Q2 2018 HEALTH CARE & LIFE SCIENCES SPOTLIGHT
M&A trends and private equity deal activity
“Mega-mergers could significantly change who the decisionmakers are within the industry.”

Ron Ellis,
Senior Director, Transaction Advisory Services
For some time now, the health care industry has seen steady increases in the volume of mergers and acquisitions (M&A) against a backdrop of significant change, albeit transformation that has only contributed to the sector’s growth. From the demographic to the technological, transformative shifts within health care show few signs of stopping, although the dealmaking they have aided and abetted has grown increasingly complex. As M&A has resulted in larger and larger entities in key industry segments, resulting transactions have only grown in size, as exemplified by the ongoing mega-mergers such as the $69 billion purchase of Aetna by CVS Health. The US Department of Justice just announced it would not contest the merger, which is an encouraging sign for additional vertical integration going forward. In addition, the avid interest on the part of financial sponsors and the increasingly large sums at their disposal have also contributed to significant expansion in aggregate transaction multiples.

“On both the sell side and the buy side, investors are willing to pay high multiples,” says Ron Ellis, senior director with transaction advisory services at RSM US LLP. “Certain segments like dermatology, physician practices, dentistry and more are ripe for consolidation.” This has been the case for some time, which has led to an increasing number of sellers flocking to market. In turn, then, the primary challenge for those looking to buy is adequate diligence across both the qualitative and quantitative—consult RSM US LLP’s latest insight article on running a smooth sale for concise tips. Especially for private equity (PE) sponsors that are still keenly sourcing retail health care opportunities, prioritizing review of the smaller firms that were previously owned by families or founders is critical.
In the current sellers’ market, it is imperative to heed due diligence across all types of risk factors. Anecdotally, there is talk of increasing numbers of prospective PE buyers walking away from deals given the quality of the target companies, and given the level of current transaction multiples, one can hardly blame them. Savvy investors still looking for exposure to health care companies are now emphasizing the creation of sell-side quality-of-earnings reports, and looking for founder- and family-owned businesses that have undergone an audit—accordingly, to adopt the seller’s perspective, garnering at least some type of financial review is well worth investment. Moreover, the inclusion of qualitative data is also key—brand loyalty, for example—and is a useful data point when it comes to analysis of a local care provider. Last but not least, especially for those firms that may undergo management transitions as part of the acquisition, personnel forecast or succession plans can help entice buyers, especially if the firm is a smaller care provider.

Of care providers in general, office-based specialty practices such as podiatry, fertility, behavioral health, ophthalmology and dermatology are especially attractive to buyers in the current market. Their potential to serve as a platform base for future growth via the acquisition of ancillary service providers is especially alluring. Consequently, there appears to be no curbing dealmakers’ appetites for such companies going forward.
The dealmaking environment within health care is complex and competitive, so current transaction prices are quite costly. These are critical factors to consider when making a forecast. Considering the spate of mega mergers that are likely to close this year, yet slowly diminishing volume, it is clear that the supply and demand dynamics are likely to continue shifting inexorably. Investors still want exposure to health care companies, but must balance the need for exposure with paying the right price for the right company. Consequently, it is likely volume will even out at best, as there isn’t an endless supply of businesses for acquirers’ purview. Buyers will still focus on either vertical integration or other types of consolidation at the top of the market, or in the case of financial sponsors, delve into fragmented niches where proportionally greater growth opportunities reside.

As for industrywide issues, increased adoption of technology and demonstration of the ability to adapt in the face of regulatory pressures and their knock-on effects will be top of mind for health care firm leaders. For example, firms need to be able to navigate potentially murky regulatory arenas that may grow increasingly dynamic. Ellis states, “Parts of the Affordable Care Act may have been eroded, so there have been some changes to reimbursement, but there has also been action to increase funding for programs to combat opioid addiction and further fund behavioral health.” Accordingly, companies must continue to embrace and anticipate changes stemming from regulatory updates and technological advances in particular.
SOARING BUYOUT MULTIPLES LEAD TO DECLINES IN VOLUME FOR PE INVESTORS.

Median PE buyout size soared to $175M—the highest tally on record—in 2018 to date.

PE firms will still pay up for companies, however, often lining up prospective add-on targets in tandem with original platform buys.

EXIT VOLUME SLIDES ONCE AGAIN IN TEPID CLIMATE FOR HEALTH CARE IPOS.

Zero health care IPOs were recorded by PE-sponsored companies due to greater allure of other exit routes.

The bulk of exit volume remains concentrated in services supported by a consolidation in fragmented care niches.

TAKING ADVANTAGE OF THE CURRENT EXIT CLIMATE SHOULD BE PRIORITIZED BY SELLERS.

The macro environment for selling remains strong, especially to larger PE firms that can take portfolio companies to a higher rate of growth.

Executing an efficient sale is a savvy mix of qualitative and quantitative data along with detailed succession plans to mitigate talent continuity problems.
2018 SEES GENTLE SLIDE IN ACTIVITY

Across both Europe and North America, health care M&A activity was more muted by volume in the first half of the year even relative to a slowing back half of 2017. In tandem with relatively robust—at least on a historical basis—deal value, it is clear that the median level of deal sizes is taking a toll on aggregate tallies. Although the median transaction size is down from the heights of the final quarter of 2017, the average transaction size is still hovering around historic medians, once again reinforcing the surmise that buyers are dissuaded by how much price tags have inflated.

It should be noted that this trend is highly cyclical, as it is more in response to the evolution of dealmaking conditions than the health care industry’s overall growth trajectory, which is robust across multiple segments. Consequently, there is still an optimistic bull case to be made for M&A activity to remain fairly strong going forward.
DIMINISHING AVERAGE, MEDIANs SIGNIFY RISING CAUTION

Investors may well be focused on the lower end of the market in an effort to find bargains, but the fact that both average and median transaction sizes took a downturn, in tandem with diminishing overall volume, suggests some are refusing to pay inflated prices.

UPTICK IN DEVICES AND SUPPLIES

Proportionally, an uptick in the volume of devices and supplies entails a quirk in timing more than anything else, but it is worth noting that lesser-explored niches of health care are enjoying more and more attention as technical advances are made.
STILL-ROBUST VALUE

After a blockbuster 2017, PE firms are taking more of a breather in terms of volume, although aggregate deal value is still on pace to exceed nearly every other year this decade. The growing popularity of sourcing amid the lower middle market is likely a prime contributor to deal volume skewing toward the center and middle of the market, while lofty prices still underpin robust deal value.

NEW HIGH FOR BUYOUT SIZE

In contrast to overall M&A deal sizes, the median PE buyout size has only continued to achieve new highs. Significant sums of dry powder continue to exert upward pressure, while investors are still able to justify writing hefty checks due to growth expectations, often lining up add-on prospects almost simultaneously with the original platform acquisition.
The Value of RSM’s Middle-Market Leadership

Focusing on the middle market, RSM US provides integrated transaction advisory, tax, assurance and consulting services. Our work with nearly 2,000 health care and life sciences companies gives us a deep understanding of the key trends impacting the industry. In addition, we have performed due diligence on more than 2,200 deals in the past five years, almost 300 of which were health care and life sciences transactions. This in-depth knowledge provides our private equity and strategic buyer clients with industry-specific due diligence considerations.