

ts insights

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Private Equity and Politics Dominate Healthcare M&A

Why is M&A among healthcare service providers so hot? The two biggest factors in this broad scale industry consolidation are private equity and politics, according to Steven Elek, who leads the Healthcare Practice in the Transaction Services Group of PricewaterhouseCoopers. Steve's 20+ years of experience span many sectors of the healthcare industry. He is responsible for delivering a wide range of acquisition, divestiture, and corporate finance-related services to PwC's clients.

TS: Steve, what's happening with healthcare M&A right now?

Steve Elek: Over the last twelve to eighteen months, we've seen significant activity in virtually every area of healthcare services and managed care. Total deal volume was about \$138 billion for the first nine months of this year, compared with \$92 billion for all of 2003.

TS: What's driving this?

Elek: Several factors. From a macroeconomic standpoint, it's demographics. The oldest baby boomers are reaching an age where they need more healthcare. There's a lot of demand on the system right now, and this will continue through the decade and beyond.

Government mandates are another key driver. The Medicare Prescription Drug Improvement and Modernization Act of 2003 is putting \$400 to \$500 billion dollars into the healthcare system over the next several years. That's a huge reallocation of federal monies. Winners include Medicare managed care plans, rural providers, drug companies, and PBMs (pharmacy benefit managers).

A third factor is the entry of new buyers, primarily the private equity funds. Four or five years ago, only a handful of firms did healthcare deals. But over the last two to three years, a lot more private equity firms have recognized that the industry offers significant opportunity for sustained growth, and have begun doing healthcare deals.

So I think it's fair to say that we're going to see more M&A activity over the next twelve to eighteen months.

TS: Looking ahead, do you expect private equity to be a bigger factor in the market?

Elek: Yes, definitely. Currently, there is about \$100 billion of private equity capital available, with perhaps 20 to 25 percent targeting healthcare. Also, the debt financing environment is very favorable with some sources focusing more exclusively on healthcare. It is not unusual for these debt offerings to become oversubscribed as multiple financing sources vie for the opportunity to underwrite a company.

TS: What sorts of assets are the private equity players going for?

Elek: They're focusing on four or five areas within health services where demand is continually increasing. Hospitals, in particular, have significant capital requirements given their infrastructure and an ongoing need to reinvest in technology and facilities. Because the vast majority of hospitals are not-for-profit, they can't access the capital markets the same way publicly traded companies do. This factor alone is driving many such hospitals to look at mergers, consolidations, joint ventures, or outright sales of their facilities, and often the buyer is a for-profit hospital company with private equity backing.

Private equity buyers also have a strong interest in the more fragmented segments of health care services including long-term care and companies that provide home healthcare, hospice care, and staffing. These sectors offer consolidation opportunities and are often seen as effective lower cost alternatives to in-patient care and employee-based staffing.

Another sector that's attracting a lot of private equity interest

is pharmacy benefit managers or PBMs. Beginning in 2006, the new Medicare law will bring post-retirement prescription coverage to a whole new group of retirees who weren't covered by their former employers' plans, and could not afford the high premiums associated with private coverage. PBMs, for the most part, will deliver drugs to most of these people.

TS: *So what are some the major healthcare corporations doing?*

Elek: They're active in the market as well. There have been a number of managed care transactions over the last several months, including the Anthem/WellPoint deal which should be closing shortly now that it has received the approval of California's insurance commissioner, UnitedHealth Group's purchase of Oxford Health Plans, and HIP Health Plan of New York's acquisition of ConnectiCare. For-profit hospital chains are also looking to consolidate and otherwise expand their footprint in order to further build market share in the areas where they operate. Two examples are LifePoint Hospital's acquisition of Province Healthcare and Ardent Healthcare's acquisition of Hillcrest Healthcare System.

TS: *Are private equity buyers butting heads with corporate acquirers?*

Elek: They often compete on deals, not only with corporate acquirers but with each other. Interestingly enough, on many recent transactions, there have been more private equity than corporate bidders. This is a big shift from a few years ago when strategic buyers dominated the market.

TS: *What do you think are the reasons for this?*

Elek: Basically there are two. The amount private equity funding focused on healthcare has increased significantly due to the industry's favorable long-term growth characteristics. And the desire of some firms to create strong platform companies that can drive growth through add-on acquisitions and capture the kinds of synergies needed to enhance profitability.

TS: *What are some good examples of that?*

Elek: I'll give you two. Vanguard Health Systems, which owns and runs acute care hospitals, is a portfolio company of The Blackstone Group. Ardent Health Services, which owns and runs acute and behavioral hospitals, is a portfolio company of Welsh, Carson, Anderson & Stowe. Vanguard or

Ardent might do a deal, but any needed equity financing would come from their private equity sponsors.

TS: *So platform companies almost constitute a third class of buyer?*

Elek: Yes. A private equity firm might do a stand-alone deal to enter a particular sector, and then use its acquisition as a platform for purchasing other assets. When this happens, the platform company essentially becomes the consolidator, with funding from its private equity parent. The target typically is a company with significant growth potential, or one whose profits lag behind its competitors.

TS: *Is this pattern any different from what other industry players are doing?*

Elek: Basically no. Private equity firms and corporate buyers are both looking for companies with strong growth potential. There are two key differentiators though. The first is that a private equity firm often uses a newly acquired company as a platform for making further acquisitions, while a corporation is more likely to merge any acquisition with their existing operations. The second is that private equity firms generally have shorter investment horizons. A corporation may hold an acquired business indefinitely, while a private equity firm usually looks to exit in three to seven years either through a sale or public offering.

TS: *This sounds like a good, old-fashioned industry consolidation!*

Elek: Absolutely. Building critical mass increases a healthcare provider's market share and presence putting the company in a better position to negotiate with managed care providers.

TS: *Will there be more cross-border activity?*

Elek: No, not in a meaningful way, at least in the provider and managed care sectors. The U.S. market is still unique compared with most other developed countries where there is more government ownership and regulation of the healthcare system.

However, issues we face in the U.S., like an aging population and escalating costs, affect other developed countries as well. To deal with these issues, the U.K., for example, is reaching out to the private sector, creating new opportunities for U.S. healthcare companies and private equity firms. You

will also see more cross-border activity in sectors like pharmaceuticals, biotech and medical devices that have less idiosyncratic markets.

TS: *What do the next six to 12 months look like for this industry?*

Elek: I think the increased levels of M&A activity will continue, with much more competition for deals and higher prices. Many sectors are already seeing prices at levels almost unprecedented given the nature of the businesses. And you will continue to have strategic and private equity buyers competing for transactions.

TS: *What about large deals?*

Elek: We'll probably see some large managed care deals as major companies look to build a much broader footprint and gain leverage with large employers. I think you'll also see some significant activity with for-profit hospital chains as they look to increase their market presence and share.

TS: *Do acquirers feel a sense of urgency?*

Elek: Yes, absolutely. Companies and private equity funds don't want to lose an attractive property to someone else. Also, private equity funds have never had more money to put to work. I think you're also seeing corporate buyers baking synergies or presumed synergies into their deals to help justify the prices they're paying. The big question—and risk—is whether they'll integrate aggressively enough to capture those synergies in a timely fashion.

TS: *Do you see any signs that the market is becoming overheated?*

Elek: I think we're close. Virtually all sectors of the healthcare space are as active as I've seen them in at least five years. That said, I think the sector will stay very hot for the next two years or so.

TS: *What's the wildcard in all of this?*

Elek: The biggest wildcard is how President Bush and the Republican Congress will address the harsh realities of a

large budget deficit, rising healthcare spending and aging baby boomers. Everyone in Congress understands how the changing U.S. demographics will influence demand for healthcare services in the years to come. The big questions are where are we going to get the money to pay for these services, and how much responsibility is the government—versus the private sector—going to assume? Prospective acquirers have to figure out which sectors of the healthcare industry are likely to flourish under the second Bush administration.

TS: *So the ultimate wildcard is the one everyone's already talking about – how do you give our aging population access the healthcare services and drugs they need in a cost effective manner?*

Elek: Yes. In this environment, Medicare Advantage plans and PBMs are likely to thrive as President Bush continues to promote private sector solutions for drug delivery and payment. Congress may curtail planned increases in Medicare reimbursements to healthcare providers, with hospitals potentially targeted for the biggest cuts since they are the largest beneficiaries of payment increases.

The last time the nation faced a large budget deficit, Congress passed the Balanced Budget Act of 1997 which reduced many government spending programs, including Medicare. An equivalent cut in today's dollars would reduce Medicare by \$450 billion over the next 10 years, roughly offsetting the cost of drug coverage under the Medicare Modernization Act. And a groundswell of support from seniors and state governments could make the re-importation of lower cost drugs from Canada [where prices are sometimes 50% less] a reality, with adverse implications for drug industry profits.

TS: *So that's what makes forecasting M&A in the healthcare industry so challenging?*

Elek: You bet!