SPECIAL EDITION

PHARMACY SERVICES M&A: WHERE IT'S BEEN AND WHERE IT'S HEADED

What do mergers and acquisitions and Trump's hair have in common?

Well, for one, they require a lot of work to hold together; more importantly though, they evolve over time.

Such is the case in pharmacy services M&A.

In this Special Edition of marketWATCH, we take a look back at how pharmacy dealmaking has changed, not only to see where we've been, but to illustrate market tendencies that may be worth considering in forming your own buy-sell-hold strategies.

The Roaring 90s. We start in the 1990s – infusion therapy's version of home medical equipment's era of the "golden commode." TPN ruled. Some called it Total Parental Nutrition. We called it Ten Patient N'out: ten patients, a million in revenues, $400k in EBITDA, and adios. An era was born. Up sprang T2 Medical, Critical Care America, Home Nutritional Services, each vying to be the biggest, brashest buyer on the block. The party was on…until all the whooping and hollering woke up the neighbors, uh, insurance companies. Reimbursement tumbled, fortunes were fumbled, and infusion M&A went into a deep freeze.

*Takeaway: The Pricing Error Effect. Particularly in health care where third party payors are involved, scenarios like this play out repeatedly. As investment dollars rush into a market to capitalize on what amounts to a **pricing error**, the rush itself reveals the wrong – and it is righted. The opportunity vaporizes. What's more, it sometimes leaves behind a black hole that sucks in payors, regulators, and others that can suffocate a sector with scrutiny for years to come.*

So if you ever find yourself on the fat end of a margin in health care….

The Morose Millennium. By the 2000s, the big wave of margin reductions had washed through home infusion and the fringe players had washed out. Those that remained were more efficient and stronger. Moreover, the market was more stable, and sustainable. Arguably, the risk-profile of the sector may never have been more attractive. The market's reaction? Still feeling burned by the roaring 90s, buyers continued to hit the snooze button on home IV.

*Takeaway: The Market Lag Response. While shifts in M&A activity can be abrupt, they frequently play out over elongated periods of time. And during these transitional phases, **acquisition sentiment tends to lag real changes in risk-return fundamentals**. So even though IV economics were decidedly more attractive in the early 2000s, buyers stayed away.*

We saw the exact same pattern in home health in the wake of massive industry contraction as the sector moved from a cost-based to a prospective payment system. Even though home health could for the first time generate profits directly under PPS, buyers were agonizingly slow to react. And this opened the door to private equity which wasn't hung over from the transition and could see with clear eyes such an obvious opportunity.

Specialty Pharmacy Becomes a Thing. Although the products and services were already in play, from an M&A perspective, specialty Rx didn't really start on its path to becoming the next big thing until home IV lost its luster. It didn't take long for the sector to take center stage. In fact, in 2002, specialty Rx accounted for seven of the ten largest (announced) transactions during the year.

*Take Away: The Zero Sum Investment Effect. Mergers and acquisitions are often a zero sum game. That is, buyers often target **broad** market sectors such as pharmacy services, home care, senior housing, and more. So, **within** each broad market, for each dollar invested in a specific sector, there is one less dollar to invest in another. In pharmacy services, then, as acquisition dollars began to shift toward specialty Rx, they were taken from infusion, substantially driving down demand and price.*

Tysabri Pulled From Market. Specialty Rx was on a roll. Momentum was building. Optimism was high. And the market was breathlessly anticipating the release of Tysabri which promised to be a blockbuster biologic in the treatment of multiple sclerosis. And then in early 2005, Biogen Idec and Elan suddenly pulled the drug off the market when three patients (two of whom later died) contracted progressive multifocal leukoencephalopathy, a rare neurologic disorder. While such an isolated incident did not derail specialty Rx, it nevertheless had a sobering effect on the market – and the investment community that had fueled its rapid rise.

Take Away: The Fragile Nature of M&A. Mergers and acquisitions can be a capricious business. Especially in health care, every deal is one news item, one reimbursement cut, one regulatory change from collapse. Providers whose valuation was riding the release of Tysabri were suddenly faced with an entirely different set of proforma projections. Which is why, if you are a health care seller, once a letter of intent is executed, you can't close quickly enough.

Infusion Reclaims its Mojo. Remember the lag effect we referred to earlier? While consolidation strategies often lag changes in risk-return fundamentals, they eventually catch up. And such was the case in home IV. In 2006 and 2007, four PE sponsors launched platforms in infusion therapy (Kohlberg and Company – Critical Homecare Solutions; Ferrer Freeman – Amerita; Flexpoint Partners – Home Solutions; and Waud Capital – CarePoint Partners). In the ensuing years, these sponsors completed more than 50 transactions among themselves. Practically once more.

Take Away: The Private Equity Pattern. In M&A, where there is one PE firm, there will almost certainly be another, and another, and another, multiplying like rabbits to pursue the same opportunity. This will inevitably fuel a surge in acquisition demand and valuation that will last as long as new sponsors continue to enter the space. But once the next shiny investment thesis begins to take hold and new platform deals peter out, as sure as you can plot the way up, you can pretty much plot the slide.

BioScrip Makes a Bold Move. BioScrip started life out as a specialty pharmacy provider. But around 2010, management decided it was time for a makeover. Over the next four years, the firm sold off the bulk of its specialty business to Walgreens and snapped up a who's who of regional infusion therapy providers, including several of the PE sponsored roll-ups mentioned above. Presto chango, BioScrip was well on its way to becoming one of the largest, pure play providers of home infusion therapy in the nation.

This transformation reverberated through the industry in two key ways: First, the deal took out several of the infusion therapy acquirers that sparked the second wave of IV M&A, reducing competition for deals. Moreover, it crystallized the idea that while IV may not be as sexy as specialty Rx, with its comparably fat margins, it delivers a far greater EBITDA bang for its buck.

The Takeaway: The Diversification Imperative. After multiple buyers have swarmed a sector and snapped up many of the most attractive acquisition targets, growth can become more difficult to come by. So in a typical consolidation cycle, we often see a diversification phase where buyers target related products and services to provide another growth prong, and/or, in some cases, to boost profitability.

Such has been the case in specialty pharmacy. While we've seen meteoric revenue growth (especially with the introduction of a new therapy such as with hepatitis C), with such razor-thin margins, it's tough to bulk up on EBITDA. The solution? Acquire profitable businesses that are close enough to the core that it doesn't dilute or distract from the primary investment thesis. Consequently, we routinely see specialty pharmacy providers eyeing, vying, and buying infusion therapy providers. Exhibit A: Diplomat Specialty Pharmacy's recent acquisition of BioRx.

Size Creep Creeps Up on Specialty Rx. As briefly mentioned above, with limited distribution-type contracts, pent up demand for the latest and greatest biologics, and customer management and mail-order capabilities that creates nationwide markets, we've seen spectacular organic growth in specialty Rx. The flip side to this growth is that it can create a "chase the tail" dynamic wherein the larger an acquirer becomes, the larger an acquisition target must be to "move the needle" (this happens in most industry consolidations, however it is amplified by the unique characteristics of specialty Rx). As a result, when a sector consolidation enters the “size-creep” stage, the supply of acquisition candidates large enough to satisfy the beasts becomes constrained.

This ushered in a period that still exists today in which M&A activity has become far more a function of **supply** vs. **demand**. That's why deal volume in specialty Rx has whipsawed up and down with no discernable pattern. The market hasn't changed – just the companies that decide to play.

The Takeaway: The Size Creep Corollary. When buyers need bigger and bigger companies to acquire and there aren't enough to go around, opportunity knocks for patient consolidators to aggregate, integrate, and fabricate the “inventory” for the next player up the M&A food chain. So you see buyers like BelHealth and Salveo Pharmacy move “downstream” to cobble together the ingredients to create a supersized meal deal to satisfy those Big Mac attacks.

Meningitis Outbreak Tied to New England Compounding. As alluded to above, as consolidation cycles mature, buyers look to adjacent products and services to bolster their holdings. In pharmacy services, more than a few buyers flirted off and on with the idea of either layering compounding into their existing operations, or perhaps taking a run at consolidating these entities as a stand-alone investment thesis. Sure, it was a niche within a niche, whose revenues were often tied to a pharmacist/owner. But given its extraordinary margins and potential fit in a pharmacy service continuum, it held M&A promise. And then, in 2012, an outbreak of meningitis which was blamed for the death of 64 patients was found to have originated with New England Compounding. And that was it. Before it had a chance to become a thing, pharmacy compounding became the Voldemort of M&A – the sector “that must not be named.” For The Takeaway, see The Fragile Nature of M&A above.

Diplomat Completes Successful Public Offering. In October of 2014, Diplomat Specialty Pharmacy went public. Within a week, the market was valuing the firm at more than 25 times EBITDA for a total enterprise value of approximately $900M (for a detailed analysis of the IPO, see our marketALERT publication, “A Glimpse Inside Diplomat Pharmacy's Initial Public Offering”). From an M&A perspective, more than anything else, the deal confirmed the investment thesis in specialty pharmacy, fueling the appetite for further sector consolidation.

The Takeaway: The Public Markets Matter. When it comes to sending the Bat Signal to the M&A community, nothing beats a high profile, successful Initial Public Offering.

The Outlook for Pharmacy Services M&A

With the past as prologue, what do we anticipate in pharmacy services M&A over the next 12-24 months:

1. Despite whisper-thin margins, specialty pharmacy will march on as it continues to morph into an extraordinarily high volume, economies of scale dependent business.

2. Given M&A size creep, the real buying and selling opportunities in specialty Rx lie in the below $250-$500M revenue range. As long as there are enough Diplomat-like acquirers and Salveo-like upstream consolidators, we anticipate continued deal flow.

3. Infusion therapy should remain in an attractive, although volume constrained “stasis.”

   With all of the PE-backed consolidators that spawned the second coming of IV M&A having been acquired themselves, “vertical” integration demand has softened. The good news is that “horizontal” integration demand from margin constrained specialty Rx and institutional Rx has risen. While quite a few buyers short of a bull-run, the supply of $5-10M, pure play traditional infusion therapy providers is even more limited. And with newly minted pharmacist entrepreneurs more likely to be drawn to the sex-appeal of specialty Rx, the supply isn't likely to grow anytime soon.

   Hence, an M&A market in relative stasis that leans favorably toward IV that we further expect will support elevated pricing.

4. Given a market in which the supply of acquisition candidates is a critical gating factor, we will continue to see uneven, “lumpy” volume trends. Consequently, tempting as it may be to infer changes in the market based upon swings in quarterly deal flow, if there is any real shift in M&A patterns, it will take several quarters to fully manifest.

One more thing.

We predict that industry insiders will remain torn as to whether health care should be one word or two.

Some things are just unknowable.

INTELLIGENT DEALMAKING IN PHARMACY SERVICES M&A

The Braff Group is the leading health care services mergers and acquisitions advisory firm with a team of dealmakers focused exclusively on pharmacy services.

For more than fifteen years, we have provided sell-side only transaction services to the pharmacy and infusion therapy provider community.

With more than 250 transactions completed, The Braff Group is ranked #1 in health care mergers & acquisitions.[1]

But we never forget that **your deal** is the one that matters to you.

Let us make it a great one.

[1] Source: Thomson Reuters, based on number of deals between 2008 and 2014.

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