From Many, One

Mergers & acquisitions/private equity to drive activity

By Bert Orlov and Ayesha Medina

As consultants in health care with a focus on entrepreneurs and Private Equity (PE), we foresee a dramatic upturn in activity in 2021 and beyond for provider acquisitions (e.g., hospitals, physician practices, homecare, telehealth).

While COVID-19 temporarily slowed PE activity, the market has rebounded based on 2020 fourth-quarter published data and anecdotal data for early 2021. The COVID-19 slowdown has created pent-up demand, and COVID-19 itself will likely drive volume due to financial distress. Bain & Co reports that as innovations are made, volumes rise, and assets become available, investor interest will return stronger than ever.[1] In addition, for elderly providers and entrepreneurs, the aftermath of COVID-19 stress will likely drive exit/monetization strategies.

Beyond COVID-19, the underlying drivers of consolidation—and, therefore, PE activity—remain constant, if not stronger. Consolidation will accelerate across all segments due to needs for market power, economies of scale, and strong management to address increasing demands in technology and care management. Value-based purchasing will continue to expand as the Centers for Medicare and Medicaid Services (CMS) designs and implements new payment models.

Furthermore, integration of new technologies such as telehealth will require a move from the COVID-19 ad hoc approach to strategic positioning of patient care and operations to integrate new tools. Finally, long-simmering issues such as management of chronic disease and behavioral health care will create new markets and management demands.

In short, sellers and buyers both see opportunity. On the seller side, we foresee a strong market, hence the need to rejuvenate the vitality of their provider assets to secure best prices. Careful thinking about transitions is critical: that is, short-term challenges and, for young practitioners/entrepreneurs, long-term sale implication. A study of the past decade shows that large entities (by revenue or Earnings Before Interest, Taxes, Depreciation, and Amortization [EBITDA]) drive high purchase multiples, potentially prompting intra-sector mergers in advance of PE deals.

On the buyer side, we also see a strong market, and strong interest will require attention to detail. Defining a truly value-added strategy to support a liquidity event in from three to five years (the common target timeline) and selecting the right partners will prove critical.

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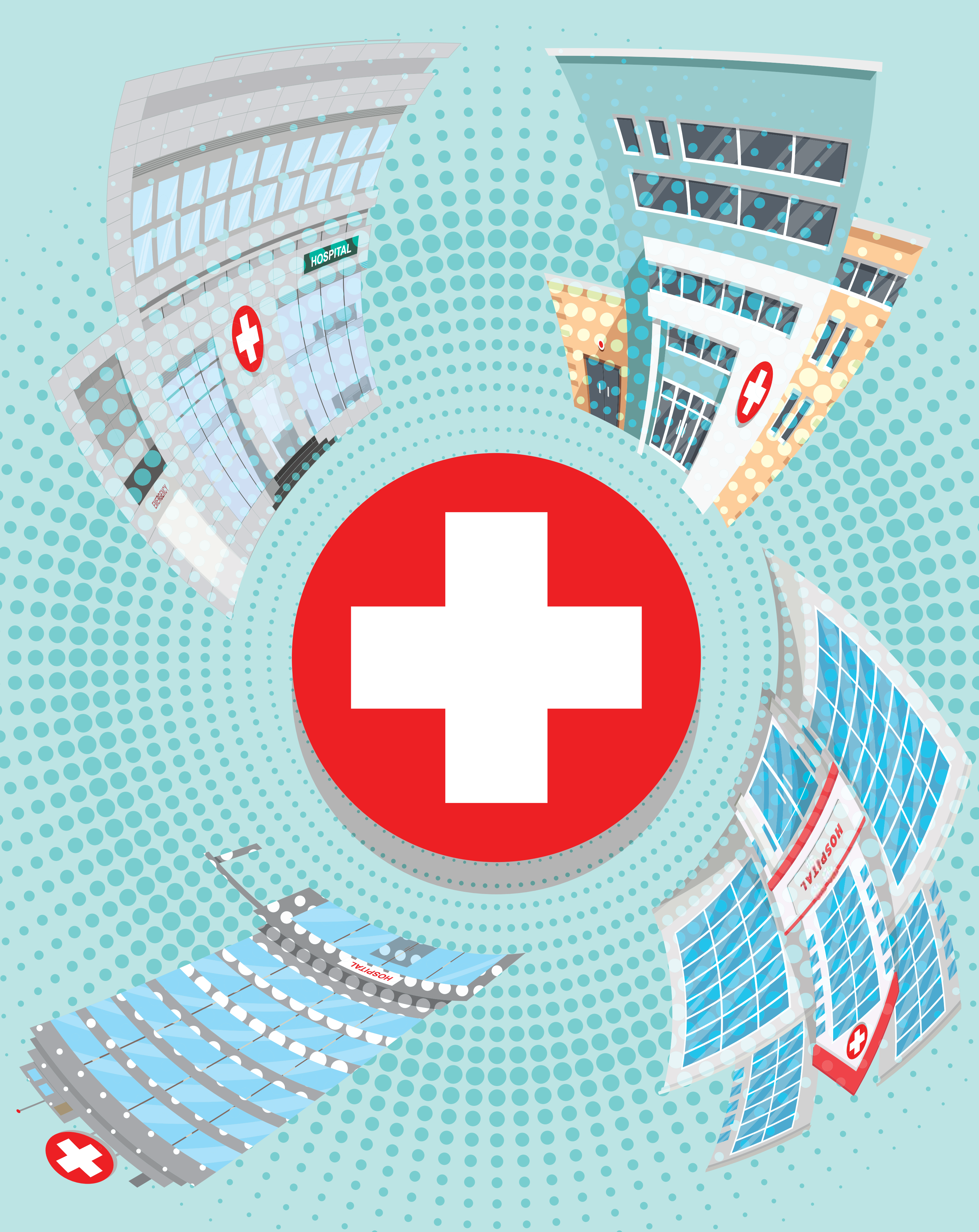
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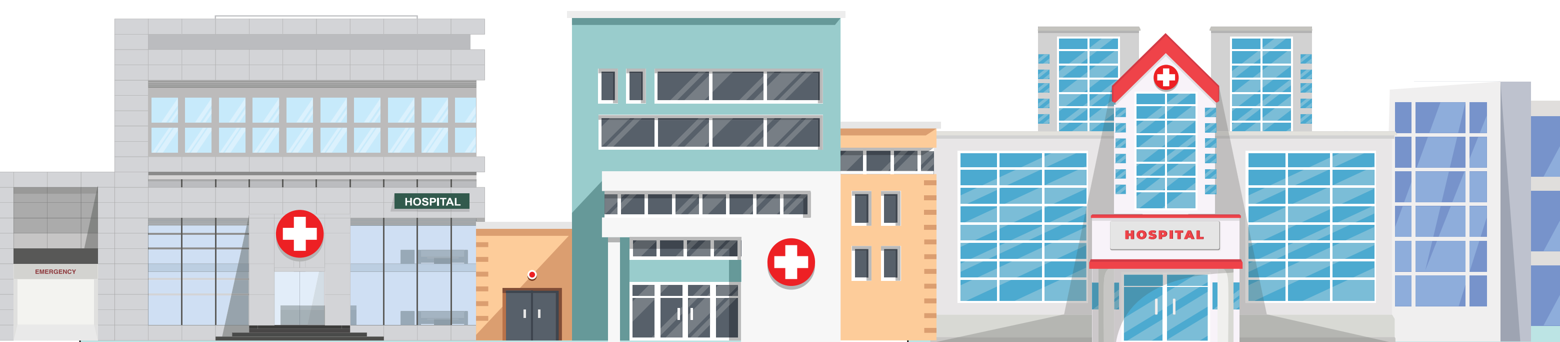
COVID Trends

Across nearly all market segments, providers have seen declines in overall volume and revenue, especially in lucrative elective procedures, historically supported by strong commercial insurance payment. This loss, combined with increased costs for staffing and personal protective equipment (PPE) has damaged the balance sheets of many providers. By mid-June of 2020, 26% of hospital systems had used more than 50% of their reserves, and another 41% of hospital systems had expended between 21% and 50% of their reserves, per a Waller and Kaufman Hall report.[2]

Further, data remain unclear regarding whether volumes will return to pre-COVID-19 levels or a lower baseline will emerge. Finally, new costs in telehealth and other new approaches to patient care delivery may drive up costs. All these factors put many providers at risk.

With vaccinations accelerating, the move back to some form of normalcy has begun. However, financial and emotional "PTSD" is emerging, with many providers seeking a post-COVID-19 exit. By 2030, inpatient hospital revenue will fall 35% compared to today, and demand for hospital beds will be 44% percent lower.[3] Thus, hospitals are likely to be fewer in number and smaller in size than they are currently, advancing industry consolidation with small players particularly vulnerable. According to *Healthcare Finance*, merger and acquisition (M&A) activity will surge as independent health systems look for partners.[4] While deal flow has slowed due to the inability to meet in person, the rise in vaccinations should allow a return to some semblance of normal.

We expect to see deal flow grow materially as vaccination progresses in 2021.



1 Trends: Hospitals

Movement toward consolidation that is not directly related to COVID-19 will advance industry-wide. Deloitte modeled the potential, yielding an estimate that only 50% of current health systems will likely remain in 10 years.[5] Deloitte also reported the consensus among chief financial officers (CFOs) that the pandemic will increase consolidation within the industry.[6] Organizations that were weak pre-pandemic will emerge even weaker.

The survey also found that only 27% of organizations had more than 60 days cash-on-hand. Healthcare M&A activity has shifted to large-scale deals in which both organizations have at least $1 billion in annual revenue. The third quarter of 2020 saw four such deals announced, according to Kaufman Hall.[7] This result should come as no surprise given that similar waves of consolidation have occurred in other industries (e.g., banking, airlines, retail) where market, regulatory, and financial pressures led to M&A and other partnering arrangements. With hospital consolidation, growth in size/scale of physician and ancillary service networks inevitably comes where hospital systems own/control practices.

2 Trends: Physician Practices

For physician practices, increased consolidation is due to acquisition by hospitals, thereby laying a foundation for P/E firms as alternatives. Primary care practices owned by a hospital/health system grew from 28% in 2010 to 44% in 2016.[8] By 2018, American Medical Association data show that 35% of all practicing physicians worked either directly for a hospital or in a practice partly owned by a system. Furthermore, big insurance companies are also venturing into the provider space. For example, UnitedHealth Group's Optum Division recently acquired Surgical Care Affiliates for $2.3 billion, setting the base for OptumCare's primary and specialty care division, which focuses on acquiring or partnering with private medical practices.

Independent medical practices are now increasingly looking to private equity, which is responding, fueling healthcare consolidation. *The Journal of the American Medical Association* found that the number of private equity deals with physician practices across specialties more than doubled between

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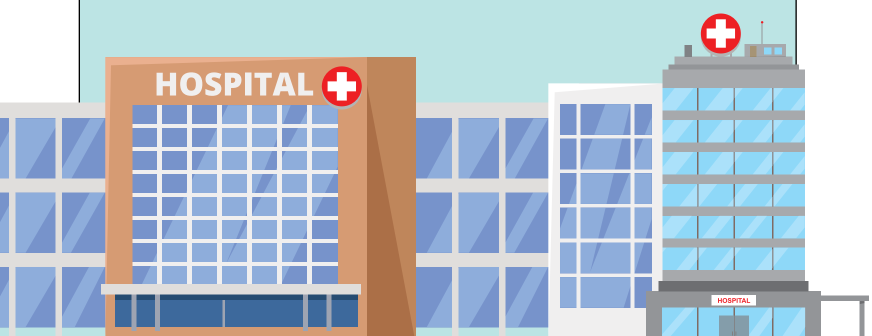
3 Trends: Home Care

Historically, the home care industry has included a large number of small entities. In the context of an emergent, post-COVID-19 market, many of these players will likely seek exits. Overall, the last two years have seen more than 100 in-home related transactions. In 2018, private equity accounted for 57 of the 129 transactions; in 2019, private equity accounted for 46 of the 101 transactions. Overall, second-quarter 2020 saw a drop in M&A activity as prospective home health buyers navigated the impacts of both the COVID-19 emergency and the CMS Patient-Driven Groupings Model (PDGM). However, we see heightened interest in the home care segment, as well as its associated hospice and physician-at-home services. For example, Amedisys, Inc., pairs home health and hospice with the overarching strategy of most of the large providers, which is to provide patient care across the post-acute continuum.

4 Trends: Telehealth

We anticipate similar trends in telehealth as a distinct line of business. Anecdotally, we are seeing significant interest in freestanding telehealth businesses, as well as traditional businesses that incorporate telehealth. This interest stems from the twin beliefs that telehealth has long been poised for explosive growth and that its moment has arrived.

This year has already started to see multibillion-dollar mergers, as Grand Rounds and Doctor On Demand look to offer coordinated care and support, representing the latest consolidation within telehealth and virtual care.[11] CMS will likely extend reimbursement for these services as New York State has done for Medicaid.[12] Focal areas will likely include routine care and chronic care management, behavioral health, and ancillaries such as physical therapy and at-home diagnostics, as well as the potential for "hospital at home." GPJ



2013 and 2016. According to Ernst & Young, $32.9 billion in private equity was invested in 647 healthcare transactions in 2018, double the investments made in 2014.

An aging provider base—especially among primary care physicians (PCPs)—will drive exit strategies via PE.[9] A 2018 Survey of America's Physicians found that 45.8% of more than 8,700 responding doctors plan to retire, merge, or sell their practices, and that number has likely risen as a result of COVID-19. In terms of pricing, that potential rush to market will not likely dampen purchase prices because of the accelerating physician shortage. The Association of American Medical Colleges projects that the United States will face a shortage of between 54,100 and 139,000 physicians by 2033.

Thus, we see more and bigger PE deals in the primary care space. For example, the private equity firm Carlyle Group invested $350 million in One Medical, a national primary care clinic operator with offices from San Francisco to Miami.[10]

Bert Orlov *is a managing director in the Health Care Consulting Group of EisnerAmper. He specializes in strategy, transactions, operations, and project management for physician groups and hospital systems.* ***Ayesha Medina*** *is a junior consultant with EisnerAmper.*

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