2023 ANNUAL HEALTH REPORT

HEALTHCARE PRIVATE EQUITY

McDermott Will & Emery

INTRODUCTION

Private equity investment in healthcare reached an all-time high in 2022, with reports putting the overall deal value at a staggering $151 billion. But 2023 is shaping up to be a very different year, with investors pulling back as they try to figure out how long the landscape will be dominated by rising labor costs and interest rates. Here are five trends to watch in private equity healthcare investing from our conversations with leading investors and bankers.

1

RISING LABOR COSTS

No deal can be made in the healthcare sector without considering how wage inflation will impact a business's performance. Wage inflation is being seen among both employed and contract workers and has been notable among mid-level providers, such as nursing home aides and medical scribes. At the same time, healthcare operates on a reimbursement model, meaning those increased labor costs cannot be passed on, which in turn ends up squeezing margins. Since it is difficult to determine how long wage inflation will continue, some investors are shying away from healthcare businesses that are heavy on providers, such as nursing homes. Going forward, some investors are looking at automation and digital tools to reduce labor costs. Others will seek to improve returns by sharing risk with insurers through value-based care options. But there could be some good news on the horizon; if labor costs come down in the next 18-24 months that may lead to improved margins.

2

FROZEN CREDIT MARKET

Over the last decade, private mergers and acquisitions were dominated by roll ups that were facilitated by low interest rates, large lines of credit, and delayed draw term notes. Those models worked because there were a lot of pro forma adjustments that incrementally increased leverage, but problems are beginning to arise now that businesses are seeing lower margins due to the increased cost of labor and supplies. As the credit markets begin to move again, the interest rate environment is likely to become more important as we think about business models in healthcare. Looking back to the lessons from the 2008 financial crisis, many investors chose to over-equitize in a frozen credit market and they were rewarded for that risk through lower prices. However, in the current market, prices continue at near 2021 levels, leaving investors without an incentive to take on that risk. But not all investors agree; some are holding onto "dry powder" and are willing to finance deals on their own for attractive opportunities.

3

PRICING MISMATCH

The disconnect between the various economic factors squeezing healthcare and the valuation of healthcare businesses is definitely throwing cold water on some deals. It will take time for sellers to adjust to lower valuations and in the absence of lower interest rates it is difficult to bridge the gap, one investor explained. Sellers are also becoming more patient in the current environment. Since many healthcare assets are owned by private equity already, these funds are unwilling to sell in a market where the exit market does not have an appetite for scaled assets.

4

DEALS ARE NOT ALL THE SAME

While the deal market may be contracting compared with 2021, investors are willing to make deals for the right companies. However, portfolios, regions, and management teams are all key factors. Investors are looking for the subsectors that are best able to weather the current environment and for executives who understand how to adapt their business model to deal with challenges, such as staffing shortages and rising labor costs. While healthcare leaders will still be expected to be growth-oriented, they also now need to be hunting for savings in a way not necessary before in healthcare. Those companies that can differentiate themselves over the next 12 months on key labor challenges will be at a significant advantage.

5

CREATIVE STRATEGIES EMERGE TO BRIDGE THE GAP

Delayed exits and continuation funds are two approaches investors are taking to meet current deal challenges. Some bankers find continuation funds are a good option when working with existing limited partners but that bringing new entities into the mix can slow down the process. Others are wary of continuation funds because of the increasing regulatory scrutiny on these vehicles, instead favoring 50/50 recaps that bring in an equity co-investor as a strategy to exit some of their investment early or to refinance. Other strategies, such as taking public companies private and using equity backstops, are not gaining as much traction because of continued high valuations. However, those strategies could come to the forefront if valuations begin to fall in 2023.

THE TOP TAKEAWAYS

Investors predicted a bumpy road ahead for 2023 – likely worse than 2022 – but they also said they expect healthcare to outperform other industries in the coming years. Even a recession could provide a silver lining for healthcare investors, panelists said, because it would help solve the labor challenges but would be unlikely to significantly dampen demand for services.

HEAR MORE FROM OUR TEAM ON THE 2023 INVESTING OUTLOOK

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