

The Journal of Private Equity

This article focuses on the healthcare provider industry and will discuss how a confluence of factors in the industry, driven by a combination of legislative and technology issues, make this a sector worth considering. This article also discusses how private equity investors can spot a diamond in the rough, and explains how capital infusion can move the needle on operational performance and returns in this very hot industry.

Positioning for the ‘Healthcare Boom’

What Industries Offer the Biggest Upside for Private Equity, and How Can Companies Scale with the Market?

The financial crisis and recession has wreaked havoc on the private equity market, which locked out many private equity firms from the kinds of deals that in the past would have been done almost effortlessly. Meanwhile, the equity markets were so weak that the IPO route became virtually non-existent, leaving start-up investors with very few exit options.

However, in the past six months the credit markets have opened up somewhat (at least for small or medium-sized deals), and the broad market recovery has improved the IPO outlook, returning the investment landscape to some degree of normalcy. History shows us that it’s always darkest before the dawn, which begs the questions: Where should private equity investors be committing capital throughout the remainder of 2010, and into 2011?

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A Rising Tide for Healthcare

There are a number of factors impacting the healthcare industry that potentially create an unprecedented investment opportunity. For example the new Healthcare Reform bill, signed into law on March 23, 2010 creates business opportunities for health insurance companies. It will also serve as a rising tide for the entire healthcare industry as 32 million previously uninsured Americans will now be covered. The total government investment in the Healthcare Bill will total more than \$1 trillion during the next 10 years, by some estimates, and the total impact to the private sector is practically immeasurable as of now.

Similarly, the healthcare provisions in the American Recovery and Reinvestment Act establish a framework and specific protocols that guide the move toward the widespread use of electronic medical records. This will be a significant boost for

productivity but will require a significant upfront investment by hospitals, private practices, insurance companies and others who will need to comply with this sweeping trend.

A convergence of recent events have made healthcare a very exciting sector for now, and according to a recent poll by Management Consulting Firm Grant Thornton (1), the healthcare sector is holding strong as one of the most attractive sectors for private equity. The survey of over 100 private equity executives found that healthcare had been the most active and will remain as the most attractive sector for investment. Half of the executives polled placed healthcare sector in the top three most interesting for the next year, while 52 percent of firms cited healthcare as the sector they had been most active in over the last twelve months. Overall, there is growing interest in this sector and an expectation that the business opportunity will remain for years to come as new technologies and standards are created and adopted.

From an investor standpoint, there are significant challenges in identifying businesses that are most likely to benefit from this healthcare renaissance. More specifically, the creation of Electronic Health Records, ICD-10 coding and Revenue Cycle Management, are just a few opportunities that have emerged in the healthcare provider sector; ICD-10 coding is also an opportunity in the payer sector. Both create significant opportunities for technology providers that will be outfitting so many facilities with the new technologies they need to comply with new regulation.

From a private equity standpoint, there has been a flurry of healthcare deals in the last few months. In March, Cerberus paid \$830 million for Boston group Caritas Christi Health Care. In April, KKR partnered with Triton for the €850m acquisition of Nordic hospitals and nursing homes operator Ambea. Mid-market deal flow has also been strong. In April, CapMan acquiring Finnish care company Esperri. In May, HgCapital acquired Swedish disability care group Frösunda from Polaris for €130m. These deals illustrate the impact of private equity transactions on the continued growth of the industry and the efficiencies these healthcare concerns can realize by rethinking their operational and financial structures in light of the multitude of changes the industry is experiencing.

The Industry Landscape: Issues, Challenges & Opportunities

The healthcare provisions of ARRA promise a significant improvement in operational efficiency, quality and safety through a variety of technology initiatives. The implementation of the underlying technologies will have a widespread effect on hospitals and physicians. Challenges emerge in creating interoperability among disparate systems with improved security and enabling outsourcing of specific tasks that are repeatable to partners who excel in handling them.

The forces of change through technology and outsourcing solutions are really an opportunity in the next five years for healthcare providers to revisit everything they do - from practice management, billing, laboratory and emergency management to pharmacy apps. Service providers who offer domain specific services will capture a significant piece of the healthcare market, especially as it accelerates. The Private Equity firms with the foresight to identify and invest in the most promising of these companies will make them more competitive, capture a large market share and derive economic rewards.

But, choose carefully. There will likely be an influx of new technology providers as this market continues to heat up. Healthcare facilities are likely to select partners with significant industry experience so that new technologies can be applied properly. There are a number of issues to consider, when determining the types of companies that will be winners in this market.

Prior to the introduction of EMRs, most hospitals and healthcare facilities were not forced to operate mission-critical systems and sophisticated applications that must be always on, backed up, and comply with stringent newly strengthened privacy and security regulations. This is a significant market. Analysts estimate that currently fewer than 12 percent of physicians have electronic health records (EHRs). The U.S. government wants that number to move to 90 percent adoption by physicians and 60 percent by larger health systems. There has been a good deal of concern throughout the industry that privacy issues may come into play as these technologies are implemented. However, this is a perception that has already started to change and, in fact, the systems and controls that a number of technology companies have already implemented address the issue completely.

Compliance to HIPAA, the Data Protection Act and information security certifications help in maintaining and enhancing privacy issues. Several service providers have adopted and have been certified for adoptions, and are well positioned for strong growth as new healthcare regulations take effect. This will become an important component in identifying the winning companies that will serve the healthcare industry in the next 3 to 5 years, and will ultimately make the best investment.

The push toward healthcare reform and increased public reporting will require increasingly large amounts of data-sharing, reporting, transaction processing and coordination. Technology providers will need to guarantee the highest degree of information access while including disaster recovery systems while ensuring security.

In general, technology providers in this industry will need to that understand all the nuances of healthcare industry, including the provider, payer, government perspectives, and public health organizations such as the CDC, NIH, and FDA.

Scaling a Business to Meet Demand

As the Healthcare Reform Bill takes effect, it will act as a 'rising tide' affecting the entire healthcare industry. The simultaneous move toward the adoption of electronic medical records will create a substantial business opportunities for the outsourcing industry and technology providers in particular, who can service this demand.

Private Equity has an opportunity to affect the players by driving better operational performance and higher valuations. The companies that will benefit the most from the Healthcare 'boom' are those that have a strong underlying value proposition and relevant experience, and can also scale up to meet demand. This often calls for a significant capital infusion in order to streamline processes, enhance overall capacity and establish better cost controls to scale up.

We've found that in more than 70 percent of cases, investments in technology have not been made by providers because of an inability to raise capital or realize ROI for the capital they've already raised. Recently, players and service providers in the industry have to come together to provide capital to the facilities while also operating the resources at lowered costs to be able to realize better returns and thus stronger ROI. There are a number of factors driving the healthcare market, offering a significant investment opportunity for private equity firms that know how to identify the companies who will benefit the most from it.

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