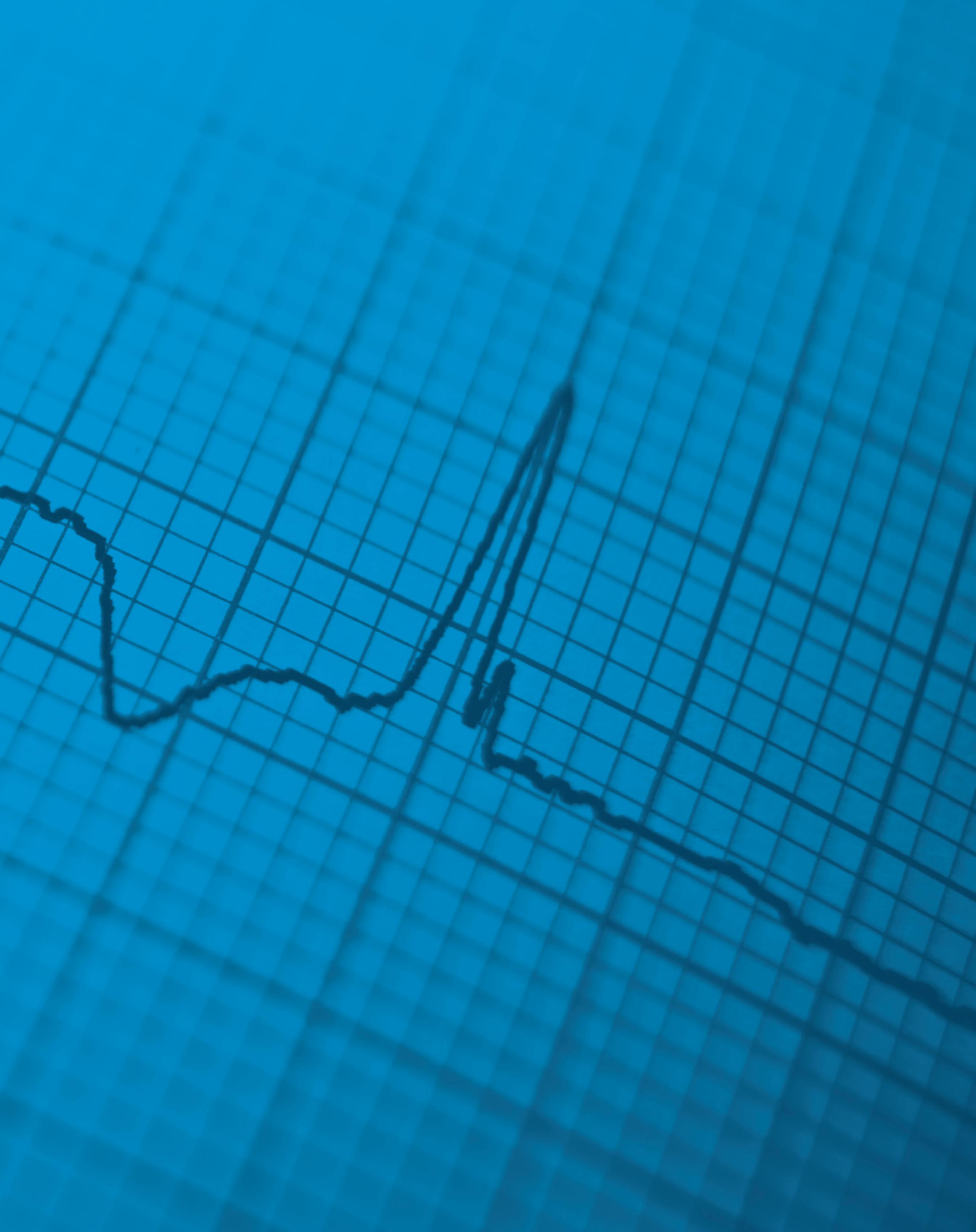
Proskauer»

Disruption, Innovation and Consolidation

Insights into the Trends Driving Health Care Deals in 2018



Proskauer and Deloitte convened health care industry leaders to discuss important developments in health care M&A and the regulatory and legislative landscape facing the industry. These are the seven key takeaways:

1. Powerful forces are driving disruption
2. New entrants and novel combinations are shaking things up
3. More money is in play, driving historic deal activity
4. Deals are about building scale and (sometimes) driving efficiency and quality
5. Private Equity interest remains strong despite high valuations and regulatory uncertainty
6. Value-based payment models, population health remain attractive to investors
7. Midterm elections and budget pressures impact D.C. health policy

1. Powerful forces are driving disruption

The pace and scope of health care deals are only two dimensions of broad-based disruption across the industry. Rapid changes are taking place in the areas of digital health management, consumerism, on-demand pharmacies, retail experiences, greater price transparency and many others.

An even bigger story is how heavyweight investors from outside the health care sector – particularly the unlikely allies of J.P. Morgan, Berkshire Hathaway and Amazon – are making moves to disrupt and reshape the health industry with the aim of making the industry more cost-effective and efficient.

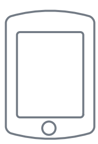
Disruption Forces

Digital Health Management

Investments trending towards analytics and population health capabilities

The Changing Consumer

Consumers are more informed and involved, and their preferences are shifting toward enhanced personalization, convenience and digital connectivity



Evolving Care Delivery Models

New care delivery, with patients being treated at new sites of care, including via virtual means

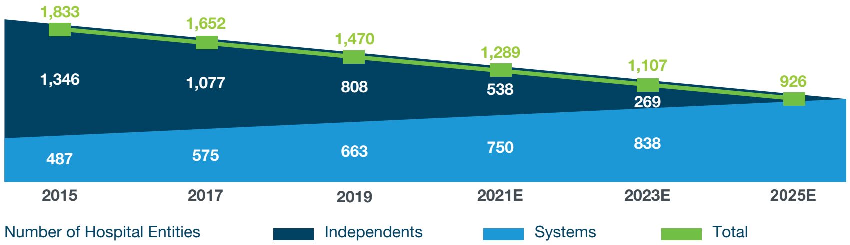
2. New entrants and novel combinations are shaking things up

Consolidation continues as players seek scale and access to new markets. There has been an increasing number of cross-sector combinations, both through vertical integration and expansion of capabilities across traditionally separate sectors.

Expected Consolidation

The provider sector is poised for significant consolidation in the next decade.

Goodbye Independents?



* Irving Levin Associates; each "transaction" may include multiple assets/entities.;
Deloitte Health Solutions "Great Consolidation";
Assumes 100 transactions per year for 10 years.

New entrants – including big brands with vast resources – are causing further disruption. For example, Amazon is taking steps toward drug and device distribution and Apple launched its Health Record EHR Patient Data Viewer. Those two giants, along with Google, have developed data and analysis solutions for health care as well. We can expect more innovation and disruption for such players in the coming years.

Tech and science opportunities bigger on the vertical side

"I believe there are big opportunities for vertical integration at the intersection of technology, analytics and science. I see this playing out in three major categories, the advancements in precision medicine, consumer collected data for prevention, diagnosis and treatment, and moving health care closer to the home, or the lowest cost setting of care."

Devin Carty, Martin Ventures and Trilliant Health

A lot of transactions, but many not well-thought through

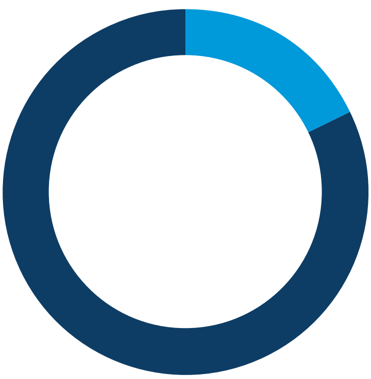
"What I see happening is a lot of the activity in terms of stimulating or encouraging transactions [but there are] too many that are just not well-thought through and people are saying, 'I've got that, too.'"

Mark Wagar, Heritage Medical Systems

3. More money is in play, driving historic deal activity

Health care spending in the U.S. continues to rise. It's now over $3.5 trillion in the U.S., representing 18% of GDP. What's more, Centers for Medicare & Medicaid Services predicts that it will surpass 20% of GDP by 2025. Meanwhile, for the first time in 2017, health care sector employment surpassed that of both retail and manufacturing.

This growth in spending and industry employment has been accompanied by an increase in the amount and speed of capital coming into the sector. In 2017, both health care and overall private equity deal values surged to the highest levels since 2007. Health care deals comprised 18% of the number of deals, representing $43 billion in value.



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in value.

Go Big or Get Out

"The capital markets are ready. But what I see has changed when I look at this slew of megadeals – whether it's Albertsons/Rite-Aid, Cigna/Express Scripts, Amazon/Berkshire/JPM/Optum, Walmart/Humana – is we've got to go big or get out. The notion of scale is no longer local or even regional."

Paul Keckley, The Keckley Report

Tons of Consolidation in 2017

"Total deal value increased again in 2017 as did the total number of deals in health care. This was the case for not only hospitals, but also surgery centers, dialysis centers, physician practices and so on. We are continuing to see tons of consolidation – 2017 was a record year for that."

Bill Siren, Deloitte Consulting LLP

4. Deals are about building scale and (sometimes) driving efficiency and quality

The focus of much of the recent M&A activity has been on driving scale, rather than pursuing cost reductions. On the buy side, the driving force is to gain leverage as a means to negotiate with payers, enhance revenue and, sometimes, to cut costs. Another goal is to increase geographic coverage.

2017 was a record year for M&A activity among providers – with 988 reported transactions across all provider entities. The provider sector is poised for ever-greater consolidation in the next decade.

It's not about cutting expenses, but about growth opportunities

"We are disciplined operators and while there may be opportunities to use our scale to gain cost efficiencies…where we really spend a lot of time and effort is understanding the growth opportunities – whether it's gaps in service, understanding if the systems themselves need more capital, and where the capital can be spent – so that as we look at the long term horizon for the health system, we're able to make the investments necessary to be successful."

Monica Cintado, Vice President - Development, HCA

For buyers, it's about competition, not quality

"They want to make defensive moves to stop their encroaching competition. Oh, and they also want to improve quality, although … the notion of let's do a deal in order to enhance patient care is not something I have heard a lot of over the years."

Monte Dube, Partner, Health Care Department, Proskauer

Will consumers win with horizontal deals?

"Fundamentally the big question is: Will all of this horizontal activity reduce costs? And will the consumer win at the end of the day? It's a tough question."

David Manko, Partner, Health Care Department, Proskauer

5. Private equity interest remains strong despite high valuations and regulatory uncertainty

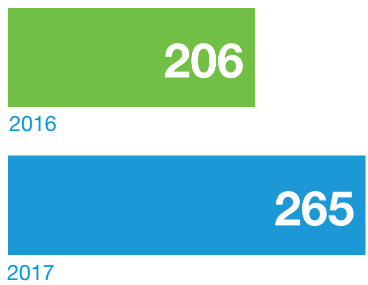
Despite high valuations in the marketplace, private equity investment has maintained its vigor, with an abundance of available capital that has kept the market tipped in the seller's favor. Bain reported that the total disclosed deal value of private equity investment in health care in 2017 was $42.6 billion, which was up 17% over 2016, and was the highest level since 2007. The deal count rose to 265 in 2017 (from 206 in 2016).

Competition for deals may, in fact, represent a larger hurdle than regulators, which have not shown signs of increasing the level of scrutiny – or likelihood of rejection – of deals in the sector.

$42.6 Billion

Private equity investment in Health Care in 2017.

Deal Count



Most deals get done and sail through

"I think that there is an unnecessary amount of fear out there in the industry with regard to the likelihood of an antitrust enforcement. Fewer than 10% of deals have a second request, and of those very few are challenged. So, yes, you do get front-page news and I wouldn't want to be one of the hospitals or health systems that's challenged – that's a multimillion-dollar defense. But those are the outliers. Most deals get done and sail through."

Monte Dube, Proskauer

6. Value-based payment models, population health remain attractive to investors

Like a scene from *The Empire Strikes Back*, major industry players have shown that they're still a match for the onslaught of disruptive forces, from new competitors to breakthrough technologies.

The shift from fee-for-service models to value-based models in the industry continues, driving greater investment interest even as challenges persist in accurately determining revenue and expense factors. Private equity remains interested in technologies that can increase value and improve outcomes by leveraging data.

Complexity of alternative models drives cost

"We really forged very heavily into alternative payment models and value-based models. And the complexity of those, determining net revenue appropriately, requires time and resources of our teams."

Cindy Clemence, Trinity Health

Acquisitions and integrations must increase values

"…We're mostly focused on vertical, rather than horizontal, integration and our view on integration and consolidation is unlike [that of] five or ten years ago. As we move forward, increasingly health care is going to be about delivering value, either to the customers, who are largely employers of the government, or the consumers, or both, and the acquisitions and the integrations that we undertake need to be aimed at increasing that value in some way..."

Niyum Gandhi, Mount Sinai Health System

How do we migrate to FFV without irreparably damaging our financial position?

"Health System CEOs, say: 'Our primary concern is… how do we migrate from fee-for-service to fee-for-value without destroying our financial position, including revenue, margin and capital cost? We must balance risk taking with improvements in throughput, quality and outcomes with increases in patient volume. Imbalance in one area can lead to devastating results. And, we must migrate. Staying the same is not an option."

Michael Main, Deloitte Consulting LLP

7. Midterm elections and budget pressures impact D.C. health policy

All eyes are on the midterms. If Democrats win narrow control of the U.S. House, we can expect health system stabilization efforts and maybe even a push for a national reinsurance plan. But, if the GOP keeps control, ACA repeal could be back on the table, with a bill that gives states more flexibility in coverage design and benefits.

The U.S. Department of Health and Human Services is pushing insurers and pharmacy benefits managers to get more aggressive in managing drug prices for consumers, signaling greater scrutiny of rebates and more granular reporting requirements. Expect potentially greater formulary flexibility in Medicare.

Evolving Regulatory Environment

Governing Agenda

Affordable Care Act (ACA)

Payment Reform

Changes to Medicaid

Tax Reform

Move incrementally – or hit a brick wall

"Bottom line with health care in D.C. is that as long as you're talking about it incrementally, you're probably in good stead. If you're talking about doing something big that's going to change the world and make health care better, odds are you're going to run into a brick wall."

Brian Fortune, Farragut Square Group

Message to drugmakers: Reduce price or else

"We obviously have a transactional president who sees things on a transactional basis and before the midterms he's going to the drug companies and saying, 'You'd better reduce your price – or else.'"

Monte Dube, Proskauer

Conclusion

The busy health care deal market reflects a dynamic industry undergoing seismic change. Pressure from employers and government for more value-based payment arrangements is leading to new alliances across sectors in an effort to produce better outcomes, lower costs and higher patient satisfaction. Beyond joining forces with others to acquire new capabilities, health care companies are combining to achieve the scale that gives them more influence with purchasers, suppliers and consumers of their products and services. Disruptive new entrants to the marketplace – including Amazon, Apple and Alphabet (Google) – represent both potential partners and threats to industry incumbents. All of this transformation is being fueled by virtually limitless capital from private equity investors and lenders and the public capital markets, and, for the moment, policymakers appear content to let the private market determine winners and losers. Tighten your seat belt and hold on tight.

We hope you found these insights into the trends driving health care deals and the developments in the regulatory and legislative landscape to be useful. Please feel free to contact any of the Health Care partners listed below with questions.

Principal Contacts:

Monte I. Dube
Partner

Chicago
+1.312.962.3533
mdube@proskauer.com

Edward S. Kornreich
Partner

New York
+1.212.969.3395
ekornreich@proskauer.com

David A. Manko
Partner

New York
+1.212.969.343
dmanko@proskauer.com

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