McGuireWoods

THE CORNER SERIES

Episode 94: What Are Healthcare Investment Packs Pursuing? With Matt Searles and Bart Walker

Episode Summary

Investors, as Bart Walker likes to say, "tend to run in packs." The co-chair of McGuireWoods' healthcare industry team, Bart describes the current "pack" running not so much toward value-based care but rather toward "some risk element, something more interesting than just traditional fee-for-service."

In this conversation with host Geoff Cockrell, Bart and Matt Searles from Merritt Healthcare explore the slowdown from previous market peaks. But they also highlight opportunities in consumer-focused segments. Tune in for their insights about trends in regulatory scrutiny, artificial intelligence, and joint ventures.

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, a partner at McGuireWoods. Here at The Corner Series, we try to bring together dealmakers and thought leaders at the intersection of healthcare and private equity.

(00:33):

Today we've got two guests, my partner Bart Walker, a partner in our healthcare group, and longtime friend Matt Searles, who's a managing director at Merritt Healthcare. We're going to talk some about provider services and other areas where investment is flowing. But Matt and Bart, if you could both give an introduction of yourselves. Matt, maybe start with you.

Matt Searles (00:51):

Yeah, thank you. My name is Matt Searles with Merritt Healthcare Advisors, and we are a lower-middle market to middle-market healthcare investment bank. We have 14 folks in the firm and operate nationwide.

Bart Walker (01:02):

And this is Bart Walker, partner with McGuireWoods. I'm one of the co-chairs of the healthcare industry team. I practice in the healthcare department. And most of my practice is healthcare provider services M&A with also what I'd call a minor in pharma, pharma services deals.

Geoff Cockrell (01:17):

Matt, maybe we'll start with you. Just a heat check on the market. We've spent 18 months-ish of an accumulation of headwinds in areas that had had only tailwinds for quite a while. In particular, we've all done lots of work in provider services consolidation. For the longest time that was just tailwinds. Now it's a mix. How would you assess the current market in the provider services arena and where you are seeing investment going and where you're seeing sellers?

Matt Searles (01:47):

Yeah, I don't think it was really a free for all it was certainly pre and during COVID. Just a combination of issues driving the market. So I would say, it's accurate to say it's slowed down. Maybe it's correcting in some fashion. We are seeing relatively active space, but from a valuation perspective and from a deal flow perspective, I think we're certainly off those peaks.

(02:08):

And so what's driving that? I think there's a few things. Obviously, interest rates are higher. I do think that there was a lot of aggressive behavior in that period of time, and I think some of these folks, consolidators have gotten a little out over their skis in terms of having to refinance in different interest rate environment. And I just think there's this general, this is certainly not a political comment, but the general uncertainty now in the economy based on the obvious tariff activity and things of that nature. So we've definitely seen deals slower and where we are seeing services deals, like in the PPM space, it would be interesting and mostly add-on type of deals, whereas some of the larger deals have slowed down pretty dramatically.

Geoff Cockrell (02:45):

And Bart, from where you sit within provider services still, it would seem that all subsectors are not created equal, that there has been different headwinds in different subsectors. There's been different tailwinds in different subsectors. And some even presentation of new strategic buyers. How would you handicap the segmentation within provider service?

Bart Walker (03:06):

I think that's right. It's been interesting, you mentioned strategic acquirers. We've seen an increase in folks like hospitals and health systems getting more active in their investments. We've also seen folks like Cardinal and some other big players who haven't traditionally played in the provider side of the pond getting more active there as real competitive bidder for a lot of these deals. And as you point out, not all sectors or sub-sectors are created equally. We're fond of saying that investors tend to run in packs, and so the latest flavor of the months tend to center around things, not so much value-based care, but some risk element, something more interesting than just traditional fee for service. And then also things with elements of consumer consumption, things like cosmetic elements or retail or pharma, pharmacy compounding, specialty pharma services, things like that that we haven't really seen in the past.

Geoff Cockrell (04:02):

And Matt, from a seller's perspective, you talk with a lot of founder owners in businesses that are coming to market. What's the temperature there? I mean, have they made peace with the idea that the current market, the current cost of capital has implications on purchase price multiples? Is there a sense that they've missed part of a window? What's the temperature on the seller side?

Matt Searles (04:27):

Yeah, I think that generally multiples are still high enough for the right seller to get them interested in a potential transaction. So I don't know I really had a client come and say, "Hey, I wanted a 12x. I'm getting an 8x. We're not going to do it." Because I think the reasons a lot of the folks, physicians are in different areas in our business, the reason they're doing deals is it's just the pressure that they're under, the inability to stay independent. And it's a whole other podcast I know. But once they're feeling those pressures, I feel like those are the ones that are going to be ready to do a deal like that. I wouldn't say pricing doesn't matter, but there are some fundamental reasons for wanting to go out. And so we haven't really gotten a push back, but clearly a palpable difference in what folks are paying, whether it be a platformer or an add-on.

Geoff Cockrell (05:07):

And Bart, I see a lot in my practice, an evolution of provider platforms not looking just at raw consolidation and looking a lot more at different forms of joint ventures, whether that's ASC chains, health systems. What are you seeing on the joint venture end of that?

Bart Walker (05:26):

Yeah, that's a good observation. The time has likely passed when just pure financial engineering and consolidation with the roll-up strategy can get you where you need in terms of exit multiples. From a joint venture perspective, it's been interesting to see because we are seeing more and more folks joint venturing, not just with physicians or hospitals, but also with other types of platforms, whether it's oncology, infusion, urology, lithotripsy, all over the place. We're seeing new and interesting models, which raises some interesting questions around things like non-competes. Antitrust regulation is always front and center, especially with a lot of these new state laws that are being passed around. Healthcare acquisitions and private equity investment in healthcare. Definitely some interesting things on that front.

Geoff Cockrell (06:13):

Matt, maybe turning the conversation a little bit. Bart mentioned the continued slow rise of interest in value-based care, value-based contracting. From where you sit, how significant is the value-based care dynamics in sellers? Is that a prerequisite that you have some thesis surrounding that or how does value-based care and value-based contracting figure into the market from your...

Matt Searles (06:37):

I think it's prudent for any of these platforms to be considering it. And I won't say what specialty because it'll give it away, but I sat through some buyer meetings with three very credible large platforms. Two of them as you talk to them, there's nothing going on in value-based care, absolutely nothing. And as far as even to say, they'd be a waste of time to be looking at or to be focused on getting through their markets and their business without having to really pay attention to it. And the third that has invested heavily in it and has made it a profitable aspect of their business. And just for me personally, I think that it's just a matter of time before it becomes something that is going to be integral to all these practices and is going to be in every market.

(07:15):

So I certainly think I can observe a successful platform is not really doing anything in that regard and being successful, but others that are very much focused and invested on it. And I think it's a little bit more of a brick house from my perspective because I absolutely think it's coming. Even though it isn't sitting in your market at the moment, doesn't mean it's not going to appear and part of that. And to go into that spectrum, you have to have very sophisticated systems to measure outcomes, and so it's not something you can catch up with that easily.

Geoff Cockrell (07:40):

And Bart, from where you sit, is it kind of binary with platforms in the same way that Matt was describing and that people are either getting very involved with value-based contracting or just kind of not at all, or is it a little bit more of a dipping your toe in if that's even feasible, what are you seeing?

Bart Walker (07:57):

Yeah, it's hard to dabble. Like Matt said, you have to have certain systems and processes in place to really do that. Late last year, mid last year, a lot of the publicly traded comparables that were really, really heavily into value-based care, in particular programs like managed Medicaid and Medicare Advantage, they were heavily reliant on those models, just got absolutely crushed. So we saw valuations come way, way down on those. At the same time, I don't really see a groundswell of support for the notion that Medicare rates are going to just increase on their own in the future, and I don't see the commercial payers making big moves to just increase fee-for-service revenue at all.

(08:37):

So in light of that, you got to find some other more creative sources of revenue. And maybe some of these value-based care models, however they evolve, end up looking like that. I've seen a renewal in interest in direct-to-employer care, so actually providing network or providing providers directly to self-insured programs for large employers. So I think there's probably some room to grow there for sure. But I don't know that you have to be all in on it, but I think you have to be in it in a substantial enough way to be able to do it credibly.

Matt Searles (09:07):

Yeah. And Bart, it's interesting, we have a client in the market right now doing just that, drawing a lot of interest and then managing primarily for corporations in a certain market and doing it from a value-based perspective. So absolutely, I think that's the case.

Geoff Cockrell (09:19):

And there's lots of ways to enter that fray, whether that is limited at-risk contracting or scaled at-risk contracting. There's ways to mitigate as you enter that from where I sit.

(09:32):

What are you seeing, Matt, from the big box buyers? Because one of the challenges has been in consolidation, you pull together some provider platform, you add things to it, maybe sell to a bigger private equity fund and eventually may run out of room for there to be bigger and bigger and bigger. There's been lots of questions about whether the IPO market is going to open to those. Bart mentioned some new strategic buyers. Are you seeing more robust strength for upstream purchasers?

Matt Searles (10:00):

Yeah, and you mentioned just now. I mean, I can think of a platform just because we deal with them quite frequently in HOPCo that I think very likely will go public at some point. Has reached, not going to guess at their valuation, but it's in the billions and functioning as a strategic company largely. And so I think that that option always exists. In these capital markets, we know now that our private debt markets, our private capital markets are with the large funds out there, they're as big as the public markets and you can get accomplished just as much with them.

(10:25):

I did just... Your question made me think, you guys had mentioned Cardinal, but there's others. We've gotten calls from very active, capable funds coming in from overseas, Siemens family office and Sojitz, a large Japanese bank, very actively looking at the space. And so not just the usual suspects, the Optums I guess maybe you might be referring to in the services space. But we're seeing some others that have the capital and the ability to not pass it along at some point. They're going to be able to operate as their own independent strategic company.

Geoff Cockrell (10:54):

Turning away from provider services, another area where there's been an immense amount of investment is in pharma services, which while it goes by a single moniker, covers a whole array of service type businesses supporting the development and commercialization of drugs. For a long time, the funding into that pathway from big pharma has just felt endless and that drove a lot of interest in acquisition in that space. Funding commitments and that arena have become a little bit more checkered recently. To your eye, how has that changed, if it has, the interest in investment in pharma services generally?

Bart Walker (11:35):

Yeah, I think there are new people interested in pharma service investments. I think a lot of the P funds saw their healthcare provider businesses, a lot of their investments getting long in the tooth, running up to their investment realization horizon. And some have used continuation vehicles and secondary markets to keep those investments going, but there's been this renewed interest in things like pharma services, which gives you some exposure to the life sciences world without actually having binary drug approval risk or clinical trial risk on the drug discovery side.

(12:12):

So we really haven't seen GE funds in particular looking straight up pharma companies, but they have been interested in investing in the whole constellation of companies around that, whether it's contract manufacturing, distribution, supply chain. Particularly around biologics, there are some interesting areas that appear to be pretty niche areas that are actually pretty large addressable markets. And I think COVID showed us that domestic manufacturing and domestic supply is something that was not really something people paid attention to much. They were just seeking the lowest cost provider of those services and goods and now there's a renewed interest in building that out domestically. So I think there are some opportunities there for sure.

Geoff Cockrell (12:57):

And Matt, I know you do quite a bit in the pharma arena, both in the pharma services venues, but also in direct pharma companies. How would you describe a heat map over that very diverse set of companies?

Matt Searles (13:11):

I think I agree directionally with what Bart was saying. I think if you look at it at a 30,000 foot level, we don't have a very preventative system. You look for areas to take out costs, clearly pharmaceuticals, Ozempic being probably the most at- hand example, are going to make a really big difference in healthcare costs. As a result, it's going to draw a lot of attention. So we see pretty bullish on that segment and pretty actively trying to maintain our presence in it.

Geoff Cockrell (13:36):

Maybe turning the conversation one more time. As everyone knows, artificial intelligence is going to take over the world and change everything, but it's hard to know when and how. What are you seeing in investment opportunities surrounding the intersection of healthcare technology and artificial intelligence?

Matt Searles (13:55):

Yeah, I guess I can tell you years back, four or five years ago, people didn't even mention it. And now everyone's got a strategy. And I'm not sure everyone's got a coherent strategy, but I think people generally recognize that it's going to be able to accelerate a lot of aspects of their business and manage them in a way that is more efficient. It's going to lead to value creation. And so everyone that we run into, at least most of the credible buyers that we bump into the most, they articulate some strategy in that regard and I don't think we're going to see it go in the other direction.

Geoff Cockrell (14:25):

Bart, are you seeing investment opportunities that are built around AI or is that still a bit off?

Bart Walker (14:31):

Not yet. We've really not seen that yet. I think people are still looking at the technology, playing with it, trying to figure out how it can improve processes and operations. But there's a couple components to it. One is I think technologically what the evolution looks like and how quickly that turns into something that's a practical use case. And then the second factor is just adoption. We saw this with physicians when they adopted electronic medical records systems back in the early 2000s, mid '10s. And I remember going to the doctor's office and watching my doctor fumble around with the EMR for almost the entire doctor's appointment. I think there are going to be some pains with adopting that. Hopefully, this is a little bit easier to use and we've learned some lessons through that process, but I don't know that there's a big patient comfort level just yet with really putting AI front and center.

(15:23):

It's ultimately still like human business where you've got a human decision-maker at the end of the day and it's going to have to be something that is transparent to patients and not something that they view as foreign right off the bat or you're going to have a real problem with adoption. So I think it'll take some time to digest. Unfortunately, the technology's evolving a lot more quickly than the humans are. It'll take us a little bit of time to get our arms around it and figure out what to do with it.

Matt Searles (15:50):

Yeah, what you'll see too, guys, in my opinion is we're not going to be able to hire Sam Altman to work in our little company somewhere doing AI. So you're going to see once the dust settles on who really has the most usable platform, people are going to use those tools that these other folks have created and the names that we know are kind of on their microeconomic basis to do whatever it's they need to do. And I agree with Bart, it's going to evolve. It's very hard to say. So I don't see anybody popping up in healthcare saying, "Hey, we're healthcare AI. We're going to make a difference." I think that's still, that technology is still very much focused on a very small group of Chinese and Silicon Valley companies that are going to be essentially the engines for what we use in the future as AI.

Geoff Cockrell (16:29):

Yeah. And we can see it even in the legal arena. AI you think of it in general of it can in general do all of these crazy things, but right now they are zeroing in on very, very specific use cases that are exactly pointed at cutting out labor elements, and it's hard to know what the ramifications of that exercise is going to be. We wrestle with it in the legal community as to how's that going to change staffing and the need for lawyers.

(16:57):

We're going to be having similar dynamics around to what extent can AI change the people needs of some of these businesses, and I just think it's going to be very disruptive in ways that we can't quite put our finger on at the moment. It may not ultimately be bad for the industries or certainly probably not bad for the market in general, but how that evolves is going to be quite a bit of a ride.

(17:21):

All right, we probably have time for one more topic. Let's end on a sour note. We're all experiencing heightened levels of intrusion, state regulators, antitrust and otherwise. Matt, from where you are, how big of an impact has some of those things had on your deal processes?

Matt Searles (17:40):

Yeah, I mean, listen, the one example I'll use is California. Back in April last year, they put into place their notification and functional review requirements and it put an incredible chill on services deals in California from people not willing to be those first few deals that get looked at, do all that diligence, spend all that money, and then potentially have somebody tell you no to folks just wanting you to take a wait and see.

(18:06):

Now, I will tell you to California's credit, I personally believe in regulation. Without it we're far worse off. But there was some question about whether it was really just kind of an ideological position that they were taking that they didn't want "private equity" in healthcare. And I think as it's come out, we really see, in my opinion, what they're after is just making sure that the cost to the consumer doesn't go up and they are approving these deals and they are doing things that I think are positive.

(18:30):

But make no mistake, Connecticut's another really good example where the default answer just seems to be no, even if that's not what the actual regulations say. So I think that there's good regulation and there's bad regulation and we have our eye on it because where folks think they're not going to be able to transact freely, it's going to absolutely put a chill on the market and it did, in my opinion, in the first six, eight months went on in California.

Geoff Cockrell (18:50):

Bart, you're in the Southeast, which can sometimes be a little bit more libertine. How's that playing out in other markets.

Bart Walker (18:58):

We like to think of ourselves as the Wild West where anything goes, Geoff. But in this unregulated wasteland, there have been a lot of efforts to enact these state laws. And the vast majority of our deals, I would say were under the Hart-Scott-Rodino federal filing threshold. So I think it was like 120 million-ish in enterprise value.

(19:20):

A lot of these state laws are without regard to dollar value. So we're seeing a lot of smaller deals that never received any kind of scrutiny whatsoever. Now people are looking at them very closely. And I agree with what Matt said. You look at what Oregon and Washington did, they were two of the first states that enacted these laws. They received scrutiny, but they also received a lot of approvals. So while somebody's looking at it, doesn't mean your deal's necessarily dead in the water.

(19:44):

The other thing it's done is it's created a moat for those who do have investments in those areas. So if you are comfortable with a regulatory regime or if you have a diversified asset or platform that operates in a bunch of different states where you can tolerate that risk, I would think as a bidder that actually gives you a competitive advantage because the pool of willing bidders is going to be smaller than it otherwise would be.

(20:06):

I can't really predict what politically is going to happen given the shift in Washington, DC, if that impacts the states negatively or positive. I could see on one hand, in the absence of strong federal regulation or the FDC taking a step back, do the states now take a step forward and start to be more assertive in regulating these transactions at their level? I think some states, and we've actually already seen it, we've seen four or five states have come out with new legislation with a renewed vigor where they've had bills previously introduced that just failed. Now they're reinvigorating those efforts and coming forth and bringing more of these laws on the books.

(20:44):

So it's something we track on a daily, weekly basis and it's ever evolving. But I don't know that it cleanly breaks down geographically either.

Geoff Cockrell (20:53):

I also think that these state and even federal scrutiny items can be process impediments and make the process more difficult. But my little plug for private equity and healthcare is that I've seen lots and lots and lots of business thesis and investment, and I really don't see folks investing that don't have a clear eye on how their investment is going to impact the kind of triple aims, the healthcare policy of improving outcomes, improving access, and controlling overall costs. I don't see many investors being enthused about an investment that is not supporting those. And ultimately, I think that will carry the day. So while the process impediments can be material, I'm ultimately more optimistic that this will be less of an issue.

(21:43):

We could talk for quite a while, but maybe we'll end it there. Matt and Bart, it's always a ton of fun to talk with you guys and thanks a ton for joining.

Matt Searles (21:52):

All right, thank you.

Bart Walker (21:53):

Thanks, Geoff.

Voice over (21:57):

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.

(22:10):