



SEPTEMBER 2010

EXECUTIVE SUMMARY

**BUSINESS LAW AND GOVERNANCE
PRACTICE GROUP**

Healthcare M&A Market Trends and Drivers

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After a few years of stagnation and inconsistent activity in the healthcare merger and acquisition (M&A) market, 2010 is shaping up to be a vibrant year in both the number of transactions and aggregate value. In the first half of 2010, 558 healthcare M&A transactions were announced or completed (a 33% increase from the first half of 2009) with a total disclosed value of approximately \$154.9 billion (a year-over-year increase of 80%).¹

Overview

The healthcare marketplace continues to be very dynamic with numerous internal and external forces that influence drivers and impact trends, which almost always results in an active M&A environment. The convergence of technologies and the complementary nature of sales channels and business models create porous lines that separate the sub-sectors of the healthcare industry. This both enables and requires large healthcare strategic buyers to be on a continuous search for acquisitions of new businesses and technologies that leverage internal capabilities and competencies.

While there are a multitude of reasons for the current trends in healthcare M&A activity, two primary drivers are the macro economic downturn in late 2008 and the healthcare reform legislation passed by Congress this spring. While these developments quelled activity in healthcare M&A, they also positioned the market for the recent positive spike in transaction activity. The implications of the

¹ Source: Capital IQ.

economic downturn are better articulated in the context of the various participants in the healthcare M&A market, which are outlined in greater detail below. However, the healthcare reform legislation had a more-immediate and general impact across the healthcare continuum, as many potential acquirers chose to remain on the sidelines of the M&A market until they were able to reasonably assess the potential fallout and implications of the sweeping legislation to business models, market trends, and growth initiatives within the healthcare marketplace. Even with macro economic and political headwinds, the healthcare M&A market remained active, which validates the continued levels of interest and the potential opportunities that exist in the healthcare industry.

Strategic Buyers

As the outcome of the healthcare reform legislation became clear, a growing number of strategic buyers re-entered the market and did so aggressively and with purpose. This was due in large part to actions taken during the economic downturn. Many healthcare companies used the economic downturn as an opportunity for internal reviews to calibrate operations, streamline workforces, and optimize margin performance for the low-growth economic climate. Beyond these operational steps, many revisited and recalibrated their growth strategies and determined which product offerings were core and non-core to the revised strategic vision. This was a positive approach versus the technology bubble in the early 2000s, when many strategic buyers focused on capital preservation strategies. So, while deal activity may have been lacking in 2008 and 2009, healthcare companies emerged from the downturn with optimized operations, strong cash positions, improving stock currencies, a defined and energized global vision, a pipeline of non-core divestitures, and a need for acquired growth opportunities.

With strategic visions established, many traditional healthcare strategic buyers and new strategic buyers with healthcare initiatives have emerged with proactive approaches to healthcare M&A. Strategic buyers are aggressively and enthusiastically courting desirable targets, from early-stage, venture-backed

technology companies, to multi-billion dollar public companies. Given the confidence instilled from months of strategic assessments, buyers are more willing to pay handsome premiums for synergistic targets that fit within their defined vision. However, strategic buyers have also shown a discipline that was somewhat lacking prior to 2008. Buyers have shown patience by acquiring only those targets that fit the pre-defined vision and have avoided impulsive acquisitions of actionable targets in areas adjacent to the vision. Although buyers have shown a willingness to pay premiums for desirable assets, strategic buyers are seeking to make acquisitions at a discount, as sellers' expectations have moderated in the current market climate.

Venture Capitalists

Healthcare companies sponsored by venture capitalists have found the current economic environment very challenging. Venture-backed healthcare companies are typically not profitable by their nature, and they therefore require fresh capital to fund development activities. Their ability to weather poor economic and difficult capital raising environments is limited. While many venture-backed healthcare companies have contemplated accessing the private or public markets, increasingly selective and expensive private capital and limited public market windows have caused many to avoid external capital raising altogether. Instead these firms are focusing on internal financing rounds or alternative exit scenarios, including sales.

While venture-backed companies have turned to their established investor base, many healthcare venture capitalists are faced with challenges of their own in supporting their current portfolio companies. Although most have reserved funds, in many cases their available capital has proved inadequate in the current economic climate. As venture capital firms are selectively backing portfolio companies, those remaining are left with limited options, often resulting in attempts to sell at previously undesirable valuation levels. In addition, several healthcare venture capital firms are faced with the need to raise new funds in an increasingly difficult landscape. Because of this unique situation, many venture

capitalists have an increased desire to show positive exits to bolster their marketability with potential new limited partners. This desire for exits has led to select quasi-distressed sales and has resulted in moderated valuation expectations. Across all industries in 2009, only 262 venture-backed M&A transactions with a total disclosed value of \$12.3 billion were completed, compared with 2007, when 378 venture-backed M&A transactions with a total disclosed value of \$29.3 billion were completed.² Even with the venture-backed M&A environment at near historic lows, many venture-backed companies are formally or informally in the market for sale. Given the difficult landscape, sellers are increasingly open to alternative deal structures that include earn-outs, milestone payments, and timed payments to bridge gaps in valuation expectations.

Private Equity Sponsors

Most private equity-backed healthcare companies were able to pull back during the economic downturn, with the exceptions being those who were overleveraged when growth and profit margins tightened. The ability to access knowledge and capital from financially savvy and deep-pocketed backers significantly benefited private equity-backed healthcare companies. Much like strategic buyers, many sponsor-backed companies optimized operations and planned bolt-on acquisition strategies while their cash flow—though slightly diminished—pulled them through the downturn.

Private equity sponsors also pulled back during the downturn. The healthcare reform process, in conjunction with public market turbulence, created such an opaque healthcare M&A valuation environment that only the savviest and most aggressive players attempted to navigate transactions. As such, there is approximately \$418 billion of uninvested capital³ sitting on the sidelines and significant pent-up demand for healthcare assets from private equity funds. As the debt markets have thawed slightly, healthcare-focused private equity groups

² Source: Thomson Reuters & National Venture Capital Association; PricewaterhouseCoopers and National Venture Capital Association MoneyTree™ Report Q4 2009/Full-year 2009.

³ PitchBook; Private Equity Investment Trends - 3Q 2010.

are re-entering the market deploying significant capital on acquisitions. However, many are finding the healthcare M&A market quite competitive due to proactive strategic buyers and increasing interest from traditionally non-healthcare-focused financial sponsors attracted by the high-growth nature of the market. Because of these trends, private equity sponsors are increasingly willing to pursue targets slightly outside of their traditional investment criteria to access platforms in healthcare.

The combination of these factors has made private equity sponsors aware of the potential value of current healthcare portfolio companies, if they were to take them to market. As a result, private equity firms are seeking to divest certain portfolio companies that could yield premium multiples from strategic buyers. Further, with the changing tax landscape, many private equity sponsors have made a push to bring portfolio companies to market by the third quarter to attempt to close transactions by year-end.

Privately Held Companies

Though typically able to weather the economic downturn, privately held companies' expectations and desires for M&A exits have been substantially impacted. Diminishing growth and profitability profiles, in conjunction with the lack of deep-pocketed financial sponsors and tightening credit markets, have created challenges for privately held companies. This, in turn, had a psychological impact on the views of privately held company owners on the attractiveness of M&A exit alternatives and valuation expectations. Many privately held companies saw the window to sell at premium valuations close instantly at the end of 2008. Over the last two years, the volume of inbound calls from private equity sponsors willing to pay attractive valuations for their businesses diminished. With the economic downturn and evolving M&A market landscape, many privately held healthcare companies realized their vulnerability to economic swings and the increased amount of effort required to maintain and navigate a business through difficult economic conditions. With renewed interest from private equity sponsors and the window to sell reopening, many do not wish

to miss another opportunity despite more moderate valuation levels. More importantly, privately held company owners have been forced to re-evaluate their personal wealth portfolios with a fresh lesson on the importance of diversifying personal wealth away from a single asset. As privately held companies have explored the opportunity to sell, many have taken note of the shifting risk-reward profile of owning a company with the changing tax policies. With business prospects recovering, active strategic and financial buyers, and a changing personal finance and tax landscape, many owners are again contemplating a sale process.

In addition to the deal volume and values in recent months, there are a number of companies for sale or contemplating a sale process. Of course, the sub-sectors within healthcare have varying levels of activity and noteworthy transactions, but in general the current overall healthcare M&A market is vibrant, with more transaction activity anticipated in the second half of 2010 and in 2011.

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