

Insights

Pros and Cons of Health Care Private Equity

March 12, 2021

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Private equity (or PE) continues to have a strong interest in physician practices, surgery centers, and other health care ventures.

What is PE? At its core, PE is an alternative investment class consisting of capital that is not listed on a public exchange. PE is comprised of funds and investors that directly invest in private companies. Similar to venture capital, most PE firms invest in companies and then look to sell their stake in 3 to 5 years for a substantial profit. In the past, PE deals were focused on the higher end of the "middle market", between \$500 million and \$1 billion, but investments in health care ventures have often been for much less. No matter the transaction size, PE firms expect a large stake in the business and typically do not wish to be mere passive minority investors. PE uses its position to try and make the company more valuable so that it can sell its interest later for a significant profit.

<u>Characteristics.</u> Unlike traditional financings, PE firms are much more hands-on and expect to have more insight into the running of your business, as they have more "skin in the game" than a traditional lender. Moreover, individual partners in a PE firm often have their own money invested and can earn performance and management fees. Accordingly, they have strong personal incentives to increase a company's performance and eventual value.

Still, many health care companies remain skeptical of PE investments. They are particularly concerned about dilution of ownership interest and a loss of control to a third party who may or may not have much health care experience. In many cases, the PE firm will want to be actively involved. This could mean losing control of basic elements of the business, including hiring and firing employees, maintaining workplace culture, setting strategic direction, and selecting a management team. Other PE firms retain more of an advisory role and do not necessarily take control of these issues, with many simply wanting a seat on the board and a more formal organizational and reporting structure.

On the other hand, many physicians like the idea of focusing exclusively on clinical issues, leaving administration and management to others, and often others with more expertise. In addition, PE firms can often bring more resources, like human resources, compliance, and collections and billing support, as well as funds for EMR



systems, at-risk payor contracting, and investment in ancillaries, like surgery centers. Being a part of a larger organization can also often help with payor contracting.

Although a PE firm's overall goal is to increase business value, it is important to define the "value" for each party. Whereas, the PE firm is typically most focused on the financial value of the business, a physician's definition of "value" may include a more long-term outlook, with concerns about employees, patients, professional independence, and the like. This inherent tension makes it critical for a robust governance structure to be implemented at the time of the PE investment.

<u>Auctions.</u> When looking for a PE firm partner, it is important to consider many options. Too often companies are approached by PE firms (rather than vice versa) and neglect to consider other PE firms and opportunities. It is typically more advisable to first engage an advisor who can help with an "auction" to solicit interest from multiple PE firms. While such an advisor will lead to additional transaction expenses upfront, they often can lead to finding the best monetary opportunity and the best cultural fit.

Other Advisors. Structuring and negotiating a PE deal is always complex, and health care PE deals are even more so based on various corporate practice of medicine rules. It is important to have a team of experienced advisors helping you through the process. To prepare for meeting with PE firms, it is important that you take the time to write out your company's history. You should also consider the amount of funds that you are seeking and your strategic reason for doing so. In other words, what are you going to do with the PE money? It should be more than just distributing it to owners. Remember that the PE firm is looking for significant growth opportunities and there is only continued growth opportunities with engaged and productive practitioners.

Offer Letter and Diligence. Even before a PE firm makes an offer, the PE firm will want to perform a detailed diligence investigation of your company. They will require significant amounts of data and follow-up discussions and analysis. This process can take a large amount of time from the owners and also the company's management team, which means it will be very challenging to keep the process a secret at that point. Confidentiality agreements that protect company and patient information, establish clear procedures for the diligence process to maintain secrecy, and even include employee non-solicitation protections are critical.

<u>Miscellaneous.</u> Currently, health care is a hot market sector and valuations are high, primarily because of a surplus of PE capital that needs to be deployed and what PE firms view as a limited supply of opportunities. If you need help understanding the pros and cons of these opportunities, please contact **Thomas N. Hutchinson** or **Brian M. Heaton**.