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Growth equity in healthcare: new opportunities for private equity

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Healthcare investments have been a favorite of private equity investors for more than a decade. Throughout 2023, reported North American healthcare buyout deal values topped $29 billion, and almost $60 billion globally. See Heathcare Private Equity Market 2023: Year in Review and Outlook, Bain & Company, Jan. 3, 2024, https://bit.ly/4aXQDcC.

As competition to invest in mature healthcare businesses has increased and investors seek to maintain returns, growth equity has emerged as a strategic focus in the healthcare space. While growth equity investing is not new, it is increasingly recognized as a separate and distinct asset class with unique returns, strategies and risks for both sponsors and the limited partner community.

Why growth equity?

Growth equity investing typically focuses on businesses that occupy the space between very early-stage businesses favored by venture capital and more established businesses often targeted by traditional private equity. On the one hand, many growth-stage businesses are not yet profitable, may not be open to a control investment, or might be highly complicated, which makes them less appealing to traditional private equity.

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However, these businesses are ripe for growth equity and have idiosyncratic alpha, the element of return which cannot be easily replicated and is, in this way, unique. On the other hand, growth-stage businesses are generally more established than venture-stage businesses and have begun to demonstrate market traction and differentiation from their competitors. This mitigates risk of loss to a certain extent and allows investors to work with management teams to focus on driving growth, as opposed to staking an initial foothold in the market and attaining operational stability.

Growth investors are often drawn to the flexible capital arrangements, idiosyncratic alpha and opportunities to lean into and transform purpose-built businesses throughout the growth cycle. By their nature, growth-stage businesses are typically smaller, more agile, less risk-averse and more growth-oriented than their mature counterparts.

These characteristics invite structured equity investments where founders and management retain a significant equity stake in the business, thus limiting the upfront capital investment required to play in the space and providing appropriate down side protection for increased risk. The key in structuring a growth investment is to ensure that the incentives of founders and management remain aligned with the incentives of the business and, by extension, their investors.

By their nature, growth investments offer significant opportunities for investment returns, particularly where lack of integration or an underinvestment in experienced management or technology is an impediment to growth. In both instances, a successful growth equity investor can seamlessly leverage its experience, resources and network to break down barriers and unlock unrealized growth potential in the business. Often, the growth equity investor is the first source of institutional capital for a business and the first outside party to come in and optimize the business, which can lead to higher operational return on investment than is generally found in traditional private equity investments.

Opportunities in healthcare

While growth equity investment opportunities exist broadly across the healthcare industry, certain sectors have garnered particular attention from investors in recent years, including life sciences (such as the research, development, and manufacturing of pharmaceuticals, biomedical technology, medical devices, and similar products and services), healthcare services (the provision of healthcare, including through managed physician practices) and medical benefits management (the management of health insurance and other medical benefits by a third-party service provider).

Life sciences businesses, particularly those that service the life sciences end-market (where the final transaction takes place in the life sciences value chain), tend to be very high quality and offer protection against loss and asymmetric opportunities for investment returns.

For example, pharmaceutical companies and other life sciences end-market businesses tend to avoid changing suppliers and other service providers once a relationship has been established due to the regulatory infrastructure governing those relationships, including licensure requirements, governmental approvals, and other restrictions. They are also generally somewhat price-insensitive and highly quality-focused, which affords their suppliers and other service providers a degree of protection against loss while offering derivative exposure to a market that has exponential growth potential.

Healthcare services businesses have recently been experiencing pressures from rising labor costs, lackluster valuations (at least as compared to the frothy valuations of the recent past) and over-indebtedness, most of which can be resolved or ameliorated by an infusion of structured, flexible, equity capital.

One strategy of growth equity investors in the healthcare services space is to drive efficiency by moving as much care delivery as appropriate out of the hospital setting, where costs are often highest, to non-hospital providers like ambulatory surgery centers, clinics, and other physician practices, and helping providers be more efficient when care cannot be adequately provided outside of hospitals.

Opportunities also exist for medical benefits management businesses to mitigate health insurance costs, which are now often one of the largest expense categories for employers. Many employers have found that their service providers are ill-suited to drive innovation and have begun reexamining how they procure, pay for and manage medical benefits. This has created a substantial market opportunity for new, creative businesses capable of bending the cost curve and delivering value to employers and their employees.

Finally, as in any vertical investment, quality healthcare businesses in any subsector that have a strong management team, a proven, differentiated business model, and a compelling mission will continue to generate strong investment interest.

The challenges

Growth equity investment in healthcare is not without its challenges, many of which arise as a function of the relatively early stage at which growth investments are typically made. These businesses are often managed by founders whose background may be in healthcare instead of business or finance and who therefore may initially view investors not as strategic partners but as little more than a source of financing.

For this reason, it is imperative that investors educate their new partners as to the basic private equity business model, the strategy underlying non-controlling structured capital investments, and their experience, track record and resources. Growth equity investors should emphasize their successes as well as their institutional knowledge, operational expertise and access to new markets and suppliers.

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Upfront alignment of goals, incentives and expectations is especially crucial in the case of minority equity investments where the founder or pre-investment management team retains overall control of the business. Alignment is much simpler to achieve when the credibility of the investor is established early on and when all parties understand from the outset the mutual end goal and the strategy to get there.

Just as important as forging strong partnerships through mutual trust and alignment is the ability to identify which prospective partnerships are not going to work prior to committing considerable time and capital. Early conversations with the management team and thoughtful, focused diligence (both financial and legal) are paramount.

Experienced advisors who know how to uncover potential pain points and liabilities often pay for themselves many times over by knowing how to mitigate those risks on the front end or, alternatively, when to spare the cost of remediation and walk away.

Path forward

We expect to continue to see increased deal volume in the growth equity space across the healthcare industry. The challenges of the healthcare industry necessarily require evolving and sometimes novel solutions and business models that are driven more and more by entrepreneurial innovation and technology.

Technology and innovation are key components of growth equity deals. As investors compete to put dollars to work, the intersection of the development of technology and new or adapted business models in the healthcare industry will offer growth investors the opportunity for attractive returns.

About the authors

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