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Partner Insight Series:

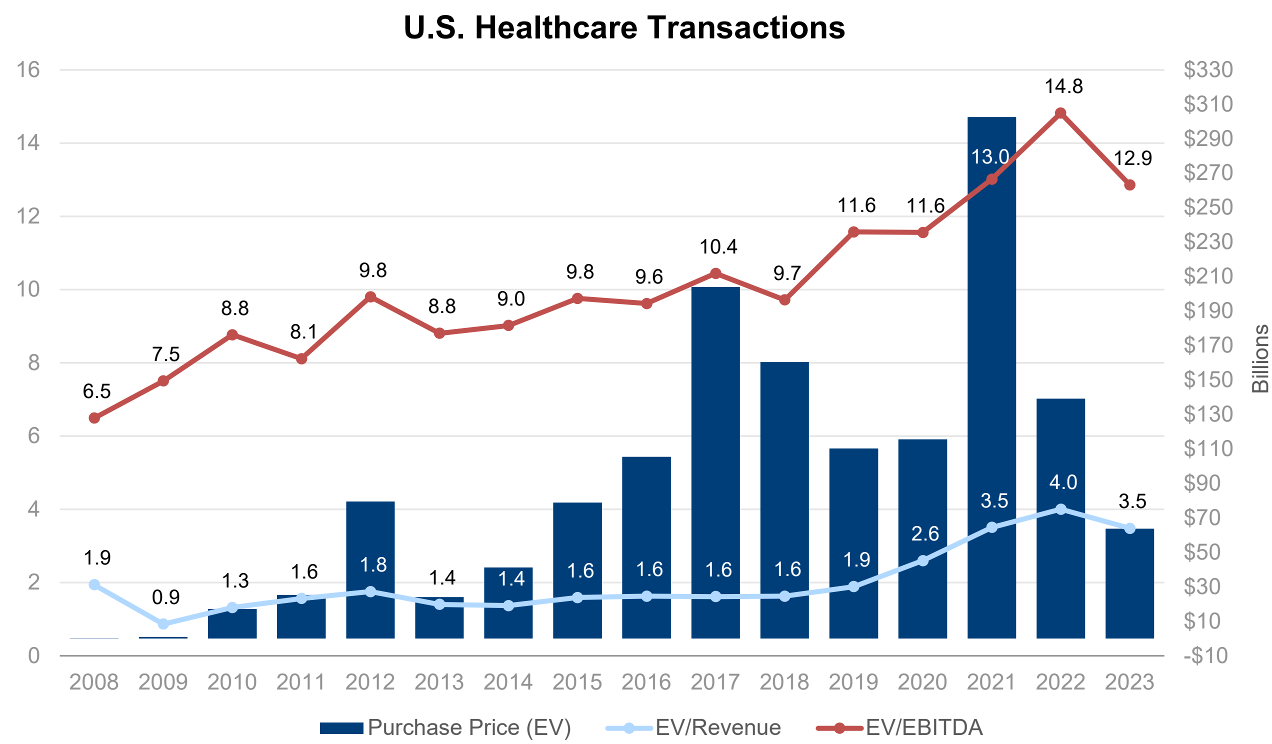
Healthcare Transactions Update

September 18, 2023

Healthcare Transactions Update

In the past ten years, the healthcare industry has experienced a wave of transaction activity. Private equity ("PE") transaction activity in the healthcare sector peaked in 2021 with over 1,027 deals closing that year[1], and many of the country's largest hospital and health systems were acquisitive. However, in the past 18 months both the quantity and value of healthcare transactions have experienced downward pressure from macroeconomic uncertainty in the U.S., rising interest rates, and heightened antitrust concerns. Beginning in the second half of 2022 and continuing into early 2023, the number of large hospital and health system transactions have decreased, as these have faced particular scrutiny from the Federal Trade Commission ("FTC") and typically require larger amounts of debt funding due to their size. Although healthcare services PE deals have declined since the 2021 peak, volume thus far in 2023 is still double the activity level from 2018-2020, which shows promise considering the current economic climate[2].

Using data from Scope Research, the chart below summarizes healthcare transaction activity since 2008[3]. Healthcare transaction activity increased significantly over this time, especially beginning in 2017. As the number of transactions and overall deal value grew, so did the enterprise value ("EV") in relation to revenue (or sales) and EBITDA. While multiples have declined in 2023, the trend line remains overwhelmingly positive.



[1] Pitchbook Data, Inc. (2023, August 11). *Industry Research: Healthcare Services Report, Q2 2023*.
[2] PwC. (n.d.). *Health services: US Deals 2023 midyear outlook.* https://www.pwc.com/us/en/industries/health-industries/library/health-services-deals-outlook.html
[3] Scope Research. Healthcare M&A Valuation Database: Q2 2023 [Data set]. Accessed August 30, 2023.

We have observed several trends based on available data and our recent experience in the healthcare transaction arena, including the following:

- A number of "megadeals," categorized as transactions valued at $5 billion or greater, have been announced or already closed this year (though fewer than in prior years).
- Much of the PE activity in the healthcare space has shifted away from some of the historically "hot" subsectors, such as dermatology, ophthalmology, and veterinary medicine. PE acquirers are either shifting to new areas and/or focusing on add-on activity rather than building out new platforms.
- The Ambulatory Surgery Center ("ASC") sector has continued to see a large amount of activity as the industry remains highly fragmented.

This article recaps recent transaction activity for healthcare facilities and physician practices, outlines some of the headwinds and tailwinds for transaction activity for both subsectors and reveals our observations and expectations for the remainder of 2023 and into 2024.

Healthcare Facilities – Hospitals and ASCs

Transaction activity in recent years for hospitals and ASCs is a dual narrative. While the number and deal size for ASC transactions has remained steady, hospital transaction activity has remained low. This is driven in part by the increased federal anti-trust concerns and the rising cost of financing for mega-deals involving large hospitals and health systems.

Hospitals continue to experience compressed margins due to static or declining reimbursement rates in conjunction with increased operating costs (especially labor expenses and supplies). As hospitals work to manage this economic reality, many may be forced to consolidate with larger systems to remain viable for the long-term.

Larger health systems will likely look to continue expanding their ambulatory outpatient care options – whether that be ASC, urgent care, or other outpatient settings. There may also be a continued shift to the "hospital-at-home" model. Based on one study from McKinsey & Company, survey results indicate that 15 to 40 percent of additional Medicare fee-for-service and Medicare Advantage spending could be delivered at home. This includes post-acute and long-term care (which is expected to be utilized less) as well as infusions[4]. Given capital constraints, we expect that many health systems will seek joint venture partners in order to mitigate financing risks.

ASCs have been one of the largest areas of healthcare investment. We expect this to continue into the remainder of 2023 and beyond, as more surgical volume is shifted to outpatient settings. It remains to be seen what Congress will do as it relates to site neutrality (i.e., equalizing payments between outpatient departments of hospitals ("HOPDs") and ASC or physician office settings.) If Congress does indeed pass legislation on this front, we anticipate this would lead to even more investment in ASCs. However, the timing and likelihood of this remains uncertain.

[4] Bessennyy, Oleg, Chmielewski, Michelle, Koffel, Anne, & Shah, Amit. (2022, February 1). *From facility to home: How healthcare could shift by 2025.* McKinsey & Company. https://www.mckinsey.com/industries/healthcare/our-insights/from-facility-to-home-how-healthcare-could-shift-by-2023#/

ASC aggregators have acquired both independent ASCs and large portfolios. United Surgical Partners International ("USPI"), a subsidiary of Tenet Healthcare's, closed large transactions in both 2021 and 2022. The number and value of these transactions going forward will likely depend on changes in interest rates and federal regulation, but we expect add-on activity and consolidation to continue as hospital reimbursement and cost pressures endure and ASCs remain profitable.

Physicians

Compared to the surge of physician practice transaction activity in 2021 that somewhat plateaued in 2022, transaction volume has been much slower in 2023. However, that is not to say that we anticipate activity to continue at this slower pace. While volume trends in many specialties that were historically active have slowed (e.g., dermatology, gastroenterology, vision), others are shifting in the opposite direction. In particular, the cardiovascular subsector has experienced an increase in activity due in part to changes in reimbursement policy, as well as a flurry of add-on activity from Webster-backed Cardiovascular Associates of America. Other areas that we are seeing or expect to see an increase in transaction volume include primary care and orthopedics (which is in conjunction with the growth in ASCs).

Specific to primary care, as more payers shift to a value-based care model, we expect that outside investors will look to capitalize on these opportunities to earn a margin on excess profits above and beyond traditional fee-for-service revenue. However, this will likely vary throughout the country as it is our experience that different geographies have more or less value-based care commercial managed care contracting. That said, William Blair's equity research group expects large provider groups like Oak Street Health, Privia Health, and VillageMD will be able to capitalize on their growth strategies amidst the growing shift to Medicare Advantage plans[5].

Trends and Expectations

Along with the decline in transaction activity compared to 2021, valuation multiples have also decreased, due in part to higher interest rates. The revenue multiple has decreased from its peak of 14.8 to 12.9 in 2023, but this remains elevated in comparison to 2008-2020. Likewise, the EBITDA multiple hit a new high of 4.0 in 2022 before dropping back to 3.5 so far in 2023. Still, this remains well above historical norms.

In light of current economic conditions, buyers are scrutinizing their targets more heavily during the due diligence process than they were during the peak transaction years. In our experience, buyers are less likely to accept certain seller-proposed EBITDA adjustments than they would have been in years prior when the market was running very hot. This can be particularly difficult for physician add-on activity of smaller practices.

PE healthcare funds had raised $13.3 billion in capital as of July 23, 2023, which is strong for the first half of the year (2021 total fundraising was $18.3 billion for reference). This can be attributed

[5] William Blair. (2023, August 15). Equity Research: Healthcare Services. *Advanced primary care update: Despite utilization worries, performance remains strong; Partnerships driving industry growth.*

to PE managers' tendency to invest in recession-resistant businesses[6]. With this excess liquidity, we expect this will result in a continued pace for healthcare transactions through this year and next, likely with many working to close before year end, as fund managers look to earn a return on investors' capital.

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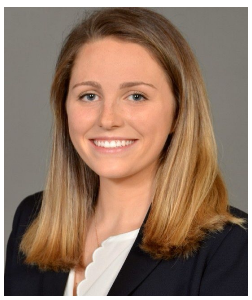
Arielle joined JTaylor in 2016 and provides consulting and valuation services. Her fields of expertise include transaction advisory, due diligence related to mergers and acquisitions, and business valuations. Clients served by Arielle in the healthcare industry include independent physician practices and national physician management companies, ASCs, free-standing cancer clinics, and large multi-hospital and health systems. Additionally, Arielle has represented a number of closely held businesses in a variety of service industries as part of a business exit strategy.



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Reganne recently joined JTaylor after graduating from Texas Christian University with a Master of Accounting degree. She provides a variety of consulting and advisory services with an emphasis in the healthcare industry. She is currently pursuing the exams to become a licensed CPA.

[6] Pitchbook Data, Inc. (2023, August 7). *Industry Research: Healthcare Funds Report: H1 2023.*