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PRIVATE EQUITY: FRIEND OR FOE TO HEALTHCARE?

ANALYSIS | BY JACK O'BRIEN | AUGUST 12, 2021

Finance executives evaluate the role of private equity in the healthcare industry and forecast how the dynamic will evolve. When private equity firms invest in healthcare, who benefits?

KEY TAKEAWAYS

- Private equity firms must consider how to make transactions advantageous for medical groups beyond the initial financial windfall.
- Physician practices must do their due diligence when considering a potential deal with a private equity firm.
- The alignment between healthcare's mission and economics is key. PE firms must find a way to build economic models that do not simply lead to near-term profits and cause damage to the healthcare ecosystem.

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Healthcare has long been a target for private equity (PE) firms seeking high returns in a critical segment of the economy. This trend started more than a decade ago as PE firms acquired hospitals and acute care sites before looking at physician practices and other assets. According to an article in Buyouts Insider, PE investors switched their focus around 2018 from hospital acquisitions to less-costly, smaller specialty groups.

Bain & Company's *2021 Global Healthcare Private Equity and M&A Report* found that investors are pursuing new "buy-and-build" strategies in less-penetrated segments of the provider sector. The report found that there is increased focus among PE firms on areas that are promoting the shift toward home-based and outpatient care, along with "risk-bearing targets," like Medicare Advantage providers operating under capitation models and behavioral health providers.

Understanding the financial impact of PE investment in healthcare has become a point of concern among industry executives, including hospital CFOs, as recent studies have pointed to higher prices.

To better understand PE's involvement in the healthcare sector, HealthLeaders spoke with several industry leaders and investors for insights on the current dynamic and whether PE investors are friends or foes to the mission of healthcare.

A PE-INVESTED HOSPITAL WEIGHS IN

Altus Health System is an integrated health network based in Pearland, Texas, operated by ZT Corporate, a Houston-based private equity firm that specializes in healthcare investments. Altus recorded an annual revenue of $4.42 million in 2021, according to Dun & Bradstreet.

Kraig Killough serves in a dual role as president of Altus Community Healthcare, operated by ZT Corporate, where he is a managing director, overseeing the company's growth strategy. Sheheryar Shah serves as corporate chief investment officer at ZT.

Killough says that in the mid-2000s, ZT identified a lack of coordination between healthcare providers, and the firm has been pursuing a goal of establishing acute care health systems across Texas. Altus currently has two hospitals located in Baytown and Houston, along with 12 freestanding ERs.

He says another focus for ZT and Altus is the future of healthcare technology, and notes that there is "tremendous amount of [growth] opportunity" around a roll-up strategy based on technology and the "basics of community health."

A roll-up, according to Killough, is when PE firms acquire companies that can allow for economies of scale, consolidate management and cash flow, add value to a system, and provide expanded geographical reach.

Killough says that in the past, PE took a top-down approach of buying hospitals and health systems, whereas now, PE is undergoing a bottom-up approach of filling in gaps by pursuing specialty groups and physician practices.

His thoughts are in line with a *JAMA* study released in February 2020 that found more than 350 physician practices were acquired by PE firms between 2013 and 2016. The research indicated that PE firms see ample business opportunities in the physician practice space, expecting annual returns greater than 20%, though there remain "unknown implications for care delivery and patient outcomes."

PE provides physician practices with a backstop to improve their cash cycle and back-office processes, such as with management reporting and compliance work, Shah says.

The only way to solve the "$4 trillion problem in American healthcare" is through more innovation and disruption, Killough says, requiring a partnership between PE and physicians. He adds that the pandemic has given PE a renewed focus on healthcare, reiterating that investors can be the "wick" to move such innovations and initiatives forward.

Shah says that in healthcare, physicians don't need venture capital to operate, so consolidating different businesses in the same modality through a roll-up strategy becomes easier for investors over time. As an example, Shah points to dental practices, which can have multiple practices in geographical locations and be combined in a roll-up strategy to drive higher margins with consolidated operations.

Reflecting on how the dynamics between PE and healthcare have evolved over the past decade, Shah points to how the Affordable Care Act gave investors confidence to double down on the industry as a core investment sector.

Beyond the physician practices, Shah says he is also eyeing growth in health technology, wellness services, and biopharmaceuticals, which demonstrated that the previously slow-moving vaccination development processes can be accelerated by additional investment.

"[Most people] have an Apple Watch® and can monitor their blood pressure for pretty much the whole day. Five years back, that was something you had to plug in like a machine in your arm," Shah says. "Those macroeconomic trends have helped PE double down in healthcare. As a matter of fact, Q4 2020 was the most active quarter in PE healthcare transactions across all sectors. So, that's a testament to the fact that the market is still strong, and the investors feel very strongly about healthcare as an investment."

Shah pushes back on criticism that PE's interest in healthcare is a cynical financial play.

"From a cultural standpoint, I think one thing that mainly changes with the involvement of a PE firm is visibility into the performance of those particular healthcare businesses and holding internal teams accountable on those metrics. It becomes a more metric-driven exercise," Shah says. "One thing I want to be clear about is that no PE firm or their executive officers get involved in how delivery of care is being administered. At the same time, a patient is the most important piece, so the idea is always to deliver world-class level care."

THE PHYSICIAN PRACTICE ANGLE

Given that PE money has increasingly moved away from acute care facilities and hospitals toward physician practices, it's important to understand what factors are at play for leaders in that space.

"I think it depends on the situation, but over the last year with those [physician] practices that maybe didn't fare as well from COVID-19 downturn and patient volume, [they] might be looking at [PE] as a kind of the upside of, 'All right, we finally have somebody that can actually invest in resources for us,' " Akash Madiah, CFO of Medical Group Management Association (MGMA), says.

Short-term financial windfall must be weighed against the long-term implications for physician practices, according to Madiah, such as whether they are going to be part of the eventual sale in three to five years.

One outlier is Steward Health Care, the Dallas-based physician-owned company.

In June 2020, Steward reached an agreement to buy back control from Cerberus Capital Management, L.P., a New York–based PE firm. Steward, which manages 35 community hospitals across nine states, was owned by Cerberus for a decade.

After the transaction was announced, Steward CEO Dr. Ralph de la Torre issued a statement that healthcare was in a "transformational moment" due to COVID-19.

"I want to thank Cerberus for their support in growing Steward Health Care into a national system caring for millions of patients around the country. We look forward to achieving the next level of patient-centric care, through a doctor-owned structure that unites all aspects of care delivery and prevention in ways never before contemplated."

Madiah says the missions of PE and healthcare can be compatible but adds that it relies on the structure of the deal. He acknowledges that PE may have the stigma of not having an "altruistic motive," but says if a struggling medical practice can secure the necessary financial resources from an investment and streamline the administrative burden, then it can prove to be a positive decision.

He says that PE must consider how to make a transaction advantageous for a medical group beyond the initial financial windfall, with a particular focus on easing the administrative burden for smaller providers.

Madiah says he has heard from medical group executives operating surgical, orthopedic, and optometry practices who are pondering their options as COVID-19 subsides. Ophthalmology practices, in particular, have been a prime target for PE in recent years, as acquisitions of the specialty practices doubled from 2017 to 2018, according to a *Health Affairs* study published in June 2020.

Just as investors have factors to consider when pursuing a potential deal, Madiah says that independent physician leaders must do their due diligence. He says that executives must decide whether the pandemic has been a tipping point and marks a time to engage with larger acquirers, like PE firms.

"I've heard of those instances, but again, you have to be very clear on what you want as a provider when you're entering into those transactions," Madiah says.

BALANCING OPPORTUNITY WITH COMPATIBILITY

This is an "exciting moment in time" for the healthcare investor community, according to Rafael Cofiño, a partner at Great Hill Partners, a Boston-based PE firm.

Cofiño says he is bullish on PE's prospects going forward, more so than in the past decade, noting that while healthcare moves slowly, technology is breaking down the traditional brick-and-mortar localized care delivery system, expanding access and lowering costs.

"I think [technology] opens up a lot of opportunities going forward for healthcare, and I think PE will bring the capital, the know-how, and the alignments of how to help [healthcare organizations] build assets of scale."

With healthcare accounting for nearly one-fifth of the national GDP, there is a range of opportunities for healthcare investors, Cofiño says, whether involving more traditional providers and care delivery methods, or increasingly around biotech solutions.

Changes are also accelerating across the industry, he says, pointing to regulatory requirements that make it harder to be a small, independent provider. Meanwhile, COVID-19 exposed the weaknesses that small providers face in a fee-for-service environment, which will likely boost the shift toward value-based care (VBC).

These dynamic shifts have amplified the need for healthcare companies to maintain sufficient capital resources on hand to fend off competition and seize opportunities as they present.

"We think the role that the healthcare investors will play probably goes up in importance, both to drive and create the next-generation companies and be an important change agent to enable some of these providers to evolve down that lane," Cofiño says.

He offers examples of PE-supported success across the industry related to oncology and kidney care, which helped companies scale evidence-based care solutions to benefit the patient. Shifting to settings with lower costs of care can be good for a healthcare company, Cofiño adds, and also resonates across the industry if competitors start to mimic this behavior to avoid losing market share.

While PE firms are adept at sizing up opportunities and pursuing them, when it comes to healthcare, ensuring that the missions of the acquiring and acquired organizations are transparent and well aligned is crucial.

Cofiño says compatibility relies on cultural alignment between healthcare organizations and the PE firm, noting that the economic model has to support the care mission.

"As with anything, there are never perfect examples, but I think we're seeing some strong evidence of some of these models working quite well for [something I like to call] the '3 Ps,'— good for the patient, good for the provider, and good for the payer," Cofiño says.

Addressing the PE community, Cofiño says there is more work to do, stating that the alignment between the mission and the economics is key. He says PE firms must find a way to build economic models that don't simply look for shortcuts that lead to near-term profits while causing long-term damage to the healthcare ecosystem.

"There needs to be a recognition that this is not just about profit-and-loss statements, but there is a human element in caring for people," Cofiño says. "We're big believers that if you align those two aspects, frankly, you'll be able to build larger and much more sustainable businesses, which is ultimately the Holy Grail."

FOLLOWING THE TRENDLINES IN PE INVESTMENT

Following the money is a critical component of understanding any business model, especially PE, which has evolved in healthcare.

Bill Hanlon is managing director at Hammond Hanlon Camp LLC (H2C), a strategic advisory and investment banking firm focused on healthcare.

Hanlon says that anything with a material impact on the cost and quality of care is an attractive growth area for PE firms. He says that he has noticed over time that wherever Medicare reimbursement is going, PE is pursuing as well, and notes that firms are adept at exploiting changes in reimbursement, namely behavioral health services.

Kevin Taggart, managing partner of Mertz Taggart, a healthcare M&A firm, agreed with this point during a *Behavioral Health Business* webinar; he expects 2021 to be "a big year" for PE investment in mental health services.

Forward-looking, Hanlon says large PE firms are somewhat limited in their healthcare pursuits because the deals are going to involve organizations that have large, installed bases of fixed assets, like hospital chains or long-term care companies. He says that this presents an additional challenge since the general perception is of the hospital as a cost center, which may not be the best place to invest for the long-term future because of the focus on reducing costs.

Meanwhile, Hanlon says mid-tier and smaller-sized PE firms are looking to be nimble and quick with the opportunities available, noting that there are still areas to consolidate, particularly in specialty areas.

"PE has found a formula that says, 'If we can roll-up quickly, we can get in and out and move this investment from the smaller to larger owners and get the returns we need in the funds,' " Hanlon says. "[PE] is looking for those mom-and-pops or fragmented businesses that still have roll-up opportunities."

Stewart Jamieson, a vice president at H2C, says PE has provided benefits to healthcare organizations seeking additional capital and fundamental processes, though he notes that there are "bad actors" in the space.

Echoing Hanlon's point that PE will adapt to changing dynamics and reimbursement structures, Jamieson says the move away from acute care hospital settings has made urgent care facilities a bigger target for PE. He adds that PE firms also prefer investing in small businesses as opposed to larger medical groups or hospitals due to how innovative those companies are, which allows for the investors to have a quick and meaningful impact.

Bill Watts, a vice president at H2C, says PE has been an overall positive force on healthcare, especially through the pandemic.

Watts says that PE investment has allowed postacute companies to grow and test new business models, and that these investors are trying to find cost-effective care settings for the patient and are not looking for unprofitable areas to manage. He predicts that more investments will head toward in-home care and telehealth.

He says that PE has become more aggressive in looking at large-platform companies that are increasingly specialized, meaning more small and medium-sized businesses are likely to get rolled up.

"It's almost hard to find a platform company that doesn't have a PE sponsor standing behind it, and I think we're going to see a bifurcation," Watts says. "Some investors are going to be sophisticated and specialized, whereas you have others, like BrightSpring [Health Services] backed by KKR that just bought Abode Healthcare, that are looking more broadly. They're looking at all of the different services around the patient and trying to capture that whole continuum of care."

WHAT HAPPENS WHEN THE MONEY RUNS OUT?

To some, the "horse is already out of the barn" as it relates to PE investment in healthcare. There are instances where PE is helpful and beneficial to the bottom line of providers, but there are potential downsides to PE involvement in healthcare.

In August 2020, a *JAMA* study found hospitals acquired by PE firms experienced increases in net income as well as improvement in quality metrics.

Compared to non-acquired hospitals, PE-bought provider organizations saw a mean increase in annual net income of more than $2.3 million, an increase of $407 in total charge per inpatient day, and an increase of $0.31 in total charge to cost ratio.

On the quality side, *JAMA* found that the aggregate quality score for acute myocardial infarction increased 3.3%, while the aggregate score for pneumonia increased 2.9%.

Chuck Salvo is managing director at ToneyKorf Partners, a New York–based healthcare management advisory firm. Prior to joining ToneyKorf, Salvo served as senior vice president of physician services at Brookdale University Hospital Medical Center, a Brooklyn-based nonprofit facility.

Salvo says within the PE industry, there are a lot of talented individuals who can bend the cost curve and fund beneficial initiatives like telehealth, and companies like One Medical and Oak Street Health, which cater to underserved patient populations.

However, Salvo says that since PE firms have a term of exit, typically within five to seven years, to meet shareholder obligations, it is fair to raise a concern about what happens when the money runs out.

"I have a feeling that the rural areas are going to be the ones that have the most difficulty if they take PE money and it does not pan out as hoped," Salvo says. "There's not going to be anybody coming in behind them to say, 'We'll take this off your hands and we'll keep it open.' "

Salvo's concerns echo an *Annals of Internal Medicine* study published in September 2020 that found PE-owned hospitals are, on average, more likely to be located in low-income, rural areas.

These hospitals had fewer full-time equivalent employees per occupied bed compared to non-acquired hospitals, a finding that researchers said "[raised] concern." However, the study did not conclude whether PE investment negatively impacted patient care.

PARTING ADVICE FOR HEALTHCARE LEADERS

The industry is in a mature stage of PE involvement in core hospital services, according to Salvo, and every hole is being mined across the healthcare continuum due to lingering segmentation.

"I don't see [PE investment] stopping until every single data point on the care continuum has been evaluated and mined for whatever inefficiencies might be there," he says.

Salvo urges provider leaders to consider what they need out of a PE transaction, secure concessions around quality, and ensure that the new management will continue to invest as the industry moves away from FFS.

"I think there's a possibility that a firm or an investor that is playing the long game will understand that and [a healthcare executive] won't get everything they're asking for, but I think [negotiating with a potential PE investor] is vital to the long-term sustainability of the hospital," Salvo says. "It also will help from a public perception standpoint, because I don't think that any PE investment in a community or a rural hospital is going to be viewed from the public standpoint as a positive."

Salvo warns that it will be tough for stand-alone hospitals to survive in this burgeoning environment and forecasts a coming battle among health systems consolidating to scale up with large payers, while PE firms pursue investments to gain further footing in the industry.

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