



EPISODE 3: FINDING THE RIGHT DOSE OF PORTFOLIO RISK

INSIGHTS FROM THE BDO CENTER FOR HEALTHCARE EXCELLENCE & INNOVATION

Steven: Good morning, everybody. I'm Steven Shill. I'm a fellow colleague of Patrick's and I'm a fellow leader at the BDO Center for Healthcare Excellence and Innovation. I'll obviously echo Patrick's words in welcoming and thanking you all for joining us today. And I also want to thank Karen for kicking off the morning on such a high note.

Our first panel today is Finding the Right Dose of Portfolio Risk. We have Bert Notini, managing director with New Mountain Capital based in New York. He's a leading alternative investment manager. Bert has a wealth of experience in healthcare and the technology industries through his impressive career as an attorney and a senior executive. Bert has navigated turnarounds and sales to strategic buyers, and he also serves on numerous boards. His current director roles include Western Dental, Medical Specialty Distributors, Ciox Health, and Island Medical.

And, last but not least, to my extreme left, Ira Coleman, who's the chairman and partner of McDermott Will & Emery, one of the largest global law firms. Ira focuses on major M&A and controversy matters, particularly within the health and private equity areas. Ira is a frequent author and speaker on private equity, health law, and leadership topics.

So if you'll all just put your hands together and welcome our panelists. Okay.

HOW IS PRIVATE EQUITY ADDRESSING HEALTHCARE TRENDS? [2:02]

So now, we're going to kick off with the fun and games. Dr. DeSalvo just spoke about the social determinants of health that are transforming the industry and, frankly, the delivery of care. To what extent are PE managers looking for portfolio companies that are really addressing the big picture concerns like aging population, new therapies for diseases, and let's say bending the curve.

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[How is Uncertainty Affecting Deal Making?](#)
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Steven: Bert, what are your thoughts?

Bert: Yeah. I think that we're a generalist firm. We're from New Mountain Capital. We have a lot of capital under management, with actively managing a little over \$10 billion. But we're a growth-oriented firm and for our investors we try to find places in the market where we can both drive returns and do it by driving growth, as opposed to classic buyout of leverage and what have you. So that brings you around pretty rapidly to health as a sector.

We're probably about 30 percent today of our fund invested in healthcare. And we have both providers, for example, dental services, some emergency room services. Our biggest focus from around the growth point, and I think it goes to what Dr. DeSalvo says, is a thesis around really focusing on meeting the patient where the patient resides, and then really going in and enabling the workflows so that change can happen.

Our fundamental perspective is that in order for this change to occur, interoperability, alternative site, delivery of service, better quality, lower cost, it's not a rip and replace. It will not actually be sort of a Silicon Valley genius who figures this out. It's actually going into these very, very deeply rooted workflows in automating them, transforming them, bringing them together, and then sort of repositioning to point the way the models come together. So that's how we think about it.

So I think we do, as we underwrite our investment, and we only get rewarded if we actually create a lot of value for our investors by creating a lot of value in the healthcare system as a purely private player. And the way we see doing that is exactly by addressing these macro trends with a long-term view. We're not trying to do it today, tomorrow, the next day. We have a long hold period. We're not afraid to invest a lot of capital. We don't take on a lot of debt. So we really drive serious growth over the long haul, but I think this is absolutely the fundamental thesis we invest on.

Steven: Thanks, Bert. Ira, what do you see your clients doing?

Ira: Well, I sit in a unique position on this panel because I don't have to put my money on the line and I get to say, "Hey, that's a great idea. We'll paper it up." And then if it doesn't work out we go, "Oh, sorry. We'll take it apart now and then do it all over again." So—

Steven: You'll find somebody to sue.

Ira: Yeah. It's a great position to be in. Right? So what we're seeing-- last year we closed out the year as the most active healthcare law firm in the world with 57 large transactions in the healthcare private equity space alone. So we see it, and it's very interesting to see the changes and I want to pick up on Bert's comment. We're not seeing these transformational, "Hey, let's go in and change everything. Rip it apart and build it up." It's the

incremental and it's the best ideas sometimes don't win. It's the ideas that can be actualized win.

So yesterday we had a panel on digitalized health and we had some folks from Kaiser Permanente Ventures there, and what did they say? She was talking about-- before they make an investment, they'll have the nurses on the floor kind of walk through it and say, "Is this something you guys will use?" Why? Because they don't have any time. There's no extra time to figure something out. Or even if it's the newest, coolest toy or whatever it is, and everybody agrees the end results are great, if you can't drive it through the system, it's not going to happen.

So what we see is a lot of the consumerization. Everybody's carrying around little supercomputers in their pocket, even at some of the lower ends of the socioeconomic spectrum, and that's changing a lot of things, and then now with the belief that others outside the healthcare space can add a heck of a lot of value.

So do I think Amazon can solve some of the issues that Karen was pointing out better than the way a healthcare system is traditionally doing it, like Atul Gawande's medical hot-spotting, go into the place in Camden, New Jersey and deliver the food and make sure the services are going? Yeah.

When you break it down and you say the way the US healthcare system works, you have these patients that have all kinds of issues, and what are we doing? We're having our sickest people go visit seven different doctors' offices. They don't remember when the appointments are. It's really set up to be convenient for the doctor, not for the patient. So maybe sending somebody in with a backpack full of electronics and doing all the pre-services for them and then doing a Face-Time visit is much more effective.

Who's better at doing that? You don't have to be a healthcare company to do that, you just have to be smart at logistics and getting people on the ground. So we're seeing a lot of innovation around that. Problem is it's a long way to go.

So what are we seeing our private equity clients do? It's a lot on the physicians' strategies, the roll-ups. We're seeing a tremendous amount of energy around, what I would call, physician practice management 2.0. And I know we work with the wonderful folks at BDO on doing the work in doing a lot of these roll-ups. And we think they are going to be different than the ones in the late '90s and early 2000s that didn't work out. And we think that they're driven on the right things now, rather than the kind of poof deals and you'll make a lot of money when the company goes public.

This is much more of the type of care that you need to give the type of interfacing with the patient in a digital way, and the health systems in a digital way, and being able to accept risk in doing that, that the smaller physician groups just can't do at that scale.

THE PUSH TOWARDS CONSUMER-CENTRIC STRATEGIES [9:16]

Steven: Yeah. Well, you must have been reading my mind, Ira, because that was going to be my next question. But maybe you can put a slightly different spin on it.

So, as you mentioned, there's obviously been a big push towards consumer-centric strategies, making the healthcare experience a much more convenient one for consumers. And we mentioned earlier, and I think, if we could put up that slide. There we go. We got it.

So we mentioned earlier that in our survey we found providers expect that the CVS-Aetna deal will obviously have a major impact on consumerism. So how is the more empowered consumer going to change the industry? And I'm going to mix it up a little bit over here. Bert, why don't you kick off and share your thoughts?

Bert: I mean these are really big macro trends. I think everyone is trying to understand what's called the "Amazon Impact." And from our point of view, as we're doing our underwriting, it's a major new entrant into the market. And I think even the quality of the thinking out there, among the bankers and the consultants and all, I think it's still kind of coming to rest. It's good but everyone's still scratching their heads.

I think the way we think about it a little bit, and maybe this is more of an investment perspective than the kind of the care necessarily perspective, is that we kind of see the world really breaking between, let's call it, consumers of healthcare products and services and patients.

So on the patient side, you have really high acuity needs, very seriously ill patients needing some sort of specialty. And then you have others that are consumers that can really have consumer-directed care, can access products and services that are much less critical to their long-term health.

So we look at that as a fundamental divide. We think Amazon makes the point there. We also think that Amazon really reinforces the point of alternative site, post-acute, outside the hospital setting for care, because now that supply chain to get access to at least the products is just going to be that much more robust. Because they move in the pharma, that will increase, and that's a whole different question of how it is or is not disruptive to the sort of the pharmacy side.

I think on the integration of CVS-Aetna, this is a very interesting first move among, let's call it, the transformation of the payers. So you can also think about what Optum's doing more generally

in building services, having providers, etc. So these are very significant, very positive changes to the total landscape. As we look at it, we continue to look at, say, both of these, in the same way as, "Are we investing behind those fundamental businesses that will drive lower cost, better care, more direct contact with the patient where the patients resides over a long-term to kind of be comfortable with our underwriting terms?"

Steven: Ira? Is the consumer going to benefit? Is the healthcare consumer going to benefit?

Ira: Oh, absolutely. And I think they're going to be-- continue to be more empowered. And I'll go further, I think, than even Bert did on what Amazon can do. Because I don't think it's just the product side, I do think it's the service side, as well.

I just moved into an apartment in New York and we had to get some TVs hung on a wall, right, because that's what you do now, you don't put them in big armoires anymore. Right? So we went on Amazon, got Amazon home services to come for \$150 bucks, they put them up, buried the wires in there.

Would I do a house call with the Columbia Presbyterian Hospital doctor that was set up by Amazon? Absolutely. Absolutely. Would everybody do that? I don't know, but I think that the breakdown, that the better way to deliver services they have. And it's not just product.

So I wouldn't put it, "It's got to come in a box. It's got to be delivered by a drone." I think people who you talk to who work on the Amazon services side enjoy it. They like the freedom. They like using technology to set their schedule the way they want. I think there's an incredible medical workforce that doesn't want to conform to the standard business hours that can be of service. I think people will do that. I think we have technology out there with the MDLIVEs of the world and the Teladocs, and it's part of the health plans now.

The benefits are out there, but the problem is 90 percent of companies that have them, only 10 percent of the population are availing themselves to that.

HOW IS UNCERTAINTY AFFECTING DEAL MAKING? [14:38]

Steven: Thank you. So the other thing that's obviously evident in the healthcare industry is the level of uncertainty. There's still a significant amount of it, and whether it be uncertainty as to ultimately how the Affordable Care Act is going shake out or other issues, reimbursement, and now even income tax

reform. In your opinion, how is this level of uncertainty going to impact valuations and deal flow? How about you, Bert?

Bert: I think the things that break it down that are-- the greatest risk is where you take on a reimbursement risk. That's where you have the pressure on policymakers potentially bringing in the most, and things can change there and so you have to be super careful.

And I can say almost every time we have a business that's got reimbursement to it, we have great, interesting experiences. We kind of usually underwrite them in a way that we know what we're doing so it works out fine, but it's always a little bit of a rocky ride.

I think the other two areas, though, that we think a lot about are at-risk more and more, this model being an at-risk model. So getting behind all the businesses that enable providers to be at-risk is going to be part of the future, so we like to think of that catch of the data that brings you to systems, that brings you lowering costs, that brings you to specialization.

And then the other thing, longer term, is what the American version of single payer ultimately looks like. We will be through this administration in a heartbeat and who knows what comes next? It may be the same, it may be different, and even if it's the same it may be different.

You have a couple of states out here, one big one that I think we're actually sitting in right now, that would say single payer is where we ought to go. But that's the beginning of the discussion, what does a single payer look like? Is it really a big version of Medicare Advantage? Is that the way it really works? How does that play out? So we're thinking all the time about those trends as well and trying to just be fundamental to what enables any of those outcomes, and I think then we can feel kind of good about creating real value.

CROSS-BORDER DEALS AND DIVERSIFICATION [16:52]

Steven: What role do cross-border transactions play in your, or your clients', diversification strategies? This is a multi-level question. That's the first part of it. And second of all, are any of you investing there or any of your clients investing there? And if not, what other regions are your clients looking for, or yourselves looking for investment opportunities in? So, Ira, maybe you could kick off that.

Ira: Sure. So, our Shanghai office brought 140 people to this conference, just on healthcare services investment, both inbound and outbound. It's been pretty amazing. We thought we'd have 10. We had to redo the room size twice.

What are they are talking about is what I would call scratching the surface of what we're doing here, but fundamentally building the healthcare services business in certain areas in China. And it's amazing. The managing partner, my China office, one of the highest paid lawyers in Shanghai – I know this because we did data reports on it, right – when he had the flu, he was standing on line to receive his healthcare services on the streets of Shanghai with 50 people in front of him. And that's the way care is delivered.

He didn't think there was anything wrong with waiting two and a half hours. It would never fly in the US, so I think there are tremendous elements of a differentiated system in the making there. So, we're seeing a lot of that. In the UK and Pan-Europe, we're doing a lot of deals with German private equity funds. We're very interested in US healthcare.

We also did some work with UK private equity and family offices, very interested in making US healthcare investments. First time we've seen that in a while. Bert's firm actually was a possible co-investor on a deal that we bid on for a national urgent care platform, which the UK likes that model. At least these investors, they like that model; it's very familiar to them and they think it's got a lot of legs, so they want to move and bring it to the US, and Canada, and Mexico.

Steven: Bert?

Bert: From our point of view, we're a domestically-focused fund so we kind of see it from three angles. One, we are getting inbound inquiries around some of our companies from China-based investors which has been a bit of surprise, and enterprises, real estate conglomerates wanting to think about acquiring healthcare assets, for example. So, I can't say there's a lot of traction there, but it's been interesting inbound.

Secondly, where we really see the leverage still, and this is maybe just more of an old-school model but new to healthcare, we're seeing the cost arbitrage becoming an important part of the delivery model. That, we're seeing as a driver of the cost curve kind of a bending down.

And I'd say that the third where we see it, is we have three different distribution businesses around Healthcare One that's sort of an alternative site, pure play to really the home that's leveraging device-enabled therapies in the home which is a large US player. We're now seeing opportunities to move that, at least North into Canada. We're looking at potentially some European opportunities, a little different model there, but that's in early days.

We're also, another company that we own that's the largest distributor of contact lenses in the country, thinking about looking at some new ways to-- but those are sort of those more logistics

business, where you're leveraging technology and enablement and know-how. So, we're very early days, I would say, on that. We don't see the need to invest too much behind that in order to drive what we need to drive, but that's kind of a little bit maybe of who we are as a firm.

Ira: Wealthy people all over the world are acting very similar. They act very similar. They buy the same brands. They stay in the same hotels. We're pretty boring.

So when they're going to look at healthcare on a global basis- when you have a brand, like a Johns Hopkins or a Mayo Clinic or

the like, they'll gravitate towards that if you brand it the right way, and we're seeing that.

Steven: Well, thank you gentlemen for this fantastic discussion. You've given us great insight to how you guys view the sector and how you're responding to capitalizing on innovation, and, of course, the right dose of risk which was the original intention of the event. So thank you very much. Appreciate it.

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