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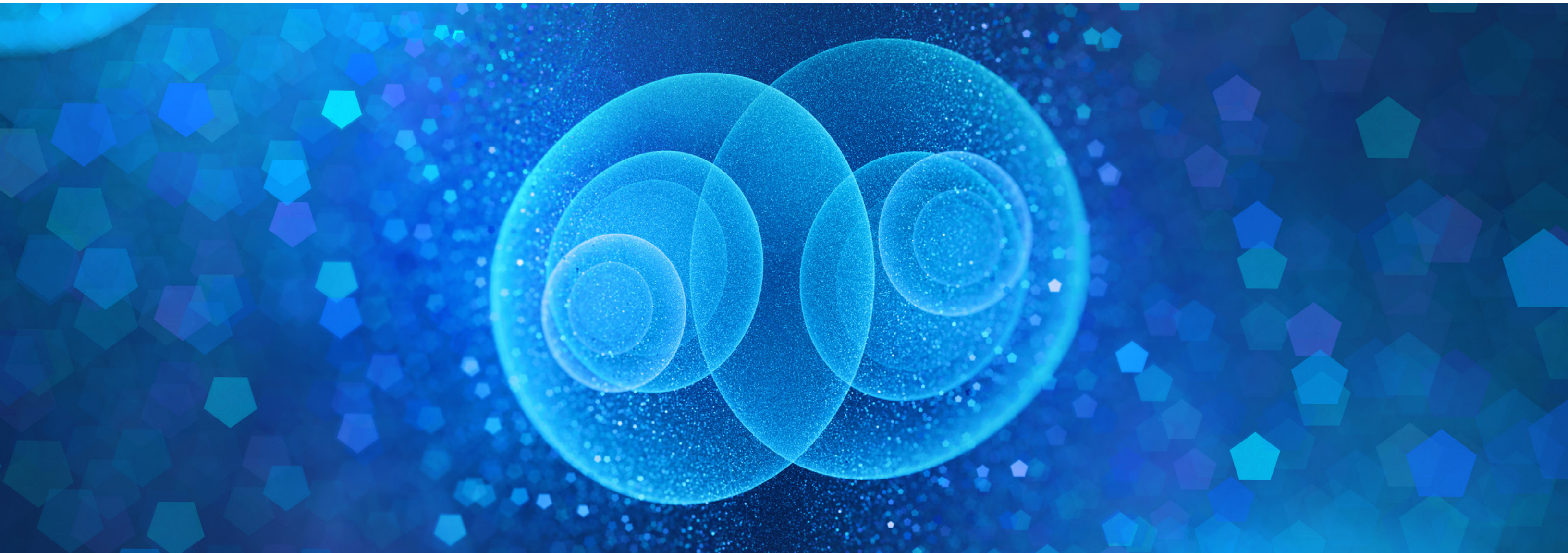

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Private Equity

The next act in healthcare private equity

Corporate divestitures offer untapped opportunities in the healthcare sector.

Clay Bischoff, Brian Fox, and David Quigley

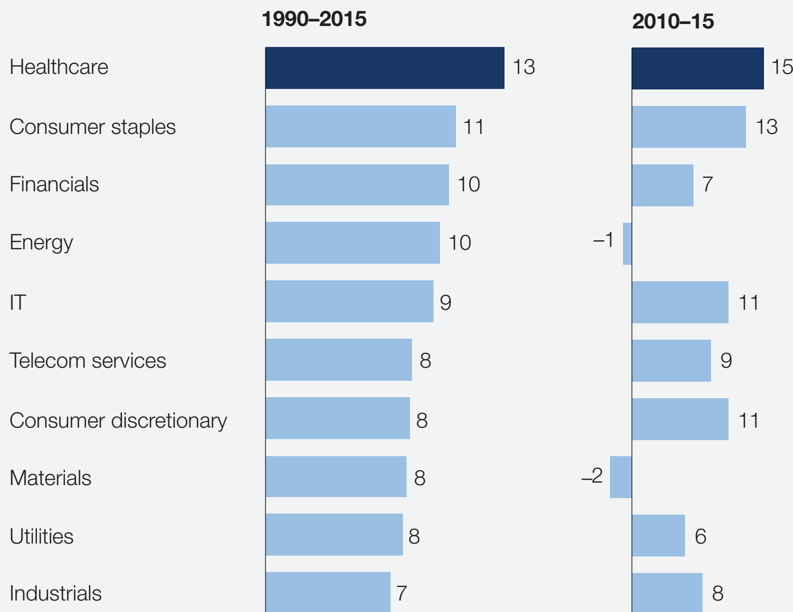
Buyout firms have taken an increasingly large role in healthcare, investing in the full range of companies: insurers, hospitals, pharmaceutical companies, medical-technology firms, and many kinds of service provider. Historically, success has come from making “smart bets” on companies well positioned to capitalize on an industry trend or shift. TPG’s buyout of Par Pharmaceutical and Clayton, Dubilier & Rice’s acquisition of Envision Healthcare are examples of investments that benefited from secular industry tailwinds. Those same factors have propelled the healthcare sector to a leading performance in public markets over the past five years (Exhibit 1).

While healthcare will continue to grow quickly, the traditional approach may run into problems. Valuation multiples are high, as private-equity firms often compete against strategic investors that can pay for synergies. Perhaps as a result, private investors are increasingly buying companies from their peers. In fact, 6 of the 11 healthcare private-equity acquisitions in the first half of 2016 were sponsor-to-sponsor sales. In many situations, the low-hanging fruit may well have been picked and is now being resold.

The source of growth in the sector is also shifting, in a way that does not play to buyout firms’ strengths. Biotech is driving a substantial proportion of the value creation in healthcare (Exhibit 2) yet is typically a difficult subsector for buyout firms to access. Venture capital is better positioned to invest in the early stages of these innovative, high-growth companies—and when they are mature, the companies command such

Exhibit 1

Healthcare has led all sectors in total returns to shareholders.



[1] Sample includes global companies with real revenues greater than $500 million in any year between 1985 and 2016. TRS calculated as compound annual growth rate and weighted for the market capitalization in each sector.

Source: McKinsey Global Institute analysis

high valuations that public-market investors are better positioned relative to private equity.

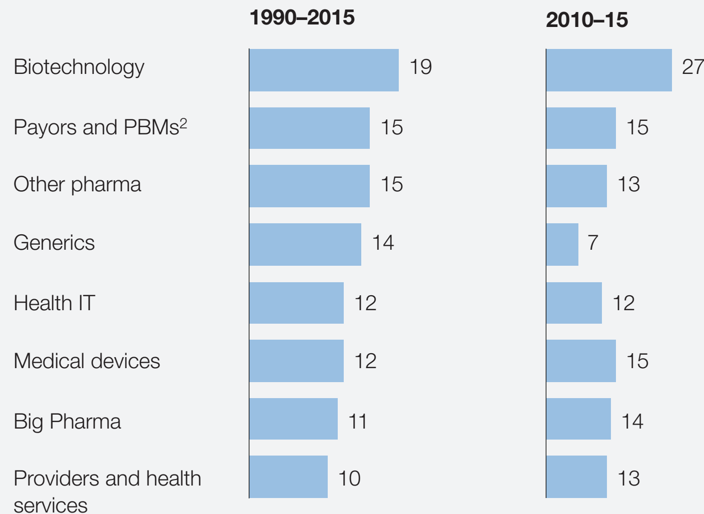
Within this context, private-equity firms must reach deeper into their playbook and find other ways to create value. While we see several exciting opportunities, the most interesting is probably the divestiture, which we define as the sale of a business unit or division from a corporate parent. These transactions can be complex, as the private-equity firm must typically convert business units into stand-alone companies. Yet we believe they represent a compelling investment opportunity for three reasons. Supply is increasing, as more companies are looking to sell a division. Price is often not the determining factor, meaning private-equity firms can avoid an auction. And the skills needed to stand up a new company, such as capital allocation and execution, are a part of many private-equity firms' arsenal.

More specifically:

- As pressure mounts on companies to maintain top-line organic growth and sharpen focus, more are looking to sell unwanted or noncore units. In certain situations, such as to win regulatory approval for a merger, companies

Exhibit 2

Biotech is the leading subsector within healthcare.



[1] Sample includes global companies with real revenues greater than $500 million in any year between 1985 and 2016. TRS calculated as compound annual growth rate and weighted for the market capitalization in each sector.
[2] Pharmacy benefit managers.

Source: McKinsey Corporate Performance Center

are required to sell some assets. Divesting makes sense for companies; our research has shown that corporates that actively reallocate capital produce total returns to shareholders of 10 percent annually, versus 6 percent for companies that reallocate only infrequently. Healthcare companies seem to be catching on. Excluding businesses that were spun out as stand-alone companies, corporate companies divested a record $115 billion of healthcare assets in 2015. The value of such divestitures was twice as high in 2013–15 as in 2010–12.

- Price is often not the only factor in divestitures, which often require the buyer and seller to negotiate two agreements, one governing the purchase and one the transition of services. Many buyers are not equipped to manage these types of complex deals; others are unwilling. Sellers also find it preferable to move quickly toward negotiation with a single bidder. Private-equity firms skilled in managing these negotiations have an advantage. Furthermore, private-equity firms can also cultivate relationships with healthcare companies that strategic buyers (that is, other healthcare companies) would find difficult to achieve. In this way, private buyers may get a head start on divestiture opportunities and avoid a multibidder auction.

- Many private-equity firms have capabilities well suited to transform underperforming business units into stand-alone companies and improve

their finances. Active private owners can add value through effective management changes (for example, adding leaders with a proven track record of success in running healthcare companies) and establishing regular and challenging dialogue with management through a new board of directors. Private-equity firms can introduce some discipline to the capital-allocation process and help their acquisitions pivot from capital preservation to funding ambitious growth and long-term strategic bets. These could include vertical integration (as seen, for example, in the acquisition of Nordion by GTCR's Sterigenics in 2014) or growth through highly strategic acquisitions (for example, under JLL Partners ownership, Patheon acquired a series of companies to broaden its service offerings).

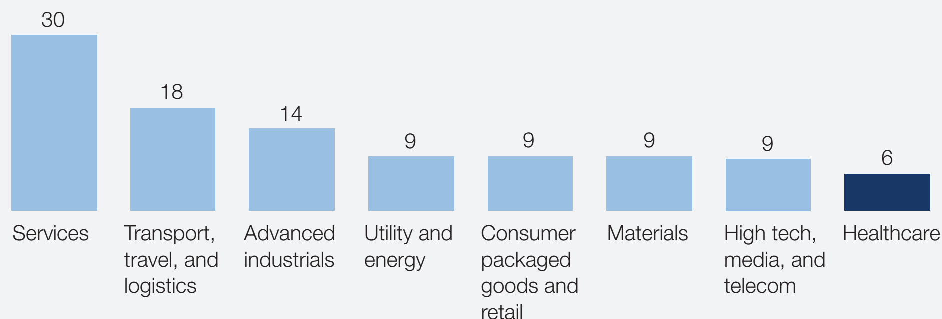
Corporate divestitures already represent a strong source of deal flow for private-equity investors in other sectors. And although data are scarce, we think it is likely that divestiture deals in healthcare generate a disproportionate number of "home run" deals. PMSI, Physio-Control, and DSI Renal—all private-equity acquisitions of corporate divestitures—are only a few examples of successful investments for their private-equity sponsors. Some firms found success in such deals. Water Street Healthcare Partners is perhaps the most active; more than 40 percent of its deals are sourced from corporations. It invested in CareCentrix, a divestiture from Gentiva that provides services for home healthcare, and made it one of the fastest-growing companies in healthcare before exiting in 2011. Similarly, the company invested in OraPharma (Johnson & Johnson's oral-health business), accelerated its growth, and eventually sold it.

Nonetheless, private equity acquires fewer carve-outs from healthcare companies than it does in other sectors (Exhibit 3). Private-equity investment represents only 6 percent of all healthcare

Exhibit 3

Private equity invests comparatively little in healthcare divestitures.

Private equity's share of total divestitures, 2010–H1 2016[1]
%



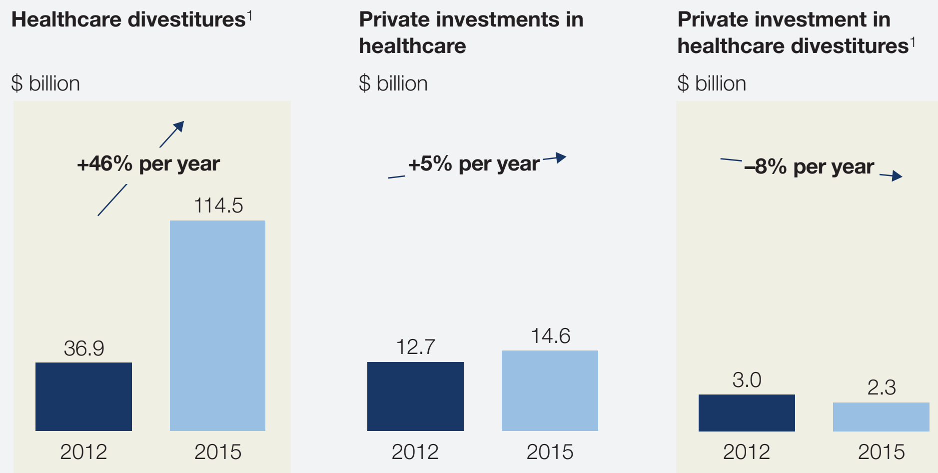
Note: Includes only majority-stake acquisitions.

[1] First half of 2016. Corporate divestitures greater than $25 million—does not include sales by private investors; acquirer is private investor; excludes spinoffs.

Source: Dealogic; McKinsey analysis

Exhibit 4

Private investment is not keeping pace.



Note: Includes only majority-stake acquisitions.

[1] Corporate divestitures greater than $25 million—does not include sales by private investors; excludes spinoffs.

Source: Dealogic; McKinsey analysis

corporate-divestiture activity. Furthermore, that investment has not kept pace with total healthcare private-equity deal volume or total divestiture volume over the past three years (Exhibit 4). The formidable competition from corporates is a contributor to this trend; many leading healthcare companies enjoy a synergy advantage and are able to bid more aggressively against private-equity firms for assets. This advantage is particularly powerful when the business unit that is being divested shares cost infrastructure with its corporate parent (for example, sales force, finance, IT). Healthcare corporate acquirers can absorb these business units without needing to invest in this cost infrastructure, while private-equity firms must not only figure out how to disentangle the business unit from the parent but also invest to stand it up as its own company.

Beyond the synergy factor, a simple lack of focus among private-equity firms is likely another reason why deals have not happened. For several years, growth-oriented healthcare investors have enjoyed an abundance of attractive investment opportunities; divestitures are typically more work for the acquirer and often have a less exciting revenue-growth profile (often a reason why they are being divested). As the bar gets higher to find deals and deliver returns, private-equity investors should be more proactive: they should seek opportunities to develop stronger relationships with companies that are reevaluating their portfolios and refine the skills needed to complete a divestiture deal. ■

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