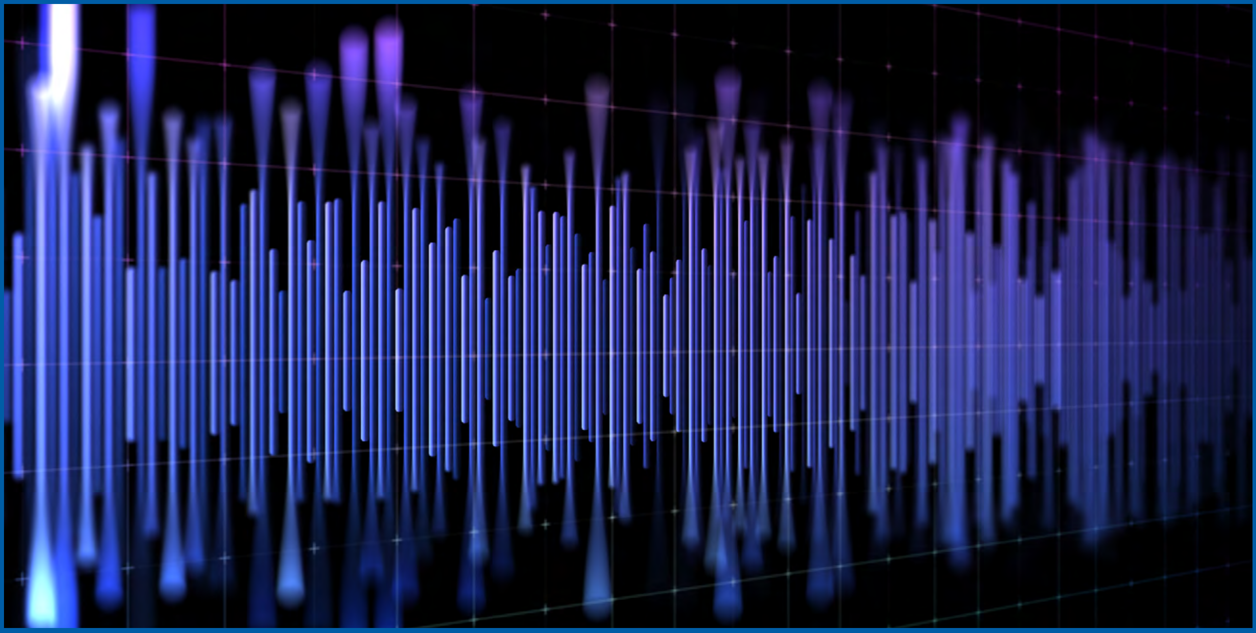
2017 in Review: The Year M&A Shook the Healthcare Landscape

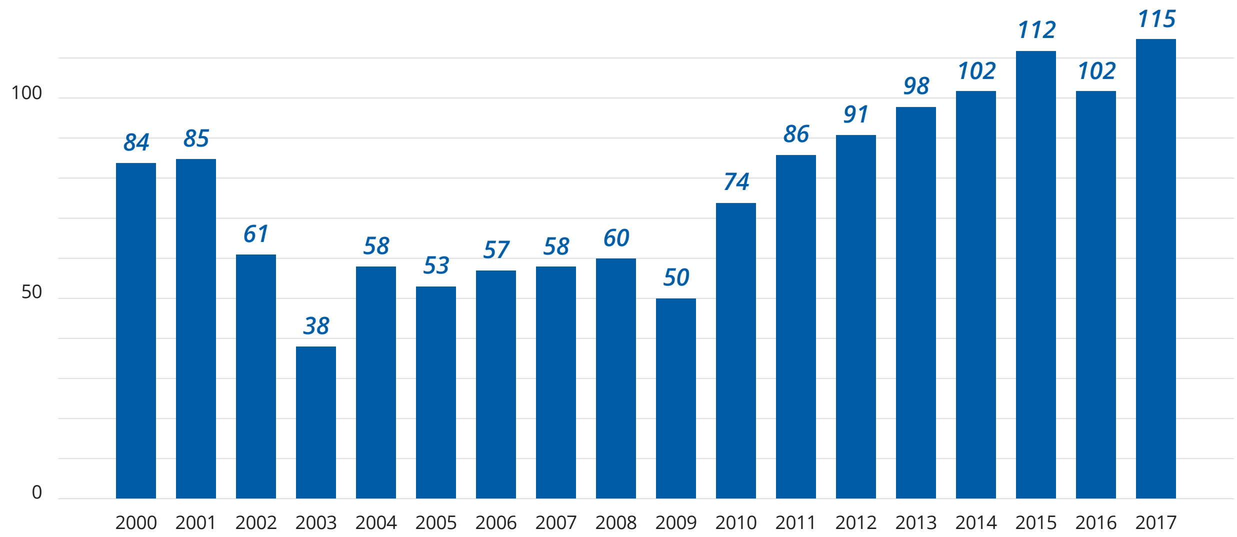


Top Trends by the Numbers

- 115 transactions announced in 2017, the highest number in recent history
- 10 transactions involve sellers with net revenues of $1 billion or greater, representing the largest number of mega-deals ever recorded [1]
- The largest regional health system transaction announced was the merger of Advocate Health Care and Aurora Health Care, which would have combined revenue of nearly $11 billion and create the 10th largest not-for-profit hospital system in the country
- 32 percent of 2017 sale transactions involved for-profit divestitures, driven mostly by Community Health Systems (10 transactions including 23 hospitals), Quorum (six transactions including eight hospitals), and Tenet (three transactions including seven hospitals)
- Pennsylvania (14 deals), Georgia (nine deals), and Texas (eight deals) were the most active states in terms of mergers and acquisitions in 2017

With 115 announced deals, up almost 13 percent over 2016, 2017 has been appropriately tagged as a transformative year for healthcare deal making. The implications reach far beyond the unprecedented number of individual transactions. Organizational size and scale have mattered for decades—but today, they are proving to be imperatives. Transactions have moved from a heavy financial rationale to a more strategic one, with higher-rated organizations now scaling up at a pace and level that exceeds the steady activity involving smaller and more vulnerable providers. Intellectual capital, brand and presence, network infrastructure, risk-bearing capabilities, care continuum, clinical and business intelligence, consumerism, capital resources, and diversified operations represent the most frequently cited benefits of these transformative partnerships.

Figure 1. Hospital and Health System M&A Activity, 2000-2017



Source: Kaufman Hall Transactions Data

1 Note: For transactions other than acquisitions, such as mergers, joint operating agreements, and joint ventures, seller is defined as the entity with smaller net patient service revenue.

The cost-cutting mantra of “do more with less” is juxtaposed with a new imperative—“do more with more.” As organizations look at what they lack and select strategies for closing the gaps, the response has been strategic partnerships to create broader, richer, and more complementary portfolios. While the old business model of economies of scale and synergies may still matter, accessing and capitalizing on intangible asset investments and reducing susceptibility to commoditization through network formation have brought an entirely new echelon of leading-edge partnerships. And these partnerships are blurring and sometimes busting traditional boundaries of healthcare business lines, and setting the stage for a new era of leaders to complete the transformation of healthcare services in America.

Figure 2. 2017 Hospital and Health System M&A by the Numbers

Year in Review

Total Announced Deals	115
Top Three States for Announced Deals	
Pennsylvania	13
Georgia	9
Texas	8
Breakdown by Target Size (as % of total)	
Revenues < $100M	48%
Revenues between $100 and $500M	29%
Revenues between $500M and $1B	14%
Revenues > $1B	9%
Not-for-Profit/For-Profit Deals (as % of total)	
Not-for-Profit Acquiring Not-for-Profit	57%
Not-for-Profit Acquiring For-Profit	16%
For-Profit Acquiring Not-for-Profit	11%
For-Profit Acquiring For-Profit	16%
% of Distressed Transactions	21%

Source: Kaufman Hall Transactions Data

By September, 2017 M&A activity was on pace to set a new standard by many metrics, but the last quarter provided a finale that exceeded anyone’s expectations. The announcement of pivotal mega deals demonstrates how non-provider entities are moving aggressively into the provider space made vulnerable by high costs, low value, and lack of consumer focus. Nimble and well-financed competitors see opportunities to cut costs, increase conveniences, and improve outcomes by significantly upping the ante on size and scale, and bringing more efficient and consumer-friendly business models to the market. While these incursions do not pose a comprehensive threat to health systems, the emergence of healthcare segments that can be scaled is clear and signals the potential for new market entrants to focus on tactical competition with legacy providers.

In December 2017, CVS Health announced its intention to enter the health insurance arena with the $69 billion acquisition of Aetna. This deal will create the nation’s second largest company by revenue and will aid CVS in its goal of turning its stores and clinics across the country into convenient and accessible healthcare centers.[1] Another deal announced in December was Optum’s $4.9 billion acquisition of DaVita Medical Group, one of the nation’s largest physician groups with more than 280 care clinics. Optum is a powerhouse multi-disciplinary health service provider and part of UnitedHealth Group, the nation’s largest insurer.[2]

In this report, we take a closer look at these and other trends underlying the transformative year of 2017, along with a lens to the future to explore what we expect to see take shape in 2018.

Super-sized Deals Surge in the Rush to Build Scale

> *"You can't be too big to compete in today's developing healthcare market."*
>
> — KAUFMAN HALL CHAIR KEN KAUFMAN

Announced deals among hospitals and health systems reached unprecedented size and scale in 2017, with 10 transactions involving sellers with net revenues of $1 billion or greater. Dignity Health and Catholic Health Initiatives (CHI) signed an agreement in late 2017. With more than $27 billion in annual revenues, this combined organization will be the largest not-for-profit health system in the country and, based on revenue size, would be larger than most publicly traded players, falling second only to HCA.[3] If another deal announced in late 2017 between Ascension and Providence St. Joseph Health goes through, the resulting organization would be even larger than the Dignity/CHI combination, according to *The Wall Street Journal*.[4]

The collective impact of the standard-breaking activity in 2017 is remarkable. As indicated in Figure 3, the total number of transactions announced in 2015 and 2017 was roughly equivalent, but the aggregated revenue of the transacted organizations is markedly different. The *value* of the partnership activity in 2017 was essentially double that of 2015, given the same *volume* of activity.

Figure 3. Transactions and Associated Revenue Per Year, 2013-2017

Year	Transacted Revenue ($ billions)	Number of Transactions
2017	$63,186	115
2016	$31,288	102
2015	$32,028	112
2014	$23,098	102
2013	$31,328	98

Sources: Kaufman Hall Transactions Data, S&P Median Credit Rating Reports, Moody's Median Credit Rating Reports, Moody's Credit Rating Changes Reports.

Key Strategic and Reinvestment Priorities for the New Dignity/CHI System

- Expansion of community-based care, offering access to services in a variety of outpatient and virtual care settings closer to home
- Clinical programs focused on special populations and those suffering from chronic illnesses to keep people and communities healthier for longer
- Further advancement of digital technologies and innovations like stroke robots and Google Glass, which create a more personalized and efficient care experience

Source: Dignity Health and Catholic Health Initiatives: "Dignity Health and Catholic Health Initiatives to Combine to Form New Catholic Health System Focused on Creating Healthier Communities." Press release, Dec. 7, 2017.

Catholic and other not-for-profit health systems led the charge in the mega-deal healthcare provider space. These organizations, even those with substantial size and brand cachet, recognize the imperative to build scale and enhance their strategic positions as competition escalates rapidly.

Figure 4. Notable Large Deals in 2017

Organizations	*State*	*Combined Net Revenue ($ Billions)*	*Status*
Dignity Health/CHI	National	$28.4	Regulatory Approval Phase
Carolinas HealthCare System/ UNC Health Care	NC/SC	$13.4	Announced August 2017
Advocate Health Care/ Aurora Health Care	IL/WI	$11.0	Announced December 2017
Beth Israel Deaconess/Lahey Health/ New England Baptist Hospital/Anna Jaques Hospital/Mount Auburn Hospital	MA	$5.0	Regulatory Approval Phase
Greenville Health System/ Palmetto Health	SC	$3.9	Regulatory Approval Phase

Sources: Kaufman Hall Transactions Data, S&P Median Credit Rating Reports, Moody's Median Credit Rating Reports, Moody's Credit Rating Changes Reports.

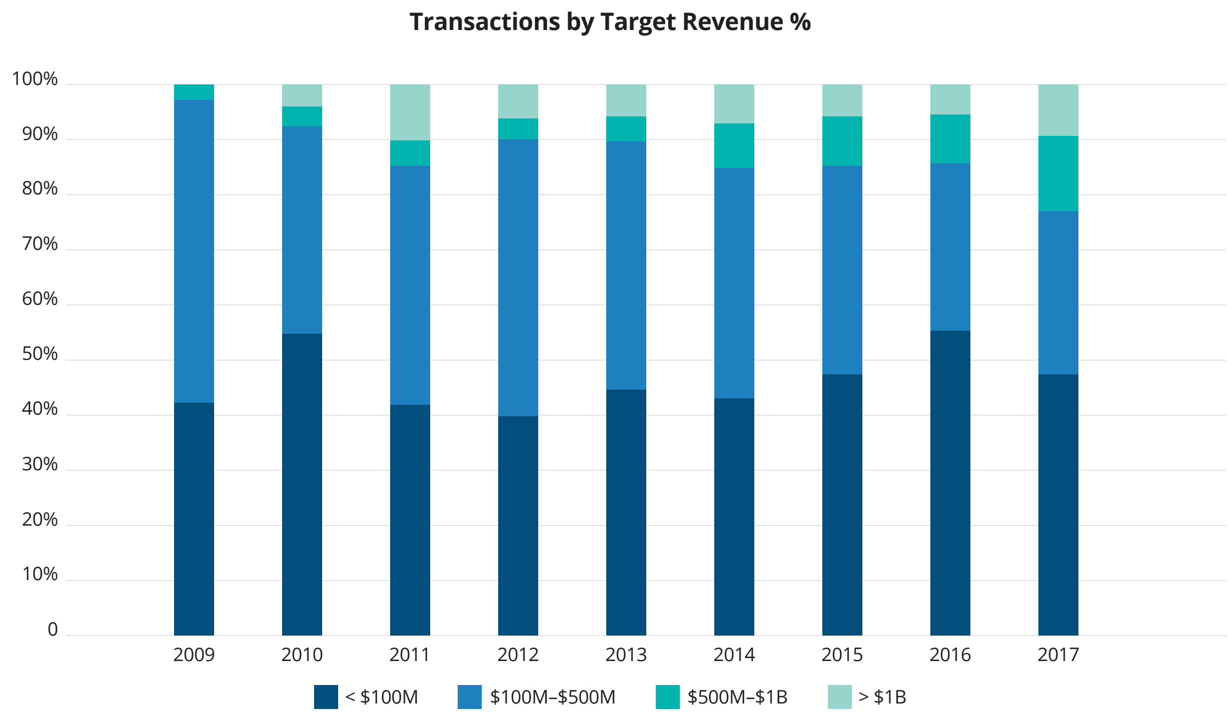
On August 31, Carolinas HealthCare System and UNC Health Care announced their intention to create one of the country's leading not-for-profit health systems by combining UNC's highly regarded academic medical center with Carolinas' large, comprehensive delivery system. While both organizations are strong in their own right, together their clinical, medical education, and research resources are expected to enhance access to high quality, cost-efficient care, particularly for underserved and rural populations.[5]

In July 2017, Beth Israel Deaconess and Lahey Health, along with three Massachusetts community hospitals, signed a definitive agreement to merge. While the deal is pending regulatory approval, if successful, the combined organization would generate more than $5 billion in revenues. It would be the second largest health system in the state behind Boston-based Partners HealthCare, which generates more than $12 billion in annual revenues.[6]

Smaller Deals that Are Still Big

When taking a closer look at 2017's 115 deals, a shift in the composition of transacting organizations continues as providers adapt to the changing competitive environment. Outside of the mega deals, there is an increasing number of transactions involving organizations with revenues between $500 million and $1 billion. In 2017, 16 transactions involved hospitals of this size compared to just one in 2009. This change illustrates the emerging strategic rationale of partnership activity. Most organizations with a revenue base approaching $1 billion are likely market leaders or at least market differentiators. Their increasing pursuit of a larger solution supports the industrywide trend to realize scale.

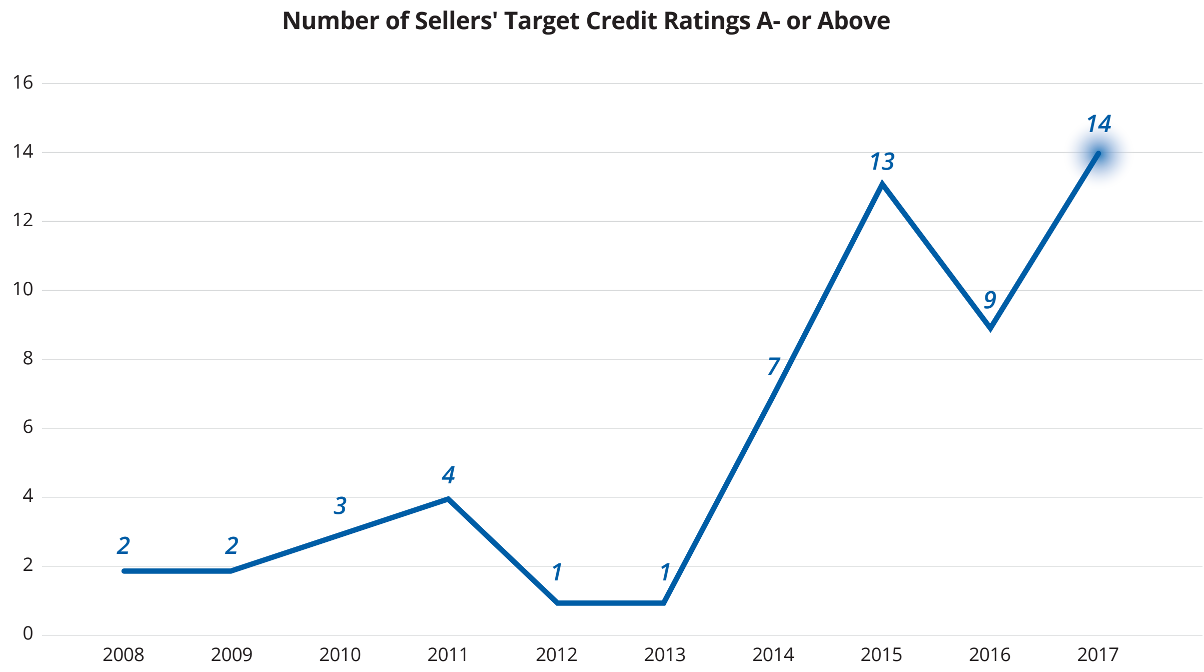
Figure 5. Hospital/System Transactions by Target Revenue Category, 2009-2017



Source: Kaufman Hall Transactions Data

Similar strategic concepts play out when looking at the number of higher-rated hospital credits now seeking partners. This growing trend took off in 2014 and continues to reach unprecedented levels. In 2017, 14 deals involved a seller with a credit rating of A- and better, compared to nine deals in 2016 and one in 2013. Examples include Cedars-Sinai/Torrance Memorial Medical Center, University of Pittsburgh/Pinnacle Health System, and Orlando Health/Lakeland Regional Health.

Figure 6. Hospital/System Transactions: Participation from the Top End
Number of Sellers' Target Credit Ratings at A- and Better



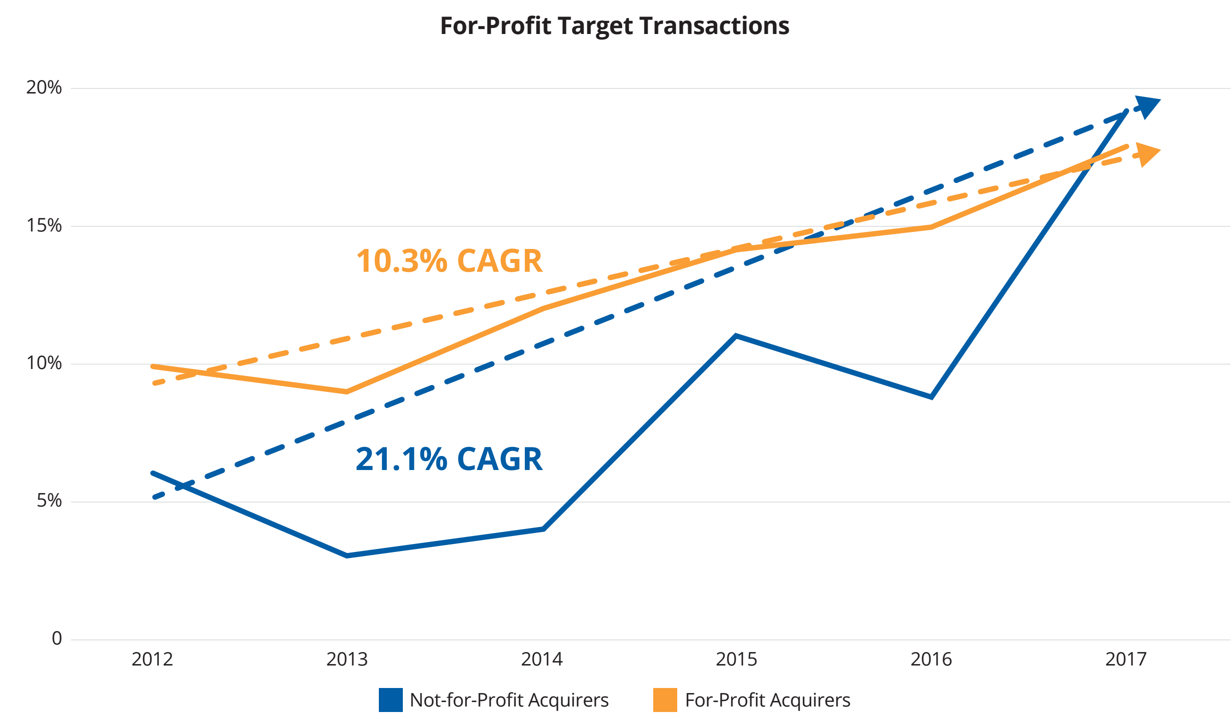
Source: Kaufman Hall Transactions Data, S&P Median Credit Rating Reports, Moody's Median Credit Rating Reports, Moody's Credit Rating Changes Reports.

Hot Spots: Select States and For-Profits

Pennsylvania, Georgia, and Texas were the most active states in 2017 with 14, nine, and eight transactions, respectively. These states have seen significant consolidation recently with a total of 26, 23, and 29 deals over the past three years. Much of this activity has involved larger health systems acquiring smaller entities to gain access to larger population bases.

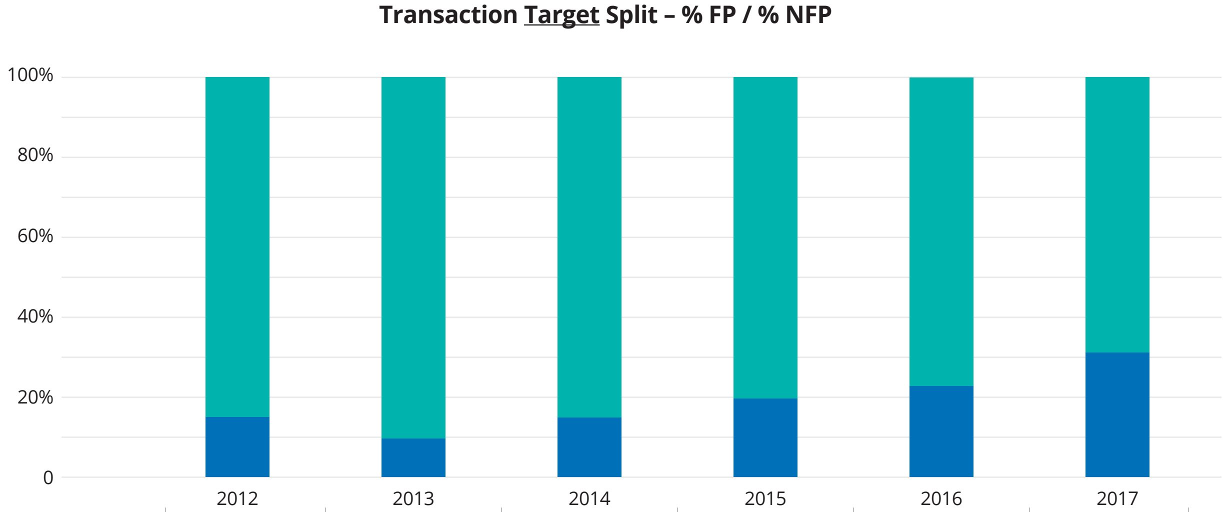
Of the 115 deals announced in 2017, 37 involved for-profit targets, led in part by the ongoing divestitures of Tenet Health, Community Health Systems, and Quorum Health as these large, for-profit operators look to reduce debt and enhance operations in key strategic markets. However, unlike years past, not-for-profit organizations are stepping up as buyers of some of these for-profit assets. More than 16 percent of the M&A deals announced in 2017 involved not-for-profit organizations purchasing a for-profit. In fact, for the first time in recent history, more transactions occurred in which not-for-profits purchased for-profit organizations than for-profit organizations purchased one another. This trend has been accelerating, as shown in Figure 7, at a 21.1 percent CAGR, with not-for-profit organizations becoming increasingly prevalent acquirers of for-profit hospitals. University of Pennsylvania Health System, UPMC Pinnacle, and Reading Health System acquired multiple hospitals from Community Health Systems in 2017.[7]

Figure 7. For-Profit Target Transactions, 2012-2017



Source: Kaufman Hall Transactions Data.

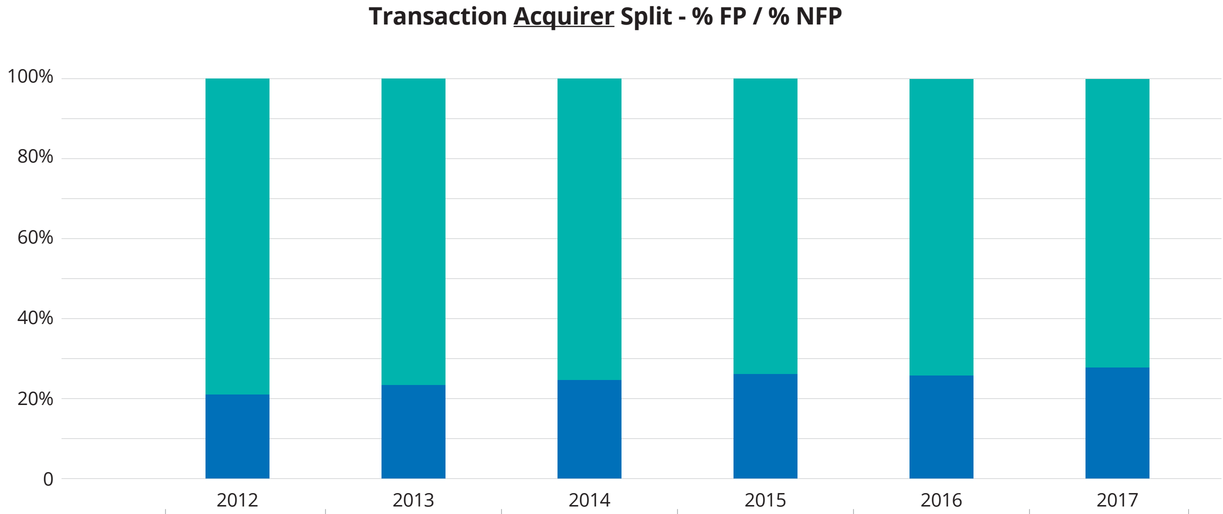
Figure 8. Not-for-Profit versus For-Profit as Transaction Targets, 2012-2017



	2012	2013	2014	2015	2016	2017
% NFP	**83.5%**	**89.4%**	**83.8%**	**79.5%**	**76.5%**	**67.8%**
% FP	**16.5%**	**10.6%**	**16.2%**	**20.5%**	**23.5%**	**32.2%**

Source: Kaufman Hall Transactions Data

Figure 9. Not-for-Profit versus For-Profit as Transaction Acquirers, 2012-2017



	2012	2013	2014	2015	2016	2017
% NFP	**78.0%**	**76.1%**	**75.7%**	**73.4%**	**73.5%**	**72.2%**
% FP	**22.0%**	**23.9%**	**24.3%**	**26.6%**	**26.5%**	**27.8%**

Source: Kaufman Hall Transactions Data

For-profit providers continue to enter into partnerships with not-for-profit providers as a means of establishing a core set of services that are relevant to a community, without having to own all of a particular market. Signs of more collaboration and less competition between for-profits and not-for-profits are on the rise as external competitive threats prompt organizations to see each other in a new light. In May 2017, Ardent Health Services, a privately-held, for-profit hospital management company created a joint venture with the University of Kansas Health System to acquire St. Francis Health in Topeka, Kansas. This is not a new strategy for Ardent. Approximately one-third of its total revenue base is generated from joint ventures with not-for-profit health systems.[8]

Lens to 2018 and Beyond

With merger and acquisition activity showing no signs of slowing in 2018, what does the future hold? Are we moving toward having a handful of regional systems and operators that control the nation's hospitals and outpatient clinics? What will happen as massive, cash-rich corporations target the $3 trillion healthcare sector? Will new competitors and new business models force legacy hospitals and health systems to become more efficient, consumer-focused, and data-driven organizations, fueling even higher levels of consolidation and partnership activity? Will these bold combinations of insurers and providers be like Kaiser and Intermountain, or could they bring new levels of competition and disruption?

Kaufman Hall expects the following trends to dominate the experiences of legacy hospitals and health systems in 2018:

> *"The question is: Should healthcare capital be focused on solving big problems and getting reward for them, or just focused on the status quo?"*
>
> — ANDY SLAVITT
> Former Acting Administrator of the Centers for Medicare & Medicaid Services

- Continuation of mega deals at the national level involving larger, well-capitalized, and high-performing providers
- Increasing size and scale of regional and local deals, and more multi-state activity as systems strive for broader scope and access to bigger populations
- Active alignment of non-traditional players to selectively compete in certain segments, and to exploit areas of inefficiency or lack of coordination in healthcare, likely to the detriment of legacy providers
- New and increasing interest in healthcare services from new capital sources and sponsors that seek to benefit from stable revenues and anticipated profits available to leading disruptors
- Larger players beginning to rationalize their post-merger portfolios, providing buying opportunities for both for-profit and not-for-profit providers
- More collaboration between for-profit and not-for-profit providers
- Continued momentum in transactions along the continuum of care, including areas such as large physicians groups, long-term care, and labs

Waiting in the wings are the extraordinary disruptors known as Apple and Amazon, planning their debut on the U.S. healthcare stage. Apple recently explored purchasing two medical clinic companies.[9] Amazon is licensed as a wholesale pharmacy in at least 12 states and is looking to acquire generic drug companies.[10] Will their different philosophies for bringing together partners to achieve transformation work in the healthcare industry?

2017 will likely be looked back upon as a bellwether for 2018 and beyond as the industry transforms itself with both proactive initiatives and reactionary responses to epic levels of disruption.

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