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THE CORNER SERIES

Has the Reset Really Hurt Healthcare M&A? With Diwakar Sinha

Episode Summary

Pointing to renewed optimism in healthcare transactions, Diwakar Sinha suggests that "2025 looks very promising and should be a very successful year in the M&A space." As founder and CEO of Polaris Healthcare Partners, Diwakar shares insights on the current landscape in which regional platforms with $2 to $5 million EBITDA are increasingly coming to market. His conversation with McGuireWoods partner and host Geoff Cockrell covers the effects of changing capital costs on deal structures, the emergence of new buyer expectations and the reconciliation of seller valuations post-pandemic.

Transcript

Voice over (00:00):

This is The Corner Series, a McGuireWoods series exploring business and legal issues prevalent in today's private equity industry. Tune in with McGuireWoods partner Geoff Cockrell as he and specialists share real-world insight to help enhance your knowledge.

Geoff Cockrell (00:19):

Thank you for joining another episode of The Corner Series. I'm your host, Geoff Cockrell. Here at The Corner Series, we try to bring together deal makers and thought leaders at the intersection of healthcare and private equity. Today I'm joined by Diwakar Sinha, the founder and CEO of Polaris Healthcare Partners, which does a mix of investment banking services, but also various consulting streams. A lot of their work has been in the dental arena, but they work with other healthcare subsectors as well. Diwakar, maybe give an introduction of yourself and Polaris before we jump into some questions and discussion.

Diwakar Sinha (00:54):

Sure, yeah. Polaris Healthcare Partners is a transaction advisory firm that has a significant presence in the dental space, but we're also in the medical space such as dermatology, plastic surgery, and the ENT space, and other healthcare subsectors. We provide consulting, and also, we just launched clinical coaching in the healthcare verticals.

Geoff Cockrell (01:17):

Maybe we'll start with getting your take on what the current state of the market is and by market, I mean M&A market. In particular, is there any disconnect between much larger platforms versus smaller provider-owned platforms in that regard?

Diwakar Sinha (01:34):

Yeah, I think coming out into 2025, we're seeing a lot of midsize platforms around 2 to 5 million dollars in EBITDA going to market. That is more in the regional space versus in 2024, we saw a lot of larger platforms going to market. Some processes were successful, some processes were unsuccessful due to the market conditions with cost of capital, but 2025 looks very promising and should be a very successful year in the M&A space so we're very optimistic about it.

Geoff Cockrell (02:05):

Let's keep focusing up market here at first. So ultimately, what's happening at the tip-top of the market will trickle its way down. What's your take on the state of the market for much larger platforms, let's call it 100, 200 million dollar EBITDA, and what does that look like to you?

Diwakar Sinha (02:27):

Yeah, I think you're still going to see some level of consolidation in that space. We see bigger platforms converging in that space continue to aggregate downstream into the regional space, but we do see one or two platforms in that market converging this year, and we see the cost of capital with their balance sheets being fairly leveraged and coming down as far as cost of capital improving. We're fairly optimistic about 2025 with them as far as one or two platforms in the dental space specifically coming out and converging in 100 to 200 million dollar space.

Geoff Cockrell (03:03):

Do you view that as mere lateral consolidation, meaning two larger platforms combining, or do you view that as the next layer of buyer? Because the next layer of buyer always begs the question of if you're talking about a cash buyer as opposed to two companies merging on a relatively non-cash basis, a true cash buyer has to have a different philosophy of where they're going to take that business. Do you see full cash buyers at that end, whether you're talking larger private equity funds or perhaps IPOs or perhaps large institutional investors, who are the cash buyers up in that end of the market?

Diwakar Sinha (03:47):

I think some of the firms are exploring an IPO option in the market as going into '25 to '26, but we also see some firms doing a lateral merger in that space. We see a mix of both in that space, but I think both are going to be explored depending on the size or the strategy of the firm.

Geoff Cockrell (04:05):

I think that's right, and to me, that's a gating question on everything downstream. Even you're talking about much, much smaller regional firms that are building to a certain size and then they're selling to somebody a little bit bigger. If eventually that process runs out of steam, then it will stall the whole market. I do agree that the top of the market is thawing a bit, and I view that as a necessary component of the downstream things continuing, but maybe dropping down a level, at the intermediate size, larger platforms, do you see them opening up their acquisition pathways that those have been somewhat stalled? What are you seeing in the intermediate level of the market?

Diwakar Sinha (04:48):

Yeah, I think going from 2024 to '25, as cost of capital improves, we see a lot of M&A activity improving, and those firms are starting their acquisition process in '24 and Q4 '24 to Q1 '25. We see significant improvement in those mid-size platforms looking to grow and positions themselves into the 2025 market, and then some mid-size platforms starting their process. We see both ends. Some platforms that are 20 to 50 million dollars in EBITDA, not ready to go to market in 2025, continue to go downstream and looking to acquire platforms and some platforms that are 20 to 50 million dollars in EBITDA, pausing their acquisition process, cleaning up their EBITDA balance sheet and starting their sell-side process prior towards Q3, Q4, and 2025 in the process of 2026 so we see both sides of that process.

Geoff Cockrell (05:46):

You mentioned the cost of capital with much higher interest rates, and that to me has two impacts. One being that existing platforms find themselves in some measure of distress as the caring cost on that debt is a much higher cash imposition, and we will come back to that. But the other impact on that higher cost of capital has a downward pressure on purchase price multiples and in the intermediate level of the market, some of those downward pressures on EBITDA multiples has created a real disconnect on bid ask of pricing. Maybe let's take the first of those two topics. To what degree have platforms at that intermediate size been encountering higher levels of distress in your travels?

Diwakar Sinha (06:37):

Yeah, I think we talked a little bit about earlier in 2024, there are some transactions that went to market and some processes did not have a successful completion. They either paused and they might be going to market in 2025, and so cost of capital in general is probably 200, depending on the index, 200 to 400 basis points higher depending on the cycle in 2024. That did put a lot of compression in these multiples depending on the prices, and so some of these processes did not see a successful compression based on the multiple that the parties were looking for. A lot of failed processes across the healthcare spectrum, so some of those parties put the process in pause, so we see them coming back out in 2025 and looking to restart that process. There are at least one or two turns shy in 2024 based on what they're looking for based on the cost of capital.

Geoff Cockrell (07:38):

The platforms in that range, if you're not able to expand through acquisition, it puts pressure on organic growth. What has been the performance over the last, let's say, 12 or so months of organic growth at that level if growth through acquisitions has been difficult?

Diwakar Sinha (07:59):

I think there's been good focus on internal improvement, good focus on the operations in the business and same store growth, and they've been focusing on 2% to 4% top line improvement, but the significant focus on internal EBITDA improvement within the business, right? You see cost-cutting improvements within the organization as far as what operational changes they need to be making on while maintaining top line growth of good modest two to 4% growth. We've been looking at that on these midsize groups across the different verticals to maintain that.

Geoff Cockrell (08:35):

Flipping the cost of capital prism downward to the bid ask on smaller platforms, has there been a reconciliation on the smaller provider owned platforms, a reconciliation of that bid ask? Clearly, the cost of capital's had downward pressure on purchase price at that part of the market, and that's been a tough pill to swallow. Have you seen sellers reorienting themselves to what the actual value of their practice is?

Diwakar Sinha (09:06):

Yes. I think in 2024, there's less transactions market in 2025. I think there's renewed energy in the space, but I also see sellers understanding that there's a new marketing space and expectations. I think advisors in the market are going to sellers talking about the new marketing space. You see deal structure differently in the form of role of equity, in the form of earn outs where the equity sits. I think the advisors in the market are having real conversations with the sellers. I think sellers are understanding the new market space that the multiples that were in 2021, 2022 are not there in 2025. Same time, I do understand the desire to maximize shareholder value so I think if you have a good practice, you're still able to get good value for your practice. I think in 2025, there's still a good value to be had.

(09:57):

There's still a lot of dry powder coming out of 2024. As I said earlier, in 2024, a lot of transactions were put on pause, so there's a lot of dry powder available for 2025 to execute on it. I still think 2025 is a good year if you're looking to go to a market and find the right party, I think you still get a good value in the space. But I still think overall there's a little bit of resetting, but I do think sellers are reasonable and understand that there's a new market expectation, but the deal being structured correctly, I think you can achieve a good balance.

Geoff Cockrell (10:30):

The performance of platforms has not been consistent as you look at the market, and there seem to be some platforms that have done well, others that have really struggled. I wonder if you might have thoughts on what some of the through lines are of the ones that have performed better than those that haven't, what are some of the through lines of those high performer?

Diwakar Sinha (10:54):

I think just the overall arching themes probably been discipline and staying within the box and deal structure. I think the platforms that have continued to perform well over the years have stayed within the box within their, I'm not going to say geography, but stayed within the discipline of what they truly are and what they're trying to build in the business. They're going outside the box a little bit. They've mitigated that with deal structure, the right claw backs or warrants within the deal to focus on those aspects of it and mitigated the deal structure. They continue to perform well even if they've gone outside the deal, their core box on that so I think discipline's been the overarching thing.

Geoff Cockrell (11:40):

I think that's right. I'd probably also say finding a way to achieve the correct version of provider alignment has been a through line of the ones that have really performed. As I've seen a bunch of these platforms, one of the dynamics that has been a differentiator is those that have thought about structures from a joint venture perspective. Meaning the question of where exactly is rollover going to land? Is it going to be at a topco level? Is it going to be at a lower level joint venture MSO, and what are the implications on current cash flow? Do you agree with that assessment? And when you're advising folks on the sell side, how much do those preferences come into how you're going to market?

Diwakar Sinha (12:29):

Yeah, I think looking at structuring the alignment of providers and how many the providers are aligned correctly within that and making sure there's good rollover equity and things like that, I think is meaningful to deal structure.

Geoff Cockrell (12:42):

For sure, and one of the pieces that I also think can impact that alignment is making sure you have laser focus from a platform perspective, laser focus on what the current economics are to the providers, which is I think one of the advantages of the joint venture model as opposed to topco equity is that the joint venture model is usually the cash flow that's running through that intermediate DSO is cash flowing to the minority owners in that a way that topco equity usually is not, meaning the dollars that come up to the topco are usually being utilized to satisfy enterprise level debt and do other acquisitions and other things, whereas the intermediate DSO joint venture model has different cash flow implications, as I look at some of the models that have had success versus those that have not, I think a laser focus on what the structural implications of current cash flow are.

Diwakar Sinha (13:46):

Absolutely. Yeah, I think the JV model has been overall more successful because it ties the providers to the regional impact and allows for the continuity and care series of change. In three years or five years if a provider wants to transition, also allows continuity with another provider in the geography, so there's ways to structure that and think through that as the platform scales.

Geoff Cockrell (14:12):

Another through line to my eye of those that have had success versus not is designing the structure so that it has centralized control and consistency. What I mean by that is the easiest way to get an add-on acquisition completed is to leave the target more or less the way it is. Everything is easier in the deal if you're leaving most of the dynamics at the local practice the same, so that makes it easy to add on acquisitions, it makes it hard to integrate. When you have less integration, the overall model tends to behave more like a bunch of individual practices that have different needs and desires versus a more consistent employment-based model for the overall organization. When you're advising provider-owned sellers in that environment, how do you think about that topic?

Diwakar Sinha (15:11):

Yeah, I think that's difficult, right? I think as you're acquiring a regional platform or a platform, integration is meaningful too because you want to have a systemized platform. There's different tools out there to look at integration within the platforms. You want to provide minimal disruption in integration and want to think through that in your diligence to see how would you integrate that business into your platform. But integration is key is you don't want to have different platforms in different regions in the market.

(15:42):

I think that comes down to understanding if you were to acquire that platform, what does the integration process look like? And how can you systemize that within your business as far as what their practice management solution looks like versus yours? Can something sit on top of their platform and can you run it with minimal disruption? I mean, ideally that's the solution, and if you were to standardize to your practice management or whatever the integration tool might be, how does the onboarding process look like, and how does that culture look at the onboarding process? What does your onboarding process look like, therefore? I think those are the things we need to be thinking about as far as the process of integration and that needs to be taken on board as far as the risk they're in when acquiring the business.

Geoff Cockrell (16:28):

Maybe pulling the view back a little bit away from just dental, you mentioned you also work in other provider sectors, dermatology, plastic surgery, ENT, to name a few. Those are very different businesses than dental is in a number of respects. But maybe one respect that I'd be curious to get your thoughts on is just the degree to which the providers, A, make a ton more money and, B, they drive the business maybe in a different way. What are some of the different dynamics that you see in some of these other healthcare subsectors?

Diwakar Sinha (17:04):

Yeah, so I think in the cosmetic aesthetic space, obviously you see in plastic surgery, dermatology, you see med spa. I think it's a good market that's expanding fairly rapidly, but we remove that and just focus on the plastic surgery dermatology space. Similar in some aspects to dental, it's a very provider driven space in both the dermatology and the plastic surgery space. We tend to stay predominantly in the cosmetic side of that business. Still huge traditional fee for service business, good expansion in space, a lot of emerging group practice in that space, a lot of additional providers being added in that space and a lot of growth in that space. We see a ton of opportunity in the dermatology and plastic surgery, the additional cash flow being generated in that space.

Geoff Cockrell (17:52):

You also, I know, do operational consulting. What role does improved operations have in some of these businesses?

Diwakar Sinha (18:00):

I think as we get into any of these healthcare verticals, we look at where they are as far as everything is with how do they, where they are as far as in their life cycle and where they're trying to be as far as towards the exit of their business. Our goal is to get into these platforms and look at their two to five year horizon towards an exit, and maximize the operational efficiencies within the business and work with the executive team. That can come in the form of work with the operations team on the business side to maximize business execution, or with the clinical side. We just recently added clinical coaching just in the dental side of the business, so we now have clinical coaches that work with the general and specialty and the orthodontic side of the business, and then we'll go into the other healthcare verticals. But that's to work on the operational and clinical execution, typically 12 to 36 months before having a transactional event in the business to maximize the value of the business.

Geoff Cockrell (18:59):

And is that consulting happening in the context of a still provider owned business or is that a tool that is in the toolbox of, say, a financial buyer or once they've done an acquisition.

Diwakar Sinha (19:12):

Both.

Geoff Cockrell (19:13):

How would you describe the roles of consulting for a platform that's headed towards a sale versus one that's followed a sale?

Diwakar Sinha (19:21):

Yeah, so I think with the financial buyers, some of this executed on it, they'll continue to work on the integration and continue to grow in that process. Our operational team would work to continue to work on their strategy to scale that business. And then on the clinical side, our doctors would work within the business to continue to work with their associate partners, or their associate in the business to continue their clinical development within the business and continue to work on their growth strategy as they continue to bring on associates within the practice and scale that business.

(19:55):

And if they're acquiring businesses and continue to build that skill set from their associate's lens, or their partner lens as far as adding specialty services or improving case acceptance from a doctor lens or improving upon operational executions from their executive team to make sure when the integration's happening, or when the same store improvement needs to happen, that's actually executing based on the sponsor's execution plan so that from the financial sponsor's lens.

(20:23):

And then on a go-to market strategy, we put a goalpost out there of, "Hey, we're 12 to 24 months from a go-to market strategy." We'd work with the sponsor to understand, okay, what are the rocks or the financial goalposts we have that we want to hit to meet the outcomes? We would reverse engineer that on a quarter to quarter basis to get to that outcome over 12 to 24 months.

Geoff Cockrell (20:48):

Diwakar, I think we'll end it there. Really appreciate you joining, you have a ton of insight, and this has been a lot of fun.

Diwakar Sinha (20:57):

Geoff, thank you for having me.

Voice over (21:02):

Thank you for joining us on this installment of The Corner Series. To learn more about today's discussion, please email host Geoff Cockrell at gcockrell@mcguirewoods.com. We look forward to hearing from you.

(21:15):