HARBOR HEALTHCARE CONSULTANTS
Mergers & Acquisitions

Market Outlook

2020 LONG-TERM CARE PHARMACY - ROARING INTO 2020, FOR NOW

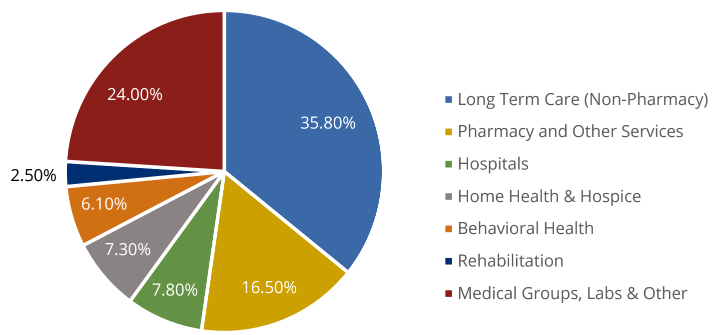
The last 20 years delivered ups and downs to long-term care (LTC) pharmacies that caused significant disruption in the M&A space. Strategic players swept across the nation, gobbling up small and middle-market businesses in order to gain market dominance. CMS underwent several rounds of updates to their reimbursement plans that either accelerated or decelerated the rate of consolidation. PBMs continue their stronghold as opaque middlemen, controlling drug prices through complex negotiations and burden some pharmacies with complex contracts and DIR fees[1]. The US economy experienced the greatest economic downturn since the great depression, followed by a decade of incredible recovery that was fortified by quantitative easing, technology, job creation and a swelling demographic. With so much momentum in the broader economy, it appears the record healthcare and pharmacy deal activity will continue roaring into 2020, for now.

Deal value and spending across the entire healthcare sector set a new record in 2019 and posted more than $400 billion in disclosed spending, eclipsing the previous year (and then record) by more than 20%[2]. As a sub-sector of healthcare, many pharmacy transactions are private and therefore not publicly available. However, pharmacy is a large contributor to the 'healthcare services' sub-sector, which accounts for more than 35% of the total 2019 healthcare transaction values[3]. Bear in mind, this portion includes several mega deals (Equian LLC, Longs Drugs, Pharmerica, etc.). Within the pharmacy segment, LTC plays an influential role in the M&A space. The exclusive business relationships of LTC allow larger acquirers to rapidly realize synergies with acquisitions while smaller players gain immediate access to new geographic regions and valuable national contracts. Larger players can also continue to increase market share and stave off competition. These components contribute to the continual consolidation of the segment and strong buyer demand enhances valuations and deal terms.

The first half of any calendar year is generally active in M&A and is a prime time for sellers. Buyers have new acquisition mandates and capital availability is high. That said, the strategic agendas of financial sponsors are now more diversified and include not only targets capable of aggressive growth, but firms also perceive healthcare acquisitions as a hedge against a potential economic downturn. Private equity (PE) has over $1.7 trillion of dry powder and they are proactively looking for take-private opportunities, corporate divestitures, partnerships with mid-market companies,

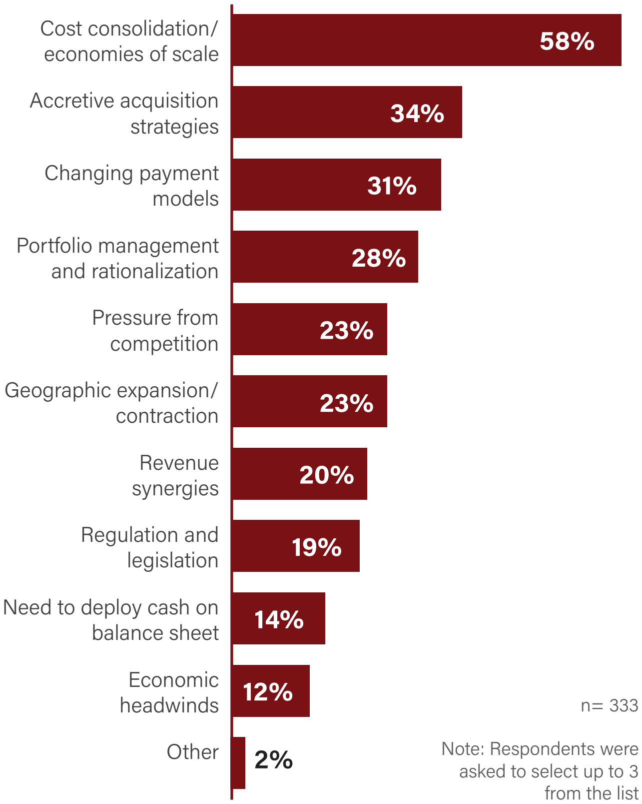
> ***According to Bloomberg Law, 39% of respondents [surveyed] said they thought the healthcare sector was in or nearing a bubble.[4]***

2019 Healthcare M&A Deals by Sub-sector



[3] Us Health Services Deals Insights Year-end 2019. PWC. https://www.pwc.com/us/en/industries/health-industries/library/health-services-quarterly-deals-insights.html

Biggest drivers of M&A activity in the healthcare and life sciences sectors



[4] Opportunities and Challenges in an Evolving Market – 2020 healthcare and life sciences investment outlook. KPMG. https://institutes.kpmg.us/content/dam/institutes/en/healthcare-life-sciences/pdfs/2020/hcls-investment-outlook.pdf

and other alternative structures to bridge the gap between buyers' and sellers' value expectations[2]. In a nutshell, good deals are hard to find these days.

For LTC, the spread of new technology, a boom in the aging American population and a need for acquirers to diversify their portfolios has attracted many new players to the space. As new players enter the market, bidding activity and valuations increase. Keep in mind that larger size firms tend to attract higher multiples and smaller transactions may involve more complexities. Acquirers are aggressively seeking new targets to buy and prefer engaging in transactions with a seller that is unrepresented, permitting more control from start to finish. Valuations generally fall within a range of annualized EBITDA multiples or other valuation methodologies. The multiples range between 6-10x and maybe based off historical or future earnings, depending on the characteristics of the business. Valuations are also highly dependent on other factors, including but not limited to: operational profile, geographical location and footprint, contracts, growth/decline, facility mix, therapy mix, etc.

With the release of CMS' revised payment models, a very clear message is communicated to companies and professionals within the healthcare industry: it's time to redesign your business around a value-based-care model. For 20 years, CMS relied on the PPS and RUGs models and those finally reached a conclusion. The new PDPMs and associated reimbursements turn fee-for-service models into a revenue stream that may now be uncomfortable for many providers. As a result, smaller operators (particularly on the facility side), may opt to exit while valuations are attractive, rather than redesign their business and risk future performance.

The healthcare sub-sector with the highest reported number of transactions in 2019 was LTC (i.e. senior housing, non-pharmacy). The consolidation in this sub-sector has created an environment of more sophisticated groups dominating the space. These groups demand a full suite of services from their pharmacy providers including technology, medication management, consulting, staff and training, that can be a challenge for independent owners to fulfill. To compete and succeed, pharmacies will need more than great long-term relationships.

> ***These seismic changes in the US health industry are forcing healthcare organizations to rethink their strategic identities as they struggle to compete and survive in business models that are becoming obsolete.[5]***

> ***Similarly, nearly 60% of voters nationally. . .signaled that prescription drug costs are the most significant to them or their family, just behind out-of-pocket health care costs. Rural voters overwhelmingly chose illicit drug and opioid use as a common public health issue in their communities.[6]***

They need to make significant investments in enhancing their services, further straining the income of an already tight-margin business.

While some businesses struggle as a result of new reimbursements and consolidation, still others benefit. Independent and assisted living, memory care and group homes are gaining ground. The behavioral health sub-sector is rapidly growing, driven demonstratively by awareness and new treatment methods. Pharmacy providers servicing this category (e.g. IDD, ICFs/IID), are receiving a lot of attention from strategic buyers and financial sponsors alike. Historically, when demand builds in a sector or segment, sellers are wise to capitalize on this activity before pressure on margins and competitive forces dampen buyer appetite.

Pillpack, Instamed, Haven, CVS-Aetna, and Pharmerica are seismic acquisitions and partnerships that serve as harbingers to a new age in healthcare. Haven, for example, JPMorgan Chase, Amazon and Berkshire Hathaway's combined vision to deliver high-quality and transparent health care at a reasonable cost, brings a fresh mindset with new ideas about how healthcare can be delivered succesfully. In order to compete and remain relevant in this new age, firms must adapt or risk becoming obsolete. While technology plays the biggest role in this adaptation, vertical and horizontal integration, new models, and cost reduction measures, are also contributing to the record level deal activity in healthcare and pharmacy. At this early stage of the year, 2020 does not appear to show signs of a slowing M&A market, however it's a little early to tell. The election, trade disagreements, virus outbreaks and an increasing probability of recession could hit the brakes on the strong consolidation and valuation momentum.

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