Privcap/
Context for Private Capital Investment

TRANSCRIPT

The Healthcare Private Equity Opportunity

David Snow, Privcap:

Hello, and welcome to Privcap. My name is David Snow, Co-Founder and CEO of Privcap and we have a great webinar for you with some leaders from the private equity and healthcare space. They are going to walk us through the incredible opportunities for private equity investment in the healthcare space, which as everyone knows, is going through some monumental changes. And so what do these changes mean for private equity. I'm fascinating to hear what our experts have to say.

So before we jump into the main part of our conversation, first of all I'd like to thank our partner on this program, Proskauer. And I would like to ask the three experts to briefly introduce themselves. Why don't we start with Adam Blumenthal from Blue Wolf Capital Partners?

Adam Blumenthal, Blue Wolf Capital Partners:

Sure, thanks David. So this is Adam Blumenthal. I'm the Managing Partner of Blue Wolf Capital, and we're a special situations fund that focuses on carve-outs, on distressed situations, on unconventional or complicated negotiations, and often investments in opportunities that arise from those where either managing or regulatory environment or managing a relationship with organized labor is critical to the ongoing success of an enterprise. And so our attention has been turned over the years, both to the healthcare delivery system and to a number of sort of supporting elements of that value chain, both in terms of outsource services and in terms of outpatient services. And as far as we can tell, the stress is placed on the industry by the changing payment models and as well as improving technology, mean that we're really just at the beginning of the kinds of investing that we're likely to do.

Snow: Great, and Tom Flynn from SV Life Sciences.

Tom Flynn, SV Life Sciences:

Thanks, David. I am a Managing Partner at SV Life Sciences. We are a 20-year-old, healthcare-focused venture capital and private equity firm. We invest in three sectors of the industry: biotechnology,

medical devices, and healthcare services and healthcare IT. I focus on that latter segment, which is the growth capital side of our investment strategy.

Snow: Thank you. And Richard Zall, would you mind introducing yourself and your firm?

Richard Zall, Proskauer:

Be happy to, David. Thank you. I'm Rick Zall. I'm a Partner at the law firm of Proskauer Rose, based in our New York office. I chair Proskauer's healthcare industry practice, and we have over 75 lawyers across the United States who are focused on corporate transactions and healthcare regulatory counseling, advising private equity sponsors and lenders, and healthcare operators in deal diligence, structuring, negotiation and documentation of transactions. We're focused on the healthcare services and IT markets, and the middle market, primarily.

Snow: Great. Well why don't we get into the main body of our conversation now. I'd like to remind our audience that we will save time for questions for our experts toward the end of the 45-minute webinar. You can send in your questions anonymously, and we definitely will have time for that. Let's start with a question, maybe we can throw the first one to Tom from SV Life Sciences. What have been, from your perspective, some of the most important changes to the healthcare landscape that have presented interesting opportunities to put your growth capital to work?

Flynn: I think because it's healthcare, David, Rick Zall will tell you that legislation and regulation play an enormous role in how we react and invest proactively in the industry. And in the last five years or so, we've had a couple of significant acts. One is, as part of the stimulus funding act, we had EMR meaningful use dollars provided to the healthcare system which provided tens of billions of dollars for health systems and physician offices to implement EMRs and use them in a meaningful way. So for us, what that meant was there was a near-term opportunity to help those organizations select, implement EMRs. And now that that plumbing if you will has been laid, there are downstream opportunities to utilize the data that those EMRs are producing which creates opportunities for both further software investing as well as technology-enabled services investing.

And then the accountable care act, which as we know has been a huge deal. That has done a number of things which we can get into as this goes on, but the previous reference to changing payment models, bundled payments, holding providers accountable for the outcomes of

care instead of just fee for service. That's pretty meaningful. As part of the ACA, we had mental health parody, which has created a lot of attention on behavioral care. So there are a number of impacts coming out of that, as well as healthcare exchanges in the benefits marketplace. So between those two acts, we kind of feel like the federal government laid a blueprint for us for the next decade to exploit interesting opportunities in healthcare.

Snow: Before I throw the next question to Adam, just a quick follow-up question for you Tom. Behavioral care, very briefly, what are some examples of those kinds of services?

Flynn: Well, we recently invested in a company that is acquiring and building inpatient, psychiatric hospitals. If you look at statistics about the number of those facilities, the number in the United States over the last 20 or 30 years has about halved as the country made a policy decision to kind of de-institutional that population, and the pendulum swung too far. So in many, many cities in this country, for people who are acute risk of hurting themselves or others, there are not enough inpatient, behavioral beds available to get those patients stable. So that's us reacting to a particular facility supply-demand situation, but beyond that with mental health parody, I think employers and insurers are much more focused on providing adequate behavioral care. And we are beginning to see non-profits and for-profits alike experiment with models like telemedicine for behavioral care.

There are some interesting studies out that suggest that the consistent utilization of say, therapy, improves as a result of telemedicine where you don't require the recipient to leave their home and sit in a waiting room prior to getting therapy. So I think there are both kind of traditional opportunities like the inpatient behavioral hospital opportunity, as well as some kind of more technology-enabled opportunities.

Snow: And Adam from Blue Wolf, how important are these new regulations such as affordable care act in shaping the way that your firm invests in healthcare? Is that a, would you say that that's the most important change that's happened in the market in the past few years?

Blumenthal: Well, it's hard to say that it's the most important change. There, certainly there are overwhelming advances in technology and in treatment that allow a huge movement of services away from hospital-based and toward outpatient based. And that's not just because of cost pressure. That's because convenience and quality and customer-experience all can work better for many less acute conditions in an outpatient setting. So I think regardless of changes in

legislation and the regulatory environment, there is structural change in healthcare services and delivery-driven simply by new ways of doing things.

But there also is an overlay on that of, which has two components. One is the new payment models, as Tom was saying. People are trying to figure out how to move to more value-based pricing, and people are trying to figure out how to live within that regime. And that creates a whole set of opportunities, really I think, to do things better. But second, a second element of the ACA was Medicaid expansion and so there's a large population of folks who have insurance coverage, but for whom service delivery and in general their interaction with the healthcare system, is essential disorganized and chaotic. And if there's anything that is sort of an underlying truth, it's that healthcare works better when it's consistent and coordinated and delivered in a rational way. And it's possible to spend a phenomenal amount of money and get terrible outcomes if you don't do that. And so the movement to take all of those folks and find ways to effectively delivery care, I think, there's tremendous pressure to innovate and to build new things as a result of that change as well.

Snow: And Rick Zall from Proskauer, would you say that as you help clients navigate all of these new rules and regulatory changes, is that really affecting their approach to investing? And are they coming up with new innovations and business models to try to make money in the new environment?

Zall: Well I think it's absolutely essential now to understand how the mix of state and federal laws and regulations affect a particular business, and the opportunity it presents. Certainly, I think, healthcare is among the most regulated and because of the state-federal matrix that we have, there's really a need for most national companies to understand both the federal and the state regulations and laws.

And so it used to be that we would see people look at opportunities and ask whether there was any regulatory overlay. Now I think people understand that there is, of course, applicable laws and regulations and they're changing on almost a daily basis. And so the question is, how to assess where those laws and regulations are going to impact a business going forward. And we try hard to crystal ball that based on what we've seen in the past, cause history does tend to repeat itself, and help evaluated the risks.

Are there risk that are manageable that a particular business model takes into account? For example, corporate practice of medicine regulations that restrict the ability of business corporations to directly

provide physician services, or in some cases, facility services. Has the company that might be the target of an investment set up a business model that's scalable that won't run into obstacles going forward or not? And are those rules changing. We find we're spending a lot more time with that kind of risk-assessment process than before.

Snow: I guess just a quick follow-up question for you, Rick. Would you say that it's even more challenging now to read several years into the future for how a regulatory regime might affect a private equity investment? Is it more challenging, or has it always been just about as challenging?

Zall: I think it's been very challenging for the last several decades, since the federal government got into the business of not only regulating but actually purchasing healthcare through Medicare and Medicaid. I think there was a period of time right before the passage of the affordable care act, when there was tremendous uncertainty about whether the rules would change or not, whether there would be a federal health-reform law or not.

Actually, I think that a lot of that uncertainty has resolved itself, even though there is still some judicial action to be taken regarding the subsidies for the exchanges. But I think that after 2010, when the affordable care act was passed, that there was greater certainty, greater predictability. Obviously around the edges, there are a lot of ongoing changes. But I think that investors can by and large, assess the trends – some of the things Adam and Tom have mentioned in terms of the use of data, the focus on value rather than volume of care – that a lot of those things now have settled a bit and there's a consensus about what the framework is.

Snow: Why don't we move to a discussion about deal flow. And we're fortunate to have two different types of private equity firms in the form of Blue Wolf and SV Life Science. Maybe starting with Tom, talk about your deal flow right now. Why are you seeing sellers, or potential partners, interested in partnering with your firm? What are their motivations, and what do they see in you as a partner, beyond your capital?

Flynn: Well, I think there are two things going on in our world, and just to frame this for folks so they understand what our deal world is. On the healthcare services side, we are generally growth capital and small buyout investors. We get interested in companies kind of around the $3 million EBITA mark and go up from there. And on the IT side, we are investors who will invest in loss-making companies. We prefer not

to, but our cutoff there is about $5 million of recurring revenue. So those are our lower limits to give you a sense of where we play.

And I think it's a little different generally on the IT versus services side. I would say on the healthcare IT side, generally the activity is around raising growth capital. Many of the software models that we look at are SAAS-based, hosted model. Because of the way those revenue models work and the marketing required, there's typically a period of cash consumption. And so those are kind of traditional, usual minority growth capital deals. And those companies are obviously interested in valuation and terms and all that. But I think they're also looking for investors that can help them strategize about what the next three to five years looks like as they build their business. How to best position themselves for exit to a strategic buyer, and so folks like us are trying to demonstrate to those companies that we would be an effective partner along those dimension.

Over on the healthcare services side, I think that market is – at least at our end of the market – is being driven more by liquidity desires by owners. So we tend to invest in a lot of founder-owned companies in healthcare services. Twenty years ago, there weren't that many private equity firms that would cash out an owner in part, and then leave that same owner in place running the business. That's routine today, so folks who have built business realize that they've created wealth and are often looking to monetize some of that wealth through a recap transaction. And I think that, in turn, has been aided by the tremendous liquidity we see in the markets now. Debt is extremely cheap. Lenders have gotten increasingly aggressive since the financial crisis, and so even at our end of the market, you see leverage ratios at three, four, five times EBITA depending on the characteristics of the business.

So, and those folks I think might be looking for different things. One certainly is a good partner, but secondly for a founder who might have been working at their business for 10, 15 years, they may also be looking for a partner who can bring some additional operating talent to their business to help that business scale to the next level. Might also create a succession plan for the founder, and so one of the ways that we go to market on the healthcare services side is we will work very closely with executives in residence. We call them venture partners. Other firms call them operating partners, but they are proven healthcare services executives who have multiple successes, and we will partner with them looking for these types of founder situations where our ability to introduce this venture partner potentially as a board member, potentially as executive chairman, potentially as CEO can often be a differentiating characteristic to that

founder as they think about scaling their business and ultimately creating a succession plan for themselves.

Snow: Adam, as someone from a firm that looks for complicated deals, deals with maybe some hair on them, deals that are challenging that other firms might not want to do, talk about your sourcing platform and the way that you come across the opportunities in the healthcare space that are right for your firm.

Blumenthal: Sure. Well, the nice thing about looking at distressed and challenged and complicated situations is that there, often one can find them simply by reading the papers. And so two things which have worked well for us are, we've identified a couple of large health plans and payers who have, in some ways had a lot of expansion through, as a result of the ACA. But who also are experiencing a lot of cost pressures and organizational pressures. And of course, those folks are eager as they grow in markets to have really aligned and thoughtful partnerships with people they know on the service delivery side.

And so one strategy that we've been pursuing quite actively is looking at where those folks are growing, looking at some of the undermanaged delivery platforms in those areas, and seeing if there's a way to buy those assets which based on however they exist today, but go in there with a relationship that can start to drive volume and start to bring something more than the traditional sets of relationships that grow them. And so that's been very market specific and partner specific, but we've had some very interesting conversations as a result of that.

The other thing I think that has worked well for us is finding folks who are capital constrained, systems that know that. Their future is in morphing from really a hospital-driven paradigm to a network paradigm, and that involves sometimes just alliances, but very often building some new things. And in states like New York where there's a lot of regulatory control over what people can and can't do, we have looked at a number of, and actually are well underway on one joined venture with a not-for-profit hospital that really is a phenomenal institution, but one which by law and corporate form simply has limited access to capital. And a partnership with them turns out to both create a great investment opportunity, and offer us and a way for them to change from what they are really into what they want to be. And we think that there's a lot of room for that model to grow as well.

Snow: I think it's important for investors, whether they're generalist GPs or limited partners thinking about possibly doing some co-investing. It's important for them to understand the peculiarities and the very

specific kinds of due diligence that take place leading up to a private equity healthcare investment. Maybe Rick from Proskauer, you can walk through what are some tires that need to be kicked – specifically in healthcare – that maybe people who are not experts in healthcare space should understand.

Zall: Sure. There is a long list, unfortunately or fortunately, but as we've said the industry is highly regulated. And so I would categorize this in a couple ways. One, there's sort of general overall diligence about a company which most investors want to find out about. How's it been set up? How have they gone about finding employees and making sure that they are complying with all of the general rules that businesses of any kind have to deal with? And are they organized in an appropriate way?

The next level really is more healthcare-specific in terms of whether the company has obtained and is in good standing with the authorities who have to license or accredit the service. For service providers or for medical device makers or pharma companies, there are gating issues in order for them to conduct the business they conduct. And we certainly go through a lot of information about what has been obtained and whether it's still current, whether there have been any regulatory audits that might have uncovered issues and whether those issues were dealt with.

Beyond licensing, business arrangements are subject to a lot of scrutiny by both state and federal government. People have probably heard about the anti-kickback laws and the start law, civil monetary penalty law that essentially restrict how healthcare companies deal with vendors. How they deal with physicians, all designed to prevent fraud and abusive relationships. And those are things that are potential show-stoppers that need to be evaluated as well as a company's overall compliance program.

And one of the challenges is that it's easy to put a compliance plan together and have it look terrific up on a shelf somewhere. The question that really needs to be evaluated is, is it operation and what has really happened and are there processes in place to really prevent the kinds of abuses that the government's looking for.

Another important area is payment. Obviously the revenue flows are critical to these businesses, and most of the businesses that Adam and Tom have been talking about do rely on third-party reimbursement whether it's government through Medicare or Medicaid, or whether it's commercial payers. And for every kind of service, there are separate reimbursement rules. So kicking the tires on how a

company's going about deciding what they're entitled to, how they bill and collect for it, is very important.

And maybe lastly I would say, in the whole data area Tom mentioned earlier the explosion of electronic health technology. And what has come with that are a lot of efficiencies and improvements in diagnosis and treatment. But with all that data comes the risk of breach, and we've seen this. There was the Anthem incident just a few weeks ago where there was a hack of their website. And so assuring that the data that these companies have is adequately protected and that if there's a breach, it could be dealt with, is another area we look at almost all the time.

Snow: Sounds like a lot of work for sure to make sure that a healthcare investment is going to be what the GP hopes. We have a bit more time, and I'd like to get into the top investment theses that investors have. But want to remind the audience that following this conversation, maybe in about five or six minutes, we're going to have some time for Q&A. We already have some good questions in, and so please do think of some good questions for our experts.

Adam, what investment theses or plays are you most excited about in the current environment?

Blumenthal: Sure well, look, I think the – I sort of engaged with that a little bit in the earlier questions. But the single most exciting thing that we think that we're doing is building outpatient facilities in partnership with not-for-profit hospitals in communities which have a preponderance of Medicare and Medicaid lives, which typically have been underserved by that type of facility. And a way to put that in really concrete terms is if you live where I do in New York and you walk around Manhattan, like it doesn't matter where you get hit by a bus. You could walk into an urgent care center within 50 feet. And assuming that you didn't get too hard, they would deal with you in 45 minutes. Same thing happens to you in Brooklyn, you're going to be likely in somebody's emergency room for double the average national wait times – six hours. And the insurance company is going to spend $2,000.00 for something that, in Manhattan, would be dealt with for $400.00.

And we think that because, simply because of the expansion in Medicaid eligibility, the economics of operating in those kinds of areas has changed fundamentally. [00:32:00] And we think that's an exciting thing to build. And so of all the things we're doing, we think that's sort of the most, sort of like, mainlining an investment thesis that you can see here and smell just as you walk down the street.

Snow: Tom, given that you are involved in a number of different subsectors within healthcare, can you name one or two plays or investment theses that you are particularly excited about in the current environment?

Flynn: Yeah, we talked about the EMR spending that's gone on so providers have much better access to data than they once did. And now they're turning to the utilization of that data in evolving payment models that Adam referenced. So we're very focused on population health management and data analytics software models on the IT side. And on the services side, one thing we haven't talked about is just the enormous changes going on with the U.S. physician population. That population is increasingly female over time, is increasingly employed rather than self-employed. Many by hospitals, and in fact, if you look at the demographics of the aging U.S. population versus the expansion of the physician pool, there are persistent projections of physician shortages. So I think that creates a number of opportunities to deploy mid-level providers in various service models. To evolve the physician practice model to more of an at-risk model and not just a fee for service, volume-orientation.

There's lots of private equity activity in aggregation of specialists. It's been done for years – neonatology, hospitalists more recently with anesthesiologists and dermatologist. And then finally as I eluded to before, I mean we have to apply technology to these looming physician shortages and so telehealth is one thing that we're spending a lot of time with.

Snow: Why don't we move to questions from our audience. We've got some good ones in, and Tom, let me know if you want to take this one. It is, is there a biotech bubble? That's a question from an LP in our audience who says biotech receives 69% of all life sciences investments in 2014. Is this the case of too much money chasing deals that don't have a 50-50% chance of success? What do you think?

Flynn: Well, as noted upfront, I don't work in our biotechnology practice, and people with many more educational degrees than me do – physicians and PhDs. But I sit on our investment committee, and my response to that would be that I think the phenomenal volume of biotech IPOs that we've seen in the last few years inevitably will slow. The window for those public market exits for biotech companies that are still in the clinic with their products as opposed to on the market, it's been a great exit time there. And that public window will inevitably close. So I think that side of the market has some cyclic and unusual features to it.

On the buy side however, I would say that unlike in technology deals, technology entrepreneurs when they see their more mature peers going public on the IPO market, they very quickly translate those values into their pre-money valuations. And you see enormous upward pressure on pre-money values. You don't see that in biotech. We invest in pre-clinical companies, so companies that have not yet been, have tested their product in man. Usually they've done animal testing for safety, toxicology, etc. But haven't yet achieved proof of concept, and in those deals we see no upward pressure on pre-money valuations.

And then I would layer a second thing on, which is I think we are coming into a period of incredibly improving research efficiency. And there are a lot of scientific reasons behind that that would take longer to get into, and I'm not really qualified to articulate as well as my partners. But we are tremendously excited because we see the ability to invest in these companies with reasonable pre-money valuations, deploy less capital to get to proof of concept, and so my answer would be we're tremendously excited by what's happening in biotech.

Okay. Let's move on to another question. I think actually maybe Adam and Rick can address it. The question is, I have seen Optum United activity buying MSOs and physician practices. Do you see them as a competitor, or perhaps even a strategic buyer for healthcare services delivery businesses? Do you understand their end-game? Maybe Adam, is that something you can comment on?

Blumenthal: Yeah, sure. So I think – why don't we start with the end-game? I don't think anybody really has a great end-game right now. I think that there is, in general, a belief that integrated service delivery models that include both, that integrate from risk management through service delivery through physician practices and are tied together by a data stream probably are the kinds of organizations that will survive in the long run.

And everybody who is one of those things, is trying to take a leadership role in becoming what they think the end-game looks like. There's a lot of debate and a lot of positions about who should take a leadership role, and whether that integration really involves ownership, or just involves various types of risk-bearing or risk-sharing contracts and arrangements. Whether networks are open or closed, all of those I think you can have like lots of debates about. But I think we're at an exciting time where lots of people are trying to move in that direction, and some are going to succeed and some are going to fail, and nobody knows the principals on which that's going to happen.

So yes, they're competitors. But yes, they're also potential exits and I doubt they know their own end-game.

Snow: Rick, do you have something, do you have some comments to add to Adam's analysis?

Zall: I do, I do. I basically agree with what Adam said about what's going on. I think there's a lot of convergence right now in the market between the providers and the payers trying to grab space that they can claim to be their own. With the payers moving from insurance products and risk-bearing services into service delivery, and the hospitals and physicians understanding that with payment moving from volume to value and outcomes that care management and risk-taking is really important to be able to maximize their revenue. So I do think Optum, which is a division of United, is an example of a particularly aggressive payer that has been moving into the care management area by buying or investing in physician management service organizations.

We're also seeing some payers, like the Florida Blues, directly either buying or starting up physician service practices in their markets so that they have a captive delivery capability. And we're seeing hospitals, a lot of the large systems – Ascension, Catholic Health Initiatives – buying health plans or joint venturing. The big deal in California with Anthem and several hospitals is another example. So I think everyone's competing with everybody else in this marketplace. I think it's a big marketplace, so there's room for it. But depending on the market, I think we'll see payers and providers competing and collaborating.

Snow: Great. I don't know is anyone can comment on this in great detail, but maybe Tom, this is something you have a view on. We have a question here about opportunities in telehealth or telemedicine, and I assume that that refers to basically people getting their medical care partially taken care of remotely or with a doctor who's not in the room. Do you see opportunities there?

Flynn: Yeah. Yeah, and I mentioned earlier, it's something we're quite focused on right now partly because there is an infrastructure in place in most markets not to have effective, real-time video link. And that technology has become much less expensive over time. Secondly, because there are physician shortages certainly in some markets, and you could argue that over the coming years nationally. So creating more cost-effective ways to interact with patients and better utilize physician time is critical.

And there are a couple ways to play it. One is you can play the pure technology side, and there are companies out there that are venture backed that are providing the tools to do telemedicine. We are more focused on kind of the technology-enabled service side of it, and as I said, much of our early focus has been on behavioral telemedicine which we see as a natural application of the technology.

Snow: Rick, before we wrap things up, any observations you can make about private equity involvement in telemedicine?

Zall: Yes. We're seeing a lot of companies getting into this area as the, both the reimbursement rules and the regulatory environment is improving. Many payers are now seeing the values that Tom was mentioning of an efficient, low-cost way of delivering care, and are starting to cover televisits. We're also seeing a lot of the state law barriers to telehealth being relaxed in many states. And so whether it's at a very basic level of just urgent care consultations or a child in the middle of the night that a parent is worried about and getting a doctor on the phone to triage it. Or remote monitoring of chronic conditions like congestive heart failure or even remote treatment. There is a successful ICU company, intensive care, where there's a call center and there's real-time monitoring of ICU patients in rural communities that the technology is there. And I think the regulatory and payment environment is opening up and consumers want it. So we're seeing a lot more activity there and think it's a promising area.

Snow: Well great. Well this is a huge topic. We're out of time for today's webinar, but I hope that I can invite all of you to come back on a Privcap program and continue to help our audience understand the exciting opportunities in the private equity healthcare space. But for now, I'd like to thank our partner and sponsor, Proskauer for making this possible. I'd like to thank our experts for donating their time and though leadership, and also our audience for spending time with the Privcap program. But for now, we're going to say good-bye and see you next time.