INDUSTRY EVOLUTION

The art of healthy investing

From technology to public policy, healthcare has been rapidly changing in recent years, which has influenced deal activity and the way private equity and private credit firms invest in the sector. **Stuart Smartt** of NXT Capital discusses investing in the one of the largest sectors of the US economy

Q Have you noticed an increase in healthcare specialty private equity firms or healthcare-specific private equity funds?

SS: A few healthcare-specific private equity firms and family offices do exist but more prevalent are funds that view healthcare as a top three or top four strategic focus for the fund, and they have, similar to NXT, a focused industry vertical for the fund.

There's been a palpable increase in capital allocated to the healthcare and healthcare-IT space across the board for a host of reasons.

One: Fundamentally, healthcare, as we all know, is a meaningful part of our GDP, approaching 20 percent. So for asset managers, it makes sense to dedicate a portion of their portfolio to the healthcare sector.

Two: There exists a plethora of opportunities for consolidation in the provider services and pharma services sectors, and sponsors are quite efficient at consolidating scale quickly, regardless of the sub-sector.

Three: Increasing healthcare costs and regulations have presented opportunities to disrupt the landscape. Technology and innovative care models, population health management and the like, have not only the goal of reducing costs but also improving outcomes.

Four: Although not immune, the healthcare sector is more resistant to economic downturns than non-healthcare sectors. Couple all of this to the aging population and 'baby boomer' retirement wave, and there's tremendous demand for high-quality healthcare assets for the foreseeable future, regardless of where the money is sourced.

Q We've talked about private equity firms in healthcare, now let's switch to the other component of the capital structure. Have you noticed a lot of new private credit managers or alternative lenders coming into the healthcare space?

SS: I don't foresee a shortage of debt capital allocated to the space, and similar to us, looking to back the right sponsor making the right strategic decision for their investment, we have to approach our decisions on the lending side with a similar mindset.

As healthcare industry specialists, it is our role to identify attractive investments in what may be perceived as a challenging sub-sector and, consequently, steer clear of the not-so-good investments in a sub-sector that the market generally supports.

From my position, there's an increase in our competitive set. Although they're less relevant on senior-stretch and uni-tranche structures, banks still have a seat at the table.

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Additionally, there are new entrants into the private debt lending space that have made a splash in the market and are ultimately trying to deploy dollars at a very rapid pace, and you always have a variety of generalist lenders that allocate a certain part of their dollars into the sector.

All healthcare lenders are competing across multiple angles against a variety of different sources chasing a scarce resource: high-quality financing opportunities.

Q How have healthcare lending platforms in the private market evolved?

SS: In a traditional syndication process, a lead arranger underwrites and may hold a small portion of the facilities, but they ultimately distribute those dollars onto the balance sheet of a variety of different investors.

In this market, as a way of reducing syndication or execution risk, many borrowers opt to go for fewer lenders or, in most cases, a club environment, to speak for the entirety of the financing amount so they eliminate market risk in distributing their financing needs.

For NXT, when we identify a compelling opportunity, we seek to put as much money to work in any given transaction as we can. We are basically leveraging a fixed amount of underwriting due diligence time across a larger investment which is obviously more favourable than a smaller investment.

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That said, in many cases, a handful of lenders are all brought forward in a transaction, and ultimately, multiple parties will have to play nicely in the sandbox. The club splits the financing among themselves and ultimately lock arms to constructively support the company and growth going forward.

Fortunately, it's not always a zero-sum game on the lending side like it is on the equity side, in that NXT often finds its way forward in leading clubbed transactions that present the opportunity to increase commitment amounts with time.

Q Why have buy-and-build strategies become so popular?

SS: It allows investors to start with smaller cheques, knowing that there is an opportunity to deploy additional capital. They can leg in over time with add-ons as they come about.

This has proven to be a viable strategy for some larger funds that have come downmarket to seed a platform investment. I think at the core of the financial opportunity that buy-and-build strategies present is multiple arbitrage because smaller provider practices without infrastructure trade for a fraction of a robust platform. So the whole is greater than the sum of its parts upon exit.

Additionally, the white space is sufficient to provide consolidation for the hold period and beyond, since organic same-store growth may mature with time. And, since there are many PE funds, small and large alike, there's almost always a financial buyer for an exit should a strategic option be less appealing.

Q What are some of the troubles that would throw a buy-and-build platform off track?

SS: Private equity sponsors tend to focus on building out the platform, which I would characterise at its core level as people and systems.

Having an owner-founder-seller of a business entering into a relationship with an institutional investor can sometimes bring about behavioural changes from the owner-founder and potentially large shareholders in the doctor group.

So, finding the right people and the right roles on the clinician side and then, to supplement that, the right executive team, the right leadership, the right organisational tree to support the growth – I think that's where some of the bumps in the road can lie.

Second to that, on the systems side, we find that typically smaller practice groups and smaller platforms have potentially underinvested in their systems. And institutional investors tend to come in and augment the investment with sizable dollars and often new systems, which means a transition from legacy systems that can ultimately disrupt processes and providing quality care.

So, people and systems I would say tend to require a little handholding, especially out of the gate, in order to keep the investment on track.

Q How has growing consumerism affected healthcare dealflow?

SS: At the core of middle-market healthcare lending for us is healthcare services, and at the core of nearly all healthcare services is a human-to-human interaction at a moment in time. This would include provider-to-patient interaction and the ensuing levels of consumer satisfaction.

The ability to hire the best people, choose the right vendors, collect the proper information, bill the appropriate amount the first time and offer an overall enjoyable patient experience can greatly determine the success of a given platform in the healthcare services context.

We've started to see new partnerships approach the market with a fresh set of eyes with a fresh approach to common

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problems, putting the consumer at the core of trying to figure out how to make healthcare interactions as efficient and satisfying as possible.

Q How has cost containment affected healthcare investing?

SS: I would say that cost containment doesn't impair dealflow. It informs the market of investors where to most appropriately direct their focus.

At the epicenter of cost containment are capital-intensive, higher-cost settings such as acute care hospitals or skilled nursing facilities, given that that is where the preponderance of dollars is spent. And as such, the bar is higher for us when financing those opportunities.

For us, in a nutshell, if we can think about a thesis as improving care, it's probably going to reduce costs. And if you're reducing costs, you tend to be on the right side of the equation as it relates to healthcare becoming an increasing part of our GDP.

Q How has the evolution of technology affected healthcare investment?

SS: I would characterise technology as the gift that keeps on giving, in that there will always be technology that comes to the market that is, either in small or in large fashion, disrupting the market. For the transactions that we support, again, we probably witness less of the technology and more so those partnerships and the new channel investments that shape the investment activity.

As lenders we tend not to make a "bet" on one particular technology, intellectual property or patent. Instead, we are backing experienced people and teams that may benefit from the underlying technology. As an example, as more surgical procedures have migrated from an inpatient to an outpatient setting, physician practices can now capture ancillary revenue streams to enhance the margins of their office-based services. This type of change can have a positive impact on patient outcomes and profitability alike.

Q How has the opioid epidemic affected healthcare investment activity?

SS: There are several facets of the market that touch this epidemic from in-patient substance abuse facilities to medication-assisted therapies to step-down and outpatient settings. On top of that, there are benefit managers and health IT solutions that also serve those growing end markets.

If you take it a step further, pharma suppliers and distributors are under intense legal focus, potentially drawing a comparison to Big Tobacco as a corollary, calling out the social responsibility angle.

And it goes even further to interventional pain providers that do in-office drug testing. We're seeing an increasing number of providers facing fraud and criminal charges, so it's a sector where compliance is more important than ever before. On top of that, Medicare Part D providers were just asked to respond to this situation with better tracking and monitoring.

And finally, coming at it in a different way, benefit-plan design can consider facilitating other clinical pathways to alleviating pain, for example physical therapy or chiropractic care, as a means of dampening the reflex to prescribe opioids as frontline therapy.

So, if you think about your question, you've got this one macro trend and it flows through our industry in a half a dozen ways or more of how deals can be ultimately pursued, how various constituents in the value chain can ultimately be backed with an investment, how something at a macro level can factor into deal flow. ■

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