RESHAPING HEALTHCARE M&A
HOW COMPETITION AND TECHNOLOGY ARE CHANGING THE GAME
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AS HEALTHCARE COMPANIES seek to adapt and thrive in a fast-changing environment, M&A is playing a crucial role. The numbers bear this out: There were 579 deals for U.S. healthcare targets in 2017, the second-highest total on record, according to Mergermarket data. The appetite for deals is fueling a highly favorable market for sellers. For instance, the median EBITDA multiple for U.S. healthcare targets increased nearly 3x from 2015 to 2017, reaching the level of 13.8x.

Both up and down market, a common theme in healthcare M&A has emerged: Buyers are looking for acquisitions that can evolve and respond to the rapidly changing landscape. Big insurers are joining forces with distributors to create new, vertically integrated structures. Private equity firms are consolidating fragmented sub-sectors and investing in technology that can reduce costs and change how care is delivered.

Indeed, leveraging innovation to save on costs is a key motivation for deals. “Everything is about cost take-out, given the amount of competitive pressure in the industry,” said Brad Haller, a director in West Monroe Partners’ M&A practice who focuses on healthcare deals. “All of the different stakeholders are trying to outdo each other on price.”

To better understand the drivers and challenges for healthcare acquirers – and to analyze the role of technology in healthcare M&A – West Monroe conducted a survey of 100 market practitioners in partnership with Mergermarket. The survey indicates that the healthcare sector’s robust financial performance will drive dealmaking amid heightened competition for targets. Acquirers are leveraging domain expertise and forming novel alliances to win deals and create value post-close. Technological change is at the forefront, as buyers use M&A to gain access to technology and disrupt the competition. Yet our study shows that due diligence in the areas of IT and cybersecurity – which have become cornerstones of the modern healthcare industry – often fall short.

The race for assets is likely to heat up further as strategic buyers and private equity firms look to put capital to work. The task for acquirers is to place the right bets in this dynamic market.

READ THIS RESEARCH TO LEARN:

- How healthcare acquirers are coping with intense competition for deals
- Which types of healthcare targets are most attractive to buyers
- Which regulatory issues are influencing M&A decisions the most
- Differences in the approach to healthcare M&A between strategic buyers and PE firms
The top challenge in seeking healthcare deals is the shortage of attractive targets, according to a quarter of respondents (25%). Respondents gave various definitions for "attractive," but focused mainly on the dearth of targets valued at $100m or less; the difficulty in finding companies with the right technology or products to sustain growth; and the lack of targets that have the right strategic fit for their business.

Technology presents both opportunities and a major test for acquirers: A plurality of respondents (36%) said the biggest challenge to healthcare companies over the next one to three years will be the fast pace of change in technology. This sentiment is driving M&A interest in companies with strong IP and up-to-date IT systems.

Gaining greater market share in a dynamic market requires thinking outside the box: More than three-quarters of respondents said they would definitely (31%) or likely (48%) seek more joint ventures and alliances over the next 12 to 18 months.

49% of respondents said they were dissatisfied with the compliance and cybersecurity due diligence in their recent healthcare deals – underlining the complexity of the technology landscape in the industry. Relatedly, 58% of respondents said they had discovered a cybersecurity problem at an acquired healthcare company after the deal was done.

A variety of regulatory issues are affecting the market, with the transition to value-based care representing the biggest impact on their approach to dealmaking. Acquirers are paying close attention to targets’ capabilities in this area as the industry makes the slow-but-steady shift away from the fee-for-service model.

The ability to adapt is critical: 41% of respondents said a company’s preparedness to respond to regulatory change was a top concern when it comes to operational or personnel issues, and 40% said a management team’s willingness and ability to adapt to market trends was a top priority.

"Everything is about cost take-out, given the amount of competitive pressure in the industry.

Brad Haller, West Monroe"

"Any kind of dip in valuations, especially for biotech acquisitions, could drive a buyer’s market in the industry.

Will Hinde, West Monroe"
THE U.S. HEALTHCARE industry is experiencing a historic boom, and is expected to add 4 million new jobs by 2026 – accounting for about one-third of total job growth, according to Department of Labor projections. This growth is being driven by spending: In 2016, health expenditures made up nearly 18% of U.S. GDP, compared to just over 10% 30 years ago.

Companies in the sector are also seeing robust increases in profitability, which in turn is driving M&A activity. Our survey finds that attractive margins (32%) is the top factor attracting potential buyers to healthcare assets, and revenue or profit growth (41%) is the operational metric most important in driving the M&A strategies of healthcare sector acquirers.

Many healthcare companies – especially payers, medical device companies, and some drug makers – are posting strong earnings, even while navigating regulatory change and the emergence of new technologies. In the fourth quarter of 2017, to name just a few examples, UnitedHealth saw its earnings more than double from the year earlier to $3.62bn and pharmaceutical giant Pfizer’s earnings increased nearly 50% to $1.57bn, in addition to a $10.7bn tax-related benefit.

Profits in select sub-sectors have been accompanied by steady dealmaking activity, as large-cap companies employ vertical integration deals to open up new avenues to reach consumers. Both 2017 and early 2018 featured landmark deals reinforcing these themes, including CVS Health’s agreement to spend $69bn buying insurer Aetna.

WHICH OF THE FOLLOWING TRENDS WILL MAKE HEALTHCARE TARGETS MORE ATTRACTIVE OVER THE COMING ONE TO THREE YEARS? (SELECT THE MOST IMPORTANT)
Earnings growth in the sector is driving M&A activity lower in the market as well - especially by private equity players.

Demographic and other macro trends are largely driving expansion of the healthcare industry. When asked about the factors spurring interest in the sector, respondents to our survey said the overall growth in demand for care (23%) and the aging population (23%) were key elements.

The number of Americans ages 65 and older rose from 35 million in 2000 to 49.2 million in 2016, according to U.S. Census Bureau population estimates. This shift is propelling sub-sectors such as pharmaceuticals and home healthcare.

“Home health certainly has its challenges from a reimbursement perspective,” said a managing director at a generalist PE firm with long-term capital. “But if you have the subject-matter expertise and you can buy something of scale, you can really drive efficiencies and compete well, because of favorable demographic trends.”

Reimbursement is certainly a major factor shaping dealmakers’ decisions in the healthcare sector – especially for financial buyers.

Home health certainly has its challenges from a reimbursement perspective. But if you have the subject-matter expertise ... you can really compete well.

Managing director at a PE firm with long-term capital

### PE vs. Corporate Buyers

Private equity focused on demographics

Attractive margins represented the top driver of healthcare deals for both strategic (39%) and financial acquirers (28%). But close second and third choices for PE firms were the aging population (25%) and overall growth in the demand for care (24%). Notably, 13% of PE respondents also said overall competition for assets made healthcare targets attractive, suggesting that they anticipate a strong exit environment.
In working with PE sponsors, the biggest risk we see is the level of reimbursement from the government," said Haller. “They want to keep that as low as possible, and will even step back from the brink of a deal and walk away if a final analysis shows a large portion of government reimbursement in their finances.”

Indeed, it pays to be selective when it comes to financial issues at potential targets, according to our respondents. Nearly three-quarters of those surveyed (73%) said they had walked away from a potential healthcare deal at some point, and financial and/or tax issues were the main reason for doing so.

Broadly speaking, this phenomenon is likely connected to the pursuit of attractive margins.Dealmakers may abandon a deal if they conclude that their target’s recent market growth doesn’t look sustainable, or if there are discrepancies in targets’ reported margins.

As competition rises, buyers leverage expertise – and get creative

Not surprisingly, with the number of interested buyers growing ever larger in the healthcare sector, a quarter of respondents said a shortage of attractive targets (25%) was their biggest financial or market barrier to making acquisitions at present.

“Excessive competition for targets means that a lot of attention is being concentrated on fewer companies,” said the director of acquisitions and development at a skilled nursing care facilities company. “These high-quality targets get noticed and acquired in the market much sooner than others.”

However, this survey result begs another question: What kinds of targets do buyers find attractive exactly? Besides high profit margins, respondents gave a variety of answers, but three major topics emerged.

First, acquirers cited difficulty finding enough targets in their price range, especially around or below $100m. This may explain the growing phenomenon of private equity buyers,
in particular, going upmarket to make purchases, as well as joining forces with other PE firms, or even strategic acquirers, to gain access to a new range of targets. This trend could be seen in the recent $1.4bn acquisition of hospice operator Curo Health Services by a consortium of three buyers: insurer Humana and financial buyers TPG Capital and Welsh, Carson, Anderson & Stowe. The group said they plan to combine the company with the hospice unit of Kindred Healthcare, which the three buyers also purchased together in December 2017, in a deal valued at $3.9bn.

Second, buyers are facing challenges in securing deals with companies that have technology or products advanced enough to maintain robust growth – in other words, mature businesses with a sustainable model. And third, they aren’t always able to find targets that represent a strategic fit with their business.

The shortage of attractive targets comes with other problems. Respondents mentioned an excessive competition for targets (20%), condensed timelines for due diligence (20%) and high valuations (20%).

“Valuations are a big concern in the current market,” said an operating partner at a PE firm based on the East Coast that specializes in life sciences and healthcare. “Businesses that have matured over time have accumulated assets that have increased in value. With affordable valuations being a criteria of attractive targets, the number has fallen considerably.”

Data on healthcare multiples in recent years provides evidence to back up this perception. In 2017, the median EV/EBITDA multiple for U.S. healthcare transactions was 13.8x, which is down slightly from the median figure of 14.5x in 2016 but a substantial increase over the 10.9x seen in 2015.

Healthcare companies and PE firms alike have developed an impressive toolbox of methods to help them overcome the challenges they face in sourcing targets. One of the main strategies both groups are using is to consolidate or scale up to increase competitiveness (58%) – in contrast to the vertical integration seen among many large-cap players.

Among financial buyers, it has now become more or less standard practice to employ the operating partner model. Firms are gathering a stable of 10 or more former executives with domain expertise who can replace managers at platform companies or execute a roll-up, as well as drive innovation.

WHAT IS THE BIGGEST FINANCIAL OR MARKET BARRIER TO HEALTHCARE ACQUISITIONS FOR YOUR FIRM CURRENTLY? (SELECT THE MOST IMPORTANT)

- **25%** Shortage of attractive targets
- **20%** High valuations
- **20%** Condensed timelines for due diligence
- **20%** Excessive competition for targets
- **15%** High debt loads at potential targets
“We leverage domain and sector expertise in all markets, healthcare and non-healthcare,” said a managing director at a Midwest-based PE firm that invests an average of US$35m per transaction. “That’s part of our differentiation. If you don’t have an angle, you’re just money. And from our perspective, that’s never an auction you should win.”

Strategies besides consolidation and vertical integration are also on the table for some in the industry. Take pharmaceutical and life sciences companies, which together have accumulated huge amounts of capital and could make ambitious plays if the right market conditions appear.

“Any kind of dip in valuations, especially for biotech acquisitions, could drive a buyer’s market in the industry,” said Will Hinde, leader of West Monroe’s Healthcare & Life Sciences practice. “It could be a prime opportunity for companies to come in and use some of the cash that’s been sitting offshore for decades. They’re being careful now to place bets based on therapeutic areas, but if something were to fundamentally change, pharma firms may expand into adjacent sectors.”

Indeed, some drug companies are already making somewhat non-traditional purchases. Take Swiss pharmaceutical company Roche’s $1.9bn acquisition of cancer software developer Flatiron Health in February 2018. Roche hopes to use Flatiron’s technology to accelerate its own development of new therapies – but will also allow its software to be used by others in the industry.

**WHAT ARE THE MAIN STRATEGIC DRIVERS OF HEALTHCARE ACQUISITIONS FOR YOUR FIRM CURRENTLY? (SELECT TOP TWO)**

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<th>Driver</th>
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<tr>
<td>Consolidation or scaling up to increase competitiveness</td>
<td>58%</td>
</tr>
<tr>
<td>Opportunity to disrupt incumbents using technology</td>
<td>48%</td>
</tr>
<tr>
<td>Expansion into new markets</td>
<td>37%</td>
</tr>
<tr>
<td>Transformative acquisitions</td>
<td>29%</td>
</tr>
<tr>
<td>Adding bolt-on assets to platform companies</td>
<td>8%</td>
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“We leverage domain and sector expertise in all markets, healthcare and non-healthcare. That’s part of our differentiation. If you don’t have an angle, you’re just money. And from our perspective, that’s never an auction you should win.”

Managing director at a Midwest-based PE firm
Joint ventures open new opportunities and save on costs

More than three-quarters of our respondents said they would either definitely (31%) or likely (48%) pursue partnerships, alliances, and joint ventures (JVs) over the next 12 to 18 months as an alternative to straightforward acquisitions.

JVs and partnerships can be ideal when one party wants to remain independent but both sides could make gains through close cooperation. This is especially true in life sciences, in which the development life cycle demands a diverse range of expertise. Alliances also allow buyers to realize value earlier by avoiding some of the most challenging aspects of M&A deals, such as fully integrating infrastructures, cultures, and technology.

JVs can be a means of accessing new technology as well. Indeed, by far the most prominent reason cited by respondents for seeking partnerships and joint ventures was the opportunity to access outside technology or expertise (57%).

Pressure on top-line growth is driving divestitures

More than half of our survey respondents said they thought sales by large-cap healthcare companies would increase significantly (32%) or moderately (31%) in the year ahead.

"There is significant pressure on large-cap healthcare companies either on the growth front or because of regulatory changes," said a director of corporate development at a Northeast-based healthcare software company. “I think as pressure continues to mount, companies will find it challenging to maintain top-line growth. Some will react by sharpening their focus and selling non-core assets.”

A prime illustration of this trend could be seen in General Electric’s $1.05bn divestiture of part of its healthcare IT business to PE buyer Veritas Capital in March 2018. The deal comes as GE plans to sell around $20bn in assets in an attempt to streamline the overstretched conglomerate. For its part, the deal was the latest in a series of healthcare acquisitions by Veritas of assets carved out by strategics, including its $820m purchase of healthcare services business Verisk Health from Verisk Analytics in 2016.

WHAT DO YOU EXPECT TO HAPPEN TO THE NUMBER OF DIVESTITURES BY LARGE-CAP HEALTHCARE COMPANIES OVER THE COMING 12 MONTHS?

- Increase significantly (by more than 25%)
- Increase somewhat (by 5%-25%)
- Remain about the same (within 5% of the 2017 total)
- Decrease somewhat (by 5%-25%)

79% of respondents say they will pursue alliances or joint ventures in the next 12 to 18 months
This approach has been used with success by Boston-based Ginkgo Bioworks, a biotechnology firm that designs and prints DNA to create customized microorganisms. Ginkgo formed a partnership with drug discovery company Synlogic in December 2017 to accelerate development of “living medicines.”

Perhaps the most intriguing partnerships are those with truly transformative potential. In January 2018, Amazon, Berkshire Hathaway, and JP Morgan caused a major stir in the press by announcing a joint venture aimed at bringing down healthcare costs and improving care for their employees.

The deal may be a sign of more innovative joint ventures and alliances to follow. However, it should be cautioned that companies outside the healthcare industry often struggle to disrupt incumbents, despite their significant financial and human capital.

“When companies outside of healthcare or pharma look at the sectors as a space they can disrupt, they often think that they can bring a lot of money and scale to the problem,” said Hinde. “What they don’t realize is that pharma, for example, is already sitting on a lot of money and has a lot of experience and scale. Many of the problems facing the industry have already been examined quite extensively.”

In April 2018, Amazon tacitly admitted that it lacked the proper expertise to disrupt one area of healthcare – selling pharmaceutical products to hospitals. The online retail giant reportedly struggled to convince hospitals to overhaul their current purchasing process, and would also have needed to upgrade its warehouse facilities to accommodate temperature-sensitive medical products.

**WHAT ARE THE GREATEST BENEFITS OF HEALTHCARE PARTNERSHIPS, ALLIANCES AND JOINT VENTURES (AS SEPARATE FROM PURE ACQUISITIONS OR MERGERS)? (SELECT TOP TWO)**

- Provides us access to outside expertise and/or technology: 57%
- Lowers our risk profile: 43%
- Allows us to grow top-line revenue more quickly: 42%
- Allows us to save on costs associated with regulatory compliance: 38%
- Secures funding on favorable terms: 16%
- Others: 38%

**WILL YOU TARGET MORE HEALTHCARE PARTNERSHIPS, ALLIANCES AND JOINT VENTURES OVER THE COMING 12 TO 18 MONTHS?**

- Yes, we will pursue more partnerships, alliances and JVs: 79%
- No, we likely won’t pursue more: 2%
- Remains unclear at present: 19%
TECHNOLOGY HAS EMERGED as one of the central forces – if not the most important force of all – shaping acquirers’ M&A strategies in the healthcare sector. More than a third of our survey respondents (36%) said the fast pace of technological change would pose the greatest challenge to healthcare companies over the coming one to three years. In the context of M&A, this raises the importance of IT due diligence in the targeting phase, and makes it critical to plan how acquired companies will be able to adapt, or disrupt, going forward.

“Technological change is positive, as it improves performance and opens up new opportunities,” said an operating partner at a Northeast-based PE firm focused exclusively on healthcare. “But when the pace of change is very fast, it can become challenging to adapt quickly enough to keep a business on track.”

### PE vs. Corporate Buyers

**Technology a bigger priority for PE buyers**

Interestingly, improvements to a company’s technology appear to be more important to financial buyers than to strategic acquirers. When asked about the biggest challenge respondents faced in deriving or creating value from a healthcare acquisition, 26% of PE respondents said making effective investments in tech represented the top challenge, compared to just 12% of strategic respondents who said the same. “The challenge was to make the right amount of investment that would launch the organization to the next level,” said a managing director at a PE firm focused exclusively on healthcare, referring to the firm’s investment in a medical device company in 2017.

<table>
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<th>Trend</th>
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<tr>
<td>Fast pace of technological change</td>
<td>36%</td>
</tr>
<tr>
<td>Transition to value-based care</td>
<td>21%</td>
</tr>
<tr>
<td>Uncertainty regarding regulatory change</td>
<td>16%</td>
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<tr>
<td>Cost of regulatory compliance</td>
<td>15%</td>
</tr>
<tr>
<td>Appearance of new industry models (e.g., hospitals’ plan to form a generic drug company)</td>
<td>7%</td>
</tr>
<tr>
<td>Appearance of new entrants to the industry (e.g., Amazon-Berkshire Hathaway-JP Morgan)</td>
<td>5%</td>
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To be sure, buyers said they are looking for targets capable of evolving with the rapidly shifting environment – or, those capable of proactively transforming that environment themselves. In that sense, the emergence of new digital tools is seen as a prime opportunity: 48% of respondents said one of their top two strategic drivers for making healthcare acquisitions was the chance to disrupt incumbents through the use of technology.

There could be some low-hanging fruit when it comes to disruption, given how far behind the healthcare industry remains in certain areas. Take, for example, the widespread lack of convenient digital options for patients to arrange and manage their care.

“Many multi-site healthcare providers do not have that Amazon-like customer experience,” said Haller. “We’re all used to that in the consumer space now, but healthcare is still far behind. They often use the excuse of needing to manage patient-protected data, which is valid. But there’s also a real opportunity to improve.”

Mobile and data analytics top the priority list for acquisition

A wide range of technologies is seen as having potential to advance the industry. Among our survey respondents, the technologies deemed most attractive at targets were mobile tools (49%), data analytics capabilities (37%), and the use of blockchain (30%). Wearables, sensors and trackers (25%) and telehealth tools (20%) – all of which intersect with the mobile space – are also drawing interest among buyers.

As these technologies mature, some players are working to consolidate in order to build an early lead within their niche.

For instance, telehealth company American Well, which was founded in 2006 and is one of the more established telemedicine providers in the industry, continued to expand its capabilities by acquiring virtual care company Avizia in April 2018. Avizia specializes in acute care services, and combined with American Well’s outpatient offerings, the expanded company will be able to deliver a single platform to its clients.

Technological change is positive, as it improves performance and opens up new opportunities. But when the pace of change is very fast, it can become challenging to adapt quickly enough to keep a business on track.

Operating partner at a Northeast-based PE firm

One area we see on both the pharma and provider side is companies trying to turn data into actionable insights. The trend of collecting data for data’s sake seems to be waning.

Will Hinde, West Monroe
tools are increasingly being found as components of more complex businesses, as companies seek to adapt to the demands of the modern medical system.

Data analytics is also a promising technology that a range of healthcare companies is seeking to exploit. Whereas the focus once was on simply adopting EMRs and gathering data, mining that information for insights has become the priority. Demonstrating this trend, HIMSS Analytics ranked clinical business intelligence one of the top areas for investment by hospitals in 2018.

“One area we see on both the pharma and provider side is companies trying to turn data into actionable insights,” said Hinde. “The trend of collecting data for data’s sake seems to be waning, and what’s becoming more important is what you can do with that data.”

It should come as little surprise, given the enthusiasm for new tech tools among our respondents, that over a quarter (26%) named digital health and healthcare IT (HCIT) as the most appealing sub-sector when it comes to acquisitions. Notably, one survey participant said that digital and HCIT tools are increasingly being found as components of more complex businesses, as companies seek to adapt to the demands of the modern medical system.

48% of respondents said one of their top strategic drivers for making healthcare acquisitions was the chance to disrupt incumbents using technology.

**WHICH TYPES OF HEALTHCARE TECHNOLOGY OR SOFTWARE MAKE THE MOST ATTRACTIVE ACQUISITIONS FOR YOU? (SELECT TOP TWO)**

- **49%** Mobile technology
- **37%** Data analytics
- **30%** Blockchain
- **25%** Wearables, sensors and trackers
- **25%** Telehealth tools
- **16%** Robotics
- **15%** Artificial intelligence
- **8%** Virtual and augmented reality
WHICH HEALTHCARE SUB-SECTORS CURRENTLY HOLD THE MOST INTEREST FOR YOUR FIRM WHEN IT COMES TO ACQUISITION TARGETS? (RANK 1-2-3 IN TERMS OF PRIORITY)

Digital health / healthcare IT companies
- Rank 1: 26%
- Rank 2: 17%
- Rank 3: 17%

Biotech and pharmaceutical companies
- Rank 1: 20%
- Rank 2: 17%
- Rank 3: 9%

Home health, long-term care and hospice services
- Rank 1: 16%
- Rank 2: 14%
- Rank 3: 8%

Medical devices and equipment
- Rank 1: 13%
- Rank 2: 12%
- Rank 3: 10%

Multi-site ancillary practices (e.g., dental, dermatology)
- Rank 1: 7%
- Rank 2: 11%
- Rank 3: 13%

Non-hospital provider facilities (e.g., acute care centers, clinics, nursing centers, surgery centers)
- Rank 1: 10%
- Rank 2: 12%
- Rank 3: 8%

CROs and biotech services firms
- Rank 1: 3%
- Rank 2: 7%
- Rank 3: 14%

Hospitals
- Rank 1: 3%
- Rank 2: 3%
- Rank 3: 7%

Genomics
- Rank 1: 4%
- Rank 2: 7%
Cybersecurity due diligence falling short

Our survey results also indicate that as buyers seek more technology-focused businesses, cybersecurity and IT issues at healthcare targets demand more attention and better expertise.

When evaluating due diligence in recent healthcare deals, 49% of respondents said they were dissatisfied with work in cybersecurity. That figure is up from 16% in West Monroe’s 2017 “Software M&A Frenzy” report and up from 3% in West Monroe’s “Cybersecurity Due Diligence in M&A” report, suggesting growing problems from issues such as compressed diligence timelines and greater cyber risk due to the nature of HIPAA and PII.

“Security problems of healthcare businesses are commonplace,” said Haller. “But spotting issues takes time and system access – it can’t be effectively done through basic penetration testing alone. Equally as important as the system security is the governance and process around managing cybersecurity risk, which can be harder to identify during compressed diligence timelines.”

More than a quarter of respondents (27%) also said they were dissatisfied with the IT due diligence in their recent M&A transactions. Increasingly, acquirers are also looking for – and not always getting – input from advisors about the upside potential of a company’s IT systems in the diligence process, instead of just analysis of the weaknesses. This underlines the fact that, in many cases, the quality of a target’s technology can make or break its ability to grow successfully post-close.

When buyers are targeting healthcare deals, the top cybersecurity issues respondents said they watch for at potential acquisitions are a lack of personnel with deep knowledge of cybersecurity (54%) and vulnerability to insider breaches (48%). Provider roll-ups, for example — in which many small practices, each with their own individual IT systems, are combined — can yield big cybersecurity challenges.
“Without question, the biggest issue we see in provider roll-ups is security, whether that’s safeguarding protected health information (PHI) or credit card data,” said Haller. “All these clinics have some ability to accept payment for co-pays, but they don’t all have a good sense of what they’re supposed to be doing to protect both types of data.”

The issue is complicated by the significant expense involved in centralizing different functions, which in turn can change the business process. This can potentially affect the model of the roll-up.

In evaluating the IT infrastructure at targets, the quality of the systems and any relevant IP is a key consideration, according to respondents. More than two-thirds (68%) said they strongly agreed with the statement that low-quality IT infrastructure or IP at a healthcare company makes it a much less attractive target.

One over-the-top example of the pitfalls that can arise from sub-standard IP is the now infamous case of Theranos. The Silicon Valley healthcare company promised to revolutionize blood testing with a finger prick test and raised more than $700m from investors. It opened wellness centers in several Walgreens drugstores and ran conventional blood tests, but it never actually produced the technology it advertised.

Without question, the biggest issue we see in provider roll-ups is security, whether that’s safeguarding protected health information or credit card data.

Brad Haller, West Monroe
Low-quality IT infrastructure or IP at a healthcare company makes it a much less attractive target for acquisition. 68% agree, 32% disagree.

Technology and system integration challenges are creating added complexity to transactions in the healthcare industry. 48% agree, 7% disagree, 45% neutral.

PLEASE STATE WHETHER YOU AGREE WITH THE FOLLOWING STATEMENTS ABOUT TECHNOLOGY IN HEALTHCARE

HAVE YOU EVER DISCOVERED A CYBERSECURITY PROBLEM AT AN ACQUIRED COMPANY AFTER THE DEAL WAS DONE?

42% No, 58% Yes.

How often do cybersecurity problems slip through the cracks?

A full 58% of survey respondents said they had discovered a cybersecurity problem at an acquired healthcare company after the deal was done. This result underlines not only the prevalence of cybersecurity risks, but also problems with due diligence in this area.

What’s more, this figure is up from 52% who said they had discovered a cybersecurity problem at an acquisition in West Monroe’s 2017 “Software M&A Frenzy” study and 40% in our 2016 “Testing the Defenses: Cybersecurity Due Diligence in M&A” study.

In this year’s survey, the main issues uncovered were a lack of robust cybersecurity infrastructure (30%), vulnerability to insider breaches (26%) and a lack of personnel with deep knowledge of cybersecurity issues (24%). To be sure, cybersecurity can sometimes be a training problem. Among the top-ten list of tips for promoting cybersecurity in healthcare recommended by the U.S. Department of Health and Human Services, the No. 1 recommendation is “establish a security culture.” Without that corporate culture, cybersecurity issues can easily appear or existing ones can get worse and go unnoticed.
REGULATORY CHANGES HAVE an outsized effect on the healthcare industry — and the landscape has seen seismic shifts in recent years.

One of the biggest changes being driven in part by regulation is the move from fee-for-service to value-based payments. It should come as little surprise, then, that a plurality of our survey respondents (19%) said this transition was the regulatory issue having the most impact on their approach to dealmaking.

“The majority of healthcare firms are well accustomed to the fee-for-service model, and to deliver value-based care they will need to make changes to their infrastructure and work flow,” said an operating partner at a PE firm that focuses exclusively on healthcare companies. “They will need to collaborate, integrate clinical and financial data, and will need capabilities to evaluate, negotiate and administer risk-based contracting arrangements.”

Many companies have entered the market to help health systems make this transition, and are drawing interest from buyers. In one recent deal, health analytics company Inovalon Holdings paid $1.2bn for online health information provider ABILITY Network in March 2018,

WHICH RECENT OR POTENTIAL REGULATORY ISSUE IS AFFECTING YOUR M&A STRATEGY THE MOST CURRENTLY?

- Move from fee-for-service to bundled/value-based payments: 19%
- End of cost-sharing reduction payments to insurers: 18%
- Repeal of the individual mandate: 16%
- Possibility of new regulation to lower drug prices: 13%
- Reduced Medicaid contributions to states: 13%
- Uncertain future of the ACA: 11%
- Reduced reimbursement on 340B qualified drugs: 10%
creating an integrated platform for improving value-based care. ABILITY had received investment from Summit Partners and Bain Capital Ventures.

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expensing (19%), and changes to tax liabilities of not-for-profit entities (16%).

How these changes will ultimately affect the attractiveness of targets remains somewhat unclear. Nearly one-third of respondents (32%) said the law’s effects on healthcare companies would depend largely on the specific target. But 35% said they think the effects will be more positive than negative, and 27% said there will be a roughly equal mix of positive and negative effects.

In January, pharma company executives told the Mergermarket news service that they expected the tax law to increase capital available for acquisitions. They cautioned, however, that it likely wouldn’t have a huge impact.

To be sure, some of our survey respondents welcome the bill. “The tax reform law will certainly provide relief to healthcare businesses,” said a managing director at a mid-market PE firm that specializes partly in healthcare. “It will give them some financial breathing room and allow them to reinvest the saved capital back into their businesses.”

Given the speed of industry change and the outsized effects of new policies, the ability of companies to adapt is crucial. A plurality of our survey participants (41%) said that a company’s preparedness to respond to regulatory change was one of their top two concerns when it comes to evaluating a target’s operational and personnel issues. At the same time, 40% said that a management team’s willingness and ability to adapt to market trends was a top-two concern.

“Market trends are continuously changing, and in the coming years the frequency of change will be even higher,” said the CFO at a multi-site medical system operator with over 600 facilities nationally. “Only those firms that are willing to adapt to this change will be able to sustain their businesses.”

![Survey Results]

**WHAT EFFECT DO YOU EXPECT THE TAX REFORM LAW TO HAVE ON THE ATTRACTIVENESS OF HEALTHCARE COMPANIES OVER THE COMING 12 TO 24 MONTHS? (SELECT ONE)**

- More positive than negative: 35%
- More negative than positive: 6%
- Roughly equal mix of positive and negative effects: 27%
- It will depend largely on the specific target: 32%

40% of respondents said a management team’s willingness and ability to adapt to market trends was a top concern.
WHEN EVALUATING A HEALTHCARE TARGET’S OPERATIONAL AND PERSONNEL ISSUES, WHAT ARE YOUR TOP CONCERNS? (SELECT TOP TWO)

1. Company’s preparedness to respond to regulatory change - 41%
2. Management team’s willingness and ability to adapt to market trends - 40%
3. Company’s emphasis on innovation - 39%
4. Compatibility with the management team - 33%
5. Experience and expertise of the management team - 33%
6. Talent acquisition and retention - 13%

PE vs. Corporate Buyers
PE firms focused more on regulatory risk
One of the largest differences in our survey between PE and strategic respondents came with regard to their main concerns when evaluating a target’s operations and personnel. The top choice by PE respondents was a company’s preparedness to respond to regulatory change (51%), while the same answer was chosen by only 21% of strategic respondents. And the biggest issue for strategic buyers was a management team’s willingness and ability to adapt to market trends (55%), which was only the No. 4 choice of PE respondents (33%). This result underlines the fact that PE firms have a limited window in which to grow their portfolio companies; as a result, they need to be sure that a target can cope with sudden shifts in regulation. On the strategic side, buyers are looking for partners on the target’s management team who can help steer the business in the right direction over an extended period.

51% of PE respondents put priority on a company’s preparedness to react to regulatory change
IN THE CURRENT competitive environment, dealmakers are devoting substantial energy to the targeting phase in M&A. But there is also an increasing appreciation for the importance of the post-close period, when a promising asset can realize its potential – or succumb to business pressures, if the new owner isn’t sufficiently nimble.

One issue that remains a perennial concern in this phase is cultural fit. Among respondents who reported oversights in due diligence for their most recent acquisition, over a third said their biggest error was not detecting a mismatch in work cultures (36%). What’s more, the third most-cited challenge in the integration phase was a culture clash with the acquired company’s personnel (21%).

IN YOUR MOST RECENT HEALTHCARE ACQUISITION, WHAT WERE THE BIGGEST OVERSIGHTS MADE DURING DUE DILIGENCE?

- **Mismatch in work cultures**: 36%
- **Outdated IT infrastructure**: 26%
- **Ill-equipped management team**: 18%
- **Financial misses**: 10%
- **Cybersecurity vulnerabilities or undisclosed breaches**: 10%

IN YOUR MOST RECENT HEALTHCARE ACQUISITION, WHAT WAS THE BIGGEST CHALLENGE IN THE INTEGRATION/POST-CLOSE PHASE? (SELECT THE MOST IMPORTANT)

- **Allocating investment effectively**: 24%
- **Making effective cost cuts**: 22%
- **Culture clash with the acquired company’s personnel**: 21%
- **Capturing identified synergies from diligence**: 14%
- **Combining IT infrastructures**: 10%
- **Retaining key personnel**: 9%
had worked together on federal policy initiatives and knew each other for years, Mergermarket reported.

Beyond culture, respondents said the biggest challenges that cropped up after a deal was done included figuring out how to allocate investments (24%) and making effective cost cuts (22%). The close spread between the answers suggests buyers’ post-close challenges remain many and fragmented.

When it comes to finding areas to cut costs, respondents in this survey mentioned IT systems and supply chains — including by merging existing operations.

Transformation in the industry puts pressure on buyers as well. Over a quarter of respondents (27%) said the most significant challenge in deriving or creating value from their most recent acquisition was adapting to evolving conditions in the market.

Fostering relationships with potential partners is one key way of gaining insight into the potential fit. Take the case of the merger of home nursing services LHC Group and Almost Family in November 2017. The $954m deal took place as a result of efforts of the two companies’ CEOs, who

**PE vs. Corporate Buyers**

Culture challenges loom larger for PE

Nearly a quarter of PE respondents (24%) said a culture clash with the acquired company’s personnel represented the top issue they faced in the integration phase, compared to 15% of corporate respondents who said the same. Indeed, differences in management style and the limited ownership period can make the adjustment to PE control more challenging. The top issue cited by corporate respondents was making effective cost cuts (30%), an answer chosen by just 18% of PE participants.

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**IN YOUR MOST RECENT HEALTHCARE ACQUISITION, WHAT WAS THE BIGGEST CHALLENGE IN DERIVING OR CREATING VALUE FROM THE COMPANY? (SELECT THE MOST IMPORTANT)**

<table>
<thead>
<tr>
<th>Option</th>
<th>Percentage</th>
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</thead>
<tbody>
<tr>
<td>Adapting to evolving market conditions</td>
<td>27%</td>
</tr>
<tr>
<td>Making effective investments in technology</td>
<td>21%</td>
</tr>
<tr>
<td>Expanding into new products</td>
<td>20%</td>
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<tr>
<td>Expanding into new markets</td>
<td>16%</td>
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<tr>
<td>Transforming the company’s operating model</td>
<td>16%</td>
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PE vs. Corporate Buyers
Exit opportunities abound in seller’s market
Even with the hurdles facing some businesses post-close, the environment for private equity exits has been robust in recent years. In 2017, there were 114 PE exits of U.S. healthcare companies, valued at a total of $36.1bn, according to Mergermarket data. That is the same deal count and a 25% increase in value compared to a year earlier.

Achieving the target value for an asset, on the desired timetable, is not always a simple task, however. One difficulty faced by PE firms is preparing adequately for the exit process.

It may come as a surprise, then, that more than half of our PE respondents (52%) said they typically begin preparations for sale more than two years after an acquisition. Forty-three percent said they begin preparations one to two years after purchase and 5% said they begin them less than a year after making an acquisition.

By their nature, most PE firms are preparing for exit from the start in a sense, since they will need to sell the company eventually. But they may not initiate a formal process right away. “Financial buyers might not fully disclose their exit strategy with the management team or create elaborate plans around how they’re going to get there,” said Haller.

In addition, the proliferation of PE deals means that hold periods vary widely. In one recent exit, Palladium Equity Partners announced in April 2018 that it would sell, Dallas-based Jordan Health Services, one of the nation’s largest home care providers, after having acquired the company in 2010. Palladium sold Jordan Health to fellow PE firms Kelso & Company and Blue Wolf Capital Partners for $2.7bn.

Another sell-side trend demonstrates the strength of the healthcare market presently.

“...some of the same healthcare companies come on the block every two to three years, because there’s such a seller’s market at the moment,” said Haller.
THE EVOLVING HEALTHCARE landscape presents both abundant risks and rewards for acquirers. Strong financial performance is driving dealmaking, as is the desire to use acquisitions to grab hold of new technologies capable of disruption or solving problems. At the same time, rapid change and regulatory uncertainty present formidable challenges as buyers consider potential targets.

In interviewing industry executives, several key takeaways emerged when it comes to healthcare M&A:

**To find targets and win deals, acquirers are getting creative.** Buyers are increasingly forming unorthodox consortia, going upmarket to identify targets, and creating joint ventures to access technology. At PE firms, domain expertise is more important than ever.

**Mobile tools and data analytics are key technologies at M&A targets.** Companies with products enabling mobile capabilities and creating actionable insights from data are especially attractive in the current market. These technologies in particular are expected to have a significant impact on healthcare in the coming years.

**IT and cybersecurity due diligence often falls short.** Dissatisfaction with the quality of due diligence in these areas is high, emphasizing the need for buyers to devote additional resources to the process – especially as timelines tighten amid competition for deals.

**The transition to value-based care looms large for buyers.** Regulatory change is a perennial challenge for healthcare companies, and no issue is more influential at the moment than the move away from the fee-for-service model. Many acquirers are focused intently on businesses’ ability to thrive in the new environment.

**For all the emphasis on software and hardware, the human element remains essential.** The best cybersecurity programs are dangerously ineffective without a security-minded culture. And when it comes to due diligence, the clash between corporate cultures is a larger problem than incompatible IT, according to this survey.

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In Q1 2018, Mergermarket surveyed 100 senior executives via phone to better understand the appetite, strategy, and processes for healthcare M&A transactions. Respondents were all based in the United States, and were divided among corporate executives (33%) and private equity executives (67%).

All respondent firms had completed at least one healthcare deal in the past two years and plan to target healthcare companies for acquisition in the coming 12-18 months. Corporate respondents were split 43% with up to $250 million in annual revenue; 27% with annual revenue between $251 million and $500 million; 24% between $501 million and $1 billion; and 6% between $1 billion and $1.5 billion.
CORPORATE RESPONDENTS: IN WHICH OF THE FOLLOWING SUB-SECTORS IS YOUR COMPANY?

- Biotechs: 24%
- Medical device and equipment company: 24%
- Medtech/digital health/HCIT: 24%
- Provider: 27%

PRIVATE EQUITY RESPONDENTS: WHICH OF THE FOLLOWING BEST DESCRIBES YOU?

- Deal side at PE firms that invest heavily in healthcare: 51%
- Operating partner at PE firms that invest heavily in healthcare: 49%

CORPORATE RESPONDENTS: IN WHICH CATEGORY IS YOUR FIRM’S ANNUAL REVENUE?

- Up to $250m: 24%
- $251 - $500m: 27%
- $501m - $1bn: 43%
- $1bn - $1.5bn: 6%

PRIVATE EQUITY RESPONDENTS: DOES YOUR FIRM SPECIALIZE IN THE HEALTHCARE SECTOR?

- Yes, exclusively: 39%
- Yes, partially: 51%
- No, we are a generalist firm: 10%
Mergermarket is an unparalleled, independent mergers & acquisitions (M&A) proprietary intelligence tool. Unlike any other service of its kind, Mergermarket provides a complete overview of the M&A market by offering both a forward-looking intelligence database and a historical deals database, achieving real revenues for Mergermarket clients.

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For more information, please contact:
Erik Wickman
Global Managing Director, Remark
Tel: (212) 686-3329
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Contacts

Media and Press Inquiries:
Christina Galoozis
Media Relations Manager
312.447.6623
cgaloozis@wmp.com

Brad Haller
Director, Mergers & Acquisitions
bhaler@wmp.com

Will Hinde
Managing Director, Healthcare & Life Sciences
whinde@wmp.com
ABOUT THE AUTHORS

BRAD HALLER

Brad Haller is a director in West Monroe's Mergers & Acquisitions practice, where he primarily focuses on healthcare deals. He has 15 years of experience advising companies on due diligence, post-merger integration, divestiture analysis, cost-takeout, program management, process improvement, technology modernization, and target operating models.

bhaller@wmp.com

WILL HINDE

Will Hinde is a managing director with West Monroe Partners, leader of the firm's Healthcare and Life Sciences practice, and a member of the executive team. He has more than 20 years of experience helping health plans, providers, life sciences companies and health IT organizations apply strategy and technology to create value during mergers & acquisitions.

whinde@wmp.com

CONTRIBUTORS

Ed Francis
Director, Healthcare & Life Sciences

Nathan Ray
Sr. Manager, Healthcare & Life Sciences

Keith Swiat
Director, Cybersecurity
An uncommon blend of business savvy and technical expertise that can help you achieve sustainable success.