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Valuation of Healthcare Service Sector Enterprises for Purposes of Private Equity Investment: Introduction (Part 1 of a 3 Part Series)

A growing number of *private equity* (PE) groups are approaching large physician-held groups and other healthcare service enterprises, including hospitals and outpatient enterprises, seeking investment opportunities in the clinical services industry. This influx of PE investment is not only ameliorating a dearth of financial capital available to healthcare service enterprise's, but are also allowing these provider groups to "*step up*" to the next phase of growth by providing the management capital (e.g., resources, knowledge, skills, and ability) to facilitate the provider's transition to *value-based reimbursement*.

PE is a capital funding source that is not available through a public exchange and is often utilized to: (1) expand a business; (2) fund new technology; or, (3) supplement an established entity's working capital.[1] PE investors often invest in an established (and perhaps faltering) business in hopes of restructuring the business and installing professional business management, with the ultimate goal of making the business more efficient and more profitable.[2] It should be noted that this type of investing is distinct from *venture capitalism* (VC), as VC investors generally invest in the creation of a new business, [3] with the goal of capturing returns resulting from the large growth opportunities of start-ups over a short period of time.

While the global economic insecurity throughout 2016 resulted in a sharp decline in overall PE deals – spurred by uncertainty arising from events such as Brexit and the U.S. presidential election – PE deals in the U.S. healthcare industry hit a decade high in 2016, reaching $36.4 billion.[4] This milestone (which will likely be surpassed in 2017, considering the current pace of deals[5]) continues the trend of significant growth in healthcare PE investment, during which PE deals soared from approximately $16 billion in 2013 to approximately $30 billion in 2014.[6] These numbers indicate that, over the past decade, an increasing number of investors have become more knowledgeable about, and more comfortable with, entering a perilous market with complex regulation and uncertain reimbursement.[7]

Despite rising healthcare costs and the aforementioned volatility of the healthcare industry,[8] PE investors have nevertheless been drawn to the stability provided by a reliably aging population with increasing demands for healthcare services; an influx of newly insured individuals due in part to the *2010 Patient Protection and Affordable Care Act* (ACA); and, an increasing incidence and prevalence of chronic disease.[9] Consequently, the healthcare industry has ranked in the top three industries in rates of return every year since 2011.[10] This achievement has not gone unnoticed, as new investors such as generalist PE investors; sovereign wealth funds; pension funds; family offices; and, providers themselves, have invested in healthcare service sector enterprises, creating a new level of competition for general PE buyout funds.[11] The increased interest in healthcare PE investment targets has been undeterred by the uncertainty surrounding the future of healthcare reform, possibly due,[12] at least in part, to the sheer size and scope of healthcare (as it comprises almost 20 percent of the U.S. *gross domestic product*[13]).

Over the past couple of decades, the provider services subsector has ranked sixth in the healthcare industry in median returns.[14] These provider service sector enterprises garnered particular interest from PE investors over the past several years, partly due to the success of the buyout of both for-profit, publicly traded health systems such as Hospital Corporation of America (HCA), and large, privately owned healthcare service sector companies such as ManorCare.[15] More recently, the deal value for the U.S. provider sector increased from $7.3 billion in 2015 to $11.8 billion in 2016.[16] Some of the more popular healthcare service enterprise PE targets included retail health (e.g., physical therapy) and dermatology.[17]

Moreover, providers themselves are launching other investment arms to support their service enterprise's initiatives, focusing their investments in digital health, medical devices, and diagnostics.[18] For example, in December 2016, Inova Health System, a large health system in the Washington, DC metropolitan area, announced the creation and launch of *Inova Strategic Investments* (ISI), which "…*will invest in healthcare venture funds and will also invest directly into companies aligned with Inova's strategic priorities as part of Inova's vision to be a global leader in the delivery of personalized health*."[19] Mid-sized hospitals are also seeking to invest, for example, Spectrum Health, a midsized health system located in Grand Rapids,

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Michigan, created a $100 million fund in 2017 "…*to invest in personalized medicine, information technology, population health management and other emerging technologies*."[20]

Although the U.S. healthcare industry has been relatively unstable over the past several years, traversing: the paradigm shift from *volume*- to *value*-based reimbursement; the increasing regulatory scrutiny of healthcare transactions; and, the continuing uncertainty regarding the state of healthcare reform, the healthcare PE market is considered an opportunity for investors.[21] PE investors have turned to specific subsectors that are more likely to remain stable amid the healthcare industry's political, regulatory, and reimbursement volatility.[22] The consistently high returns on healthcare PE investments have kept investment interest in the healthcare service sector high, resulting in increased valuations and a diversification of investors.

The future installments in this three-part series will discuss the special valuation considerations of these going concern enterprises, and will compare and contrast this PE investment trend with the failed *physician practice management company* (PPMC) business model of the 1990s.

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