



Episode 129 Special Crossover Edition: McGuireWoods Healthcare PE Conference Preview

Episode Summary

This special episode is a crossover between The Corner Series and Provident's Healthcare DealCast released across both McGuireWoods' and Provident Healthcare Partners' channels.

McGuireWoods partner [Geoff Cockrell](#) is joined by [Steve Grassa](#), director of Provident Healthcare Partners, for a wide-ranging discussion on the healthcare services landscape including the provider services market, opportunities for emerging buyers and what defines an "A-caliber" asset.

This conversation also serves as a preview of McGuireWoods' Healthcare Private Equity Conference later this month, where Geoff will lead a banker-focused panel discussion.

Transcript

Voiceover (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.

Steve Grassa (00:19):

Thank you for joining another episode of Provident Healthcare DealCast. I'll be your host today, Steve Grassa, Director at Provident Healthcare Partners, and I'm excited to be joined by Geoff Cockrell. He's a good friend of the firm and partner at McGuireWoods. Geoff hosts, for those of you that don't know, the most preeminent podcast in the business, and was kind enough to come on to ours and we're really excited to have him. So with that, Geoff, why don't you start with an introduction and then guide the discussion from there?

Geoff Cockrell (00:44):

Thanks, Steve. This will be a ton of fun. I'm Geoff Cockrell, a partner at McGuireWoods. I'm also the host of The Corner Series, a podcast that kind of focuses on the intersection of healthcare and private

equity. Steve and I are going to be pushing this out through both of our channels, so welcome to listeners from both of our podcasts. This will be a lot of fun. Today, we're a couple weeks away from McGuireWoods' Healthcare Private Equity Conference, which is April 29 and 30, so hoping to see you all there. We're going to release this ahead of that, and we wanted to kind of prime that event with a little bit of discussion surrounding, among other things, the state of market for provider services, some trends that we're seeing.

(01:21):

There's still a lot of deals in that space that we both see. There's challenges, there's opportunities, but we're going to kind of explore the provider services arena and then some other dynamics. Steve, maybe to kind of set the table a little bit from where you guys at Providence sit, and I know you guys do a ton in the provider services arena, what's your assessment of the state of the provider services market, let's say, compared to 12 months ago?

Steve Grassa (01:47):

Yeah, thanks, Geoff. I mean, I think as it relates to PM more generally speaking, from a broad strokes perspective, I think compared to 12 months ago, we're seeing some increased deal activity, particularly from some of the big box strategic acquirers that have executed on a land grab of sorts in the space, like namely some of the drug distribution companies and ASC management companies that have been targeting some of these sponsor-backed platforms. Depends on the specialty. So as it relates to some of the ASC consolidators, they've specifically targeted specialties like orthopedics, cardiology, gastroenterology, even ophthalmology to a degree. And then some of the big news more recently has been on the drug distribution side with the likes of Cencora, McKesson, and Cardinal being hyperactive across some of the drug-heavy physician specialties.

(02:38):

And so we've seen that sort of dominate the news in recent months and within the last call it 12 to 18 months or so. Whereas, historically within the space, most of the exit activity had been sort of sponsored to sponsor trades, some strategic deals with private equity-backed platforms trading to larger private equity-backed platforms. And we can unpack that a little bit further as well. But just generally from a high-level perspective, we're starting to see things pick back up. That's mainly driven by a lot of these large strategic acquirers moving into select specialties and really making a big wave within each of the spaces.

Geoff Cockrell (03:13):

Yeah, that's consistent with what I'm seeing. And I'd kind of put the slowdown that we saw in PPM arena into kind of two different causal buckets. One is kind of temporary, the other is structural. The temporary one were dynamics that could change rather quickly and have changed, those being an environment where there's kind of acute labor pressure. So provider demands becoming very sharp

and expensive, but also kind of balance sheet pressures of things that were acquired in '21, early '22 that were quite expensive and were kind of predicated on a low cost of debt capital environment.

(03:54):

That environment changed and all of a sudden the balance sheet became very crowded. The debt service loads on a lot of those platforms, A, quickly squeezed out kind of capital for other kind of acquisition and growth, and in some places kind of squeezed out the company entirely. But balance sheet problems are much more resolvable, sometimes painfully, sometimes not painfully, but balance sheet problems can be resolved, especially in the context within the four corners of the business, it actually cash flows pretty well.

(04:20):

The other one, and you've alluded to it, is more structural. Like if you're a hundred-million-dollar-plus EBIT provider business, who's going to buy that? And that, as you noted, had been kind of sponsored to sponsor, but the idea that there's just bigger sponsors and bigger sponsors and bigger sponsors or a consortium of them, that there's no end to that line, that proved to be incorrect. And public markets have not been super available in that environment. The absence of kind of ever bigger private equity buyers kind of clamped down that arena.

(04:48):

And you've noted, but we're starting to see some new buyers that have kind of different ambitions, whether that's ASC chains buying ASC-heavy sectors or heavy drug prescribing sectors. My question for you, Steve, is that on that front, are there other avenues of new emerging buyers? Or for now, is it really just these kind of drug manufacturers and ASC consolidators that are the new buyers?

Steve Grassa (05:12):

Yeah. I mean, I think I'd still expect to see some sponsors invest in the space selectively. I think they see the opportunity to invest at more reasonable valuation levels now. They're going to have a much higher bar. And I think the groups that invest in the space, they're going to want to have some experience within PPM and pull from a playbook on what's worked, what hasn't for either themselves or for some of their peers, whether it's integration, organic growth or just... These are obviously very hard businesses to run, and so you need a very well-informed investor that's either done it before or that has comfort in their ability to draw on similar playbooks in adjacent spaces. So I don't think that trade is dead. Again, there's a much higher bar.

(05:54):

I think strategic deals still makes sense. You made the point on size. Size matters. There's sort of a sweet spot where you grow big enough to scale, but not big enough to size yourself out of strategic deals where you're trading to a larger private equity-backed platform in your given specialty. So it's situations where you have regional private equity-backed players creating to some of the larger

national consolidators. I think that may still take shape in the coming months. So in the case of like dermatology, for example, there are a lot of hyperlocalized regional players where Forefront, Epiphany, Schweiger, some of the more national players are good landing spots.

(06:31):

And then in eyecare, EyeSouth Partners is obviously one of the larger multi-specialty ophthalmology players that I think would be interested in acquiring MSOs that have performed well. You still have those options and then being a little bit more creative, like continuation funds to sort of extend the timeline. We've seen some businesses, some funds raise equity and double down in spaces, and again, extend the timeline and kind of reset the value range. And then in spaces like dermatology, we've seen mergers take shape to capture market share, to densify for payer leverage sake. There's a cost synergies play, creating immediate scale.

(07:10):

So I'd expect to see some of these platforms come together through like cashless merger situations as well, and then potentially get big enough to the point where you IPO. I mean, the public markets aren't that favorable at this point in time, but we've heard rumblings of a few of the larger platforms poke around in the public markets and sort of gear up for an eventual IPO in the next six, 12, 18 months or so.

Geoff Cockrell (07:32):

Yeah. Those mergers of equal, sometimes you put air quotes around those words, buys time for the market to evolve. And you're exactly right. In the meantime, you can continue your incremental growth and maybe grab some synergies growth. One kind of related question is there's been a lot of discussion of what they call them zombie funds or zombie platforms. It's not a very flattering description, but in general, platform that's been held for a long time.

(07:55):

And one question that you hear a lot is to what extent are internal fund dynamics just going to kind of force a transaction, even if it ends up being not a bad deal for the fund, but mediocre one, but they've just held it for a long time? To what extent do you think that given the size of the market of kind of long-in-the-tooth provider services platforms held by PE, to what extent are the internal dynamics of the fund going to kind create sale pressure that's going to activate parts of the market?

Steve Grassa (08:22):

Yeah. I mean, I think at a high level, it certainly comes into play. There are some of these spaces where they've been consolidating since '17, '18, '19, so long in the tooth is the appropriate phrase right there coming up on seven, eight, nine years within their whole period. I think there's some creative things that a lot of these funds can do to extend the timeline, but there will inevitably situations where you're going to start to see pressures to exit over the near term. And I think there's

going to be sort of a reset in terms of valuation expectations. And we've seen the bid ask spread compress in recent months and in recent years to reflect this new environment.

(08:59):

And then, you mentioned earlier credit markets. I think just a lot of the funds may want to refinance out their existing debt. There's a real vintage problem in the PPM space, but yet a lot of these firms paying really high exorbitant multiples at a point in time, underwriting to pro forma EBITDA and then leveraging businesses at five, six times debt multiples. And the math worked at rate levels a few years ago, but today, debt service coverage can be difficult and physician retention's a problem. That's no longer just an operating issue, it's at a point of credit risk. So it's no coincidence that a lot of the platforms that were established in call it the 2019-to-2022 timeframe have been the ones in distress recently.

Geoff Cockrell (09:39):

Talking about credit impacts, there's been tons of discussion about the kind of brewing and present private credit challenges. You can source a fair amount of that back to kind of a lot of investments in 2020, 2021 range in kind of SaaS businesses that have been dramatically impacted by AI. To what extent are you seeing the challenges in the private credit market impacting capital availability in the kind of healthcare generally and maybe PPM and provider services more specifically?

Steve Grassa (10:13):

It's certainly impacted it. And I think it's more pronounced within PPM. PPM had its challenges before this big private credit crunch that we've seen play out. You have a lot of lenders that are sort of up to their nose in PPM assets, and so less and less want to put more money to work there. They've been much more selective, lower leverage, and want to work with sponsors with a track record in PPM, and that goes for lenders, too. Some of the generalist credit funds are frankly just sitting out of some of these deals.

(10:43):

Whereas, the healthcare ones still willing to put money to work, but have been much more selectively active. And there's been a lot more scrutiny on adjustments on the earnings base that groups are willing to underwrite to. But I think we're still seeing opportunity for well-run businesses with strong growth to merit some forward-looking growth types of adjustments, albeit more than reason than in years past.

Geoff Cockrell (11:07):

You mentioned earlier one of the deal drivers being kind of larger ASC chains. I would put kind of that evolution under the heading of the rise of larger joint venture relationships, whether that is ASC chains or health systems. To what extent on the large platforms are you seeing kind of these JV ideas growing and expanding and what do you think that's going to do to the market for those platforms?

Steve Grassa (11:34):

Yeah, we've seen it's been a significant part of the playbook for some of these ASC management companies to do sort of a three-way JV between health system, physician, and ASC companies to benefit significantly from a rate perspective. And it just makes a lot of sense strategically for all parties involved and creates the ultimate alignment, especially from a physician standpoint. There's obviously some significant benefit from moving procedures into this lower cost outpatient setting and to get health system engagement and JVs in play now. It's been a big part of the playbook over the last year or so for ASC-centric sellers and ASC-centric businesses. And we'd expect that to play out on the sponsor side as well as you continue to move up market and upstream into some of these platforms that expect to trade hands over the next few years.

(12:25):

Geoff, in the past, there had been significant strategic activity from some of the pay providers, and it's been more acquired recently due to some of the antitrust scrutiny, congressional investigations. And I think there's a lot of regulatory risk and reputational risk as well. But any particular reason why you've seen that slow down in recent months and years, and do you expect it to eventually pick back up on a go forward basis?

Geoff Cockrell (12:53):

My sense is that payers are very attuned to antitrust concerns at the moment. And I mean, they've made a lot of investments, but I think that there's a lot of scrutiny on that process, both externally and internally, plus the idea that a few large payers with significant provider arms can buy everything. Everybody's solution of who you're going to sell to was just a handful of kind of payer buyers. That was never a sustainable idea. So I think you've hit some level of critical mass there. I think they've got kind of antitrust concerns and headwinds about how much consolidation they can realistically do without kind of making some of those concerns worse. So as a kind of panacea buyer in that arena, I think that we'll probably see a little bit less of that. I could be wrong, but that's my sense.

Steve Grassa (13:39):

I tend to agree. I mean, I think it's hard to make money on it from the payer perspective. It's expensive. It could be messy. It sounds great on paper, but I think it's hard to pull off. When you think of like an ASC buyer versus a payer, the payer thesis is obviously centered on cost reduction. Whereas, the ASC and company incentive is aligned with volume and revenue generation. And so there's sort of like a conflict optics there. Geoff, what have you seen from a payer services perspective in this space and how has that evolved over time?

Geoff Cockrell (14:09):

I think that the economic drivers of benefits for large employers kind of bringing the insurance function in-house or outsourced away from big payers is pretty profound. And so it's also difficult in that if

you're not just having a relationship with a payer, then there's a whole bunch of functions you have to put in place or have available to kind of execute on a employer-based insurance program. So I've seen a lot of kind of investment thesis that are around kind of accumulating into one vehicle all of the different elements of what you would need to do to kind of go to market with a employer-based insurance product and is driving a lot of kind of activity in that space.

(14:52):

And at the same time, you're seeing the threshold of how many employees realistically do you have to have to be able to enter that arena has been consistently coming down. So you've got an expanding kind of opening up of that market, you got pretty material benefits to the employers themselves on cost. All those things are synthesizing into a lot of activity in that space. Are you seeing kind of some of the same dynamic?

Steve Grassa (15:16):

Yeah, we are. And I give you like from a private equity lens or from an investment lens, there's a lot of good fundamental tailwinds to like about that space at large. And I think there's some specific ways you could play it to get exposure and access without sort of taking on risk yourself. So it's definitely a space that by Provident we are, we've circled as a priority area for us in an area where we think there's going to be a lot of capital inflows moving in over the next few years.

Geoff Cockrell (15:45):

Yeah. And you also have the benefit in those areas of you're generally not talking about those services businesses don't have the same kind of government reimbursement risk. So that opens up the arena of buyers and private equity funds where that's kind of aligned that for a lot of investors that would like exposure to healthcare generally, but are not super keen on having direct government reimbursement-type risk. That's a very interesting area that draws a lot of different buyers.

Steve Grassa (16:10):

Owning providers is hard, and that's proven out over the last few years. So we've found that a lot of funds have tried to look at different ways or different angles to play the provision of care without owning the provision of care. I think it's sort of like the next step in this evolution of investment into provider services.

Geoff Cockrell (16:28):

Going back to the PPM arena, even in challenging markets kind of mantra that you often hear is that there's always a market for an A-caliber asset. And I think that's largely true. Question for you, in kind of the PPM arena, what makes an A-quality asset? And realistically, what percentage of kind of aggregate assets can really bear the title of an A asset?

Steve Grassa (16:57):

Yeah, it's a good question. I think there's a lot of ways to look at it. I mean, first, from a growth perspective, in our view, organic growth will always trump M&A in organic growth. And so focused on hiring providers, retaining providers, same unit, same clinic sales is going to be really important. M&A fits within the broader growth construct and playbook, but I think groups that have been more selective and strategic about it have tended to do better over the last few years. And groups that have really invested in integration, and not homogenous integration, you need to keep local practice identity and brand and culture. I'm talking about integration at like the back office infrastructure level, such that patients and doctors don't notice any change, but the economics improve. So I think groups that have been very selective and strategic about their approach to M&A and haven't just collected practices and stacked EBITDA without any real integration have been the ones that will prove out to be the winners in the space.

(17:56):

And then, physician alignment is obviously very important and helps with retention and recruiting and getting the next generation of physicians all rowing in the same direction. I think there are a lot of levers you can pull to be able to get physicians aligned and to help retain physicians because ultimately, at the end of the day, the assets walk out the door every evening and so you want to make sure that they ultimately come back. And then ancillaries is probably another one. Those have been the real moneymakers for some of these practices with ASCs, infusion, path, lab, imaging, ability to layer on some of these other revenue streams that are highly profitable. And geography matters, too. All things equal, it's harder to establish a platform in states like Oregon or Washington where there are corporate practice medicine restrictions than it is in, say, Texas. And that's a theme that we're starting to see play out across states throughout the country as well.

Geoff Cockrell (18:49):

On the alignment aspect of that, and I agree with all those kind of dynamics, from what you've seen, what kind of structures or elements, so not cultural, I'm just thinking kind of economic structures, what structures do you think provide the most alignment? And the questions being, is it better to align economic interest more locally? Is it, do you think better to have more central topco economics? What's the distinction between kind of second-bite-at-the-apple sale economics, whether at a topco or a sub-level versus kind of current cash pay? What are the drivers of good alignment structures in your mind?

Steve Grassa (19:27):

I think starting with compensation, the models that have done better have been models where compensation is tied to -line performance. So some of these scrape models we've seen in some specialties, like it hasn't really played out in eyecare and some others that are more focused on a percentage of individually performed collections, but I think that has created better alignment between physicians and between the MSO. You made the point on local equity and having your economic

interest tied to the growth of your individual practice or your individual market. And I think that resonates well with a lot of physicians and create significant alignment as well. I think the other big one is just to make sure that the younger crop or generation of physicians is aligned and giving those folks a clear path to partner into equity ownership into and getting everybody on the same page is going to be really important for the success of a lot of these platforms going forward.

(20:24):

So Geoff, it was really great to speak with you as always. Learned a lot from the conversation. I hope our listeners did as well. As you mentioned at the onset, we have the McGuireWoods' Healthcare Private Equity Conference coming up in a few weeks. Really excited to learn a little bit more and lean into some of these topics and some of the breakout sessions there as well. I'll be doing a breakout session on ASC alignment and an ASC strategy hosted at the conference. So hope to see folks there. And I know you'll be hosting a session as well, if you want to give a shameless plug for that.

Geoff Cockrell (20:57):

Yeah. No, I'm leading a banker's discussion. So we'll have a whole array of investment bankers sharing their thoughts on it, but it's always a great event and looking forward to seeing you at it. And thank you for having me on your guys' show. It's a great one and I really appreciate it.

Steve Grassa (21:10):

Sounds great. Appreciate it, Geoff. Take care.

Voiceover (21:16):

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. This series was recorded and is being made available by McGuireWoods for informational purposes only. By accessing this series, you acknowledge that McGuireWoods makes no warranty, guarantee, or representation as to the accuracy or sufficiency of the information featured in this installment. The views, information, or opinions expressed are solely those of the individuals involved and do not necessarily reflect those of McGuireWoods. This series should not be used as a substitute for competent legal advice from a licensed professional attorney in your state and should not be construed as an offer to make or consider any investment or course of action.