How Community-based Healthcare Is Consolidating

Data provided by

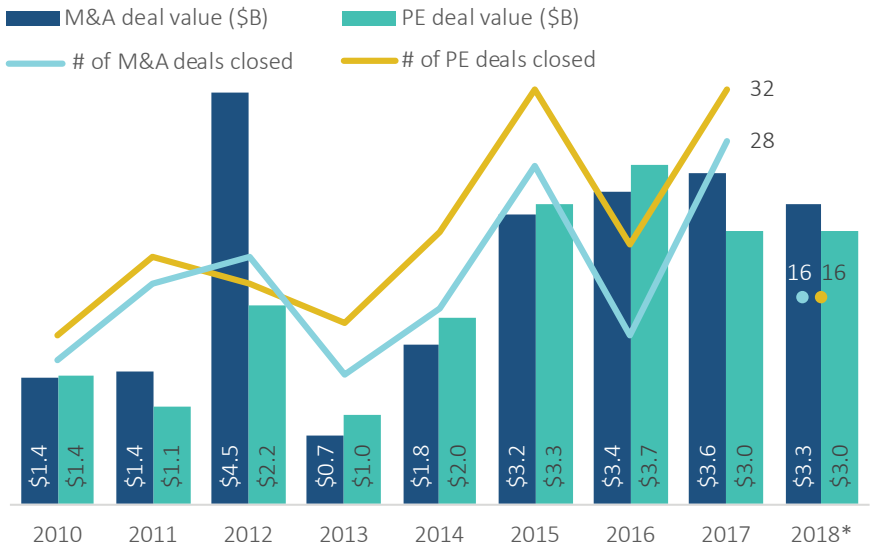
PitchBook

VECTOR MEDICAL GROUP

Healthcare dealmaking remains as dynamic as ever

PE activity makes up the bulk of all M&A

US PE activity & M&A activity in community-based healthcare



Source: PitchBook
*As of July 16, 2018

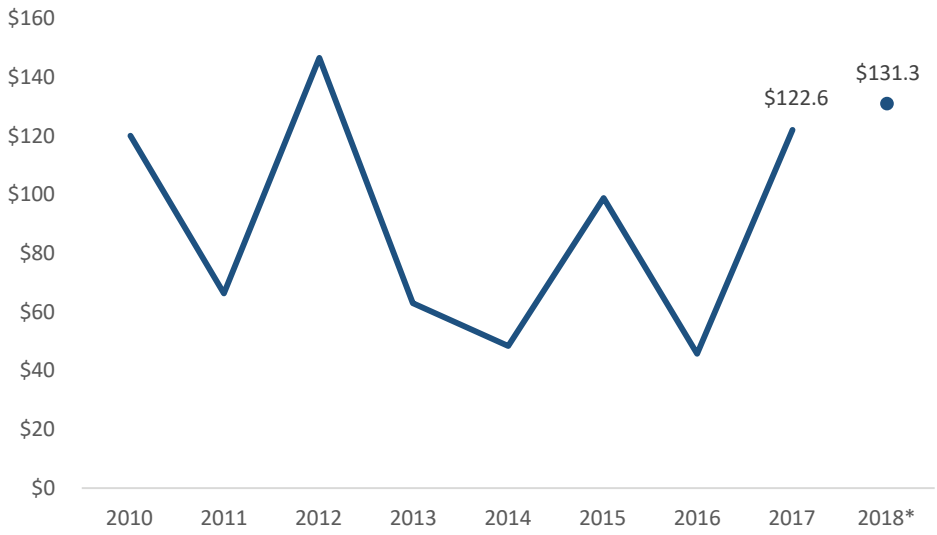
Across the US, M&A activity within healthcare is booming. Primary factors contributing to this transformation include the industrywide shift to value-based repayment, increased cost of care delivery and demographic changes leading to increased patient volume. Since the healthcare field is quite diverse, each subsector merits analysis. One area, community-related healthcare systems, can be nonprofit or own a particular regional focus. Given a higher level of fragmentation and specialty focus in terms of geography, community hospital and other community care systems look to merge not only to achieve reduction of cost via synergies but also to amass a greater number of specialties with broader outreach.

Last year, 28 M&A transactions occurred within community-related healthcare systems, aggregating a near-record $3.6 billion in total deal value. (See the bottom of page 2 for the specific methodology used to define this). However, just past mid-year 2018, 16 M&A deals for $3.3 billion have transpired to almost match the 2017 tally. Including minority growth transactions, PE investors have made up the bulk of all these deals. Such a trend makes sense when considering PE investment rationale, which is to buy and build to mitigate relatively high asset prices as well as to ensure a platform for future growth. Accordingly, they have pursued consolidation within community-related healthcare systems, uniting disparate providers across multiple locations and specialties.

Since sample sizes for these transactions are small, trend lines can be variable. What is clear is that prices have been somewhat elevated over the past three years. There are two key drivers behind this increase: heightened levels of PE dry powder (capital committed to buyout strategies by institutions) and the natural progression of the M&A cycle. The first enables greater competition on the part of PE investors looking for exposure to healthcare within their portfolios, and the second driver involves the transition from a less crowded, less competitive market place to a crowded environment wherein more buyers compete for companies at necessarily higher prices, thus making it more difficult to justify paying up.

Deal sizes remain on the higher end

Median M&A deal size ($M) in US community-based healthcare



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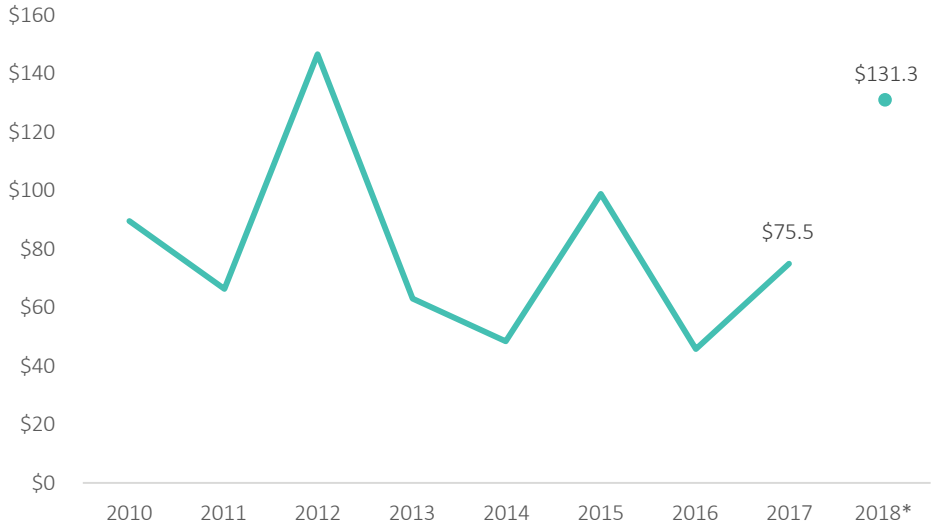
Methodology

The community-based dealmaking data was generated using a custom list of keywords in order to identify appropriate companies within the PitchBook Platform. Otherwise, customary PitchBook reports' methodologies for M&A and PE transaction classification was utilized.

Buyout firms are paying up more and more

Median PE deal size ($M) in US community-based healthcare



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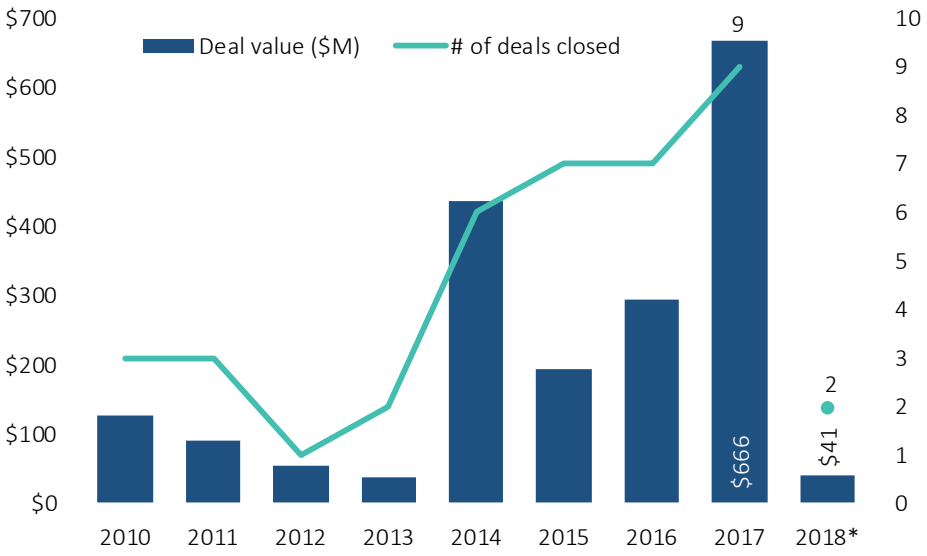
Growth investing hit an all-time high last year
US PE growth investing in community-based healthcare



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Such a cyclical progression can result in volume eventually declining. However, that does not appear to have happened yet. What has occurred is a greater incidence of growth transactions on the part of PE investors. A common strategy in general, the mild uptick in the incidence of such minority plays could also be driven by newer entrants into the healthcare space looking for alternative strategies to circumvent competitive auctions for assets.

Secondary buyouts' (SBO) popularity speaks to increased scaling within the space
Select transactions in community-based healthcare in US

COMPANY	DEAL SIZE ($M)	CLOSE DATE	DEAL TYPE	LOCATION
nThrive	$2,700	January 27, 2016	Take-private	Alpharetta, Georgia
Curo Health Services	$1,400	July 11, 2018	SBO	Mooresville, North Carolina
RCCH HealthCare Partners	$800	December 8, 2015	SBO	Brentwood, Tennessee
Curo Health Services	$730	August 12, 2014	SBO	Mooresville, North Carolina
U.S. Renal Care	$565	July 3, 2012	Management buyout	Plano, Texas

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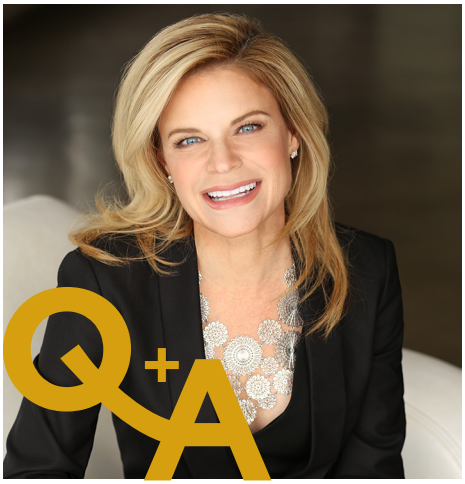

Dana Jacoby of DJI Discusses How Community-based Healthcare Is Transforming

When it comes to community-related health systems, what are the key dynamics within this space that set it apart from other healthcare segments?

Community-based health systems continue to provide many of the day-to-day medical services in the specialty healthcare space. Select medical specialties have chosen to remain independent versus joining hospitals or large integrated health systems. This has given many of these entities a more distinct culture and operational background than larger or already-merged healthcare segments.

The key dynamics that set these community-based systems apart are the following:

- The culture and personalities of the physicians
- Ancillary service and/or additional revenue opportunities that provide independent, community-based groups the ability to remain separate from large hospitals or integrated healthcare systems
- Patient demographics which include complementary or additional revenue streams (i.e. cash pay, ambulatory service offerings, and/or other complements to their fee-for-service revenues)
- Geographic and/or payor benefits that made staying independent possible or probable
- The desire to remain independent despite market conditions
- Payor conditions that were amenable to the community-based sector of medicine

Total cost of care contracting will become an important catalyst for practice acquisitions in the future.

What are the primary hurdles for firms looking to merge within this space?

Acquisitions of multispecialty and primary care practices by integrated delivery systems, PE firms or large health systems that have followed common processes with relatively predictable issues relating to purchase agreements, employment contracts and compensation.

In contrast, acquisitions of single-specialty practices (until recently) have been less common, with motivations for acquisitions varying by specialty type, group size and market structure. Total cost of care contracting will become an important catalyst for practice acquisitions in the future. Firms will need to take into consideration:

- The independent nature of the physicians they are acquiring
- Varying business models of consolidation and compensation that never truly took root. Even though many community-based groups operate under one tax identification number, they continue to do business in multi-pod or multi-division structures
- The lack of leadership and/or lack of a C-Suite managing the operations and strategy of the overall entity
- Differing physician motivations, attitudes, cultures and ideas of the future of the overall business entity
- Contracts and/or alignments that have been embraced by certain physicians, but not all

Select medical specialties have chosen to remain independent versus joining hospitals or large integrated health systems.

- Unraveling a disjointed entity and creating one, single-business minded entity or corporation

- A lack of education around EBITDA and/or revenue best practices (i.e. physicians taking all monies out of the business or operations for their own needs versus re-investing for the greater good of the whole)

- Politics, culture, differing billing, management, data platforms and varying objectives in the overall operations of care and consolidation

Let's go more in depth for M&A: What other, lesser-known issues should potential acquirers look out for?

The biggest challenge I have seen in the community-based M&A space is having patience and taking the appropriate time to overcome the cultural, political and financial hurdles that exist. Many firms feel they are already adept at conducting M&A, so they go into community-based deals with a naïve lens. Potential acquirers are not prepared for the nuanced approach to business that small or medium physician practices bring to the overall process. Physician groups who have remained community-based have successfully built ancillary services, service lines and other entrepreneurial revenues in their select geographies.

In short, many community-based leaders have built models for running their medical practices themselves with very little assistance or oversight from large scale entities or operators.

As a result, many of our physicians in the community space were physicians by day while running and growing their small healthcare business in between patients or during off-hours.

As M&A takes root, mergers between small healthcare entities that have their own culture, leadership, business models and a strong entrepreneurial foundation can be extremely difficult, especially when taking into consideration the ever-evolving healthcare landscape.

Many of our physicians and leaders of community-based practices are having a difficult enough time running their businesses in the current environment, let alone trying to conduct due diligence or merge into a differing entity. PE firms and strategic partnerships are not always prepared for the deeply seeded cultural, financial and political ties of community-based entities. As mentioned previously, many times what has made community-based groups successfully independent was the ability to run faster than the competition in their respective regional market. This may mean IT, operations or finance were originally structured to run the business versus trying to go through the due diligence required for a sale.

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How do the motives of financial sponsors aka PE firms looking to grow more active in this space differ from those of companies just consolidating?

The motives of PE firms truly should not be overly different from groups who are just consolidating. PE firms tend to have an exit in mind as they are beginning the process. I have found the PE firms have a vision around how to best architect their consolidations geographically, operationally, etc. in the event that they might want to merge or sell down the road. This may mean a closer eye around ancillaries, geographies, full-time equivalents, etc.

PE firms also tend to understand the infrastructure investment and initially are willing to make quick investments to get the mergers up and running or positioned for success. This logically makes a lot of sense due to the PE parent company backing. For independent mergers where there is not a large financial or parent entity, physicians or healthcare systems have to dip into their own revenues to build out the appropriate infrastructure. Loans and board approvals can take a fair amount of time versus a PE who may already have budget attached to an infrastructure build.