
SPECIALTY PHARMACY NEWS

Specialty Pharmacy, Home Infusion Arenas Are Seeing Renewed, Growing M&A Interest

Merger and acquisition (M&A) activity among specialty pharmacies and home infusion companies continues to show signs of renewed life following a tremendous slowdown in first-quarter 2009. And while deals certainly aren't occurring at the robust rate they were a couple of years ago, a handful of industry dynamics means that M&A activity involving specialty pharmacies and home infusion firms should see a rebound in 2010, industry sources say.

"We expect to see further M&A activity," says Atheer Kaddis, Pharm.D., vice president of managed markets at Diplomat Specialty Pharmacy. "However, this will be less than what we have seen in the past five years." Nevertheless, says F. Randy Vogenberg, Ph.D., co-founder of pharmaceutical consulting firm Employer-based Pharmaceutical Strategies, LLC, M&A activity should still increase from the current low levels, as it will be necessary for many companies' survival.

Various factors have dampened interest in M&A activity. Most obviously, "the economic slowdown definitely had an impact on people from a variety of perspectives," says Dexter Braff, president of The Braff Group, a health care M&A company. "It's been a malaise that's caused everyone to pull back and stop." M&A activity involving companies providing pharmacy services — specialty pharmacies, home infusion firms and institutional pharmacies — was particularly affected by the downturn because so many of the deals were driven by private-equity groups. In fact, from 2006 to the first half of 2009, private equity accounted for almost double the M&A activity among pharmacy-services firms (38%) compared with nonpharmacy companies (21%). With a reduction of credit availability, private-equity companies were "largely retreating in 2009," he says.

In addition, the constrained lines of credit have a greater impact on private-equity firms than they might have on other potential buyers, as these companies make money by investing in companies, building them up and selling them later, Braff points out (*SPN 11/08, p. 3*). "In the financial machinations of private

equity, generally speaking, the more debt you can use to finance transactions, the greater your rates of return can be," he explains. By taking this tack, these companies can "enjoy the benefits of leverage." The more equity that the firms put into deals, the lower the rates of return that they are generally able to generate, he says. "So to get the returns they are looking for, these companies are now faced with the prospect of preferring to pay less for the companies they are trying to buy," says Braff.

"If you have cash, this is a good time to seek new investments," says Bill Sullivan, principal consultant with Specialty Pharmacy Solutions, LLC. "Banks have tightened up on lines of credit, so financing is less likely an option."

The economic downturn also meant the number of people on private insurance rolls dropped as people lost jobs, notes Braff. In addition, many companies were spooked by the prospect of health care reform. Companies panicked because they believed the sky was falling, he contends. However, once companies had time to consider potential changes, they realized not only could they manage what lies ahead but also that reform could bring them more covered lives as people previously uninsured are added to insurance rolls.

But the No. 1 driver of the reduction of M&A activity among pharmacy services companies probably has far less to do with a lack of interest in the sector than with the lack of supply of acquisition candidates, Braff maintains. "From a buyer perspective, they want candidates and are looking for them, but they can't find them," he tells *SPN*. A number of causes have contributed to this dynamic. For one, pharmacy services, he explains, is a "relatively small market." There are about 10,000 home health providers, but specialty pharmacies, home infusion companies and institutional pharmacies combined represent less than 2,000 of those companies.

In addition, many of these firms are smaller in terms of annual revenues than companies that traditionally represent attractive acquisition targets, says

Braff. "It's very, very hard to find platform companies. To find a company doing more than \$10 million or even \$5 million annually in revenues is very difficult," he asserts. And third, "the run-up of [M&A] activity the last couple of years is contributing to the lack of supply," he says.

Landscape Favors Pharmacy Services Sector

Nevertheless, numerous factors are occurring that are already spurring interest in the pharmacy services sector. In fact, data from The Braff Group show that M&A activity among home health companies, including pharmacy services, continues to rebound from the first quarter of 2009, when it was at its lowest level in almost seven years (*SPN 9/09, p. 1*).

The overall health care landscape means that specialty pharmacies and home infusion companies are attractive acquisition targets in the current health care environment, contends Braff. "There are some favorable things happening from a global market perspective" — such as a burgeoning pharmaceutical pipeline, the shifting of many conditions from acute to chronic and the growth of personalized medicine — that will favor the infusion therapy and specialty pharmacy industries in general, says Braff. There is a general understanding, he says, that companies with a high-touch approach — ones that can handle patients at a face-to-face level as opposed to through, say, mail order — are in the best position for the changing marketplace.

"The spend on specialty pharmacy is growing faster than any other pharmacy segment," he notes.

"With that, predictably, more and more buyers will be coming out of the woodwork. This augurs well for the market." Furthermore, says Braff, the focus on specialty pharmaceuticals "draws more entrants into the marketplace." He explains that the marketplace tends to move in a certain direction — interest from buyers leads to more demand, which leads to greater valuation, which leads to a greater number of transactions. "This wave of activity repeats itself; it cycles," he claims, particularly in segments with a smaller number of players.

2010 should also see an increase in the number of potential acquisition candidates. Some of the growth will be a result of people with expertise who are at existing companies going out on their own or companies breaking off from others, says Braff. "We expect to see this in smaller numbers because there are a smaller number of existing companies, so there will be a smaller number of progenies," he says. And while specialty pharmacy and home infusion may take a more specific, greater skill set than other home health areas such as hospice, people with unique expertise and industry contacts can do exceptionally well, he says. "Particularly in specialty pharmacy, it's possible to build a company from zero to \$50 million [in annual revenues] quickly with the right manufacturer relationships and the right sales relationships. We've seen companies go from zero to \$100 million in three years in oral oncology." However, he adds, "the profit margins are thinner. I'm not saying it's easy." But if companies have expertise and can get relationships with manufactur-

Third-Quarter 2009 Merger and Acquisition Activity – Home Health Care Sector

Sector	2Q2009	3Q2009	% Change	3Q2008	3Q2009	% Change	Year-to-Date 2008	Year-to-Date 2009	% Change
Home Health Arena (HHA) — Medicare Certified	18	25	38.9%	18	25	38.9%	57	54	-5.3%
HHA — Medicaid	1	—	-100.0%	3	—	-100.0%	6	3	-50.0%
HHA — Private Duty	6	7	16.7%	6	7	16.7%	22	18	-18.2%
HHA — Other	1	3	200.0%	1	3	200.0%	7	7	0.0%
Subtotal HHA	26	35	34.6%	28	35	25.0%	92	82	-10.9%
Hospice	3	7	133.3%	4	7	75.0%	12	17	41.7%
Staffing	6	3	-50.0%	6	3	-50.0%	22	11	-50.0%
Home Medical Equipment	16	15	-6.3%	6	15	-150.0%	25	37	48.0%
Infusion Therapy	5	1	-80.0%	5	1	-80.0%	14	8	-42.9%
Institutional Pharmacy	2	2	0.0%	3	2	-33.3%	4	5	25.0%
Specialty Pharmacy	1	3	200.0%	7	3	-57.1%	11	4	-63.6%
Total	59	66	11.9%	59	66	11.9%	180	164	-8.9%

SOURCE: The Braff Group, *Perspectives*, December 2009.

ers, particularly exclusive-distribution contracts for products, they can grow very quickly, he says.

As credit begins to open up, says Braff, this will bring private-equity groups, among others, back into the game. In addition, some companies have weathered the economy better than others and are in better shape to make deals, contends Sullivan. "The big-box specialty pharmacies (mostly owned by PBMs and/or retail chains) all are sitting on piles of cash and have been able to refill their investments' piggy banks with successive fiscal quarters of record profits."

Capital Gains Tax Hike May Spur M&A

Also potentially spurring M&A activity in 2010 is a favorable capital gains tax rate that could take a hit from two different fronts at the beginning of next year. "There are a lot of people very anxious about the notion of being hit with a great capital gains tax in 2011," explains Braff. Without congressional intervention, tax cuts enacted in 2003 during the Bush administration will expire at the end of 2010 due to a sunset provision. So on Jan. 1, 2011, the tax rate is set to go from 15% to 20%. And the chances of the rate reverting seem good, he says. "Given the economic conditions, it's hard to imagine extending the capital gains break. A whole lot of people out there think the rate is going to go to 20%."

Capital gains are taxed only when a transaction occurs, so higher rates tend to discourage M&A activity. "When companies automatically lose 5% of the purchase price, this is not an insignificant number," Braff says. "It also becomes more significant when you contemplate the notion that one of the health reform measures under discussion is paying for reform in part with increases in capital gains of 5.4%." The House health reform bill (H.R. 3200) proposes that individuals with a modified adjusted gross income that is more than \$500,000 and families with a modified adjusted gross income of more than \$1 million be subject to this tax, which would also take effect Jan. 1, 2011. "So together, you're now talking about a 10% increase," points out Braff. "Companies would have to wait for 2012 to outgrow what they just lost from a tax perspective."

The slowing of the economy in 2009 resulted in a "pent-up demand to sell and buy," says Braff. But with the potential capital gains tax increase in 2011, companies will have "a relatively short window" to make deals, he says. "Would-be 2011 sellers will sell in 2010, would-be 2010 sellers will sell in 2010, and would-be 2009 sellers will sell in 2010."

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