Q1 2018 HEALTH CARE & LIFE SCIENCES SPOTLIGHT

M&A trends and private equity deal activity

THE POWER OF BEING UNDERSTOOD
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"Buyers are focusing more and more on reimbursement risks & changes in receivables."

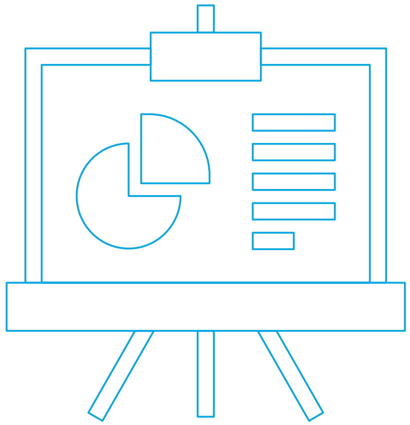
Ron Ellis,

Senior Director, Transaction Advisory Services

1 BIG PICTURE | 2 SPOTLIGHT | 3 LOOKING FORWARD | 4 THE NUMBER STORY | 5 CHARTING THE RESULTS

1 | BIG PICTURE

The health care industry remains characterized by significant opportunities for innovation and investment. Longer-term demographic trends and slow-moving yet consequential regulatory changes continue to contribute to the sector's shifting dynamics. However, the deal-making environment remains complicated due to imbalances in supply and demand. With potentially monolithic mergers such as Aetna and Humana blocked last year, consolidation at the top appears to be moving more toward the vertical rather than the horizontal, as the even-more-mammoth $69 billion acquisition of Aetna by CVS Health continues. In other health care segments, horizontal consolidation is also steady, yet nowhere near the levels seen in recent years. The decline in overall volume of mergers and acquisitions (M&A) can be attributed more to timing, as many acquirers focus more on post-integration absorption plans and financial sponsors look for better value in the consistently high-priced environment.



"The buy side has become a lot more concentrated in add-ons," says Ron Ellis, senior director with transaction advisory services at RSM US. More and more niches are being explored by financial sponsors as well as acquirers in general, ranging from behavioral health to dermatology. The key traits unifying the health care segments that are commanding the most attention are: favorable regulatory dynamics, lesser exposure to reimbursement risks, regional potentiality (although Ellis states that state-by-state factors do matter) and, last but not least, significant fragmentation. "There are other ways than just the pure numbers to drive growth when it comes to adding on," Ellis says.

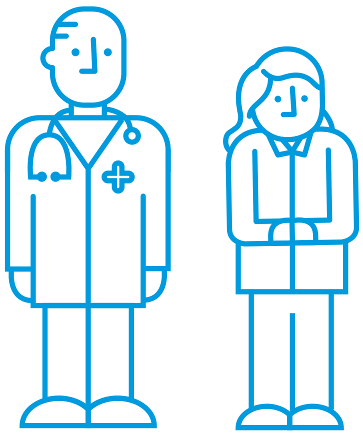
RELATIONSHIP MANAGEMENT MORE CRITICAL THAN EVER BEFORE

The network of complex relationships that make up the life sciences industry can contribute to significant complications for multiple companies. Every pharmaceutical, medical device and biotechnology company must leverage third parties, but with each benefit of such relationships comes an associated risk. From security to regulatory compliance, the range of risks is broad, but there are three key areas in particular to heed in the current environment: regulatory compliance, data security and reputational impact, as highlighted recently by RSM US professionals. (To address the full gamut of risks, the Life Sciences Third-Party Relationship Management practice of RSM US contains additional resources for consultation.) Although significant uncertainty around potential policy changes remains intact, there is still significant regulatory overhang to ensure providers are in compliance with, particularly given how easy it is to garner negative exposure in today's era of mass, 24/7 media. Hence the need to pay more attention to consumers' concerns, especially regarding the safeguarding of their sensitive data, as well as to have more control of and transparency around the chain of care. In short, third-party relationships are a paramount concern in life sciences, but for health care in general, all types of relationships matter.

3 | LOOKING FORWARD

The narrative of synchronized global growth remains intact, although there are some troubling signs given macrofinancial trends among sovereign debt loads and contentious political topics such as trade. However, the health care industry remains somewhat insulated from such shocks and enjoys multiple positive drivers like aging populations and recent technological advances, to list just two separate areas. Consequently, its specific economics look set to persist, although that in turn contributes to the factors that have been exacerbating businesses' challenges for the past two decades: inexorably rising costs, considerable regulatory burden and significant upfront costs when it comes to grappling with innovation.

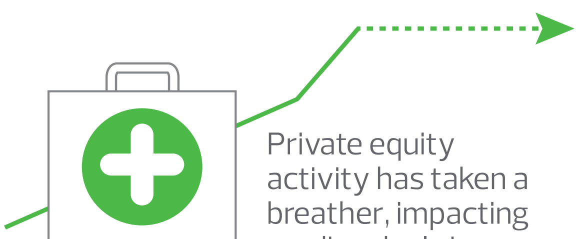
Meanwhile, the deal-making environment looks set to remain pricey for at least the near term, but opportunities in the lower end of the middle market, amid niche care providers, still persist; meanwhile, new ways to leverage cost-saving technology could lead to newer, more efficient provision of holistic care, as well as the expansion of new consumer segments as preventive health care becomes more digitized. That said, in the shorter term, deal-makers will still face many challenges. As Ellis states, "The reason we get called so much on the sell side is that we help explain the real numbers based on value and not necessarily what ended up on historical books and tax returns, as you have to factor in seasonality, run rates and more." Especially with many small enterprise owners looking to take advantage of the current climate, those challenges are unlikely to go away any time soon. On the buy side, reimbursement rates remain a primary concern, according to Ellis. "Your population and payer mix matter more than on the sell side," he says.



4 | THE NUMBER STORY

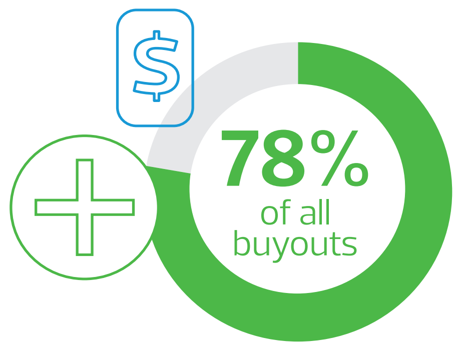
DEALMAKERS TAKE A PAUSE FOR A QUARTER, AS TRANSACTIONS REMAIN PRICEY

Despite more selective buyers and a high-priced market, **health care M&A deal size remains relatively high.**



Private equity activity has taken a breather, impacting median deal sizes after a record year.

MORE THAN EVER, PRIVATE EQUITY FIRMS ARE HUNTING AVIDLY FOR VALUE AND WILLING TO PUT IN LEGWORK



Blockbuster buying-and-building by private equity: add-ons comprise 78 percent of all Q1 buyout activity.

CYBERSECURITY MEASURES BECOME EVER MORE IMPERATIVE AS REGULATIONS EVOLVE TO PRIORITIZE CONSUMERS

PREPARATION IS KEY:
Effective May 25, the European Union's **General Data Protection Regulation** program goes into effect.

FOR LIFE-SCIENCE COMPANIES,

protection of data across their entire chain of suppliers and providers is paramount.

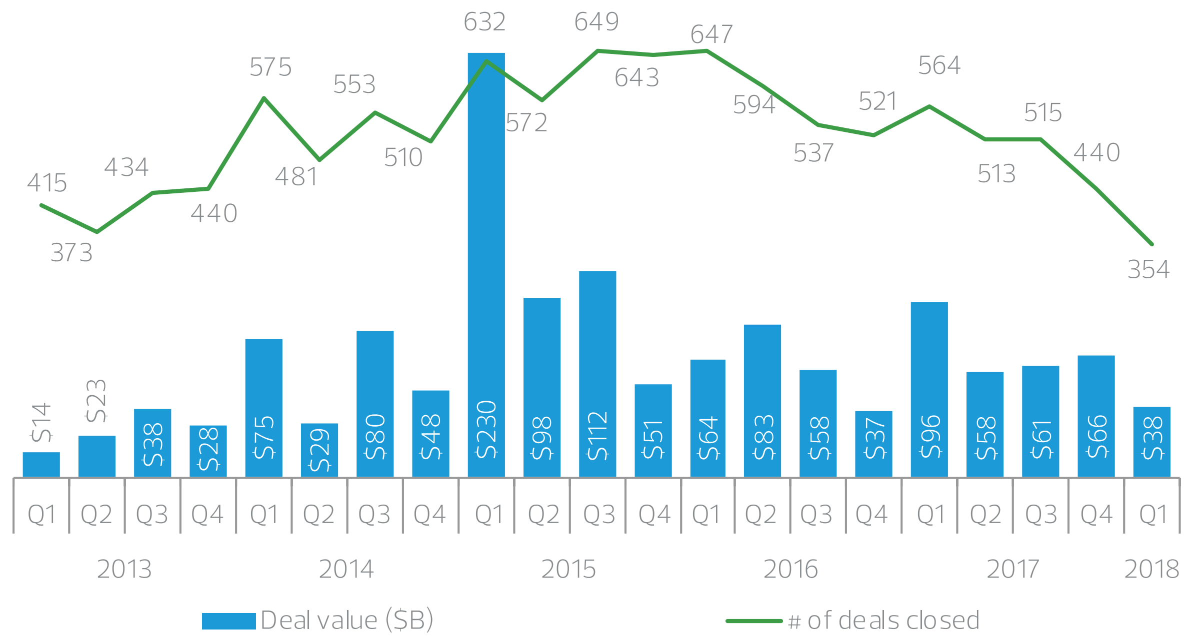
5 | CHARTING THE RESULTS

2018 STARTS SLOW

Across both Europe and North America, health care M&A activity declined between the final quarter of 2017 and the first quarter of 2018 in both value and volume by significant amounts. Year-over-year the declines are more dramatic due to outlier transactions in the first quarter of 2017. It is key to note that this tally is of completed transactions, and thus increases in times taken to close deals will affect this figure.

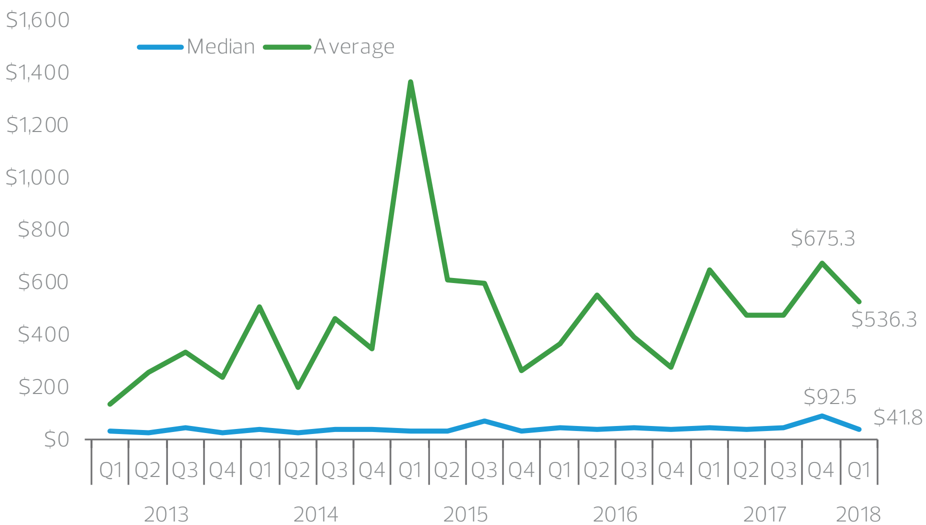
However, the decline is still significant, bringing health care M&A activity back to levels unseen since 2013. There is little indication this diminishing is anything other than cyclical, however, as activity hasn't plummeted so drastically that figures are historically unprecedented. The environment appears more marked by caution, as investors take their time and private equity (PE) funds in particular took a breather at 2018's start.

HC M&A DEAL ACTIVITY



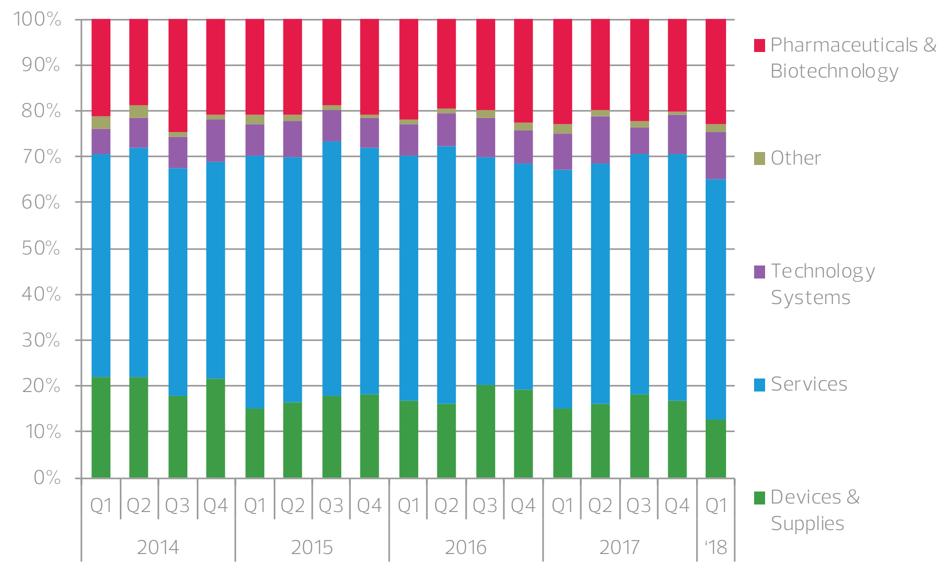
Source: PitchBook

HC M&A MEDIAN & AVERAGE DEAL SIZE ($M)



Source: PitchBook

HC M&A DEALS (#) BY SECTOR



Source: PitchBook

MEDIAN DEAL SIZE SUBSIDES TO 2016 LEVELS

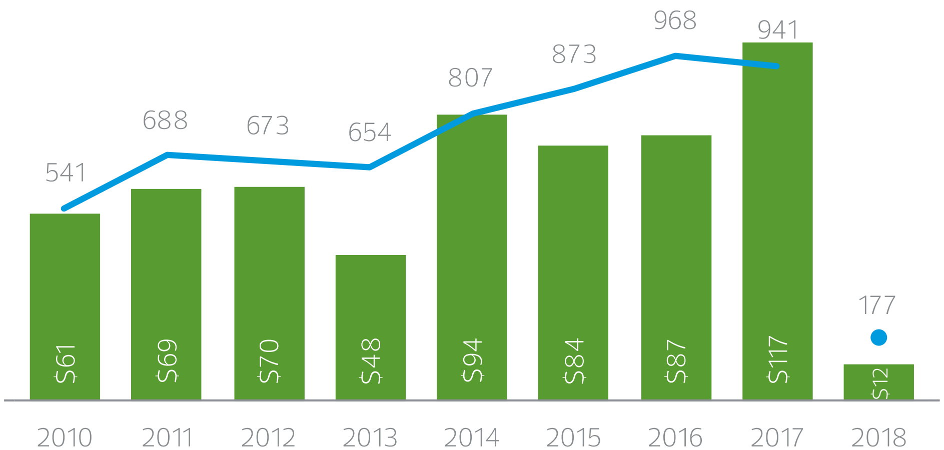
One of the more telling signs that deal-makers are focused toward the lower end of the market in terms of size range is the median transaction size, which subsided after two relatively lofty quarters.

A DOWNTURN IN SERVICES

A key driver of the decline in M&A volume was the slump in health care services transactions, which fell to fewer than 200 completed in Q1 2018, a level unseen since Q2 2013.

5 | CHARTING THE RESULTS

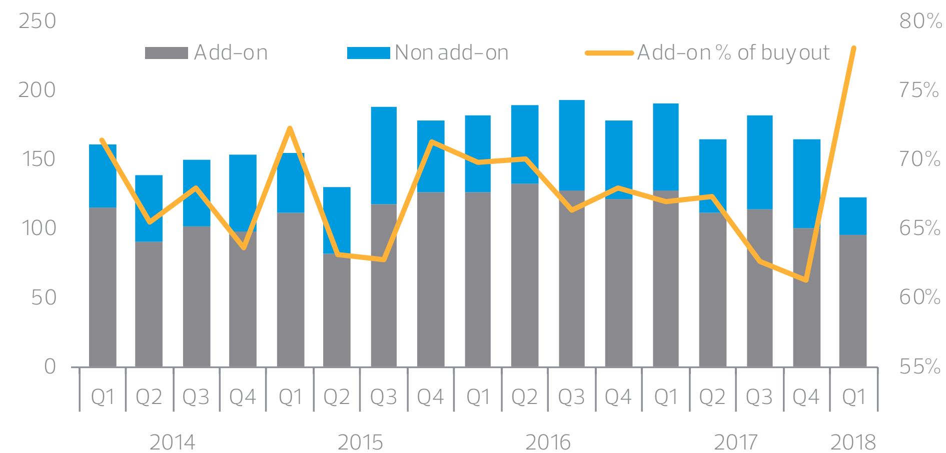
HC PE ACTIVITY IN NORTH AMERICA & EUROPE



Source: PitchBook

**As of March 31, 2018*

HC ADD-ONS AS % OF BUYOUTS



Source: PitchBook

VALUE FALLS FASTER THAN VOLUME

Across Europe and North America, PE buyers took a breather after a blockbuster year in deal value. Although quarterly volume to kick off 2018 did not decline as precipitously as one might have suspected, aggregate value may decline further as PE firms more avidly pursue better-priced platform building in niche care segments such as behavioral health.

RECORD ADD-ON PROPORTIONS

PE appetite for consolidating smaller entities in a larger platform is well exemplified by a record add-on proportion of all buyout activity in Q1 2018. No less than 78 percent of all buyouts in that quarter were add-ons, a testament to investors' keen focus on rolling up smaller care providers or inaugurating a platform build.

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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 4,300 middle-market businesses and professional services companies gives us a deep understanding of the key trends impacting the industry. In addition, we have performed due diligence on more than 2,000 deal in the past five years, over 300 of which were business and professional services transactions. This in-depth knowledge provides our private equity and strategic buyer clients with industry-specific due diligence considerations.

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