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Private Equity and Health Care Investments: How Has COVID-19 Impacted Deal Flow?

Arielle Schmeck, JTaylor

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Entering 2020, private equity (PE) investment in health care services was on pace to surpass historic rates of investment in the industry, despite PE health care deal activity achieving record highs in the preceding years. However, by mid-March 2020, the health care services deal space, along with most other transaction activity, came to a complete halt as the COVID-19 pandemic forced businesses to close and created significant economic uncertainty. While many industries saw a significant decline in total investment throughout the remainder of 2020, many PE investors turned to the health care services arena as somewhat of a safe haven as the U.S. economy began to re-open in the second half of 2020. In total, while deal value decreased by 7% from 2019 to 2020, total deal count increased by 10% as more investors looked to add-on to existing platforms rather than seeking out new, larger targets of interest.[1]

This increased deal activity, which saw a particularly large surge in the fourth quarter of 2020, continued throughout 2021. Preliminary data indicates that both deal count and deal value in the health care sector increased in 2021, outpacing the historic 2019 levels.[2] This article examines PE health care deal activity pre- and post-emergence of COVID in the United States and key drivers in PE health care investment throughout this time period.

Comparing 2020 and 2021 Investment Activity to Pre-COVID Levels

As the global COVID-19 pandemic began to force shutdowns in March 2020, a significant portion of deal activity followed suit. Reported active M&A deals in June 2020 were down 46% from pre-COVID levels.[3] Additionally, not only were buyers and sellers not entering into new transactions during the second quarter of 2020, but many deals that were in process before COVID hit were either suspended or terminated. In one survey conducted by the Alliance of M&A Advisors, respondents indicated that 40% of the deals in-process in February 2020 were suspended/on-hold in June 2020 and another 14% had been terminated by either the buyer or seller.[4] However, health care transactions had the highest successful close rate of any industry (approximately 32%), even ahead of information technology and information data/content/delivery.[5]

While the number of deals closed during the summer of 2020 remained somewhat depressed compared to prior periods, more than 200 health care deals closed between June 1, 2020, and September 30, 2020.[6] Sellers spanned the health care industry spectrum, including dermatology, radiology, home care, medical devices, and other health technology (healthtech) companies. Across all industries, deal activity remained strong into the last quarter of 2020, particularly in December, which saw reported deal activity back to 97% of pre-COVID levels.[7] Overall, the number of deals closed in 2020 was down only 11% from 2019 since the high volume of activity late in the year made up for the pause in transactions during the early months of the pandemic.[8] Hundreds of deals in the health

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care industry closed during the fourth quarter, including some PE-backed “mega-deals” (transactions between companies with combined revenues in excess of $1 billion), such as:

- The Vistria Group and Centerbridge Partners leveraged buy-out (LBO) of Help at Home;
- Aspen Dental Management’s LBO of ClearChoice (via its financial sponsors); and
- Radiology Partners’ LBO of Mednax (via its financial sponsors).

In total, PE deal activity in the health care sector remained relatively consistent as a percentage of total deals between 2019 (15.6%) and 2020 (14.1%).[9]

Entering 2021, the transaction market remained very active. Many PE firms were seeking to invest dry powder that had accumulated throughout the pandemic, in addition to having the ability to obtain cheap debt financing due to low interest rates. The transition to a new presidential administration and anticipated tax increases caused many sellers to look to make exits ahead of a potential capital gains tax hike. Because both buyers and sellers had motivations to complete transactions, over 3,700 deals closed in the first half of 2021 across all industries, worth a combined $456.6 billion—approximately two-thirds of the total deal value transacted in all of 2020.[10] The second quarter of 2021 had the second highest deal activity in a decade, trailing only the fourth quarter of 2020 which, as noted above, was unusually high as buyers and sellers pushed to close deals before the end of the year.[11] This elevated level of activity persisted, as third quarter 2021 activity outpaced the second quarter with approximately 1,200 deals closed for a total deal value of over $140 billion.[12] This trend continued throughout the remainder of 2021, with the deal count through December 31, 2021, expected to exceed 8,600, for a total deal value of $1,237.5 billion.[13] This reflects approximately a 50% increase in the number of deals and a 64% increase in deal value from pre-COVID 2019 levels, which to that point had been a high mark.

Drivers in PE Health Care Investment

According to one study, health care PE deal values tripled from 2010 to 2019.[14] This increase in activity is driven by a variety of factors, including relatively reliable revenue streams stemming from an aging population and the rise in per-capita health care spending. PE investment in the health care sector remained popular in 2020 and 2021 as a number of new opportunities emerged from the pandemic, including telehealth, behavioral and mental health, home health, outpatient care, and other areas of interest. Many expect this activity to continue into 2022 as investors look to expand or add new areas of growth to their portfolios. A few key opportunities have spurred much of the activity in recent years.

First, PE has targeted the health care industry due to its relatively fragmented nature, particularly in the provider space. PE firms have utilized a “roll-up” strategy to aggregate smaller providers into larger organizations in order to achieve economies of scale, provide more efficient administration and expertise, and potentially access higher commercial reimbursement rates. Historically, PE has been aggressive and successful in rolling-up specialty practices such as dermatology, radiology, and dentistry. Dermatology deal activity has cooled in recent years, which some observers attribute to “lack of strategy diversification” and “strategic missteps by some large platforms.”[15] However, other specialties continue to receive PE attention, including vision, pain management, orthopedics, and other traditionally high-reimbursement specialties. PE buyers are particularly interested in these specialties due to their attractive margins and large ancillary revenue streams. PE’s interest in these core segments is demonstrated by the growth in “add-on” investments, in which a smaller acquisition in the same provider segment is added to an existing platform. Add-on acquisitions in the health care sector as a percentage of total PE buyouts have increased from 78.5% in 2016 to 84.4% in 2021.[16] Many PE firms, trying to maximize the exit value during an era of elevated transaction multiples, have continued pursuing add-ons much later into an investment’s

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holding period. In fact, "with many believing that multiples will contract in the coming years, or at least not rise much higher, firms are pursuing aggressive inorganic growth for their platforms from day one and continuing to add on deep into their holding periods. . . . we have heard multiple reports of platforms being valued on the EBITDA from add-ons still under the letter of intent . . ."[17]

While the number of add-on acquisitions has been increasing, one area that has historically seen less PE activity is primary care, though that seems to be changing. As value-based care and capitated payment models (where providers are paid a fixed rate to manage an individual's care rather than billing for each service) become more popular, PE investors are seeking an opportunity to share in some of the cost-savings and efficiencies, as well as improve clinical outcomes through data analytics and information sharing across their platform entities.[18] Around 80% of states now use capitated payment models for Medicaid,[19] and Medicaid enrollment has increased, particularly given COVID's impact on the labor market. Additionally, a growing number of Medicare beneficiaries are choosing to enroll in capitated Medicare Advantage plans rather than the traditional fee-for-service Medicare program. In fact, participation in Medicare Advantage is expected to outpace enrollment in traditional Medicare in less than ten years.[20] The growth in capitated plans, coupled with this model's incentive to control costs while improving clinical outcomes, will likely continue to fuel PE's investment in primary care in the near term. Analysts note that "there is widespread industry and political consensus that [value-based care] is the future of healthcare in the US, even if the change comes slowly to some parts of the payer-provider ecosystem. As a result, the few large-scale VBC platforms that exist are trading at high multiples, with both PE firms and payers (insurance companies) as suiters."[21] The amount of activity is yet to be determined, as a large portion of primary care providers are already employed and/or affiliated with large health systems. Still, the introduction of payers as potential buyers provides PE with additional exit options for this type of practice.

In addition to primary care, PE buyers are attracted to behavioral and mental health, as well as home care providers. As mental health continues to become more destigmatized, and reimbursement for these services increases, PE is seeking opportunities to consolidate one of the more fragmented areas of the health care provider spectrum. Partly fueled by the pandemic and partly driven by legislative mandates, there has been an increase in coverage for behavioral health and an increase in reimbursement rates for these services. Payers have begun to realize that investing in mental and behavioral health services can improve the overall health of their insureds, reducing the cost of care over the long term. Within behavioral health, PE buyers appear to be particularly interested in outpatient care, autism, and intellectual and developmental disability services.[22] As it relates to home care providers, hospice and dialysis have been popular areas of investment, as these services remained relatively unaffected by COVID.[23]

The last area that has seen a significant increase in PE investment recently is healthtech. While COVID led to exponential growth in telemedicine and telehealth, the continued reliance on technology, data analytics, and informatics has also increased deal activity in this space. With the shift to value-based care and capitation payment models, physician groups and other health care providers are increasingly reliant on accurate, real-time data to manage their patient populations effectively and efficiently without having to increase the number of patients visits and/or procedures.[24] In addition to health care data analytics companies, another growing area within healthtech is health insurance technology. These companies provide solutions for health insurers in order to better manage patients' benefits by streamlining prior authorizations, eligibility, insurance verification, etc. In addition to PE interest, many insurers are also looking to acquire these entities in order to vertically integrate and bring cost-savings in-house.

Finally, though much of the health care services sector saw an increase in investment activity throughout 2020 and 2021, certain providers, especially nursing facility providers and hospitals, are still struggling due to increased operating costs, decreased labor capacity, and lost revenue associated with COVID precautions. As a result, these provider types saw more exits during 2021 as buyers sought to limit their losses. For example, Leonard Green &

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Partners sold back its majority stake in two Rhode Island hospitals and Apollo (NYSE: APO) reportedly sold LifePoint Health, a rural hospital chain, to its own Fund IX for a loss.[25] The combination of declining reimbursement rates and a decrease in occupancy led Five Star Senior Living (NYSE: FVE) to exit its skilled nursing business.[26]

Transaction Structure Implications

In addition to the impact on deal activity itself, COVID has also changed the way that many PE health care deals, and deals in the market overall, are structured. For many providers, COVID significantly reduced volume and associated revenue in early 2020. Providers continued to face challenges throughout 2020 and 2021 as surges in virus activity continued to impact volumes, either as a result of capacity limitations or patient reluctance to seek medical care for non-COVID needs. To account for these disruptions, many buyers and sellers agreed to "COVID-19 add backs," or EBITDA pro forma adjustments, to portray what the practice operating results might have been absent the impact of COVID. Since the majority of health care deals are based on an EBITDA multiple, this led to an increase in deal value that otherwise would not have existed without this adjustment. Buyers often agreed to these adjustments because of the highly competitive transaction landscape. However, to attempt to mitigate their investment risk, many buyers included an earnout rather than paying the full transaction price at close, meaning a portion of the purchase price would be withheld until certain measured metrics had been achieved post-transaction.[27] However, earnouts in health care deals, especially those involving physician services, can be tricky due to corporate practice of medicine laws in certain states as well as Stark Law considerations. Accordingly, some health care buyers instead prefer to negotiate a larger portion of the purchase price to go into roll-over equity, requiring the seller to share the risk by having a vested interest in the post-transaction operating results rather than receiving the full purchase price at closing.

Looking Ahead

Many of the conditions that spurred PE activity in late 2020 and throughout 2021 still exist. While the expected future tax increases did not pass as of the writing of this article, there is still a widely held view that some form of tax increases is likely. Congressional leaders have indicated that they still plan to bring some form of tax and spending legislation to a vote in early 2022. Accordingly, sellers motivated to avoid potential tax increases may continue pushing to close deals as soon as possible, particularly given the uncertainty of what effective date might be in play in connection with any increase in taxes on capital gains.

While the potential tax changes have driven an increase in deal activity in the short term, the Executive Order issued by President Biden in July 2021 may impact deals going forward, particularly the mega-deals that have been prominent recently. Among other provisions, the Order calls on the Department of Justice and Federal Trade Commission (FTC) to "enforce the antitrust laws vigorously" and "challenge prior bad mergers that past Administrations did not previously challenge."[28] Furthermore, the Order states that "enforcement should focus in particular on . . . healthcare markets (which includes prescription drugs, hospital consolidation, and insurance), and the tech sector."[29] This will likely lead to more scrutiny for PE transactions in the health care industry and may extend the timeline for closing deals even if deal activity continues. In fact, one attorney notes that "providers with deals before the [FTC] are already seeing a significantly wider range of questions from the FTC around the possible effects of the deal on medical professionals and other staff, including the existence of non-compete arrangements and other aspects of competition related to employment."[30] In addition, the FTC initiated a study in 2021 to determine the impacts of non-hospital provider mergers. It is anticipated that this will lead to increased enforcement activity with regard to non-hospital provider transactions—potentially even challenges to deals that have already been completed.[31] Nonetheless, many of the opportunities addressed above will lead to continued acquisitions in the health care sector, despite the increase in regulatory oversight.

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Conclusion

PE investment in the health care industry does not seem to be a trend that will end anytime soon. Despite the lull in deal activity during the early months of the COVID pandemic, PE investment quickly picked back up in late 2020 and ultimately almost matched the historic investment amounts from 2019. As market conditions created a perfect storm for deal activity, 2021 became a record-setting year for health care PE transactions in both volume and deal value. Though many expect that deal activity in 2022 won't be as hot as 2021, PE deal activity in the health care space is expected to continue at a strong pace. As PE groups continue looking to deploy their excess dry powder, health care will likely continue to be a popular area of investment, particularly for those with the expertise to navigate the complex regulatory environment. Additionally, given the fragmentation that still exists in the health care provider market, and the growing healthtech arena, there will continue to be areas of opportunity for PE investors even in a climate of increased regulatory scrutiny.

Arielle Schmeck, CPA/ABV, CM&AA, is a Senior Manager—Consulting Services at JTaylor. Arielle joined JTaylor in 2016 and provides consulting and valuation services. She has gained experience in various practice areas with an emphasis in the health care industry. Arielle's fields of expertise include transaction advisory, due diligence related to mergers and acquisitions, and business valuations. Clients served by Arielle in the health care industry include large multi-hospital health systems, national physician management companies, free-standing cancer clinics, ambulatory surgery centers, and physician practices. Arielle graduated from Texas Christian University with a Bachelor of Business Administration and a Masters of Accountancy. Arielle is a Certified Public Accountant, Accredited in Business Valuation, a Certified Merger and Acquisition Advisor, and a member of the American Institute of Certified Public Accountants. Prior to joining JTaylor, Arielle worked at Ernst & Young in the Audit Practice, focusing on the oil and gas industry.

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