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Health-Care Transactions Update: June

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As the first half of 2016 has come to a close, it continues to be evident that in a macro-economic environment that has seen a great deal of uncertainty, trepidation, and at times chaos, the health-care industry in the United States has proven to be as immune as a sector can be to such turbulence. There can be no doubt that health-care providers are rapidly changing and evolving to meet the demands of an increasingly patient-centric system and larger, macroeconomic trends toward greater consumerism. They also are striving to flourish and abide by increasing rules and limitations put upon the industry by outside forces, both legal and financial.

As the deals listed in the June transaction report continue to demonstrate, two of the largest drivers overall are (i) the continued influx of private equity capital into the industry, and (ii) the horizontal and vertical expansion by some of the largest corporations within the sector as they look to maintain market strength, to better position themselves to thrive under more prevalent value-based payments and risk assumption models, and to stay ahead of perceived industry risks.

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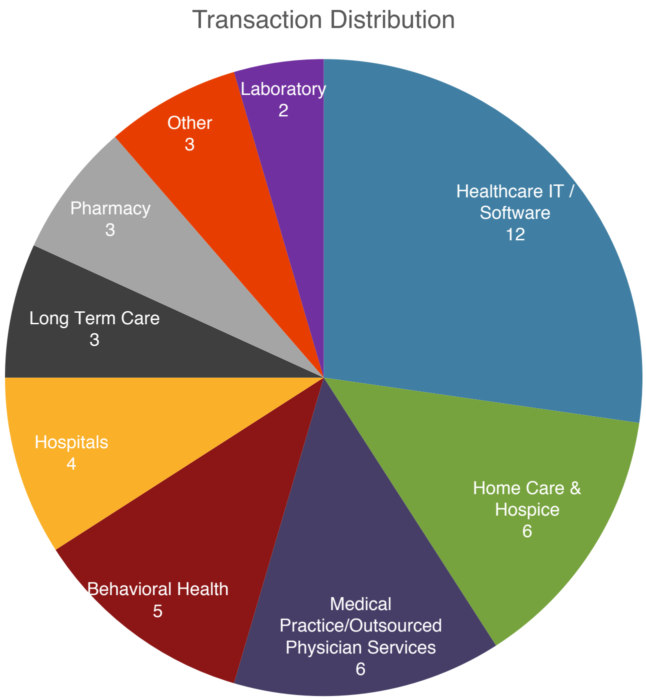
Private Equity Influence.

Within health-care services, and particularly in the middle market, private equity groups have long been and continue to be a driving force of consolidation activity where a traditional ''buy and build'' strategy can be implemented amidst a highly fragmented competitive landscape. Many of these more mature sectors now boast publicly traded consolidators, such as anesthesia providers, dialysis clinics, and ASC management, while some are still experiencing the private equity swell.

Throughout the first half of the year, when hospitals and health systems are removed from the data set, private equity groups were involved in nearly 50 percent of all transactions, either as the buyer of a standalone platform, an acquiring company, or a selling company. Looking across the subsectors that are driving investment amongst private equity groups, there have been significant deal volumes within behavioral health, dental, dermatology, and rehabilitation (nearly 50 deals year-to-date combined in these sectors). All of these industries remain heavily fragmented and present significant opportunity, not only from the standpoint of significant roll-up potential, but also that small practices and locations across these sectors are more exposed to reimbursement pressure, growth challenges, recruiting difficulties, higher regulatory oversight/requirements and payment models that impose greater risk upon providers and require increased coordination, health IT, data management and analysis, resulting in additional related cost pressures. These key drivers have led many



smaller providers to seek to join the stability and safety of larger groups.

While there has been a strong uptick in the rate at which providers are joining hospitals and health systems—which a recent Modern Healthcare survey pegged at nearly a 10 percent increase across 84 respondents as well as 20-plus percent increase for a number of the largest systems in the country—the private equity model has emerged to provide an alternative landing spot for physician groups who recognize the need to be part of a larger organization but prefer to avoid joining the larger system models directly.

Lower Margins Are Also Driving Decisions to Buy vs. Build

Health-care providers are concluding that strategically affiliating with adjacent companies that provide experience and expertise is a more efficient strategy than building it on their own. Costs, time commitments and the availability of opportunities have made the decision to buy the preferred strategy of Providers. According to the *Q4 2015 Health Management Academy–H2C Strategic Survey of C-Suite Executives at leading Health Systems* (''survey''), 63 percent of executives believe their 2016 operating margin will be lower than their 2015 margin. Instead of building capabilities in adjacent businesses, providers are planning to buy rehabilitation facilities, long-term care facilities and ambulatory care facilities (not exhaustive). Thirty-six percent of executives in the survey expect to make these acquisitions in the next six months; others said they planned to form partnerships around clinical services. Purchasing a mature business allows health systems to minimize development costs and allows for quicker integration into their existing business.

Strategic Consolidation.

While private equity has most certainly made a great deal of noise over the first two quarters of 2016, strategic consolidators haven't sat back and watched idly. A few key areas that are worth highlighting:

Life Sciences and Pharma Services—As technological and scientific advances continue, outsourcing of research and development and other services continues to increase at an all-time high. CROs continue to expand their service offerings, more recently focusing efforts on site management organizations, patient recruitment services, and technology-enabled analytical tools. Laboratories continue to seek out unique, niche service providers that have the ability to expand a buyer's testing capabilities and help mitigate any perceived risk in areas where there may be reimbursement or regulatory risk. Other unique players in areas like contract manufacturing, supply chain management, and production/storage/distribution solutions have also all experienced consolidation as companies continue to focus on expansion not only of their geographic footprint but also service offerings.

Health-Care IT—The first two quarters have witnessed no slowdown in either private equity investment or strategic consolidation as it pertains to anything health-care IT/software related. There is no subsector of the health-care industry that isn't heavily impacted by technology, both positively and negatively. As investment capital continues to fund innovation and provide solutions with definitive positive downstream benefits to the cost structure of the health-care landscape, consolidators of all types will continue to invest in these services either on a software-as-a-service/business-to-business basis for true technology buyers, or providers and other organizations looking to bring certain technologies in-house to gain a competitive advantage on their peers.

Health Systems—While there were smaller transactions amongst health systems and other acute hospital providers, providers remain active and interested in pursuing larger scale acquisitions and affiliations across a wide array of regions. They remain cognizant of the winning streak that the Federal Trade Commission has enjoyed in health-care antitrust enforcement in recent years, but more recent victories for health-care providers related to both market definition and state immunity doctrine defenses have helped to bolster the spirits of providers and investors looking to continue to enter into innovative health-care arrangements to at least some extent. These developments merit continued, close monitoring by health-care stakeholders. Additional successes on the health-care antitrust front may energize some health-care stakeholders to explore larger opportunities.

Separately, Health Systems continue to explore and remain active in smaller deals as well, particularly as it pertains to transactions involving telehealth, behavioral health, physician practices, data analytics and health IT.

Post-Acute Care—As a sector that has seen a strong reemergence in the eyes of private equity and strategic buyers, post-acute care services again are becoming an attractive place to be for sellers. After waves of reimbursement cuts and other payment and regulatory changes, providers that strategically refocused their businesses to operate under the new environment have positioned themselves to be rewarded as demographic trends continue to be tilted in their favor. Previous issues of this feature have noted the continuous, substantial transactional activity in this sector and additional

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ISSN 1064-2137

factors contributing to the same. As smaller players continue to be squeezed out of an industry that requires high threshold of size and clout to achieve a reasonable profitability level, mid-sized and large providers are poised to continue growing via multiple channels, which only increases their allure to the largest consolidators as well as financial investors.

Physician Practices—As discussed above in the context of private equity investment, nearly every type of physician group is in some form of play for consolidation. Whether from hospital systems, payers, private equity groups, or other large strategic entities looking to build formidable national platforms, this sector, while broad in definition, continues to remain at the forefront of activity. Ambulatory surgical center companies continue to make acquisitions into synergistic physician service groups, while multi-specialty and primary care groups continue to be the focus of hospitals and health systems and an array of other buyer types looking to achieve both regional and national growth.

All of the above continue to be driven by value-based payment models, increased risk on and accountability of providers for health-care quality, results and costs, and ever advancing health IT capabilities that are vital to the performance of all health-care stakeholders.

Second Half 2016 Outlook.

Consolidation shows no immediate sign of slowing; however, multiple outside events are expected to have varying degrees of impact across a number of verticals. There are multiple multi-billion dollar mergers currently undergoing regulatory review, with some having the potential to provide for significant ramifications one way or another. The FTC and antitrust scrutiny of health transactions continues to be an important factor to be considered by providers and investors early in the acquisition or affiliation process, and certain recent "wins" for health-care providers indicate that this area will merit continued close monitoring.

Recent indications from Congress that it is interested, and perhaps even eager, to revise provisions of the Stark Law, which imposes often restrictive requirements upon the structure of a wide range of transactions and other relationships between physicians and other health providers also merits close attention, and, depending upon the action taken, may materially impact the number and type of health-care transactions in the future. And as the presidential election heats up, the health-care industry is poised to be put into the spotlight, and while nothing policy-oriented is likely to shift things near-term, there is always the potential that market perception or overall uncertainty can change the environment as it pertains to deal making.

The list of select transactions involving health-care providers, managed care and services companies for June 2016 was compiled by health-care investment bankers using publicly available information, including articles, websites and press releases. The list is at http://src.bna.com/gSH.

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Epstein, Becker & Green PC did not comment on any particular transaction or party discussed or listed in this article.