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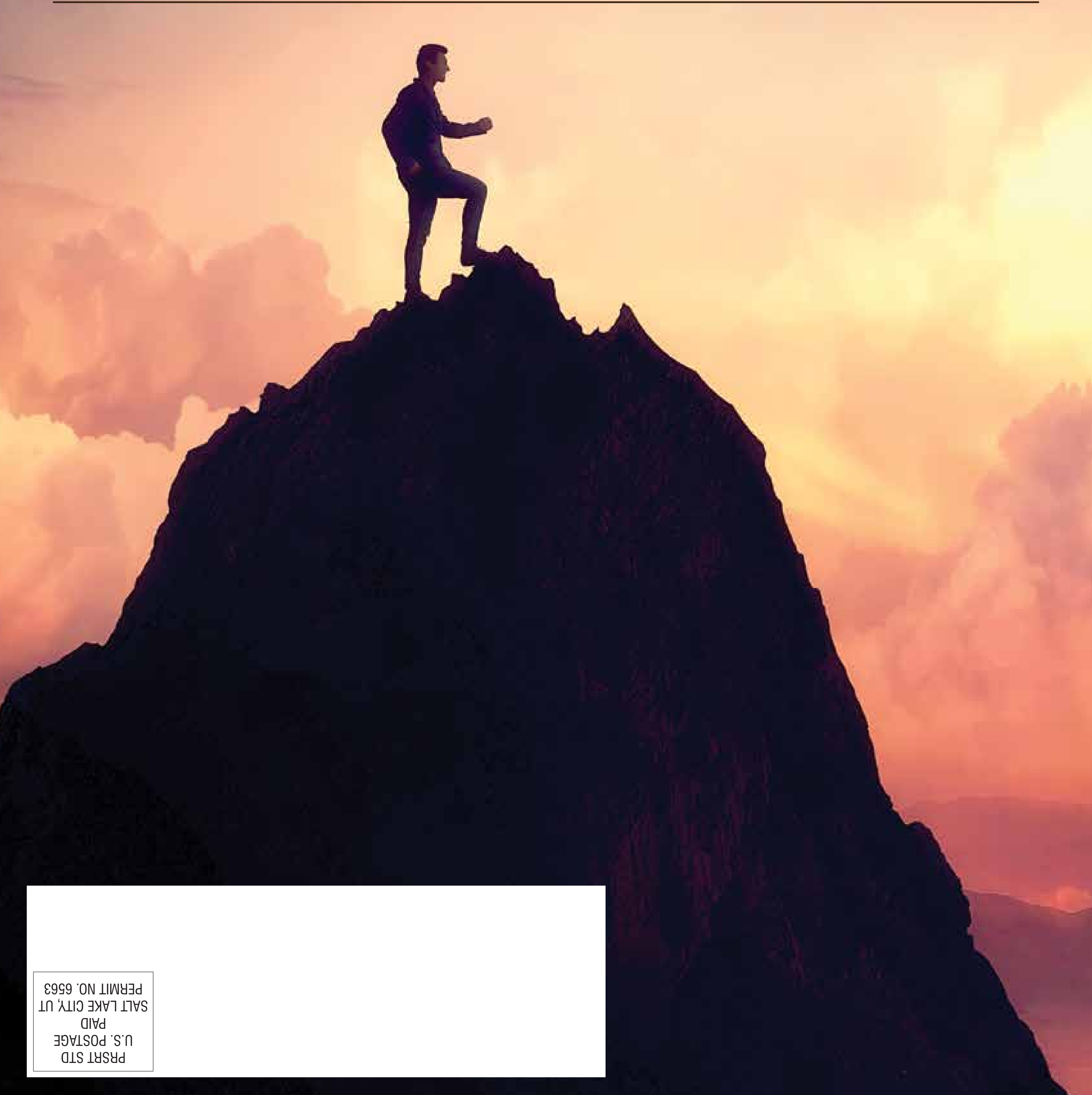

HEALTHCARE INSIGHTS

Private Equity Investment in the Healthcare Industry: Private Equity's Fast and Furious Entry into Healthcare

(Part III of III)

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Private equity (PE) and venture capital (VC) firms are attracted by the potential for growth that exists in the healthcare industry; however, significant barriers also exist that may limit the expansion of PE and VC in healthcare, including the requirement for specialized knowledge to understand the operations of a clinical services provider, healthcare industry specific regulatory issues, latent long lasting risks underlying the provision of clinical services, i.e., malpractice liability, and a competitive marketplace dominated by larger national healthcare providers.

VC, and to a lesser extent PE, have been exceedingly successful as engines of innovation, particularly with their investments in software and technology. However, the portfolio strategy of investing in multiple start-ups with the expectation that some or most will fail, but the successful investments will outweigh the losing investments, may be less suited to the healthcare industry, in which the failures represent potentially catastrophic results for patients. Accordingly, the adoption of innovative techniques in the healthcare industry is a slow process of testing and verification prior to widespread use. As a consequence, potential breakthrough techniques may not produce positive results within the typical three- to seven-year investment horizon of PE and VC investors.

Despite these barriers, the steady march of PE in the healthcare industry continues. Questions remain as to where the structure of the marketplace will settle, e.g., as an industry dominated by PE investment similar to the software and technology industries, a market dominated by traditional health services providers with the specialized knowledge to own and operate healthcare enterprises, or as a hybrid industry with both PE and traditional providers claiming those practice areas containing the greatest opportunity to leverage their specific knowledge, skills, and abilities. Regardless of the outcome, the recent PE and VC interest in the healthcare industry will only hasten the decline of the smaller independent physician practices and feed the healthcare trend of agglomeration and consolidation.

HEALTHCARE PE MARKET PLACE

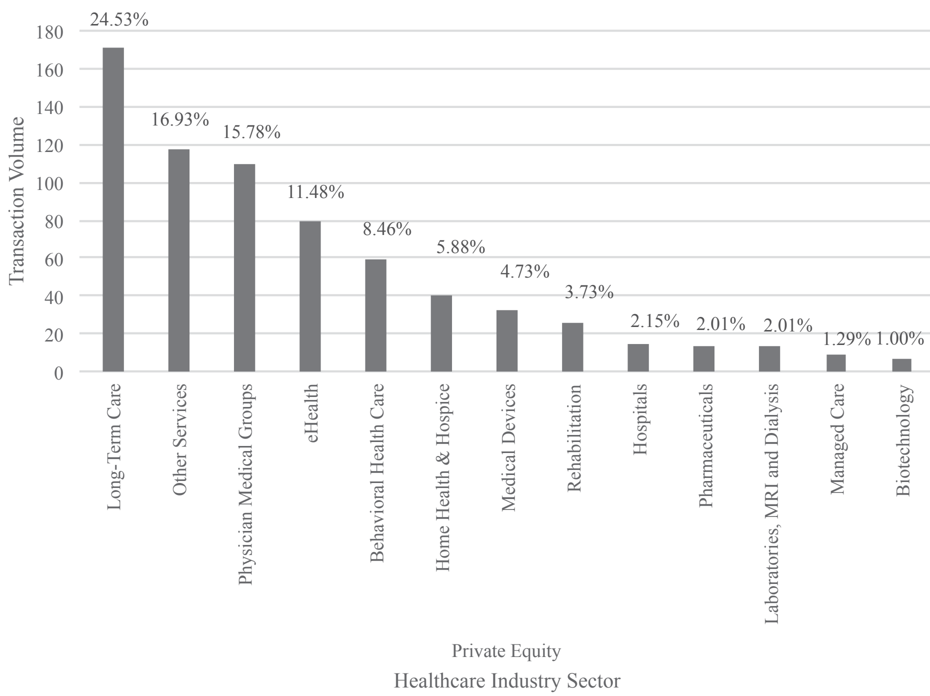
PE and VC investment is continuing to expand in the healthcare industry. Currently, there are at least 734 PE groups actively investing in the U.S. healthcare industry.[1] From 2006 to 2018, the VC deal volume for the healthcare services and systems sub-sector increased from 126 deals to 541 deals (a CAGR of 12.9 percent) and a commensurate increase in dollars invested from $1.13 billion to $6.80 billion (CAGR of 16.2 percent).[2] Average dollars invested per deal also increased in the healthcare services and systems sub-sector, from $8.9 million in 2006 to $12.6 million in 2018 (a CAGR of 2.90 percent).[3] Over the same period, total VC deal volume increased at a CAGR of 8.50 percent, with dollars invested growing at CAGR of 13.30 percent, and average dollars invested per deal grew at a CAGR of 4.40 percent.[4] Over the 2006–2016 period, the healthcare services and systems sub-sector grew from 3.85 percent to 5.19 percent of total dollars invested by VC firms, and deal volume grew from 3.77 percent of VC transactions to 6.05 percent of VC transactions.[5]

According to the Irving Levin and Associates *Deal Search Online*,[6] 5,962 transactions involving the acquisition or

1 M&A Research Database, Private Equity Info, https://www.privateequityinfo.com/ (Accessed 3/19/19).
2 The 4Q 2018 PitchBook-NVCA Venture Monitor" PitchBook Data Inc., National Venture Capital Association (NVCA), 2019, Table Deals by Sector.
3 CAGR = Compound Annual Growth Rate. "The 4Q 2018 PitchBook-NVCA Venture Monitor" PitchBook Data Inc., National Venture Capital Association (NVCA), 2019, Table Deals by Sector.
4 The 4Q 2018 PitchBook-NVCA Venture Monitor" PitchBook Data Inc., National Venture Capital Association (NVCA), 2019, Table Deals by Sector.
5 *Ibid.*
6 A database reporting mergers and acquisition data for over 26,000 transactions in 12 healthcare sectors. Deal Search Online, Irving Levin and Associates, https://products.levinassociates.com/deal-search-online (Accessed 3/18/19).

merger of a healthcare entity were reported between October 2014 and February 2019 from all acquirers.[7] Of those, 697 transactions (11.69 percent) involved a PE or VC investor.[8] The distribution of those transactions by the target sector is set forth in Exhibit 1.

EXHIBIT 1: TRANSACTION VOLUME BY TARGET HEALTHCARE INDUSTRY SECTOR, OCTOBER 2014–FEBRUARY 2019[9]



This data suggests that PE and VC investment in healthcare has expanded beyond their more traditional targets of software and technology to include investments in clinical services, such as long-term care and physician medical groups, with 193 of the 242 reported transactions in 2018 (~eighty percent) involving targets within a healthcare industry sub-sector that provides direct patient care.[10]

In addition, transaction volume also shows PE and VC firms steadily increasing their investment in healthcare enterprises from 2014 through 2018.[11] See Exhibit 2.

7 Deal Search Online” Irving Levin and Associates, https://products.levinassociates.com/deal-search-online (Accessed 3/18/19).

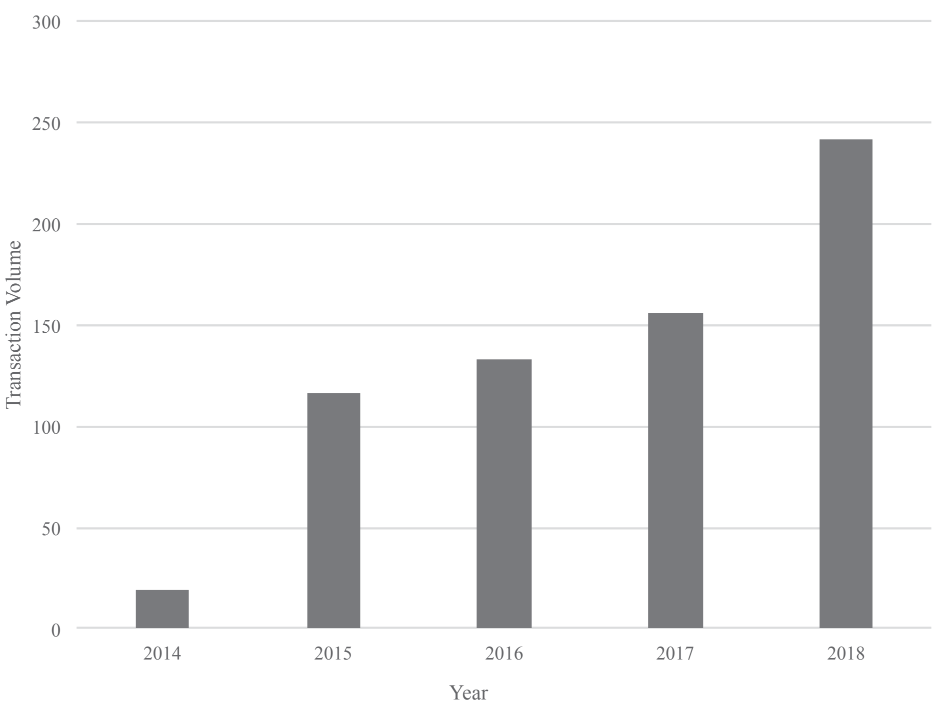
8 *Ibid.*

9 *Ibid.*

10 *Ibid.*

11 *Ibid.*

EXHIBIT 2: HEALTHCARE PE AND VC TRANSACTION VOLUME BY YEAR



This evidence suggests the increasing trend within PE and VC firms for healthcare-related investments, including patient services. As was previously noted, PE and VC funds prefer relatively short holding periods, ranging from three to seven years. This limited time horizon motivates a near-sighted perspective regarding the profitability of these acquisitions. This may affect patient care as longer-term projects with the potential to improve patient outcomes may be foregone in favor of strategies that maximize the profitability in the near term to facilitate a more profitable exit.[12] The firewall to preventing these baser profit-motivated instincts of PE and VC funds are the autonomy of physicians regarding patient care and the limitation on the corporate practice of medicine, which is discussed below.

REGULATORY CONCERNS

Corporate Practice of Medicine (CPOM) Laws

Almost all states have provisions against CPOM.[13] Although the regulated content of CPOM provisions varies across states, these laws generally prohibit unlicensed individuals or corporations from engaging in the practice of medicine by employing licensed physicians.[14] CPOM laws were established with the intent of ensuring that licensed physicians could practice medicine without pressure from a lay person or being "subject to commercialization or exploitation,"[15] and dictate what type of relationship healthcare entities may have with physicians (i.e., employment versus independent contractor).[16] Of note, these regulations are not always codified—they may instead be inferred through state Attorney General guidance, case law, and/or state medical board decisions.[17] The specific provisions of these laws wherein the target company is located will likely drive the scope of the PE firm's involvement in the venture, and may also impact upon the provisions included in the management agreement between the parties (which alignment strategy is described further below).

Other Legal Considerations

Other regulatory hurdles that may impact PE and VC investment in healthcare include, but are not limited to, the following:

1. State Certificate of Need (CON) Laws
2. Insurance Laws
3. Fee-Splitting Prohibitions
4. Restrictions on Restrictive Covenants
5. Federal and State Licensure,

12 Private Equity Purchasing More Physician Practices" By Jack O'Brien, Health Leaders, January 8, 2019, https://www.healthleadersmedia.com/finance/private-equity-purchasing-more-physician-practices (Accessed 3/19/19); "Top health industry issues of 2019: The New Health Economy comes of age" PwC Health Research Institute, 2019, https://www.pwc.com/us/en/industries/health-services/pdf/pwc-us-healthcare-top-health-industry-issues-2019.pdf (Accessed 3/19/19), p. 32.

13 Advocacy Handbook, 4th Edition" EMRA, https://www.emra.org/books/advocacy-handbook/chapter-18-corporate-practice/ (Accessed 1/29/19).

14 The Corporate Practice of Medicine" TMA Office of General Counsel, Texas Medical Association, September 2016, p. 1.

15 People v. United Medical Service" 362 Ill. 442, 200 N.E. 157, 163 (1936), p. 6.

16 Advocacy Handbook, 4th Edition" EMRA, https://www.emra.org/books/advocacy-handbook/chapter-18-corporate-practice/ (Accessed 1/29/19).

17 Important Transactional and Regulatory Issues in Health Care Private Equity Transactions" Lisa Genecov and Michele Masucci, ABA Emerging Issues in Healthcare Law Conference, March 13–16, 2019, Slide 9.

Accreditation, and Permitting (especially when a change of ownership or control is involved)

6. Fraud and abuse laws[18]

In regards to fraud and abuse violations, it is important to note that, just because a PE firm is not a healthcare provider, does not mean that they are immune to fraud and abuse enforcement. For example, one federal lawsuit currently before the Southern District of Florida alleges that a PE fund directly funded certain marketing schemes that were actually illegal kickbacks, violating the *False Claims Act*.[19] A second lawsuit, in the District of Massachusetts, asserts that the PE fund was directly involved in the operations of the facility such that the PE fund can be held liable for the submission of false claims to the federal government.[20]

DEAL STRUCTURES BETWEEN PE AND VC FIRMS AND HEALTHCARE ENTERPRISES

PE and VC funds have numerous options available to them regarding the structure of their healthcare industry investment. Many factors will impact on a firm's decision as to the most effective investment structure to employ, including the competitive, regulatory, reimbursement, and technological environments in which the target company operates.

Direct/Majority Ownership

PE and VC firms commonly utilize direct ownership or majority ownership of healthcare entities in structuring their investments. Direct investment involves the PE/VC fund acquiring, for a specified price, a defined ownership interest in a target. Typically, PE and VC firms will create a wholly-owned subsidiary company for the acquisition that will hold the ownership interest in the acquired company, thus creating a layer of liability protection to the parent company, i.e., the PE/VC fund. For partial acquisitions, the transaction may include a cash payment for the acquired equity or an equity swap, whereby the target company owners receive remuneration in the form of a partnership interest in the limited partnership of the PE/VC fund.

For complete (100 percent) acquisition, PE/VC firms may opt for an asset purchase, in contrast to the equity purchase structure discussed above, whereby the PE/VC firm agrees to purchase (usually through a wholly-owned subsidiary) substantially all of the assets of the target company, with the liabilities retained by the legacy target company after acquisition. This structure further restricts the PE/VC firm's exposure to risks associated with hidden liabilities.

An example of a direct ownership acquisition involving PE investment is the July 2, 2018 sale of Kindred Healthcare to a consortium comprised of Humana, Inc., TPG Capital (a PE firm that invests in a broad set of industries including healthcare), and Welsh, Carson, Anderson & Stowe (WCAS), a healthcare and technology-focused PE group.[21] The terms of the purchase agreement separated the long-term acute care hospital, inpatient rehabilitation facilities and the contract rehabilitation services business (referred to as Kindred Healthcare) from the home health, hospice, and community care business (referred to as Kindred at Home).[22] The Kindred Healthcare portion of the transaction will be owned by TPG and WCAS, while the Kindred at Home portion will include Humana, Inc. as a forty percent owner.[23] In remuneration, the consortium paid nine dollars per share to the stockholders of Kindred Care in a cash deal.[24]

Joint Venture

Another potential deal structure that may be considered by PE and VC firms is the formation of a joint venture with a partner already operating within the healthcare industry. This model can be mutually beneficial to both parties as the PE/VC firm can provide financial capital and management expertise, and the healthcare industry partner can provide the specialized knowledge, skills, and abilities necessary to assess the value of healthcare enterprises, and to provide expertise in operations post-acquisition. This model also affords both members independence in their operations, while sharing in the profit stream generated by the joint venture.

An example of this type of investment structure is the 2011 joint venture formed between the Catholic-owned healthcare organization Ascension Healthcare and the PE firm Oak Hill Partners.[25] Under the terms of the joint venture agreement,

18 Important Transactional and Regulatory Issues in Health Care Private Equity Transactions" Lisa Genecov and Michele Masucci, ABA Emerging Issues in Healthcare Law Conference, March 13–16, 2019, Slide 10, 18.

19 United States ex rel. Medrano and Lopez v. Diabetic Care Rx, LLC dba Patient Care America et al., No. 15-CV-62617 (S.D. Fla.), First Amended Federal Civil False Claims Act Complaint and Request for Jury Trial, p 1–2.

20 United States ex rel. Martino-Fleming v. South Bay Mental Health Center, Civ. Action No. 15-13065 (D. Mass.), Introduction, p. 1–2.

21 Kindred Healthcare to be Acquired by TPG Capital, Welsh, Carson, Anderson & Stowe and Humana Inc. for $9.00 per Share in Cash" Exhibit 99.1, Kindred Healthcare, Securities and Exchange Commission, https://www.sec.gov/Archives/edgar/data/1060009/000119312517372825/d513446dex991.htm (Accessed 3/19/19).

22 *Ibid.*

23 Kindred Healthcare to be Acquired by TPG Capital, Welsh, Carson, Anderson & Stowe and Humana Inc. for $9.00 per Share in Cash" Exhibit 99.1, Kindred Healthcare, Securities and Exchange Commission, https://www.sec.gov/Archives/edgar/data/1060009/000119312517372825/d513446dex991.htm (Accessed 3/19/19).

24 *Ibid.*

25 Offering Salvation" By Joe Carlson, Crain's Detroit Business, February 21, 2011, https://www.crainsdetroit.com/article/20110221/HEALTH/110229996/

Ascension and Oak Hill created a for-profit independent health system called Ascension Health Care Network, whose mission was to acquire struggling Catholic hospitals.[26] Ascension's main motivation in joining this joint venture was to help these hospitals raise necessary capital while preserving their Catholic identity.[27] In return, Oak Hill received the benefit of Ascension Health's experience in providing hospital services to patients within the strictures of the Catholic faith.[28]

Management Services Organizations

CPOM laws (see above) can provide significant barriers to PE ownership of healthcare providers in those jurisdictions that have adopted these laws. One method that can be employed by PE firms to participate in the healthcare industry without running afoul of these regulatory restrictions is to invest in management services organizations (MSOs) that provide management services such as billing, administrative, financial and accounting, human resources, and staffing services, to physician practices, typically for a management fee that can be either a fixed fee or a percentage of the practice revenue.[29] Often, these MSOs can be carved out of an existing physician practice and sold, in part or in whole, to a PE firm, providing an influx of capital to the residual physician clinical practice. Should the physicians wish to retain an ownership position in the MSO as well, the MSO portion of the business can be transferred to a holding company owned by the physicians with shares being sold to the PE group.

The sale of the MSO is almost always contingent upon the residual clinical practice entering into an exclusive management services agreement that ensures the profit generating ability of the MSO for the foreseeable future. After separation, the MSO is capable of expanding its client base by contracting with additional provider groups to leverage economies of scale to further enhance the profitability of the MSO, and the physician practice is relieved of the administrative and management burden that may have been limiting the physicians' ability to focus on the provision of clinical services.

The August 2018 partnership between JW Childs (JWC), a PE group, and New Jersey Urology (NJU), a large urology practice, is an example of this type of deal structure. According to the terms of the agreement, a new entity, named Urology Management Associates, was formed to provide urology practice management services to NJU with plans to expand throughout the New York Metro area and then nationally.[30] This deal came on the heels of NJU merging with Delaware Valley Urology, creating the largest single specialty urology practice in the U.S.[31]

Real Estate Investment Trusts

Similarly, MSOs, PC, and VC firms can also invest in Healthcare Real Estate Investment Trusts (REITs) to invest in the healthcare industry while avoiding the restrictions of healthcare regulations, such as CPOM laws. REITs have a number of similarities with PE/VC firms, e.g., they both collect funds from multiple investors with the goal of acquiring a portfolio of assets that will generate a stream of income in the future. While PE/VC look to acquire portfolio companies with the goal of selling their property interest in the future for a profit, REITs are interested in acquiring real estate properties with the goal of providing a stream of profits from the rental revenues of the properties. REIT investments typically have a buy-and-hold strategy, with rental payments providing the income stream, in contrast to PE/VC firms, which rely on capital appreciation to provide a stream of income to the fund. These similarities make REITs a natural investment vehicle for PE firms that want to participate in the healthcare industry without the complexity of operating a healthcare provider practice directly. In addition, current trends within the healthcare marketplace have made healthcare REITs in the long-term care (LTC) sector more attractive to PE investors.[32] Changes to the reimbursement environment have squeezed the margins of LTC facilities, with value-based reimbursement making acute care hospitals less predisposed to discharge patients to a skilled nursing facility, as this would reduce their span of control over the quality of the patient services provided, coupled with the reliance on relatively low Medicare and Medicaid reimbursement for LTC services and the less reliable out-of-pocket payments.[33]

The combination of these market forces have led to some LTC providers and, consequently, the REITs that own the property in which they operate, to struggle with low occupancy and low

offering-salvation (Accessed 3/19/19).

26 *Ibid.*

27 *Ibid.*

28 *Ibid.*

29 Physician Practice Management Arrangements: State Fee-Splitting Prohibitions and the Corporate Practice of Medicine" By Janice A. Anderson and Cullin B. Hughes, Compliance Today, Health Care Compliance Association, January 2014, p. 30.

30 J.W. Childs Associates Forms Urology Management Associates with New Jersey Urology" New Jersey Urology, September 5, 2018, https://www.njurology.com/j-w-childs-associates-forms-urology-management-associates-with-new-jersey-urology/ (Accessed 3/19/19).

31 JW Childs Associates and NJU form Urology Management Associates" September 4, 2018, https://www.pehub.com/2018/09/j-w-childs-associates-and-nju-form-urology-management-associates/# (Accessed 3/19/19).

32 REIT-owned post-acute providers attractive to private equity investors" By Maria Castellucci, Modern Healthcare, September 8, 2018, https://www.modernhealthcare.com/article/20180908/NEWS/180909941/reit-owned-post-acute-providers-attractive-to-private-equity-investors (Accessed 3/19/19).

33 *Ibid.*

cash flows. This provides opportunities to PE firms to buy up the REITs at bargain prices. This strategy is based upon the belief that, as the Baby Boomer generation continues to age, the occupancy rates will rise, along with the cash flow derived from rental payments. In this instance, in the absence of the capital provided by the PE firm, the REIT would likely fall into bankruptcy, possibly taking the LTC operating company with it, resulting in a reduction in the level of LTC facilities and leading to shortages when the Baby Boomer generation ages to the point that LTC is a necessity.[34]

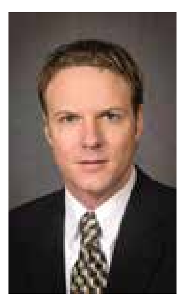
An example of a PE firm investing in REIT assets is the June 2018 transaction between Apollo Global Management, an alternative investment PE group based in New York City, and HCP, Inc. an Irvine, California based REIT, to sell twenty-two senior housing communities with 2,781 units.[35] As a result of this transaction, Apollo Global Management was able to fulfill their aims of pursuing both geographic/product diversity and value-added strategies.[36] Prior to this transaction, HCP had been selling its senior housing to various investment companies in order to gain more financial stability and reduce its lease exposure to its housing property management company: Brookdale Senior Living Inc.[37] One of these prior transactions include the sixty-four properties (5,697 units) HCP sold to Blackstone Group LP a PE, alternative asset management, and financial services firm, for $1.13 billion in 2017.[38]

CONCLUSION

PE and VC investment in the healthcare industry has been on the rise over the past few years and is expected to continue. The search for profits to feed PE investors' appetite for risk/profit have lead PE and VC firms to expand their scope beyond the more traditional roles of investing in healthcare software and technology to operating companies with direct patient care responsibilities. However, healthcare market entry barriers, arising from regulatory concerns, have led to PE/VC groups relying on alternative deal structures that allow the funds to avoid restrictions arising from healthcare industry regulations such as CPOM laws.

This shorter-term focus of PE/VC funds may make the industry better suited to turn-around investments in the healthcare industry. By investing in struggling healthcare providers, PE/VC funds can be directed toward stabilizing and improving the management practices of these providers and avoiding access to care issues arising from failing healthcare providers. Although PE and VC investment is no panacea for the healthcare industry, as profit maximizing motives and the invisible hand of the market will still direct when, where, and how PE and VC firms enter the marketplace it does provide an alternative source of financing. Under the right circumstances, these investment sources can have a beneficial effect on the ability of some providers to meet the needs of their patient populations, and, as is evinced by the REIT investments, PE and VC investments may help to alleviate the potential for future shortages in the provision of healthcare services.

Not only may the increased PE/VC investment in healthcare be a considerable value driver in the valuation of healthcare enterprises, but is also changing the universe of hypothetical "willing buyers," as considered in the Fair Market Value (FMV) analysis.[39] Because these transactions are susceptible to allegations of CPOM, fee splitting, and fraud and abuse law violations, healthcare and PE entities typically seek an opinion as to the FMV of the prospective transaction, which presents an opportunity for those valuation professionals with an understanding of how valuation approaches and methods are employed within the context of the unique attributes of the healthcare industry, i.e., reimbursement of services, increased regulatory scrutiny, competitive forces within the ever-expanding marketplace, and technological impact on the delivery (and sites) of care. VE



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34 *Ibid.*

35 $428 Million Brookdale Portfolio to be Apollo's Senior Living Investment Launchpad" By Tim Mullaney, Senior Housing News, August 13, 2018, https://seniorhousingnews.com/2018/08/13/428-million-brookdale-portfolio-apollos-senior-living-investment-launchpad/ (Accessed 3/29/19).

36 HCP Sheds More Brookdale Properties" By Steve Monroe, Irving Levin Associates, https://seniorcare.levinassociates.com/2018/11/02/hcp-sheds-more-brookdale-properties/ (Accessed 3/29/19).

37 Apollo Is Buying an HCP Senior-Housing Portfolio" By Gillian Tan, Bloomberg, June 22, 2018, https://www.bloomberg.com/news/articles/2018-06-22/apollo-is-said-to-be-buyer-of-an-hcp-senior-housing-portfolio (Accessed 3/29/19).

38 *Ibid.*

39 "Healthcare Valuation: The Financial Appraisal of Enterprises, Assets, and Services" By Robert James Cimasi, MHA, ASA, FRICS, MCBA, AVA, CM&AA, Volume 2, Hoboken, NJ: John Wiley & Sons (2014), p. 18–19.