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**Leerink Swann's
James Boylan is
among those
anticipating
healthcare dealflow
will continue to
swell, pushed
along by a set of
diverse drivers**

Cocktail Therapy

Healthcare

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By KEN MacFADYEN

When former Teleflex, Inc. chairman and chief executive Jeff Black spoke at a January JPMorgan Healthcare Conference, he took pains to convince attendees the company does indeed belong at a health-care-focused symposium. Considering Teleflex had spent the bulk of its 60-plus-year existence as an automotive parts supplier, its name is not exactly synonymous with the medical devices sector. Yet over the past five years, since its \$2 billion acquisition of catheter-based products maker Arrow International, Teleflex has gradually morphed into a player in the space. The company essentially traded up. It turned over its industrial businesses that sell into other, less-appealing end markets, all while accumulating healthcare assets with better margins that play into better demographics. Black's extreme makeover was effectively capped off at the end of January, when Benson Smith -- a veteran in the devices space -- was installed as the company's new CEO.

The enthusiasm drawing dealmakers to the space can be summed up by the three primary drivers -- demographics, dislocation and deadlines. A fourth, distress, could also be included, but is specific to certain segments. It is the aging baby boomer generation, of course, stimulating the end market growth, while the pressure on the system and the reform meant as a remedy are creating the dislocation. The deadlines, dealmakers already know, is the patent cliff that has been spurring acquisition activity among the pharmaceutical giants for the past decade. Taken together, it all translates into a frenzied deal environment attracting buyers and sellers of all shapes and sizes diving into the various crosscurrents of opportunity.

"The activity is broad-based," describes Leerink Swann's James Boylan, head of investment banking at the healthcare-focused boutique. "We continue to see aggressive and even hostile transactions. We're seeing the traditional consolidators, foreign buyers, and new entrants; the bigger companies are looking to add new technologies and new products, but we're also seeing the weaker players fish through the assets to add scale."

If one were to quantify the sector's eminence, the \$51 billion-plus worth of transactions in the first quarter of the year, according to Thomson Reuters data, is building up to a pace not seen since 2007, when the sector completed over 2,100 deals worth a combined \$257.8 billion. The valuations -- anecdotally exceeding 10x Ebitda in certain segments -- are also at the high end of historic levels and expected to climb.

The breadth and velocity of activity in the space can be difficult to capture. In one 48-hour stretch in the second week of April, for instance, more than 25 deals were either completed or announced. Sanofi-aventis completed its exchange offer for Genzyme Corp., Pfizer sold its Capsugel unit to Kohlberg Kravis Roberts; Thermo-Fisher Scientific finalized its sales of Athena Diagnostics and Lancaster Laboratories; Japan's Daiichi Sankyo Co. completed the acquisition of Plexikon, Inc.; and Health Care REIT wrapped up its purchase of Genesis HealthCare's real estate assets. And these were just the more sizable deals, which together represented a total value exceeding \$25 billion. In the same 48 hours, Waud Capital expanded its Acadia Healthcare behavioral health rollup, while Merck & Co. agreed to acquire ophthalmology specialist Inspire Pharmaceuticals. Also, on the periphery of the sector, communications company Harris Corp., IT and engineering outfit NCI Inc. and packaging company CCL Industries all cinched new acquisitions delivering exposure to healthcare.

The deal market may resemble 2007 on paper, though Boylan sees a few significant differences, noting that the blockbuster deals have, for the most part, receded into the background. "People are starting to look through the patent cliffs, largely because they're already upon us," he says. "The analysts have no choice but to look beyond them and recast." And Big Pharma, Boylan adds, is viewing M&A through a narrower lens. "They're more focused on specific M&A strategies, preferring to go after high-quality science, particularly in the orphan and specialty disease categories."

Merck's acquisition of Inspire Pharmaceuticals reflects this more granular focus.

Boylan's career track, in a lot of ways, mirrors the trend line in healthcare. He spent over 12 years at Merrill Lynch, where he worked on more than 80 deals, including Celgene's \$2.9 billion acquisition of Pharmion, Lifecell's \$1.7 billion sale to Kinetic Concepts, and Pfizer's \$90 billion merger with Warner Lambert. He moved to healthcare specialist Leerink Swann in 2009, shortly after Merrill's sale to Bank of America. Leerink's focus on the small and mid-cap market coincidentally lines up with the current palate of buyers today, who are largely pursuing growth and innovation-oriented assets.

When discussing the opportunity in the sector, for many buyers, the conversation usually begins and ends with reform. The anniversary marking the passing of the Patient Protection and Affordable Care Act came and went in March, and many are still trying to

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digest the impact and navigate through the moving pieces of the landmark legislation. That's not to say that buyers aren't cognizant of other drivers or that the recession-resistant appeal of the industry is any less of a factor. But many investors are focused on the overriding theme of the bill that the system has to become more efficient.

"We just added 32 million insured people, but reform will not add a single new doctor; that creates a significant dislocation that will present a huge opportunity for anyone who can solve the problems that presents," described Duane Morris partner Mitchell Goldman, who spoke at the Association for Corporate Growth's InterGrowth Conference in March.

Hence, the race for innovation Boylan alluded to.

"Demographics are a big part of the story, but I think once healthcare spending accounts for 20% of the GDP, you will see an urgency to figure out how to better coordinate the delivery and payment systems," observes Dechert Partner Susan Hendrickson, who leads the law firm's corporate and securities healthcare team.

This isn't lost on companies like Emdeon, which recently outlined a plan to transform into a healthcare informatics business -- a strategy meant to pivot the payment cycle management company so it faces the opportunity in areas

such as payment integrity. Emdeon, in March, detailed for analysts a goal of expanding its analytics business to represent roughly 30% of its total revenues, up from five percent last year. It will also build out its payment services offerings, while its network and applications businesses make up less of the targeted product mix. Acquisitions, of course, are going to be part and parcel to the strategy. The company is said be currently tracking over 20 targets across all verticals. Last year, Emdeon acquired Chamberlin Edmonds, and sealed a number of other buys that fed into its provider-based ePayment suite and its denial and recovery services business. It also added strategic consulting to its payer solutions business.

The quest for efficiency is also driving consolidation among specialists that allow providers to outsource services. Providence Equity Partners backed Virtual Radiologic and soon after added Night-

hawk Radiology to the platform, creating a giant in the teleradiology space.

"You're going to see a lot deals premised on wrenching inefficiencies out of the system," Hendrickson adds, pointing to the wave of REIT acquisitions, allowing healthcare groups to focus on care delivery, while monetizing their real estate assets in the process.

While reform presents some low hanging fruit for companies and investors, the industry's exposure and reliance on state and federal budgets creates volatility and risk. The fiscal 2012 budget proposal unveiled by House Budget Chairman Paul Ryan in early April probably put a lump in the throat of some in the sector, as it advanced the GOP's goal to remove funding for and appeal the healthcare legislation. The proposed budget also sought to retool Medicaid, by converting the federal program into capped block grants to state governments and also floated a 2022 deadline, at which point Medicare would be transitioned into a voucher program.

If anything, the GOP budget underscores the fiscal constraints that will keep operators in the sector on their toes. Apria Healthcare's Chris Karkenny, an executive vice president and chief financial officer at the Blackstone Group-owned homecare company, also participated on the healthcare panel at InterGrowth. The conference occurred before the GOP's proposed budget was made public, but Karkenny still tried to drive home to the audience that changes in funding can have widespread effects.

"It all trickles down," he said. "If the government takes it out of somewhere, it's going to impact the whole marketplace. You may not be a Medicare business, but you're kidding yourself if you don't think those cuts will be felt in other areas too."

Investors longer of tooth probably remember the string of bankruptcies among long-term care providers following abrupt changes to Medicare reimbursement rates in the late Nineties.

Assuming legislation stays in place, dealmakers will still find themselves spinning their wheels as lawmakers continue to iron out the kinks.

Curtis Lane, founder and senior managing director of merchant bank MTS Health Partners, recites an oft-repeated warning when it comes to reform efforts. "There are going to be unintended consequences," he insists.

Take the premise that reform will add 32 million insured individuals. Lane cites that the uninsured aren't actually forced to buy coverage until they need to. "People will choose to pay the penalty of being uninsured until the cost of being sick is more than the cost

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of insurance,” he describes. A corollary is that only sick individuals will seek to buy insurance, causing premiums to climb.

Lane says he has also seen some unintended consequences emerge as it relates to M&A. He cites the “36-Month Rule,” which applies to home health agencies that participate in Medicare. A home health agency is required to wait 36 months following its initial enrollment in Medicare before it can sell a majority-stake if it intends to maintain its status in the Medicare program. The clock then resets following a change-of-control forcing the HHA to wait another 36 months before it can be sold again and maintain its accreditation. The Centers for Medicare and Medicaid have

tweaked the rule to provide some flexibility, and allows an exemption, for instance, if an owner dies. Lane, though, says the rule still creates some significant roadblocks that may seem counter productive to the administration’s stated goals.

Beyond restricting the scale lawmakers sought to encourage through reform, Lane observes, “Why would a lender even finance an HHA if they couldn’t foreclose on a business and sell it to someone else.”



Still, he remains bullish about the sector’s prospects, calling it one of the few industries in which unit volume growth is inevitable. He adds the caveat that the growing end market is offset somewhat “by the headwinds in price,” alluding to the pressures facing federal and state budgets. “Pricing is going to be more erratic, because it’s the one area the government can actually control.” He adds that buyers would be wise to keep leverage multiples in check.

Leerink’s Boylan is perhaps more optimistic. He describes that he is running across more examples in which the “winning bidders paid significant premiums over the next highest bids,” a sign that companies are assuming a ‘must buy’ urgency

amid the altered universe. He adds that while he has run across processes in which books are sent out to 50 or more possible suitors, the tendency increasingly is to run a narrower process -- a sign that the winners amid the frenzied environment are becoming easier to identify.

“The biggest threat to dealflow,” Boylan identifies, “is if the transactions we’re seeing today, don’t pan out.”

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