Ep.5: A Banker, Consultant, and Operator on Private Equity in Consumer Health

Rusty Ray (00:06):

Hi, I'm Rusty Ray. I'm with Alantra. I head up the US Healthcare Investment Banking team here in New York. You are listening to Crossroads, our podcast that focuses on interesting products and services in the healthcare space, all with an eye towards M&A. On this episode, we are joined by two guests, Chris Harley-Martin, who formally spent 30 years at GSK, most recently as Global Head of Consumer Health Business Development, and Charles Tillen, a partner with Bain and Company's private equity group, as well as the leader of Bain's newly-formed consumer health practice.

(00:38):

This is an interesting episode as all of us have spent decades in and around consumer health, all from very different perspectives. Myself as a financial advisor for clients pursuing acquisitions or divestitures, Chris as a strategic leader and operator of brands globally, and Charles as a consultant helping platforms think about their own strategies, as well as diligencing acquisitions. One of the common threads we have all seen develop over the years is the increased role of private equity in transactions across the consumer health space. When we all first started, private equity simply did not look at the sector. It was just not attractive to them. Since then, a lot has changed and PE cannot be ignored as a buyer group, especially as we look at the flood of upcoming transactions in the space that are likely the results of certain spinouts. We'll kick off with Chris for his initial thoughts.

Chris Harley-Martin (01:31):

So when I first started transacting in consumer healthcare, which is more than 20 years ago now, I don't really remember private equity playing a big role in those transactions. Certainly private equity was active in broader healthcare, and working at GSK, I could see that, mostly in pharmaceuticals and associated businesses, hospitals, diagnostics devices, but not so much in the consumer healthcare market. In fact, I'm not even sure there was a distinctive consumer healthcare market at all.

(02:00):

The industry seemed quite dull, I suppose, low growth, slow-moving, for the most part highly regulated, with many of the more attractive but underleveraged assets trapped inside larger companies who typically weren't investing in them, but they were also reluctant to give them up because they'd provided, within the group, relatively stable cash flows. So you had certain inertia, I think, in the industry. Equally, regulation made it difficult for innovators and new market entrants had no infrastructure or market access, but surely that's changed.

(02:34):

Charles, I'm curious, what do you think of the things that have changed, that mean that private equity are now more attracted to the consumer healthcare market?

Charles Tillen (02:45):

To steal a little bit of your timeline, because I think you mentioned two decades, it's actually worth thinking of private equity over that time period because 20 years ago, private equity wasn't organized by sector. It was just LBO funds in general, and they didn't even think about "do we invest in consumer health?" I don't even think consumer health was a term that anyone could have recognized. Over the decade that came after that, private equity did start to sectorize, to make it into a verb, but you would have a healthcare sector, and you would have a consumer product sector. You didn't really have intersections between the two. Healthcare spans so many different spaces. I won't list them all here, and it's only at the edges that it begins to intersect with consumers, and that's when you get into OTC, VMS and retail health. As those things have emerged, private equity has begun to look at them as opportunities, whereas before it wasn't on the radar.

(03:39):

The main reason they want to look at it is because the tailwinds are fantastic. We're talking decades long tailwinds about demographic behavior and needs, advocating for your own health, buying products for your own health. That is perfectly set up for VMHS. It is for OTC as well, but OTC carried a regulatory risk in a sense that made private equity hesitant, other than their healthcare practice. Their consumer products people were uncomfortable with it, but now you'll see that that is converging and there have been a couple of test cases, I think in that time period where private equity has seen that there is a landscape where they can add value. They started to look for platforms and they wanted to find, M&A pipelines for those platforms and professionalize those platforms and then curate them ultimately to sell to a strategic like a Nestle or a Unilever or someone else.

(04:27):

More recently, we're seeing the divestments of the large portfolios as pharma is saying OTC is different. It's not really healthcare. It's actually more consumer now.

Chris Harley-Martin (04:37):

That's really interesting. Rusty, your healthcare practice bridges both pharma and consumer healthcare. Do you think the private equity buyers are different in those two spaces or is it the same group? Do they have different or similar needs as they've emerged to be enthusiastic about this sector?

Rusty Ray (04:55):

That's an interesting question. I will have to provide one anecdote about you, Chris, before answering that. In the very first transaction we did for you, I turned up with a target list that included some private equity firms, and I think you looked at me sideways and said, "Really?" So how times have changed.

(05:14):

I can tell you that I field calls daily of lots of generalist funds that want to "get into healthcare." When you ask them what that means, "Well, we want something that doesn't have any payer exposure, doesn't have any reimbursement risk. And we don't have anybody here on our team that can understand the scientific nature of these assets, so maybe revenue cycle management." Something that's more of a business services, if you will. I know that's pretty far from consumer health.

(05:44):

There is this growing development of a niche within consumer health because it is both healthcare and it is consumer, not to make a pun there, but the fact that it has this healthcare exposure with regulatory risk, manufacturing quality, these are such key elements in buying a brand or running a business of the sort, and that's where people fall down, especially in transactions because they don't think about day zero. How do I actually transition this thing? How do I get the marketing authorizations in various countries around the world? How do I do new product development? Because I may have to do additional clinical trials or I may have to do formulation work. These are very, very complex components of running these businesses that are not necessarily average within the consumer world.

(06:32):

That said, a lot of the marketing, sales, especially e-comm, really draws from the consumer experiences, so we're seeing more and more private equity really have a focus around OTC consumer health. I think that's broadened to VMS as VMS has shown a lot of growth.

Chris Harley-Martin (06:50):

Charles, I'm kind of curious. You do a lot of buy-side work for private equity, a lot of diligence. What are private equity thinking about? What are they looking at? What do they worry about when they look at investing in this sector?

Charles Tillen (07:04):

They become increasingly more sophisticated in understanding it's not just "I'm buying a growth investment". It's where does it sit on the consumer health spectrum? What they're looking for, particularly in the priorities for diligence that we're asked to conduct, comes down to, first of all, are the brands really brands? Because sometimes something may appear to be a brand, but when you dig into it, it's more of a molecule or an ingredient that just happens to have a label on it and it's never been marketed as a brand. And if it's legitimately branded, that means there's consumer support for it. How deep is that consumer support? Likewise, we'll have to speak to retailers to understand how they perceive the brand, how attractive it is for them to stock it, what are the facings, what is the velocity? There's classic analysis that just goes into determining that.

(07:49):

The next thing they worry about is fad risk. This has more related to VMS than it is to OTC, and how do we assess that? I call it portfolio beta because there can be other things in the portfolio that can soften the fad, but you do have to understand where do things sit on the range of fad versus a little bit more scientifically proven or safer, where there's longer research, longer purchase patterns.

(08:12):

The third thing they look at beyond the brandedness, the fad risk, is going to be the platform suitability. PE loves platforms because they want to put other things into it, like an M&A pipeline so they can scale it, benefit from the scaling, and ultimately create a company that a corporate would like to own or an IPO is sufficient for. And so you have to say, what could be added to this platform? Does the platform mean anything? What are the sources of strength in terms of the retailer relationships, points of distribution, et cetera? Is it a one therapeutic area? Is it multiple therapeutic areas? Is it OTC only? Is it OTC plus VMS? Are there things out there we think we could add to this and curate over time and create a bigger story?

Chris Harley-Martin (08:51):

Do you sense or see much difference between the geographies?

Charles Tillen (08:55):

No, there are definitely differences, and they're definitely aware of the differences. The thing about consumer health is it is a global category that's attractive virtually everywhere, even if it's more mature in some areas than other areas. What private equity has struggled with is usually their teams are regionally based, so the North American team's going to be thinking about North American opportunities, EMEA team likewise. Then when there's something that trends, that goes across both of those markets or even more markets, the teams have to work together and that's where when partnering with someone like us actually helps because we're the connective tissue that can look at multi-markets for them.

Chris Harley-Martin (09:32):

Completely understand. Rusty, I'm curious if we move to the transaction itself with private equity, how they're approaching transactions, what the differences between a strategic and private equity might be, what the considerations are.

Rusty Ray (09:45):

If they don't have a platform, you're not as beholden to kind of the strategic fit. I do believe that most private equity firms, when they look at a portfolio of brands, if they're being divested out of a large pharmaceutical company, initially try to think of this, "Can we build a platform around skincare, cough, cold, respiratory?" whatever the case may be. They quickly kind of shelve that idea because the reality is you can't always select the kinds of assets you want, and they sort of then fall into the idea that "Okay, let's just get good assets. Do they have good brand equity? Can we build on that? How far and how fast is it falling? Are there distribution risks?" and things like that. Those become the more key elements in dealing with them in trying to position your brand for sale.

(10:30):

The other thing as you get into the conversation with private equity, I think the most important thing is making sure they have capability. Can they transact? The really hard part of the story is when you as a seller, you're a pharmaceutical or strategic or divesting brands and private equity takes over, are they going to be a big pain in the butt post-close? Are they going to come back to you with questions or needs or wants and long-term transition arrangements? I think that is often overlooked because they pay a robust price and they say all the right things, but the reality is do they have the knowledge to actually run the business from day one or close to day one? So you're scrambling and running around trying to help them as a buyer and be a good corporate citizen, but it ends up being very time-consuming and very difficult to manage.

Chris Harley-Martin (11:19):

I think turning to the future, I'm very optimistic about private equity's role in consumer healthcare. First, the dynamics, as Charles has already mentioned, in the industry, remain attractive, good tailwinds, driving growth and margin. The industry is fragmented still and pretty resilient.

(11:38):

The second is, again, mentioned, but really worth reiterating, private equity now has precedent. Precedent seems to me to matter a great deal. When I've been talking to private equity in the last few months, it really differentiates when you're talking to people who've already been in this sector, have invested and had a successful exit.

(11:58):

The third is that I think a defined industry is emerging, and why does that matter? Well, it's part of thinking about how to exit. Actually if there is a defined industry where you can forecast what the multiple or their exit might be if you choose to IPO for the larger ones, or you've got strategics, you've got very clear aims to grow and need significant brands inside their portfolios and you've got something to offer them, then actually the exit is a little clearer. The world isn't without its problems.

(12:28):

I hear today, Rusty, financing is now the issue of the moment. Is that just cyclical? Is that there's a problem today, but it'll be gone tomorrow? Or should we be worried about financing as a break on the potential for private equity to be in the market?

Rusty Ray (12:46):

I wish I knew the future of the financing market. It's an odd time because while we're seeing pricing on financing get more expensive, which we all know private equity uses to juice returns and get deal done at higher multiples, that's countered by the massive amounts of money that most private equity funds have raised from COVID on. I don't speak to anyone that hasn't raised a new fund and it's bigger than their last. It could be a temporary issue. You over-equitize a business today and recap with debt later to kind of get those returns or find a way to get those returns. So it's not something that's permanent, but it is something that's weighing on the minds of folks today for sure. I haven't seen yet that it's pushed down multiples in the market. I think the private equity buyers have kind of said, "Hey, we're going to over-equitize things today because we know we want to be in the space and this is an important thesis for us."

Chris Harley-Martin (13:49):

Charles, maybe we can leave the last word to you. Focused on the future, what's private equity have to be best at to win in this market?

Charles Tillen (13:59):

There's two dimensions, I think, to answering that question. The first is when they diligence something, when they look at something, there has to be a compelling thesis. But the more important part, Chris, is that they have to commit to a value creation plan and proactively manage the investment to whatever the next holder will be. They can't sit back and expect it to happen. Part of that is providing talent if talent is needed. For example, e-commerce, there's always going to be a need to put e-commerce talent in. Part of it is holding a discipline management process and ensuring that investments get made that need to be made. If it's marketing, that marketing gets put in there that's measured and we can see what was effective. So it's an activist holding period that's different than 10 years ago.

(14:49):

The other thing that goes with that, by the way, Rusty said there's abundant capital that's out there and maybe they're over-equitizing, but multiples have lifted private equity for 15 years. You can't assume that multiples will always lift, so you have to create value through proactive ownership and generate a better margin, a better ROIC, whatever it takes. And there always has to be a next owner. This is a very critical part. You cannot take all the value out of the company during your whole period or try to pursue every single avenue. There has to be room for the next owner to do something with it as well. Those are the best holds, and that's the current approach.

Rusty Ray (15:27):

Well, that wraps up our discussion with Chris and Charles. Really interesting to hear their perspectives on private equity in the consumer health space from their vantage points. You can't really point to one factor for private equity's emergence in space, but I think from this conversation, a couple of key areas include: the definition of a distinct consumer health space has emerged, it's not just the baby brother of pharma; the realization that there are fantastic global tailwinds; the increased comfort by private equity around highly regulated products; the opportunity for M&A; and the successful exits by many of their private equity peers.

(16:05):

While we've all spent considerable time in the space in our respective fields, one of the things I've realized in talking with these two gentlemen, and our clients do as well, is the value of advice from different perspectives. In just speaking for myself, I've felt tremendous value in having people like Chris and Charles in the room with me who can speak from a very different perspective, be it operational or consulting. If you'd like to hear our additional thoughts on the space, please feel free to reach out to us.