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Private Equity Practice

Private equity opportunities in healthcare tech

Although private equity firms have been hesitant to invest in healthcare tech, they have reason to invest in promising targets now.

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Healthcare technology companies have historically gotten less attention from private equity (PE) investors than they might warrant. Admittedly, healthcare tech is complex, making it difficult to understand the industry and identify good assets. Investors are already hesitant to invest in young companies. And many prospective PE targets in healthcare tech offer solutions in unproven markets that are vulnerable to disruption, further dampening investor interest. Investors may be especially dissuaded if deal sourcing and due diligence require substantial cooperation between interdisciplinary teams in healthcare and technology.

Despite these challenges, maturing healthcare tech companies can be good targets for PE firms ready to apply rigorous analysis and invest in growing companies in US and European markets. Healthcare companies with a strong technology component are valued, on average, at 17.1 times earnings, compared with 14.9 times average across the industry, with lower multiples for companies without strong technological components; for example, pharmaceuticals average 15.1 times and healthcare providers average 11.4 times (Exhibit 1).[1] In recent years, well-managed healthcare tech companies have performed even better, with some exits at 23 to 25 times EBITDA.

Structural factors create opportunities for further growth. Healthcare lags behind other industries on digitization. This tardiness is due partly to the difficulty of managing the range of stakeholders, regulations, and privacy concerns involved in digitizing records and processes that affect sensitive information.[2]

However, the industry will soon have no choice but to catch up—fast. Various trends, including funding deficits in public healthcare systems and price pressures on pharmaceuticals, have driven healthcare players to seek ways to reduce operating costs and improve productivity.[3] Meanwhile, an increasingly complex regulatory environment means that digital solutions are the best way to ensure monitoring and compliance in some parts of the healthcare market. These burgeoning digital needs translate into significant opportunities for healthcare technology providers, companies that provide technology-enabled solutions for healthcare industry players. In fact, the first cohort of European and US healthcare tech companies is now sufficiently mature for PE firms to consider as investment candidates. Especially attractive are ones that can become platform providers—entities that create and maintain the basis for data exchange, analytics, and user engagement.[4]

PE firms should invest in such companies now to capture disproportionate benefits. Here we highlight ways that these firms can identify winning healthcare-tech investments.

What is healthcare tech?

At its core, healthcare tech refers to technology-enabled products and services in healthcare. Distinct from medical devices and diagnostics, healthcare tech focuses on facilitating and enabling healthcare functions.

Healthcare tech is a vast, hyper-fragmented field. Individual companies may serve a specific vertical, such as pharmaceuticals, medical technology, providers, or regulators, in a portion of that vertical's value chain. In that context, individual companies usually fulfill a specific need—for example, digitizing core processes

[1] Dealogic; Multiples are calculated using data from announced (and not withdrawn) deals greater than $5 million for which transaction multiples are available. Only targets with target regions of North America, Western Europe, or developed economies in Asia–Pacific are included. Search terms for healthcare tech deals were "healthcare technology, software, and services" and "medical technology" and were then manually curated to match the definition of healthcare tech used in this article.

[2] Stefan Biesdorf and Florian Niedermann, "Healthcare's digital future," July 2014, McKinsey.com.

[3] Nikhil Sahni, Pooja Kumar, Edward Levine, and Shubham Singhal, *The productivity imperative for healthcare delivery in the United States*, February 2019, McKinsey.com.

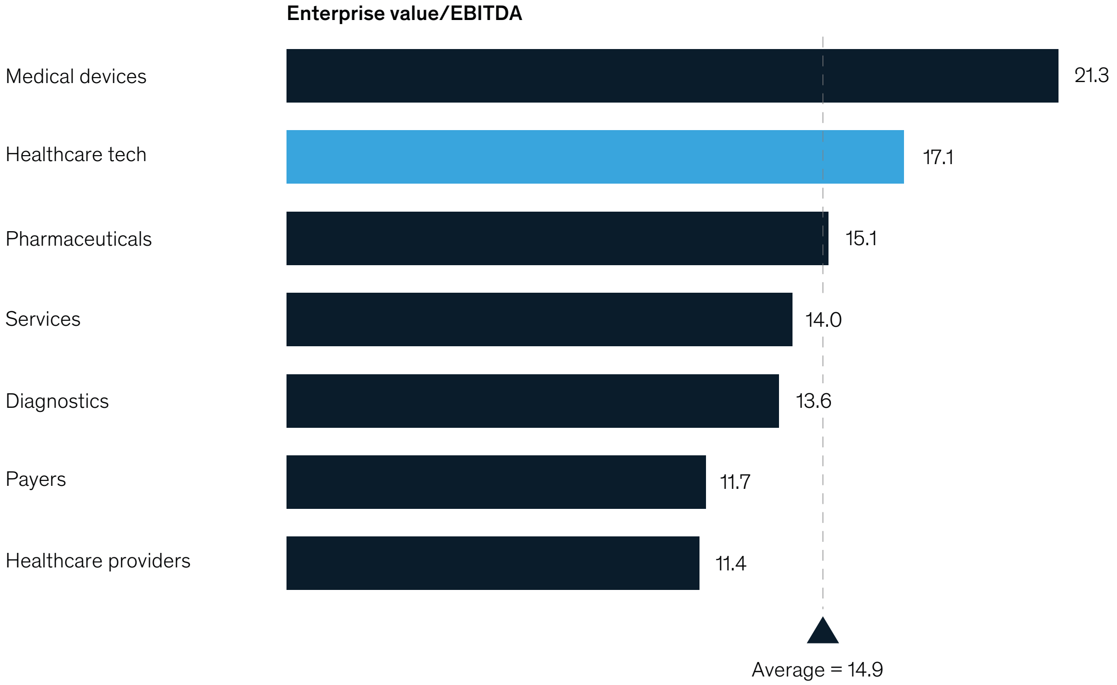
[4] Elina Onitskansky, Prashanth Reddy, Shubham Singhal, and Sri Velamoor, "Why the evolving healthcare services and technology market matters," May 2018, McKinsey.com.

[5] Preqin, press searches. Deal-volume data for all US and European PE deals in the healthcare sector was gathered using Preqin database's classification. Likewise for healthcare tech data, which was found by searching for the term "healthcare IT." There were no size restrictions for deals. All deals were closed between January 1, 2015 and December 31, 2018.

Exhibit 1

Healthcare tech multiples surpass those of most other healthcare subcategories.

Developed countries' deal multiples[1] by subcategory, Publicly reported, Jan 1, 2016–Jan 28, 2019



[1] Announced (and not withdrawn) deals above $5 million for which EV/EBITDA transaction multiples were available; only targets where target region was North America, Western Europe, or developed Asia–Pacific included.

Source: Dealogic; McKinsey analysis

or providing digital health solutions. Healthcare tech companies can provide or facilitate anything from electronic medical records to clinical-trial management software (Exhibit 2).

Nontech healthcare companies can sometimes have technological components that bolster their core (nontechnological) services or products. For instance, some companies provide services and products to support pharma companies' medical affairs functions, which often come with a software tool such as a workflow-management tool for publications.

Time to invest in healthcare tech

Often stereotyped as targets more suitable for venture capital than for PE, healthcare tech sees relatively few deals, especially outside the United States. Healthcare tech deals made up only 7 percent of European and US healthcare deal volume from 2015 to 2018, and 83 percent of global healthcare tech deals occurred in the United States over this period (Exhibit 3).[5]

Firms are reluctant to invest in healthcare tech for structural and cultural reasons, but discerning investors can find many opportunities in the industry, which is projected to grow 14 percent per year through 2023.[6]

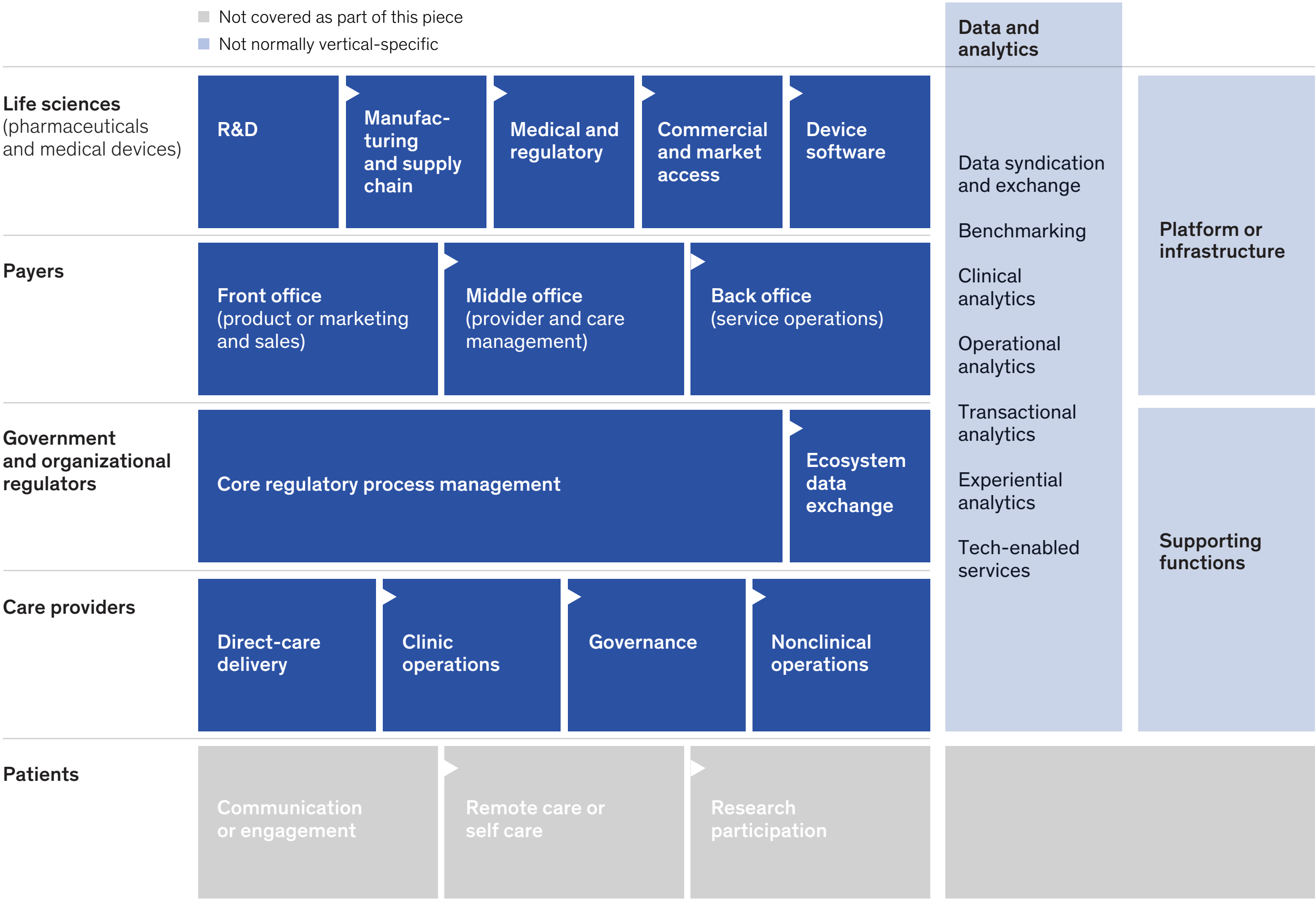
Historically timid PE firms

Before PE firms invest in healthcare tech, they must adjust their mind-set about pursuing targets that are smaller than typical PE investments. What's

[6] Sumant Ugalmugale, Ajay Devgire, *Healthcare information technology (IT) market size by solution*, Global Market Insights, April 2019, gminsights.com.

Exhibit 2

The healthcare tech landscape is highly complex and fragmented.



▨ Not covered as part of this piece
▨ Not normally vertical-specific

Life sciences (pharmaceuticals and medical devices): R&D; Manufacturing and supply chain; Medical and regulatory; Commercial and market access; Device software

Payers: Front office (product or marketing and sales); Middle office (provider and care management); Back office (service operations)

Government and organizational regulators: Core regulatory process management; Ecosystem data exchange

Care providers: Direct-care delivery; Clinic operations; Governance; Nonclinical operations

Patients: Communication or engagement; Remote care or self care; Research participation

Data and analytics: Data syndication and exchange; Benchmarking; Clinical analytics; Operational analytics; Transactional analytics; Experiential analytics; Tech-enabled services

Platform or infrastructure

Supporting functions

more, investors are sometimes unable or unwilling to underwrite high multiples for healthcare tech companies for fear that the assets are not worth their valuations; venture-capital funding tends to bid up healthcare tech companies' valuations, after which interested PE investors must compete against each other as well as established healthcare players for targets. However, the fear of unreasonably high multiples might be unfounded. Many healthcare tech companies serve growing markets, and market positions, once secured—especially as part of a platform or suite of solutions—are often defensible. Such assets are worth their higher multiples.

The fear of high multiples is related to the difficulty of identifying good assets from the large number of available deals and opaque markets. Due diligence in healthcare tech requires the ability to evaluate customer needs, competitive dynamics, regulatory pressures, differences among geographies, and emerging sectors—without a developed base of customers or many competitors as points of comparison. It can often be difficult to obtain accurate and comprehensive information about the relevant markets, making due diligence challenging. Exacerbating the complexity of deal sourcing and due diligence is the difficulty of effectively coordinating healthcare and technology teams within PE firms.

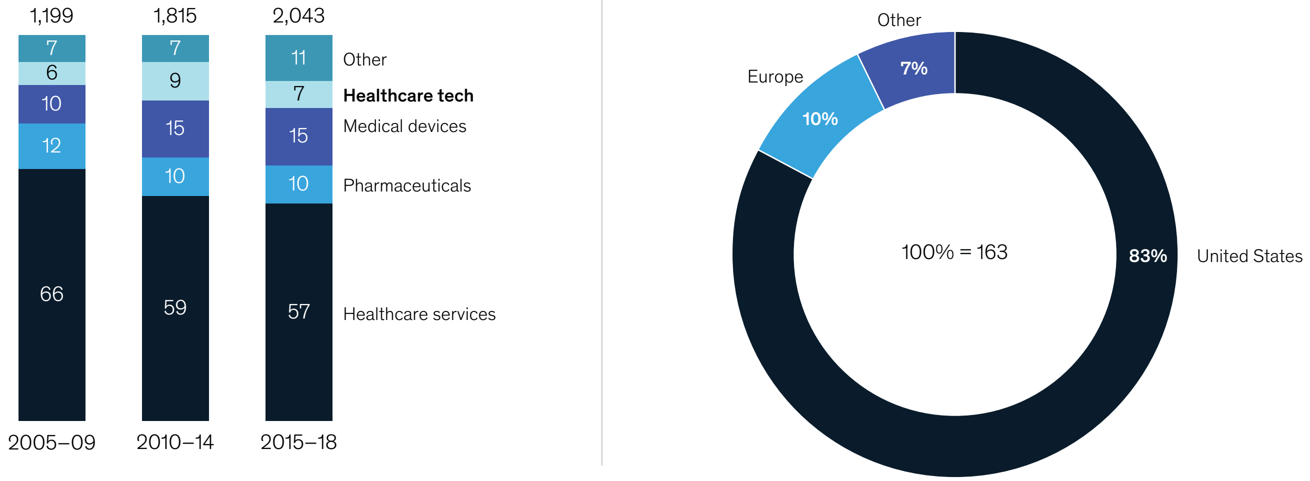
Healthcare tech investment from PE firms is also stymied by PE funds' fear of threats and disruption

Exhibit 3

Healthcare tech deals are still underrepresented in private-equity deals compared with other healthcare businesses, with the United States driving most of the deal activity.

European and US private-equity healthcare deal volume by subcategory,[1]
% of total private-equity healthcare volume
(100% = total volume)

Deal volume healthcare IT deals 2015–18,[2]
Total private-equity healthcare deal volume by region
(100% = total volume)



Note: Figures may not sum to 100% because of rounding.

[1] All US and European PE deals in healthcare sector as defined by Preqin database, regardless of size, between January 1, 2005 and December 31, 2018.
[2] All healthcare deals in all regions in healthcare IT as defined by Preqin, regardless of size, between January 1, 2015 and December 31, 2018.

Source: Preqin; McKinsey analysis

to healthcare tech companies. Threats include industry enterprise players that can organically enter the field through pre-existing relationships; disruptive start-ups; deep-pocketed, nonhealthcare corporates, such as large technology companies; and even customers' internal tools. However, careful due diligence that focuses on firms that are relatively insulated from short-term disruption can mitigate risks for PE firms.

Opportunities for PE firms that invest now

In the early days of the healthcare tech market, most healthcare tech firms presented more appropriate investments for venture-capital and growth-capital funds, but many are now mature enough to benefit from PE investment and guidance. Moreover, the first crop of healthcare tech companies, many of which were acquired by growth funds between 2010 and 2014, will soon be ready for PE consideration as growth funds prepare to exit after a typical five-year holding period.

Maturing healthcare tech companies have demonstrated a proof of concept, have won flagship customers, and are consistently profitable. The best targets for PE firms will come from the often-overlooked middle tier of companies that are unlikely to reach billion-dollar valuations but have the potential for double-digit growth. These companies can benefit the most from investment and expertise (Exhibit 4).

For example, electronic clinical outcome assessment (eCOA), medical affairs process management, and patient safety are areas where midtier players split the market. Because many healthcare tech solutions do not fully address customers' needs, good-to-great solutions can establish market leadership positions relatively quickly, even with sales cycles that can stretch into years.

Other than optimizing midtier companies in fragmented subindustries, PE firms can identify companies that provide function-wide platforms. Incumbents and corporates are already trying to establish themselves as platform providers, and those that succeed are likely to become the standard for their portion of the healthcare value chain. These companies can then grow and cement their position by providing analytics services for the data they gather. Because platform providers are exceptionally difficult to replace, companies need to become standard-setters now and win disproportionate returns later—or position themselves to be acquired at a premium by the eventual platform provider.

Timing is an important factor, regardless of the submarkets PE investors decide to address. Healthcare digitization means that firms that invest in healthcare tech now rather than later are more likely to capture value from growth within crucial markets. Entering the market now also means that PE investors can more easily roll up assets in fragmented markets and build scale and market share.[7] In fact, healthcare tech companies are already pursuing roll-ups: an eCOA company acquired seven small companies in the field between 2009 and 2017. Healthcare tech companies in diverse global markets are pursuing similar moves (see sidebar, “Creating value through M&A and roll-ups”).

Maximizing the odds of success in healthcare tech

The best way to ensure success in sourcing and evaluating deals in healthcare tech is to have PE firms’ healthcare and technology teams collaborate throughout the process. Unfortunately, this collaboration is sometimes difficult to achieve. Having teams with relevant industry and technical

[7] A roll-up occurs when investors acquire multiple companies in the same market and merge them.

Sidebar

Creating value through M&A and roll-ups.

For healthcare tech companies, strategic M&A and roll-ups can facilitate geographic expansion, allow companies to pursue adjacent business lines, and potentially monetize data.

One British patient-safety technology company combined with another in a different country to achieve a significant presence in their home markets. Similarly, a workforce-management company has successfully pursued acquisitions of companies that cover adjacent areas of healthcare-workforce management, including solutions for contingent-workforce payment and vendor management. Both of these approaches to expansion allow companies to gain scale and professionalize their operations more quickly.

However, safely gathering and monetizing data may be the ultimate accomplishment for healthcare tech companies. For example, to meet a wider array of customer needs and expand the amount of data it can aggregate, a provider of clinical-trial data-management software is moving into analytics and benchmarking by methodically acquiring companies that offer complementary products and services. As the components of its larger business evolve, the company is attempting to create an additional revenue stream from data as a service and as a subscription product. The company further supported the move with the recent acquisition of an industry-leading data-management and analytics company. As a result, its enterprise value increased fourteenfold in eight years. Thus, this approach can yield rich returns and augment an already strong position.

Exhibit 4

Private equity can tap into a ‘forgotten’ midtier opportunity across the healthcare tech landscape.

🟦 Most attractive area for PE investors

	Life sciences	Payers	Governments or regulators	Care providers
Enterprise systems: established players of $500 million+ revenue addressing enterprise-wide needs	Clinical trial management systems Procurement Customer-relationship management Core manufacturing systems	Pricing and underwriting analytics Provider credentialing and contracting software Enrollment- and account-management systems	Quality measurement and reporting Knowledge and content management Health information exchange Public-health signals Postmarketing surveillance systems (can be built in house)	Electronic medical records (EMR) Picture archiving and communication systems (PACS) Facilities management Supply-chain management, including procurement Radiology information system (RIS)
Established specialty players: systems specialized on a single task, established ability to address need, fragmented landscape of $20 million–$200 million revenue players	Electronic Clinical Outcomes Assessment (eCOA) Risk-based monitoring Medical affairs process management Medical information solutions Real-world-evidence (RWE) study design Regulatory reporting	Niche customer-relationship management Broker services Population health-management solutions Healthcare value analytics Risk coding or adjustments Payment integrity	Adverse-event reporting Signal detection tools and analytics	Patient safety and quality reporting systems Medicine or device tracking and monitoring Provider and vendor credentialing Contract and document management Retrieval of information Staff management Financial reporting Revenue-cycle management
Entrants or start-ups: ultraniche systems, unproven ability to address needs or revenue generation, hyperfragmented space of <$20 million revenue players	X-omics (eg, genomics, proteomics, transcriptomics) Real-world-evidence aggregators Digital diagnostics and digital interventions (eg, apps)	Network analytics or population health management Patient-facing engagement (eg, customer service, apps, etc) Machine learning–enabled payment integrity	Advanced analytics–linked signal detection and analysis	Telehealth Disease-specific clinical decision support Patient satisfaction or feedback

knowledge work together is not a new idea. But it is worth reinforcing how valuable it is for healthcare investors to retool their approach to incorporate technical expertise, including knowledge of the risk of disruption. Having access to both healthcare and technical experts will help investors evaluate the strength of the market as well as targets' core business and growth prospects.

Candidates must fulfill important needs in growing markets

PE healthcare candidates should be neither start-ups nor enterprise systems, and they should address an unmet market need. A way to diagnose whether a product meets a need is to ascertain whether customers have identified the problem and asked for solutions. This method should eliminate companies that simply provide interesting software from consideration.

The best candidates demonstrate new revenue-creation opportunities, increase the efficiency of existing processes, and reduce costs or risks. For example, material-tracking software in clinical settings, especially in surgical and critical-care environments, can capture data that allow hospitals and healthcare providers to improve clinical performance, procurement processes, and material-management practices.

Attractive markets should be growing and have room for growth. Investors can identify such markets by their low technological penetration, high levels of paper use, and regulatory trends that encourage or force the use of technological solutions. These traits are especially important because of healthcare customers' "stickiness" and long contract cycles, which make new-business development critical to sustained growth.

The best markets for healthcare tech companies that are interesting to PE investors are those that are not large enough to be appealing to enterprise players. In our experience, markets of less than $1 billion are safest for maturing healthcare tech companies because they are too small to appeal to large corporate investors. Such markets should also present material barriers for entry. Acquisition targets' products may not necessarily contain proprietary code, but they should possess advantages that aren't easily replicated by entrants from other fields. Such advantages include user-friendly interfaces built based on privileged customer relationships and specialized knowledge of stakeholders.

The company and its core offerings must be well regarded

By the time a company is a target of a PE firm, its solution should be comparable to competitors' offerings in its ability to meet customer needs. This assessment will likely require a combination of technical reviews and in-depth customer interviews to understand customer perceptions of the solution. Technological assessments from PE funds' technology teams will also be necessary to confirm that the target has a sound, flexible tech stack (the frameworks and tools developers work with).

Strong targets must have a record of customer success, which can involve a "soft" element that requires due-diligence teams to use perception to arrive at insights that aren't necessarily reflected in conventional metrics. Due diligence must therefore go beyond standard measures of customer experience such as customer satisfaction scores and include in-depth customer interviews to understand demonstrable customer impact and check for serious issues. Issues include risks such as high-impact events, often related to compliance, that could shatter credibility and damage key customer relationships.

Investors must also evaluate the company's operations to ensure that the right talent and processes are in place. Management should contain a mix of healthcare and technology experts who understand the solution and its opportunities for growth. Investors should also speak to nonmanagement employees to understand if best practices such as agile methodologies are embedded in the company.[8] To evaluate how well the company attracts and retains talent, investors should examine employee-churn data and interview a cross-section of employees for insights on the company's talent blind spots. If a PE firm decides to acquire a target, it must prepare to continuously invest in development—including talent, product, and customer service.

The company must be prepared and able to scale
PE-friendly healthcare-tech investments must be scalable. To keep up with growth, the tech stack must have the capacity for rapid increases in the number of jobs and users. To help the solution evolve as it scales, the company should have a clear road map for R&D, product improvements, and technology initiatives.

Similarly, the nontechnical components of the business must also be able to accommodate growth. To support increased demands, the company must have the ability to increase infrastructure such as customer service and implementation teams. As with technology road maps, the company should have a corresponding hiring plan, organizational structure, and training plan that accounts for future growth. Investors can learn about targets' scalability through interviews with functional leaders and in-depth independent assessments.

Not all solutions can scale beyond their original use case, so investors must confirm that targets' solutions have avenues for growth. For instance, some payment-management systems are specific to their provider environments and countries or were created to meet esoteric regulatory demands in their original markets. The due-diligence process should help investors make sure that no vertical- or market-specific elements could make a product difficult to scale beyond its original context. If a team does plan to expand, investors should confirm that plans exist to credibly mitigate the risk of encountering hurdles in new markets.

Finally, healthcare tech companies can grow by acquiring and repackaging proprietary data for their customers. Common uses of proprietary data are performance analytics and benchmarking. However, data-privacy regulations, the need for consent (often from patients), intellectual property, data quality, or simply a lack of customer participation often prevent companies from achieving this kind of growth. Companies that can overcome these common but substantial obstacles would have a rare advantage over their competitors that cannot aggregate and repurpose customer data.

European and US PE firms have a significant opportunity to capture value from strategic healthcare-tech investments. Investors that take decisive action while focusing on targets with growing businesses that compete in attractive markets, with strong prospects for growth, can benefit most. PE firms' trademark investment, expertise, and pursuit for continuous improvement in healthcare tech can generate investor returns while helping create better outcomes in healthcare.

[8] Santiago Comella-Dorda, Krish Krishnakanthan, Jeff Maurone, and Gayatri Shenai, "A business leader's guide to agile," July 2017, McKinsey.com.

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