



## Private Equity and Healthcare: A Perfect Marriage?

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On June 18, 2021, a panel of academic researchers and a practitioner met to discuss the nature of private equity investments in the healthcare sector. The discussion addressed the increasing interest of private equity investors in the healthcare sector and the benefits and challenges of these investments. The panelists were **Amitabh Chandra** (Ethel Zimmerman Wiener Professor of Public Policy, Harvard Kennedy School and Henry and Allison McCance Professor of Business Administration, Harvard Business School), **Ashvin Gandhi** (Assistant Professor, Anderson School of Management, UCLA), and **Clay Richards** (Chief Executive Officer, naviHealth). The discussion was moderated by **Victoria Ivashina** (Lovett-Learned Professor of Business Administration, Harvard Business School).

In 2019, private equity investments in the U.S. healthcare industry totaled \$46.7 billion, up from \$29.6 billion in the prior year,<sup>1</sup> yet much is not understood about the impact of these investments. There is much debate about whether PE firms improve the performance of healthcare companies and generate better returns, or instead weaken the long-term health of these companies with greater indebtedness, minor improvements in quality, and soaring prices on healthcare services for consumers.

Assessing these claims is complex. Media accounts have generally focused on cases that illustrate the negative aspects of private equity investments in healthcare. The general worry is that because PE acquirers are highly profit-motivated, they may be more likely to exploit market power, raise prices, or lower quality. Also, PE may be more willing to employ capital structures that are riskier or short-term in nature. However, many studies suggest the healthcare sector is

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<sup>1</sup> “2020 Vision: Healthcare private equity sees record year with disclosed deal values climbing to \$78.9 billion,” *Bain & Company’s Ninth Global Healthcare Private Equity and Corporate M&A Report*, March 9, 2020, <https://www.bain.com/about/media-center/press-releases/2020/healthcare-private-equity-report/>.

a laggard in productivity.<sup>2</sup> The tools of private equity may be able to improve the operational and financial performance of healthcare companies. Moreover, venture capitalists have provided the funding for the development of life-saving drugs. Even credible academic assessments are difficult in this arena, because it is often hard to fully trace out transactions (e.g., roll-ups of multiple transactions) or assess the complex web of payments associated with some deals (e.g., management fees, related party contracts, and real estate sales).

### ***Opportunities in the Healthcare Sector***

The healthcare industry offers a range of opportunities for private capital investments, from biotechnology and pharmaceuticals on the one hand to hospitals on the other, which represent 10% and 31% of consumer healthcare spending in 2019, respectively.<sup>3</sup> Much of the R&D spending in the development of innovative drugs is done by smaller biotech firms that are funded by venture capital firms and then later acquired by larger pharmaceuticals or biotechnology firms. On the health services side, private equity firms often prove to be efficacious partners, not only for the capital they provide. Even though most PE firms are strictly profit-driven, they can have a longer-term perspective than a publicly traded corporation fixated on quarterly earnings, and can consequentially help accelerate business growth. PE firms are also extremely skilled at identifying talented management teams, and can play a vital role in bringing innovation to healthcare through investments in technology.

Moreover, given the highly regulated nature of the health services industry, PE firms are often well equipped to navigate the overwhelming regulatory environment to help achieve operational efficiencies. For instance, the complexities of healthcare's reimbursement and ratings systems provide an opportunity for sophisticated and motivated investors to improve operations, lowering costs or improving real or perceived quality. PE-acquired firms seem to be particularly aggressive in responding to the incentives introduced by healthcare regulation.<sup>4</sup>

### ***Challenges in investing in Healthcare***

At the same time, the panelists identified several challenges associated with such investments:

- **Geographic Preferences.** The share of venture capital funding in biotechnology and pharmaceutical companies is concentrated in a handful of cities. These cities (e.g., Boston, Bay Area (San Francisco/San Jose), San Diego) also happen to be where most of the basic science research is being done. The top ten cities with the most patents in biopharma account

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<sup>2</sup> Louise Sheiner and Anna Malinovskaya, "Measuring Productivity in Healthcare: An Analysis of the Literature," Hutchins Center, Brookings Institute, 2016, [https://www.brookings.edu/wp-content/uploads/2016/08/hp-lit-review\\_final.pdf](https://www.brookings.edu/wp-content/uploads/2016/08/hp-lit-review_final.pdf).

<sup>3</sup> National Health Expenditures 2019 Highlights, Centers for Medicare & Medicaid Services, <https://www.cms.gov/files/document/highlights.pdf>.

<sup>4</sup> Gandhi, Ashvin, YoungJun Song, and Prabhava Upadrashta, "Private Equity, Consumers, and Competition," working paper, February 10, 2021.

for 70% of the patents in clinical development, 75% of the patents used to launch a drug, and 90% of the patents used in breakthrough drugs.<sup>5</sup> While there are advantages for the investors and entrepreneurs to be co-located and concentrated in certain cities, there are constraints to being in a few areas. Most of the top cities are extremely expensive, which could make it difficult to attract talent, and VCs could be missing out on great entrepreneurs and opportunities outside of the top cities. Also, whether this growth model is replicable in other areas is uncertain. On the health service side, we do not see the same geographic concentration of investments.

➤ **Challenges in Adopting Innovation in Healthcare.** There are three notable challenges in putting innovations to work in the health services sector:

- One of the primary reasons why innovation is difficult in healthcare services is regulation. The complexity of the regulatory system with misaligned incentives, combined with the fact that healthcare providers tend to be more risk-averse than many other firms, results in slower innovation. An example is that hospitals are paid a fixed amount no matter how long the hospital stay, incentivizing them to get patients out quickly. Thus, the incentive is to increase volume, rather than improve (often problematic) consumer experience. On the other hand, in managed care, the situation is the opposite: nursing homes are paid more the longer the patient stays, much like a hotel. Nursing homes are not incentivized to get patients out. In the end, one patient out of five from nursing homes goes back to the hospital and then the cycle starts again.
- Another challenge is that most hospitals are not-for-profit. The not-for-profit nature impedes market forces from operating efficiently in the healthcare system. Non-profit hospitals with no shareholder accountability rarely go out of business, even if problematically managed and with poor allocation of capital. They generally have a lifeline from the federal or state government, who stand by to bail them out.
- The third challenge stems from the fact that the government, through Medicare and Medicaid, is the largest payer of health services. This creates the risk that if an innovation implemented by PE firms successfully removes any waste, the government could capture the value-added surplus created, by just cutting their payment rates.

### ***Implications of Competition on Investments in the Healthcare Sector***

Recent evidence suggests that private equity may respond differently than others managers to competitive incentives in the healthcare industry. In a study of nursing homes, academic research shows that PE-owned facilities exhibit greater “competitive sensitivity,” meaning they compete more aggressively when competitive incentives are strong and exploit market power more

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<sup>5</sup> Amitabh Chandra, Cirrus Foroughi, and Lauren Mostrom "Venture Capital Led Entrepreneurship in Health Care," in Michael J. Andrews, Aaron Chatterji, Josh Lerner and Scott Stern, *The Role of Innovation and Entrepreneurship in Economic Growth*, Chicago, University of Chicago Press, 2021.

aggressively when competitive incentives are weak.<sup>6</sup> In competitive settings where quality of care is salient, the research shows that quality increases. In non-competitive settings, the opposite is true in PE-owned firms where the research shows that quality decreases and prices go up. But academic studies have also shown that horizontal mergers in hospital services (e.g., hospitals or physician groups merging), that claim to improve scale efficiency, have few favorable outcomes. In these cases, prices often go up and patients' experiences go down.<sup>7</sup>

While competition is important in the health services investment space, the opposite is true in the biopharma space. Competition is not good for innovation. Monopoly power through patents is essential. Otherwise, firms would not be willing to take the risk to develop drugs if there is no reward at the end.

### ***Final Thoughts***

Healthcare is likely to remain one of the most important industries for private equity investors. There is a doubtless positive role for private equity investors in the healthcare sector, the panelists agreed: private equity is well equipped to remove much of the waste and inefficient operations in the healthcare sector. For society, this efficiency enhancement can be just as important as developing drugs: high quality nursing and long-term care are often crucial inpatient outcomes. But to be efficacious, private equity groups need to have the right incentives to improve efficiency and the quality of patient outcomes.

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<sup>6</sup> Gandhi et al, *op. cit.*

<sup>7</sup> Beaulieu, Nancy, Ph.D., Leemore S. Dafny, Ph.D., Bruce E. Landon, M.D., M.B.A., Jesse B. Dalton, M.A., Ifedayo Kuye, M.D., M.B.A., and J. Michael McWilliams, M.D., Ph.D., "Changes in Quality of Care after Hospital Mergers and Acquisitions," *New England Journal of Medicine*, January 2, 2020.