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HEALTHCARE INSIGHTS

Private Equity Investment in the Healthcare Industry: The Fundamentals of Private Equity

(Part I of III)

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While private equity investment has declined in the past couple of years due to global economic insecurity, private equity transactions in the healthcare industry have been growing significantly.[1] A growing number of private equity 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 private equity investment is not only ameliorating a dearth of financial capital available to healthcare service enterprises, but is 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.

This first installment of a three-part series will describe the fundamentals of the private equity industry, in general, and set forth a common terminology that will be utilized throughout the series. The second and third installments will further discuss the trends in private equity utilization in the healthcare industry.

FINANCIAL INTERMEDIATION

A hallmark of an advanced economy is the development of financial intermediaries, i.e., middlemen that operate between economic actors to facilitate economic transactions.[2] In the investment arena, this role is often fulfilled by financial institutions such as banks, insurance companies, or pension funds, among numerous others.[3] These institutions collect excess financial capital from savers and invest those funds to generate financial returns, wherein a portion is retained by the financial institution as compensation for the services provided and the remainder is distributed to the individual investors.

A simple example is a common savings account with a commercial bank under the fractional reserve banking system.[4] The bank collects deposits from the account holder and in return, promises to make interest payments to the account holder at an expressed rate of interest. The bank then invests the collected deposits (less the regulated capital reserve requirements) by way of loans, also with an expressed interest rate, which is greater than the interest rate paid on the deposits. In this manner, the bank redirects the excess capital of the savers into productive use by the borrowers, i.e., the bank acts as the middleman between the saver and the borrower.

The difference between the interest charged to the borrower and the interest paid to the saver is the bank's compensation for providing these intermediation services, as well as:

1. Remuneration for the assumption of a portion of the default risk of the issued loans
2. The risks arising from converting the short-term on-demand liabilities (i.e., the savings accounts) into long term assets (i.e., the loans)
3. Providing the due diligence related to the credit worthiness of the borrowers
4. Providing diversification benefits by distributing the credit risk of numerous loans across the bank's entire depositor clientele[5]

1 "Global Healthcare Private Equity and Corporate M&A Report 2017" By Kara Murphy et al., Bain and Company, April 19, 2017, http://www.bain.com/publications/articles/global-healthcare-pe-and-corporate-ma-report-2017.aspx (Accessed 11/10/17).

2 "Financial Intermediary" Investopedia, https://www.investopedia.com/terms/f/financialintermediary.asp (Accessed 12/18/18).

3 "Chapter 2: Financial Intermediaries and Financial Innovation" in "Foundations of Financial Markets and Institutions" By Frank J. Fabozzi, et al., Prentice-Hall: Upper Saddle River, NJ, 2002, p. 15.

4 "Chapter 4: Depository Institutions: Activities and Characteristics" in "Foundations of Financial Markets and Institutions" By Frank J. Fabozzi, et al., Prentice-Hall: Upper Saddle River, NJ, 2002, p. 43–64.

5 "Chapter 2: Financial Intermediaries and Financial Innovation" in "Foundations of Financial Markets and Institutions" By Frank J. Fabozzi, et al, Prentice-Hall: Upper Saddle River, NJ, 2002, p. 16–18.

As noted above, several other financial institutions also perform an intermediation function. In addition to pension funds and insurance companies, the financial intermediation function is also performed, to a greater or lesser extent, by multiple financial firms, including:

1. Publicly traded equity markets
2. Hedge funds
3. Investment banks
4. Mutual funds
5. Private equity funds[6]

Each of these financial institutions provide a specific form of intermediation that is typically defined by the types of investors and types of users of financial capital that are connected through the firm's activities with an abundant opportunity for overlap.

Financial intermediation exists to assist market participants in completing economic and financial transactions. Search costs can be a significant expense for both investors and borrowers, an expense that may tend to limit the number of transactions undertaken, as some transactions may have their returns subsumed by these costs. Financial intermediaries can assist in overcoming this hurdle by reducing these search costs for both parties, thereby increasing the potential volume of transactions consummated.

Imagine a situation where a borrower seeks funds for a startup company in an economy that lacks financial intermediaries, i.e., no banks, no equity markets, no private equity funds. How would this borrower find funding for their project—through attempts to solicit funds from high net worth individuals? By taking an ad out in the paper? These options require the borrower to expend both time and financial capital to fund in pursuit of an uncertain outcome.

Should those expenses exceed the expected returns from the project (or diminish them below the borrower's hurdle rate[7]) the project will not be funded, despite the fact that there may exist willing investors with excess capital in search of investment opportunities. Financial intermediaries exist to help investors and borrowers overcome these obstacles.

WHAT IS PRIVATE EQUITY?

As was previously noted, multiple institutional categories exist in the financial intermediation industry, all providing a similar, yet distinct, function within the marketplace. These financial intermediaries can be defined by the specific market participants to which they provide their intermediation services. Among these categories, private equity funds serve the unique market comprised of investors seeking returns on their invested capital from privately held companies, i.e., companies whose equity is not traded on a formal public securities exchange.[8] Typically, these borrowers have limited access to capital, restricted to personally guaranteed loans from commercial banks and loans from the firm's owners and their friends and family. Private equity, therefore, services a more uncertain set of potential investments and consequently demands returns commensurate with those assumed risks. Accordingly, in the spectrum of financial intermediaries, private equity tends to exist toward the high-risk-high-reward end, thereby providing investors with a greater tolerance to risk to access these private company investments.[9]

Private equity firms can be further subdivided based upon the particular niche within privately held companies in which they invest. Generally speaking, private equity typically invests in the following four areas:

1. Venture Capital
2. Distressed Companies
3. Mezzanine Financing
4. Buyouts[10]

The traditional concept of private equity is likely that of the venture capital firm. These types of private equity funds seek out investments in early to mid-stage startup companies (often pre-revenue).[11] The private equity firm will commit capital to a portfolio of potential firms with the knowledge that often these companies will never achieve profitability, but a potentially small number of the investments may

6 "What is Financial Intermediary?" Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/knowledge/finance/financial-intermediary-transactions/ (Accessed 12/18/18); "Financial Intermediaries in the United States: Development and Impact on Firms and Employment Relations" by Eileen Appelbaum, Rosemary Batt, Jae Eun Lee, Cornell University ILR School, 2014.

7 Defined as "the minimum rate of return on a project or investment required by a manager or investor. "Hurdle Rate" Investopedia, May 17, 2018, https://www.investopedia.com/terms/h/hurdlerate.asp (Accessed 12/18/18).

8 "Chapter 19: Issuing Securities to the Public" in "Modern Financial Management" By Stephen A. Ross, McGraw-Hill/Irwin: New York, NY, 2008, p. 570–573.

9 "Part 1: What is Private Equity? Private Equity Education Series" UBS Alternative Investments, December 13, 2010, https://www.activeallocator.com/static/pdf/UBS%20Compendium%20Alternative%20Investments%20Education%20Series.pdf (Accessed 12/18/18).

10 "Part 3: Private Equity Strategies, Private Equity Education Series" UBS Alternative Investments, December 13, 2010, https://www.activeallocator.com/static/pdf/UBS%20Compendium%20Alternative%20Investments%20Education%20Series.pdf (Accessed 12/18/18).

11 "Unpacking Private Equity, Characteristics and Implications by Asset Class" McCombie Group, http://www.mccombiegroup.com/wp-content/uploads/2013/03/20130222-Unpacking-Private-Equity.pdf (Accessed 12/18/18).

generate returns sufficient to offset the losses from the non-performing investments. This is a strategy that has been applied repeatedly throughout the technology startup boom in Silicon Valley.

Another alternative to a venture capital investment strategy for private equity firms is to purchase distressed companies with the intention of managing a turnaround. This strategy involves investment in firms that have a solid core concept, but perhaps also have issues with capital access or with low quality of management.[12] These investments often require a considerable amount of management control to be exercised by the private equity firm. Private equity funds investing in distressed companies will often have a short term (i.e., three to five year) investment horizon, after which they will divest of the (hopefully healthier) firm at a premium over their acquisition price. It should be noted that this type of private equity investment need not involve the complete acquisition of a distressed firm, only the ceding of control to the private equity investor. As with venture capital firms, distressed company private equity funds will invest in a broad portfolio of distressed companies with the aim to offset losses from firms that ultimately end up in bankruptcy with benefits received from successful turnarounds.

Mezzanine financing is another niche activity that is often performed by specialized private equity firms. Mezzanine financing is placed firmly in the gray area between debt and equity financing. This strategy involves investment through debt which may be convertible to equity or include purchase warrants/options for equity at a specified price in the future.[13] Private equity firms engaged in mezzanine financing will earn contractual interest payments on the loaned capital, but should the value of the company increase significantly, the conversion rights or purchase options may become valuable. Often, this type of lending is secured by late stage startup firms that have a reasonable track record of profitability and provide greater flexibility than traditional senior debt,[14] e.g., the ability to capitalize interest into the loan in the event that the company fails to generate sufficient income to make an interest payment. Firms often enter into mezzanine debt obligations to reduce the amount of equity investment required and may allow equity investors to leverage their equity investment and enhance returns. Ordinarily, firms are capitalized with a combination of senior debt (up to the amount a lender is willing to commit) and owner's equity capital. Through the use of mezzanine debt, the required equity investment may be reduced by including a second lender, which reduces the amount of capital to be invested by the equity owners. While less risky than other types of private equity due to the debt-like nature of the investment, mezzanine financing by private equity firms will often also be spread across multiple firms to limit the risk of complete loss and to maximize the potential upside benefits. Mezzanine financing is often utilized by developed start-up firms that have a solid revenue history, but are still in the pre-initial public offering (IPO) stage, in order to finance additional expansion.

Buyouts or leveraged buyout private equity firms are similar to distressed company private equity investors, in that their strategy involves the acquisition of companies with the goal of restructuring the firm to enhance profitability for sale under a relatively short time horizon. However, buyout funds differ from distressed company funds in that they are not necessarily seeking out financially distressed firms to invest in; instead, they are seeking firms with unrealized cash flow potential that, under the right type of management, could be fully achieved. Like distressed company investors, buyout private equity firms provide an enhanced depth of management and access to capital that allow the acquired company to reach its full potential. Leveraged buyout private equity firms rely heavily on debt markets for financing (potentially up to ninety percent) of their investments in companies which debt will subsequently be repaid when the improved firm is sold at a premium over the private equity purchase price, netting the buy-out fund the difference between the acquisition price and the exit price.[15] Buy-out firms may also enter into lucrative management services agreements with the acquired companies as an additional source of revenue from the investment.

While it is convenient to classify private equity firms into the above groups, more often than not, a single private equity fund will engage in multiple strategies simultaneously, creating sub-funds that engage in all of the above strategies. Further, the list set forth above is not exhaustive, as private equity is an active area of investment wherein the search for returns motivates innovation within the market.

12 *Ibid*.

13 "Mezzanine Financing" Investopedia, https://www.investopedia.com/terms/m/mezzaninefinancing.asp (Accessed 12/18/18).

14 Defined as "borrowed money that a company must repay first [before senior debt] if it goes out of business." "Senior Debt" Investopedia, July 31, 2018, https://www.investopedia.com/terms/s/seniordebt.asp (Accessed 12/18/18).

15 "7 Private Equity Strategies Investors Should Know" Darc Matter, https://blog.darcmatter.com/7-private-equity-strategies-investors-should-know/ (Accessed 12/18/18).

In addition to classifying private equity funds by their investment strategy, it is also possible to consider the industry (or industries) within which the private equity fund invests its capital. Private equity funds tend to fall into one of two types of investors: 1) generalists investing in a broad array of firms across multiple industries and 2) industry-specific investments restricting the fund to a specific industry in which the firm has a comparative advantage in knowledge and experience. Private equity firms employing a venture capital, distressed company, or buyout strategy, which require significant management input by the private equity firm to be successful, will often specialize within an industry in which their principals have experience. However, as with the strategies above, a fund may also specialize in multiple companies across industries, particularly those which may offer opportunities for synergies that can further enhance their return prospects across their portfolio of investments.

As a result, a particular private equity fund (which may be one of many individual funds managed by a private equity group) can be classified by their investment strategy and their industry, e.g., Acme fund is a healthcare services buyout fund or Acme fund is a gas and power distressed company fund.

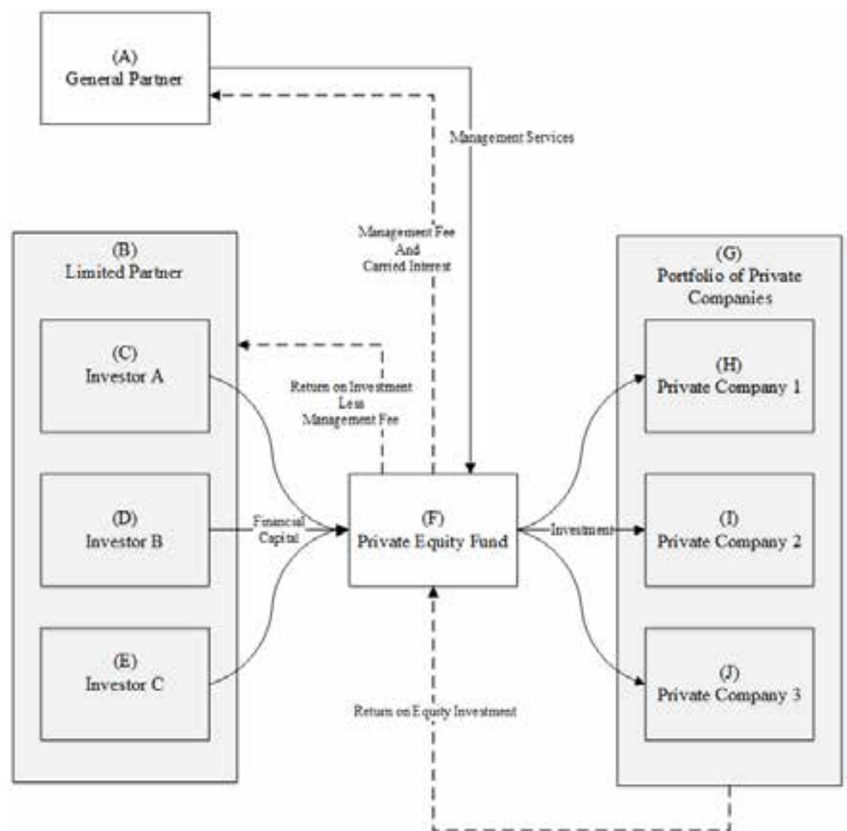
The Structure of a Private Equity Fund

Private equity funds are typically organized as partnerships, with the external investors in the fund being referred to as limited partners and the private equity firm as the general partner. The limited partners are typically comprised of investors with access to large amounts of capital, such as pension funds, endowments, or high net worth individuals, among others. The general partner is the private equity firm(s) that performs the management functions for the fund.

Returns generated by the fund are divided between the general partner and the limited partners as per the partnership agreement. The general partner is typically compensated through management fees based on a percentage of assets under management, as well as, a performance fee (often referred to as carried interest), which is based upon a share of the profitability of the fund and often subject to a hurdle rate, i.e., the performance fee is a share of the profits after a specified minimum return.

The below exhibit sets forth the structure of a simplified private equity fund:[16]

16 "Chapter 19: Issuing Securities to the Public" in "Modern Financial Management" By Stephen A. Ross, McGraw-Hill/Irwin: New York, NY, 2008, p. 570–573.



In actuality, private equity funds can be significantly more complicated, spanning multiple different funds with complex compensation schemes for the general partner and various limited partners with differing partnership percentages.

Conclusion

Private equity is a form of financial intermediation that seeks to connect investors seeking returns with potential investments in operations that do not currently have access to formal equity markets. Private equity funds allow investors to participate in the ownership of these privately held companies, while diversifying their risk across numerous investment opportunities. Private equity funds can come in several "flavors," which are typically defined by their investment strategy and specialization (or

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lack of) in a specific industry. These funds are generally organized as partnerships between a private equity firm, which provides the management services to the private equity fund, and investors, which provide the capital.

The aggressive search for returns and the flexibility of the private equity model have resulted in the private equity industry being a hot bed for investment in innovative products and services, as evidenced in the private equity investments throughout the technology industry. It would only seem natural that the healthcare industry, which is undergoing rapid changes in technology and regulation, would be ripe for an infusion of capital from the private equity industry.

The second and third installments of this three-part series will review trends in the use of private equity in general and within the healthcare industry.

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