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A Review of Key Factors Driving Healthcare Dealmaking

Data provided by

Introduction

The US healthcare industry is expected to reach 20% of GDP by 2024. While there has been considerable advancement in both the quality and delivery of care, efforts to contain the rapid rise in expenditures have been complicated by the effects of an aging population, unaligned incentives as a by-product of the historical payor-patient relationship and a lack of communication and coordination across the continuum of care delivery. Implementation of the Affordable Care Act (ACA) in 2010—with legislative enforcement enacted in 2014—had a significant impact, establishing provisions to curb rising costs, including a transition from fee-for-service reimbursement to value-based payment models.

Industry constituents are adapting to the new realities of healthcare, including shifting reimbursement, increasing regulations and changing consumer preferences. Healthcare dealmaking, from strategic M&A to private equity investment, has evolved in parallel with the industry's overall transformation. Consolidation is expected to continue as large healthcare companies seek to accelerate growth and add new capabilities to enhance their value propositions to industry constituents. PE investment is similarly expected to remain robust, as investors seek to deploy record levels of capital, leverage their healthcare domain expertise and augment existing portfolio companies with new services and enhanced capabilities.

This industry brief spotlights themes that are defining the evolution of healthcare dealmaking—focusing on key industry constituents—and traces a convergence of trends that will continue to drive strategic M&A and PE investment into the future.

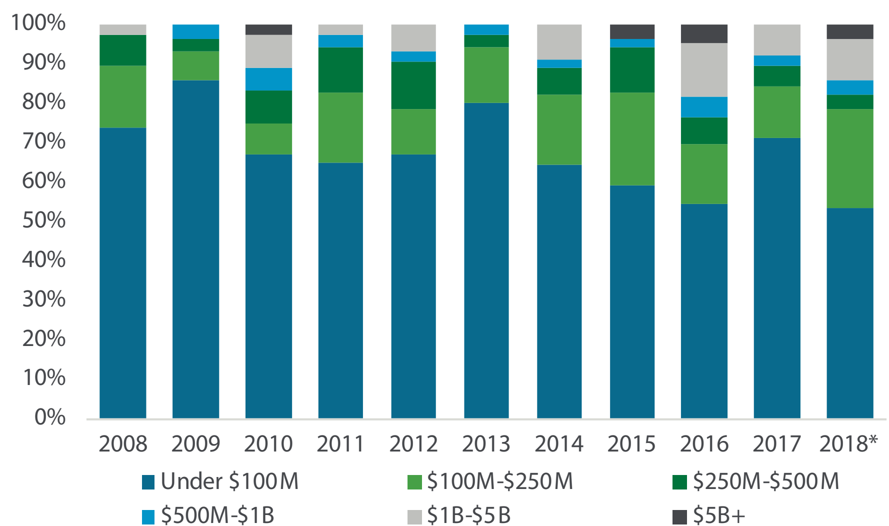
Evolving providers

Health systems, physicians and other traditional provider constituents have seen broad ramifications flow from these aforementioned industry developments that have changed the economic and operational dynamics of providing care. In recent years, providers have seen material reductions in reimbursement for certain services and continue to grapple with the ongoing philosophical shift from fee-for-service models to value-based care. Increased regulation has implemented new standards such as the use of electronic health records, which have created corresponding administrative burdens. These burdens and an aging population (yielding physician retirements) have led to doctor shortages in certain specialties.

As a result, providers have largely sought to increase scale and make technological investments to counter threats to their profitability. In addition, we have seen the development and implementation of a variety of differentiated models for leveraging human capital to make operations more efficient and reduce costs. For example, an increasing proportion of services has moved out of the hospital and into lower-cost settings through the proliferation of freestanding emergency rooms, ambulatory surgery centers, urgent care, walk-in clinics and telehealth services. Further, the industry has seen providers leverage practice management software and revenue cycle management services due to an increased focus on integrating technology into the business of practicing medicine to drive efficiencies. Larger physician groups have formed to drive scale, leverage investment capital and increase bargaining power, particularly with payors.

> Scale has increased, leading to M&A volume concentrating in larger deals.

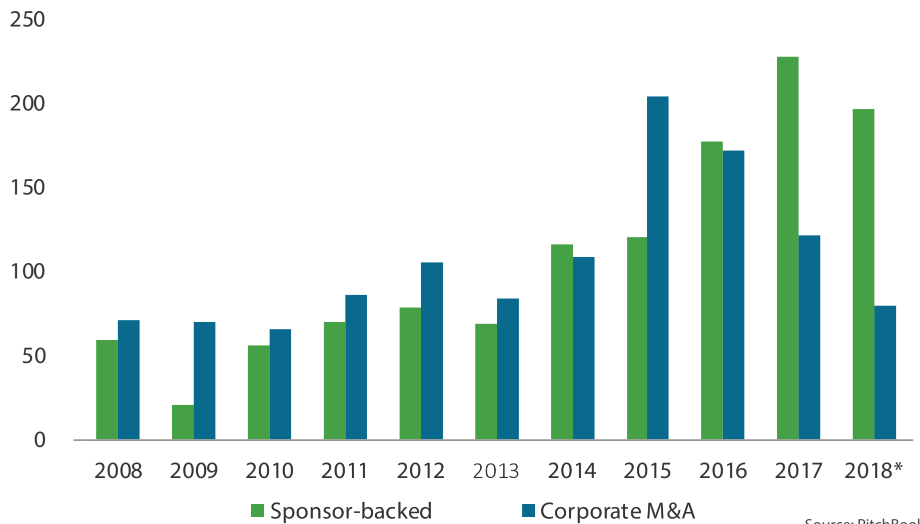
US healthcare services M&A (#) by size



Source: PitchBook
*As of November 8, 2018

While much of providers' adaptation to these changes has taken place organically, M&A has been a core strategy in the transformation of the provider landscape. Several unique combinations have created differentiated operators attempting to disrupt historical approaches to care and replace them with new and innovative systems for care management, taking share from traditional providers. For instance, the industry has seen numerous joint ventures, partnerships and mergers between health systems and alternate sites of care to increase care coordination and expand access points. Acquisitions of alternate sites of care by non-health system entities (such as managed care and outsourced services platforms) have increased to provide diversification and implement other differentiated strategies and cross-selling. There have also been several high-profile acquisitions of independent physician groups and physician services organizations by larger physician platforms, management services organizations and managed care organizations. This activity has been compounded by investment from PE groups acquiring platforms where they see unique angles to improve efficiency and drive value in a rapidly evolving provider landscape.

US healthcare services M&A (#) by sponsor type



Ever-growing payors

The managed care industry has transformed significantly in recent years in order to adapt to rising costs, evolving care models and shifting reimbursement structures. The ACA expanded care for millions of Americans while also jumpstarting certain initiatives to improve health outcomes and cost-efficiency. On the employer-sponsored side of managed care, financial responsibility is increasingly delegated to the patient through investment in consumer-centric healthcare offerings such as high-deductible health plans, health savings accounts and price-transparency solutions. On the government-sponsored side of managed care, a proliferation of data-analytics is driving customized care-management models with a particular focus on addressing care gaps and improving outcomes among those highest-risk, chronic member populations. Furthermore, recent value-based initiatives have galvanized the move away from fee-for-service government reimbursement toward managed care with an emphasis on preventative care practices and holistic management of the member.

> PE groups have accounted for an increasing share of healthcare services M&A across all sub-sectors.

While industry fundamentals and tailwinds remain strong, the ACA has driven an increased need for scale and better coordination across the healthcare continuum. Yet as the industry is being pressured by this paradigm shift, regulators have denied horizontal mergers among several of the larger managed-care companies, driving payors to scale in other areas. The recent wave of managed-care consolidation has driven the roll-up of companies in ancillary healthcare subsectors as well as the creation of certain mega-healthcare companies (i.e. UnitedHealthcare/Optum, CVS/Aetna, Cigna/Express Scripts). This vertical consolidation has in many ways reshaped the managed-care landscape, in which players are now seeking greater oversight of the consumer journey, ownership of historically outsourced medical expenses, control over healthcare delivery, coordination around chronic-care populations and ultimately the latitude to create more optimal and flexible plan-design structures.

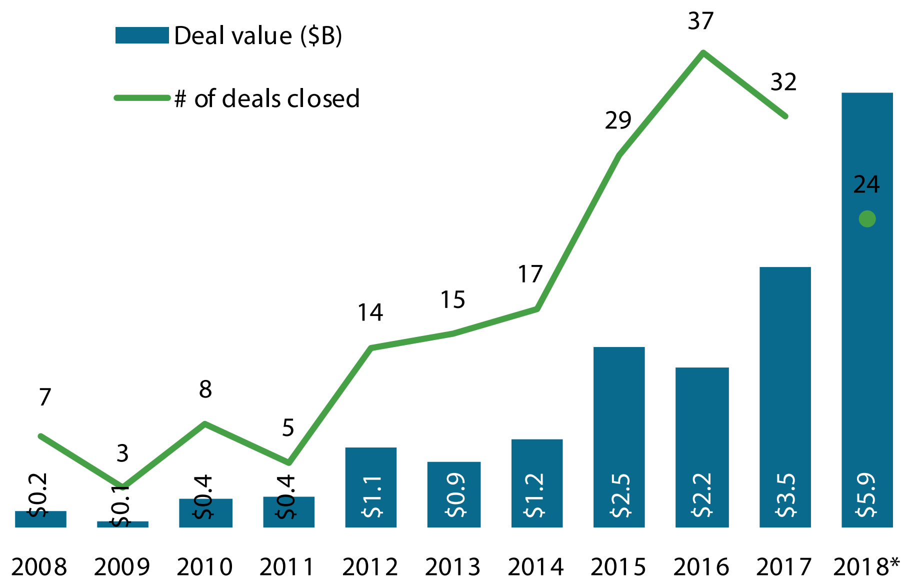
The rise of consumerism

Against a backdrop of reimbursement pressure, increased risk exposure and heightened focus on cost control, payors and employers have been forced to increase their use of high-deductible health plans for their member populations. Increased out-of-pocket expenses and rising premiums have outpaced both inflation and wage growth, resulting in an increased financial burden to patients. Not surprisingly, this shift in financial responsibility has had an impact on how patients seek out and obtain care. Cost, quality and convenience now drive patients' decision making, and providers and payors are adapting to accommodate the rise of the healthcare "consumer."

Digital health M&A has surged as the industry trends toward convenient care.

While a rise in consumerism is a driver of multiple healthcare trends, a common theme is consumer engagement. Payors seek to engage consumers early and often in an attempt to improve overall health, influence decision making and push consumers to higher-quality, lower-cost sites of care. From the provider's perspective, the patient responsibility portion of the bill has become too large to ignore, forcing providers to rethink how they engage with and collect from these patients turned consumers. Whether it is telehealth, health and wellness platforms or technology-driven patient intake and collection solutions, this change in consumer behavior has given rise to a new subset of healthcare-focused companies and with it, a significant increase in M&A activity from strategic acquirers and PE investors.

US digital health M&A activity



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Proliferation of healthcare technology & outsourcing

A broad and growing ecosystem of technology and outsourced services companies is playing a significant role in increasing efficiency and cost containment throughout the healthcare industry.

Health systems and care providers are under intense pressure from shifts in reimbursement levels, increased administrative burdens and the transition from fee-for-service delivery models to value-based care models. Providers are increasingly turning to third-party companies with differentiated technology and outsourced services to overcome these challenges. For example, demand has markedly increased for technology vendors offering electronic health records, revenue cycle management and other capabilities due to regulatory mandates for the use of electronic health records and complexities in the billing and reimbursement discussion with payors. Use of outsourced clinical laboratory services has grown as providers contemplate the cost effectiveness of maintaining in-house capabilities and find overwhelming value in the ancillary services labs provide. Health systems have also increased use of outsourced physician staffing services due to the cost and complexities associated with recruiting healthcare professionals and managing those relationships. These and other providers of outsourced services to physicians can expect demand to grow as the transformation of the provider landscape continues.

Payor organizations have also benefited from the proliferation of third-party outsourced services companies that provide a broad array of solutions to address challenges associated with healthcare reform imperatives. As payors play a greater role in managing the patient journey across the healthcare continuum, they have sought out

a growing universe of third-party outsourced services companies who offer differentiated solutions and compelling value in areas such as patient engagement, care coordination, medication therapy management and behavioral health. Payors also continue to rely upon third-party outsourced

Outsourced services have been particularly embraced by payors, providers and pharmaceutical companies to improve efficiency and control costs.

services companies such as population health management platforms and data analytics services to monitor the performance metrics of their provider constituents, enabling them to rank and reward superior providers while filtering out providers that exhibit inconsistent care delivery.

Pharmaceutical and biotechnology companies have experienced strong growth in recent years due to the commercialization of marquee innovative drugs, favorable population demographics and the increasing use of medicines globally. However, the industry faces headwinds including persistent political pressure to lower drug prices, looming patent cliffs and growing complexity managing the product development lifecycle. Against this backdrop, strong scientific innovation and accelerated regulatory approval pathways have driven significant capital investments into research and development. Pre-clinical and clinical trial activity is near an all-time high and manufacturers are increasingly turning to differentiated providers of outsourced services to execute core drug development and manufacturing processes. Contract research organizations offer deep scientific expertise and a proven ability to cost-effectively accelerate all aspects of global drug trial execution including trial design, site identification and patient recruitment, monitoring and regulatory submission. Contract development and manufacturing organizations also solve key product lifecycle challenges including formulation development, production at scale and final dose packaging. Further, a broad ecosystem of outsourced services organizations has emerged to address a growing array of other pain points in areas such as health economics, market access, commercialization, laboratory testing and e-clinical technology.

The healthcare industry has observed robust strategic M&A across technology services platforms, and provider, payor- and pharma-focused outsourcing services. Laboratories, for instance, have

M&A in order to acquire technological capabilities has become increasingly popular, in line with the outsourcing trend.

increasingly sought to add scale and diversify their portfolio of value-added services through acquisitions of regional labs while some have even expanded into pharma services. Several PBMs have been acquired by payors and retailers to create more integrated and differentiated offerings and enhance patient/provider connectivity. CROs are also using M&A to increasingly integrate analytics and data capabilities to conduct trials more effectively and provide a broader array of services for pharma. Consolidation of technology and outsourced services providers is expected to continue as end-market demand grows for a broader and more technologically advanced set of services from a smaller set of vendors.

Methodology

Deal value is defined as the total amount of equity and debt used in the PE investment. PitchBook's total deal value figures include deal amounts that were not collected by PitchBook but have been extrapolated using a multidimensional estimation matrix. Some datasets will include these extrapolated numbers while others will be compiled using only data collected directly by PitchBook; this explains any potential discrepancies. Digital health is defined as companies engaged in building hardware and software solutions to empower individuals to more easily keep track of their health, and provide healthcare providers better tools to communicate with and treat patients. This space includes a host of mobile applications designed to track fitness activity, sleep, nutrition, weight, and medication intake, telemedicine programs to make it easier to connect with health professionals, EHR and clinical workflow software, digital wearable devices, remote monitoring and diagnostics software, artificial intelligence platforms, and genomics testing technology.