The leader in Health Care Services Mergers & Acquisitions

INSIGHT INTO HEALTH CARE SERVICES MERGERS & ACQUISITIONS

THE BRAFF REPORT

Health Care M & A in the Time of COVID-19

It was all going great. Record deal flow. Record valuations. Soaring access to debt. And then...

The Potential Fallout from Coronavirus

What We Can Infer from the Global Financial Crisis of 2008-2009

From a health care mergers and acquisitions point of view, what can we expect in a nation, an economy, a stock market, a health care delivery system, a workforce, and a collective psyche that is reeling under the inexorable march of COVID-19 across the globe?

To begin to answer this question, it is instructive to examine what happened during the last global financial crisis (GFC) that cratered the world's economy in 2008-2009.

As illustrated in the chart below, the recession took a tremendous bite out of overall US M&A activity, both in terms of deal count and total capital invested.

But take a closer look and an interesting statistic emerges.

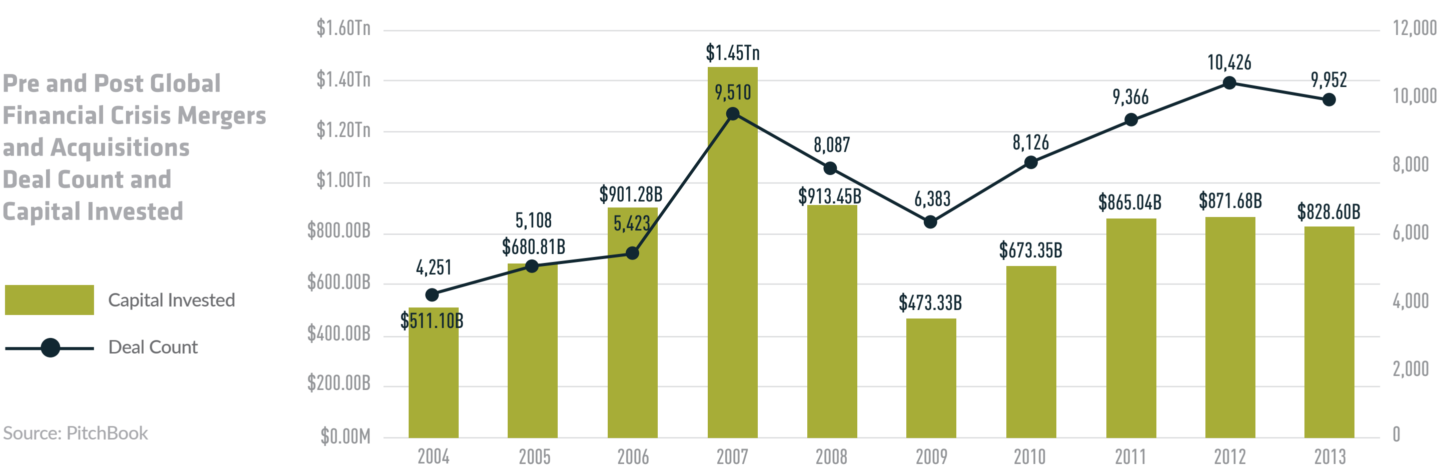
During and immediately after the collapse, the amount of capital invested fell more than 67%. But if we look at deal count, the volume dropped considerably less – just under 33%. Moreover, by 2012, deal count had risen to pre-crisis levels. But by 2013, total invested capital had only recovered about 50% of its 2007 peak.

So, what's the takeaway here?

Larger transactions took a disproportionately greater, and lasting, hit than smaller deals. Buyers were willing to get back into the market, but not at the same scale as previously.

This was not only due to the **rapid contraction of debt** available to finance these deals, but also a **flight to lower risk** – the less you invest, the less you have to lose.

Pre and Post Global Financial Crisis Mergers and Acquisitions Deal Count and Capital Invested



Source: PitchBook

What We Can Infer from the Global Financial Crisis of 2008-2009 (cont.)

If we narrow our view to the lower middle market of health care services, we see a somewhat similar, albeit less pronounced, pattern.

Consider the following.

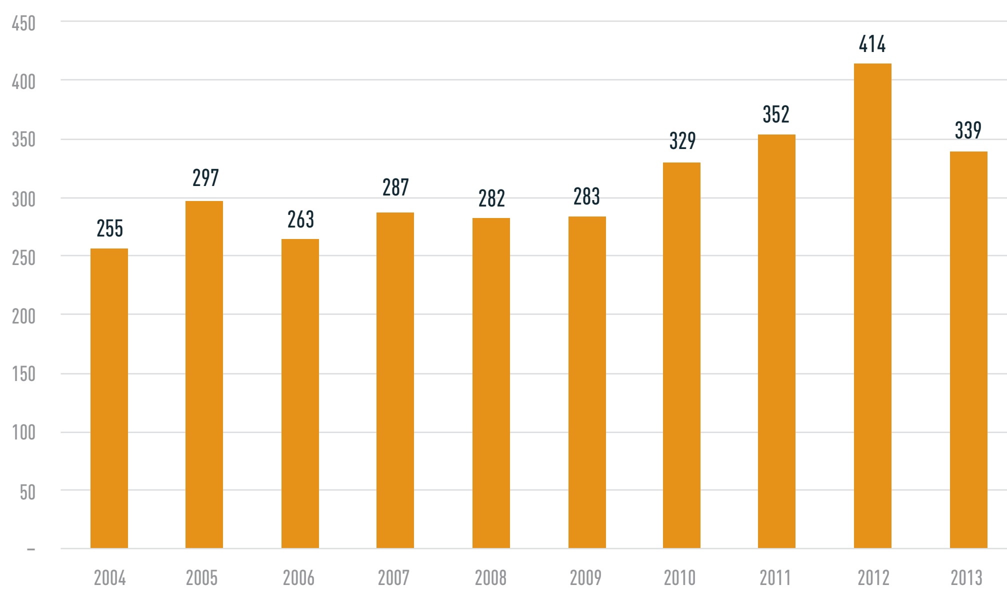
Based upon proprietary data collected and analyzed by The Braff Group, over the same period, while the modest gains made between 2004-2007 tailed off, **we did not see any meaningful decline in health care services deal flow**. Notably, by the very nature of the health care services sector, **these deals were almost entirely below $50M in purchase price**. What's more, by 2010, deal flow began to markedly accelerate.

But it was more than just the lower financial exposure attendant to smaller investments that propped up the market. With demand for health care almost entirely inelastic, the sector tends to outperform others during market slowdowns.

So, post-recession, many investors turned toward health care to shore up their portfolios.

Pre and Post Global Financial Crisis Lower Middle Market Health Care Services Deal Count

Source: The Braff Group

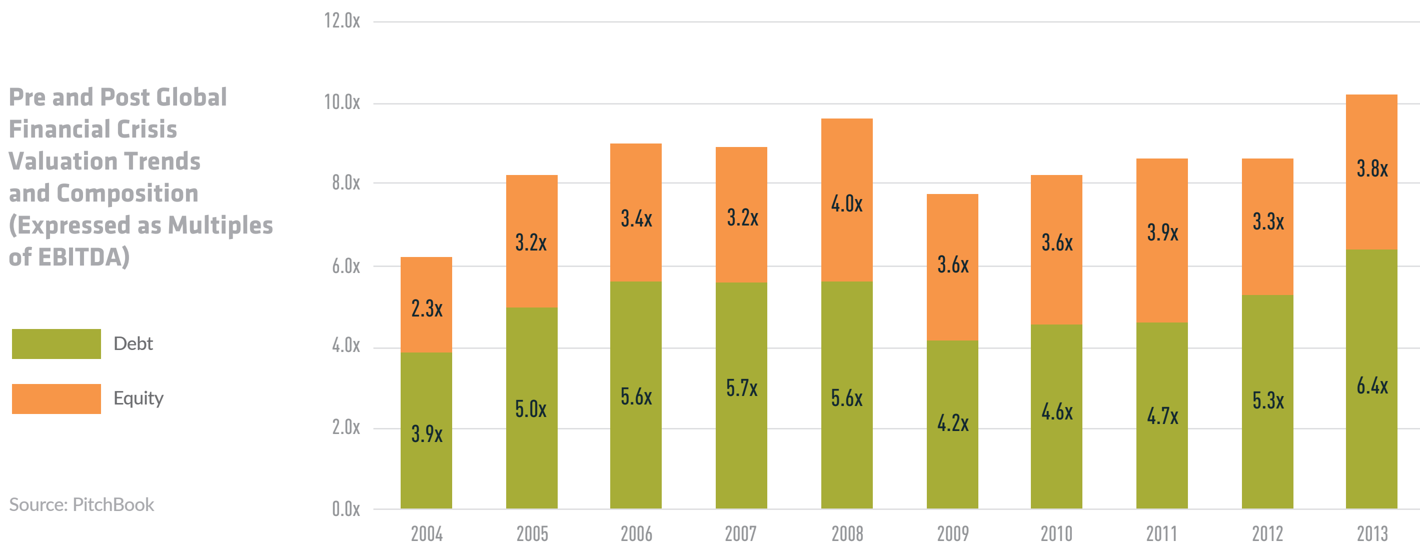


What about the valuations?

As you may have guessed, and as illustrated in the chart below, valuations pretty much mirrored changes in deal count. We do note, however, that they lagged the decline in activity by about a year. This may be due to the tendency for M&A dynamics to lag changes in the market as transactions already in play often get completed, and often at or near the original deal terms.

The chart also illustrates the interplay between debt capacity and valuation; in this case, how tightening of the debt markets post-GFC contributed greatly to the fall-off in pricing.

Pre and Post Global Financial Crisis Valuation Trends and Composition (Expressed as Multiples of EBITDA)



Source: PitchBook

It played out much the same for lower middle market health care services deals. However, as a corollary to larger deals taking a disproportionate hit than smaller deals, valuations at the upper end of the spectrum fell 35-40%, while those a bit further down the line saw price contractions of only 15-20%.

In summary then, based upon the last financial meltdown, one **might** infer the following for health care services M&A over the next three to 18 months:

- **M&A activity will fall, but less for smaller deals than larger transactions.**
- **Reduced access to debt will constrain deal flow and valuation, particularly for larger sized deals.**
- **Buyers will lean towards smaller investments to mitigate risk.**
- **Buyers will favor health care to capitalize on the sector's counter-cyclical nature.**

With the above as context, how do we anticipate M&A will actually play out under COVID-19?

Taken one by one:

1. Deal flow will contract – immediately, and at least for the next 3-6 months.

We won't be seeing much of a lag effect this time around. Many deals that were on the cusp of closing have been abruptly shuttered as buyers, like the rest of the nation – and the world – react to the shear enormity of what we are facing.

With the above as context, how do we anticipate M&A will actually play out under COVID-19? (cont.)

Specifically, buyers will sit back and assess the near-to-mid-to-long term consequences the virus will have on the go-forward performance of acquisition candidates. This is particularly the case in service businesses, and even more particularly so in health care service businesses.

While you might think that the fortunes of health care providers would rise as demand for their services soars, the impact under the pandemic is more nuanced.

Hospice providers are being prevented from entering nursing homes. Parents are not sending their children to **autism clinics**.

Likewise, census in **addiction treatment programs** is falling. Front-line **home health** nurses and paraprofessionals are under tremendous stress, not only from the fear of contracting the illness and spreading it to their families, but also from challenges taking care of children no longer in school. With states reeling from massive losses in tax revenues, unless the Feds step in at unprecedented levels, **Medicaid and state funded providers** will likely be squeezed. And then there's the interruption in the day-to-day activities of **insurance companies and other third-party payors and administrators** that enable health care service providers to get paid.

2. Credit necessary to finance deals will tighten.

In an excellent article published by PitchBook on the potential impact of COVID-19 on private equity, they suggest that,

> *As of the beginning of March, roughly $860 million in leveraged loans came to market, relative to roughly $81 billion as of the end of January, reflecting a decline of more than 99%, according to LCD. We view these securities as adequate proxies for the pricing and availability of debt that goes into LBO transactions. Given the fall-off in demand for such risk assets, we expect to see continued tightening in the credit markets applicable to the upper ends of PE.*[1]

The article does, however, go on to say that with respect to private debt,[2]

"While banks are likely to pull back in a recessionary environment, private debt funds are sitting on $241.4 billion in dry powder globally as of Q2 2019 and are likely to continue investing through a downturn."

It is important to note, however, that (a) this type of debt is more expensive than traditional lending, (b) is typically limited to large issuances, and (c) will also be more difficult to secure in such a volatile market.

In technical terms, then, the market is spooked, and money is going to be tight.

3. We anticipate that at least some PE dry powder will be used to shore up existing portfolio companies, leaving less equity to finance additional follow-on transactions.

4. Valuations are going to take a hit.

Consider the following:

- Valuation is a function of risk; the greater the risk, the lower the value.
- Immediately prior to the onset of COVID-19, valuation multiples, supported in part by over-zealous lenders, were at or near record highs.
- Credit markets are going to tighten.
- Buyers will likely use the crisis as cover to pull back on runaway multiples that, due to competitive forces, they were unable, or unwilling to do on their own.

So yeah, particularly for the larger deals that enjoyed unprecedented size premiums, pricing is going to suffer.

5. As buyers cautiously re-enter the market, they will once again start with comparatively smaller deals.

Nothing magical here. Same as what we saw after the last market collapse. Just plain old risk mitigation.

[1]"COVID-19, the Sell-Everything Trade, and the Impact on Private Markets," PitchBook, March 2020
[2]Unlike traditional lending which comes from banks, private debt generally comes from institutional investors. In the capital structure, private debt occupies the space between traditional bank debt and equity. It is perhaps best explained by the quip, "Private debt is an expensive form of debt, but a cheap form of equity."
(Private Debt: The Four Most Frequently Asked Questions by Entrepreneurs, Pride Capital, November 2019)

With the above as context, how do we anticipate M&A will actually play out under COVID-19? (cont.)

6. Buyers will once again favor health care investments, but likely in a different manner than we've seen in the past.

After the global financial crisis in 2008-2009, investment dollars were spread across virtually all facets of health care. However, in the aftermath of COVID-19, buyers may **initially** be a bit more cautious investing in primarily service providers due to concerns detailed in the first bullet above.

So where will the health care dollars go? To name a few:

- **Telemedicine and telepsychology**
- **Remote patient monitoring**
- **Home diagnostic testing**
- **Bio-pharmacology**
- **Innovations in protecting medical personnel from disease spread**
- **On-demand, flexible infrastructure that will enable providers to quickly scale up operations as needed on a temporary basis**

So, how about some good news?

Once the market settles (broadly, and particularly in health care services) – and it will settle – the demand for health care service providers should rebound quickly.

The fundamentals that have driven health care investment to record levels will still be there, perhaps more so in the wake of a global pandemic. Regardless of who wins the elections in the fall, in the aftermath of COVID-19, we would anticipate that the public will have little appetite to cut back on health care coverage. More likely, we will see increased access, and maybe, just maybe, at least some trepidation to cut reimbursement over the near-term.

Unfortunately, what payment cuts, complex regulations, frustration in dealing with insurance providers, and the financial crisis of 2008-2009, largely couldn't do, the fall-out from COVID-19 may. That is, cause more than just a few providers to struggle.

But wait, you say, "This section is supposed to be about good news."

Well, it can be if you're a well-capitalized provider and use the disruption in the market to rescue faltering companies. This doesn't have to be a shark-fest. Sellers under such circumstances recognize that they aren't going to get a premium. But for buyers willing to pay a fair price, and equally important, give the seller's caregivers and support staff a home, there could be extraordinary opportunity to gain an inside track on such deals, as well as do some good for your business, the seller, their employees, the community, and you.

If there was Love in the Time of Cholera,[3] perhaps there can be Love in the Time of COVID-19.

[3]Perhaps not so clever literary reference.

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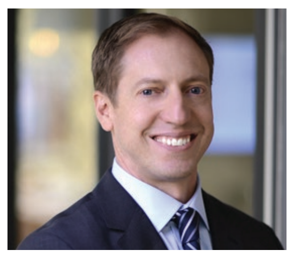

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