Q1 2014 US health services deals insights

May 2014

A publication from the PwC's Deals practice

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What's the role of the consumer in due diligence?

The heart of the matter

Health services Q1 2014 in review

In the first quarter of 2014, the total volume of deals remained consistent with the same period in 2013; however, the value of announced deals rose 152% to $12.3 billion. While some adjustment may be necessary to reflect deals without announced value, there remains optimism that larger deal sizes may represent renewed confidence as the dust settles from the implementation of the ACA's Insurance Exchanges.

From a sector perspective, acute care hospitals and physician practices had reduced announced activity. Hospital deal activity may be experiencing a short term slowdown as buyers and sellers digest the large-scale deals announced in 2013 by Tenet Healthcare and Community Health Systems. However, our outlook for hospital deal activity in 2014 continues to be optimistic as the impetus for greater alignment and size remains unchanged. In the physician practice sector, physician practice management companies were the sole source of buyers for the nine announced deals as they seek volume to counteract lower reimbursement environments.

For the remaining provider sectors, the long term care sector continued to lead both volume and value metrics for the quarter. Conversely, the home health, behavioral health, and rehabilitation sectors lagged with 11 total deals announced in the quarter—down from 18 total deals for the same period in 2013.

In the managed care sector, deal volume ticked up from two announced deals in the first quarter of 2013 to five announced deals in the first quarter of 2014. Unfortunately, deal value was not disclosed for the 2014 deals.

For private equity, the volume of deals with traditional provider or payer targets remained sluggish in the first quarter of 2014 as investors focus on niche markets and services. Financial buyers may be facing headwinds in the form of tighter lending standards and also may face rising prices for target companies as strategic buyers compete for the same opportunities. However, private equity interest in international healthcare investments has emerged as a recent positive trend.

Finally, as our Spotlight Article this quarter, we recognize the role of the customer in the evaluation of healthcare transaction strategies. As many healthcare investment hypotheses stress the importance of market share to their enterprise valuation—whether in terms of population served or lives managed—we discuss the risks, opportunities, and diligence considerations that may help better assess the landscape of potential deals.

An in-depth discussion

Health services Q1 2014 in review

Sector synopses: Hospitals

During Q1 2014, deal volume experienced a decrease when compared to Q1 2013. The total volume of hospital transactions was down from 21 in Q1 2013 to 12 in Q1 2014, a decrease of nearly 43%. However, deal value increased from $320 million in Q1 2013 to $388 million in Q1 2014. This is largely the result of the $369 million announced acquisition of Chindex International in February. Chindex is an American healthcare company that provides services in China through the operation of a network of private primary care hospitals and affiliated ambulatory clinics. Thus, excluding this transaction from the deal value 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.

Community Health Systems closed its $7.6 billion acquisition of Health Management Associates on January 22, 2014. This occurred following agreement to divest Riverview Regional Medical Center in Gadsden, Alabama and Carolina Pines Regional Medical Center in Hartsville, South Carolina to address antitrust concerns. Upon closing, Community Health Systems became the largest hospital chain in the country, based on hospital count.

The softened deal activity of Q1 2014 does not necessarily indicate a slowdown. Hospitals (both for profit and not-for profit) across many geographies within the US continue to assess strategic alternatives, specifically addressing their market position, long term strategy and the recent large transactions which have reinforced a "bigger is better" mentality within the hospital sector. Overall, 2013 deal value was inflated by Community's acquisition noted above, as well as Tenet Healthcare Corp's $4.3 billion acquisition of Vanguard Health Systems. Although hospital transaction value in 2014 may not eclipse 2013 levels, expect to see continued deal activity/ volume in this sector given as more hospital providers continue to explore strategic alternatives.

Q1 2014 selected deals

Table A

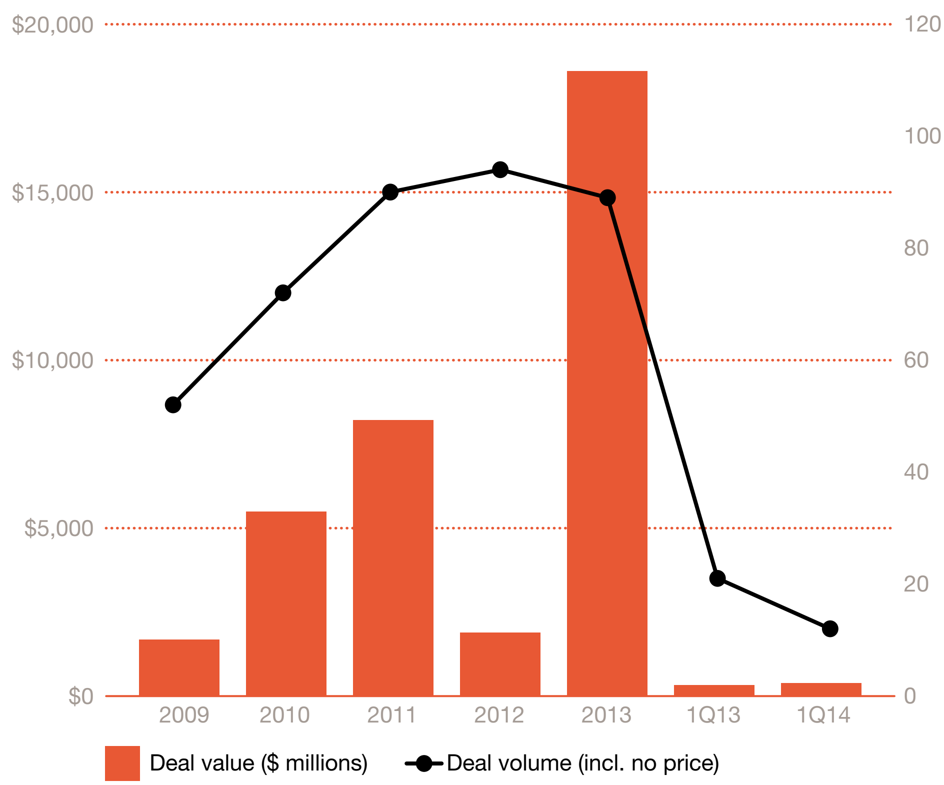
Announcement date	Target	Acquiror	Deal value $ (million)
14-Jan-14	Grandview Medical Center	Tristar Health	ND
17-Feb-14	Chindex International, Inc.	TPG Capital and Fosun Pharma	$369.000
4-Mar-14	2 hospitals in India	Narayana Health	ND

ND—not disclosed

Source: *The Health Care M&A Information Source*, www.healthcareMandA.com

Deal value and number

Figure 1: Hospitals



Source: *The Health Care M&A Information Source*, www.healthcareMandA.com

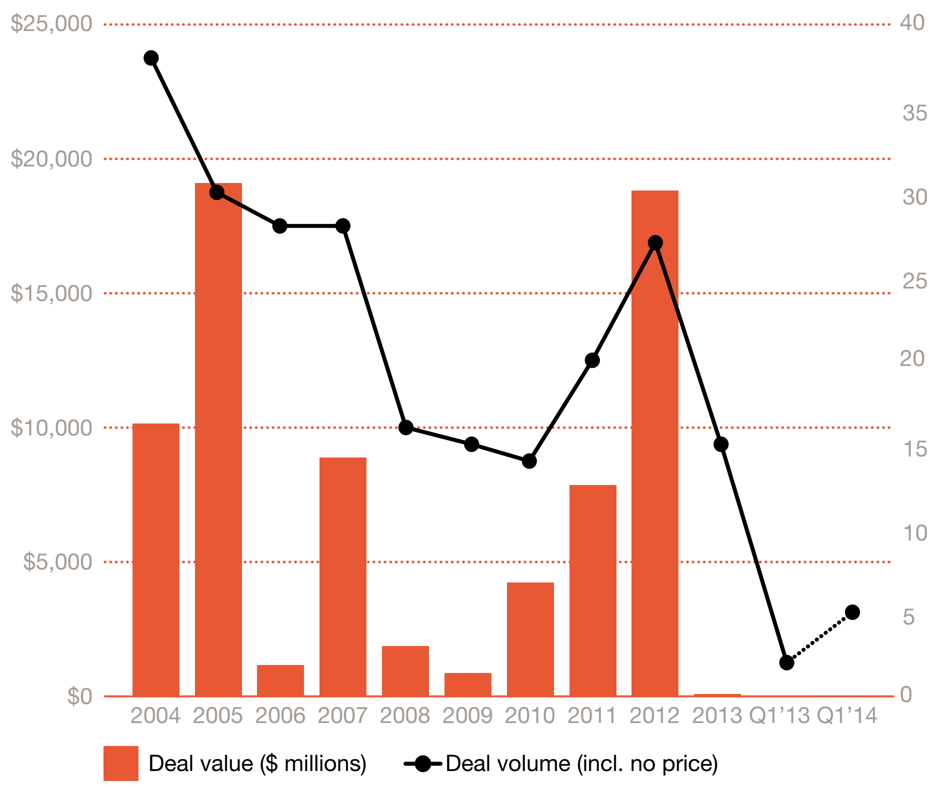
Managed care

M&A activity in the managed care sector was up slightly in Q1 2014 as deal volume increased 150% relative to Q1 2013. Dollar volume activity was not disclosed for any of the deals announced in Q1 2014.

From a divestiture standpoint, Wellpoint agreed to sell its online contact lens retail subsidiary (1–800-contacts), a business acquired in June 2012 for $900 million, to private equity firm Thomas H. Lee Partners for an undisclosed price. Wellpoint also sold the glasses.com website to Italian eyewear company, Luxottica.

The market for EMRs has received continued attention from managed care companies. UnitedHealth Group announced its acquisition of a majority stake in Audax Health Solutions, Inc. in February 2014, through a data analytics subsidiary of Optum, following an acquisition of Humedica in January 2013.

Figure 2: Managed care



Source: *The Health Care M&A Information Source*, www.healthcareMandA.com

Moving forward into 2014, an increase in M&A activity is still likely as managed care companies work to meet the required milestones of ACA.

Q1 2014 selected deals

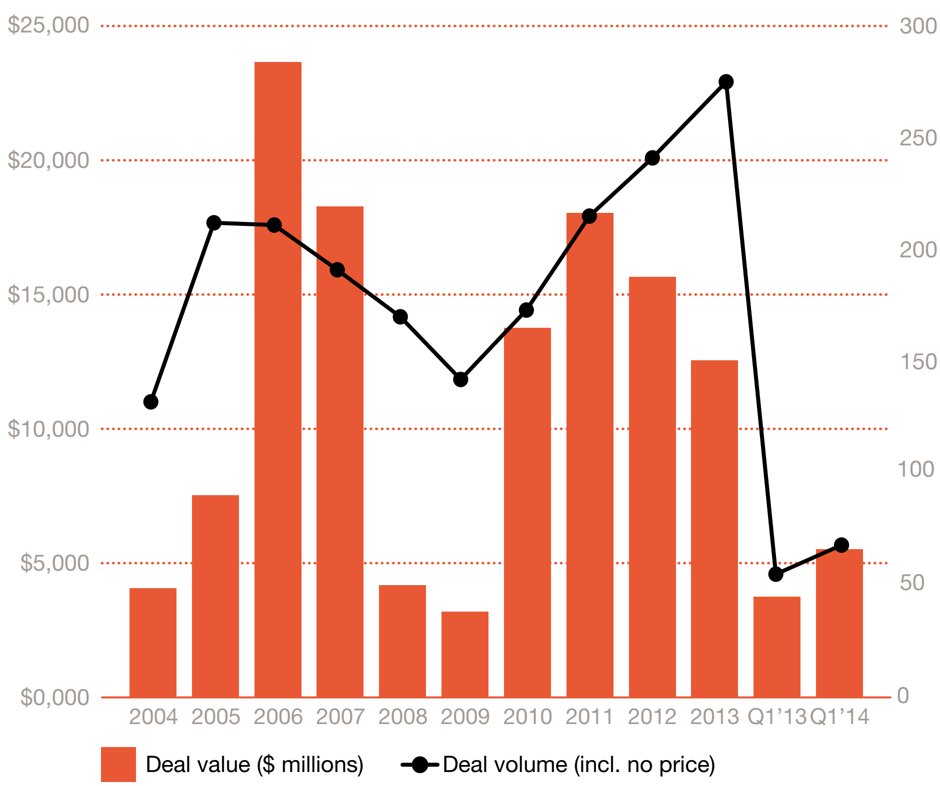
Table B

Announcement date	Target	Acquiror	Deal value $ (million)
17-Jan-14	PPOplus, LLC	Stratose	NA
28-Jan-14	Dental Select	Brent Williams	NA
04-Feb-14	Arkansas Managed Care Organization	Stratose	NA
18-Feb-14	Blue Cross of Northeastern Pennsylvania	HighMark, Inc.	NA

Source: *The Health Care M&A Information Source*, www.healthcareMandA.com

Deal value and number

Figure 3: Post-acute care: Long-term care, home health & rehabilitation



Source: *The Health Care M&A Information Source*, www.healthcareMandA.com

Post-acute care

Long-term care: This sector has started the first quarter of 2014 where it left off in 2013, leading the sectors in both volume and value, as well as making gains over the first quarter in 2013.

The largest and most notable transaction was that by Brookdale, and their acquisition of Emeritus. This acquisition significantly expanded the reach of the company in higher population states such as New York and New Jersey, and other north east states, and was well received by the stock markets. Yet, reports that this transaction means the company has just 10% market share underlines the long-term potential for consolidation in this sector.

Such deals, in conjunction with positive operating trends, will continue to build confidence in decision makers and help support strong M&A trends in this sector.

Home health and rehabilitation have started at a slower pace, with smaller volumes and values recorded compared to the first quarter in 2013, with just two deals in the home health and hospice sector (values were not released) and six deals in the rehabilitation sector.

2014 selected deals

Table C

Announcement date	Target	Acquiror	Deal value $ (million)
20-Feb-14	Emeritus Corporation	Brookdale Senior Living, Inc.	$2,800
17-Mar-14	80 senior care facilities	NorthStar Realty Finance	1,050
11-Feb-14	Sunrise Senior Living	Revera, Inc.	300
31-Mar-14	Conservatory Senior Living	Kayne Anderson Real Estate	290
Others			1,011
Long-term care			5,451
# of deals			60
Home health care & hospice			60
# of deals			6
Rehabilitation			N/P
# of deals			2
Total post-acute			5,511
# of deals			68

Source: *The Health Care M&A Information Source*, www.healthcareMandA.com

Physician practices

Announced deal volumes were slightly down from Q1 2014, although as typical with physician practice acquisitions, few deal values were announced. Hospitals and health systems, who tend to acquire primary care physician groups in an effort to maintain referral volume, appear to be slowing down their pace of acquisitions. In 2011, hospitals and health systems accounted for 51% of all physician practice volume, but by 2013 accounted for only 14%. During Q1 2014, physician practice management companies accounted for all nine of the reported deals with MEDNAX and IPC The Hospitalist Company each reporting two deals.

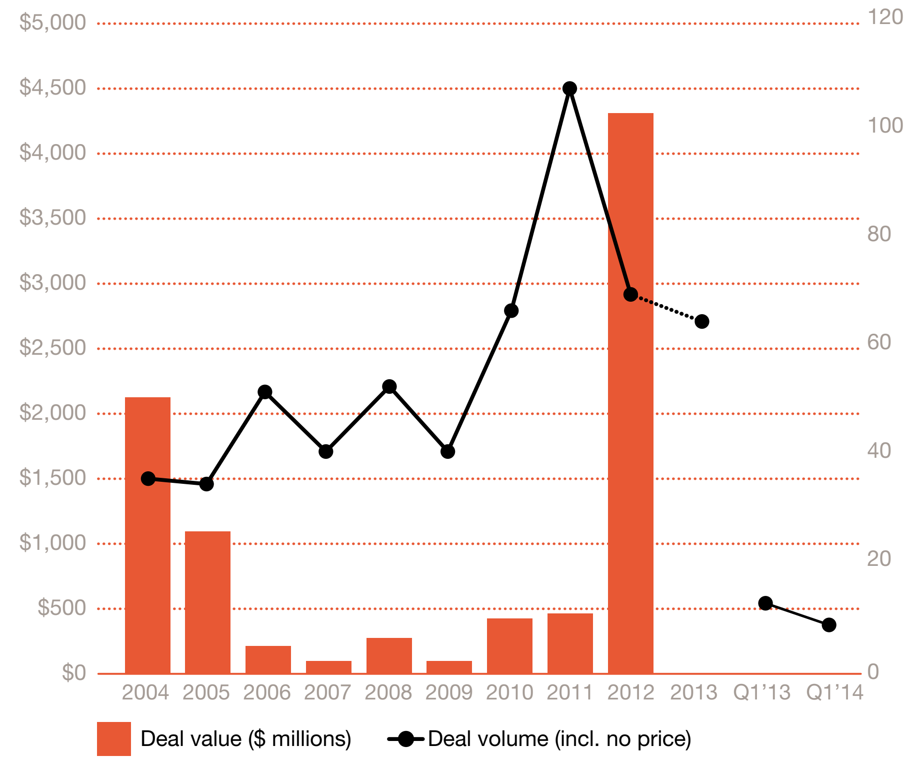
The current trend of physician practice acquisitions by physician practice management companies is expected to continue in the near term as specialty-based physician groups look for ways to respond to reimbursement changes and higher regulatory costs of maintaining their practices.

Private equity

As discussed in PwC's US health services deals insights annual report, Q1 2014 private equity deals were highlighted by Carlyle's $4.15 billion announced acquisition of Johnson & Johnson's Ortho Clinical Diagnostics ("OCD") unit. The deal is to be financed with $3.3 billion of debt including $2.15 billion of term loans and $1.15 billion of bonds. Carlyle's most recent large carve-out experiences are outside of the healthcare industry but include carve-outs from companies with the same global reach as J&J such as Illinois Tool Works, United Technologies and DuPont.

Investors' appetite for debt and risk still remains robust in Q1 2014 but regulatory pressures may loom on the horizon for US banks. As reported by the Wall Street Journal, the Federal Reserve has been demanding compliance with 2013 guidance that banks should avoid financing deals that involve debt to EBITDA ratios greater than six times. The ability of private equity firms continuing to be price competitive in

Figure 4: Physician medical group



Source: *The Health Care M&A Information Source*, www.healthcareMandA.com

Q1 2014 announced deals

Table D

	Transaction count		Announced deal value ($million)	
PE dealer by type	Q1 2013	Q1 2014	Q1 2013	Q1 2014
Healthcare providers & services	5	5		
Healthcare equipment & supplies	8	6		
Hospitals	3	–		
Payers	1	–		
Total announced deals	17	15	$324	$5,558

Q1 2014 includes Medpace/Cinven
Q1 2013 = Symphonic acquisition by United Health includes Medpace/Cinven

Source: Thomson Reuters

the current market may be hindered by these regulations but opportunity exists for non-bank financing such as broker dealers and credit arms of private equity firms. Nevertheless, high-yield corporate debt rates remain favorable for buyout funds averaging less than 6% (evidenced by the yield on the following ETFs as of March 31, 2014: SPDR Barclays High Yield Bond, "JNK" and iShares iBoxx High Yield Corporate Bond, "HYG").

Pure play providers, hospitals and payer deal counts remain sluggish in Q1 2014 as investors focus on niche markets and services. Large funds however have been investing internationally in the sector. Bain Capital announced an acquisition of Grupo Notre Dame Intermedica a Brazilian managed care and health plan operator which also owns many of the hospitals and providers in its network. International deal counts and values are not included in our data sets.

Continued private equity interest remains strong in the Contract Research Outsourcing ("CRO") markets evidenced by Cinven's acquisition of Cincinnati, OH based Medpace. Medpace is a mid-market CRO with operations in the US and Europe. The announced deal value of $915 million approximates a 10x trailing EBITDA multiple. This multiple still trails larger public competitors such as Quintiles whose enterprise value/EBITDA currently exceeds 13x (as calculated by Capital IQ).

Other services

In Q1 2014, 24 transactions were announced with total deal value of approximately $730 million. This compares to 21 transactions in Q1 2013 valued at $2.3 billion which includes Cardinal Health's $2.1 billion acquisition of AssuraMed. Excluding that deal, Q1 2014 exhibits growth from Q1 2013.

Furthering the CRO discussion from the private equity segment, Charles River Laboratories announced a $179 million acquisition of the CRO division of Galapagos. Operating under the BioFocus and Argenta names, this division provides pre-clinical target and drug discovery services and operates out of the United Kingdom and the Netherlands. Given the recent tail winds in the CRO deal market in general, it will be interesting to see if acquisitions in this sector are a sign of more to come.

Dublin based ICON added on to its Phase I–IV CRO portfolio by acquiring Reston, VA based Aptiv Solutions for $143.5 million. Aptiv operates globally in 16 countries including an oncology focused Japanese operation. This transaction will add to ICON's existing operations in Tokyo and Osaka, Japan.

Q1 2014 selected deals other services

Table E

Acquisition date	Target	Acquiror	Deal value $ (million)
9-Jan-14	HealthTronics Inc	Altaris Capital Partners	$85.0
20-Jan-14	N Scottsdale Family & Cosmetic	Sebring Software	2.0
13-Feb-14	American Care Air Ambulance	PhotoMedex Inc	106.4
18-Feb-14	Berchtold Holdings AG	Stryker Corporation	172.0
3-Mar-14	CRO division of Galapagos	Charles River Laboratories	179.0
24-Mar-14	Cedarburg Pharmaceuticals	Albany Molecular Research	41.0
31-Mar-14	Aptiv Solutions	ICON plc	143.5
Others			N/A
# of deals			24

Source: *The Health Care M&A Information Source*, www.healthcareMandA.com

Spotlight article

What's the role of the customer in due diligence?

There's an interesting convergence of trends in today's healthcare markets. On the one hand payers, providers, pharmaceutical and device manufacturers face an increasingly consumer (customer) driven market in which patients will have more choice, more information, and more cost sharing responsibility than ever before. But on the other hand, new risk sharing models and cost pressures are forcing consolidations amongst providers and payers.

This begs the question, what's the consumerism lens that needs to be applied to these emerging M&A deals?

Assuming that one can simply "buy" market share is a potentially fatal mistake; it implies that customers are captive. Prior to the launch of healthcare reform that was not only a fair assumption, it was often reality. Consumers were captive; employers paid for coverage and the balance of information skewed heavily towards providers. Resultantly, consumers often did simply what they were told to do and seldom voted with their feet in resistance. In that context, the acquisition of a local practice, hospital or member base was akin to buying a stable book of business.

But the game is changing in many ways. Information asymmetries are leveling (e.g., pricing, provider ratings and other quality measures are becoming more transparent), switching costs are shrinking, and as consumers are increasingly exposed to high out of pocket costs, they are questioning what is real value and shunning the payers and providers that don't deliver. In other words, your customers are no longer held captive and in fact are voting with their feet.

Recent history suggests that north of 50% of M&A deals in consumer-driven categories don't reach their full value because of customer attrition, in short customers shift their loyalties elsewhere. Why? While research doesn't pinpoint one specific cause, it is not much of a stretch to imagine that changes in pricing, quality, customer experience and brand perceptions are likely suspects.

So how can healthcare organizations reduce the risks of customer loss and more quickly realize the efficiencies they hope for in M&A deals? Including real customer economics, satisfaction measures and ultimately experience delivery as part of the due diligence in healthcare M&A deals can be a game changer.

There's an old adage in customer driven companies: "know thy customer." Today's healthcare industry needs to evolve beyond the concept of a patient, beyond the reality of a consumer and into real customer intimacy and knowledge.

Back to the point about fatalistic assumptions, payers and providers have traditionally assumed that people are alike simply because they share a condition or payer type. In other words, because two patients have diabetes it was assumed they would have the same preferences when it comes to their treatment. That's akin to saying all people with dirty hair need one type of shampoo. If that's the case, then why is the US shampoo/conditioner category a multi-billion dollar business with 100+ brands? Because while consumers may be linked by a common need, they do in fact have different tastes. Someone most certainly will rise "head and shoulders" above their competition given this reality.

In the era of big data, there's no shortage of information on your customers and those of potential acquisitions. However, most healthcare organizations aren't equipped with the capabilities to aggregate and analyze the data, much less develop actionable strategies. The right analytics can uncover insights could fundamentally influence your thinking. Some examples:

- Customers can be segmented not only by condition and/or episode, but also by beliefs, influences and purchase behaviors that indicate how they make critical decisions. For example, an analysis may reveal a customer segment that is highly interested in self-service options (at much lower cost). A provider or payer would be smart to assess its ability to adequately cater to this customer's needs or recognize the likelihood of losing them after a deal closes. The reality is that every customer has a "recipe" of expectations around their experience and you must know it and deliver to it.
- Concentrations of customer segments can be pinpointed to specific geographic areas. This data can also be supplemented with overlays of your market footprint and those of your competitors. This kind of "heat mapping" provides data-driven views of underserved areas, market saturation, alignment of specialty groups against customer needs and competitive vulnerabilities.
- Financial analyses can also be performed against customer segments to better understand the drivers of cost, profit and future growth. This kind of data not only informs valuation discussions, but also long-term decisions surrounding risks and investments needed to fully realize the value of a deal. Today's best healthcare companies are aggressively developing a Customer Lifetime Value (CLV) perspective much like the telecommunications, financial services and retail industries have done for years.
- While not a financial variable, an organization's mission is often an impetus in M&A deals. Insight into the customers of your organization (or those of a potential partner) will help executive leaders to make decisions around "mission fit" in potential mergers/acquisitions.

In his new book "David vs. Goliath," Malcolm Gladwell talks about the brilliance of great strategy being the ability to change the game to your advantage. Taking a customer-centric view of future M&A deals puts your organization in a position to lead the Customer Revolution that will shape our business tomorrow.

PwC's Healthcare Customer practice is solely focused on helping clients to realize the full value of the customer opportunities unfolding in healthcare. The practice includes an extensive analytics hub built to deliver quick, actionable customer insights based on a set of in-depth, proprietary tools. Let us talk with you about how customer understanding can be a source of competitive advantage in the new healthcare economy.

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.

The merger and acquisition data contained in various charts and tables in this report has been included with the permission of the publisher of *The Health Care M&A Information Source,* www.healthcareMandA.com.

Acknowledgments

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