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How to avoid the pain

Changes in the ways healthcare is delivered, along with political and regulatory considerations, present pitfalls for healthcare investing. **Adam Willis**, head of healthcare, and **Tim Wentink**, managing director in Madison Capital Funding's healthcare team, consider how to operate successfully

Q There's been a prevalence of buy-and-build strategies in healthcare. Why are they so popular?

Adam Willis: I think both broader healthcare industry fundamentals as well as market dynamics are driving these buy-and-build strategies. From an industry perspective, as the healthcare market consolidates (especially at the payor level), regulatory complexity increases, and reimbursements continue to decline, industry participants are trying to achieve scale to turn it into a financial and competitive advantage, while adding the resources needed for ever-changing requirements.

Private equity sponsors are following these broader healthcare trends; yet, with competition fierce for assets, especially those of scale, investors are looking to capitalise on consolidation and are moving "down market" to buy smaller, less expensive healthcare assets to subsequently build.

With this approach, a sponsor can create value by building a more competitively positioned healthcare company of size, while at the same time averaging down their entry purchase multiple and deploying the optimal level of capital.

Tim Wentink: More specifically, I would say it is also getting harder for the individual providers to compete against larger practices which have a lot of advantages including: investments in infrastructure, technology, compliance, revenue cycle management, and in-house ancillary services (ie, labs and ambulatory surgery centers).

Adam Willis

"DEAL TERMS IN HEALTHCARE ON BOTH THE PRIVATE EQUITY AND LENDING SIDE ARE HIGHLY AGGRESSIVE RIGHT NOW"

Altogether, it is becoming more attractive for providers to sell to or join larger organisations as it allows them to (1) spend less time on administrative functions while focusing on their job as a physician, (2) participate in ancillary revenue streams that would have otherwise been referred to another organization and (3) have an improved quality of life with less total hours worked.

Q Given the complexity and expertise needed for this sector, what are you seeing in deal terms?

AW: Deal terms in healthcare on both the private equity and lending side are highly aggressive right now. With strong industry fundamentals driving growth combined with a market overflowing in capital, healthcare enterprise valuations continue to be at record highs.

This situation is forcing investors to push the limits on deal terms in order to deploy capital and meet return hurdles, whether it be purchase and leverage multiples, covenants or lack thereof, or "true" EBITDA. In our eyes, it places an even greater emphasis on healthcare expertise where one must gain comfort balancing these aggressive terms with a highly complex and ever-changing healthcare landscape.

Q Last year there was a concerted effort by President Trump and Congress to repeal the Affordable Care Act. Did that affect deal flow at all?

AW: Despite all the political noise, healthcare deal volume remained robust in 2017. There were certain subsectors of healthcare, however, where uncertainty caused by the effort to repeal did impact deal volume, such as those areas with heavy exposure to Medicaid in Affordable Care Act expansion states. But overall, 2017 was a highly active year, a pattern we expect to continue into 2018.

Q They did repeal the individual mandate in the tax overhaul Congress passed. Has that affected your deal pipeline and the healthcare space?

AW: Our momentum into 2018 remains strong thus far, so no, the mandate repeal does not appear to have negatively impacted our pipeline. In talking with other investors, they too do not generally view the repeal as a significant risk given only a small subset of the total insured population [I believe it is around 4 percent] has coverage via the exchanges.

Additionally, many experts feel that the government incentives as opposed to the penalty associated with the individual mandate were the key motivator for insurance enrollment. These incentives still remain today.

Q How do lenders underwrite risks related to Medicare and Medicaid reimbursement rates?

TW: I would say this is one of the reasons having a specialised team dedicated to healthcare is important. The thought of Medicare and Medicaid reimbursement pressure is nothing new to us. When looking to make an investment, we always have that in our minds, and are generally looking for a diversified payor mix.

However, when there is some concentration amongst payors, we will do a lot of diligence, whether it be through our own in-house experience, or our network of expert consultants to generate a highly educated view on the reimbursement outlook going forward. There can always be unforeseen events that can impact reimbursement rates, but having a deep expertise goes a long way in mitigating the risks.

Tim Wentink

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AW: You also must understand the red flags that drive potential rate reductions, such as increased utilisation [of a certain procedure or treatment], out of network billing, recent Office Inspector General or Government Accountability Office findings, or technological changes that make a procedure more efficient. Anytime you identify certain characteristics such as these in an investment, it could be a signal that potential reimbursement changes are on the horizon.

Q When you're looking at healthcare, there's been rapid change in the technology area. How does that affect investment?

AW: Technology has made a huge impact on healthcare, and subsequently healthcare investment. Technology has created treatment efficiencies, greater care coordination, and a prevalence of data which ultimately, improves and allows for the measurement of outcomes.

In fact, technology has contributed to the fundamental shift in how healthcare is paid for, such as value-based reimbursement and pay-for-performance. In essence, technology has made investing in healthcare not just a volume game, but a quality game as well.

Q How has technology played a role in the quantity-versus-quality game?

TW: Technology has really enhanced the ability to gather and analyse data, and is helping to shine a light on which providers produce good outcomes versus bad outcomes. This data is not only helpful for payors to provide financial incentives for good outcomes versus bad, but also is becoming more available for patients to choose providers that have the best outcomes for their need.

Q A lot of technology companies - Google, Apple, Amazon - have all been moving into this space. How has that affected investment?

TW: I would say that specifically related to the Amazon-Berkshire Hathaway-JPMorgan news, I think there is an ability for them to make a positive change within the healthcare system utilising their large employee base and technology. However,

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the current system is very complex, and has other large well-established players which will be difficult to displace. As a result, I think the impact from these groups will be a longer-term evolution versus seeing significant changes overnight. And I think they've even admitted to that.

AW: I agree with Tim, but anytime you hear names like Amazon, Apple or Google, you must pay attention as an investor. While there are certain attributes of the healthcare sector which make it more complicated to navigate, so rapid entry presents a challenge, these companies have proven to be disruptors in any area entered.

In a positive way, I believe the threat of entry is forcing current industry participants to think more creatively about their products or services and look for ways to stay ahead of the curve, such as what is happening with the Aetna-CVS merger. But from an investor perspective, it seems to pose a medium to longer-term risk.

Q Are you seeing a move toward more inpatient care or outpatient, and what effect is that having on investment?

TW: We've definitely been seeing a trend toward more outpatient care. If a procedure can just as easily be done in an ambulatory surgery center versus an in-patient hospital setting, it benefits patients, physicians and payors alike.

From a patient's perspective, the trend towards high-deductible plans is driving more thoughtfulness on how they are spending healthcare dollars as they have more skin in the game. Also, payors would much rather have patients go to an outpatient center as the fee schedules are significantly cheaper than having a procedure done in a hospital.

And on the physician side, they are participating in more investment/ownership in ambulatory surgery centers, which allows them to capture a piece of the revenue that would have otherwise gone to the hospital.

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Q Is there one area of healthcare that's garnering a lot of attention from sponsors, lenders and the like?

AW: The sector of healthcare that continues to garner significant attention, and one where we are seeing an influx of transaction activity, is behavioral health. First, like other sectors in healthcare, it is very highly fragmented, so it is ripe for the buy-and-build strategy.

Secondly, with gun violence, opioid abuse and other tragic events making headlines, awareness of the impact that poor mental health can have, not only on our communities, but also the overall cost to the system, is at an all-time high.

Investors have recognised the bipartisan support for addressing mental health issues, and are actively searching for investment opportunities across the sector (such as substance abuse, autism and/or intellectual disabilities) to ride these tailwinds.

Q How has consumerism affected healthcare?

TW: The push towards more and more high-deductible plans as well as technology advancements allowing for patients to access physician performance information have definitely been driving increased consumerism in healthcare.

Anybody who has a high-deductible healthcare plan, versus 10 years ago when you didn't, is seeing the impact when you go to a physician's office and actually have to pay the bill. That's starting to change behavior, and driving patients to look for high quality and more efficient care.

Q What's the hardest part of a deal to underwrite?

AW: The hardest part of a healthcare deal to underwrite is a potential change in the reimbursement or regulatory landscape. The "stroke-of-the-pen risk" as people say. These risks are not something you can "Google" and no one has a crystal ball. You need to make educated assessments based on all different variables including other deals you have been in because there can often be corollaries. I think, again, this is where healthcare expertise and experience is critical. Otherwise, you don't know what you don't know until it is too late.

Q What's something that doesn't get as much airtime on healthcare as you think it could?

AW: I think historically one part of healthcare that didn't get enough airtime, sadly to say, is quality of care; [though] it's getting more attention today than it did in the past. Now, because of evolving payment models, increasing transparency as well as consumerism in healthcare, quality of care has become a much bigger area of focus, especially for investors.

TW: I'd also say that great compliance is critical, with more scrutiny and audits these days. If you don't have a strong compliance program you are putting yourself at risk of having a very negative outcome on your investment. ■