Q3 2018 HEALTH CARE & LIFE SCIENCES SPOTLIGHT
M&A trends and private equity deal activity
“The big picture is there is still so much cash chasing so few deals.”

Ron Ellis, Senior Director, Transaction Advisory Services
As the health care landscape continues to experience slow-paced but significant change, so too have M&A trends evolved. Key segments are still seeing significant consolidation, such as clinics and outpatient services, or retail health segments such as dermatology. Other segments are dominated by megamergers as giant companies grapple with stubbornly rising prices by uniting additional services under one corporate umbrella, thereby courting additional patient flow. An inexorable march toward larger chains in many cases seems inevitable, primarily for health care services; although the ongoing disruption of models by more efficient application of technology for data flow continuity and security will still require substantial investment.

“Our clients, spanning both strategic and financial sponsors, are still sitting on a lot of cash,” says Ron Ellis, senior director with transaction advisory services at RSM US LLP (RSM). “They are chasing deals and want to get them done this year.” On the private equity side in particular, avid buyers are propelling overall M&A volume forward. “And as may be surmised when there’s an abundance of cash and plenty of buyers, the biggest challenge for fund managers is finding the right asset and obtaining exclusivity in the bidding process,” says Andy Jenkins, partner with transaction advisory services at RSM. There are many factors for fund managers poised for longer holding times in particular, to consider, from pen risk of fluctuating related regulations to innovation and implementation of health care information technology. In short, acquirers still have plenty of work cut out for them, especially in the current landscape.
The life sciences and medical devices spaces are intriguing arenas for analysis when it comes to private equity, particularly as many development and investment opportunities in biotechnology and other aspects of life sciences have traditionally been dominated by venture capital firms. However, for more established life sciences companies, such as those still private yet with products further down the line, there are potential mutually beneficial transactions to be struck with private equity funds of sufficient credibility and size. Heightened venture valuations and deal sizes have only further elevated to levels typical of private equity growth investors, for example. Yet prospective buyers or investors at even early stages must contend with competition from strategic acquirers. A recent study from SRS Acquiom noted that more biotechnology companies have been acquired at the preclinical or phase 2 stage, surely due to the success of over 70 percent of milestone events based on preclinical progress being paid out, and over 50 percent for progress in phase 1.

Requirements are evolving as well. Alliance–like reporting, meeting procedures, change–of–control terms, and sellers’ ability to transfer earnout rights in certain circumstances are all increasingly common. Key issues for prospective investors to consider, in addition, remain the market positioning of products, regulatory risks, pipelines, potential capital pressures and forecasted expenditures and sufficient due diligence. A quality–of–earnings report is considered a common best practice—even sellers are increasingly likely to perform such an analysis before they go into the sales process, according to RSM industry professionals. As the market is frothy, but buyers are still relatively wary, sellers are also looking to incorporate any appealing noncash assets, plus factors such as employee retention and long–term strategy, all in order to help close more quickly at today’s current level of valuations.
Supply and demand dynamics continue to yield robust dealmaking volume within health care, particularly with aggregate deal values skewed by megatransactions. Forecasts pertaining to volume are complicated given the level of dry powder available for private equity funds, not to mention the level of cash corporate players have on hand. Accordingly, buyers will continue to remain active, keeping valuations high and sustaining the sellers’ market. Consolidation will only continue; megamergers such as the CVS–Aetna acquisition are signaling not the end of that trend, but rather the latest examples. Interest rate rises will affect some but not much of private equity fund managers' incentives, as many are already baking in the potential ramifications of rate hikes, and that timing is fairly protracted. Sellers will continue to press eagerly to offload the most worthwhile assets given current prices—but those same prices will prompt them also to prepare even more thoroughly to expedite buyers' screening. Last, but not least, a slowly unrolling yet inevitable wave of innovation in pharmaceuticals will continue to effect changes in prescription pricing and associated payments, as biosimilars contribute to lowering prices and as novel therapies, particularly in immunotherapies, enter the realm of viability.
HEALTH CARE M&A REMAINS SUBDUED IN Q3, RELATIVE TO HIGHS OF 2015

Median transaction size for M&A jumped to $100 million, exposing pricing pressures for the best assets are taking a toll on volume.

Services lead in volume, but devices, supplies, pharmaceuticals and biotechnology segments enjoyed relatively strong activity in Q3.

40 PERCENT of Q3 2018 M&A volume involved PE.

IN CHALLENGING SELLERS’ MARKET FOR LIFE SCIENCES AND MEDICAL DEVICES, PE AND STRATEGICS VIE COMPETITIVELY

Armed with significant dry powder, select PE funds are able to price compete with strategics for the best assets.

Devising creative investment structures for relatively early-stage life sciences and device companies is still viable for PE funds.

ROBUST PE ACTIVITY SPEAKS TO INDUSTRY DYNAMICS AND FUND STRATEGIES’ DIVERSIFICATION

PE buyers are taking advantage of a strong sellers’ market, still utilizing add-ons in over half of all buyouts.

High prices aren’t yet impacting volume overly, although median buyout size hit a massive $15.4M.

Growth investing set for a rebound in volume, nearly hitting 200 transactions, third-highest tally of the decade.
Relative to the highs seen in 2015, overall health care M&A activity across Europe and North America remained subdued. However, reviewing quarterly tallies since early 2016, volume has persisted at a steady and historically healthy dip, while aggregate deal value has remained even more robust. Consolidation will continue to drive much activity going forward, with no end in sight, especially in North America. Much of any slowing in activity is most likely attributable to just how pricey the climate has become, which doesn’t dissuade many buyers but can contribute to slowing volume on a quarterly basis. “We aren’t forecasting any significant change in the competitive environment,” Jenkins says. “If anything, processes will get shorter. Rather than four or five months of diligence, as in the past, bids are collected much more rapidly, a few are selected, and then all parties move forward.” Given that aggressive timeframe, according to Ellis, there could even be a bump in the final quarter, as dealmakers look to close transactions prior to the year ending.
MEDIAN & AVERAGE HC & LS M&A SIZE ($M)

Just one quarter after diminishing averages and medians seemed to be signifying rising caution, the median M&A size surged to a record level of $100 million. Potentially a temporal aberration, the surest conclusion is that price levels will remain high if not necessarily that record-breaking going forward, as both means and motivation abound for buyers to pay up in quite a few cases.

HC & LS M&A (#) BY SECTOR

The volume of pharmaceuticals & biotechnology transactions held steady for another quarter to yield. Boosted by ongoing acquisitions of early-stage biotechnology companies, such volume looks set to remain fairly robust, as pharmaceuticals giants continue to invest in prospective pipelines.
ON PACE TO MAINTAIN SIGNIFICANT HIGHS

Although down from blockbuster highs in 2017, this year will likely close at the second-highest tally of private equity deal value in health care of the decade. Volume may look set for a steeper decline, but it is still a bit premature to draw conclusions. “4Q looks set to be strong,” says Ellis. “Since many platform buyouts were performed in the past few years, add-ons to those platforms will likely bolster volume going forward.”

RECORD ADDING ON

Given the sheer size of the health care sector, the opportunities for consolidation within fragmented niches abound. Moreover, they look set to persist for some time, so new highs in add-on proportions will likely persist, with only the potential for high prices dissuading hopeful private equity investors from snapping up additional portfolio companies at a rapid clip.
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.