Modern Healthcare

M&A Watch: Hospitals Seeking Mergers with Bigger Players Can be Choosier

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It has taken Rockford (Ill.) Memorial Hospital more than three years and three attempts to find a partner, but its latest deal with Janesville, Wis.-based Mercy Health System may be its strongest yet.

The 297-bed hospital had two failed deals before it found Mercy, a three-hospital system that also operates MercyCare Health Plans. But in that time, Rockford has improved its financial performance. In its most recent earnings report for the third quarter of 2014, its operating surplus had more than doubled compared with the same period in the previous year. Revenue also increased 10%.

Gregory Hagood, president of SOLIC Capital, which served as Rockford's adviser in the transaction, said the Mercy deal gave Rockford Memorial the opportunity to be part of a large system, with access to health-plan assets, a large physician network, better patient demographics and a strong balance sheet. "This is probably even better" than previous offers, he said.

Hospitals across the country have been rapidly consolidating for some time, but more of them are doing so now from a position of financial strength as they see increased volume and an improved payer mix under the Patient Protection and Affordable Care Act. "They're getting an opportunity to be a little bit choosier about who they choose," Hagood said. Even in a not-for-profit deal where no money is changing hands, the seller can ask for more capital or clinical commitments from the buyer, he added.

The Rockford deal, which closed this month, was one of 35 transactions among acute-care hospitals announced in the fourth quarter. That was the highest number since the second quarter of 2013, according to Modern Healthcare's quarterly M&A Watch report.

Yet Hagood suggested that M&A activity is poised to ramp up in 2015, as continued payment cuts reverse some of those financial gains and drive more alliances.

In total, healthcare providers inked 105 transactions in the fourth quarter of 2014, with a publicly disclosed value of $7.8 billion, according to the M&A Watch report. The numbers were well above the same period in 2013, when acquirers spent only $3.6 billion and forged 85 deals. The fourth-quarter figures, however, represented a modest pullback from the third quarter's peak of $13.9 billion in value and 110 transactions.

MH Takeaways

Hospitals can be choosier based on increased volume and an improved payer mix under healthcare reform, but continued payment cuts could drive even more alliances.

That slowdown is not expected to last. "We have seen a frenetic level of activity in planning for 2015," said Jeff Swearingen, managing director at Edgemont Capital Partners. "Valuations have been very strong in 2014 and we expect that to continue into 2015."

M&A Watch tracked 279 publicly announced deals across four healthcare sectors in the fourth quarter, which represented a 2.1% decline from the previous quarter but a 13.4% increase over the fourth quarter of 2013. The deals included transactions for providers, insurers, life sciences companies and vendors.

Deal value in the fourth quarter also reflected a continued seller's market, increasing to $118.7 billion, nearly double the previous quarter's $60.7 billion and more than triple the $35.8 billion in value during the same period last year. More than half the value was concentrated in one huge pharmaceutical deal—Actavis' $66 billion play for Allergan, which allowed the Botox maker to fend off hostile suitor Valeant Pharmaceuticals.

The high values also reflected the positive effects from healthcare reform, which brought in additional paying customers for providers and insurers and created demand for new products and services. In addition, the M&A market received a boost from the debt market, where low interest rates and a hearty appetite from lenders benefited industry players and financial investors.

Private-equity firms forged 57 deals in the fourth quarter, either on their own or through a portfolio company, with deal value reaching $3.1 billion. That number was 42.5% higher than the 40 deals in the third quarter, worth a publicly disclosed $1.9 billion. It was more than double the 28 deals in the fourth quarter of 2013, though value in that period reached $3.9 billion.

2014 Q4 Healthcare M&A Watch report

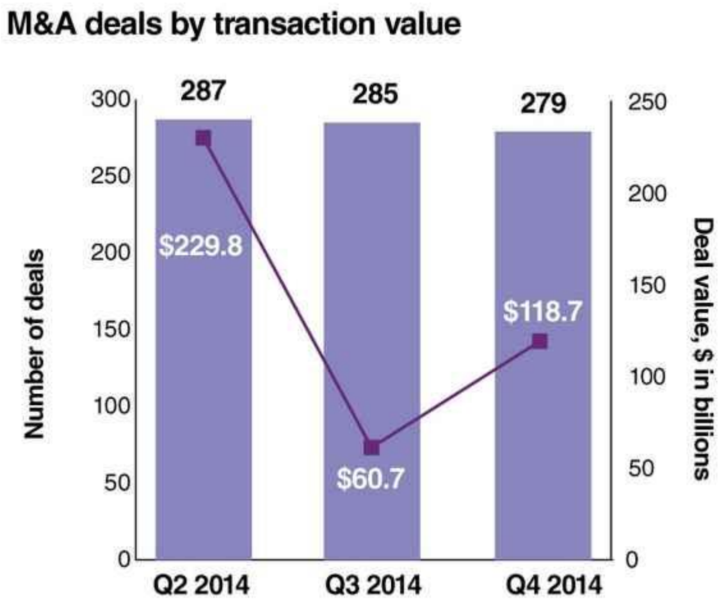
In addition to traditional lenders, a number of new parties have been eager to extend financing to healthcare companies, including specialty financing firms, business development corporations and hedge funds, said Rob Harris, a healthcare financing attorney at Waller. Coupled with low interest rates, private-equity buyers have been able to compete for targets on a level playing field with industry players. “We've seen a ton of sponsor deals,” Harris said, referring to financial buyers.

As health systems have gotten bigger, the ripple effect has spilled over into the vendor space. Companies that contract with hospitals, including physician staffing, software and consulting services, need to get larger to keep up with more complex clients, Hagood said.

TeamHealth, a Knoxville, Tenn.-based physician staffing firm, continued its buying spree, completing four deals in the fourth quarter after closing five in the previous quarter. “We continue to see tremendous activity in the hospital-based specialties,” said Swearingen, who specializes in physician practice M&A.

He served as an adviser to Ohio-based Premier Physician Services, which was acquired by TeamHealth in October.

Hospital-based physician-specialty practices are consolidating under larger staffing firms. Meanwhile, office-based specialty practices and primary-care practices mainly have been gobbled up by hospitals, he said. Private-equity firms also have entered the arena in the past few quarters after being relatively absent from the clinician space for most of 2013, according to M&A Watch data.

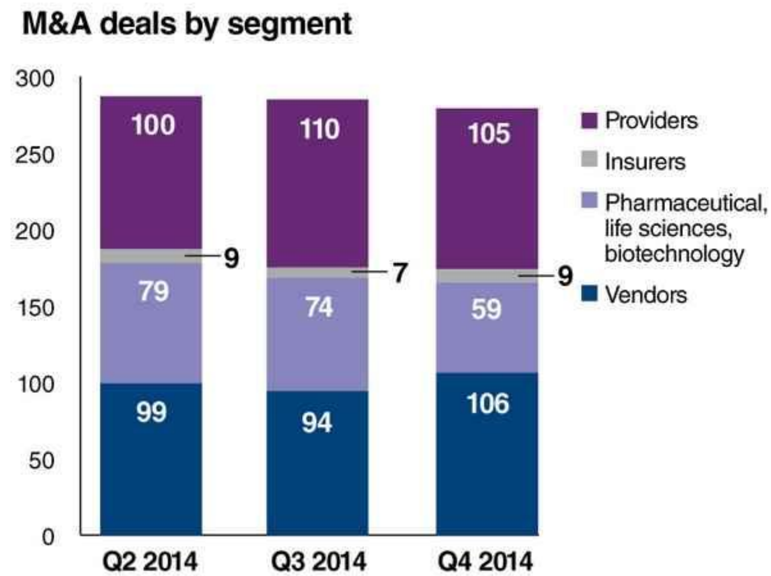


Vendors signed 106 deals in the quarter with a disclosed value of $19.8 billion. Volume increased 12.8% over the previous quarter and 19.1% over the same period in 2013. Deal value, meanwhile, more than doubled quarter over quarter, and more than tripled year over year.

The quarter's second-largest healthcare deal, which came out of the vendor sector, was Becton, Dickinson & Co.'s $12.2 billion bid for CareFusion, maker of medical equipment and technology. More than three-quarters of the total deal value, or $90.1 billion, came from the pharmaceutical, biotechnology and life sciences sector, where acquirers all year long have shown a willingness to pay blockbuster prices for desirable targets. The frenzy has swept up not only the industry's major players, but smaller companies with promising compounds or technology.

Munich-based Definiens, which analyzes tissue images to help predict how individuals will respond to treatments, recently had completed a 15 million euro funding round and added a new investor when it received a $150 million takeover offer from MedImmune, a division of AstraZeneca. The offer was unexpected, but attractive. “You wouldn't raise financing if you planned to sell the company,” CEO Thomas Heydler said. “The really interesting thing for us (is) we're a small company which now has the backing of a major player.”

His company's software has applications in drug discovery and in developing diagnostics. Interest in personalized medicine has increased as a way to improve outcomes and hold down costs by targeting expensive therapies to the patients who stand to benefit the most. “It's not only a biology play,” Heydler said. “It becomes much more of an information play.”



The M&A Watch report tracks only deals with a change in ownership, not the looser alliances that are creating new connections among healthcare providers. These less formal arrangements, which allow providers to retain their independence, are increasingly attractive because of heightened scrutiny from antitrust regulators and religious institutions, said AnnJeannette Colwell, a market analyst at Decision Resources Group. She was referring to a recent move by the U.S. Conference of Catholic Bishops to ensure that in deals between Catholic and non-Catholic healthcare organizations, Catholic providers do not “cooperate immorally with the unacceptable procedures conducted in other healthcare entities with which they may be connected.”

Still, traditional mergers are likely to remain a major part of the healthcare landscape because of their clear parameters and quicker results. Non-ownership deals can be tricky.

For instance, in Indiana, three hospital partners disbanded their non-ownership alliance as of Dec. 31, citing differences in how they planned to contract with health plans offered on the federal insurance exchange. Community Health Network and St. Vincent Health, two of the largest systems in Indiana, had formed the Accountable Care Consortium with six community hospitals under Suburban Health Organization just two years earlier.

“There can be too many cooks in the kitchen,” Colwell said. “We've seen some of these deals dismantled if the health systems have different strategies when it comes to the Affordable Care Act.”

Looser alliances also require partners of equal financial strength, and there's concern that the initial boost from healthcare reform might not last. Acute-care providers will continue to face payment cuts as well as shrinking inpatient volume that will necessitate a shift to an outpatient strategy, said Mark Claster, president at Carl Marks Advisors.

“M&A is at a frenzied level for lots of different reasons and I think consolidation will continue,” he said. “For a small community hospital, the handwriting is on the wall. You need to execute a strategy of growth.”

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