PRIVATE EQUITY
PERSPECTIVES
PODCAST

EPISODE 16:
PRIVATE EQUITY'S Rx FOR HEALTHCARE

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

INTRODUCTION

Todd: Hello, and welcome to another episode of BDO's Private Equity PErspectives podcast. I'm Todd Kinney, National Relationship Director in BDO's Private Equity practice, and I'm based here in New York City. I'm really thrilled to have two special guests with me here today to discuss the healthcare landscape for private equity. First, I'd like to introduce Mike Grady. He's a Principal at CIP Capital. Welcome to the show, Mike. Next, we're delighted to have Dom Nicolia, who's a VP with Regal Healthcare Capital Partners here in New York. Dom, thanks for joining us.

INTRODUCTORY QUESTIONS

Todd: So, let's jump in. Mike, I'll kick things off with you first. CIP, obviously, has a very important relationship to BDO. We certainly value that, so thank you. Maybe you could tell our listeners a little bit about your firm and areas of focus for some of your investments.

Mike: Sure thing. Thanks for having me, Todd. So, CIP, we're a mid-market private equity firm focused on really growth-oriented business. We're a sector-focused fund. A common theme for us is outsourced services. Typically, these services are tech-enabled. Our investments are across core sectors, so we do a lot in human capital management, marketing, knowledge or education services, and historically and increasingly focused on healthcare services. So, within healthcare it's really tech-enabled business models that are solving challenges, containing costs, driving efficiencies into the healthcare system among all the core constituents, so providers, payers, employers, and patients. We typically invest in companies that have between $30 million and $150 million of revenue. Where we are trying to differentiate is through driving accelerated meaningful growth and also transformations of these companies while we're investors, largely through a combination

TOPICS DISCUSSED INCLUDE:

of organic growth investments. So, sales and marketing, products, technology, in addition to a pretty accelerated buy and build kind of M&A strategy. And lastly, we're based here in New York and currently investing out of our third fund.

Todd: Yeah - well, I know you guys have been super active, so the listeners will enjoy your perspectives. Turning to you, Dom. Certainly, Regal Healthcare Capital, we've started to work with your firm a lot over the last year, and I know you just raised your second fund, so congrats on that.

Dom: Thank you.

Todd: Maybe you can talk about the focus of the firm and your role there.

Dom: Sure. So, Regal's a private equity fund focused exclusively on healthcare services, specifically on multi-site healthcare businesses with a spin towards consumer-facing retail. One of our founders, Dr. David Kim, is a serial entrepreneur, a healthcare operator, and also an emergency room physician, and the other founder, Jon Santemma, is a former healthcare investment banker who was one of the leading multi-site bankers prior to starting Regal. So, Regal has six portfolio companies across the healthcare services space, spanning from dental, dermatology, fertility, autism, hospital outsourcing, and revenue cycle management. And as you mentioned, we just raised our second fund, around $165 million, and we're now spending a lot of time looking to partner with leading healthcare entrepreneurs who have $2 million to $6 million in EBITDA who can benefit from our collective operational and financial expertise as they scale.

HEALTHCARE INDUSTRY UPDATE

Todd: Awesome. Well, I had the pleasure of playing a round of golf with Dr. Kim this past summer. He's a much better golfer than me, so pass that on to him. Let's move on, as I'd like to hear both of your thoughts on the state of the healthcare industry for PE, and some opportunities in this space. So, Dom, I'll throw the question to you and then get Mike's input if you want to share your insights, too. Can you share some of the interesting trends you're seeing in PE healthcare investments and maybe touch on what types of deals you've done recently in the sector?

Dom: Sure. So, one overarching theme that we're seeing is sort of the buzzword—the consumerization of healthcare. That's sort of the center stone of our fund. As the healthcare industry's grown to almost 20% of GDP, as you know, the cost per person is skyrocketing and a disproportionate share of that's being pushed onto the patient. So, as patients are becoming more aware and more accountable for the payments from their own carer, they're starting to think of themselves more as a customer rather than a patient. And at the end of the day, all they want is affordable, high-quality, convenient care in a pleasant setting. So, gone are the days of the three-month wait list only to meet with a disinterested doctor. So, to really be successful in today's environment, healthcare businesses need to embrace this new reality and they need to optimize their business model around it. At Regal, we spend a lot of our time searching for these businesses, businesses that are leaning into this trend and who are looking to create value for the patient and who are looking to grow in the right way. So, every investment that we've made and will make at Regal have been into businesses who live and breathe these values and spend every day providing accessible care with a great patient experience whilst still holding clinical quality levels.

Todd: Sounds like a recipe for success. Mike, care to share your thoughts?

Mike: Sure, so the rising consumerism in healthcare is also a trend that we're really focused on right now and have recently kind of invested around. And again, as costs continue to rise and as Dom said, these costs being shifted more to patients given how these plans are structured, I mean, the numbers are staggering. Premiums and deductibles are growing anywhere from, call it three to five times faster than wages. Really for us the compelling business model within all this is what we call consumer-directed healthcare or consumer-directed benefits accounts. So, think about your flexible spending accounts, your health reimbursement accounts, your health savings accounts, they're all growing fast given that they provide consumers the ability to set aside pre-tax dollars to fund and alleviate the burden of growing healthcare expenses. So, we actually recently invested in a business called Benefit Resource, which is a benefits administration provider of these accounts. And we're excited about it because, one, it really drives the value to these employees in addressing rising healthcare costs, and, two, it's driving a lot of value to employers through outsourcing the administration's accounts for them through a tech-enabled service. The employers do not want to provide this service themselves. And it's also a kind of highly fragmented space which plays to our M&A strategy and buy-and-build strategy as a firm. So, very excited about it as a new investment area where we're spending time.

Todd: Awesome. So, I guess I have a quirky question for you guys. I'm wondering to what extent do you think PE is seeing healthcare as a safe bet considering the current economic dynamics? Perhaps, Mike, I'll throw this one to you first and then let Dom chime in.

Mike: Yeah. Great question. I've looked at the numbers. Looking at the last five years, I think healthcare-related deal flow and private equity has basically doubled. We've been part of this theme as we view it as a growing sustainable place to allocate capital. The themes in the industry support a variety of different types of investments and business models. To give you a couple of examples, the population continues to age and in seven to eight years we're going to have substantially more seniors in the population, which drives massive growth in more care and services for these folks. We actually invest in the marketing services business around the senior living facility and market. The growth in spending and ageing effect is also driving massive employment in healthcare. I think I just saw it now outpaces manufacturing and retail in terms of job creation. We have a human capital management investment around that theme, as well. Lastly, just, systems continue to have challenges and inefficiencies for all constituents—providers, payers, employers—really resulting in various different business models both financial back-office as well as clinical that can drive meaningful value through outsourced services and solving critical needs through technology and other means.

Todd: Dom, I'll throw the same question to you and feel free to add any perspectives that you see regarding where the trends are headed and, perhaps, deal activity versus last year.

Dom: Sure, yeah. So, first, I agree with everything Mike said. Healthcare's definitely 100% seen as a defensive investment. Right? The healthcare industry's a behemoth and it's going to be pretty hard to fundamentally change it, at least in our lifetimes. I think that makes people really comfortable investing into the space and deploying their capital. Unfortunately, people are always going to get sick and they're probably getting sicker and they're always going to be looking for a way of fixing it, regardless of the economic or political environment at that time. So, given that, we're seeing a lot of activity in the space, even compared to the market we're coming out of, and we expect that trend to accelerate going forward as people look to get their piece of the pie. But with that said, I will caution that the healthcare space isn't that different from any other industry and that little changes can sometimes cause enormous ripples for those who aren't well-prepared. One thing we're always cognizant of when looking at investments is the reimbursement outlook. So, we operate under the assumption that when the economy ultimately turns for the worse, the government's going to use that as a catalyst to make some major changes in reimbursement and certain businesses that depend on the government as a payer are really going to struggle. So, because of that, we at Regal, we try to avoid that heavy government exposure.

COFFEE BREAK WITH BDO'S PATTI SEYMOUR AND LISA COZZA

Todd: Yep. Makes sense. All right, guys. Well, I appreciate your insights on the topic. We're going to shift gears briefly for our Coffee Break with Patti Seymour, who is a Managing Director in our Industry Specialty Services practice. Patti's based in Boston and has over 25 years of experience in the biotech industry. Patti will be talking with Lisa Cozza, also a Managing Director, with our Industry Specialty Services practice in Boston. Lisa has more than 30 years of scientific operations and business development experience in the biopharmaceutical industry. Let's hear from them.

Lisa Cozza: Hi, everyone. I'm Lisa Cozza. I'm Managing Director in BDO's Biotechnology Consulting Group. Thanks for having me today. I'm joined by my colleague, Patti Seymour. Patti has more than 25 years of experience in the biotech industry across multiple supply chain disciplines. I'm excited to speak to her today about trends in gene therapy and what that could signal for investors in both life sciences and healthcare.

Patti Seymour: Thanks, Lisa. I'm glad to be here today.

Lisa Cozza: Right now, the gene therapy market is really exploding. In fact, we're seeing over 1,000 assets in development right now and the global gene therapy market is forecasted to reach almost $6 billion by 2026. So, what are some of the challenges you see gene therapy developers facing that they'll need to overcome to deliver on the promise of such treatment?

Patti Seymour: So, that's a great question, Lisa. Our focus within the biotechnology group here in BDO is to look at the manufacturing issues. So, in addition to seeking out the right technologies for the gene therapy product, we also need to figure out how to do the manufacturing, and part of the challenge is the manufacturing facilities right now are not in existence or not enough of them [are] in place to actually meet this growing demand of, as you said, over 1,000 assets and the growing development investment that we're going to see over the next five or six years.

Lisa Cozza: On that note, what challenges are CMOs facing in that respect and what risks do they pose for the broader industry and success of these gene therapies?

Patti Seymour: Yeah. So, I think that's one of the real opportunities, both for the developers and the investors in this area, isn't it? So, there's a lot of manufacturing demand right now, as I mentioned. So, if you're looking to expand your capabilities in that space or even enter it, you have a higher chance of success. If you're a current contract manufacturer, the risk of adding capacity to meet the demand for these new gene therapy molecules is actually lower because there's such a pent-up demand that your capacity will be likely to have high utilization very quickly. If you're an investor in this space as well, if you're going to help fund the construction and the running of these types of facilities, again, the return on investment is likely to be quite high because, again, the utilization of these facilities will be high and there'll be a deep pipeline of products waiting to get access to this capacity.

Lisa Cozza: Oh, that's interesting. What are the biggest regulatory hurdles gene therapy developers are facing now?

Patti Seymour: So, in the regulatory and the commercialization area, one of the issues is the number of patients in these trials tends to be quite small to begin with. Getting enough of a patient population to actually understand how these therapies work will be one of the regulatory challenges. However, once they have that number and they do achieve regulatory approval, the next step is actually reimbursement. So, just because your product has been regulatory-approved does not mean it'll be a commercial success. I think one of the areas that we follow and I think is going to be really fascinating in the foreseeable future, not just in the U.S. but in the broader global sphere, is how our healthcare system will move towards outcome-based reimbursement and the payers will consider such arrangements for gene therapies. For example, if the gene therapy company is going to charge hundreds of thousands, if not millions, of dollars for therapy, the actual payout will be based on outcome. And so that's something that we're following closely in terms of the success of these products and how much demand in terms of manufacturing will be needed.

Lisa Cozza: Sounds like there are quite a few complexities in the industry right now, and it's going to be very exciting to watch. But for now, I think we're out of time. Thanks for sharing your insights, Patti. Now back to Todd Kinney at BDO in New York.

Todd: Very enlightening. I appreciate your insights, Patti and Lisa. Now, let's get back to our conversation with my guests Dom Nicolia with Regal Healthcare Capital and Mike Grady from CIP Capital.

GROWTH ENVIRONMENT

Todd: All right. Moving on to our next topic, I'd like to focus on factors that might be triggering an uptick in deal activity and growth in healthcare. Certainly, 2018 was a notable year for transaction activity and I think I last saw that it's estimated the amount of dry powder available is about $1.8 trillion. I am getting to a question here. So, when it comes to healthcare, organizations may ask themselves, "Should we buy it or build it?" Dom, I'll go to you first, then Mike. What are your thoughts regarding buy versus build in the healthcare sector?

Dom: Sure. At Regal, we spend all of our time in the multi-site healthcare space and buy versus build is, really, in a lot of ways, the million-dollar question. Everyone in healthcare is working towards the same goal. To get as big as you can and as diverse as you can as quickly as you can. There are obviously a few reasons to this. Cost efficiencies, better rates with the payers, and, hopefully, a better experience for your patient. But the question is, how do you do it? Some people feel really strongly that you can only buy. Some people feel really strongly that you can only build. At Regal, we view it as a bit of a situational thing. Our preference is, of course, always to build it ourselves if we can. By building it, we're better able to control the quality of care and the experience of the patient and also, the ROI's often much better. But with that said, building is a risky proposition. Right? It might not work and if it does work, it might take a really long time. So sometimes, it's better to just buy a proven commodity that can add to your business right away or buy some capability that you wouldn't have otherwise been able to build. As you can imagine, in this market we're seeing companies more and more just go towards the buy-it side, right, as they're trying to build a lot of EBITDA very quickly to take advantage of the premium multiples that they'll get. I think in our view that's a perfectly reasonable strategy and there's a time and a place for it. But you just have to be careful if you go that route because a lot of groups just end up buying everything in sight and they become aggregators rather than value creators and it's just not a sustainable model.

Todd: Right. Mike, care to add anything to Dom's comments?

Mike: Sure thing. I think for us—listen, we deploy a pretty accelerated M&A strategy in all of our investments at CIP and we view healthcare as compelling and really no different as it relates to add-ons for a couple reasons. I think first, a lot of the areas in healthcare services technology where we're spending time tend to be fragmented, RCM Benefit Administration to name a few. And so, in some of these end markets, you're seeing a combination of smaller businesses that are founder-owned that could be tuck-ins, and they also tend to have other sort of PE-backed providers that could be logical combination targets or larger acquisition targets. And also, I'd say the other thing we're seeing is the industry has a lot of traditional business models that are shifting to more software and technology-driven business models. So, we often see opportunities to invest in a strong platform out of the gates may have a little bit less tech in it currently and really extend those software capabilities. Kind of techify that business through M&A and building something that's going to be really attractive down the road for strategic buyers. And so, our view across the portfolio and also in healthcare is that we do prefer to buy versus build where we can, if we see opportunities, and we tend to invest in sectors where it lends itself to that.

REGULATORY SHIFTS

Todd: Good stuff. Good stuff. Well, listen, we'll pivot here to our last topic. When we're talking healthcare, you've got to talk regulations. So, Mike, I'm going to throw this one to you and then we'll go to Dom to close it out. Has your firm been monitoring any pending regs or proposed legislation that you think could unravel or boost particular types of deals?

Mike: Sure thing. So, I'm kind of chuckling because we watched the [U.S. presidential candidates'] debate last night. I could talk about this for hours. But I think that the headline regulatory dynamic that a lot of people are monitoring right now is healthcare reform. Despite what you read, our view is that even in a very kind of Democratic administration, the most likely thing we see occurring would be more of the expansions of the Affordable Care Act, Obama Care, with things like a public option for healthcare or subsidies, as opposed to more structural change. It's something we'll continue to pay attention to. So, that's the first we're just monitoring. And secondly, I think the theme that's accelerating through reform is another buzz word is the shift from fee-for-service or a volume model to a model that revolves more around what we would say maximizing value delivered through alignment of incentives and management risk. Really, a value-based care model, right? And so, there's already been legislation passed that offers incentives to healthcare professionals that participate in some of these more risk-bearing care models. And so, with this, it really drives opportunities across various types of businesses and business models for providers, payers, all the constituents around the healthcare end market. We're seeing things like patient surveillance offerings, revenue integrity models, more sophisticated RCM models and other various services and tools to contain costs in an environment that has more payment risk.

Todd: Dom, anything to add on the regs topic?

Dom: That was very thorough.

Todd: Pretty good answer, yeah.

Dom: I agree with it all. Another thing we've been paying attention to lately is potential changes to the out-of-network billing and the related surprise billing of patients. As you can imagine, investing in the physician practice space there can potentially be a lot of out-of-network exposure. Historically, it was a legitimate growth tactic in healthcare to try to have a portion of your revenue come from out-of-network billing, because you can get substantially higher reimbursements than you would in-network with the exact same payer. You see this a lot specifically in higher-paid specialties and hospital outsourcing, hospital services. So, recently though we've seen a lot of chatter about this topic and about how it needs to go away and it really seems to be heating up with a number of proposed solutions floating around. As with most changes to the healthcare system, this probably isn't going to happen overnight, but generally in our view, when regulators are locked onto an issue, it's also probably not going to go away.

Todd: Right.

Dom: So, given this, we're spending a lot of time on reimbursement trends across the industry. And specifically, prior to making any investment, we spend a lot of time, work with a lot of external parties to get a good sense of what's going on there. To Mike's point as we move towards value-based care, we're only going to be investing in companies and businesses that are on the right side of the cost curve who are taking costs out of the system. We just don't think there's any other way to do it. At the end of the day, we don't know when or if these changes are going to happen to out-of-network, but we surely don't want to be the ones holding the bag when it does.

Todd: Yeah. Well listen, it's really great to get your take on the market and where you think it's headed, guys. So, Dom, Regal Healthcare Capital, Mike, CIP Capital, we really appreciate your time on the podcast today. I know our listeners will enjoy hearing your insights. There were definitely a few gems you guys dropped there. Speaking on behalf of BDO, we really appreciate the business relationships with both of your firms, so it's great to team up on this podcast.

Dom: Yeah.

Mike: Thanks very much.

Todd: 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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