7 Healthcare Private Equity Trends to Know

Insights from BDO's 2023 Private Capital Pulse Survey

Healthcare continues to face a challenging economic and regulatory environment. Inflation and interest rates remain elevated, increasing both the cost of care and the cost of capital. At the same time, labor expenses remain elevated compared to pre-pandemic levels, placing continued strain on operating margins. On top of all that, healthcare is looking at a regulatory environment that complicates M&A deals, particularly for traditional health systems and academic medical centers.

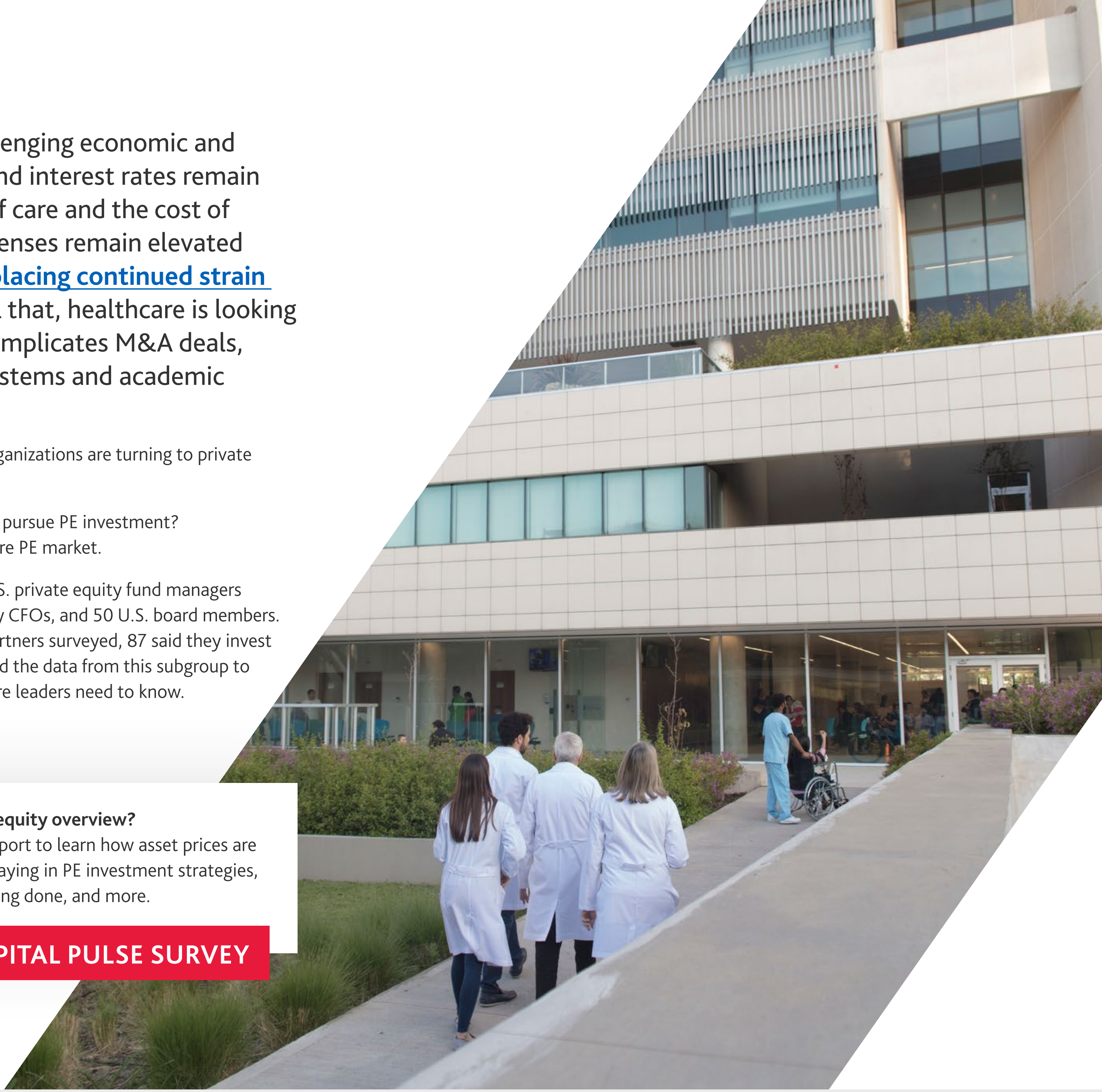
In the face of these challenges, some healthcare organizations are turning to private equity (PE) for new sources of funding.

How can these healthcare organizations prepare to pursue PE investment? The first step is understanding the current healthcare PE market.

In March 2023, BDO conducted a survey of 405 U.S. private equity fund managers and operating partners, 200 U.S. portfolio company CFOs, and 50 U.S. board members. Of the 405 equity fund managers and operating partners surveyed, 87 said they invest in healthcare (among other industries). We analyzed the data from this subgroup to identify the top healthcare PE trends that healthcare leaders need to know.

Want to get the full private equity overview?
Read our 2023 Private Capital Pulse Survey report to learn how asset prices are changing, what role ESG considerations are playing in PE investment strategies, what's stopping deals from getting done, and more.

READ THE 2023 PRIVATE CAPITAL PULSE SURVEY



7 HEALTHCARE PRIVATE EQUITY TRENDS

1. **PE is buying up distressed healthcare facilities.** When asked where their firms would direct the most capital over the next six months, 17% of respondents investing in healthcare say investing in distressed businesses, making it the top-cited answer for this group. For PE firms, turning the tide for a distressed healthcare facility represents a significant value creation opportunity. As financial challenges continue to destabilize healthcare organizations, we can expect to see an uptick in PE investment.

2. **Heightened risk exposure is slowing down deals.** In line with the full respondent pool, respondents investing in healthcare cite risk exposure uncovered during due diligence as their top challenge to closing deals in the current investment environment. That's no surprise, given PE's interest in distressed healthcare assets — distressed M&A deals inherently come with more risk. At the same time, the general business environment is also riskier than usual due to heightened interest rates and inflation. PE firms looking to make a healthcare deal in this environment will likely be hyperaware of potential risks and cautious about agreeing to take them on.

3. **Asset prices are expected to increase.** Eighty-six percent of respondents who invest in healthcare expect asset prices to increase in the next six months, with 43% expecting assets to trade as much as 10-24% higher. As a result, we may see PE firms hesitating to take on deals as valuations trend higher. This outlook among fund managers and operating partners also drives home PE's pre-pandemic thesis: that there's a lot of opportunity for value creation in healthcare. Healthcare organizations and PE firms can work together to tackle challenges like the needs of the aging U.S. population and the healthcare industry's hesitation to adopt new technologies, creating value for both patients and shareholders.

4. **ESG assessments are integral to getting deals done.** PE firms are evaluating ESG risk before making investment decisions. Eighty-four percent of respondents investing in healthcare say they have declined an investment opportunity because of ESG concerns. Surprisingly, respondents were more likely to report turning down an investment opportunity for environmental (33%) or governance (33%) reasons than for social reasons (26%). This may be due to the healthcare industry's focus on the "S" in ESG via improving health equity, making them more advanced in social areas than governance and environmental. Overall, healthcare leaders need to recognize that private equity investors are looking for evidence of sound ESG practices as part of their criteria for evaluating investment opportunities.

5. **PE is pushing top-line growth.** Respondents investing in healthcare see top-line growth as more critical than bottom-line growth over the next 12 months. That's not surprising, as top-line growth can be a better indicator of free cash flow and EBITDA. EBITDA is particularly important due to its role in determining PE multiples. As such, top-line growth is more aligned with generally used valuation methodology. The top line is also easier to grow aggressively and can be used to demonstrate the value a PE firm brings to a company, whereas the bottom line reflects costs outside of the PE firm's control, such as labor expenses.

6. **PE firms are prioritizing cost optimization in healthcare.** Twenty percent of respondents investing in healthcare cite cash flow optimization as the value creation lever they deploy most frequently across their portfolios, making it their top response. At the same time, when asked where the private equity firm's guidance is most valuable in the area of operations, 33% of respondents investing in healthcare cite overhead cost reduction. Cost optimization may be more important than ever as healthcare companies fight to stay afloat in challenging economic conditions — PE firms can help healthcare companies optimize their costs so they can continue to provide care to their communities. Cost optimization can also support the shift to value-based care, an approach to care that prioritizes achieving the best possible patient outcomes for the lowest cost, which is picking up steam as the COVID-19 pandemic subsides.

7. **Inflation continues to concern PE firms.** When asked which aspect of economic instability they are most concerned about, 44% of respondents investing in healthcare cite inflation, making it their greatest current concern. It's unlikely we'll see inflation slow until the labor market eases. High inflation may dampen PE's appetite for deals, especially as the Fed plans interest rate increases later this year.

What Comes Next?

Healthcare leaders looking to pursue PE investment need to understand investors' priorities and concerns in order to navigate the deal process effectively. Here are some steps to consider based on current PE trends:

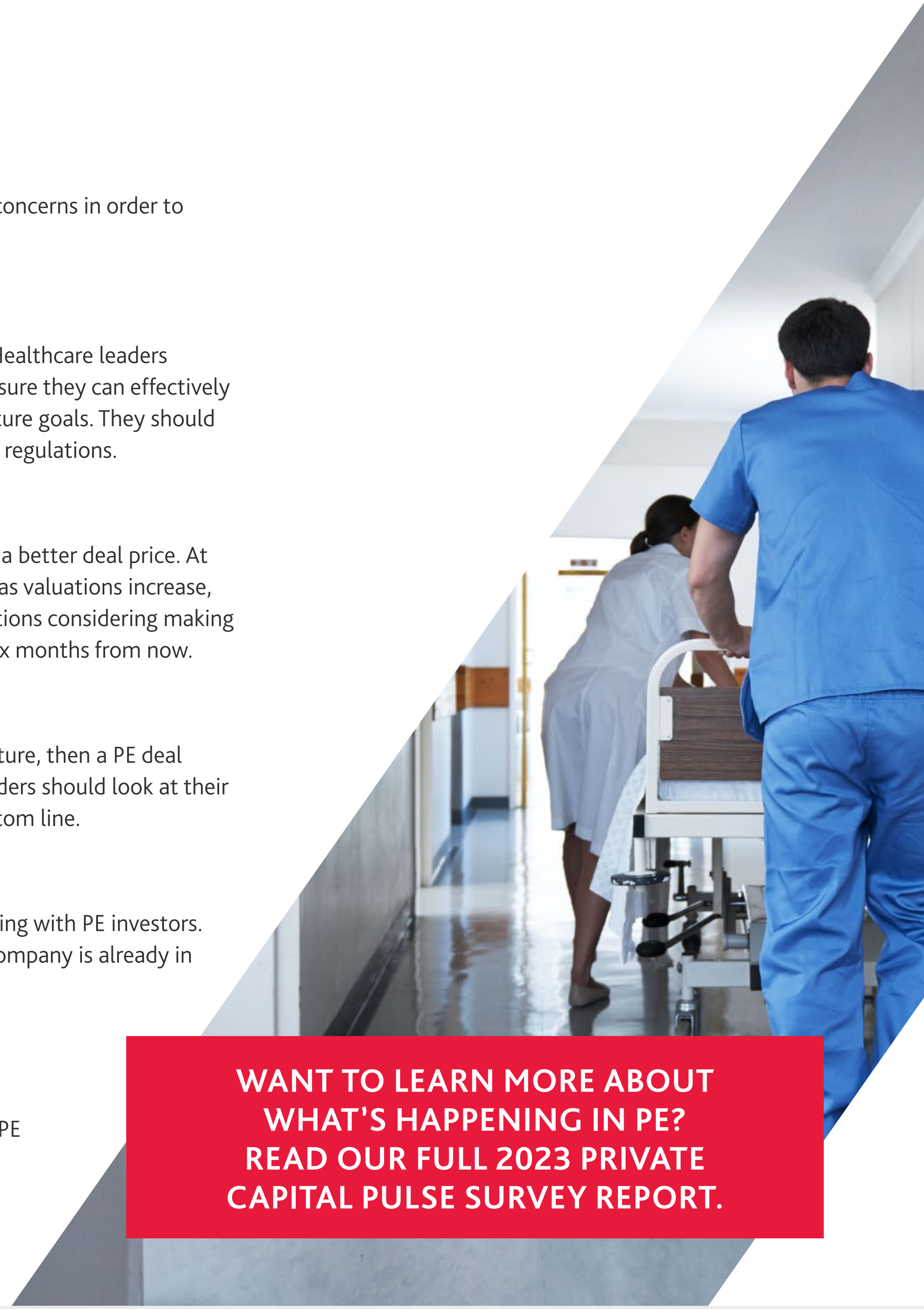
1. **Revisit ESG positioning**.
   Strong ESG positioning is only going to grow in importance among investors. Healthcare leaders exploring PE opportunities should first evaluate their ESG strategies and make sure they can effectively communicate the organization's current ESG positions, successes, risks, and future goals. They should also be prepared with detailed plans to comply with forthcoming health equity regulations.

2. **Carefully consider deal timing.**
   Healthcare assets may begin to trade higher in six months, which could secure a better deal price. At the same time, however, PE firms will likely proceed with even greater caution as valuations increase, leading to a longer negotiation and due diligence process. Healthcare organizations considering making a sale should review the risks and rewards associated with selling now versus six months from now.

3. **Take a close look at costs.**
   If the company's financial positioning is significantly impacted by its cost structure, then a PE deal may be a good avenue to perform wholesale cost optimization. Healthcare leaders should look at their companies' finances and consider how cost optimization could affect their bottom line.

4. **Reassess risks.**
   Healthcare leaders should be fully aware of their companies' risks before speaking with PE investors. Transparency can result in a smoother due diligence process, especially if the company is already in distress and has a higher risk profile as a result.

These are just a few practical steps that any healthcare organization can take to position itself for success ahead of a potential PE transaction. The key is staying up to date on what's happening in PE so leaders can ensure they're making the best possible choices to capitalize on current trends.



WANT TO LEARN MORE ABOUT WHAT'S HAPPENING IN PE? READ OUR FULL 2023 PRIVATE CAPITAL PULSE SURVEY REPORT.