PRIVATE EQUITY PERSPECTIVES PODCAST

EPISODE 27:
HEALTHCARE M&A IN THE AGE OF COVID

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

TOPICS DISCUSSED INCLUDE:

INTRODUCTION

Todd: Hello, and welcome to BDO's Private Equity PErspectives podcast. I'm Todd Kinney, National Relationship Director in BDO's Private Equity practice based in New York City. I'm excited to have a couple of special guests with me here today, both of whom work in the healthcare M&A space. Just as a quick reminder, the remarks and opinions of our guests do not necessarily represent BDO's views. With that, first I'd like to introduce Don Ritucci. Don's a managing director and head of healthcare M&A at Oppenheimer and Co. Good to have you here today, Don.

Don: It's a pleasure to be here with you both. I actually started my career investment banking in the late '90s at UBS as a healthcare M&A banker and I worked hand-in-hand with Jon. I've been in the trenches with him on a number of deals, particularly in the dental space, so it's great to reconnect here today.

Todd: Fantastic. After doing 20+ of these, we've never had guests that have worked together, so that'll bring a unique perspective. As you hinted, our second guest is Jon Santemma, who is the co-founder and general partner at Regal Healthcare Capital Partners. Jon, welcome to the podcast.

Jon: Thanks. Thanks for having me. Good to be back with you again, Don, as well. Appreciate it.

INTRODUCTORY QUESTIONS

Todd: All right, guys. Well, this should be a fun discussion. Let's jump into it. Don, I know you've got a new role over at Oppenheimer, so congrats to you on that, buddy. I think I already congratulated you on LinkedIn, but it's a great move—I actually started my banking career there. Again, as an MD and head of healthcare M&A there, maybe you can tell us a little bit about your firm and how you're spending your time.

Don: Well, many thanks again, Todd. Appreciate that. As you mentioned, I joined Oppenheimer earlier this year in January to take on that role. It's been a great first 100 days or so. In fact, the group has grown significantly. We've made five senior banker hires in the last year alone and we continue to look to grow.

Today, our healthcare group is over 35 bankers and it's the largest group here at Oppenheimer. Broadly, we're covering services and life sciences. On the services side, it's more on the payer services, behavioral services into the home, physician groups such as GI, dental, ortho, and primary care, which I know we're going to talk a little bit about later on. And then on the life sciences side, it focuses on biotech, pharma, specialty pharma, tools and diagnostics, and medical devices. So, we have the health care landscape pretty well covered.

Todd: Awesome. You certainly have a wealth of experience to bring to the conversation. Jon, again, I know we mentioned you co-founded Regal Healthcare Capital and are a general partner there. Perhaps you can give us an intro to Regal, talk about how deal making for your firm has changed in the last year, and how you approach deals in the current climate.

Jon: Sure thing, thank you. Regal is a relatively new healthcare focused private equity firm; we're about three years old. My background was healthcare investment banking. I was a health care investment banker for 20+ years, mostly working with healthcare services businesses in smaller, faster-growing subsectors, a lot of multisite as well as post-acute. Ultimately, I was the global head of healthcare at Jefferies, where I oversaw everything biotech, med-tech, [pharma and] services all over [the world]. But, services was always close to my heart and really where my client base was. After a stint as a global head of healthcare at Jefferies, I had the opportunity about three years ago, to partner with Dr. Dave Kim and start Regal.

The reason Dave and I partnered is our skillsets are pretty complementary. I had the finance background and had worked extensively with fast-growing services businesses. But Dave is really a unique animal: Dr. Kim was an engineer. He did operational consulting for a number of years with Arthur Anderson where he helped large companies be more efficient, and then switched gears and went to medical school and became an ER doctor. He was in the ER and saw how inefficient it was and decided to open one of the first urgent care clinics here in the New York market. That ultimately became CityMD, one of the largest urgent care chains in the country. In addition to that, he started a from-scratch retail dental chain, which is now 60 offices here in the tri-state market, and also started an emergency room management business, which is now top 15 in the country. Really impressive combination of physician, entrepreneurialism and operations.

We thought there was a market to start Regal and focus on businesses with less than $10 million of EBITDA in healthcare services that had a proven model but needed capital, and more importantly, expertise on how to scale quickly and how to avoid the potholes that high growth can put in front of you. Three years in, we have $250 million under management. We've got about half a dozen investments and are actively looking at more.

In terms of your second question, what's changed over the last year, COVID obviously, big factor here the last year. It had made for pretty challenging deal environment because sellers were looking for significant addbacks that were kind of difficult to prove out. And even if you could prove them out, it was a little unclear what the longer term or medium-term effects of COVID on the business would be. It made underwriting a little bit challenging, so we actually didn't do a deal over the last six to nine months as we grappled with that. That's changed as we'll talk about. But one thing we've seen is telehealth, for example, getting a huge boost. That's one impact and mental health is another. A lot of attention is now coming to mental health because of anxiety, substance abuse being up and all due to COVID and the lockdowns.

SECTOR OUTLOOK

Todd: Right. Well, listen, I appreciate you being here. That's a great foundation and I'm also a huge supporter of your partner, Dr. Kim—Great guy. Thanks again for being here.

Jon: Thank you.

Todd: Don, I'll pivot to you. I want to dive a little deeper into your take on where the healthcare space is right now in terms of investment opportunities. I recently read that Oppenheimer's healthcare investment banking group completed five primary care transactions in 2020. There is a question here, Don. Perhaps you can touch on why you think there is so much interest in primary care.

Don: It's actually a sector that's been overlooked for quite a while and did not get a lot of attention. As you mentioned, we did five deals alone in 2020. There's probably been about 50 since 2010, and we've worked on about 40% of them. I really can't say we—it's really been my partner, Mark Cabrera, who co-heads our healthcare group and leads up our healthcare services effort. He's carved out a really nice niche in the space.

And so why? When you think about it, physicians make up about 20% of all healthcare spending, and that's actually only second to hospitals. We're seeing the revitalization of the role of primary care physicians inpatient care. They're often on the frontlines of healthcare, typically the first point-of-contact for patients. They're seeing oftentimes the first signs of things like depression or cancer or chronic disease or other health concerns. They're directing the patients to get the right care in the right setting with the most appropriate provider. In essence, they're essentially the quarterbacks of healthcare. So, it's really an interesting dynamic that's going on there. That coupled with what you're seeing with government programs providing more dollars into that sector, and then the other driver is large health plans that need to work with providers to manage high patient costs. So, like a lot of things, it comes down to dollars and cents.

There's a number of studies that have been published recently. But there is one that talks about for every dollar increase in spending in primary care results in $13 in savings overall downstream. And then another one, just to put some numbers around it, talks about—if everyone saw—in the U.S. a primary care provider for the first care would save over $67 billion every year in savings. That's a really substantial impact for the overall healthcare system. Then from the investment side, the leading private equity firms out there have primary care platforms and have been very successful, whether it's an Arsenal or TPG, General Atlantic, Warburg Pincus, the list goes on. There's also been successful IPOs with the likes of Oak Street and One Call Medical, and then you've got SPACs with Cano Health—they've all added fuel to the fire. But the industry is still fragmented and there's a bit of a feeding frenzy out there because there is an imbalance that we're seeing between the buy-side and the sell-side equation: It's a bit out of whack. We're even seeing it with small single-digit EBITDA businesses that are getting into competitive bidding processes at valuations well into the mid to upper teens. It's been a very interesting dynamic of what's going on there.

Todd: Lots of good data points there, I appreciate that. I would say it certainly confirms what we've been seeing in the market. Moving on, I'll throw this next topic out to both of you. We'll start with Jon, but maybe you guys can touch on how consumerization of healthcare is influencing private equity's approach to investments. Again, Jon, if you want to kick it off and then we'll hear from Don.

Jon: Sure, I would say one of the core tenants of Regal when we founded it was to focus on that theme: the consumerization of healthcare. Urgent care really being the poster child for a healthcare experience that's better, more convenient, better care than the emergency room that it was trying to replace. We see that as a continuing trend. You have high deductible plans, you have consumers spending more and more of their own dollars on healthcare, and when you spend your own money, you expect a better experience. So again, we focus on companies that bend the cost curve and play on the consumerization of healthcare theme. Again, making care accessible, being in-network with insurance companies, building a trusted brand, providing excellent care. These are all the essential elements of meeting consumer expectations in this environment. Patients will ultimately choose to go where they get the best experience, and the best experience wins. It's a very important theme for us.

Todd: Yeah, makes sense. Don, anything to add?

Don: All right. I would echo a lot with what Jon said. Clearly, you're seeing the rise in high deductible insurance plans and medical costs climbing, so patients are less willing to tolerate—whether it's delays or inefficiencies. They're going online: Dr. Google. People prefer that, trying to self-diagnose themselves, and there are risks associated with that because conditions can go untreated. Even on the retail side, that obviously is a lot of convenience. The potential pitfall there is that you're not seeing a consistent provider. We're seeing those trends, but there's clearly some areas that need to be focused on to make sure that patients are seeing the right provider at the right time and not avoiding care because maybe it's at a high cost. It's a bit of a double-edged sword at least from my perspective.

COFFEE BREAK WITH BDO

Todd: Good points, appreciate that. All right. Well next, I'd like to turn it over to our Coffee Break guest, Steven Shill. He's a partner and the National Leader of BDO's Center for Healthcare Excellence and Innovation. Steven is based in BDO's Orange County office. Let's hear what he has to say.

Steven: Thanks, Todd. Hello, this is Steven Shill from the BDO Center for Healthcare Excellence & Innovation. Today, I'd like to talk to you about how healthcare organizations can address their own health to avoid being forced into restructuring or bankruptcy.

The COVID-19 pandemic has turned a critical eye towards the healthcare system in the U.S. and has had an outsized impact on physician practices, hospitals and senior care facilities. The government has poured in millions of dollars into healthcare organizations, but these capital injections may, in fact, be masking or even exacerbating certain issues, rather than addressing their root causes.

For example, the pandemic ignited extended staff cuts, furloughs, hurt the incomes of primary care physicians and surgeons, and exacerbated shortages in behavioral health and advanced practice nurses space. Despite best efforts to maintain liquidity, operating funds and capital allocations are spread thin. Yet, even before the COVID-19 epidemic, hospitals were impacted by the trend of lower patient volumes in emergency rooms, for example, and therefore subsequent lower new inpatient volume, making them subject to greater financial distress. Hospitals are seeing rising consumer frustrations about hospital prices and surprise medical billings, more uninsured patients, and an increase in competition with independent facilities despite their lack of affiliation or network. For example, ambulatory-type settings.

Provider relief funds are not going to solve all these problems, and this short-term sense of security may actually worsen the financial health of many of these healthcare organizations. But before hospitals become terminal, they can be turned around. This can be fixed. According to the 2021 BDO Healthcare CFO Outlook Survey, 17% of CFOs say they will pursue debt restructuring this year and just 27% said they have more than 60 days of cash on hand. Whether in times of calm or crisis, liquidity is critical to maintaining operations, ensuring payroll and having the flexibility to meet demand and opportunity.

Sometimes, an organization's distress becomes too unwieldy—in that case, a company may need to consider some serious options, and these considerations are in preparation for restructuring.

First, a company or a healthcare organization would want to set up an independent turnaround committee with representatives from different key areas within the organization. This is part of overall organizational optimization, which promotes efficiency and reduces redundancy in activities across the first and second lines of defense. It also lays a necessary foundation for rationalizing governance and streamlining processes and digitization.

Secondly, healthcare organizations should work on rationalizing governance. Eliminating extraneous activities frees up scarce resources and management bandwidth, while yielding direct efficiency benefits. Most critically, rationalized governance sets the foundation for streamlining processes as well as for digitization, which we'll deal with a little later on.

As an accountant, I always see the need for balance sheet improvement. When facing a cash crunch, taking a deeper dive into revenue streams and taking a look at the financial structure of the balance sheet is a significant step that needs to be done. Remember there are always options to renegotiate or cancel contracts, remove contingencies through negotiation or finding new or more efficient financing for the organization. Restructuring the balance sheet and balance sheet improvement will be key in this process.

Next, look to streamline and strengthen processes. This way, institutions can take a dramatic step on their efficiency–effectiveness curve while creating better employee and customer experiences. For example, investigate the day-to-day cash management for the company. Is there a way to develop a strategy to automate processes such as these and preserve bottom lines? If there is, then you should take that opportunity and go ahead and do it. Streamlined processes are always easier to automate or to improve.

Finally, digitization. Digitization and deploying advanced analytics can augment and magnify process redesign, benefitting both risk-management effectiveness and efficiency. Appropriately automated processes are less error prone and less costly. Perhaps even more important, digitization permits institutions to embed automated real-time (or near-real-time) risk controls within core processes. This reduces control failures and allows for more efficient use of resources.

Overall, maintaining operations throughout the disruption created by the pandemic requires an honest assessment of an organization's financial health. Once the key pain points are understood, then those factors can be more readily addressed during the turnaround and restructuring. For the 44% of healthcare CFOs who say maintaining adequate liquidity will be a high or a moderate challenge, having a robust understanding of their organizations' financial pain points is especially important. The distressed market speaks loudly to the idea that an effective reorganization or restructuring strategy will be a major contributor to healthcare resilience in 2021.

Thank you all for listening, and now, back over to you, Todd.

Todd: Thank you, Steven. Now, let's return to our conversation with Don Ritucci and Jon Santemma.

REGULATORY CONSIDERATIONS

Jon, jumping right back in, this next one's for you. Has the rapidly-changing pace of the COVID vaccine rollout affected any of your deal discussions? And how often do regulatory changes come up in your conversations?

Jon: Yeah. I would say things are really heating up. People are feeling a lot more confident that the worst impact of COVID is passing with the vaccine rollout. We've even seen business travel is starting to come back, so we're really busy. As I mentioned, we did not do a deal during that peak of COVID because the adjustments and expectations were kind of out of whack. But we have three letters of intent either signed or in negotiation right now and other additional opportunities coming in. And we're on the road, we're traveling, so I think the deal discussions are going to generally accelerate from here. We've already seen it.

Regulatory changes: From a macro perspective, I think the key thing is what the Biden administration is going to do with taxes.

It looks like higher taxes including higher capital gains taxes are coming next year, that'll accelerate sales so owners can lock in today's lower rates. Other than that, we expect the overall regulatory environment for healthcare to be stable or supportive.

Todd: Right, got it. Let's stay on the topic of regulatory considerations for the moment. What policy changes has the Biden administration initiated that affect the current environment for healthcare investing? Don, maybe you take that and then, we'll let Jon backfill.

Don: Yeah, I'm happy to. Jon mentioned about rising taxes and whether that's the 28% that Biden has proposed versus the 21% on the cap gains. There's a lot of speculation those will fall somewhere in the middle at 25%. But that's clearly one area.

But more on the regulatory side, being at it from an M&A perspective, I look at it—There was an article just last week that talked about the crackdown by the Federal Trade Commission, not on the services side, but on proposed mergers for pharmaceutical companies. They're going to be subject to more intensive scrutiny and that's going to fall to even smaller and medium-sized companies as well. Clearly, it's under the microscope of the current administration. Reading the tea leaves in other areas, earlier this year, the threshold for merger notification decreased from $94 million to $92 million, and while that's not a big dollar difference, it's very rare to see a decrease. The dollar amounts just typically have increased over time.

Also, the FTC and DOJ temporarily suspended early termination of the merger review. That's only the second time that's happened and they talked about just the transfer and the new administration coming in. But there have been new administrations before and that hasn't happened. So, if you look at all those data points and you piece it together, there may be some tightening that we could expect on the regulatory side.

Todd: Yeah. Now, Jon, anything you want to add there?

Jon: I think just from a health care standpoint, as I mentioned, I think we're going to see a stable to supportive regulatory environment. I don't expect to see a big Medicare expansion, but we have seen obviously, a lot of support for the ACA. The $1.9 trillion COVID relief package included an expansion of the pool of people eligible for the ACA, so we've already seen action there. I think we'll continue to see an accelerated shift to value-based care. And as I mentioned, the administration will have a particular focus on supporting mental health.

HEALTHCARE M&A FORECASTING

Todd: All right, guys, all good points. We'll move on as we reach our final theme of this session. It's time to bring out your crystal balls, so I'm going to ask you guys to forecast some predictions, and you're not alone; we do this to all of our guests. According to the 2021 BDO Healthcare CFO Outlook Survey, 44% of healthcare CFOs say the pandemic will increase in partnerships across the healthcare ecosystem. Do you guys forecast an uptick in healthcare M&A activity in 2021 as well? And the second part is: What your overall 2021 outlook for healthcare investing? Don, I'll start with you and then we'll hear from Jon.

Don: Sure, I'm happy to take that one. Look, if you asked me this five years ago, I would have said there's going to be a slowdown and probably for the past five years since then, every year, I would have said that as well. But I'm not going to say that this time. Look, the trends continue here; I can only be wrong so many times. It's things that we've heard about before: It's the amount of capital on corporate balance sheets at record levels, $2.5 trillion, based off the last S&P report. There's PE funds: A trillion dollars of dry powder. On top of that, we've got SPACs that are out there now, robust equity markets, robust debt markets. We think it's going to continue. Healthcare and IT are probably the top two sectors broadly across industries where we're seeing investments made. Just from our own pipeline and mandate, we've never been more busy with the number of active deals that we have in market, as well as the pitching and bake-off activity that we have, it's been off the charts.

Todd: Listen, all valid points. You're on the record for sure, so we'll see if it ends up holding true. Jon, what are you thinking?

Jon: I agree. I think 2021 is going to be yet another robust year. I think the activity will be up. I think all the things Don highlighted are definitely supporting factors. I also think COVID ultimately will trigger more deals in 2021. I think there are a lot of health systems that were sort of on a knife-edge financially, were staring into the abyss during COVID. I think that that experience will push some of them to maybe make some changes that they weren't necessarily willing to do before and sell some assets or enter into JVs or rationalize their businesses one way or another, which will likely lead to more M&A in addition to the factors Don mentioned. I think the other thing is again, a zero interest rate environment. There's just a lot of money out there and that provides plenty of financial incentive to do a transaction. I think people are starting to accept lower returns, given the lower rate environment and pushing up prices as well.

Todd: Certainly, good perspective. All right. Well, this is the last question, and we'll throw it out to both of you as it's all about SPACs. So a recent Keckley report newsletter stated that in 2020, of the more than 300 SPACs looking for acquisitions, 53 were focused exclusively on healthcare deals. What does the uptick in SPAC activity mean for deal making in the healthcare sector? That's the big question. Jon, I'm going to go to you first and then we'll hear from Don.

Jon: I think, as Don mentioned, the SPAC dynamic has really opened up another pool of capital for sellers of healthcare assets, primarily high-growth businesses. I think in a way, you could say that SPACs are filling a venture capital role, because they're allowing the public to invest in high-growth businesses. Companies like TalkSpace, for example, that normally, would wait longer to go public, and so from that standpoint, it's a really interesting opportunity. Obviously, there's a lot of SPAC money chasing a limited universe of those kinds of deals, so that means valuations will go up. But, I think disciplined sponsors of SPACs and their investors are going to do well.

Todd: Yeah. Don, anything else to touch on on SPAC activity?

Don: Oh, look, I think Jon said it well. We're truly adding fuel to the fire here. The meteoric rise of the SPAC has been an understatement, to say the least. We think that this trend is going to continue, although there's clearly some pause here. I think it's a new pocket of capital. I'm not sure it's going to be as robust and frothy as we've seen it today, particularly when you've got some SPACs, where you've got celebrities that are kind of leading the cause here, that would make people probably take a step back. But I think the SPACs are going to be that alternative pocket of capitalism. They'll be here going forward.

Todd: Yeah. Well, listen, I appreciate all the optimism and I think I have to agree with you guys. Should certainly be an exciting year for M&A in healthcare. Well, Don and Jon, I really appreciate you guys taking time to join the PErspectives podcast today. Certainly, a robust discussion and I'm sure our audience will appreciate your insights.

Jon: Thanks very much, Todd. It was great to be here. Appreciate it.

Don: Thanks, Todd. It's a pleasure. Jon, good to catch up.

Todd: Yeah. Guys, listen, we thank the world of Oppenheimer and Regal Healthcare Capital—appreciate our relationships with both your firms and wish you nothing but great luck this year.

To our listeners, thanks so much for tuning in. If you haven't already, we'd love for you to subscribe, rate, and leave a review of the show on iTunes. Until next time, this is BDO's Private Equity PErspectives.

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