From *Specialty Pharmacy News*

Outlook 2016: Broad View Clarifies Specialty Pharmacy, Infusion M&A Activity (with Chart: Specialty Pharmacy Deal Trends, 2001 Through Third-Quarter 2015)

- January 2016 - Volume 13 Issue 1

The specialty pharmacy and infusion therapy sectors were business as usual in 2015 as far as deals go, and there's no reason to expect that activity to change in 2016. And while a cursory glance might call into question the attractiveness of the industries to investors, a long-term evaluation of the two segments reveals that both continue to be healthy investment opportunities, says one industry expert.

Data from The Braff Group, a merger and acquisition (M&A) advisory firm focused on health care service providers, show that there were nine deals in the specialty pharmacy sector through the first three quarters of 2015 — the most recent information available — with 12 expected for the full year if the rate remains the same. That's considerably down from the 22 transactions seen in 2014. A look at those two years alone might worry investors; however, Dexter Braff, president of The Braff Group, says that to truly understand what's happening in the industry, one needs to look back over the last 14 years, which reveal an "up year, down year, up year, down year" pattern of M&A activity (see chart, p. 8). Looking at the data since 2001 in two-year increments reveals approximately 30 deals per period. The M&A trend within specialty pharmacy "looks like it's all over the place, but it's not," says Braff. "The highs don't vary a lot, and the lows don't vary a lot."

This, he tells *SPN*, is "fascinating to me.…We've seen this pattern for 10 years; it happens all the time." Still, he adds, "I would not go so far as to say this is an institutionalized pattern, where companies do a lot of transactions and then slow down." Instead, "specialty pharmacy transactions are often so large that the amount of time a buyer is going to place between transactions is going to be larger" than that seen in other industries. So this "whip-saw effect" is "much more pronounced in specialty pharmacy than virtually all other sectors we watch," he points out.

Private-Equity Activity Is up in Infusion Segment

Through the first three quarters of 2015, the most recent data available, there were already more deals in the infusion therapy sector than there were for all of 2014 — 11 vs. eight — and only one less than the 12 transactions in 2013. "If I have to surmise why that's the case, we have some elevated activity from private equity," Braff points out. "Private-equity groups are continuing to enter the space despite the fact that deal volume peaked in 2012 with 24. If we went back 10 years, we would see substantially elevated activity from 2005 to 2012, and then it started to slow down a bit. That was because the companies that spurred the growth of transaction volume were all private-equity sponsored regional players, [which] have been acquired themselves." In fact, he notes, "the number of buyers in the space and the number of sellers in the space went down at the same time." According to Braff, this "cycle of diminished activity" is "very natural" and a "function of supply and demand." But now, after M&A activity slowed down and companies exited the segment, "players want to get back in at a relatively late stage," he says, which means that a new batch of private-equity groups is investing in the infusion space.

And "the same holds true in specialty pharmacy," maintains Braff. "Virtually every year there are new people trying to get in. What makes it interesting is that we don't necessarily see these kinds of steady patterns in other health care sectors. …As an indicator for the M&A health of a sector, the continued investment in a space is a good barometer of sustained, measured demand." He points out that "when you see M&A activity, you may see that in a quick-growing market," which isn't the case with either the specialty pharmacy or infusion therapy sectors. "It's a steady bunch of investors getting in, doing their thing and then getting out."

According to Braff, "IV and specialty pharmacy are the workhorses of health care M&A activity. They continue to draw new interest and create activity" that's "nothing at a monumentally different rate, but at a sustained rate."

A notable occurrence impacting both industries is a "two-year trend that is continuing to play out of the on-and-off flirtation of specialty pharmacies buying more traditional infusion therapy companies. It's sort of this consistent theme that we've seen over and over and over again," Braff notes. "In order to punch up the margins of specialty pharmacy providers, we're seeing select acquisitions by specialty pharmacy companies of infusion companies."

Specialty pharmacy, he maintains, is "somewhat of a strange business" in that "gross profit margins are so thin, but the opportunity is so great that people are still drawn to it like bees to honey, but they can't turn the page on generating a lot of profit dollars." As an example, he points to Diplomat Pharmacy, Inc.'s "$2 billion plus in [annual] revenue and an EBITDA [i.e., earnings before interest, tax, depreciation and amortization] margin that hovers around 1%."

Specialty pharmacies are "transactional businesses; everyone has to get their medications." Still, "the biggest question that continues to befuddle the industry" is "how to capitalize" on specialty pharmacy, contends Braff. "There is no shortage of people who are rightly chasing after a very, very predictable explosion of growth. The big question is how do you do that and get ahead of the profit curve?" Investors "like to think there are economies of scale" to be leveraged, but they are "elusive" — although it's not due to a lack of trying.

"To some degree, it's the nature of the business," he explains. "You might say at this point that it is somewhat like any low-margin business where it's hard to push margins up." As an example, Braff points to grocery stores, which need to "look for things on the edges," such as coffee bars and specialty items, to be profitable. In specialty pharmacy, "all profits are on the margins." And adding an infusion company could "add 20% to an EBITDA margin."

So what are some potential companies that could jump into the M&A fray in 2016?

Braff points to Madison Dearborn Partners LLC, which purchased a majority stake in Walgreens Boots Alliance Inc.'s infusion unit last year *(SPN 2/15, p. 1)*. "To the best of my knowledge, they have not seemed to do a follow-up deal yet," he says, making it likely that such a move will occur. "We expect them to add to it, but we're not sure how they're planning" to do so. "With Walgreens still involved, initially they might be pursuing more organic growth plans." Such growth can take time to develop, so companies tend to take this route initially after a deal and then "follow up with discrete acquisition activity," he says.

OptumRx's recent purchase of AxelaCare Holdings Inc. from private-equity group Harvest Partners, LP *(SPN 12/15, p. 1)* is "noteworthy from two angles: First, what else is Optum going to buy?" says Braff. In addition, the industry has seen purchases of specialty pharmacies and specialty infusion companies by PBM-like companies, "but there's not been as much action by insurers. I would expect to see more." Braff maintains that 2015 was "a banner year for Optum," which also purchased Catamaran Corp. *(SPN 4/15, p. 1)*.

An "interesting transaction" was by Epic Health Services Inc., a "largely pediatric nursing company that bought a very sizable enteral therapy company," Option 1 Healthcare Solutions. "We have not seen a nursing provider acquire a product provider in a long time," says Braff, who notes that Epic — which is a portfolio company of private-equity group Webster Capital — "quickly followed that up with the Medco [Medical Supply] transaction," further expanding its growth in the enteral therapy services field. Epic is "committed to a new branch of growth" for itself. Might we see more of examples of this "multipronged generic strategy of coordinated care across the health care delivery system?" Deals where skilled nursing providers purchase home health or hospice firms are "very common," and hospitals are working with urgent care providers, but Epic's move is different. Braff says he wonders whether this is "a signal of first-mover development" involving purchasing and putting together ancillary services. "This is not a trend, but it happened," he says, with the backing of a "wealthy, experienced health care investor."

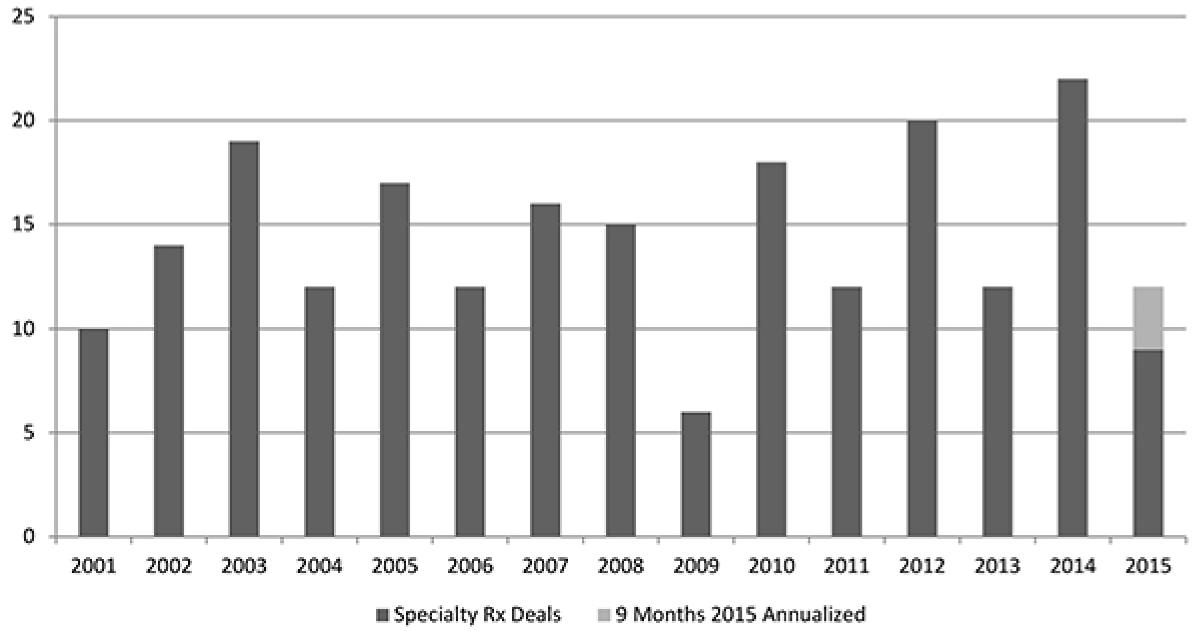
What could dampen enthusiasm for the sectors in 2016? "There's nothing out there that I can see as being different," says Braff. "That's part of the reason why we see a steady level of activity."

Still, he adds, "I suppose the Optums of the world controlling distribution could be seen as a go-forward problem. The more insurers that combine and the more they take the service elements and put them under their own umbrellas, the more extent they can use in-network and out-of-network…pricing schemes to limit competition. There may be something there — the winds are blowing. I can see where the dominos could fall if you work backwards." Such a shift would mean that "smaller providers are squeezed in a meaningful way." And while the industry could be "moving in that direction," Braff says there is "no near-term concern" about it.

"It could definitely go in that direction, but nothing will happen next year."

Contact Braff at dbraff@thebraffgroup.com.

Specialty Pharmacy Deal Trends, 2001 Through Third-Quarter 2015



SOURCE: The Braff Group. Visit www.thebraffgroup.com.

Find this article at:: http://aishealth.com/archive/nspn0116-05