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The elevated playing field for private equity in healthcare with Eric Mayeda

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Faced with intense competition and rising valuation multiples to acquire high-quality healthcare platforms, private equity (PE) firms will need to expand their value creation playbooks in order to continue to yield outsized returns relative to other sectors and public markets.

Eric Mayeda has more than 20 years of healthcare management consulting experience, serving as a senior advisor and strategist to leading healthcare-focused PE firms, public and private healthcare services, technology companies, academic medical centers, children's hospitals, national and regional health systems, physician organizations, and payors. He is the leader of the Private Equity Advisory practice at Chartis.

When Eric isn't working, you'll find him camping and hiking with his family.

Chartis: How has PE in healthcare evolved over the past year?

Eric Mayeda:

We've seen the convergence of several secular and short-term trends that have fueled continued growth in healthcare PE this past year. The tremendous amount of dry powder awaiting deployment and the cheap and accessible financing have certainly played a key part in driving deal volume and rising valuation multiples.

Further, while the pandemic has disrupted demand for certain healthcare sectors, it has also served to accelerate the innovation and adoption curves across several domains. We've seen that in the case of telehealth and hospital at home, as virtual and home-based care delivery and technology platforms were

forced to scale overnight to replace traditional clinic and facility-based care settings that were shut down in the early days of the pandemic.

Similarly, significant increases in incidence rates of anxiety and depression during the pandemic coupled with progress in societal recognition and acceptance of mental health issues have reinforced the need for scalable, high-quality models of behavioral health, and substance use disorder (SUD) care. The same is true of value-based care, which has seen unprecedented activity over the course of the past year across primary care, high-spend medical and surgical specialties, and post-acute/end-of-life care.

Collectively, these forces have made for a remarkable year in terms of deal volume and rising asset values with broad appeal extending across most sectors of healthcare.

Chartis: What are the implications we are seeing of this heightened PE activity in the market?

Mayeda:

We wouldn't be surprised to see the market start becoming more discriminating even as overall activity remains brisk.

Early indications suggest that deal volume should remain robust in 2022, given the high volume of dry powder awaiting deployment and the healthy queue of platforms preparing to launch sale processes. However, the cost of debt rising off the historic lows we've enjoyed in recent years, combined with valuation multiples at levels which exceed public comps, means some buyers may begin to be more selective around which assets they pursue, and which sectors they choose to enter.

There's been a bit of a Lake Wobegon effect permeating healthcare private equity lately — where everyone believes their platforms are above average.

Chartis: What does this Lake Wobegon effect mean for investors?

Mayeda:

For one thing, it means that thorough due diligence is particularly important in this environment. As investors face a higher bar for generating targeted returns given rising acquisition prices, the depth and types of diligence performed on prospective assets need to rise commensurately.

It's not enough to simply understand and feel good about the macro forces at play in a certain sector. Given that healthcare remains local, it is critical that investors understand and feel comfortable with a particular target's positioning in their local market. That means understanding the target vis-à-vis the local health system environment, regional payors, incumbent provider referral channels, area population demographics, and the employer landscape.

In addition, it often means needing to get deeper “under the hood” during diligence to assess the platform’s true ability to perform and grow. This includes paying close attention not only to the target’s rate of organic growth, but also the durability of existing volume and revenue sources in light of the ongoing impact of the pandemic and swiftly evolving local competitive trends. It includes examining the platform’s track record of actually achieving growth following past tuck-ins to assess readiness and maturity for continued inorganic expansion. And it includes identifying material variability of quality outcomes/performance between sites which may indicate a lack of alignment among providers or poorly developed operational or management processes.

Over time, we expect to start seeing greater separation between platforms that are truly differentiated versus those that are merely average or below.

Chartis: What does that mean for new healthcare portfolio companies?

Mayeda:

It means that a greater emphasis will need to be placed on value creation.

With the higher acquisition prices that we’re seeing, the first-order synergies and value-creation tactics that investors have relied upon historically are now built into the purchase price. Realizing returns off this higher basis point will require more aggressive and more sustained value creation efforts.

Chartis: What should PE investors consider as part of their playbook for value creation in healthcare?

Mayeda:

We’re spending a lot of time talking to clients about the importance of creating a next-generation playbook around value creation, which covers both revenue and expense optimization.

On the revenue side, the focus goes beyond simply generating a high enough rate of growth but also in ensuring that the growth is sustainable and diversified.

As an example, we’ve had several recent engagements in which we’ve worked to forge partnerships between PE-backed provider platforms and leading regional health systems. Many PE-backed platforms have historically tried to win a portion of referrals from all providers in a market. With local networks and referral channels tightening in many geographies, the ability to continue to employ a “Switzerland strategy” poses risk. As a result, platforms are increasingly seeing value in striking preferred relationships with regional health systems through a range of business arrangements as a means of securing and expanding access to key patient populations.

On the expense side, we're seeing the need to move beyond the 1.0 playbook, which largely consisted of back-office synergy realization, revenue cycle management improvements, professionalization of management teams, and the like, to now needing to optimize at the point of care and work with clinicians around how they practice. This requires clinical know-how in addition to operational and financial expertise, and that's where we see the value of true integration playing out — particularly as we think about models in value-based care, where the ability to perform is going to be driven by alignment on clinical pathways and the ability to engage with patients effectively to influence behaviors that improve health and reduce spend. That leads to a different set of strategies around value creation that are more intensive than the ones that have historically been needed during a typical 3- to 5-year hold period.

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