MERGERS & ACQUISITIONS | Roundtable

A BUSY TIME FOR HEALTHCARE INVESTORS

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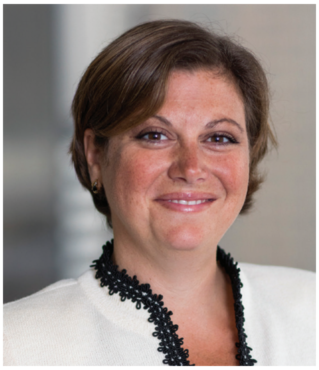


MODERATOR

Danielle Fugazy
Contributing Editor,
M&A

With an aging baby boomer population, millennials spending more on health and wellness, and fragmentation due to the local nature of healthcare, the healthcare industry is ripe for investment. However, as a result of all the tailwinds, the healthcare industry has become an extremely competitive place to invest. As an increasing number of private equity firms and strategic acquirers battle to win deals in the sector purchase price multiples have soared, leading some some private equity firms to consider unqiue deal terms. Mergers & Acquisitions hosted a roundtable to explore the current issues around investing in healthcare companies. The event was sponsored by Twin Brook Capital Partners. During the discussion roundtable participants discussed which types of deals are garnering the most attention, how regulatory changes are impacting deal making and what to expect from the industry going forward. What follows is an excerpted version of the conversation.

PARTICIPANTS:

Danielle Fugazy, Contributing Editor, *Mergers & Acquisitions*

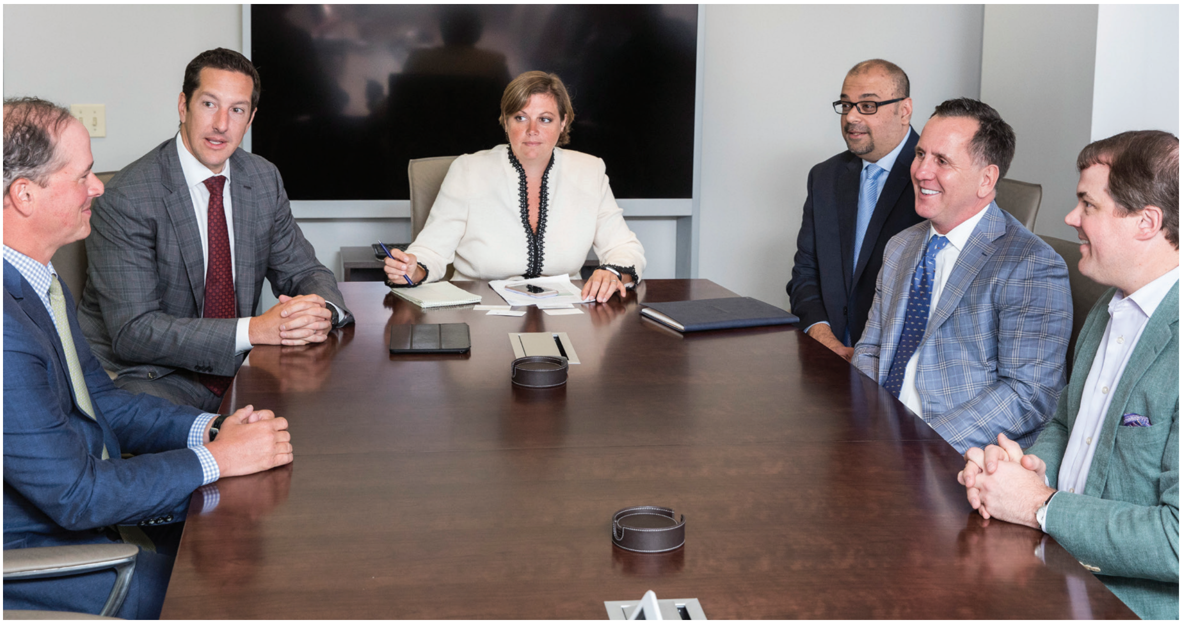
J.R. Davis, Managing Partner, Blue Sea Capital

Faraaz Kamran, Partner, Twin Brook Capital Partners

Jonathan Lewis, Managing Partner, Sheridan Capital Partners

Brian Miller, Managing Partner, Linden Capital Partners

Ken O'Keefe, CEO, Beecken Petty O'Keefe & Company



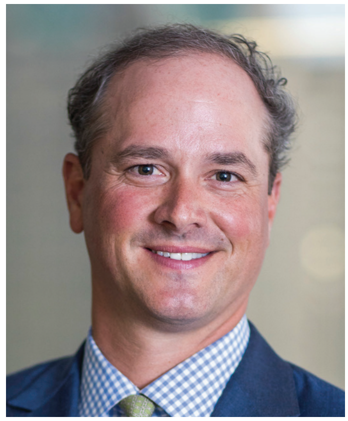
Danielle Fugazy (moderator): How would you characterize the healthcare industry today?

Ken O'Keefe, Beecken Petty O'Keefe & Co.: The healthcare industry is a $3.3 trillion industry and anticipated to go to $5.5 trillion over a 10-year period from 2015 to 2025. That is a lot of growth, and the growth is coming from volume—strong volume from demographics and more insured. And unit pricing pressure from payers is requiring companies and providers to get more efficient. This is all against the backdrop of an industry that's still very, very fragmented. The total investable public market cap of the industry, excluding pharma and the big insurers, is $800 billion.

Brian Miller, Linden Capital Partners: The forward growth rate for healthcare is 5.8 percent, according to CMS's latest update. If that were a top-line revenue growth rate for a buyout, you can turn 6 percent revenue growth into 8 or 9 percent EBITDA growth. And if you have 50 percent market debt leverage, you can produce a mid-teens equity return right there. While that is a good IRR for the larger LBO players, as you get down to the middle market, we're going to have to be pickier to find the outperformers within healthcare. That said, it is overall a great time to be in healthcare.

Jonathan Lewis, Sheridan Capital Partners: I would also add there's lot of opportunity for cost reduction and efficiency improvement to enhance bottom-line growth– there's more cost to be taken out of the system. Healthcare is notoriously inefficient and lags behind a lot of other industry sectors.

Faraaz Kamran, Twin Brook Capital Partners: For lenders, our return is really getting our money back. It's a little bit different than a private equity firm. Given our extensive experience in the sector, we feel comfortable with our appetite for taking on risk. Now we're not going to do anything that's 100 percent Medicare in one state, in one subsector. Those are places where you have stroke of the pen risk. But whenever you have expertise in healthcare, whether you're a private equity firm or a lender, you can work through the noise that's currently out there and back the right companies.



"The assets that capitalize on all the positive secular and healthcare system trends without reimbursement and/or regulatory headwinds tend to be the most popular."

J.R. Davis, Managing Partner, Blue Sea Capital

Fugazy: What subsectors within healthcare are garnering interest right now?

Lewis: I think all of us in this group have participated in practice management rollups to some degree. It's real company building, not just buying assets. It requires building infrastructure, technology and working on process improvement.

Miller: Two of our funds in the room own dental service organizations, and the sector remains active. In addition, dermatology is also very hot right now. Sixteen out of the 60 deals reported last quarter were in the dermatology space, according to HCPEA.

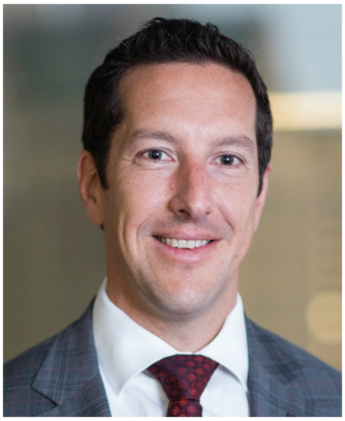
Kamran: Optical deals are also very hot now. I think orthopedic and women's health are the next two that are coming down the path from a practice management perspective. Radiology is newer. Right now, there are very few deals out there that we've seen in the sector. I think we will see more radiology deals at the end of this year, beginning of next year.

Miller: While the consolidation of specialists remains hot, there are tradeoffs. The key conversations aren't easy because they are often centered on people's current versus future compensation. But the growth plan is typically about putting additional doctors together, becoming more patient/customer-centric, improving payor relations, and putting in staff that truly cares about customer service and are compensated on that. And then you start to add scale and grow the business organically and through M&A.

O'Keefe: You can also add physician extenders that allow practices to see more patients.

Lewis: The practice management roll ups make it possible to create a structure that keeps physicians happy and productive and actually takes the workload off the providers. Quality of life for doctors has become more important than ever. Pay is important, but so is quality of life these days.

J.R. Davis, Blue Sea Capital: Practice management subsectors where scale translates into a better value proposition for patients and providers versus simply aggregating mass is of interest. The subsectors and operators with a sustainable consolidation strategy typically enable doctors to make more money, offices to be more efficient for patients, and employees to have better lifestyles. We see it in dental, eye care and dermatology.



"In more and more processes now, sellers and their advisors only invite healthcare heavy firms to participate."

Brian Miller, Managing Partner, Linden Capital Partners

Lewis: And young doctors are graduating with higher amounts of debt than ever before so the idea of buying into a practice in a traditional way is just not on the table. And the doctors generally do not want to manage an office anyway. They would rather clock in and clock out today and see patients.

Fugazy: What types of companies are garnering the highest valuations?

Lewis: There is certainly a flight to quality and diversification. Quality companies get a premium.

Davis: The assets that capitalize on all the positive secular and healthcare system trends without reimbursement and/or regulatory headwinds tend to be the most popular.

O'Keefe: Companies with $15 million to $30 million of EBITDA seem to be the best performers and private equity firms are willing to pay for them. My theory is that these companies really have better systems, better management, better revenue diversification, better growth opportunities than smaller companies, and a net balance of opportunity versus risk compared to larger ones.

Kamran: The other thing is that middle market companies like these are just better capitalized. In the middle market, you are actually trying to build something, to add value. Firms in the middle market that have done well for decades have viewed their job as a true building exercise, not just a financial engineering exercise.

Fugazy: How is the uncertainty around ACA influencing deal making?

Lewis: There continues to be uncertainty with respect to certain sectors until we know what's going to shake out. We are spending time looking at investing in areas that will not likely be impacted by ACA.

O'Keefe: Our firm has lived through two acts of Congress that dramatically changed the industry, the Balanced Budget Act of 1997, which took tens of billions out of healthcare government spending, and the ACA in 2009. And they both created winners and losers and I think it is the same here; it's just a matter of how it all plays out.

Davis: In the lower middle market, the key factor is Medicaid, and it is a state-by-state analysis. We are treading carefully and being thoughtful around businesses that are dependent on Medicaid and have benefited from the ACA's Medicaid expansion, given any potential future dislocation of the ACA.

Kamran: Regardless of changes that may be made, the impact would be three years down the line. But maybe the valuations will come down on some assets if they are directly in the cross hairs of ACA and Medicaid. Even so, it will take years to implement something, or years to unwind it. You are talking about 2020 at the earliest by the time things start happening. That's a lifetime in our business.

To be successful you have to invest where you have core competency and where there is cost containment. Investing in businesses that take patients out of the hospital to outpatient facilities or similar types of deals, are going to remain popular regardless of the legislation. You just have to make sure that you can figure out the dynamics and what will be covered in-network versus out-of-network. Our clients aren't necessarily staying away from anything; they are just being a little bit more prudent on some of those directly impacted areas.

Fugazy: How do middle market healthcare-specific private equity firms stack up against generalist firms?

Miller: Speed and certainty have become more important than ever before in auction processes. The sector-specific funds are really able to deliver that because they can prove they've completed deals in the sector before, or that they have a board member, an operating executive, or a relationship with the owners. Sector specific funds are able to show an internal conviction that the entire firm is already on board with. I have heard it's very tough for a generalist firm to try to explain why regulatory or reimbursement reform isn't going to affect your deal. In fact, in more and more processes now, sellers and their advisors only invite healthcare heavy firms to participate.

Sector-focused funds are also demonstrating that they have higher returns than generalist funds. Post-closing, the value creation process becomes the key differentiator. A Cambridge Associates study called "Declaring a Major" completed a few years ago showed that sector-specific funds have better returns than generalist funds.

O'Keefe: There are some generalist funds that have done extremely well because they siloed their healthcare group. It's sort of an embedded healthcare fund; it is not one guy doing both healthcare and business services. Funds with siloed groups are also very formidable competitors.

Davis: Exactly, our firm maintains a dedicated healthcare vertical, among a couple of industry verticals. Within healthcare, we don't try to boil the ocean, but really employ a thematic and targeted approach. Regardless of what kind of firm you have in today's market, you must be able to distinguish relative asset quality in a high-priced environment to ensure you are getting the value equation right, and we've found that requires not only being smart in healthcare but being deep and thematic within specific subsectors.

Separately, we all see many generalist funds moving into healthcare because I believe they see healthcare with better general growth rates, less relative risk of cyclicality, and more fragmentation due to the local nature of healthcare. Relative to most other industries which compete more nationally or globally, even in the lower middle market, there are generally more opportunities in healthcare to invest in regional leaders and then grow through acquisitions or organically to develop larger businesses.

"Companies with $15 million to $30 million of EBITDA seem to be the best performers and private equity firms are willing to pay for them."

Ken O'Keefe, CEO, Beecken Petty O'Keefe

Fugazy: How active are strategic acquirers in healthcare today?

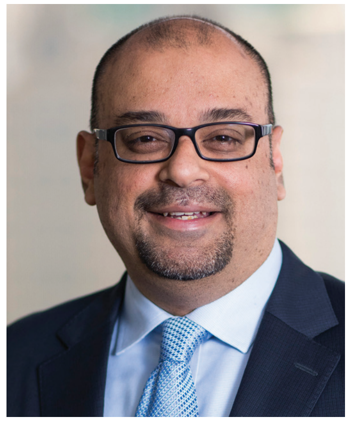
O'Keefe: More than half of our exits have been to strategic acquirers, and that wasn't true 10 years ago.

Miller: With the market's lower cost of capital, private equity has been able to compete with conservative strategics. We hear public healthcare companies complain about this often.

When we research sectors, we spend time talking with strategics about trends and competitors. There have been situations when a strategic has explained an acquisition isn't right for them right now, and they don't want to own the whole business, or that they are busy with other things and this business needs some touching up, but they could have interest at a later date. Some strategics are then willing to partner and say, if you did X, Y and Z over the next three years we'll be there upon exit. I predict strategics and private equity firms will work more together in the future.

Lewis: Strategic acquirers are frequently looking at the private equity channel as a "farm" system for assets they eventually want to acquire. Private equity has become a place to create businesses, build them up, scale them, and then sell them to strategics. It is a much more efficient way for strategics to grow their companies versus hiring and trying to build themselves.

O'Keefe: A little off topic, but we have done something a little different recently. We have had two exits in the very recent past where a financial sponsor was the most competitive value, and asked us to rollover with some of our capital and we did. It is something we never really would have thought about, or we would have dismissed a while ago. But now if you really like the platform and you're aware the business is not just calling money from investors but returning it, it's actually an interesting thing that we've now done twice in the last six months.



"It's always positive to see an owner willing to rollover with their capital."

Faraaz Kamran, Partner, Twin Brook Capital Partners

Kamran: We are actually seeing that more and it gives lenders confidence. It's always positive to see an owner willing to rollover with their capital.

Lewis: Limited partners are also more open to this than they ever have been. There is less siloing of fund to fund, and more flexibility, especially when you have a winner to continue backing. It is a great situation.

Fugazy: What are the challenges for the industry and investors?

Davis: The headwind is the amount of capital chasing opportunities within healthcare, and more generally, which manifests itself in higher prices. That said, we continue to believe that the key success factors are typically asset selection coupled with post-closing company-building and growth initiatives.

Lewis: For us, the headwinds are more around the pricing pressures. The question is, how do you deal with it? There are very, very few sectors that are experiencing pricing tailwinds. We try to focus on assets where that pricing pressure isn't as great, or that there are other dynamics in terms of patient experience that create a willingness to pay out-of-pocket.

O'Keefe: The biggest headwind is availability of capital and competition for deals. I have been in private equity 21 years and if you look at our four funds – fund one we were buying at seven, exiting at eight or nine; fund two we were buying at eight, exiting at nine or 10; fund three we were buying at nine – the point is it has just crept up. Now, we are exiting the markets at 12 to 15, and the historical market was seven to 10.

Another concern is the shortage of professionals we will likely face. Being a fragmented industry, we don't have the same management talent, and depth that other industries like IT or manufacturing have. There aren't as many big companies churning out executives that go on to do a bunch of great things in smaller companies. Accessing talent, particularly in the field to staff your operations but also in the executive offices, is something we are focused on.

Fugazy: What are the tailwinds for investors and the healthcare industry?

Lewis: The demographic tailwinds are fairly obvious, but another tailwind is technology opportunities within the sector. The patient experience is probably at the highest premium it has ever been, because you can go on the Internet and Google your providers and read reviews on what the experience has been through consumer advocacy groups and other reports. There is technology tapping this, creating more communication and more frequent communication between patients and their providers. All of this creates opportunity and is a very nice tailwind.

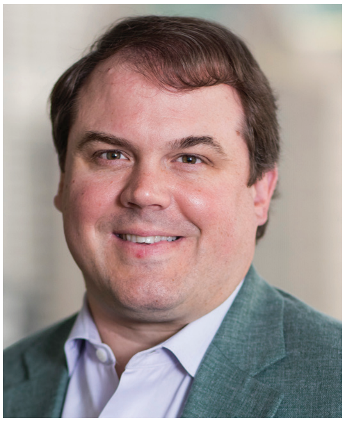
Davis: With more consumer-driven healthcare in general, innovation at the smaller end of the market, and historically inefficient incumbents, we have a greater opportunity to invest in disruptive businesses that can take share from legacy operators with less patient friendly delivery models. Nice secular organic growth rates and fragmentation that facilitates 'buyand-builds' combine to create great opportunity in the lower middle market.

O'Keefe: You have tremendous opportunity to invest in companies that could transform an entire industry. And what you're modeling is a three times return, which could be significantly greater if they're able to demonstrate this value proposition to the people that are paying. That's a great tailwind. It's also the growth. You might not think six percent growth is great, but unlike financial services, oil and gas, consumer retail, it doesn't have that dip risk—recession risk isn't nearly as profound as it is in other industries.

Davis: The bottom line is there are 10,000 people turning 65 every day, no matter what happens.

Kamran: And you cannot offshore what they need.

Fugazy: What are you expecting from the healthcare industry going forward?



"The practice management roll ups make it possible to create a structure that keeps physicians happy and productive and actually takes the workload off the providers."

Jonathan Lewis, Managing Partner, Sheridan Capital Partners

Miller: My sense is things will keep rolling as is. Valuations will remain high as investors on a broad level are not finding a lot of great areas to invest in right now. Private equity remains an attractive asset class, and healthcare especially so. At some point, if lending pulls back, private equity will pull back, and if it is like 2009 again, a great buying opportunity will arise.

Davis: Even more capital is being allocated to healthcare so I don't see any end in the near-term to the high prices being paid. As a result, we are really thoughtful about the subsectors that we work in. Next, we try to invest in category leaders that have a lot of different ways to win despite market cycles.

Kamran: I am 100 percent reactive to what my clients do. I would say my clients chase proverbial proprietary opportunities. These guys will tell you they spent years talking to executives at different companies and at some point, they all decide to sell or do something. Part of it is there has to be a deal to be made for there to be a deal to get it done. People who have done well previously have gone through multiple economic cycles, and multiple legislative cycles. The idea is that if you've done it long enough you know that if there is a business that takes cost out of the system, it's a good business regardless of what is going on in Washington DC. Strong investors know that.

O'Keefe: I think about two things. One is draconian action in Washington, whether it is through ACA or some effort to reduce spending like BBA 1997. The other risk which will take longer to play out is that multiples compress from 12 or 15 to something significantly less, which would require interest rates to go up a whole lot. We're not going to be at 12 or 15 times forever. That's impossible. The question is when it does move how quickly will it happen? The good news is that low multiples create great buying opportunities.

Kamran: We are halfway through the year. At the end of the day, there is two different types of lenders who are chasing deals. You have lenders who are just jumping into healthcare because their client is jumping into healthcare. So, they don't fundamentally understand the revenue model of the companies they are actually lending to, but they jump in because they see the opportunity. But not all companies are created equal. We are the other type of lender. For us, we are making deal-by-deal decisions. We look at each deal individually and ask, is this a good credit to back? It doesn't matter if we've done 10 deals in the same sector we decide every time if this is a good credit to back. We are not trying to back every single private equity firm out there, but instead back groups that we think are good, and credits that are worthy. We are looking at opportunities on a deal-by-deal basis.

That said, it is a busy time and there is nothing on the horizon that makes us think things are changing. Leverage might be a half-a-term higher, or a half-a-term lower, but the black swan risks are unknown. Anything could happen tomorrow, which changes things, but we do not see anything for now.

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