

New Insights into Private Equity in the US Healthcare Space: Balancing Economic Efficiency with Patient Care Quality Using Novel Metrics

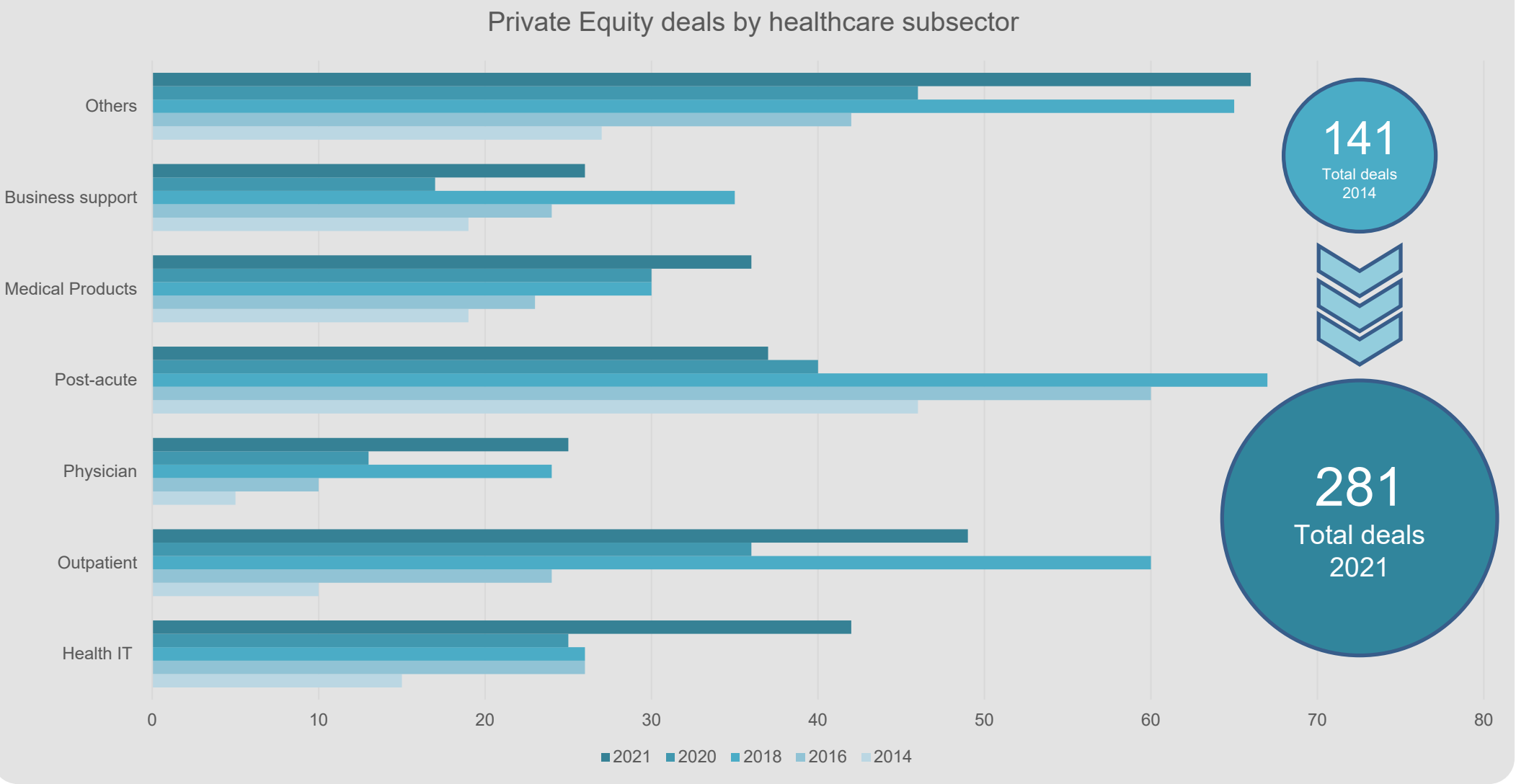
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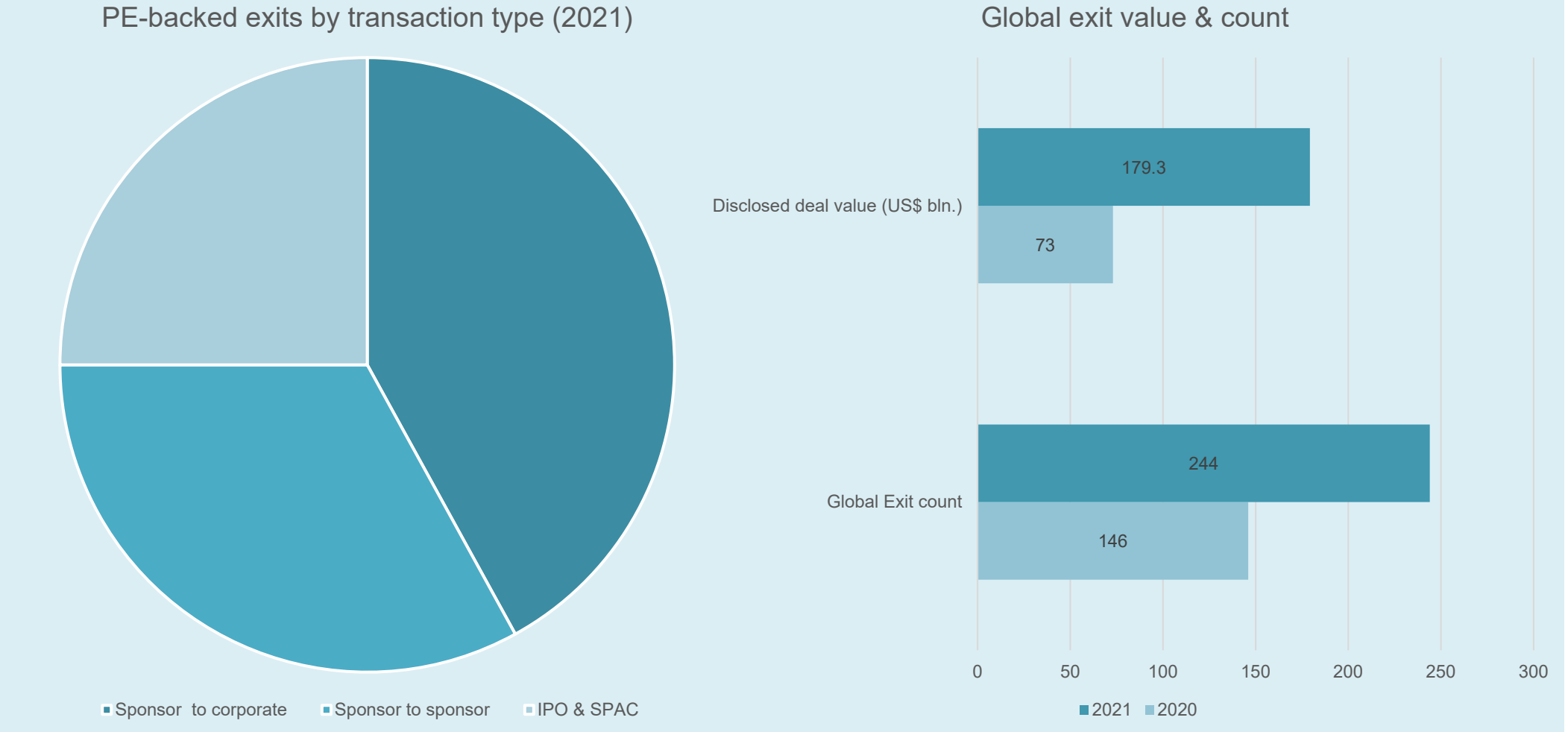
What is Private Equity?

Private Equity (PE) is an alternative investment class that enables institutional investors to acquire unlisted private companies through a fund vehicle provided by the PE firm. The acquisition process by PE firms entails a majority stake investment (>50%) or a full leveraged buy-out. Upon acquisition, PE firms often employ aggressive growth strategies to generate value. Typical exits vary, but most are commonly between 3-7 years after acquisition. PE funds charge higher management fees than other investment classes. Unlike asset managers, PE firms take on an active role in the management of the asset, often installing handpicked senior executives. Furthermore, PE investments usually take on large debt financing to leverage their position and gain a controlling stake which significantly increases the risk of future bankruptcy. PEs are disproportionately rewarded on profitable exits (carried interest) when an investment performs well while not carrying the traditional investment risks. In terms of healthcare's "public-good," quality-of-care and accessibility need to be identified as the most important metrics in benefiting society. This raises the question whether aggressive PE strategies, through optimization in single/few dimensions such as staffing, end up benefiting the patient or if this simply allows PE to generate profit while failing to improve the quality of care.

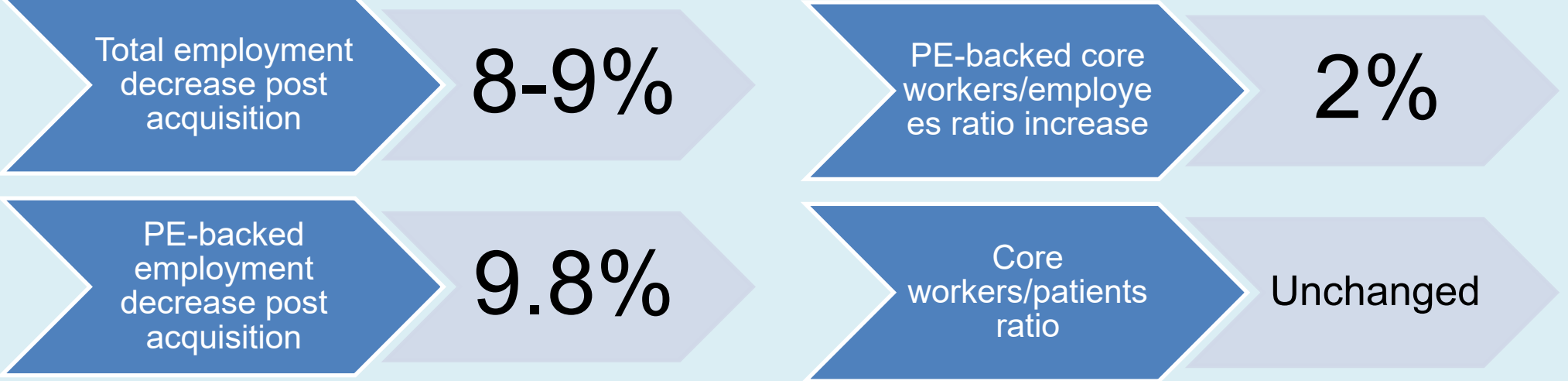
Private Equity Deal volume



Post -acquisition metrics



From a 2022 Indiana University study:

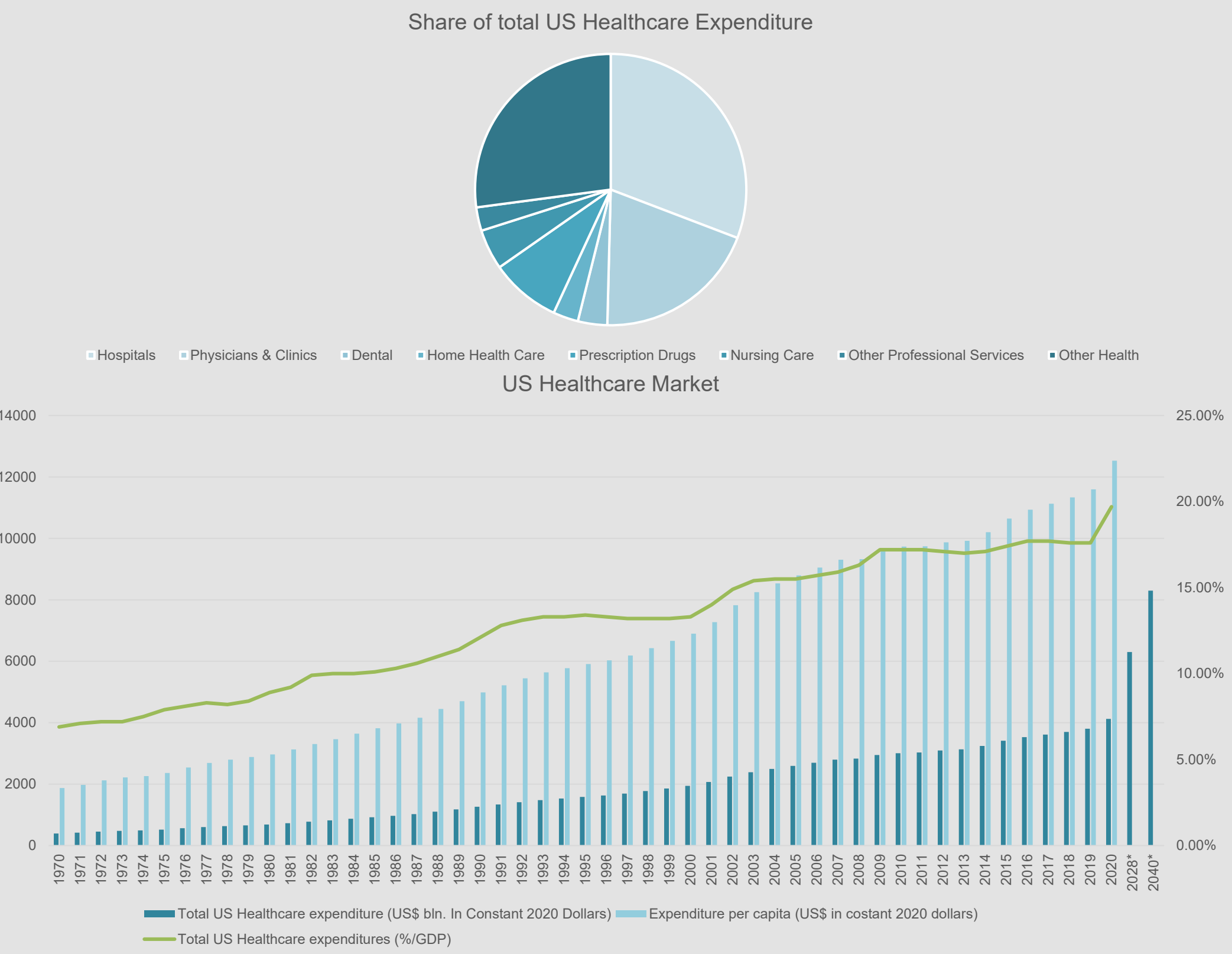


Discussion

The involvement of PE in healthcare has exploded in response to the pandemic and forces disrupting the medical sector. PE-backed acquisitions have doubled since 2014, particularly in the outpatient subsector. From a financial standpoint, PE often outperforms other investment classes. The AHIP states that PE-backed hospitals earn 30% more revenue than facilities owned by other entities. Although we have observed cases in which PE-investments fail through the over optimization in single operational aspects such as staffing, one must always consider the larger scope of the healthcare sector and the importance of quality of care. The negative connotations of PE's aggressive growth strategies will always attract public debate, as seen in the case study. Nonetheless, PE functions similarly to all other profit seeking corporations in the sense that cost-cutting strategies and increased prices underly all businesses that seek to generate bottom-line growth. The difference lies in exit strategies and the short-term nature of the duration an asset is held. Hence, do PE-investments incentivize overly aggressive cost-cutting strategies to facilitate profit in the short run? Considering this question in the context of a healthcare system will always be under close public scrutiny, is widely fragmented payment system and lacks accessibility, ambitious PE investors need to consider wider social issue in any investment decision. Is there enough room to tolerate potential investment failures in the medical field?

American Healthcare sector

- Expenditure as % of US GDP: 19.7%(2020)
- Total Expenditure: US\$ 4.1 tln. or \$12,530 per capita
- Hospital sector comprises >70% of Market share
- EBITDA 2017 -2019: 5%(US\$ 561 bln.)
- 1 in 4 adults have two or more chronic health conditions



Outlook:

- Projected EBITDA 2022 -2025: 6%(US\$ 696 bln.)
- Projected total expenditure: US\$ 6.3 tln. (2028*) and reach US\$ 8.3 tln. (2040*)

Despite strong top and bottom-line outlooks, macroeconomic factors may create headwinds due to high inflation. A study conducted by McKinsey estimated that these factors could dent EBITDA prospects by US\$ 70 bln.

COVID Implications

The COVID-19 pandemic has had a significant impact on the healthcare industry. The period was difficult for both payers and providers. On the other hand, innovation and development have scaled up since 2020, with a focus on a shift to outpatient care, more holistic health services, and increased digitalization. As a result, care-delivery services have seen the strongest growth in the healthcare sector in 2021. Following the pandemic, there have been three primary trends in the North American healthcare sector, including changes in population demographics, changes in medical care payment methods, and the growth of the outpatient sector.

Forces shifting the medical sector:

Evolving payer mix:

- Older, aging population leads payer shift towards the government segment through Medicaid/Medicare
- Medicare advantage has become more popular than fee-for-service Medicare
- Post-pandemic recovery causes a shift from Medicaid to private medical insurance resulting in increased reimbursement rates which improve margins for providers

Shift to Outpatient care:

- Increased replacement of high-cost acute-care (8-10% EBITDA) to post-acute sites (15-25%EBITDA) lead to lower costs amongst providers
- Increased demand for home-care and virtual services
- Hospital segment expected to fall to 44% of provider revenue by 2025
- Hence, providers are likely to benefit from stronger profit margins

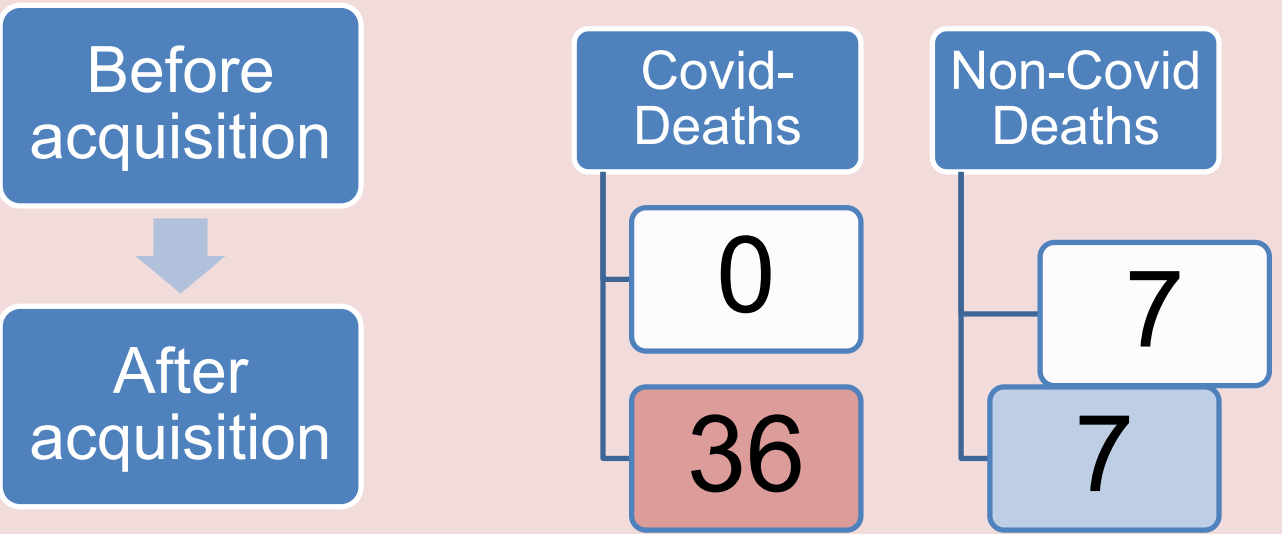
Worsening of chronic conditions:

- Chronic disease burdens have increased in recent years
- Likely to grow further as population has growing share of elderly people who require more medical care
- COVID-19 has led to a lag in receiving vital health care and checkups as the population tended to delay their visits during the pandemic.

Case Study: Nursing homes

- Target: St. Joseph's Home for the Aged
- Richmond, Virginia
- Previous Owners: Little Sisters of the Poor (Religious Institution)
- Acquisition date: June 2021
- Acquirer: The Portopiccolo Group
- Deal value: undisclosed

Following the acquisition of the nursing home, Portopiccolo implemented their own management under Accordius-Health. Within weeks, daily caretaking staffing was cut by 40-60% Reports show that some mornings only two nursing staff members worked a facility housing 72 elderly. Furthermore, Accordius filed a license to accommodate for "higher-need" patients. Such patients can be charged higher rates through the Medicare program to generate more revenue. Ultimately, the home was closed due to public scrutiny, non-delivery of services and failure to contain a Covid-outbreak. This acquisition portrays a clear failure in management. Thus, this questions PE's ability to generate investor profit while maintaining adequate quality of care. In this case, opportunities to generate efficiencies come at the cost of patient care. Hence, one must very carefully consider the balance between business efficiencies and quality of service to successfully operates in the healthcare space.



Recommendations

To further investigate the extent to which private equity impacts the medical sector, it is helpful to compile and compare similar case studies from other geographical regions in the North American market. Given the highly fragmented US medical system, the implications of PE investments in healthcare likely vary elsewhere.

Furthermore, it would be informative to observe the shift to medical technologies and wearables. Following the pandemic, I hypothesize that the general population has become significantly more aware of their health and wellbeing. We see an uptick in demand for preventative care and virtual consultations, taking the healthcare sector by storm. These subsectors may allow for more leeway between customer benefit and aggressive growth strategies. Thus, we must ponder if investments in such subsectors allow for more aggressive growth strategies through PE management. Since this sector does not directly involve vital patient care, would this pave the way to a stable middle ground between seeking profit opportunities and offering the public the best care possible?

Acknowledgements

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