The Deal

VIDEO ROUNDTABLE 2017

HEALTHCARE DEALMAKING:
TECHNOLOGY, REGULATION AND CONSOLIDATION IN 2017

EDITED BY THE DEAL

Value is now the watchword in the healthcare industry. Value means that medicine is priced based on its effectiveness, while care is priced based on outcome. Value-based healthcare aims to lower costs and improve results.

How healthcare players will operate in this new value-based universe and what that means to the world of healthcare mergers and acquisitions were the subjects of a lively discussion during a recent roundtable, "Healthcare Dealmaking: Technology, Regulation and Consolidation in 2017." The Deal LLC and Donnelley Financial Services co-sponsored the Webcast.

Panelists included **Dr. Jeffrey Jay**, senior managing director and co-founder at private equity firm **Great Point Partners LLC**; **Matthew Hemsley**, managing director of healthcare investment banking at **Piper Jaffray & Co.**; and **Patrick Pilch**, managing director and national healthcare advisory leader at consulting firm **BDO**. **Daniel Perez**, director of business strategy for **Venue**, **Donnelley Financial Services**' virtual data room, acted as moderator.

"It's all about delivering care," Pilch said.

In practical terms, it means a "shift from fee-for-service to value-based models," Hemsley added.

That emphasis on care delivery is one of the factors that has contributed to a record level of healthcare M&A, Jay explained.

He and the other panelists pointed to a value-based system in which procedures are paid by a lump sum and in which, for example, hospitals aren't paid for readmissions. Thus, the hospitals must insure that post-operative care is adequate. That's caused hospitals to acquire some of their care partners, leading to more integration of service providers.

"If you're going to participate in a value-based world in healthcare, it's better to control your outpatient partner than to just have an arrangement or some sort of deal with that partner that you can't control," Jay said. "If you want to really avoid the readmissions because you're not going to get paid for them, you want to ideally own that partner, so you can have some control over what they're doing in terms of the follow-up."

Pilch termed that approach to deliverance of healthcare as moving to a supply chain model. Such a model, he explained, will boost vertical integration "around delivery of care into the post-acute environment." That, in turn, will boost M&A.

"It could be acquisitions, it could be some transactions," Pilch said. "It could be those technologies" that will "help to make that integration work," he explained, adding "that's where there's going to be the deal opportunities for a lot of investors, but that's going to foster the consolidation" as well.

Medical device giant Medtronic provides one such example. Hemsley cited Medtronic's 2014 acquisition for $160 million of TYRX, a company which makes an antibacterial envelope that surrounds pacemakers. Medtronic sells the two together and tells hospitals that if they use the two in combination "effectively [Medtronic] will take the risk of any hospital acquired infection associated with this procedure."

In the value-based world, hospitals are taking on more risk, Pilch said. So, they need to spread out their exposure. One way to do that, he explained, is to migrate outpatients to ambulatory centers, which have "a lower cost structure, different infrastructure." That migration will continue. "You're going to see mostly an unbundling of some of the lower acuity services outside of the hospital, and the hospital will become more high acuity," such as the ICU, Pilch said.

Pilch also cited cancer treatments that he believes will move from "hospital to non-hospital settings," over the years. This migration will impact care setting and cost structure. "This will be a big driver of the overall innovation, but also the investment opportunity," he said.

Accountability is spurring consolidation in different areas of healthcare. Jay, for one, cited the example of a physical therapy provider. Hospitals are now regional and prefer to negotiate with one physical therapy company instead of a dozen individual ones. That belief led Jay's PE firm to roll up through acquisitions 21 physical therapy companies around the New York City market under the Professional Physical Therapy platform. Great Point Partners then sold that business for about $500 million to Thomas H. Lee. That firm, in turn, is now taking the company and attempting to consolidate in the Massachusetts and Northern New England market, Jay said.

Healthcare is subject to economies of scale, Jay explained, and that's contributing to a heated deal environment. "If you're a scale provider, you've got greater leverage on the revenue side, with payers and negotiating, and then, on the cost side, you've got more leverage in negotiating with suppliers," he said.

Contract research organizations, or CROs, are one part of the industry that is attracting particular investment interest, especially private equity. According

to Jay, that's because "there's tremendous tailwind of growth in this sector." Many CRO companies are racking up organic growth rates of 20%, with "good margins, reasonable predictability and cash flows," he said.

Part of the acquisition strategy is to make these companies international, Jay said. That is attractive to pharmaceutical companies running clinical tests in both the US and Europe and who would rather be dealing with just one supplier. "We can buy a U.S. company or we can buy a European company, we can make that company global, and then we're going to make it more appealing also to the pharmaceutical company."

Pharmaceuticals, themselves, are part of this value-based equation. "It's about creating the baseline of information for which they can demonstrate statistically what the value is actually created for each patient and for society at large," Hemsley explained.

So, for example, a pharma company may come out with a new drug that not only replaces existing therapies, but demonstrates that the new product can reduce hospital stay, or even prevent it. "That's actually a financial value as well as a social value, and from that the valuation can be determined," Pilch said.

While healthcare M&A is booming, the IPO market is a different story. According to Hemsley, only two medical device companies went public over the past year, as well as a couple of healthcare information technology companies. Instead, the IPO market within healthcare has been largely centered on biotech. But that market, he said, "burst about 18 months or so, so there's a flight to quality."

On the other hand, Hemsley said, more privately owned companies are going public through a reverse merger, that is, merging with a publicly traded shell.

Technology is certainly a driver in quality healthcare. Digital health, which includes everything from telemedicine to wearable devices, is another area of investor interest, as "the different pieces of the healthcare landscape are integrating digital health into how they think about holistic treatment paradigms," said Hemsley.

"We're in the beginning of the big shift," Pilch explained.

Jay cited as an example one of his firm's investments, Softbox Systems Ltd. The company provides passive temperature-controlled packing. The packing is used to ship and monitor expensive biologic drugs, which could cost thousands of dollars each, through chip technology. The chip monitors the transport temperature, when the patient opens the package and when the patient administers the drug. "This is going to revolutionize the effectiveness of drug therapies and improve healthcare outcomes across the board," Jay said.

The panelists were asked to talk about winners and losers in healthcare. Hemsley talked about margins—pharmaceuticals have large margins, as do device manufacturers. Healthcare providers, he said, have smaller and tighter margins. Pilch said digital health, pharmaceuticals and biotech will be winners, while "post-acute [care] could be a big loser."

Jay framed it differently. "If you're an innovator, you're going to be a winner, and if you are complacent, you're going to be a loser."

Jay then related this to investment strategies.

"Innovation is key, being progressive is key, having a strategy that's thoughtful about where healthcare is going, as opposed to where it has been, is going to be critical," he said. "As a private equity investor or as a dealmaker, you've got to be thinking about the future as you're doing these deals and not be looking through the rear window, if you want to be successful."

AS FEATURED ON The Deal.com

TheDeal.com (ISSN 1547-7584) is published by The Deal.