Q3 2013 US health services deals insights

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The heart of the matter

Health services Q3 2013 in review

The third quarter of 2013 realized a slight uptick over the prior two quarters in the volume of healthcare services deals with 138 total transactions. However, the value of the deals announced in Q3 2013, $15.8 billion, was up 35% over the second quarter. In both volume and value, the year-to-date period for 2013 continues to lag the same period in 2012 with volume down 4.6% and value down 25%.

Most notably, the quarter saw a continuation of the second quarter's emergence of for-profit deal activity. Where the second quarter was marked by Tenet Healthcare Corporation's proposed acquisition of Vanguard Health Systems for $4.3 billion, the third quarter opened with the announcement of Community Health System's $3.9 billion offer to purchase Health Management Associates (HMA). The recent for-profit deal activity and the size of these proposed deals may mark a significant change in the provider landscape.

For both payers and providers, deal activity based on investment theses of convergence remains cautious as parties continue to digest the financial results of the Medicare ACO pioneers. In September, the Medicare Payment Advisory Committee (MedPAC) reported that some pioneer ACO organizations reported increased costs of 1% to 2% while other participants were only able to achieve 0.5% of savings. As investors consider what additional delivery or payment model reforms may be necessary to realize the promise of ACO cost reduction, deal activity based on payer-provider convergence may remain flat.

Also, with the end of the third quarter came the long awaited activation of health insurance exchanges on October 1. The well-publicized technical challenges experienced by many visiting the websites may overshadow the overwhelming initial interest by consumers; however, whether this interest is reflective of a strong demand for insurance or, simply, consumer curiosity is yet to be determined. From a deals perspective, many investors will have to wait until enrollment figures are publicized to evaluate their forward-looking investment or divestiture strategies related to the Accountable Care Act's (ACA) promise of higher insured populations.

Finally, in this issue's Spotlight Article, we provide an overview of an emerging tactic in negotiating closing mechanisms—the Locked Box Pricing Mechanism. Recognized by many Buyers and Sellers as an alternative to traditional closing mechanisms that may help mitigate lengthy and, potentially, contentious post-closing negotiations, the Locked Box model also offers greater certainty related to the purchase price for both the Buyer and Seller at the signing of the Purchase Agreement.

An in-depth discussion

Deal activity in Q3 2013

Q3 2013 deal activity overview

Sector synopses: Hospitals

During Q3 2013, deal volume and value experienced an increase when compared to Q3 2012. The total volume of hospital transactions increased from 12 in Q3 2012 to 19 in Q3 2013, an increase of 58.3% in volume. Conversely, for the first nine months of 2013, overall deal volume is down approximately 6.6% (from 60 in YTD12 to 56 in YTD13). Overall deal value increased significantly from $38 million in Q3 2012 to $12.3 billion in Q3 2013. This is largely the result of two $1+ billion transactions (discussed later in this section) in Q3 2013. Thus, excluding the recently announced larger transaction in Q3 2013, this would indicate the remaining transactions were smaller and/or did not disclose deal value information based on these being private or not-for-profit transactions.

The two $1+ billion transactions announced in Q3 2013 were responsible for the significant increase in total deal value. This included Fresenius Helios' (a division of Fresenius SE & Co. KGaA) $4.2 billion announced acquisition of 43 German hospitals and 15 outpatient facilities from Rhoen Klinikum AG and Community Health Systems Inc. $7.6 billion announced acquisition of Health Management Associates. Additionally, Baylor Health Care System and Scott & White Healthcare completed their previously announced merger in September, 2013.

Several factors continue to serve as a catalyst for activity in this sector and include: 1) uncertainty and developments with healthcare reform, 2) convergence within the payer and provider arena, 3) expanding physician alignment (ensuring continuum of care coverage) and 4) capital needs for hospital projects.

Discussions and market evaluations continue in all geographies and have hospital operators exploring various strategic alternatives. This is driven by the continued need to find innovative ways to control costs and manage patient populations while improving quality of care.

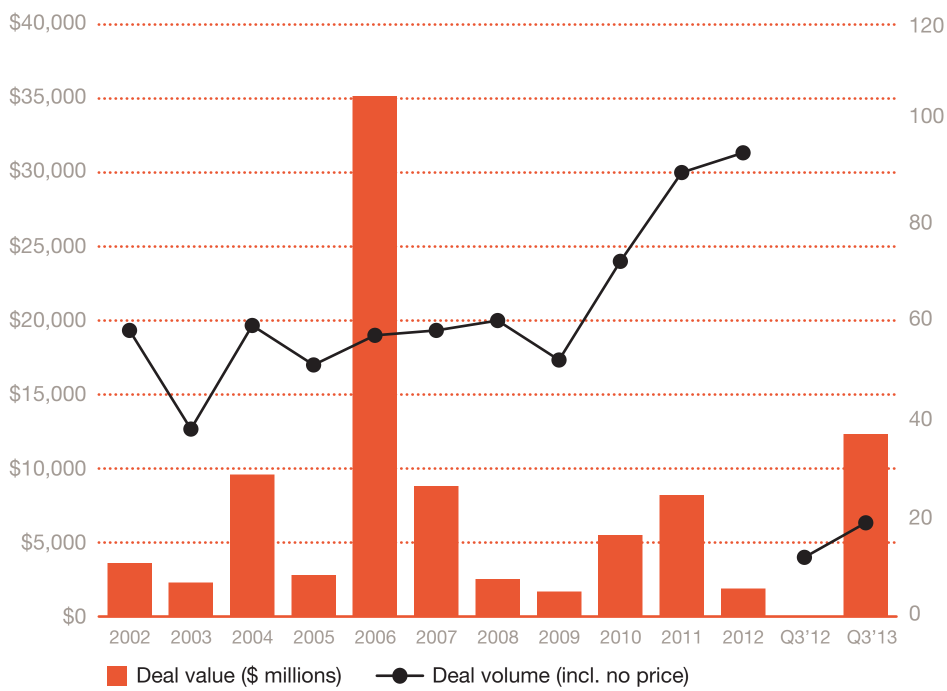
Q3 2013 selected deals

Table A

Announcement date	Target	Acquiror	Deal value $ (m)
30-Jul-13	Health Management Associates	Community Health Systems Inc.	7,600.00
14-Aug-13	3 IASIS Healthcare Hospitals	Medical Properties Trust Inc.	283.00
13-Sept-13	CharterCare Health Partners	Prospect Medical Holdings, Inc.	95.00

Source: Irving Levin Associates, Inc., The Healthcare M&A Information Source

Figure 1: Hospitals



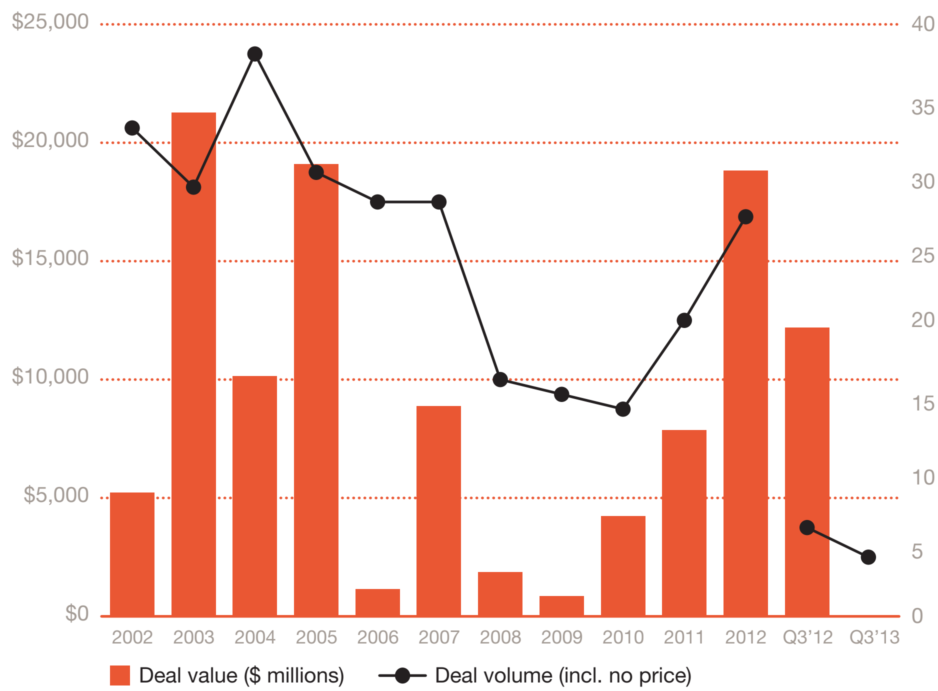
Source: Irving Levin Associates, Inc., The Healthcare M&A Information Source

Sector synopses: Managed care

Weakness in the Managed Care sector continued in Q3 2013 following the significant uptick in M&A activity in 2012. However, there was a slight uptick in deal activity from Q2 2013 (three announced deals) to Q3 2013 (four announced deals). For the nine months ending September, Managed Care announced nine deals in 2013, compared to 21 announced in the same period in 2012 (57% decline).

Despite the continued weakness in 2013, health payers continue to slowly use M&A as an avenue to expand their positions in Medicaid programs in certain parts of the country. This trend is expected to continue in anticipation of the expanded insurance coverage beginning in 2014.

Figure 2: Managed care



Source: Irving Levin Associates, Inc., The Healthcare M&A Information Source

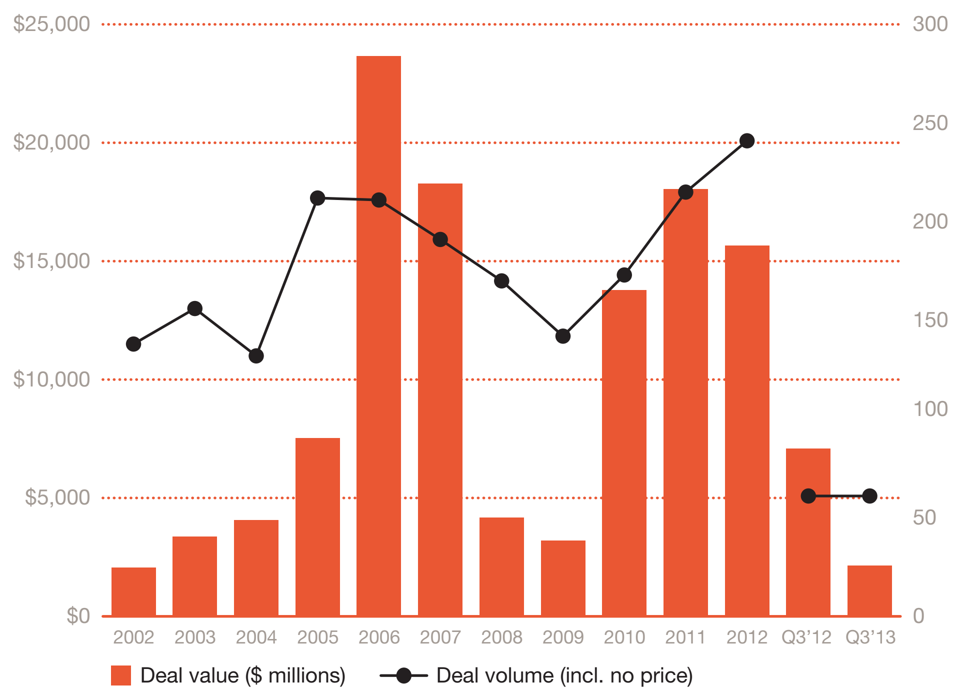
Q3 2013 selected deals

Table B

Announcement date	Target	Acquiror	Deal value $ (m)
24-Jul-13	American Eldercare Inc.	Humana, Inc.	NA
29-Jul-13	Certain assets of Community Health	Molina Healthcare, Inc.	NA
9-Sept-13	SmartD Rx Medicare Prescription Drug Plan	Express Scripts	NA

Source: Irving Levin Associates, Inc., The Healthcare M&A Information Source

Figure 3: Post-acute care



Source: Irving Levin Associates, Inc., The Healthcare M&A Information Source

Post acute deals

Table C

Announcement date	Target	Acquiror	Deal value $ (m)
9-16-2013	Ark Holding Company	Omega Healthcare Investors, Inc.	$525.0
8-5-2013	15 senior living communities (TJM Properties)	Newcastle Investment Corp.	200.0
7-1-2013	17 assisted living communities (Care Investment Trust)	NHI-Bickford	135.0
Other			754.0
Long-term care			$1,614.0
# of deals			53
9-19-2013	Harden Healthcare Holdings	Gentiva Health Services, Inc.	408.8
Home health care			$709.0
# of deals			4
Rehabilitation			$104.0
# of deals			4
Total post-acute			$2,139.0
# of deals			61

Source: Irving Levin Associates, Inc., The Healthcare M&A Information Source

Sector synopses: Post-acute care

Long-term care: This sector is notable this year as deal volumes are the highest compared to other sectors (if not by dollar value). An attractive environment for sellers to exit investments, similar to the 2006-2007 period, as a result of low interest rates and available financing (such as HUD loans) is thought to be one driver of this year's consolidation. Although most deals reported are between $5 million–$50 million, one or two larger deals have been evident in Q3 2013, such as Omega's announced acquisition of 56 nursing facilities from Ark Holding Company in September. This was one of the largest transactions for several years. If liquidity continues, continued consolidation is expected. As reimbursement issues continue to put pressure on margins, continued consolidation is expected.

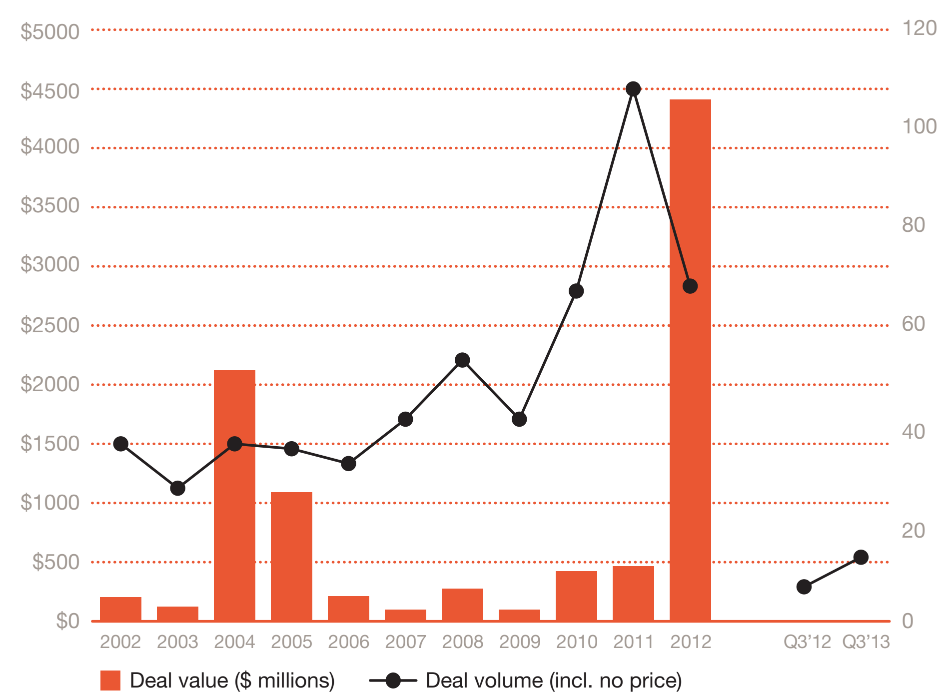
Home health and rehabilitation: The home health services sector included one notable large transaction this quarter, Gentiva's announced acquisition of Harden Healthcare. However, comparison to 2012 is skewed because Q3 2012 included The Linde Group's health's multi-billion acquisition of Lincare Holding's, Inc. Volumes and deal values in Rehabilitation remain relatively small. We may see further transactions stimulated in these sectors as the full impact of the Affordable Care Act is felt.

Sector synopses: Physician practices

Announced deal volumes ticked slightly up from Q3 2012, although as typical with physician practice acquisitions, no deal values were announced. Deal volume continues to be generated from both national and regional medical groups leveraging their economies of scale in the highly fragmented physician practice space as well as hospitals and health systems attempting to secure volumes due to changing reimbursement models.

The current trend of physician practice acquisitions by regional and national medical groups is expected to continue in the near term as physician groups look for ways to respond to reimbursement changes. For Hospital based acquisitions, it remains to be seen whether the recent acquisition trends are sustainable given the past issues of operating losses generated by hospital-owned physician practices.

Figure 4: Physician Medical Group



Source: Irving Levin Associates, Inc., The Healthcare M&A Information Source

Table D

Private equity deals across healthcare

	Q3 2012	Q3 2013
Provider deals	15	4
Payer deals	0	0
Health services	5	3
Number of PE healthcare investments	20	7
Entry*	17	4
Portfolio company	0	2
Exits	3	1
Number of PE health services investments	20	7

*Several Entries were also Exits—these have been classified as entries

Source: Dealogic

Private equity

The third quarter of 2013 continued a decline in deal volume with seven announced transactions (excluding pharma, biotech and medical devices). For comparison purposes, in the third quarter in 2012, there were 20 such transactions as shown above.

The sluggish volume of private equity deals in the third quarter of 2013 is consistent with what we experienced earlier in 2013 where six private equity deals were announced in the second quarter of 2013 and four private equity deals were announced in the first quarter of 2013.

Transactions occurring during the third quarter 2013 include Cigna's acquisition of Alegis Care (a portfolio company of Triton Pacific Capital Partners) and One Call Care Management's acquisition of TechHealth Inc (One Call is a portfolio Company of Odyssey Investment Partners).

Other

In the third quarter of 2013, the Levin data reported 30 transactions with an announced deal value of $727.7 million. This represents a similar level of deal volume when compared to the second quarter where 27 transactions were announced with a total announced deal value of $2.2 billion. In the third quarter of 2013, there were several notable deals with unannounced values in the Pharmacy Benefit Management ("PBM") space including Envision Pharmaceutical Services, ScriptSave and Apex Affinity. The largest transaction with an announced deal value for this quarter in 2013 was the $409.5 million deal involving Catamaran Corporation's acquisition of Restat LLC, also in the PBM space.

The increase in PBM deal activity this quarter is notable in the middle market as the industry is dominated by large mega-cap public companies (e.g. ExpressScripts, CVS Caremark). Payers and TPAs are increasingly looking for companies that offer end to end customer solutions and total cost containment focused not only on effective drug costs but clinical management. It is the latter that buyers seek differentiation (and higher multiples) for companies with best in class data management and integrated, scalable information technology environments. It will be interesting to follow the trends and multiples in PBM and other service deals into the fourth quarter.

Q3 2013 selected deals other services

Table E

Acquisition date	Target	Acquiror	Deal value $ (m)
1-Aug-13	Restat LLC	Catamaran Corp	409.5
29-Jul-13	Medical Management	Zotec Partners LLC	200.0
9-Sep-13	Partners RX	Magellan Health Services	100.0
18-Jul-13	Secured Health and Life	Health Insurance Innovations, Inc.	10.0
11-Jul-13	Duke Medical LLC	Sanomedics International	7.0
13-Aug-13	Healthcare Staffing Unit	Accountable Healthcare Staffing	1.2
8-Jul-13	Envision Pharmaceutical Services	TPG Capital	N/A
15-Jul-13	ScriptSave	MedImpact Healthcare Systems	N/A
31-Jul-13	Apex Affinity	MedImpact Healthcare Systems	N/A
Others			N/A*
# of deals			30

* Note 21 other deals were announced without indication of deal value in Q3 2013

Source: Irving Levin Associates, Inc., The Healthcare M&A Information Source

Spotlight article

To lock or not to lock: An introduction to the Locked Box closing mechanism

Introduction

In an increasingly sophisticated deals market, specialist knowledge of the benefits and pitfalls related to the financial and accounting aspects of the sale and purchase agreement ("SPA") can be the difference between a good deal and a great deal. In any transaction, the SPA represents the outcome of key commercial and pricing negotiations between parties. The financial aspects of the SPA are key to ensure that the Buyer is buying (and Seller is selling) what they expect, for the price they expect to pay (receive) and without undue risk.

Traditionally deals have been closed across the Globe, using a Closing Accounts pricing mechanism under which, parties to the transaction agree a 'cash free, debt free' price ("Enterprise Value") which is then adjusted post-Closing for the actual Cash, Debt and Working Capital (or some other measure, e.g., Net Assets) in the Target business at the date of Closing ("Closing Date"). In order to be able to determine these final price adjustments to Enterprise Value, Closing Accounts are drawn up and the adjustments are calculated based on the definitions and mechanism set out in the SPA and then subsequently negotiated and settled between the parties.

However, as the market continues to evolve, Buyers and Sellers are looking for ways to reduce the often lengthy process of preparing, reviewing and potentially disputing these final price adjustments derived from the Closing Accounts. And as a result, we are increasingly seeing more deals being completed under a Locked Box mechanism.

1. **The Locked Box mechanism**
   A Locked Box deal in its simplest form is a fixed price deal, whereby that price ("Equity Value") is fixed in the SPA at signing, calculated based on an historical balance sheet (the "Locked Box Balance Sheet") at a pre-signing date (the "Locked Box Date"). This fixed price for the shares of the Target business is negotiated based on the Locked Box Balance Sheet.

   Cash, Debt and Working Capital are known amounts at the Locked Box Date, and therefore Equity Value is agreed between the parties and written into the SPA. Protection against Leakage of value from the Target business between the Locked Box Date and Closing Date is provided by the Seller through representations and warranties, usually supported by an indemnity. No Closing Accounts are required and therefore no adjustment is made to price at or after the Closing Date (subject to Leakage review).

2. **Leakage**
   Leakage comprises any form of value extraction from the Target business between the Locked Box Date and Closing Date that benefits the Seller. For example this could include dividends, management fees

Table 1. No leakage of cash (need title here)

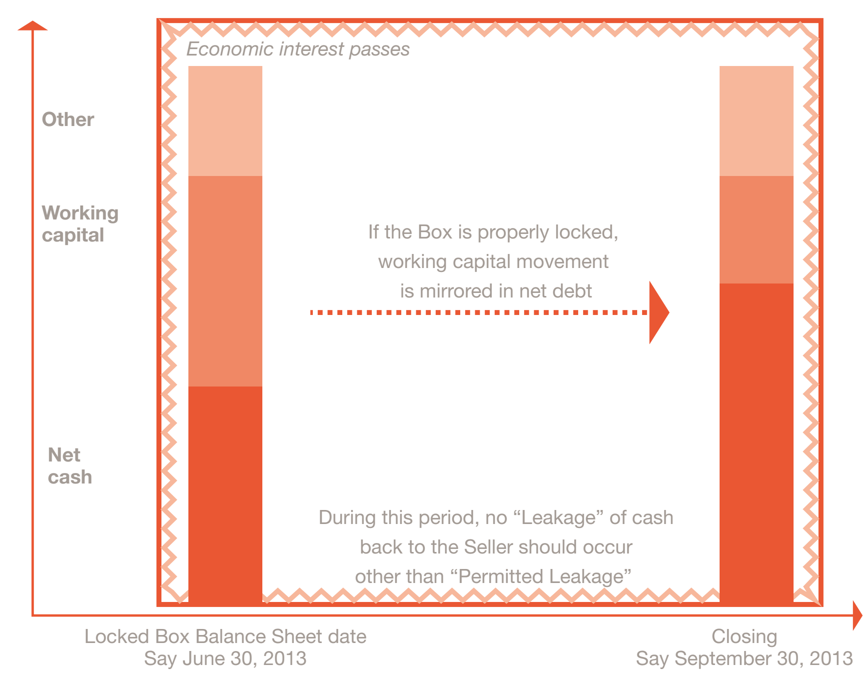


Table 2. Pricing considerations for a Locked Box are the same as for Closing Accounts, only the timing differs

Purchase Price (Enterprise Value)		**x**	Starting point—price/round 1 bids
Plus: $ for $ cash	x		
Less: $ for $ debt	(x)		
Net debt adjustment		**x/(x)**	**Price adjustments**—similar to the items that are adjusted for in a closing accounts mechanism, **except amounts are calculated based on the Locked Box Balance Sheet**
Plus: $ for $ working capital	x		
Less: Normal working capital	(x)		
Working capital adjustment		**x/(x)**	
Other cash-like and debt-like items		x/(x)	
Permitted Leakage		(x)	Defined in the Locked Box SPA
Purchase Price (equity value)		**x**	Price shown in the Locked Box SPA
Interest charge on equity value		x	Mechanism to extract profits
Total consideration		**x**	At the Locked Box Date

and transfer of assets at an undervalue. The SPA usually includes a comprehensive definition.

Permitted Leakage comprises any Leakage that is agreed between the parties and specified in the SPA. Permitted Leakage may or may not result in a reduction to Equity Value. For example, a dividend paid to the Seller after the Locked Box Date will result in a reduction to price, whereas salary payments made in the ordinary course of business to employees should not. (See Table 1)

3. **Equity Value—Pricing Considerations**
Round one of bidding is the same whether using Closing Accounts or a Locked Box mechanism. "Cash-free, debt-free" bids are submitted to the Sellers thereby setting their Enterprise Value expectations. Prior to the next stage of bidding, Sellers will often try to pre-empt potential Buyers price adjustments and use this to prepare counter arguments against potential deductions. Increasingly we are also seeing Sellers issuing their view of the Enterprise Value to Equity Value schedule in order to further "manage" Buyers' expectations of Cash, Debt and Working Capital adjustments.

The Seller may also issue some persuasive "guidance" to Buyers regarding which deductions from Enterprise Value are acceptable to the Seller, and if it is a competitive auction process, which adjustments make their bids uncompetitive.

In order for a Buyer to be able to accept this concept of fixed price for the shares based on a historical balance sheet, the Seller should offer (and the Buyer should require) a warranty representing that no Leakage has occurred or will occur from the Locked Box Date to the Closing Date. This warranty is then often backed up by an indemnity such that the Seller will reimburse the Buyer for any Leakage that occurs on a $ for $ basis (i.e. carved out of any indemnification baskets or caps). Permitted Leakage is carved out of the definition of Leakage therefore it is imperative that the Buyer asks the Seller to schedule out the items of Permitted Leakage in as much detail as possible (payee, amount, timing) such that the items can be priced accordingly.

The SPA typically set out a time period post-Closing during which the Buyer can diligence the books and records of the Target business to identify and claim for any Leakage that may have occurred.

With that being said, in our experience in the UK and Europe Leakage claims are not common. (See Table 2)

4. **Interest Charge/Cash Profits**
Given that economic interest effectively passes to Buyer from the Locked Box Date, the Buyer has the benefit of the cash profits generated from that date. In contrast, the Seller incurs an "Opportunity Cost" as they do not receive payment until the Closing Date.

   In order to compensate the Seller for this Opportunity Cost, interest is typically charged on Equity Value for the period between the Locked Box Date and Closing Date. To achieve such compensation, the Seller typically demands either:

   - An interest charge on Equity Value, reflecting the opportunity cost of the Seller not receiving the proceeds from the Buyer at the Locked Box date when economic interest passed; or
   - A proxy for the profits earned (e.g., daily profit rate) as they will not have been able to extract cash profits since the Locked Box Date.

   The interest charge, whether proposed as compensation for the opportunity cost or proxy for profits, typically reflects the expected "Cash Profits" generated by the Target after the Locked Box Date, NOT the operating cash flow.

   Regardless of the Seller's rationale, Buyers should compare the amount payable under the interest charge with the expected Cash Profits to be generated between the Locked Box Date and Closing Date. Cash Profits broadly represent the increase in net assets of the Target between the Locked Box Date and Closing Date. We highlight that Working Capital movements are dealt with through the mechanism and therefore do not impact the calculation of Cash Profits (i.e. assuming the "box is locked," and there is no Leakage, any change in Working Capital would result in an offsetting change in Net Debt).

5. **Buyer Checklist**
In order for a Buyer to be able to accept closing under a Locked Box mechanism, if the Locked Box Balance Sheet has not been subject to an audit, or to independent review, a Buyer would need to seek additional comfort over the Locked Box Balance Sheet through stronger representations and warranties over the Locked Box Balance Sheet and related Accounts. In addition to sufficient comfort over the Locked Box Balance Sheet, it will also be key for a Buyer to make sure that there are adequate systems set up within the Target business to identify Leakage; and that the Buyer can them selves get comfortable that Leakage can be identified for pricing purposes.

The Locked Box mechanism may not be appropriate for every transaction. For example, in a complex carve-out scenario a Buyer may not be able to gain enough comfort over the Locked Box Balance Sheet to fix price at signing; in which case it is likely that the mechanism would default to traditional Closing Accounts.

As a Buyer, when contemplating closing under a Locked Box pricing mechanism we suggest that you should assess the following:

- Who is a "Seller" or a "related person" for the purposes of identifying Leakage?
- Are systems set up to identify all transactions between the Target and the Seller/related persons between the Locked Box Date and Closing?
- Do you have sufficient control over potential Leakage in distant territories?
- Consider requiring a definition of Permitted Leakage.
- Consider which items of Permitted Leakage are items to be disclosed for legal reasons, with no impact on price, or whether there are items which need to be factored into price.
- Consider whether the form of the Leakage warranty is sufficient, on a $ for $ basis and carved out of the baskets and caps.

6. **Pros and Cons**
The Locked Box pricing mechanism is used to close a significant number of transactions in the UK and Europe and this article has set out how the mechanism works; together with some practical considerations to be aware of when using a Locked Box mechanism.

Although there are some obvious advantages to a Seller in using a Locked Box mechanism (and hence the perception that this mechanism is Seller-friendly), a number of these benefits will also benefit the Buyer. Provided the Seller can offer appropriate comfort over the integrity of the Locked Box Balance Sheet, accompanied by relevant warranties over the Locked Box Accounts, this mechanism can also work for a Buyer.

There are a number of key benefits to using a Locked Box mechanism, the most obvious being that it gives certainty of price for both Buyer and Seller at the time of signing the SPA, which explains why this mechanism is particularly favored by Private Equity and financial Sellers. It is also becoming increasingly popular in the Corporate Sector as well as they see this mechanism as a way of reducing some of the risks associated with Buyers using the Closing Accounts process to bridge some of the value gap through 'price-chipping' post-Closing.

As pricing is based on the Locked Box Balance Sheet, which may have been subject to independent review, there is no drawn-out debate over which accounting policies and practices should be used in the preparation of Closing Accounts, nor is there such debate regarding the form of the Closing Accounts and the process by which these accounts will be prepared, reviewed and potentially disputed; thus resulting in potentially significant time and cost savings.

Locked Box SPAs are considerably less complex documents than those using a Closing Accounts mechanism as a result of the simplicity of the mechanism. In addition to cost savings, management time is freed up to run and/or prepare to integrate the Target business as opposed to their time being tied up in preparing and debating Closing Accounts post-Closing.

The key to a successful Locked Box is making sure that the box is locked. The concept works on the basis that any movement in Working Capital will be mirrored in Net Debt and provided no value has 'leaked' from the target business back to the Sellers; and the Buyer should therefore indifferent to the fact that the Closing Balance Sheet will be different to the Locked Box Balance Sheet.

Conclusion

In summary, the pricing considerations and mechanics underlying a Locked Box mechanism are the SAME as those underlying the traditional Closing Accounts. Ultimately, the Buyer will write a check to the Seller for the shares that comprises an Equity Price (i.e., Enterprise Value adjusted for Cash, Debt and the difference between Target Working Capital and Working Capital). Value can be lost under both pricing mechanisms if these key financial drivers between Enterprise Value and Equity Value are not negotiated and treated appropriately in the SPA.

About the data

We defined US M&A activity as mergers, acquisitions, shareholder spin-offs, capital infusions, consolidations and restructurings where acquisition targets are US-based companies acquired by US or foreign acquirers. Transactions are based on announcement date, excluding repurchases, rumors, withdrawals and deals seeking buyers.

We consider deals to be mergers or acquisitions when there's a change of control or the makeup of the controlling interest changes. In the instance of an acquisition, one company takes effective control over another company or product. In a merger situation, two boards are combined and/or monies are combined. An affiliation or collaboration is neither considered a merger nor an acquisition.

Acknowledgments

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