NEW TRENDS RESHAPING HEALTHCARE M&A: HOSPITALS, HEALTH CENTERS, AND OTHER PROPERTIES

Broadly speaking, the healthcare mergers and acquisitions market is an opportunity-rich environment for buyers—though some spaces are more inviting than others.

Long-term care, for example, is in the midst of a historic bull market. Valuations have soared in recent years, as buyers have gravitated toward the perceived security offered by senior care. As Baby Boomers age, demand for healthcare and related services is expected to surge.

In the hospital space, changes in federal law helped spark a flurry of large deals, beginning in 2009. However, new challenges that are specific to the sector may act as a brake on future growth.

The rehabilitation sector is the smallest in the arena of healthcare M&A. Yet it is also coming off a record year in terms of combined total dollar volume and number of transactions. Much like with long-term care, demographic changes are primed to deliver sustained growth.

Although the laboratory, MRI and dialysis sector has seen a decline in transaction volume in the last few years, exciting new technologies are transforming the nature of the space. This development is likely to drive future transactions.

All of this raises some interesting questions: What do prospective buyers in the healthcare space need to know? And how does the need for comprehensive due diligence fit into the equation? In this article we delve deeper into the trends that are driving M&A activity in the healthcare sector for companies with strong real estate footprints.

THE HOSPITAL SECTOR

The hospital market is undergoing a fundamental shift that challenges conventional notions of how to define a merger or acquisition.

Aside from the purely financial consequences of M&A activity, the political repercussions of any transaction often vary widely. Hospitals are in a particularly sensitive position with regard to political fallout. In many cases, a local hospital serves as a major area employer and a highly valued community health resource. Public reaction to local hospitals being sold is often mixed, as news coverage is not always favorable. This potential for adverse reaction has created some hesitancy among the leadership of hospitals that would otherwise make attractive targets for buyers.

This situation has led to the adoption of a different type of deal structure that is neither a merger nor an acquisition. This structure—which may take the form of a joint venture, partnership, or affiliation—is particularly popular with non-profits. It’s also one of the fastest-growing trends in the market today.

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New legislation has also had a galvanizing effect on large corporate deals. The 2009 passage of the Patient Protection and Affordable Care Act primed the way for a group of large transactions as executives expected the size of the insured population to swell. After the Supreme Court voted to affirm the law in 2012, merger activity continued to grow, as acquirers could now operate with more certainty.

That doesn’t mean that the trend toward more activity is guaranteed to continue. The Federal Trade Commission is scrutinizing local markets with an eye toward rooting out anti-competitive practices. Additionally, financial pressures may play a role in dampening large corporate deals, as hospitals are the most expensive location at which to deliver healthcare services. Pharmacies are building large numbers of new walk-in clinics, while the construction of new outpatient surgery centers is flourishing.

Given the environment many hospitals now operate in (lower revenue, elevated costs, and declining occupancy rates), the potential for large deals in the next few years seems to have declined. However, if valuations drop low enough, buyers will likely return.

LABORATORIES, MRI AND DIALYSIS SECTOR

While the market for laboratory, MRI and dialysis companies is relatively small, this sector has seen 10 transactions valued at $1 billion or greater in the last 15 years. Private equity firms have been notably active with regard to these companies.

Unlike the robust and fast-growing long-term care market, growth in this area has been modest. The overall number of transactions has declined for three consecutive years. This numerical decline, is somewhat offset by a mammoth dollar value increase in 2014. Two of the largest deals of the last 15 years pushed 2014’s total dollar value to $11 billion—an increase of over five times the prior year.

Laboratories, MRI services and dialysis businesses have been dramatically affected by changes in technology, and those technological breakthroughs have been the impetus for many transactions. Consolidation between major renal care providers has created an enhanced care continuum through the integration of services and the MRI and radiology field has witnessed the deployment of powerful new imaging technologies.

In the laboratory space, the development of new genetic testing has spurred significant activity. As personalized medicine matures, genetic testing firms will become particularly attractive to buyers, thanks to their attractive profit margins and modest competition.

Much like in the hospital space, financial pressures will exert influence on the potential for transaction growth in the coming years. Rising costs, even for generic lab testing services, for example, may make scale increasingly important.

LONG-TERM CARE SECTOR

Given the inexorable tide of changing demographics, it’s no surprise that the long-term care market is experiencing sustained growth. It would be a mistake, however, to regard such growth as immune from market effects.

After peaking in 2006, the long-term care market has continued to increase, reaching all-time highs in both number of deals and total dollars in 2014 (slightly under 300 and $30 billion, respectively).

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This sustained growth can be ascribed to two factors: a high volume of capital in the market, and highly motivated buyers, who believe the aging of the massive Baby Boom generation all but guarantees the future viability of senior care centers.

Investor demand has been so strong that there has been some concern that the number of properties available may fail to meet market demand. Yet sellers have been equally motivated, thanks to rising valuations and the worry that they could miss the strongest bull market in sector history.

Healthcare REITs have also had a profound effect on the M&A market. In the last 15 years, seven acquisitions involving REITs (totaling $27.7 billion) represented 15 percent of all dollars spent in long-term care M&A over that same period.

The combination of acquisition-hungry large-cap public REITs and growth in the private REIT market has created historic levels of market demand. Yet the question should be asked: Are there enough potential targets to keep these REITs growing?

If current assisted living and memory care community development trends continue, the answer is a qualified yes. Alternatively, overbuilding or significantly higher interest rates could depress the long-term care market.

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REHABILITATION SECTOR

Consisting of inpatient rehab hospitals, outpatient clinics, physical therapy operations, occupational care providers, and so on, the rehabilitation market is the smallest of all healthcare sectors. As such, it has lagged behind the other sectors in terms of number of deals and total dollar volume (fewer than 25 transactions worth less than $1 billion, total, in 2014). Still, these numbers represented the strongest year on record for combined transaction number and dollar value.

The rehabilitation sector is poised to see sustained growth, as demographic changes necessitate enhanced need for its services. Additionally, providers are seeking to offer the full continuum of post-acute care. One example: Kindred Healthcare was once one of the largest operators of skilled nursing facilities. Today, it has transformed into a true post-acute care company, thanks in part to its purchases of Centerre Healthcare and RehabCare Group. These purchases expanded the company’s footprint into inpatient hospitals, physical therapy operations and home health and hospice care.

Another trend worth noting: Two of the largest rehabilitation deals since 2000 have involved REITs purchasing the real estate assets of a provider. Thanks to their low capital costs and need for aggressive growth, it’s likely more REITs will purchase assets in this sector in the future.

DUE DILIGENCE CONSIDERATIONS FOR HEALTHCARE REAL ESTATE BUYERS

Many of the trends detailed above, along with fundamental changes in the healthcare market, have helped provide buyers with an attractive range of options. Shifting demographics will likely continue to spur development of new properties, keeping the pipeline flowing for future deals. All of which makes the role of due diligence more critical than ever.

Before closing any deal, buyers involved in real estate transactions should insist on a comprehensive search strategy. Information about liens, valuations, and ownership are an essential part of any such strategy.

Key searches in the healthcare market include:

› **Hospital Lien Searches**: Many hospitals file liens against customers to recoup the cost of emergency care or ongoing services. Analysis of expected cash flow and outstanding payments that may not be on the books are critical to gaining true valuations.

› **Motor Vehicle Searches**: These searches—including the origination, transfer or release of a title or lien confirming ownership and vehicle history—are important when a fleet of vehicles, such as ambulances, are involved in an acquisition.

› **Fixture Filing Services**: It is necessary to search for filings involving collateral designated as a fixture or permanently attached to real estate, since it can be important for certain facilities where equipment or other means of treatment are integrated into the structures.

› **Negative News Searches**: These are needed to uncover problematic press coverage, which may have reputational or financial costs, especially for community-focused industries like hospitals.

Additionally, traditional real property due diligence, critical for limiting liability on any acquisition involving real estate, includes the following:

- Owner Verification Searches
- Owner/Mortgage Searches
- 10-year Grantee/Grantor Searches
- Tax Assessor Searches
- Mechanics Lien Search

Finally, legal due diligence requirements should be satisfied. These include UCC searches, federal, state and county tax lien searches, judgment and bankruptcy searches, and good standing verification.

Once these considerations have been thoroughly explored, buyers can rest secure in the knowledge that proper due diligence has been performed, thereby greatly lessening the risk of complications derailing any potential deal.

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