Revenue and Composition

Annual revenue generated by the Healthcare and Social Assistance sector is estimated at $3 trillion. The sector generated $306.6 billion in profit over the past year representing a 10.3% profit margin. Private health insurance and payments from Medicare and Medicaid account for the majority of healthcare revenue with shares of 36.7% and 26.7%, respectively

Healthcare revenue grew at a 1.9% annualized rate over the past five years to 2021, while profits increased by 3.3% per year. Revenues are projected to grow at a 1.4% annualized rate from 2021 to 2026.

U.S. Healthcare Sector: Total Revenue ($ trillion)

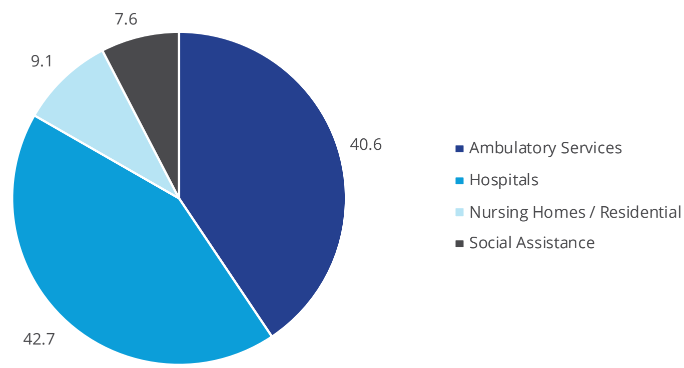


Source: IBISWorld.com

In recent years, healthcare revenue growth has been driven by rising healthcare spending and federal funding for Medicare and Medicaid. Combined private and public spending on healthcare grew at a 2.6% annualized rate over five years to 2021 to $3.6 trillion. In addition, federal funding grew by a 3.7% annualized rate over the same period.

Healthcare can be divided into four sub-sectors led by hospitals, which account for 42.7% of revenue, and ambulatory healthcare services with 40.6%. The remaining two sectors are nursing homes and residential facilities and social assistance with revenue shares of 9.1% and 7.6%, respectively.

U.S. Healthcare: Revenue Share by Sector (%)



Source: IBISWorld.com

Looking forward through 2026, healthcare revenue is expected to rise steadily, driven by an aging and growing population needing more healthcare services, particularly nursing and residential care facilities.

Conversely hospitals, which have already been severely impacted by the costs associated with the COVID-19 pandemic, are projected to face mounting losses as expenditures continue to increase, particularly for frontline workers.

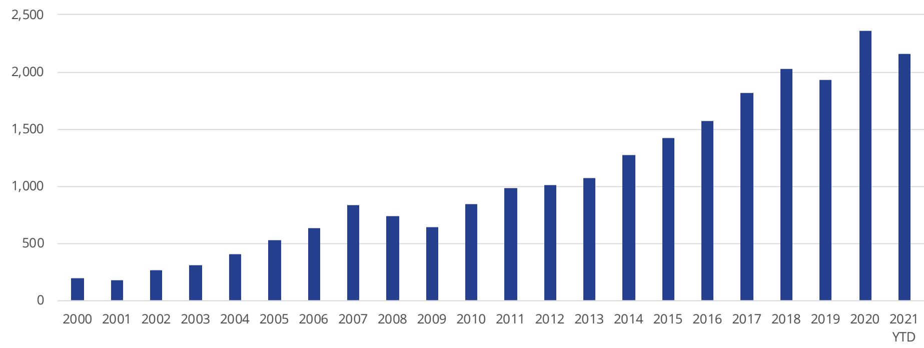
Cost control and increasing efficiency remain paramount concerns for the healthcare industry. However, fresh capital is required to invest in new facilities, equipment, technology, staff and training. This should drive increased levels of M&A activity and private equity investment.

Private Equity Investment in Healthcare

Healthcare businesses have become increasingly attractive to private equity investors. Growth in PE investment in healthcare has been outpacing broader PE deal activity since 2009. As of year-end 2019, healthcare accounted for 14% of total PE deal value and 12.3% of PE deal count.

Analysis of the number of PE healthcare transactions illustrates the extent to which investment in the healthcare sector has ramped up. Data from Pitchbook identifies 191 PE healthcare deals in the year 2000. By 2020, the annual deal total had risen more than twelve-fold to 2,360, the highest annual total on record. 2021 is on track to post a similar performance, with 1,975 PE healthcare deals closed during the first nine months of the year.

U.S. Healthcare: Private Equity Transactions / Year



Source: PitchBook

Investment in U.S. healthcare is not just restricted to domestic funds. Data tracking the top 10 PE healthcare investors from 2007 to 2020 shows that the lead investor was Alpinvest Partners, based in Amsterdam, which placed $43.5 billion in deal value during this period. Funds based in London and Toronto also feature in the top 10. The leading domestic investor was Kohlberg Kravis Roberts, based in New York, which invested $42.9 billion across 99 deals during the same period.

Investors are attracted to healthcare because the demand for healthcare services constantly needs to rise further as the U.S. population ages. This makes the sector more recession-resistant, as evidenced by its robust performance during the global financial crisis. Accordingly, the healthcare sector is viewed as having long-term performance potential coupled with less volatility. The COVID-19 pandemic has served to heighten investor demand further due to its exponential impact on demand for healthcare services and therapies.

From an investor perspective, the healthcare industry divides into two broad categories: healthcare equipment and services, and pharmaceuticals, biotechnology and life sciences. This report primarily focuses on the first category, but some general context on both is provided below.

Healthcare Equipment & Services

This category has three components: providers and services, equipment and supplies and healthcare technology (healthtech).

Healthcare providers and services are the largest area for PE investment in healthcare, accounting for almost 47% of deals by value and 64% of deals by number. Within this sub-sector, there has been an increasing investor focus on retail healthcare assets which have attractive profit margins and continued growth potential, with many patients paying out-of-pocket for these services, thereby reducing insurance reimbursement risk.

Healthcare equipment and supplies, also known as medical technology (medtech), includes instruments, machines and apparatus used in the diagnosis and treatment of illnesses. There is strong corporate interest in this sector, limiting PE investment to mostly smaller assets.

Heathtech is seeing a rapid increase in PE interest. Healthtech includes the usage of cloud-based infrastructure and big data analysis in the healthcare sector. While PE investment initially focused on electronic medical records, it has widened to cover areas such as decision/risk analysis and software development by healthcare enterprise systems.

Pharmaceuticals, Biotechnology & Life Sciences

While investment in pharma and biotech remains mostly the remit of VC funding, PE interest is increasing and gravitates to areas with a lower risk profile, such as companies with branded medications and lower R&D outlays. PE investment in this sub-sector also focuses on proven consumer products with limited pricing pressure such as EQT Partners' buyout of the skincare product firm Galderma.

Physician Services Dominate PE Investment

Acquisitions of healthcare service providers remain the dominant focus for PE investors. Over the past five years, healthcare service transactions, the bulk of which are provider deals, accounted for more than 70% of U.S. PE healthcare buyouts and more than 10% of U.S. PE deals in total.

The provider landscape remains highly fragmented. There are thousands of small, privately owned businesses, thereby creating the opportunity for PE acquisitions to consolidate such assets to drive returns through economies of scale.

In addition to rolling up existing and new holdings, PE firms are also targeting specialist operations such as dermatology, ophthalmology and orthopedics that have high reimbursement rates. Specialty practices also have a higher proportion of clients able to pay out-of-pocket.

Primary care practices also remain attractive. The higher proportion of Medicare and Medicaid patients provides guaranteed reimbursement rates instead of negotiating with major private insurance companies. One way that PE investors are countering this issue is to acquire increasing numbers of doctors and practices in a specific locale to provide greater leverage in such negotiations.

A recent example is Clayton, Dubilier & Rice's acquisition of Millennium Physician Group in Florida with more than 300 providers. Similarly, one of 2021's largest transactions saw Cano Health acquire University Health Care in South Florida for $600 million, creating a combined company with more than 1,000 staff and providers across 88 locations.

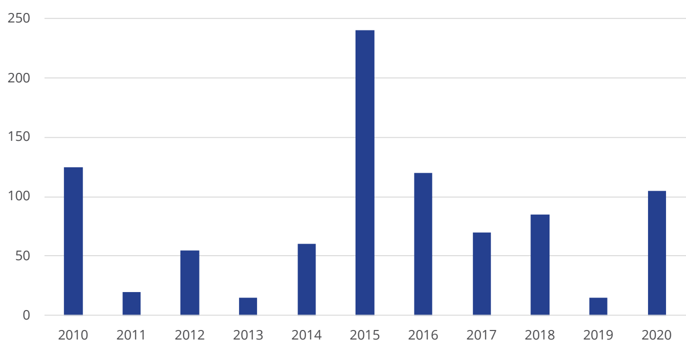
While primary care has not historically been a high margin business, such strategies, when successfully managed, are predicated on the belief that larger numbers increase efficiency and promote economies of scale. Consolidation also can enable providers to offer new services to attract and retain clients.

High levels of provider acquisitions have resulted in an increasingly lower number of physicians operating in private practice. Recent research by Avalere Health and the Physicians Advocacy Institute estimates that almost 70% of physicians are employed by hospitals or corporations such as private equity firms and insurance companies. Approximately 48,000 physicians are estimated to have quit private practice in 2019 and 2020 combined. The majority of these physicians, 29,800 in total, moved to corporate entities – predominantly PE firms and insurance companies.

Has PE Investment in Urgent Care Reached its Peak?

Urgent care was one of the earliest healthcare services to attract PE interest. The core strategy was to add clinics to existing providers and sell them at a profit after a short hold-period. Although exact counts are difficult to obtain due to PE firms' lack of disclosure requirements, it is estimated that there have been at least 30 PE urgent care acquisitions over the past 10 years involving close to 900 locations.

Urgent Care: Private Equity Deals (Locations / Year)



Source: Irving Levin Associates

However, the urgent care sector has shifted in recent years. There are now 10,400 centers across the U.S., with some locations, such as Atlanta and Dallas, estimated to have reached saturation levels. Health systems and insurers have invested heavily in urgent care and now control a combined 75% of such centers, while the PE ownership share is closer to 10%.

In addition, the growing popularity of telehealth presents a challenge to urgent care centers. Telehealth has increased exponentially with the pandemic, leading providers to diagnose an increasing number of minor health issues over video rather than in-person.

One option for PE funds is to add more urgent care sites in less saturated areas to create larger companies that can be sold at a profit. However, a potential roadblock is if trading of existing urgent care assets is necessary to finance new acquisitions. PE funds are being forced to hold some assets for longer than the initially planned period and there is anecdotal evidence that some trades have fallen through.

Outlook & Challenges

PE interest in healthcare services is set to continue to expand with the acquisition and consolidation of private provider practices at its core. However, increased diversification is anticipated to spread risk and maximize returns. This relates both to asset location and the healthcare services that are targeted.

Service areas already attracting PE interest that are expected to grow in importance include ambulatory care, healthcare technology and telemedicine, long-term care and senior living, behavioral health, managed care and diagnostic services.

Look for PE investors in healthcare to come under increased scrutiny. Restructuring often results in cutting overheads, most notably staffing. It is critical that service quality and outcomes are sustained and improved upon without passing on notably higher costs to clients. Investment in innovation and technology can result in new and improved services.

The Centers for Medicare and Medicaid Services (CMS) recently announced that it is seeking greater transparency in how PE owned healthcare firms operate. There is a perception in some areas that consolidation by PE owners can adversely impact the quality of care. The CMS is also investigating whether profits are being boosted by steering patients to non-essential procedures.

In a recent Modern Healthcare article, Pauline Lapin of the CMS is quoted as saying: "It's not always clear who is in control and making decisions for an organization. We need better transparency and line of sight into ownership, governance and leadership. For example: Who is on the board and what do they stand to gain financially?"

Another challenge for PE investors, which could be the subject of its own report, is the complex regulatory and reimbursement framework healthcare businesses and services operate. Accordingly, PE healthcare transactions are unique and, to some extent, more challenging than other PE deals. However, while legislation can always change, the high volume and sustained interest in healthcare by PE funds show that this framework can be successfully navigated.

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