Q3 2014 US health services deals insights

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A publication from the PwC's Deals practice

pwc

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The heart of the matter

Q3 2014 US health services deals insights

The pace of deal activity has picked up in the third quarter of 2014 with a total of 169 deals announced as compared to 143 and 138 deals in the first and second quarters, respectively. As compared to the same period in the prior year, we see only a slight drop in deal volume with a decline of just 1.3%. Conversely, the announced deal values for the third quarter of 2014 have dropped slightly to $11.9 billion from the second quarter total of $12.0 billion. Furthermore, as compared to the same period in the prior year, total announced deal values have increased by 5.7% from $34.6 billion in YTD 2013 to $36.5 billion in YTD 2014. However, we qualify this increase with the disclaimer that deal value is heavily dependent on public disclosure of deal value and deal volume may be the better indicator of deal appetite.

Consistent with the findings in our previous Insights report for the second quarter, the largest drops in deal volume from the YTD 2013 to the YTD 2014 periods were experienced in the Hospital (-58%), Behavioral Care (-43%), and Home Health (-13%) sectors. Looking more deeply into the continued decline in the Hospital sector's deal volume, we note one primary driver of this trend as the surge in non-traditional M&A structures that are excluded from our analysis. These structures include alliance based transactions such as joint ventures and other forms of market based partnering. As these deal structures take hold, we do see them as pre-cursors to ultimate M&A deals in the future after the parties align interests and become more familiar with each other.

Also continuing the trend from our previous report's findings, the Managed Care and Long Term Care sectors have maintained their surge in deal activity in YTD 2014 up 64% and 23%, respectively, from YTD 2013. While the dynamics driving the Managed Care sector's activity remains consistent with prior periods, the more notable activity in the YTD 2014 period is seen in the Long Term Care sector—leading the sectors in both deal volume and value. The sector's third quarter activity was marked by two large REIT transactions including NorthStar Realty Finance's $4 billion acquisition of Griffin-American Healthcare—accounting for approximately half of the published deal value in the sector.

For private equity and their interest in the healthcare services sectors, we note a decline in deal volume in the third quarter of 2014 as compared to the same period in 2013. This trend is consistent with other industries and sectors and generally attributed to more aggressive competition for deals from strategic buyers.

Finally, as our Spotlight Article this quarter, we provide insight into the variety of physician partnership models emerging across the country—ranging from clinical affiliation through to full employment models. As we describe, the selection of the most appropriate physician alignment strategy has quickly become a competitive priority for health systems across the country.

An in-depth discussion

Deal activity in Q3 2014

Sector synopses: Hospitals

Hospital deal volume was down 58% when compared to the nine months ended September 30, 2013, with deal value down 93%. While volume is a contributing factor to the decline in deal value, the transactions which were completed were also much smaller than those in 2013. Additionally, deal value for a number of 2014 transactions was not disclosed as these transactions involved not for profit entities. There were only three transactions in this space with disclosed deal values in Q3 2014.

We have seen a shift from traditional M&A within the hospital sector in terms of take control transactions towards more alliance based transactions, including joint ventures and other forms of market based partnering. For example, Ascension Health's recent deals have focused on establishing agreements with providers in Arizona, Illinois, Michigan and Wisconsin to jointly own, operate or contract for hospitals of insurance services. As these deals do not involve a change in ownership, they are not considered within the M&A activity reported.

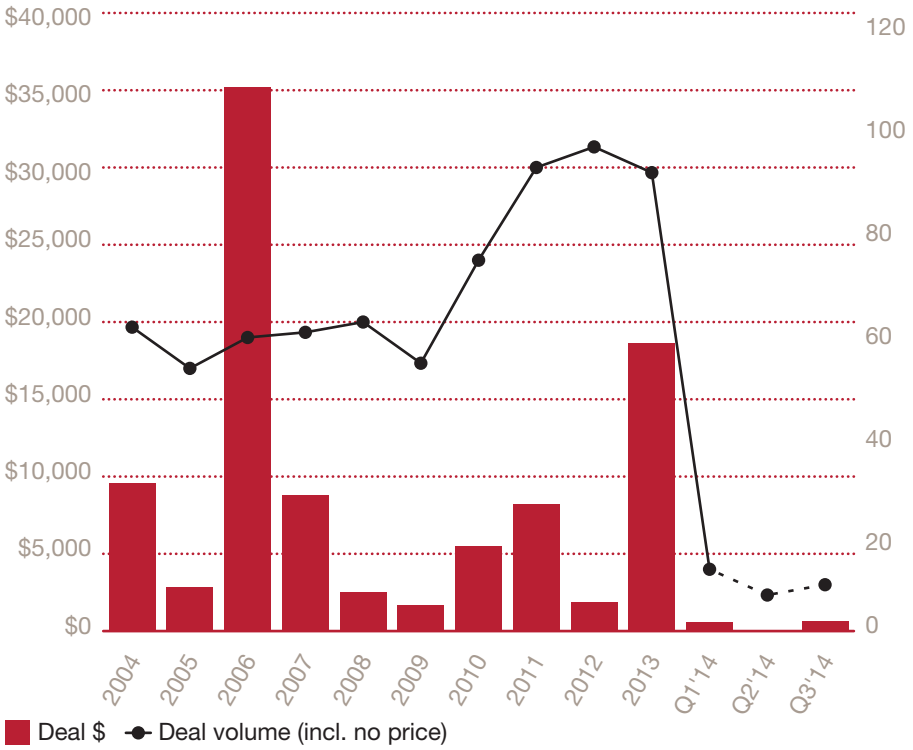
Q3 2014 selected hospital deals

Table A

Announcement date	Target	Acquiror	Deal value $ (million)
1-Aug-14	MedWest Haywood	Duke LifePoint Healthcare	$36
21-Aug-14	Conemaugh Health System	Duke LifePoint Healthcare	$500

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

Figure 1: Hospitals



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

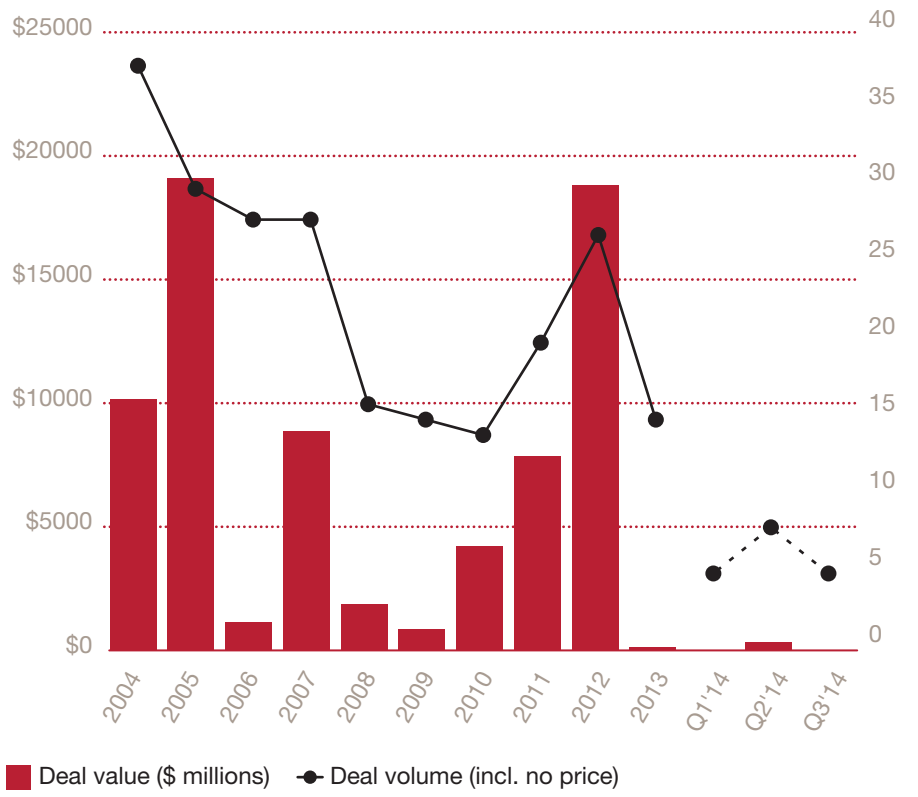
Traditional M&A activity is still taking place, just to a lesser extent than in prior years in the hospital sector. Duke LifePoint Healthcare, a joint venture between Duke University and Life Point, a for-profit hospital operations company, announced they are acquiring Conemaugh Health System, a not-for-profit hospital in Pennsylvania. Advocate Health Care also announced a merger with NorthShore University HealthSystem in Evanston in September. The combined system will be named Advocate NorthShore Health Partners.

Managed care

M&A activity in the Managed care sector remained slow but steady as another five deals were announced in Q3 2014, relative to six announced deals in Q3 2013. However, there was an overall uptick in deal activity for the nine months ending September 2014, as a total of 18 deals were announced compared to only 11 in the same period in 2013. The overall magnitude of announced deals in 2014 relative to 2013 is not clear given the amount of private acquisition activity and minimal disclosure of deal value during the periods.

The trend towards acquisition of health plans participating in government sponsored healthcare programs continued into Q3 2014. Moving forward into 2015, this trend is expected to continue as managed care companies seek opportunities to expand their member population to balance any financial uncertainty as a result of ACA.

Figure 2: Managed Care



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

Q3 2014 selected managed care deals

Table B

Announcement date	Target	Acquiror	Deal value $ (million)
01-Jul-14	Medicaid assets of Healthfirst New Jersey	WellCare Health Plans, Inc	NA
02-Jul-14	LTC Global Marketing, Inc	LTC Financial Partners, LLC	NA
08-Aug-14	Florida Medicaid assets	Molina Healthcare, Inc	NA
15-Aug-14	Medicaid contract of Healthy Palm Beaches	Molina Healthcare, Inc	NA
09-Sep-14	Citizens Choice Health Plan	Alignment Healthcare USA	NA

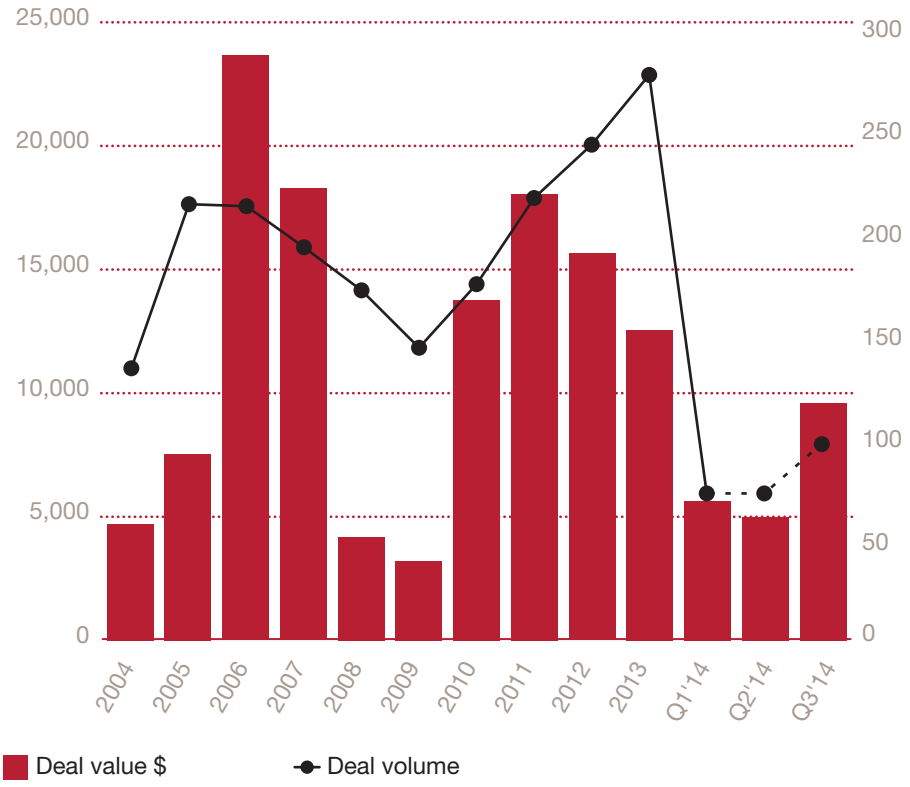
Source: *The Health Care M&A Information Source*, www.healthcareMandA.com

Post-acute care

Long-term care: This sector continues to lead the health services market in both deal volume and deal value. The three and nine months ending September 2014 demonstrated impressive increases in deal volume over prior year of 28% and 23%, respectively. Total published deal value for the three and nine months ending September 2014 was $9.0 billion and $19.6 billion, respectively, representing increases of 181% and 151%, respectively.

The deal value was dominated by two large REIT transactions. The largest transaction was by NorthStar Realty Finance, and their acquisition of Griffin-American Healthcare. The target's portfolio consists of healthcare real estate assets including medical office buildings and senior housing facilities in the US and United Kingdom. The deal value of $4 billion accounts for approximately half of the published deal value in the sector. Additionally, Health Care REIT, Inc. acquired HealthLease Properties REIT for $950 million, including debt assumption. The target consists of 53 senior housing, post-acute care, and long-term communities.

Figure 3: Post Acute—Long Term Care, Home Health and Rehabilitation



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

Home health and rehabilitation: The Home health & hospice sector picked up from the previous two quarters due to a $400 million deal by Providence Service Corporation. There were 5 deals in the rehab sector and 13 deals in the home health and hospice space, with both sectors gaining 1 deal in the quarter. Published deal values for these two sectors was $573 million in Q3 2014, up slightly from the prior year.

Q3 2014 selected post-acute care deals

Table C

Announcement date	Target	Acquiror	Deal value $ (million)	
05-Aug-14	Griffin-American Healthcare	NorthStar Realty Finance	4,000	44%
13-Aug-14	HealthLease Properties REIT	Health Care REIT, Inc.	950	11%
18-Aug-14	Skilled Healthcare Group, Inc.	Genesis HealthCare LLC	710	8%
29-Sep-14	21 retirement communities	Sabra Health Care REIT	550	6%
2-Sep-14	14 senior living properties	ROC Seniors Housing Fund	230	3%
Other			2,598	29%
Long-term care			9,038	
# of deals			77	
18-Sep-14	Matrix Medical Network	Providence Service Corp.	400	
Home health care & hospice			410	
# of deals			13	
Rehabilitation			163	
# of deals			5	
Total post-acute			9,611	
# of deals			95	

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

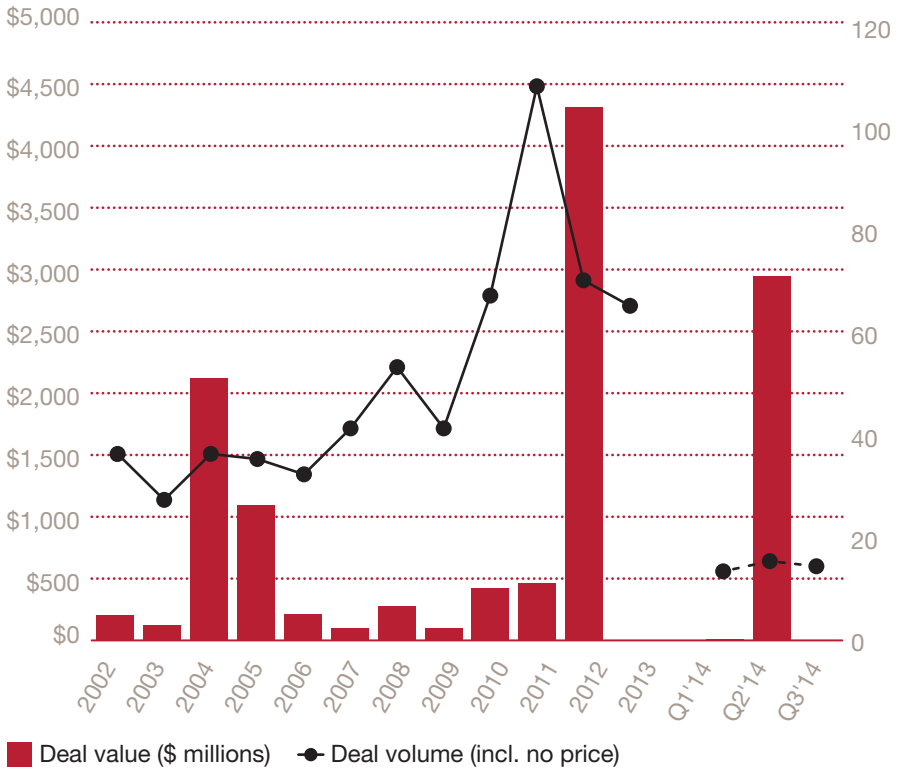
Physician practices

Announced deal volume of 14 deals in Q3 2014 was down slightly from the 15 deals reported in Q2 2014; however, as is typical for physician practice transactions, no deal values were given for Q3 2014.

The IPC The Hospitalist Company and TeamHealth Holdings led the way for deal volume, announcing 5 and 4 deals, respectively, in Q3 2014. This continues the trend for each Company of several announced deals per quarter. Mednax only announced 1 deal in Q3 2014, down from 3 deals in Q2 2014.

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.

Figure 4: Physician medical group



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

Private equity

Private equity ("PE") transaction flow in Q3 2014 declined to 6 transactions from 13 in Q3 2013. Announced transaction volume was $503 million compared to $183 million in Q3 2013. The decline in deal volume mirrors what we have observed across the United States for all PE investments across all industries sectors. Indeed, during 2014, the quarterly volume of PE deals has been declining each sequential quarter. We generally attribute this broad industry decline in PE deals to the fact that corporate buyers have been more aggressive and successful in auction processes this year. So while the fundamentals of a healthy PE investment environment exist (dry powder, availability of debt, etc.), deal flow to the PE sector has lacked.

Headlining Q3 2014 transactions is GTCR's $480 million acquisition of Cole Parmer Instrument Company a carve-out from Thermo Fisher Scientific. Cole Parmer is a leading global manufacturer and distributor of specialty laboratory equipment, instruments and supplies to customers in the pharmaceutical, biotech, healthcare, chemicals, food and other research based or regulated markets. Earlier in the year the Company divested certain businesses in a deal with GE Healthcare. While the financing markets have been stellar for private equity firms during 2014, headwinds were felt near the end of the quarter as market volatility increased. The VIX S&P 500 volatility measure closed at $16.31 on September 30 up 46% from the start of the quarter. We will continue to monitor in Q4 2014 the impact that increased volatility has on lenders appetite for high-risk paper.

Q3 2014 PE deals table

Table D

PE deals by type	Transaction count		Announced deal value ($mm)	
	Q3 2013	Q3 2014	Q3 2013	Q3 2014
Healthcare Providers & Services	6	2	135	-
Healthcare Equipment & Supplies	6	4	47.2	503.0
Hospitals	1	-	-	-
Payers	-	-	-	-
Total	**13.0**	**6.0**	**182.2**	**503.0**

Source: *Thomson Reuters*

Other Services

In Q3 2014 there were 25 transactions with announced deal value of $478 million. This compares to 30 deals with announced transaction value of $728 million in Q3 2013.

The largest announced deal of the quarter was Tecomet's acquisition of OEM Solutions a division of Symmetry Medical for $450 million. OEM Solutions manufactures high precision surgical instruments, orthopedic implants, and plastic and metal sterilization cases and trays to global medical device OEMs. Tecomet, who operates as a contract manufacturer in the medical device and aerospace industries, believes the acquisition will expand its capabilities and global reach, according to Bill Dow, CEO of Tecomet. Tecomet is a portfolio company of Genstar Capital.

Included within the other deals category without announced value was Envision Pharmaceuticals acquisition of MedTrak Services a top 30 Pharmacy Benefit Manager that manages pharmacy benefits for small to mid-sized self-insured employers. Envision Pharmaceuticals was purchased by TPG Capital in a transaction announced around a year ago in Q3 2013.

Q3 2014 selected deals other services

Table E

Acquisition Date	Target	Acquiror	Deal value (m)
23-Jul-14	Cognigen Corporation	Simulations Plus, Inc.	7.0
04-Aug-14	OEM Solutions	Tecomet Inc.	450.0
04-Sep-14	Allegro Diagnostics Corp.	Veracyte	21
Total value			**478.0**
Others			NA
			25

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

Spotlight article

Physicial partnership to lead healthcare transformation

Picking the right model for your market

Unprecedented market forces are placing significant stress on the US healthcare ecosystem. Costs have risen sharply and are projected to consume 20 percent of GDP by 2021. Relative to other industries, value improvements in care delivery have stagnated, with quality ratings for many organizations effectively flat over the past several years. And while the reforms of the Affordable Care Act were intended to reduce overall spending on care and improve quality, the legislation also expanded access to millions of previously uninsured patients, putting a greater strain on the system.

In response, payors are driving structural changes in healthcare, moving toward more affordable care in a retail environment. For example, retail-like channels such as walk-in clinics are emerging, along with new Web-based tools that improve transparency of costs and quality across providers. These measures tap into the consumerization shift, in which patients are exerting greater influence in how and where they receive care. Such measures shift risk away from payors and toward providers and patients.

Yet providers are making large-scale changes as well. Most progressive systems are now aiming for long-term cost reductions of 15 to 25 percent, far greater than the traditional goals of 5 to 10 percent. M&A activity has tripled since 2010 compared to historical trends. Increasingly, acquirers are seeking strategic partners that can increase the range and depth of care delivery in a given market.

At the heart of the transformational change is a transition to integrated delivery networks, in which providers deliver a continuum of care in a comprehensive, evidence-based, and coordinated way, with consistently high outcomes and costs that are predictable and manageable. The end result is value-based care that meets population health goals, reduces utilization, and enables sharing risk with payors.

To make integrated delivery networks succeed, health systems will need to better align with physicians, a requirement that is increasingly important given the current wave of acquisitions. As in the past, physicians will continue to exert the greatest control over referrals—and thus downstream patient volumes. More broadly, however, physicians are the "face" of the organization. They have the greatest influence over patient loyalty, which will be critical in accomplishing the goals of population management, including improvements in quality, satisfaction, utilization, and cost. Specifically, physicians can do the following:

- Ensure continuity in the flow of clinical information during hand-offs from one specialist to another, without unneeded duplications in care
- Engage the patient in retail settings

> ***"I realize physician employment was embraced and then dismantled back in the 1990s. This time it will be different. There is no more money left and providers will increasingly continue to share and take risk."***
>
> ***—Health system executive***

- Treat the patient in the most appropriate (and lowest cost) settings, such as home care when it's a better solution, and limit hospital admissions to when they are truly necessary
- Use standardized care practices and evidence-based protocols
- Focus on prevention and wellness, which requires a patient relationship over time
- Include and collaborate with supporting care team members, such as behavioral counselors, nutritionists, care coordinators, and other specialists

To maximize all potential benefits to the health system, physicians will need to be integrated along several dimensions, including financial incentives, governance, clinical practices, operational and care delivery alignment, patient experience, and cultural coherence. To be sure, some health organizations experimented with physician employment models in the 1990s, only to fail. Yet the current period is different in several key ways. Physician executives have become more prevalent and possess not only clinical experience, but also experience managing large practices and other health provider organizations. Incentives are now better aligned for doctors and health systems to manage risk and deliver value. Physicians' interest in collaborating with health systems often reflects financial incentives, such as a guaranteed income, or the costs of infrastructure for electronic medical records. Technological innovations have introduced better tools to integrate care. Clinicians have 20 years of experience in managing populations.

Most important, the stakes are now higher. For some systems and physicians, successful partnerships will be their only means of surviving.

A key part of this transformation will be a changing role for physicians in delivering and managing care as they become more team-based, use standardized care protocols, and manage populations more effectively. As a result, the way that health systems engage with physicians has to change as well, for greater alignment around clinical, operational, and financial aspects. Specifically, health systems have four possible physician alignment models: affiliation, partnership, employment, and clinical integration. The right model will vary depending on the market where the provider operates, and the urgency with which it must adapt to evolving market conditions.

Four models to partner with physicians

	Affiliation	Partnership	Employment	Clinical integration
Incentives	Limited	Quality and/or cost gain sharing	Salary with volume and/or quality kicker	Quality, cost control
Governance	Most collegial	Very collegial	Departmental leadership	Service-line dyad
Clinical practices	Physician-specific	Moving toward standardization	Moderately standardized	Protocol-driven, hard-coded in EMR
Operations	Ad hoc	Moving toward system-ness	Significant alignment in referral patterns	Coordinated system; standard scheduling, staffing, supplies
Challenges	Variable, with unpredictable volumes, outcomes, costs	Lack of influence over care model; can be hard to restructure for new payment models	Even strongest-form alignment does not guarantee productivity or consistent quality	Requires complex mechanisms for tracking risk and utilization, allocating rewards

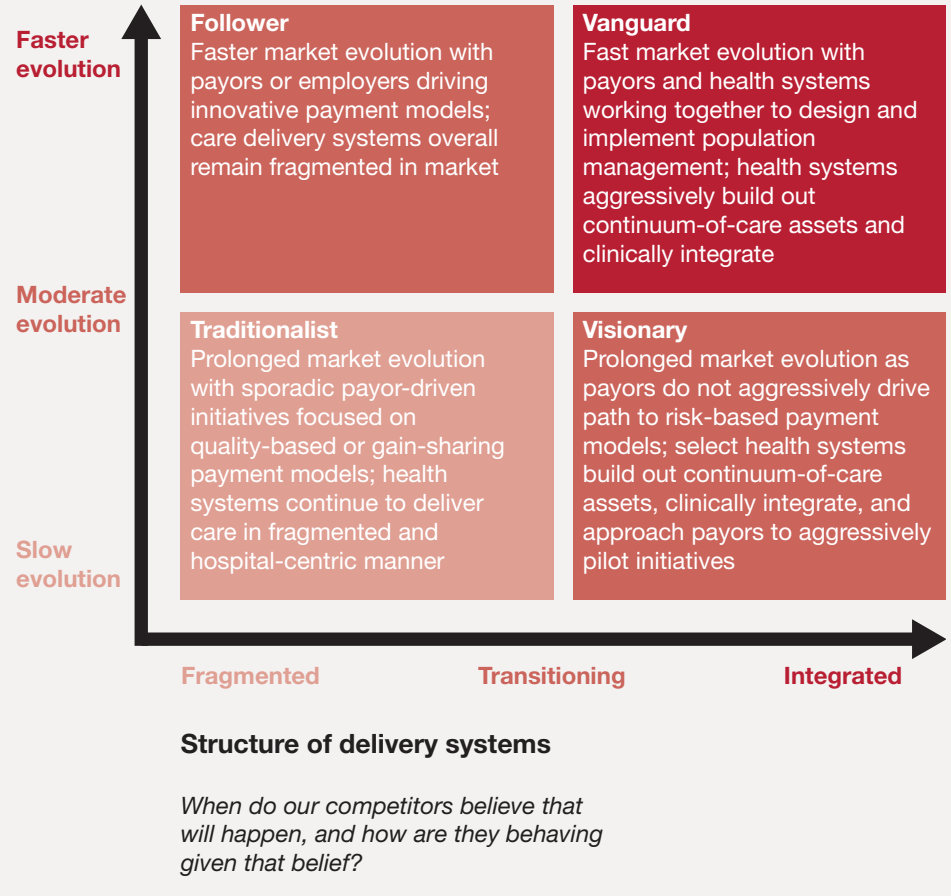
To identify the right model among these four, each health system must understand the current state of its market and the likely pace of evolution, by asking several key questions. First, when will the market reach a tipping point at which 15 to 20 percent of volume is "at risk"? This question essentially gauges the degree and speed at which payors and employers are driving change and pushing providers to assume more risk.

Second, health systems must ask when their competitors believe they will hit the 15 to 20 percent tipping point, and how the competitors are behaving given that belief. This question assesses the speed at which delivery systems are consolidating and integrating assets along a continuum of care. (In addition, a health system's current operating model—e.g., scaled portfolio, geographic cluster, hub-and-spoke, innovative, or location-based—may be a factor in its choice of alignment models.)

These broad elements—the current structure of delivery systems (the supply side) and the pace of evolution (the demand side)—weigh heavily in a health system's choice of physician alignment model.

By assessing evolution along two dimensions—supply (the degree of clinical integration within the hospital or health system and within competitors) and demand (the pace at which payors and employers are driving change)—most markets will fall into one of four archetypes: traditionalist, follower, visionary, and vanguard.

Four market archetypes for health systems



Source: Strategy& analysis

Traditionalist markets have low levels of clinical integration and slower evolution among payors and employers. In this archetype, the physician's role is still primarily that of gatekeeper—i.e., a referral base that can drive inpatient and outpatient volume and market share across the system. Follower markets experience rapid change driven by payors, and providers still offer relatively fragmented care. The preferred alignment model is to employ physicians directly, allowing health systems to move quickly, and the mix of physicians should be weighted toward primary-care physicians (PCPs), who can coordinate care and tightly manage utilization for discrete populations. Visionary markets are characterized by slower demand-side evolution, which allows innovative providers to gain a head start in implementing population management and other mechanisms to handle risk. Health systems in visionary markets need to expand the breadth and geographic reach of their clinical capabilities and may elect to employ physicians and/or form partnerships (e.g., bundled products) to ensure they have adequate coverage, as well as to lay the groundwork for more advanced value-based care models. The physician mix will likely be weighted toward specialists instead of PCPs, to ensure that the system can address a range of patient conditions. Vanguard markets see payors and providers consistently delivering care based on collaborative risk models and payment schemes. Standardized clinical practices, strong physician governance, and operational integration are all paramount, requiring a clinically integrated physician group as an alignment model to improve quality, reduce the unit cost of care, and manage utilization.

Within five to 10 years, many markets will be at the vanguard level. Yet by understanding the pathway to that archetype, hospitals and health systems can adopt the right alignment model and determine the best way to collaborate with physicians during the journey.

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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