Health Care's Silver Lining

MID-MARKET TRENDS // Sector to see strong growth despite recession fears

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Robust middle-market leveraged finance activity remained steady in the second half of 2018. However, mounting concerns that a recession may strike within the next 18 months have led investors to gravitate toward health care, with an increasing number of private equity and lending firms eyeing deals in the sector for the first time. Despite a consumer-driven shift, the overall health care industry is expected to perform better than most in response to demographic trends, necessity of care, the inability to send services overseas, and the continued existence of government programs like Medicare and Medicaid, which constitute a growing share of the payer universe.

Lenders with little to no experience in health care are investing in the space with the expectation that the sector will act as a shelter in the storm—an area where opportunities will continue to emerge, and dry powder can be put to work during the toughest of economic times.

WE EXPECT THE REMAINDER OF 2019 TO BRING REGULATORY CHANGES, REIMBURSEMENT CHANGES AND MYRIAD MARKET FLUCTUATIONS.

While there was a drop-off of middle-market investment in early 2019, robust opportunities continued for direct lenders. One subsector of health care that has experienced significant M&A activity in the past few years is physician practice management, which includes specialty areas such as dermatology, dental, optical, orthopedic, gastroenterology and urology. We expect the subsector to remain attractive to investors throughout 2019.

There's also a pipeline of activity in urgent care, companies tied to providing services for clinical trials, companies that are providing care to highly acute populations, and the medical device sectors. Finally, deals that private equity firms invested in from 2014 through 2016 should be coming to market in 2019, which should generate significant activity in secondary exits.

Alongside the overall uptick in health care deal flow comes increased lender appetite as new entrants vie for a piece of the pie. And that's where danger can emerge. Health care companies and private equity firms must conduct due diligence prior to selecting a lender with whom to partner. Expertise and a track record in health care lending is key.

For example, a lender looking at a lower middle-market health care deal for the first time may quote leverage based on the size of a company without understanding some of the fundamental risks, such as potential regulatory or reimbursement changes, or human capital risk. Simply put, it's important for a sponsor to partner with a lender who has deep experience, expertise and a track record of financing middle-market health care transactions.

We expect the remainder of 2019 to bring regulatory changes, reimbursement changes and myriad market fluctuations. Whether lenders will run to the health care market or run away from it remains to be seen.

Regardless of where we are in a cycle, we see an opportunity to provide capital for backable, solid deals, and we expect middle-market health care to be a bright spot for investors when the cycle inevitably turns. //

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