Trends in private equity healthcare investments

How private equity investors are adapting to changes in healthcare

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Despite lower global private equity deal volume in 2016 (6,538 deals as of Dec. 13, 2016, vs. 8,199 for 2015), healthcare remains a bright spot for private equity investors, leading all sectors for total shareholder returns in 2016.1,2

Even as Congress moves to unravel the Affordable Care Act (ACA), healthcare-related deal volume is expected to continue at a strong rate, particularly in digital technology, according to ValueWalk.3 Healthcare sectors such as insurance, technology, biotechnology, and pharmaceuticals could see changes in their business models, making them ripe for takeovers or investments in 2017.

The rise in healthcare focused private equity funds, such as KKR’s Health Care Strategic Growth Fund, point to investor interest in the space overall. Private equity firms have about $862 billion in available investment capital, up 14% from 2015, according to Benesch Attorneys at Law.4

**TRENDS**

Much of that capital is being invested in the digital health space, with investors especially interested in early-stage companies, according to RockHealth.5 Many firms see the alteration of the ACA as a catalyst for increased investment and acquisition in the industry as the operating environment shifts to accommodate new rules, according to a PitchBook survey.6 These shifts combined with the booming healthcare technology industry mean that sectors from pharmaceuticals to insurance to software applications will experience an increase in investment and the potential for more deal activity.

Another continuing trend will be divestitures as an exit strategy, with corporations divesting a record $115 billion of healthcare assets in 2015.7 Private equity firms are especially well-positioned to take advantage of this strategy by leveraging existing relationships and being nimble enough to quickly negotiate deals.

Another area ripe for increased deal activity is the real estate sector, which is also shifting as hospital and medical-related properties see increased demand. As the population ages, the types of properties needed will continue to evolve.

For example, many investors are looking to put money to work in long-term care facilities, assisted living or other properties that cater to an aging Baby Boomer population. As 20 million more people reach age 65 in the next 10 years, the types of medical offices, care

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4 http://www.beneschlaw.com/Files/Publication/56603b54-2ef2-4412-9784-82238bac9393/Presentation/Publication-Attachment/564b6c77-3a13-4cd7-94d9-8907f7f83bce9/HC_2016-17_SummaryReport_020917.pdf
5 http://www.beneschlaw.com/Files/Publication/55603b54-2ef2-4412-9784-82238bac9393/Presentation/Publication-Attachment/564b6c77-3a13-4cd7-94d9-8907f7f83bce9/HC_2016-17_SummaryReport_020917.pdf
6 http://bit.ly/2pKyZGy
centers, and other facilities will change to meet their health-related needs. Investors, including REITs and private equity firms, are searching for larger transactions.8

Other trends include the design and building of new medical office space as providers shift to patient-centric care models and incorporate new technology into their locations. Many large healthcare companies are expanding services to different locations and moving closer to residential areas to improve access to care.9 Developers must now offer flexible floor plans, seek convenient locations, and offer amenities that incorporate the latest green building trends or technology.

Rising healthcare spending and a growing sense that these increases are unsustainable are fueling a focus on value, affecting care settings, care delivery systems, provider networks, and more. There is a growing sense that health systems, medical practices, and other stakeholders must deliver better care at lower cost if they are to retain market share.

Another emerging real estate trend is micro-hospitals, a cross between an urgent care center and full hospital.10 While these typically have fewer inpatient beds, they are generally located in densely populated areas and can offer care at much lower costs to patients or insurers than larger facilities. This shift is driving not only new builds, but also refurbishment of existing locations and properties.

**Do your homework**

Because many of these trends represent a fundamental change in how care is delivered, private equity firms are placing a higher priority on due diligence in terms of assessing both leadership and culture prior to acquisition or investment.

For private equity owners, having the right leadership team in place is critical to success at the portfolio company and it’s a huge challenge to tackle alone. By turning to management consulting firms, companies can access unbiased resources not affected by the internal climate of the private equity firm and tap into deep expertise in leadership assessment and coaching, helping to set the management team up for success from the beginning.

Companies need to focus their diligence on what matters most and consider future potential alongside past performance. Quantifying good leadership can be a challenge, but experts recommend looking at “learning agility” or the ability to quickly adapt to change and challenging situations.11 The leaders of the future will be those who adapt their leadership styles to the needs of any situation, have a high stress

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tolerance, and are capable of managing competing priorities across the portfolio company, the private equity firm, and the external environment.

When assessing leaders for a newly acquired company and/or portfolio in private equity, it is imperative to get the right leadership team from the beginning. Depending on the type of company and role the firm is seeking, there are several key skills that the candidates must bring to the table.

First and foremost, the individual must be flexible and share the same appetite for risk as the firm, which may be looking to expand and grow the portfolio company or for an exit in the future. The firm should be open to the type of background and expertise the individual may bring to help round out the leadership team. For example, there have been multiple cases where an individual moved into a healthcare specific role from an adjacent industry — such as hospitality, retail, and multifamily — to help bring a different perspective to the company.

Doing diligence upfront and understanding past performance is key. Making sure management is aligned with your goals in the early days of the investment will also be critical for success. One of the biggest challenges for private equity firms is the inability to establish strong relationships with portfolio companies’ leaders from the beginning of the partnerships, something that often predicts the successful outcome of the investment.

**Outlook for 2017**

Private equity deal flow is expected to be strong in 2017 as fundraising continues to increase. Uncertainty over health legislation is destabilizing markets, with fewer people potentially covered if proposed Medicaid reform is adopted. This uncompensated care can be a drain on hospital finances, pushing many to look for capital infusions or mergers with bigger companies to remain in business.

The lack of capital is also shifting the types of clinics being built and where investors are looking to put capital to work. Urgent care clinics, freestanding emergency departments, and mini hospitals are all emerging areas of interest.

No matter what happens with ACA, stakeholders across healthcare want to steer more care to the places where costs are lowest. That can be urgent care as well as integrated delivery systems where all types of care — from lab testing to x-rays to pharmacy services — are connected, which reduces duplication of services and misses fewer red flags with respect to health.

Private equity activity in healthcare is also expected to increase as companies acquire new technology and look to cut costs. Deals will be challenged by already high valuations, making it difficult to generate outsized returns.

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Conclusion

Healthcare and its related industries will continue to be an attractive area for private equity investment this year, particularly as shifting demographics require changes to where, when, and how care is delivered. These changes are also causing a shift in medical real estate as care moves to more convenient, smaller, and lower-cost locations. As the population ages, developers of medical and medical office space will continue to rethink how they construct and refit buildings.

As the industry heats up, management teams that understand their targets, do thorough diligence upfront, and align their goals with management will see the largest returns. Partnering with outside firms can help private equity owners make sure they have the right management team and leaders who are adaptable to any situation — no matter the stress level — and able to juggle the multiple priorities of the private equity firm, the portfolio company, and the operating environment.

For executives to be successful, they must be able to quickly adapt to market trends, understand the vast regulatory and demographic changes, and adjust their business models accordingly. On the investment side, due diligence will become more important in order to best position the new holding to generate returns. Having expertise in a particular sector can help private equity firms make appropriate investments and leave room for improvement.
Mr. Cottone is a Managing Director in the Ferguson Partners Leadership Consulting group. Prior to joining Ferguson Partners, he was a senior leader in the Chicago office for a leadership development consultancy specializing in talent assessment, executive coaching, team effectiveness, succession planning and organizational culture. Additionally, Mr. Cottone founded his own leadership consultancy specializing in strategic thinking, group decision making, ethical leadership, inclusion and diversity and presentation and persuasion.

His approach to leadership development is underpinned by his experience managing large-scale clients, operating in multiple industries with c-suite executives, and developing internal and external talent. In addition to his executive development experience, Mr. Cottone has managed internal training and development programs for corporations and professional services firms, has led academic and leadership programs for institutions of higher education, and has lectured on crisis management and communications.

Mr. Cottone received his Master’s degree in Organizational Communication, Learning and Design and Bachelor’s degree in Psychology and Legal Studies from Ithaca College.

Ms. Pigott is a Vice President, Healthcare Practice Leader based in Ferguson Partners Ltd.’s Chicago’s office. Ms. Pigott leads the practice for the firm, working within the healthcare services and senior housing industries. Additionally, she assists in the overall execution of real estate executive search assignments across the United States. Her responsibilities include project and client management, candidate development and evaluation, and the presentation of qualified candidates to clients.

Ms. Pigott joined Ferguson Partners with a background in healthcare executive search and previously worked as a Senior Associate Director with Quick Leonard Kieffer. In this role, she identified leaders for healthcare organizations across the country.

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