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Health Care Private Equity and Venture Capital Investments: Time Is Not On Your Side

By: Scott Becker, Robert Marks and Krist Werling[1]

Growing health care services companies often have needs for capital to enable them to significantly expand their operations. Capital needs may be driven, depending on the type of company, by requirements with respect to growth in labor needs and facility expansion costs for chains of health care facilities or with regard to expensive equipment needs with respect to imaging, hospitals or other capital-intensive businesses. When in a growth mode, income from operations is often reinvested in the company itself in order to fund further growth. Thus, for a variety of reasons, companies often seek additional investment. The time frame between the need for additional capital and the timing of the expected payoff from the investment becomes a critical factor when negotiating and accepting private equity investments in the company.

Three of the most important factors relative to any investment being accepted include the valuation of the business, the amount of capital to be invested, and the amount of control and ownership the investment will provide the new investor. In general, private equity deals can be structured as minority or venture capital investments or majority buyout investments. In either situation, senior management and the founding owners will retain some equity holdings. In a majority buyout, the management's retained equity will typically be much lower.

These types of structures and preferences place tremendous pressure on the founding partners and management team of a company to pay dividends or enter into a second exit transaction at an early stage. In short, the longer the period of time between funding and a capital gain event, the better the chance the founding partners and senior management are left with a smaller and smaller share of the proceeds.

The capital structure of the health care company, in either type of transaction, will change substantially. If a venture capital investment, the investor will generally receive preferred stock, which accrues a dividend. If a buyout, the investor may leverage the company with both senior bank debt and mezzanine bank debt, which may include preferred stock. In each case, the management team and the founders often will not receive further equity returns until these preferences are satisfied.

Preferred returns mean that the party receives their capital plus a certain level of profits or income before other stockholders receive any returns. The following example helps to explain the sense of urgency that these preferences create for the management/founders group. Assume the investor has invested $10 million in exchange for a 50 percent interest in the Company, and receives an 8 percent compounding preferred return. The venture capital investor must receive $800,000 per year in returns before the other stockholders receive any money. Even if the other holders are allowed to catch up after the preferred return is made, which is not often the case, a return of $1.6 million as to the first year,

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must be made before all of the Company's stockholders are essentially on an even basis. These preferred returns can critically and negatively impact the return to a company's founding investors and other stockholders.

In many situations, the profits and income earned by the company are reinvested in the company to fuel further growth. Accordingly, the preferred returns accrue and are compounded. As such, payments to other holders become increasingly subordinated over time. For example, if the investor accrues preferred returns of $800,000 per year, which increases on a compounded basis, then it may very well be the case that the Company must receive a price in excess of $14 million or $15 million before non-preferred stockholders receive their first dollar of return.

The investor, in addition to receiving preferred returns, may also be entitled to one or several other rights if the preferred return targets are not met. These can include, for example, an increase in the preference rate, a right to assume greater control, or a right to own more of the company.

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All too often, a company's founders and other stockholders do not appreciate the amount of time pressure brought by private equity funding to turn the company. In short, in these transactions, "time is not on your side."