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Healthcare Mergers & Acquisitions

The Regulatory Forces Propelling Healthcare M&A Activity in 2018

The Takeaway:

> *We expect corporate tax cuts will further fuel healthcare M&A activity in 2018 with an emphasis on vertical deals involving managed care companies and pharmacy benefit managers (PBMs). With vertical mergers such as Humana (**HUM**) – Kindred (**KND**), CVS Health (**CVS**) – Aetna (**AET**), UnitedHealth (**UNH**) – DaVita (**DVA**), managed care organizations (MCOs) are betting on reducing spending on hospital care by keeping patients away from the hospital and better managed in the community and secondary care settings. We believe MCOs could explore additional potential acquisition targets within home health like Amedisys (**AMED**) and Almost Family (**AFAM**) as well as ambulatory assets like Surgery Partners (**SGRY**) in 2018. Political and market headwinds for PBMs make them attractive M&A targets as well. We predict hospitals will face difficulty consolidating in response. As merging health systems become ever larger, we expect significant challenges by the Federal Trade Commission (FTC), which could revisit its existing framework for reviewing the anticompetitive impact of mergers involving limited overlapping markets.*

Introduction

The last month of 2017 brought a flurry of healthcare industry merger announcements, each of which fuels further speculation about Amazon's (**AMZN**) potential healthcare market entry strategy. First, CVS Healthcare (**CVS**) announced that it would acquire health insurer Aetna (**AET**) in a cash-and-stock transaction worth $69 billion. The merging companies are promoting the deal as one that would transform delivery of healthcare services by offering local, convenient, lower-cost sites of care to improve disease management and keep patients out of the high-cost hospital setting. In another acquisition aimed at promoting lower-cost care delivery models, this week Humana (**HUM**) announced it will acquire a minority interest in Kindred's (**KND**) home health and hospice business. These merger announcements came against the backdrop of ongoing hospital consolidation. Recently, not-for-profit hospital health systems Catholic Health Initiatives and Dignity Health agreed to merge, pending approval by antitrust regulators. Media reports indicate that Ascension Health and Providence St Joseph Health are also presently considering a mega-merger. In this report, we examine the longstanding trends shaping new forms of consolidation in the healthcare industry and the outlook for healthcare M&A in 2018.

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Trends in Healthcare Industry Consolidation: Insurers Pivot from Horizontal Mergers to Vertical Integration in an Effort to Gain Leverage against an Increasingly Consolidated Hospital Market

Insurers Give Up on Horizontal Mergers…

In most healthcare markets across the U.S., hospitals are more concentrated than payers and therefore enjoy greater leverage in hospital price negotiation. In an effort to combat the increasing ability of hospitals to dictate prices—and to compete with UnitedHealth's (**UNH**) dominant status—managed care organizations proposed two major horizontal mergers in 2016: Aetna (**AET**) - Humana (**HUM**) and Cigna (**CI**) – Anthem (**ANTM**). The Department of Justice (DOJ) blocked both mergers on the grounds that the mergers would lead to undue concentration in specific markets for insurance plans. For example, to establish its prima facie case, the DOJ attempted to show that the AET-HUM combination would lead to excessive concentration in the market for individual Medicare Advantage (MA) plans.

Hospital market power remains concentrated and stands to grow as health systems propose new mergers. With payers' attempts to increase negotiating leverage thwarted, they are increasingly looking for other opportunities to reduce costs by keeping enrollees out of high-cost hospital settings. While changes in benefit design—specifically, increased cost sharing and limited provider networks—have helped insurers direct their enrollees to lower-cost points of care. But insurers understand that consumer-directed healthcare (CDHC) has limits as cost sharing can only go so high. The combined forces of rising hospital prices and a plateaued impact of CDHC are pressuring payers to cut costs by reorganizing the health system. In our view, the CVS-AET, UNH-DVA, and HUM-KND combinations are a response to these regulatory and market forces in healthcare. And with extra cash from corporate tax cuts taking effect in 2018, companies have additional funds to pursue creative integrations to hedge against the uncertain regulatory environment.

*…**In Favor of a New Spin on an Old Idea***

The idea to integrate lower-cost care settings with insurance is not novel. Kaiser Permanente and other integrated healthcare providers offer robust primary care and outpatient services in an effort to reduce population health costs. And **UNH** developed OptumCare, a comprehensive network of physicians, community clinics, urgent care, and ambulatory surgery centers (ASCs), in an effort to shift hospital volumes to lower-cost settings. But the *approach* of CVS-AET and HUM-KND is different from UNH: both transactions seek to intervene in patient care much further downstream. While the model may be more challenging to design and implement and savings would be less immediate, if they are done well, both transactions have enormous potential to attract and retain patients and reduce healthcare costs.

In our view, UNH's intent to add primary care providers to their network by acquiring DaVita Medical Group makes good sense. By integrating more physicians, nurse practitioners, and physicians' assistants into their existing portfolio of ASCs and urgent care clinics, UNH should be better able to influence patient care away

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from high-cost hospital settings. After all, it is the physician who is most likely to influence and direct patients to various touchpoints of care. Therefore, without a strong physician network, it is much more difficult to make a play for volumes by investing in low-cost healthcare infrastructure such as ASCs and urgent care clinics. If CVS-AET plans to compete as "genius bars" for healthcare delivery, they will need to fill this primary care physician gap. While nurse practitioners and physicians' assistants currently provide their MinuteClinic offerings, regulators will require physician supervision if CVS-AET offers more comprehensive services. In our view, as CVS-AET seeks volume growth, the physician-centric U.S. consumer will demand physician involvement.

In contrast, AET and HUM seem to be bypassing UNH's secondary care acquisition strategy in favor of primary care that can deliver chronic care management. A quick glance at their enrollee characteristics and product offerings tells us why. HUM and AET have much greater exposure to MA (Humana – 36%; Aetna – 18%) compared to UNH (10%). Therefore, focusing on chronic care management through home care or community-based clinics makes sense for the patient population they serve and seek to grow. (It also helps that the regulatory landscape for MA appears strong with Republican leadership controlling Congress and the Administration.) AET CEO Mark Bertolini emphasized that the CVS-AET combination would transform CVS's retail pharmacies into community health centers with service offerings including pharmacy, chronic disease management, diagnostic testing, and dialysis and related services – offers tailored to the Medicare population. UNH, on the other hand, contracts with more large employers who have a generally healthier patient population and a direct interest in immediately reducing healthcare expenditures (through ASCs and urgent care rather than hospital admissions).

Either way, we believe investors should also not rule out additional potential acquisition targets within home health like Amedisys (**AMED**) and Almost Family (**AFAM**) as well as ambulatory surgery assets like Surgery Partners (**SGRY**).

Political and Market Pressure on PBMs Is another Driving Force Behind Vertical Integration

The political and market headwinds facing PBMs make them attractive M&A targets—combining the PBM business with retail pharmacy, managed care, or drug distribution would mitigate this risk. The pharmaceutical lobby (PhRMA) has successfully deflected blame for high drug prices to PBMs as intermediaries that are not passing drug discounts down to patients. Congress subjected the PBM industry to scrutiny through several hearings, and in November, the Centers for Medicare and Medicaid Services (CMS) issued a proposed rule discussing policies to require PBM rebates more directly benefit patients. The managed care industry's impatience with PBMs seems to be coming to a head as well. Four of the eight publicly traded MCOs operate their own PBMs, and ANTM will launch its own in 2020 following a lawsuit against its current PBM Express Scripts (**ESRX**). Blue Cross Blue Shield, with more than 106 million enrollees, also runs its own PBM, Prime Therapeutics. Given these political and market forces, standalone PBMs will find themselves increasingly vulnerable.

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As acquisition targets, we have our eyes on Express Scripts (**ESRX**) and Diplomat (**DPLO**), a specialty pharmacy that recently acquired a PBM. Next year could also be the year when Amazon (**AMZN**) makes its long-awaited move into drug sales; we think they are most likely to enter the sector by acquiring an incumbent.

Will Hospital M&A Peak?

When it comes to hospital reimbursement, commercial margins are by far the most important driver of overall hospital margins. Commercial rates are significantly higher than Medicaid and Medicare rates (including fee-for-service and MA). Hospitals with dominant market presence are able to extract higher prices (and therefore margins) from commercial plans. *We have written extensively on this topic; please see our October 6, 2016 report in particular.*

Managed care organizations' pivot to vertically integrated deals will place additional pressure on hospital volumes as insurers look to shift patients away from high-cost hospital settings. At the same time, hospitals face lower margins from shifts to Medicare and Medicaid enrollment and a greater proportion of reimbursements being tied to patient outcomes. In response to these headwinds, hospitals will face increased pressure to consolidate in order to gain pricing leverage against private insurers, realize operational efficiencies (layoffs), and increase relative patient volumes. In our view, it will be difficult for health systems to thwart challenges from the Federal Trade Commission (FTC), which we expect will challenge hospital mergers aggressively. As mergers increase in size (Ascension and St. Joseph Health, for example, would create a system larger than **HCA**) they become harder to defend before the regulators. While some argue that mergers involving limited overlapping markets do not reduce competition or hurt consumers, evidence shows that mergers across hospital markets do increase prices. FTC will be under new pressure to use that evidence in their approach to mergers with little market overlap.

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