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## HEALTHCARE INSIGHTS

# Private Equity Investment in the Healthcare Industry: Past, Present, and Future

(Part II of III)

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While private equity investment has declined in the past couple of years due to global economic insecurity, private equity transactions in the healthcare industry have been growing significantly.<sup>1</sup> A growing number of private equity groups are approaching large physician-held groups and other healthcare service enterprises, including hospitals and outpatient enterprises, seeking investment opportunities in the clinical services industry. This influx of private equity investment is not only ameliorating a dearth of financial capital available to healthcare service enterprises but is also allowing these provider groups to “step up” to the next phase of growth by providing the management capital (e.g., resources, knowledge, skills, and ability) to facilitate the provider’s transition to value-based reimbursement.

This second installment of this three-part series will describe the history of the private equity industry, the current state of private equity as of fourth quarter 2018, and potential future trends in private equity.

## THE HISTORY OF PRIVATE EQUITY

The concept of private investment outside of an organized exchange has existed since the dawning of the mercantilist era, or at least as long as the rights of individuals to own property has been respected.<sup>2</sup> In the absence of property rights, the very idea of private equity would be inconceivable, as investors would lack the ability to dispose of their property interests as they see fit, and therefore would be incapable of controlling the nature, timings, and magnitude of their investment returns, making private equity investment far

too risky to consider. In fact, private equity was non-existent prior to the rise of the mercantilist class and their insistence of protections for private property in Western Europe near the end of the Renaissance period (circa 1500–1600s).<sup>3</sup>

Even after ownership rights to property were secured by individuals, initial private equity-like investments were limited to investments by wealthy individuals in typically family-based businesses.<sup>4</sup> These investments were more similar to the venture capital type start-up investments seen today, as they involved the creation of a new enterprise.<sup>5</sup> Exceptions such as the French-based *Crédit Mobilier*, founded in 1854, collected contributions from high net worth individuals and invested the funds in infrastructure investment throughout Europe and the United States, most notably, the financing of the transcontinental railway across North America.<sup>6</sup>

The modern idea of private equity is frequently traced to the founding of the American Research and Development Corporation (ARDC) in 1946 by former faculty of Harvard University and the Massachusetts Institute of Technology (MIT).<sup>7</sup> ARDC had the stated goal of increasing private investment in veteran-owned businesses during the post-World War II era.<sup>8</sup> ARDC would operate until it was sold to Textron in 1972, during which time it invested in over 150 new companies.<sup>9</sup>

1 “Global Healthcare Private Equity and Corporate M&A Report 2017” By Kara Murphy et al., Bain and Company, April 19, 2017, <http://www.bain.com/publications/articles/global-healthcare-pe-and-corporate-ma-report-2017.aspx> (Accessed 2/7/19).

2 “Mercantilism” By Will Kenton, Investopedia, March 28, 2018, <https://www.investopedia.com/terms/m/mercantilism.asp> (Accessed 2/5/19); “Mercantilism” *ArmstrongEconomics*, <https://www.armstrongeconomics.com/research/economic-thought/by-topic/mercantilism/> (Accessed 2/5/19).

3 “Mercantilism” *Encyclopedia.com*, <https://www.encyclopedia.com/social-sciences-and-law/economics-business-and-labor/economics-terms-and-concepts/mercantilism> (Accessed 2/5/19).

4 “Bank Regulations” By S.K. Singh Darya Ganj, New Delhi: Discovery Publishing House, Pvt. Ltd., 2009, p. 94.

5 *Ibid.*

6 “*Crédit Mobilier*” *Academic*, <http://enacademic.com/dic.nsf/enwiki/11592451> (Accessed 2/5/19); “*Crédit Mobilier*” *History*, <https://www.history.com/topics/19th-century/credit-mobilier> (Accessed 2/5/19).

7 “Venture Capital, American Research Development Corporation, 1946” *Entrepreneurial MIT*, <http://museum.mit.edu/150/78> (Accessed 2/5/19).

8 “Venture Capital Financing in the Republic of Macedonia: What is done and what should be done?” By Veland Ramadani, *ACRN Journal of Finance and Risk Perspectives*, Vol. 3, Issue 2, (June 2014), pp. 27–28.

9 *Ibid.*, p. 32.

However, ARDC remained a venture capital firm, investing in start-up companies that were capital constrained.<sup>10</sup> It was not until the 1980s that private equity firms other than venture capital firms began to flourish, although they were called “leveraged buyout firms” (LBOs) at that time.<sup>11</sup> These LBOs pursued a strategy of leveraging the firm’s funds by taking on debt to acquire companies (or a controlling share of a company), and forcing the company to undertake tactics to enhance the value of the firm, with the ultimate goal of the LBO exiting the investment through an outright sale or an initial public offering (IPO), thereby generating a significant return for the LBO and its investors.<sup>12</sup> These tactics are often characterized as “corporate raiding” or “hostile takeovers,” as the owners/management of the target company were not willing participants in the transaction and often did not approve of the changes made by the acquirer; the strategy would frequently result in the dismantling of the corporation into its more valuable constituent parts.<sup>13</sup> A notable example of such tactics is Carl Icahn’s acquisition of Trans-World Airlines (TWA) in 1985.<sup>14</sup>

Eventually, the negative connotations associated with the LBO industry led to firms rebranding their investment efforts as private equity, although the tactics of the corporate raiders continued, along with the development of the other private equity strategies discussed in the first installment of this series.<sup>15</sup>

The history of private equity suggests that it was an extension of venture capital, which it was, in a sense. However, this is only in a historical sense; the term private equity is typically viewed, in many academic circles, as the more general term, with venture capital reflecting a specific subset within private equity despite the order of the historical evolution of the industry.

## THE CURRENT STATE OF PRIVATE EQUITY

According to the McKinsey and Company Global Private Markets Review 2018, private market fundraising grew by 3.9 percent year on year (YOY) worldwide (including by 3.4 percent in North America) from 2016 to 2017, while the private equity fundraising portion increased by eleven percent worldwide YOY (18.6 percent in North America),<sup>16</sup> suggesting that investors are shifting into private equity from other private markets. Further, the McKinsey report assets under management (AUM) for private markets totaled ~\$5.2 trillion, with ~\$2.9 trillion (fifty-six percent) coming from North America.<sup>17</sup> Of the \$2.9 trillion in North American private market investment, ~\$1.5 trillion (fifty-one percent) comes from private equity investment.<sup>18</sup> The private equity market for North America is comprised of the following components:

1. Buyout Private Equity—\$924 billion AUM, ~sixty-two percent of North American private equity investments and ~thirty-two percent of total North American private market investments
2. Venture Capital—\$327 billion AUM, ~twenty-two percent of North American private equity investments and eleven percent of total North American private market investments
3. Growth—\$121 billion AUM, ~eight percent of North American private equity investments and four percent of total North American private market investment
4. Other—\$107 billion AUM, ~seven percent of North American private equity investments and 3.6 percent of total North American private market investments<sup>19</sup>

The report also notes that deal volume (measured in total dollars) increased by fourteen percent from 2016 to 2017,

10 “Venture Capital: 146 Sixth Street (Location of Ionics)” Innovation in Cambridge, <https://cambridgehistory.org/innovation/Venture%20Capital.html> (Accessed 2/7/2019).

11 “The Most Famous Leveraged Buyouts” By Prableen Bajpai, Investopedia, October 23, 2018, <https://www.investopedia.com/stock-analysis/020915/most-famous-leveraged-buyouts-kkr-cg-bx-vno-apo.aspx> (Accessed 2/5/19); “Leveraged Buyout (LBO)” Investing Answers, <https://investinganswers.com/financial-dictionary/businesses-corporations/leveraged-buyout-lbo-961> (Accessed 2/5/19); “Understanding Leveraged Buyout Scenarios” By Michael Schmidt, Investopedia, December 20, 2018, <https://www.investopedia.com/articles/financial-theory/08/leveraged-buyouts.asp> (Accessed 2/5/19).

12 *Ibid.*

13 “Valuation of Healthcare Service Sector Enterprises for Purposes of Private Equity Investment: Introduction” Health Capital Consultants, Vol. 10, Issue 11 (November 2017) [https://www.healthcapital.com/hcc/newsletter/11\\_17/HTML/PE/10.11\\_formatted\\_hc\\_topics\\_pe\\_11.29.17.php](https://www.healthcapital.com/hcc/newsletter/11_17/HTML/PE/10.11_formatted_hc_topics_pe_11.29.17.php) (Accessed 2/5/19); “Leveraged Buyout (LBO)” Investing Answers, <https://investinganswers.com/financial-dictionary/businesses-corporations/leveraged-buyout-lbo-961> (Accessed 2/5/19); “Carl Icahn” Encyclopaedia Britannica, <https://www.britannica.com/biography/Carl-C-Icahn> (Accessed 2/5/19).

14 “Leveraged Buyout (LBO)” Investing Answers, <https://investinganswers.com/financial-dictionary/businesses-corporations/leveraged-buyout-lbo-961> (Accessed 2/5/19); “Carl Icahn” Encyclopaedia Britannica, <https://www.britannica.com/biography/Carl-C-Icahn> (Accessed 2/5/19).

15 “Private Equity: The ‘LBO Firm’ gets a PR Facelift” Pegasus, <https://www.pegasus.com/investing-in-private-equity-the-erstwhile-lbo-firm-gets-a-pr-facelift> (Accessed 2/5/19).

16 “The Rise and Rise of Private Markets: McKinsey Global Private Markets Review 2018” McKinsey & Company, 2018, <https://www.mckinsey.com/~media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/the%20rise%20and%20rise%20of%20private%20equity/the-rise-and-rise-of-private-markets-mckinsey-global-private-markets-review-2018.ashx> (Accessed 12/13/18), p. 6.

17 *Ibid.*, p. 13.

18 *Ibid.*

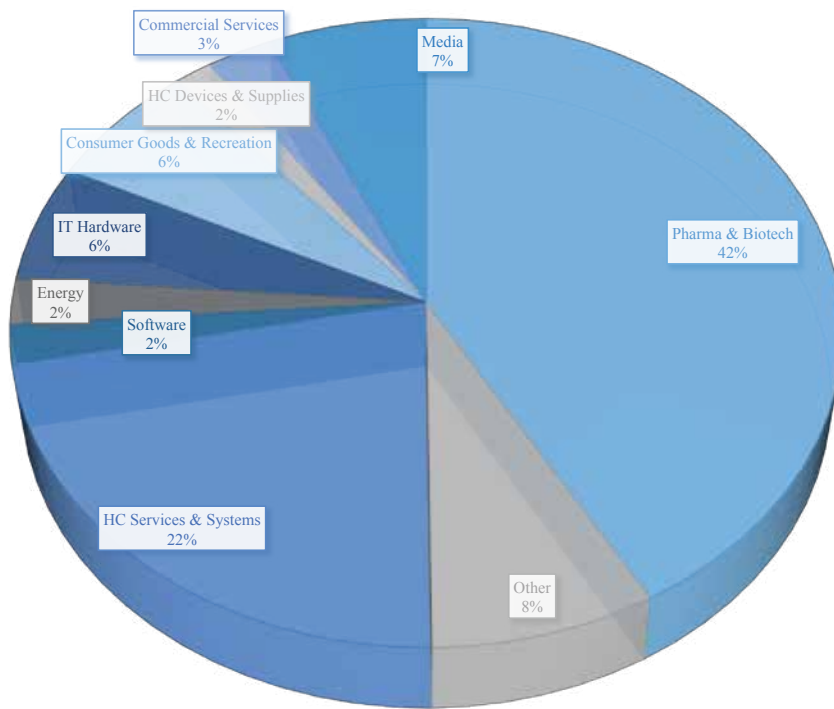
19 *Ibid.*

while deal count (measured in transactions) decreased by eight percent, suggesting that the average amount paid per deal increased significantly during that time period.<sup>20</sup>

PitchBook and the National Venture Capital Association (NVCA) have also partnered to produce a quarterly venture capital publication, entitled *Venture Monitor*, which reports copious amounts of data related to the venture capital subsector of the private equity market.<sup>21</sup> As reported in the Quarter 4, 2018 report, with data current as of 12/31/2018, total venture capital deal value increased from \$82.95 billion in 2017 to \$130.93 billion in 2018, a YOY increase of 57.83 percent, while the number of closed deals decreased from 9,489 deals in 2017 to 8,948 deals in 2018, a 5.7 percent decline.<sup>22</sup> Consequently, the average deal size in 2017 was \$8.7 million per closed deal, and \$14.6 million in 2018, representing a sixty-seven percent YOY increase.<sup>23</sup>

Exhibit 1 sets forth the distribution of private equity deals by sector.

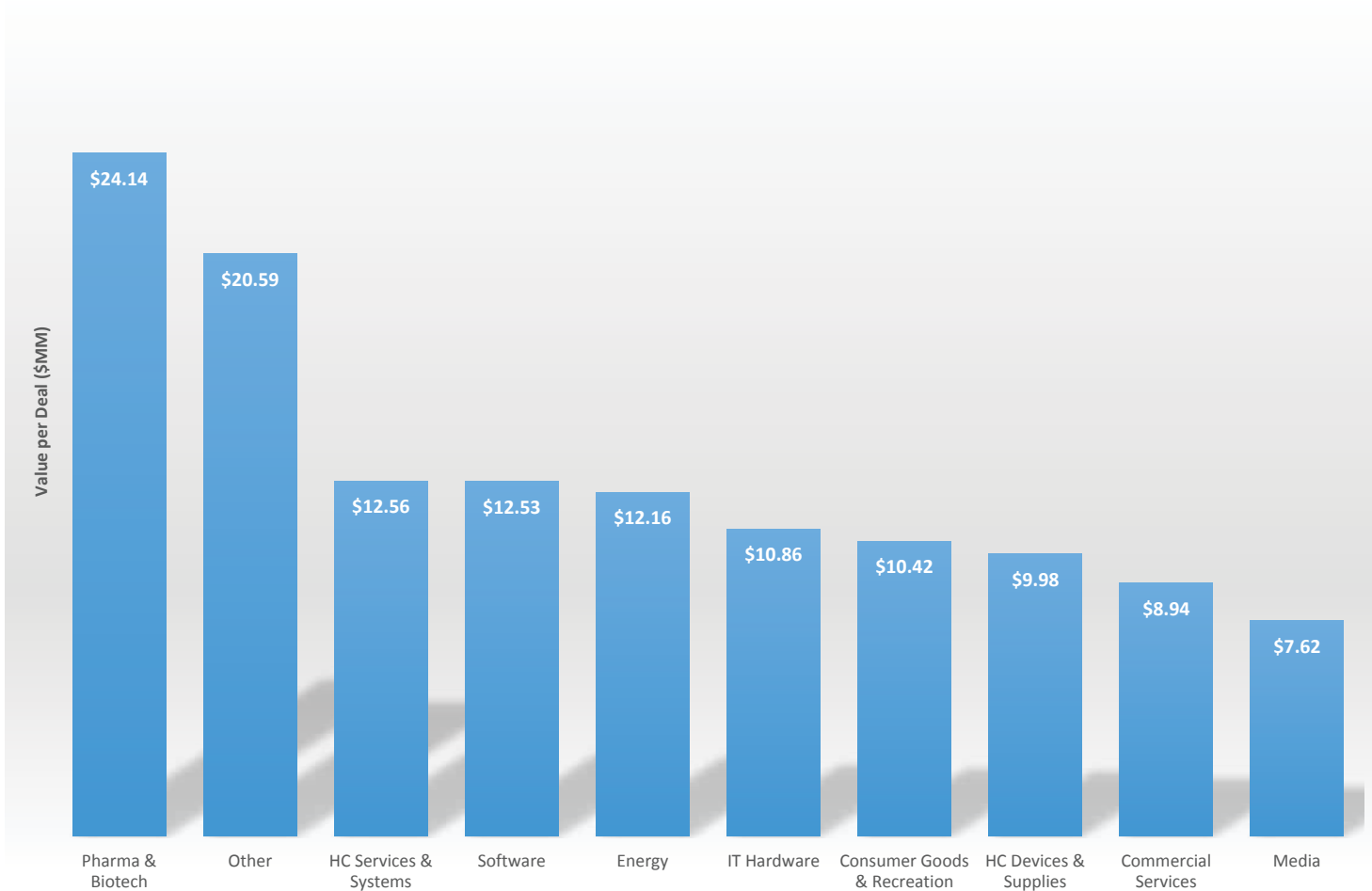
**EXHIBIT 1: PRIVATE EQUITY DEALS BY SECTOR<sup>24</sup>**



As illustrated in Exhibit 1, the deal volume is dominated by investments in the Software sector, reflecting the heavy use of venture capital by software start-ups, which has increased from thirty-six percent of deals in 2008 to forty-two percent of deals in 2018.<sup>25</sup> However, in average value per deal, Software falls to fourth place with an average of \$12,362,401 per deal; Pharmaceuticals and Biotechnology top the list at \$24,141,869.<sup>26</sup> Exhibit 2 sets forth the average value per deal for all sectors.

20 *Ibid.*, p. 17.  
 21 “The 4Q PitchBook-NVCA Venture Monitor” PitchBook Data Inc., National Venture Capital Association (NVCA), 2019, Table of Contents.  
 22 “The 4Q PitchBook-NVCA Venture Monitor” PitchBook Data Inc., National Venture Capital Association (NVCA), 2019, Table Deal Flow X Year.  
 23 *Ibid.*  
 24 “The 4Q PitchBook-NVCA Venture Monitor” PitchBook Data Inc., National Venture Capital Association (NVCA), 2019, Table Deals by Sector.  
 25 *Ibid.*  
 26 *Ibid.*

**EXHIBIT 2: VALUE PER DEAL BY SECTOR<sup>27</sup>**



These results suggest a trend of increasing use of private equity funds in the marketplace, although the number of deals have recently decreased, leading to a rise in value per deal.

**THE FUTURE OF PRIVATE EQUITY**

Generally, the outlook for private equity in 2019 and beyond is positive. While volatility reigns in public markets, owing to ongoing trade wars, uncertainty regarding tax policy, and geo-political realignments such as the so-called “Brexit” crisis in the United Kingdom, many observers expect the turbulent state of capital markets to make private equity investment more attractive, particularly to institutional

investors such as pension and sovereign wealth funds.<sup>28</sup> A recent article published in Forbes notes that “Private equity funds appreciated 8.2 percent in 2018, while virtually all major public market indexes experienced double-digit annual declines.”<sup>29</sup> The article goes on to suggest that this trend will continue into 2019, a sentiment echoed in another industry report published by the private equity firm Partners Group, which states:

27 “The 4Q PitchBook-NVCA Venture Monitor” PitchBook Data Inc., National Venture Capital Association (NVCA), 2019, Table Deals by Sector.

28 “10 Predictions For Private Equity in 2019” By Antoine Drean, Forbes, February 1, 2019, <https://www.forbes.com/sites/antoinedrean/2019/02/01/10-predictions-for-private-equity-in-2019/#74f998e65098> (Accessed 2/6/19).

29 *Ibid.*

“While our base case economic outlook projects a period of continued modest growth, we are aware that the ride may become bumpier as multiple challenges emerge. In this environment, we believe entrepreneurial ownership and strong value creation skills are the only way to generate outperformance.”<sup>30</sup>

However, the report goes on to caution investors that:

“[T]he combination of rising interest rates in the U.S., the potential effects of trade conflicts, structural challenges in Europe, and divergence in emerging markets should raise volatility in capital markets, as already witnessed in the October equity market sell-off. This is typical for the later stages of an expansion, especially in a market where elevated valuations are largely based on a low risk-free rate. Over a five-year horizon, we expect valuations to come down in light of higher U.S. inflation and rising interest rate...”<sup>31</sup>

Although the beneficial effects to valuation as a result of the recent favorable corporate tax policies may provide a soft landing for investors, providing support for valuations beyond those derived solely from “low risk-free rates.”<sup>32</sup>

Further, difficulties may arise from the crowded field of private equity firms encouraged to enter the industry by demand from investors.<sup>33</sup> Competition among private equity firms will tend to exert upward pressure on entry multiples, eroding potential gains at exit.<sup>34</sup> This highlights the need for “value creation skills,” as noted in the Partners Group report, as much of the low hanging fruit will have already been picked.<sup>35</sup> This may create a trend toward greater specialization within the private equity market, as industry-specific knowledge and the ability to identify opportunities for improvement become necessary to “wring out” the additional profits necessary to support the historical returns for the private equity industry.<sup>36</sup>

## CONCLUSION

Private equity firms have grown from an industry comprised largely of wealthy individuals investing in family businesses to a multi-billion dollar industry with investments in nearly all facets of the modern economy.<sup>37</sup> This phenomenal growth has been fueled by the ever-present demand for investments that are capable of outperforming traditional equity markets, although with these additional returns comes additional risk; the rise of the private equity market has largely been a response to the need for investors to manage these risks.<sup>38</sup> Private equity firms provide expertise to investors in mitigating these risks and determining appropriate valuations for their investments. However, the industry may be suffering from its own success, as increased competition among private equity investors is leading to ever larger valuations, squeezing the potential margins and requiring private equity firms to seek out additional skills, e.g., industry experts, to maintain their historical margins.<sup>39</sup>

The final installment of this three-part series will review trends in the use of private equity within the healthcare industry. **VE**



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30 “Highlights from the Private Markets Navigator: Outlook 2019” Partners Group, <https://www.partnersgroup.com/en/perspectives/publications/current/private-markets-outlook-2019/> (Accessed 2/6/19).

31 *Ibid.*

32 *Ibid.*

33 *Ibid.*

34 *Ibid.*

35 *Ibid.*

36 “Highlights from the Private Markets Navigator: Outlook 2019” Partners Group, <https://www.partnersgroup.com/en/perspectives/publications/current/private-markets-outlook-2019/> (Accessed 2/6/19); “10 Predictions for Private Equity in 2019” By Antoine Drean, Forbes, February 1, 2019, <https://www.forbes.com/sites/antoinedrean/2019/02/01/10-predictions-for-private-equity-in-2019/#398ad8d50987> (Accessed 2/6/19).

37 “Private Equity & Venture Capital” PrivCo, <https://www.privco.com/knowledge-bank/private-equity-and-venture-capital/private-equity-venture-capital/> (Accessed 2/7/19).

38 “Private equity rolls on: How investors and managers are responding to scale” McKinsey & Company, <https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/private-equity-rolls-on-how-investors-and-managers-are-responding-to-scale> (Accessed 2/6/19).

39 “Highlights from the Private Markets Navigator: Outlook 2019” Partners Group, <https://www.partnersgroup.com/en/perspectives/publications/current/private-markets-outlook-2019/> (Accessed 2/6/19); “Private Equity Deal Value Rises in A Crowded Market” By Hugh MacArthur, et al., Forbes, March 22, 2018, <https://www.forbes.com/sites/baininsights/2018/03/22/private-equity-deal-value-rises-in-a-crowded-market/#59bdd9e73537> (Accessed 2/7/19).