



Capturing returns in healthcare

New research finds that the healthcare sector has been very good to private equity, especially payor and pharmaceutical services. And specialist firms seem to have an edge over generalists.

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We recently analyzed 140 private investments in US healthcare companies from 1995 to 2014 and found that returns were 1.5 times higher than the broader public market, and, in five of eight subsectors, outstripped the US private-equity industry. That strong performance was mirrored in the return multiples that sellers achieved, which were 2.3 times for healthcare versus 1.7 times for all US private equity. An aging demographic has propelled the industry. And the scope for innovation and a steady supply of profitable businesses have made it a fertile market for private-equity investors.

Healthcare covers a wide range of businesses. Some provide services to hospitals and physicians, insurers, and drug companies; others supply products such as pharmaceuticals, biotechnologies, and medical technologies. Naturally, profit pools, margins, and growth rates vary widely among these subsectors; so do risk and returns (Exhibit 1).

What may surprise some is the identity of the outperforming subsectors. Consider payor services, where investors have been skeptical of growth prospects because of the pressures that payors face. Much of the activity has been driven by payors'

need for technological capabilities, to deal directly with individuals as direct purchasers of health-care or to diversify into new populations.

Also surprising is the strong performance of buyouts in pharmaceuticals (including both generics and specialty pharma). As is well known, Big Pharma has been on an acquisition spree. Private owners have sold into this wave, capitalizing on the scarcity of new high-growth pharmaceutical products. TPG's exit from Par Pharmaceutical Companies, which earned it a sevenfold return in three years, is a recent notable example. Others include Stiefel Laboratories (sold by The Blackstone Group to GlaxoSmithKline), Ikaria (New Mountain Capital/Madison Dearborn Partners to Mallinckrodt Pharmaceuticals), Talecris Biotherapeutics (Cerberus Capital Management/Ampersand Capital Partners to Grifols), and JHP Pharmaceuticals (Warburg Pincus to Par Pharmaceutical Companies).

Selecting the right subsector is not enough; we found a wide range of performance within every subsector. In part, this is driven by a handful of deals that achieved outstanding performance. These outliers skew subsector averages much higher than

medians. Leave aside these deals, however, and performance still varies considerably. We see two factors at work.

First, our research suggests that exits to strategic buyers produce higher returns than sales to other private-equity funds (Exhibit 2). Naturally, strategic buyers are often willing to pay over the odds because of the synergies they can reap, but private-equity firms have also begun to bid multiples higher.

The research also found that there is significantly greater variance in holding periods than in multiples.

The variance suggests that investors should think about the time to exit at least as much as they think about multiple expansion. Entering a transaction with a clear exit plan, based on an understanding of the asset's strategic value, is one way to do so.

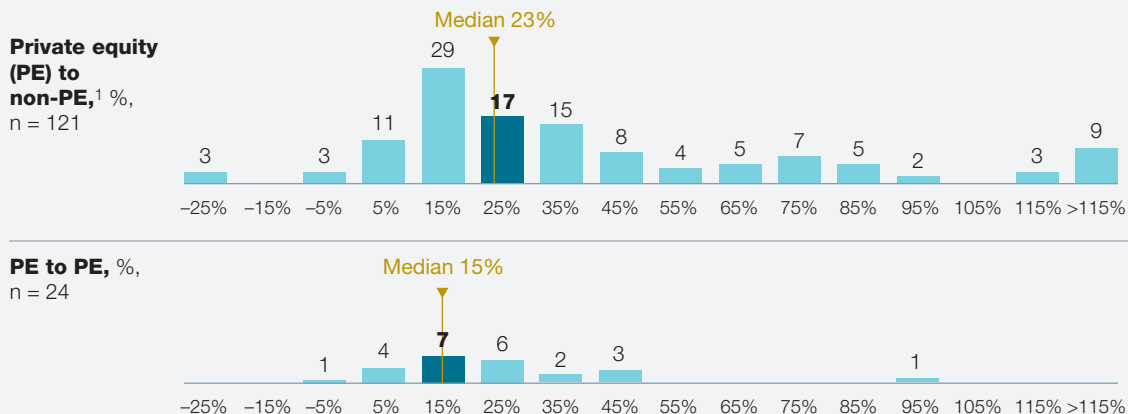
Success also seems to be driven in part by superior knowledge (Exhibit 3). Sector specialists have long argued that they have an advantage in industries as complex as healthcare. Although the data set here is small (14 deals done by specialists and 84 by generalists), it indicates that specialists have attained somewhat higher median returns than

Exhibit 1 Payor services and pharma services have generated the greatest median returns.

Target sector	Sector type ¹	Number of targets	Average deal size, \$ million	Median return rate, %	Multiple of median deal by return, x	Holding period of median deal by return, years
Payor services	Services	14	476	39	3.3	3.6
Pharma services	Services	15	321	39	2.2	2.5
Diagnostics	Services	6	183	27	2.4	3.7
Pharma and biotech	Products	22	470	26	2.7	4.0
Medical technologies	Products	29	605	20	5.4	9.4
Provider services	Services	35	356	16	2.0	4.5
Healthcare IT	Services	5	428	12	1.8	5.0
Radiology	Services	5	164	7	1.4	4.7

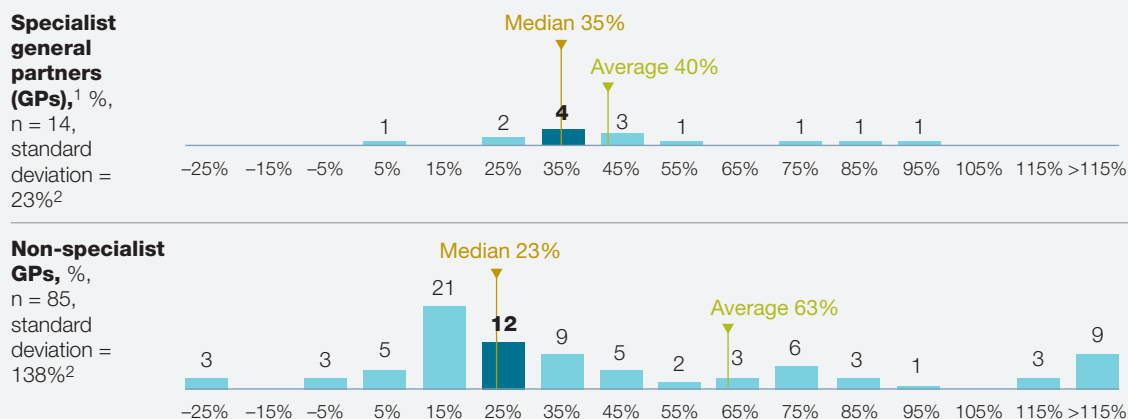
¹ Sectors with n < 5 were excluded. Consumer-health and animal-health products and services were excluded as a result. Source: PitchBook Data; Preqin; press search; S&P Capital IQ

Exhibit 2 Exits to strategic buyers have provided greater median returns.



¹Includes trade sales, IPOs.
Source: PitchBook Data; Preqin; press search; S&P Capital IQ

Exhibit 3 Specialists have higher and less-variable returns but fewer ‘blockbuster’ deals.



¹>40% of past 10-year deal volume in healthcare-related transactions. Excludes consortium deals.
²Standard deviations are statistically different at the 1% significance level (2-tail F-test p-value = 0.00).
Source: PitchBook Data; Preqin; press search; S&P Capital IQ

generalists. That they have done so with significantly less variability is what sets them apart. Healthcare expertise apparently helps to mitigate risk. Risk aversion also has a downside, of course. Specialists tended to produce fewer “blockbuster” deals (those with an internal rate of return of more than 100 percent) than generalists. ■

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