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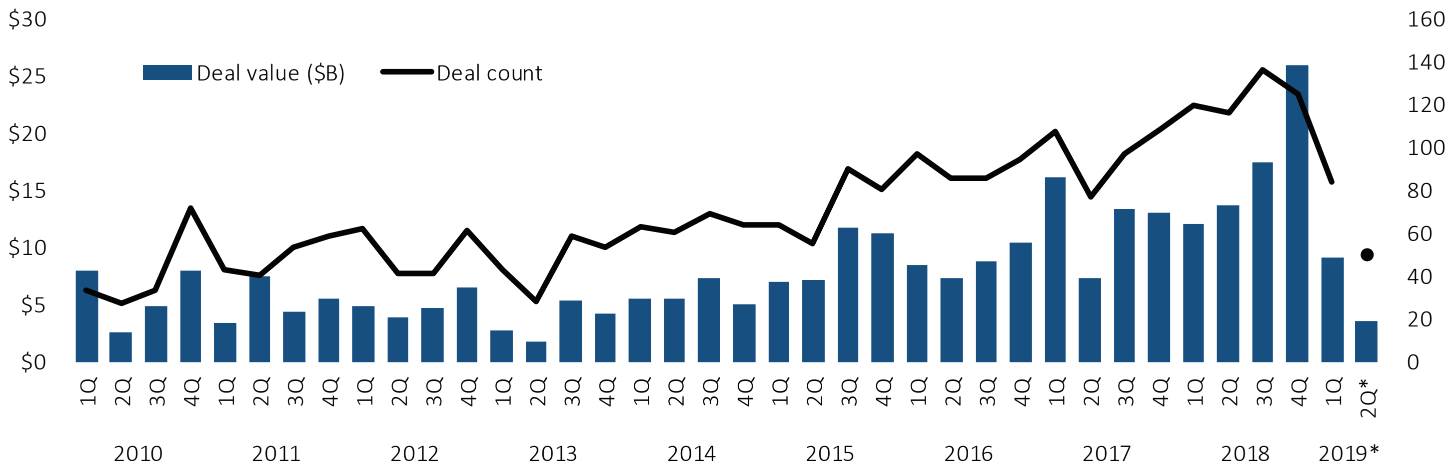
The Dynamics Driving Dealmaking in US Healthcare Services

Data provided by

PitchBook

Quarterly figures reflect growing appetite for healthcare services among financial sponsors

US buyout deal activity in healthcare services by quarter



Source: PitchBook
* As of June 1, 2019

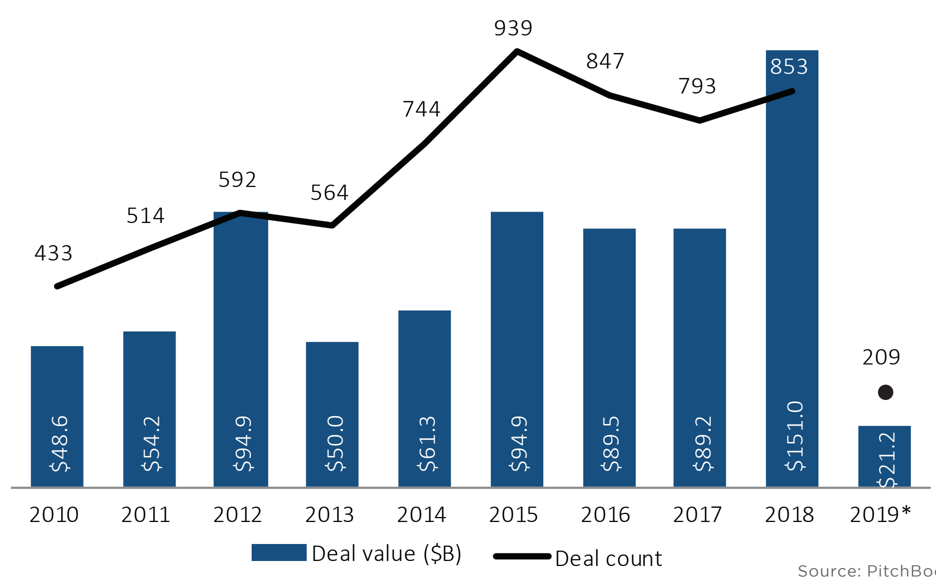
Safety in the numbers

Deal flow in US healthcare services recovered in 2018, with the space attracting an increasing share of private equity investment as firms started seeking safer havens for capital amid growing fears of a coming downturn. Healthcare assets have historically proven less prone to the ills of a recession than others. With global growth set to slow even further this year in marked contrast to the projected expansion of the healthcare industry in the US, combined with the outperformance of healthcare assets purchased during the last recession, healthcare services have only become that much more attractive to firms sitting on record levels of dry powder. Analysts expect that national healthcare spending will increase by 2% to comprise a fifth of the US economy by 2026,[1] putting companies in the space in a prime position to attract even further attention from PE firms for the foreseeable future.

And those in healthcare services are already receiving greater acquisitive interest after years of consolidation.

The M&A cycle in healthcare services picks back up

US M&A deal activity in healthcare services



Source: PitchBook
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M&A activity in 2018 represented over $150 billion in aggregate on more than 850 deals completed by financial sponsors and strategics. Although that increase in volume represents a modest gain year-over-year, overall value jumped by a staggering 41% in 2018 to its highest level since the financial crisis as mega-deals like KKR's $9.9 billion deal for Envision Healthcare, the largest buyout in the space in at least the past decade, drove a greater share of dealmaking. After bottoming out in 2009 at $24 billion across 322 transactions, M&A deal flow expanded at a compound annual growth rate of 23% in terms of value through last year.

Much of that momentum has carried over into 2019, as the prospects for US healthcare services over the long-term make the space attractive enough

[1] "CMS Office of the Actuary releases 2017-2026 Projections of National Health Expenditures," Centers for Medicare and Medicaid Services, 2018

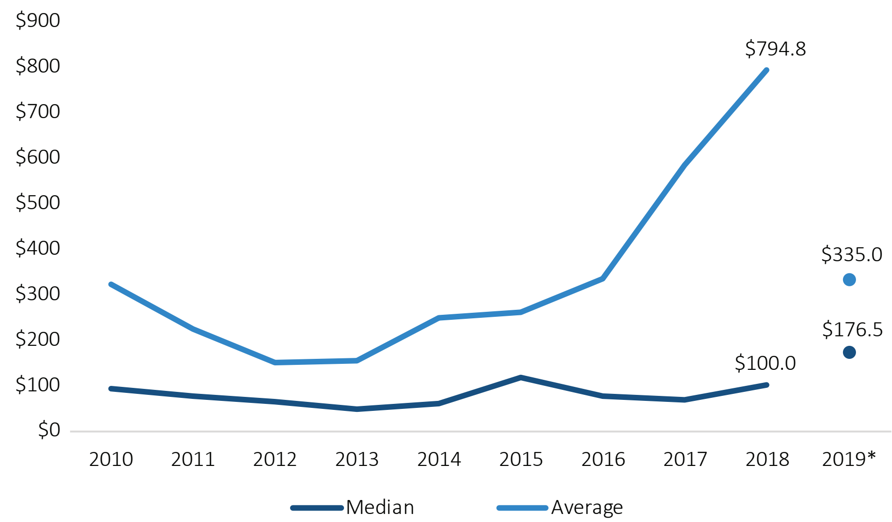
to overturn many concerns about near-term policy changes, even as the latter must be taken into account. After completion rates represented just $7.2 billion and accounted for 77 transactions in 2Q 2017, dealmakers have steadily increased allocations to healthcare services. Financial sponsors closed on records for both volume and value at 125 transactions and $25.9 billion in 4Q 2018 alone.

Compounding that interest in this space has been the wider healthcare industry's move deeper into emerging technology. This has the capacity to create greater economies of scale for service providers, with decentralized care becoming a reality as delivery comes in at a lower cost in part from outsourced patient monitoring to consumer-facing apps and devices.

"Wearable devices, patient communication, biotechnologies and telemedicine are all increasing at a rapid pace," says Dana Jacoby, founder and CEO of DJI Consulting. "A recent statistic showed that since 2012, the top 10 tech corporations in the United States have spent billions of dollars in healthcare and are competing at a very high level to solve the healthcare challenges we face daily."

The digitization of healthcare will not only sustain investment into emerging technologies for the practice, it will also transform some into providers of highly personalized, highly specialized services that could relieve

Deal value climbs on increased competition for healthcare assets
Median and average US PE deal sizes ($M) in healthcare services



Source: PitchBook
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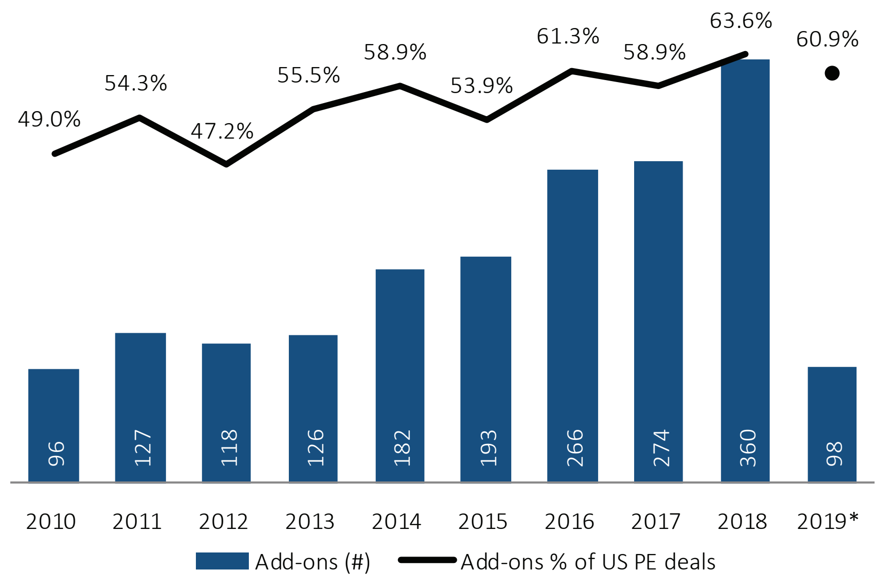
Buy-and-build strategies propel add-ons to record share of PE deals
Add-ons (#) as proportion of total US PE deals in healthcare services

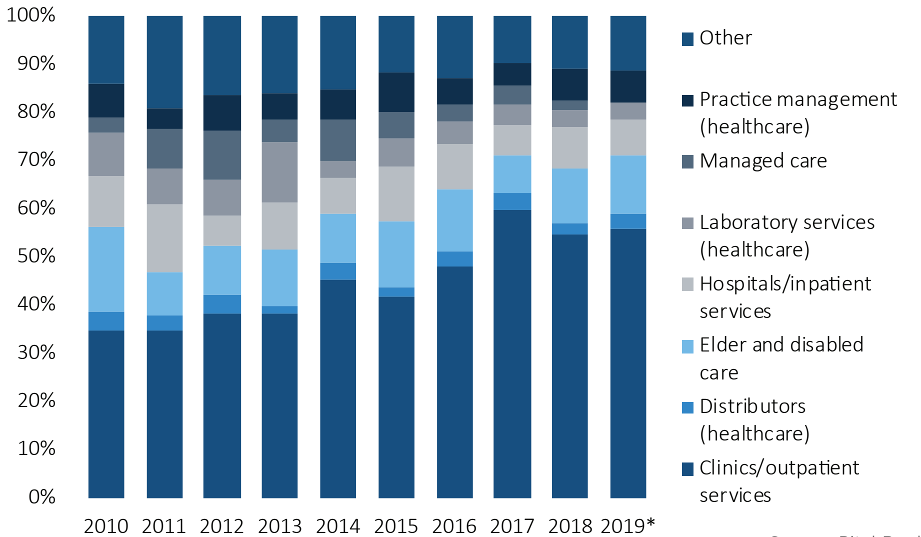


Source: PitchBook
* As of June 1, 2019

*Methodology

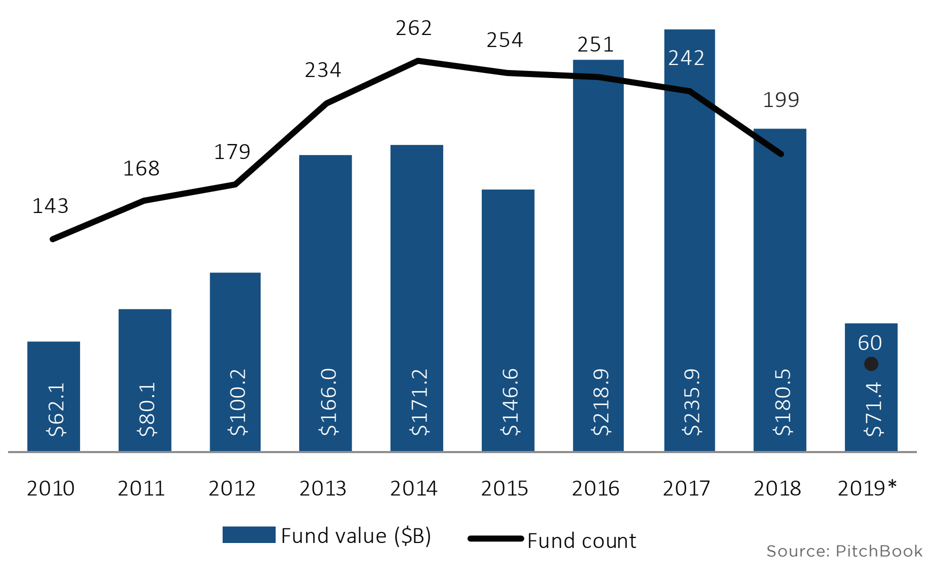
Dealmaking data on US healthcare services was generated using the PitchBook Platform's dedicated industry codes in order to curate the dataset examined in this report. Otherwise, customary PitchBook reports' methodologies for M&A transactions and PE deal flow was utilized.

Platform expansion sustains investment into clinics/outpatient services
US PE buyout deals (#) in healthcare services by segment



Source: PitchBook
* As of June 1, 2019

PE firms stand astride record levels of dry powder
US PE fundraising activity



Source: PitchBook
* As of June 1, 2019

[2] "Global Healthcare Private Equity and Corporate M&A Report 2019," Bain & Company, 2019, p. 17

some pressure from the industry's unforgiving margins by reducing customer acquisition costs and care.

PE's growing confidence borne of experience

As Bain Capital has recently pointed out, with PE expanding its presence in the space, firms have grown more confident with "underwriting deal values as they gained clarity on potential US regulatory changes, including the Affordable Care Act."[2] Competition between firms from the lower middle-market to sizable strategics will keep the pressure on large-cap financial sponsors to deploy capital. However, PE also stands astride more than $1 trillion in dry powder.

As a consequence of these developments, investors have spread their bets with remarkable consistency. Clinics and outpatient services again led the way among PE firms last year, comprising 55% of all buyouts. The push to build out platforms already under development prompted PE firms to pursue add-ons for a record 64% of all deals closed last year, helping over 200 add-ons to close in clinics and outpatient services for the first time. And access to capital has started to help investors achieve greater scale across geographies to create strong regional platforms via buy-and-build strategies that, as recently as 2015, represented only 54% of all PE deals in healthcare services.

What are the most common challenges that investors, clinics or other care providers encounter when looking to create larger platforms via merger or acquisition?

The biggest challenges of the past few years include incongruent clinic and/or provider selection, cultural collaboration, and/or creating appropriate synergies pre- and post-merger. Clients of ours who have gone through a merger or an acquisition realize that the process is not for the faint of heart. The loss of culture, the over- or underinflation of value, integration misses or misalignment should all be addressed long before the larger scale platform, merger or acquisition is designed, developed or created.

What are some of the best practices for overcoming these hurdles that you've encountered in your practice?

As simplistic as it may sound, the most critical best practice for overcoming hurdles in M&A or large strategic integration is to plan ahead. The integration and cultural immersion process should begin long before the actual deal or acquisition is ever announced. A careful assessment of each target entity can be very important to determine cultural fit, potential scalability issues, prioritization, key employee issues and leadership objectives.

Q&A with Dana Jacoby

The largest issue at the heart of implementation is the failure to analyze cultural fit upfront. Every entity has its own culture, standards and attitudes. The ability or lack thereof to address this upfront can lead to immediate or long-term failure, neither of which serves for a good situation post-merger. With the emotion, stress and varying agendas of stakeholders involved in any deal, leaders may become complacent with or distracted by the larger issues and forget that the seemingly small stuff can make or break a deal.

In which sectors of the healthcare industry does technology investment appear to be picking up more rapidly, and how do you see the adoption of emerging tech factoring into M&A going forward?

Your question is somewhat difficult to answer, as technology investment is increasing across all healthcare sectors right now. The investment in electronic medical records, claims data initiatives, population health management and artificial intelligence are all affecting healthcare, pharmaceutical and life sciences company opportunities right now. Meanwhile, Google, Alphabet, Amazon and Apple continue to make news as they compete for the next generation of healthcare wearables, devices and breakthroughs. In a recent speech at the 2019 HIMSS Conference, Seema Verma, administrator of the Centers for Medicare and Medicaid Services, stated that actuaries are predicting that if nothing is done to better control healthcare costs, by 2026 we will be spending one in every five dollars on healthcare. As a result of this large opportunity to cut costs and create efficiencies, technology investments in healthcare is going to be tremendous.

What impacts do you anticipate from FDA's acceleration of approval processes and push for frameworks around digital health?

The FDA's certification process for new technologies has been too slow for entrepreneurs to access and therefore innovate within digital healthcare. As of the FDA's FY2019 budget, there is now room for the implementation of a Center of Excellence for Digital Health, which establishes a pre-certification process for innovations in digital health. This will not only expand the FDA's reach to entrepreneurs with a more rapid certification process but also keep digital health innovation at the forefront.

While the FDA may be making it easier for developers to get certification, the frameworks the FDA are executing around digital health will ensure that patient safety is kept a priority while also continuing to motivate innovation. Additionally, it pivots the FDA's focus to the software developers in digital health and technology, rather than the product, which incentivizes developers to innovate within this field while allowing the FDA direct access to fixing and updating the software.

Healthcare in the future is going to be driven by new and innovative healthcare technologies that consumers will engage with on a daily basis. Even today we are seeing wearable devices, over-the-counter genetic testing and apps to track our activities becoming more popular and prevalent than ever before. I expect to see a massive pool of data generated by these everyday technologies from which consumers will gain greater personalized insights. This data will also be something that doctors will be able to use for providing a more holistic and reliable overview of a patient's health over a vast period of time. Rather than documenting a patient's blood pressure on that day and having to compare it to the last measurement from months prior, doctors will no longer have to fill in the gaps using guesswork. Instead, they will gain a more complete, comprehensive and certified measurement of the patient's health. Additionally, consumers of these technologies will become stakeholders in their own health in a way that is not accessible to them today, empowering people to gain knowledge about their own bodies and bear witness to the changes of a healthier lifestyle.

What are the most salient differences in how financial sponsors and strategics approach dealmaking in healthcare? How have these evolved over time in your experience?

The most significant differences between strategic and financial acquirers is how they work to evaluate a healthcare entity or business. Strategic buyers focus heavily on synergies and integration capabilities, while financial buyers tend to look at standalone cash-generating capabilities and the capacity for earnings growth. Financial buyers also often buy healthcare entities partially with debt, which causes them to scrutinize the business' capacity to generate cash flow to service a debt load. The biggest evolution around strategics vs. financial buyers in healthcare has been that not all buyers can be neatly categorized due to the evolutions and synergies happening across healthcare. As a result of this trend, "strategics" may be looking to boost their earnings and end up acting like financials as they approach a target. Other times, "financials" already own a medical practice or healthcare company in a specific space and are looking to make strategic add-ons, so they will evaluate a business more like a strategic. The other large-scale change that is occurring right now is that we are seeing a unique synergy of "complementary" businesses vs. "like" businesses. This trend is causing some interesting dealmaking and deal flow that are very custom and unlike anything I have seen previously. The synergies of physician practices, payor entities, electronic medical record companies and drug delivery companies are an example of the meld of deal flow that looks nothing like past strategic or financial sponsor acquisition or deal strategy.

Strategic buyers focus heavily on synergies and integration capabilities, while financial buyers tend to look at standalone cash-generating capabilities and the capacity for earnings. growth.

What best practices around integration have you observed post-transaction in the course of your practice?

There are five best practices we suggest around deal integration related to post-transaction success. The critical component driving best-practice deal flow success hinges on strategic discipline. Deal flow leadership can help to mitigate the risks of an inherently risky business.

Other than preparing for the post-transaction phase well in advance, the following five categories home in on the practices that separate the "best" deals and dealmakers from those that are subpar or unsuccessful:

1) *Define your success factors:* How will you measure success, maintain customer or patient focus, and align strategies, processes and systems? How will you ensure stability, customer and employee communication and operational continuity?

2) *Integration plan:* Do you have a plan for your systems to integrate? Are there specific systems that need to be built for your "go live" on day one? What does the operative structure look like on the first day the combined entity acts as one company or strategic partnership?

3) *Leadership:* How do you define and communicate the logic behind the deal? How do you manage shareholder expectations? How does the new entity create systems or make decisions? What is the new operating agreement and/or are the expectations of the board or C-Suite?

4) *Define the integration process:* What does the first 30, 60, 90 days look like? How do you define success in year 1, 3, 5 and beyond? Who holds the roadmap outlining the strategy behind your successes?

5) *Reporting metrics:* What reports are available to you, your team and the leadership to create rigor and accountability? At a minimum you should have leadership dashboards or reports, management reports, KPIs for key staff, integration reports and post-mortem reporting on the deal.

6) *Culture and consideration:* How do you gauge if the cultures are a fit? How is your leadership operating on a day-to-day basis? What is the communication strategy with the staff? How do you know the culture is conducive to short- and long-term success?

**Special thanks to Katie Cahn, Wesleyan University '20, for her contribution to this article.*