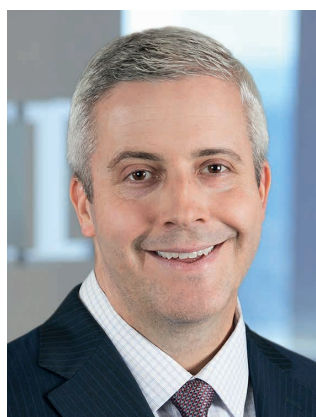


## KEYNOTE INTERVIEW

# Innovation underpins PE healthcare deals



*More creative financing and deal structures will spur healthcare investment and exit activity beyond the current focus on trophy assets and add-ons, say Ropes & Gray's **Neill Jakobe** and **Carolyn Vardi***

### **Q** How would you describe the current deal landscape for healthcare assets?

**Neill Jakobe:** There is a robust market for high-growth assets with stable cashflows. For example, biopharmaceutical solutions business Syneos Health announced in May that it had agreed to a \$7.1 billion take-private acquisition by a private investment consortium, which shows there are still private equity firms interested in this sector with capital to invest. For the good assets, we see highly competitive processes.

For clients that are selling, unless they have an asset that they think is going to generate significant interest, it is

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a tough market. We saw a lot of broken deal processes in the fourth quarter of last year and in the first quarter of 2023, and there are fewer deals with a complicated 'story' coming to market. We are seeing some dipping of a toe in the water – sellers are conducting high-level market checks and if they are not getting interest from credible buyers then they are avoiding kicking off more fulsome processes.

**Carolyn Vardi:** Even sellers that have strong assets are doing that check to

see if the market agrees and recognises the asset's value. Sellers still want to sell at 2021 prices and good assets can command those valuations, but processes are much more targeted.

The other question is how you define a good asset. Healthcare as a sector has many sub-categories and multi-site businesses that used to drive a lot of attention and value but are no longer what buyers want. Today it is healthcare technology companies and businesses with access to data that are driving demand. There is a lot of focus on software-as-a-service and any business or product that enhances efficiency, which makes sense at a time of rising costs.

## Q What does the exit market look like for PE-backed healthcare assets, and how do you expect deal volumes to evolve?

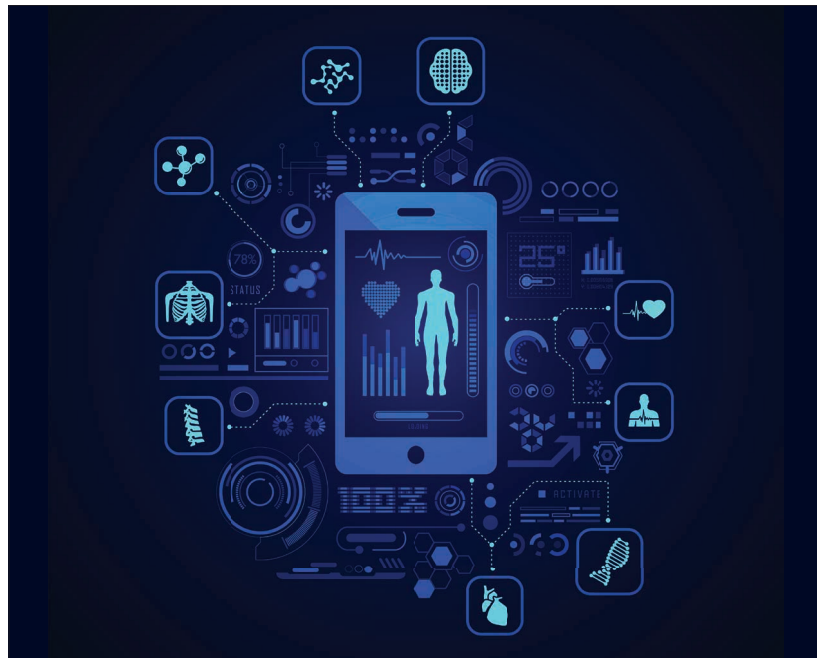
**NJ:** The exit market changes all the time, particularly when the markets are this turbulent. I was in Silicon Valley earlier in the year and people were describing potential green shoots in the deal market, and the collapse of Silicon Valley Bank happened later that same week. For good assets, the exit market remains strong. The deal markets may be slow compared with the heady markets of 2020 and 2021, but those were an exception; deal activity is not so slow relative to 2018 or 2019.

As the debt markets stabilise and inflation moderates, we will see deal activity increase. We need stabilisation and predictability to return after the challenges of the last few months, such as those involving the regional banks, the prolonged impasse around the federal debt ceiling in the US, the war in Ukraine and rising interest rates. Those challenges have made it difficult to figure out cashflow models for the next few months, let alone the next few years.

Still, there are a lot of investors under pressure from LPs to begin investing again. There is more than \$3 trillion of private equity capital sitting on the sidelines that needs to start getting deployed.

**CV:** Sponsors are looking for more creative exit opportunities and for large platform deals. A lot of the activity today centres around buy-and-build strategies involving smaller deals. That means selling larger platforms still remains a challenge, unless they are crown jewel assets.

One solution is partial exits, where another private equity firm takes a significant minority stake, allowing the control sponsor to partially monetise its investment and hold out for more stable markets. Those deals alleviate pressure for both sides because they provide some capital to return to the original



## Q What are the best opportunities for PE-backed healthcare companies right now?

**NJ:** In the healthtech sector, anything related to supporting efficiency is attractive, such as benchmarking and data metrics companies. There have also been staffing shortages across the healthcare industry, so staffing solutions businesses that did well during covid have continued to perform.

We are seeing a lot of activity in pharma services right now, including contract development and manufacturing organisations, contract research organisations and ancillary services that help companies get drug trials and medical products through testing and out to market to help patients.

**CV:** Telehealth is another big theme. Covid accelerated acceptance of telehealth services and those companies generate a lot of attention. That plays into the efficiency narrative, as well as the flexibility of workforce, while alleviating some of the fixed costs associated with real estate and so on. It also increases the potential reach and accessibility of healthcare provision.

Those businesses grew significantly during the pandemic and there was some concern about whether they had over-scaled. But generally, we have seen regulatory support for telehealth and positive patient outcomes. A lot of those businesses were started by not-for-profits or impact funds and are now moving into traditional private equity fund structures.

sponsor's investors, while providing the incoming sponsor with a new investment opportunity that shows its LPs that money is being put to work.

**NJ:** We are also seeing some parties get creative, including lining up a direct lender or holding company financing

on top of senior secured financing and/or offering some seller financing to bridge the leverage gap for bank debt right now. Seller's paper allows the seller to get paid, just over a longer period. It gives sellers cash in their pockets at a multiple they might not otherwise achieve in the current market. All these

innovations will help unlock more deal activity in the coming months.

### **Q What about healthtech deals? What are the biggest challenges there and how are you advising on them?**

**CV:** For healthcare technology, the biggest challenge is finding financing for the target company that will allow the business to grow in a healthy way. That is especially true in a high interest rate environment, which makes it harder to find lenders that see the value proposition in a target company and that can come up with the right type of debt. The market is becoming more creative with what that looks like, with much less onus on the syndicated lending markets and much more junior capital, preferred equity, structured capital and direct lending.

We have encouraged clients to go beyond their typical debt sources. A lot of private equity sponsors had one or two banks that they would go to for almost every deal, but if those banks now have problematic balance sheets, they need to expand the roster of lenders they are working with. There are plenty of direct lenders and private debt providers coming into the market and we are seeing a lot of investor inflows into direct lending funds, so pricing has come down a bit and there is a clear role for private capital on those large deals today.

**NJ:** Healthcare IT and SaaS businesses also have cost structures that you can scale to react to market conditions. But if you have people-centric businesses, there are severance costs and issues associated with the resizing of workforces that are harder to navigate. While those businesses are challenged and are trying to figure out how to recalibrate their capital structures, the SaaS model typically has higher margins, free cash flow and therefore more room to service the debt.

Sponsors are also figuring out capital solutions for add-on portfolio deals,

*“Sponsors are looking for more creative exit opportunities and for large platform deals”*

**CAROLYN VARDI**

where multiples have started to get more attractive, and are looking at interesting structures there. Those may be subordinated notes up the corporate structure, holdco debt outside the credit net or NAV loans based on the net asset value of the fund's portfolio or one or more specific assets. Private equity firms are finding new ways of accessing capital for those accretive deals.

Meanwhile, funds that have a lot of pre-cashflow portfolio companies that they acquired for significant valuations during the pandemic are encountering challenges. As operating and lending costs have gone up, some of those companies are now having to find financing at lower valuations or higher interest rates – that has been a theme of the last few months.

### **Q What resources are private funds employing to scale healthtech businesses?**

**CV:** The resources required to scale healthtech businesses are no different from other industries, in that the focus is on data and information. Investors are looking for companies that have

access to data that they can use to drive better and more efficient outcomes for patients. They want to invest in companies that are collecting, mining and then selling the data.

**NJ:** We are seeing a lot more focus on the ability to demonstrate better patient outcomes. For instance, marshalling data to measure outcomes and identify things such as where in the chain of care a patient is most effectively served, like when someone should be in a hospital versus at home. There has been significant progress made in that space, which obviously has big cost implications as the data gets better and more real-time information is available on how someone should be treated most effectively.

### **Q What other value-creation levers are likely to be prevalent in the second half of 2023 and beyond?**

**NJ:** The real levers are around the use of and access to data, and then using that data to increase efficiency in the businesses. Developing more flexible staffing solutions for variable demand environments has also been a valuable lever.

**CV:** Buy-and-build is still a strong approach and finding those smaller add-on acquisitions gives investors a chance to add significant value at lower multiples.

However, it is getting harder to find those roll-up deals, and there are also certain regulatory hurdles and concerns around those that sponsors had perhaps not focused on too much in the past. Both the US Department of Justice and the Federal Trade Commission are really sharpening their lens on those strategies, which is causing a headwind. ■

Carolyn Vardi is head of the private equity industry group at Ropes & Gray and Neill Jakobe is a member of the firm's policy committee and a partner in the firm's private equity practice