Compass Carter Osborne

HealthInvestor Awards 2024 WINNER Executive Search Firm of the Year

Deal Flow
Forecast 2024

Will a positive trading environment translate to more transactions in the sector?

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There are promising signs that deal activity in the health and social care sector is rallying.

With stubborn inflation slowly shifting, an improved long-term outlook on interest rates and the tight labour market starting to ease, some of the headwinds that blew deal activity off-course in 2023 are beginning to dissipate. At the same time, a subdued 18 months has left global private equity sitting on a record $2.59 trillion of dry powder, with increasing pressure for it to deploy in 2024.

Despite challenges, the fundamentals of health and social care remain perennially attractive for investors. The question now is whether a more positive trading environment will translate into transactions and more of that capital finding its way into the sector? To delve into the details, Compass Carter Osborne convened key advisors and investors in the healthcare space for a round table event, aimed at going beyond the mood music to discover what is happening on the ground and what that might mean for the year ahead.

Cautious Optimism

Optimism, albeit cautious in some quarters, was the overwhelming sentiment among panellists. Growing convergence of buyer/seller expectations and the long-term prospect of reduced interest rates have seen some deals that should have closed in late 2022 and 2023 finally get over the line.

While that might not indicate a rampant market, many of those around the table reported an uptick in activity in the latter part of 2023 and into the start of this year. And for some, the first weeks of 2024 have seen significant momentum.

'2023 was tough, but we got there in the end, and we closed a couple of transactions in Q4,'

said one panellist.

Overall, the panel was encouraged by activity in the first months of 2024, but agreed it was unlikely to continue accelerating in a straight line. And, as always, some assets and subsectors are earmarked for better performance than others.

'People will be focusing on what interest rates do, but we're optimistic it will be a better year, but you need to pick which mandates you take to market, and people are being careful about those because not all will sell,' said one panellist.

'But January was a record month and I've actually got more enquiries now than I ever have.'

Political Landscape

Half of the world's population is set to go to the polls in 2024, and investors will be keeping a watchful eye on what this 'super election year' means for the debt markets. Although the cost of debt is unlikely to come down to historic levels, the SONIA forward curve forecast is that interest rates will begin to come down from May onwards and, currently, H2 is projected to be the most active period.

'The large deals need to see, or have confidence in, interest rates coming down,' said one participant. 'That would be quite a kicker for M&A.

Inflation rates in the US came in hotter at 3.1% on an annualised basis in January, suggesting that Federal Reserve rates won't start dropping until June, which is why there is more optimism for the second half.'

However, there are also indications that investors in the US are buying now in anticipation of a potential Trump re-election.

One participant told the panel that while some parts of the market remained 'sticky', the US had been a 'powerhouse' since November.

'We're printing deals from the US from the end of last year and we're finding that pitch activity is off the charts at the moment,' they added.

Increasingly, some of those US deals have a UK component and while Europe is expected to experience a lull during the summer, there's potential for increased M&A activity in the UK ahead of a likely Q4 general election.

Pricing

Typically, interest rates and the value disconnect between buyer and seller expectations were the key reasons for deals cratering last year. In the UK, 15 health and social care companies that should have transacted in 2023 were still on the market at the start of 2024.

Investors are now more focused than ever on good quality businesses with strong management teams, but pricing remains an issue.

"Investors are now more focused than ever on good quality businesses"

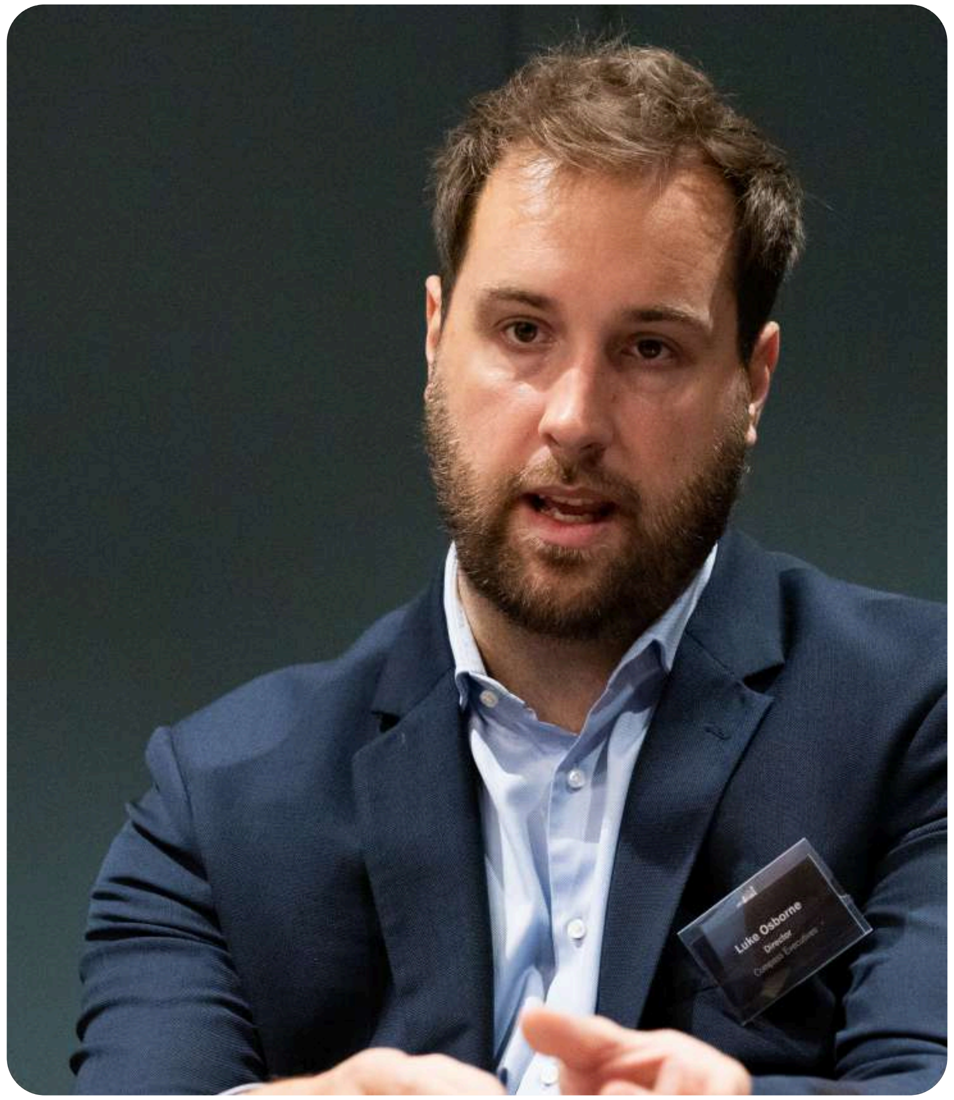
'Will those 15 deals that hung get done now? The good ones will as long as pricing is reset to the new world because interest rates aren't going down straight away,' said one participant. 'But people want to do deals. There is money to do deals, but some of the sellers still need to rebalance.'

Panellists noted an increase in small, tailored deals and fewer large-scale auctions. And while the gap between buyer and seller expectations is narrowing, most agreed that the ongoing war of attrition on price continues to impede some transactions.

> *'From our perspective, buyers have had to be more patient and creative in how they structure deals in order to try and persuade sellers that now is the right time to be doing a deal,'*
>
> said one panellist.

However, there was broad agreement that premium assets could price more aggressively, particularly given the long-term interest rate outlook, and would continue to command interest from both strategics and sponsors.

'If you've got a high-quality asset, you can still get your price,' said one participant. 'But if you have a more intermediate asset, then you have to work out why it's worth someone paying the price you want for them to buy. That's slightly trickier and you can't do that with many people, so we are seeing smaller, more bespoke processes.'



Digital Demand

Technology enabled businesses are also expected to attract more interest from investors. Much has been made of the potential for AI to transform healthcare delivery, but there was a sense among panellists that innovators will need to demonstrate a genuine business solution and sales cycle to attract funding. The sale of HBS UK, which blends outpatients and NHS insourcing with digital triage, was seen as a litmus test by industry observers and its recent acquisition by AXA Health could buoy the market for healthcare businesses with a strong technology play. Even in the US, where private equity has typically invested more heavily in healthcare services, panellists said investors are now looking for a tech upside.

'I don't think any business gets in the door unless it is tech enabled,' said one panel member. 'To attract any form of investor interest, a business needs to have invested in its tech and have a tech solution that makes it more efficient and a tech roadmap that demonstrates where it is going.'

This is likely to be particularly important for social care businesses, which have seen their margins shrink due to inflation, uplifts in the national minimum wage, and pressure on local authority fees. Out of the 15 companies that remained on the market at the beginning of the year, 13 were in the social care sector. The panel expressed doubts that a potential Labour government would make substantial improvements to the funding landscape, at least during its initial term.

'In social care, you definitely need to be close to the sector so you can pick the buyers. More than any other subsector, the number of bids you get is typically smaller than if you have a tech enabled business, where you get the excitement and the uniqueness,' said one participant.

Investor Appetite

Overall, panellists anticipated investor interest in elderly care to remain subdued, especially for enterprises dependent on local authority fees. In contrast, they reported robust appetite for adult specialist care and special education ventures. Both sectors have shown remarkable resilience, with some businesses demonstrating higher revenue quality and earnings visibility compared to other niche sectors.

However, it's in the healthcare space where investors are particularly optimistic about the prospects. Internationally, there's a strong appetite for life sciences and pharmaceuticals, fuelled in part by the emergence of new anti-obesity drugs like Ozempic. In the UK specifically, it is anticipated that increased deal activity will be driven by business that can offer solutions to NHS waiting lists.

There is a growing sense that while an incoming Labour government could kick social care reform into the long grass, it has both the 'permission and the volition' to do more on NHS outsourcing.

'The last couple of months, we have been inundated with NHS outsourcing, whether that's in the ophthalmic space, dermatology, mobility or fertility,'

said one panellist.

Another reported that insourcing providers are pivoting to outsourcing in anticipation of a Labour government. 'We've definitely seen that correlated into physical M&A activity where they need infrastructure,' they added.

Subsectors such as diagnostics, imaging and ophthalmology are also earmarked for growth, with the potential for new and interesting assets to come to market.

The ophthalmology space has seen huge growth in recent years driven by long NHS waiting lists. Referrals for treatments such as cataracts can be made by high street optometrists rather than just GPs and independent providers have responded by developing closer relationships and building out capacity. More NHS-funded cataract procedures now take place in the independent sector than in the NHS and one panellist said the work is unlikely to be repatriated back to the public sector.

'If you are looking at NHS outsourcing, you have to spot those services that are entitled to be accredited, meaning they are entitled to a contract,' explained one participant. 'That might be dermatology, diagnostics, orthopaedics, ophthalmology. Orthopaedics is a bit more expensive to build, but something like ophthalmology is relatively low CAPEX and that's why you have seen all this growth. In some areas, ophthalmology is no longer being treated at all in the local NHS hospital.'

Despite broad positive sentiment, panellists agreed that sustained improvements in buyer confidence will be essential for accelerating deal activity.

Additionally, there was a recognition that while private equity firms will be under pressure to deploy capital accumulated during a depressed 2023, very little of that dry powder is earmarked for the mid-market health and social care sector in the UK.

'Big funds are obsessing about reputational risk and that makes healthcare and children's services difficult for them,' said one panel member. 'Where we've ended up is a very specialist level of mid-market investors.'

However, panellists also reported emerging interest from impact investors, particularly in social care and children's services, with some big private equity and mid-market firms developing multi-fund strategies.

'As some of those large funds or larger mid-market funds continue to diversify, hopefully some of that diversification will be impact investment,' said one participant.

Labour in Power

While panellists believed investors would scrutinise policy statements for any funding changes that might stimulate the market, the prevailing consensus was that a change in government is unlikely to disrupt M&A activity in the sector.

One panelist observed that with the possibility of a Labour government, certain private equity funds are contemplating whether now is a good time to invest in social care, suggesting there is a sense that a 'red government will be good for funding'.

And while the US remains the preferred global investment destination, the UK's economy is maintaining relative stability, despite instability at the most senior levels of government.

'The UK is still attractive, but we do need to address this not quite 4% GDP growth in a year,' said one panel member. 'In terms of reasons to be cheerful, healthcare is still a growth sector relative to a low growth economy, but being in a low growth economy more generally is not helpful.'

However, the potential for elections to disrupt economies in other geographies could make the UK a more attractive proposition for investors. At the same time, the fact that they can't invest in China and are nervous about war in the Middle East, makes the UK one of the few relatively safe places to invest.

Barring any significant external shock factors, the prevailing sentiment among panellists was that the robust trading activity observed in the initial months of 2024 will persist and potentially gain momentum as interest rates begin to decline.

While this may not indicate a resurgence to the heightened levels of activity seen in the health and social care sectors in the immediate aftermath of the pandemic, buyers are eager to finalise deals postponed in 2023. And with investors equally keen to deploy their funds, the outlook is becoming increasingly optimistic.

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