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Jessica L. Bailey-Wheaton, Esq., Editor
Todd A. Zigrang MBA, MHA, CVA, ASA, FACHE, Publisher

Q1 2021 PE Deals Disappoint Expert Predictions

The involvement of private equity (PE) in the healthcare industry in the first quarter of 2021 disappointed investors after the number of deals closed was only half the number of deals in the same quarter of 2020.[1] Just over a year ago, when the COVID-19 pandemic was hitting the U.S. full force, the volume of transactions increased at the end of the first quarter of 2020; however, there were very few large transactions.[2] After dipping in the second quarter, the latter half of 2020 saw a revival of PE deal making, and after a particularly robust fourth quarter, investors anticipated a surge of transactions leading into 2021.[3] Instead, the volume of transactions dipped once again in the first quarter of 2021, worrying investors as to the state of PE activity in healthcare. However, the first quarter's reported deal volume is somewhat misleading. While deal volume showed a slight decline, the average value of these transactions was significantly larger, with average seller size by revenue clocking in at $676 million.[4] This *Health Capital Topics* article will review PE activity generally, and in the healthcare industry, during the COVID-19 pandemic, and discuss what is expected for the remainder of 2021, in light of PE performance in the first quarter.

As detailed more fully in the June 2020 *Health Capital Topics* article entitled, "*Post-Coronavirus Physician Practice Acquisitions: Proceed with Caution*," PE firms have become more involved in the healthcare industry in recent years.[5] Healthcare has become a popular target for PE firms for several reasons. First, investors see an opportunity to consolidate the fragmented healthcare industry as physicians have become less interested in owning their own practices due to increasing administrative burdens and capital requirements.[6] These market forces provide an opportunity for investors to deliver physician practices much-needed capital and other resources to allow these providers to continue working in an independent practice setting. At the same time, PE investors will attempt to increase the value of the practice for a later sale by increasing efficiencies and achieving economies of scale (i.e., through the aggregation of a "platform practice" acquisition and numerous subsequent "roll-up practice" acquisitions). Second, healthcare has fairly reliable revenue streams due to the U.S. government being the largest payor of medical costs, primarily through the Medicare and Medicaid programs,[7] which accounted for an estimated $799.4 billion and $613.5 billion in healthcare spending, respectively (approximately 37% of all healthcare expenditures).[8] Third, healthcare has an outsized role in the U.S. economy. National health spending is projected to grow 5.4% annually for the next decade, and national healthcare expenditures already comprise nearly 20% of the U.S. gross domestic product (GDP).[9] Fourth, healthcare has historically prevailed during economic downturns, such as the 2007-2009 Great Recession, due to insulation from payors (such as Medicare and Medicaid).[10] However, no industry was particularly safe from the financial crisis wrought by COVID-19, with much of the U.S. "nonessential" workforce either furloughed or subject to stay-at-home orders for a significant part of 2020.[11]

PE investment in healthcare began to gain traction in mid-2019 with a year of record-breaking statistics, wherein mergers and acquisitions (M&As) in total accounted for $339 billion across 3,137 deals.[12] The second quarter of 2019 saw an outstanding number of deals (220) within health services and 250 deals in pharma & life sciences, driven by synergistic technology and consolidation to help reduce overall costs.[13] The second half of 2019 declined slightly, but 2020 began with a bang – 452 healthcare industry deals totaling over $140 billion at the end of the first quarter.[14] By March 2020, the momentum investors hoped would carry into the second quarter came to a screeching halt during the height of the COVID-19 pandemic. Not only did the volume of deals slow, but many general partners also looked to back out of previously agreed upon deals.[15] The U.S. Bureau of Labor Statistics reported an economic recession in July 2020 after the U.S. economy reached its peak in February 2020,[16] and the outlook for the third quarter was bleak. However, by the end of September 2020, deal activity looked to be rebounding with high hopes for the rest of 2020 and the start of 2021.[17] True to predictions, deal activity remained robust in the fourth quarter of 2020. Despite the slowing economy, companies were not looking to ignore M&A transactions entirely, but instead became more deliberate with the deals they could complete.[18] The increase in transactions at the end of 2020 was also fueled by the presidential election, with some firms jumping to close deals before the end of the year, in an attempt to increase their after-tax proceeds now before anticipated tax rate increases in 2021.[19]

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Notably, a new PE trend started to emerge in healthcare at the end of 2020 –"mega mergers," or transactions between companies with combined revenues over $1 billion. Previously, the typical healthcare PE deal structure looked to connect smaller, fragmented pieces in the healthcare industry and offer capital and high-level management services to private practices.[20] While 2019 only saw three mega-mergers, 2020 had seven of these massive transactions, and 2021 is expected to follow suit and see an increase in transactions with this contemporary deal structure.[21]

The first quarter of 2021 did in fact meet the expectations of higher-valued transactions, but did not see an increase in volume. As noted above, the record-setting average seller size of $676 million by revenue was paired with a total of $8.8 billion in total transacted revenue for the first quarter.[22] The total revenue came in second only to the total revenue in the first quarter of 2018 of almost $13 billion.[23] There were multiple factors that contributed to this drop in deals. First, while the number of deals were below historic averages, transaction activity was on par in the context of the COVID-19 pandemic.[24] Second, some of the deals closed during the robust second half of 2020 were picked back up after getting postponed during a frenzied second quarter, and others were closed quickly in anticipation of tax changes in 2021. In other words, the concentration of PE deals in the latter half of 2020 was abnormal and would have typically been spread out over the entirety of 2020 and the first quarter of 2021, rather than concentrating those deals in a six-month period, which resulted in artificially inflated figures for those quarters (and perhaps subsequent expectations).[25]

Momentum is expected to pick up through the subsequent quarters of 2021, as PE activity from February to March alone saw an 8.6% increase.[26] Other trends that PE firms are expecting over the remainder of 2021 are still greatly influenced by the COVID-19 pandemic, such as integrating more technology into health systems. Most of the largest exits in 2020 were in technology-based companies and healthcare-focused technology companies.[27] This is attractive to investors because consumers (i.e., patients) will likely want to maintain the current flexibility between in-person and online modalities, and healthcare will also need to remain flexible to meet those needs. From this emerges a new business model that requires full integration of telehealth services and the need to strengthen capital resources.[28] Therefore, as the latter half of 2021 approaches, it is expected that healthcare providers will focus on the sustainability of their telehealth services, and investors will look to increase their footprint in the healthcare space as the adoption of technology, as well as value-based reimbursement, moves forward, creating an opportunity for PE involvement.[29]

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Todd A. Zigrang, MBA, MHA, CVA, ASA, FACHE, is the President of **HEALTH CAPITAL CONSULTANTS** (HCC), where he focuses on the areas of valuation and financial analysis for hospitals, physician practices, and other healthcare enterprises. Mr. Zigrang has over 25 years of experience providing valuation, financial, transaction and strategic advisory services nationwide in over 2,000 transactions and joint ventures. Mr. Zigrang is also considered an expert in the field of healthcare compensation for physicians, executives and other professionals.

Mr. Zigrang is the co-author of "*The Adviser's Guide to Healthcare – 2nd Edition*" [2015 – AICPA], numerous chapters in legal treatises and anthologies, and peer-reviewed and industry articles such as: *The Accountant's Business Manual* (AICPA); *Valuing Professional Practices and Licenses* (Aspen Publishers); *Valuation Strategies; Business Appraisal Practice*; and, *NACVA QuickRead*. In addition to his contributions as an author, Mr. Zigrang has served as faculty before professional and trade associations such as the American Society of Appraisers (ASA); American Health Lawyers Associate (AHLA); the American Bar Association (ABA); the National Association of Certified Valuators and Analysts (NACVA); Physician Hospitals of America (PHA); the Institute of Business Appraisers (IBA); the Healthcare Financial Management Association (HFMA); and, the CPA Leadership Institute.

Mr. Zigrang holds a Master of Science in Health Administration (MHA) and a Master of Business Administration (MBA) from the University of Missouri at Columbia. He is a Fellow of the American College of Healthcare Executives (FACHE) and holds the Accredited Senior Appraiser (ASA) designation from the American Society of Appraisers, where he has served as President of the St. Louis Chapter, and is current Chair of the ASA Healthcare Special Interest Group (HSIG).

Jessica L. Bailey-Wheaton, Esq., is Senior Vice President and General Counsel of HCC, where she conducts project management and consulting services related to the impact of both federal and state regulations on healthcare exempt organization transactions, and provides research services necessary to support certified opinions of value related to the Fair Market Value and Commercial Reasonableness of transactions related to healthcare enterprises, assets, and services.

She serves on the editorial boards of NACVA's The Value Examiner and of the American Health Lawyers Association's (AHLA's) Journal of Health & Life Sciences Law. Additionally, she is the current Chair of the American Bar Association's (ABA) Young Lawyers Division (YLD) Health Law Committee and the YLD Liaison for the ABA Health Law Section's Membership Committee. She has previously presented before the ABA, NACVA, and the National Society of Certified Healthcare Business Consultants (NSCHBC).

Ms. Bailey-Wheaton is a member of the Missouri and Illinois Bars and holds a J.D., with a concentration in Health Law, from Saint Louis University School of Law, where she served as Fall Managing Editor for the Journal of Health Law & Policy.

Daniel J. Chen, MSF, CVA, focuses on developing Fair Market Value and Commercial Reasonableness opinions related to healthcare enterprises, assets, and services. In addition he prepares, reviews and analyzes forecasted and pro forma financial statements to determine the most probable future net economic benefit related to healthcare enterprises, assets, and services and applies utilization demand and reimbursement trends to project professional medical revenue streams and ancillary services and technical component (ASTC) revenue streams. Mr. Chen holds the Certified Valuation Analyst (CVA) designation from NACVA.

Janvi R. Shah, MSF, serves as Senior Financial Analyst of HCC. Mrs. Shah holds a M.S. in Finance from Washington University Saint Louis. She develops fair market value and commercial reasonableness opinions related to healthcare enterprises, assets, and services. In addition he prepares, reviews and analyzes forecasted and pro forma financial statements to determine the most probable future net economic benefit related to healthcare enterprises, assets, and services and applies utilization demand and reimbursement trends to project professional medical revenue streams and ancillary services and technical component (ASTC) revenue streams.