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DEALMAKING

The 'huge potential' of healthcare

Technological advances are creating opportunities in the medical sector for private equity firms prepared to embrace innovation, say Baker McKenzie partners David Allen and Jane Hobson

Investment in healthcare has moved up the agenda of many large buyout firms in recent years, with healthtech emerging as the latest new asset class for the industry. Here, David Allen and Jane Hobson, partners at the law firm Baker McKenzie in London, explain why healthcare transactions are gathering momentum.

Q Why are we seeing private equity investment in healthcare increasing? What is it that makes the sector so attractive to potential sponsors?

Jane Hobson: When we talk about healthcare, we are talking about a very far-reaching industry covering pharmaceuticals, medical devices and healthcare services. Historically, private equity firms have been quite risk-averse and were not interested in anything early-stage or in development, because they couldn't guarantee returns, and so the focus was very much on hard assets such as hospitals and care homes.

More recently, we have seen more interest in medical devices and medtech, with quite a lot of carve-outs and divestments starting about five years ago, when there were really just a few private equity firms in the mix. Now we are seeing a lot more funds getting into the space, with more interest in pharmaceuticals, therapeutics, oncology, diagnostic tools and other more innovative areas.

David Allen: A decade ago, private equity firms that invested in healthcare did so through generalist teams, but we are now seeing the bigger funds developing dedicated healthcare strategies and sometimes raising healthcare funds. Those teams can invest in a broad way across the sector and understand the interconnectedness of the industry. For example, by investing in a hospital you learn about the purchasing decisions a hospital makes. This then makes you better informed when investing in product suppliers to hospitals/clinics.

> ***Healthtech presents an opportunity to combine the skills of the technology teams within PE firms with the skills of the healthcare teams***
>
> **David Allen**

Another reason that healthcare is so attractive is that these firms' investors are increasingly focused on the ESG impact of investment decisions. The societal impact of investing in healthcare can be compelling, where a portfolio company is demonstrably improving healthcare systems around the world or delivering better patient outcomes.

Q You describe healthtech and medtech as the latest new asset classes for private equity. Why?

JH: Healthtech includes preventative or analytic systems, like fitness trackers or diet planners, as opposed to medtech, which is more about the cure-based technologies used in hospitals. Private equity is getting increasingly interested in both, and everything in between, targeting the sophisticated medical devices and technologies becoming available to treat patients. This trend is particularly driven by a lot of the larger medical device companies spinning out whole non-core businesses that

Q What additional challenges do buyers face in relation to the increased regulation around healthcare transactions?

JH: In recent years, several merger control authorities, including Germany and Austria, have introduced thresholds that depend not on the revenues generated by parties but rather on the value of the transaction. This can trigger in healthcare because when buying technology or R&D-based businesses, there may be no revenues being generated but acquisitions may still require a notification, creating new hurdles to jump through. We also see an increase in foreign investment regimes shining a spotlight on healthcare deals, with most of these businesses being global and triggering filings in several markets because of the nature of the assets in relation to public health. Furthermore, where we are talking about the data of one country's subjects getting into the hands of another, there are added sensitivities.

How easy it will be to do transactions driven by data in the future remains to be seen, and all of those additional regulatory hurdles will have a particular impact when it comes to healthcare deals.

***Hobson**: deals can take two or three years to complete*

***Allen**: easy to articulate ESG impact of healthcare*

can quickly allow an incumbent to establish a big footprint through one transaction.

Going forward, there is a further angle to be exploited in medtech around the manipulation of data. Combining advanced data science skills with medical knowledge and commercialisation expertise is a huge potential area for private equity. Such deals are not easy, because different world regions have different approaches to how data can be used, and the challenges are heightened by the involvement of governments paying close attention through foreign investment reviews.

DA: Healthtech presents an opportunity to combine the skills of the technology teams within PE firms with the skills of the healthcare teams, to collaborate and bring different perspectives. Private equity can also add a lot of value through its understanding of the way that the consumer operates across so many asset classes, bringing an ability to triangulate tech, healthcare and consumer insights, which many companies struggle to do.

Q Why are healthcare carve-out deals proving so attractive, given how complicated they are to pull off?

DA: If you speak to any large-cap private equity firm today about the type of deals they are getting excited about, most will point to carve-outs and/or take-privates. Carve-outs are complicated because they involve effectively taking a division out of a larger corporate, where everything was previously entangled and where the corporate had probably undervalued the asset and perhaps neglected it, because it was non-core and the management team was not adequately incentivised. Once an independent management team is running the business, with skin in the game to drive value, then suddenly you can see great results in terms of performance.

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Carve-outs are really hard to do generally, and doing those deals in healthcare really takes the complexity up quite a few more notches, partly because private equity does not have the infrastructure required to be absorbing the assets, ie, the newco structure won't yet have any healthcare regulatory approvals.

JH: The need to set up a global pharma or medical devices business quickly is one of the main sources of complication and explains why these deals typically take two or three years to complete. Add to that the regulatory environment, where new companies need to be set up in new markets and are typically required to be immediately fully licensed, and it gets more difficult; you cannot simply transfer the licenses from the seller because the licenses will still be required in the retained business. Then there are the systems – you need to build an IT infrastructure that enables you to do what you do across the world, setting up all the necessary operating models.

You need a lot of support from the seller to close these deals, which often means delivering a series of local closes that allow you to turn off support from the seller in phases as different markets move faster than others.

DA: In the context of a competitive carve-out process, private equity has that additional execution complexity that it needs to get over compared to a strategic buyer. But once completed, a fund has a portfolio company that is able to behave as a strategic and make acquisitions with that infrastructure already in place. ■

***David Allen** leads Baker McKenzie's global private equity and funds team. He is primarily focused on M&A and restructurings for private equity funds, infrastructure funds, pension funds and other clients. He is also an expert on equity incentive structures and has extensive experience in Japan.*

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