
SPECIALTY PHARMACY NEWS

Pharmacy Sector M&A Rebounds; Reform, Private Equity May Have Led to 1Q Slump

First-quarter 2009 mergers and acquisition (M&A) activity within the pharmacy sector — which includes specialty pharmacy, home infusion and institutional pharmacy — hit the lowest level since the third quarter of 2001, according to one firm's data. But the second quarter of this year showed somewhat of an improvement over the first quarter, says Dexter Braff, president of The Braff Group, a health care M&A company.

Some broader economic factors are having an impact on specialty pharmacy and home infusion. "In general, when the economy is down, people hoard cash, the ability to finance is down, and a lot of industries tied to the economy are down," explains Braff. "There is a whole economic scenario that is contracting M&A demand across the board."

In addition, he says, "Absent credit, private equity [companies are] loath to do many transactions. Private equity relies a lot on debt to increase the rates of return that companies can get....Absent the ability to borrow money, the ability to earn those rates of return becomes substantially more difficult" (*SPN 11/08, p. 3*). So private-equity companies are lowering the price they can pay for an acquisition, which in turn hurts their ability to be competitive in making transactions, he explains. This situation "has pretty much taken private equity out of the buying mix for the most part," he maintains.

The health care industry specifically "obviously experiences some similar dynamics," says Braff. Private-equity firms' demand for health care acquisitions is down in the same way it is for other industries. "Where it's different, though, is that people look at health care as countercyclical," he says, not like industries such as automobiles, metal and electronics. "Health care is fairly inelastic. The demand for services doesn't vary greatly by income."

But, Braff tells *SPN*, the first quarter of 2009 had the lowest number of health care services transactions since the first quarter of 2002 — "similar to what we saw in other segments of the market," he notes. *So has something changed in the health care/economy equation?* No, contends Braff. "This just happens to be coincidental."

As evidence, he offers some data on changes in M&A deal volume:

◆ *For 2008 versus 2007*, the transaction volume for all middle-market deals less than \$500 million was down 17%. Transaction volume for health care services for the same period was down only 7%.

◆ *For second-quarter 2009 versus first-quarter 2009*, the transaction volume for all middle-market deals less than \$500 million was up 9%. Health care services transaction volume for the same period increased 33%.

But if it's not the economy that's having the biggest impact on health care, then what is it? Health reform, Braff maintains. He points out that first-quarter 2009 versus fourth-quarter 2008 transaction volume for all middle-market deals less than \$500 million was down 21%. Health care service transaction volume for the same period was down 27%. President Obama released his fiscal 2010 budget in the first quarter of this year, which "began an enormous focus of discussion on health care reform," says Braff. When any talk of health reform is first mentioned, he says, companies panic because they are convinced the sky is falling. And although the economy may have improved a bit from the first quarter to the second this year, the main reason for the boost in transaction volume is because companies have had a little bit of time to consider potential health care changes and to realize that they can manage whatever lies ahead, he says.

Because there is a smaller subset of deal flow within the pharmacy sector, it may be difficult to tease out trends there, says Braff. Still, there are industry-specific factors impacting M&A activity. The decline of private-equity activity overall "had a disproportionate effect on pharmacy than on other sectors we track," he says. This is because "private-equity activity in pharmacy is disproportionately higher than private-equity activity seen in any other sector we track." Private-equity acquisitions of pharmacy firms started to pick up in 2006, boomed in 2007 and slowed a bit in 2008 (*SPN 11/07, p. 5*). "Their withdrawal from the acquisitions market has had a downward pull on pharmacy," he says.

Braff also suggests not underestimating the role that the psychological mood of buyers plays in M&A activity. With many other sectors suffering greatly during the economic downturn, some buyers in the pharmacy market may be taking a cue from those industries and slowing their activity.

Also, a lot of transactions within specialty pharmacy and institutional pharmacy have tended to be large transactions of more than \$50 million. But "a heightened sense of anxiety and risk has skewed M&A activity to smaller transactions," says Braff. Companies are still making deals, but "they don't want their bets to be as big" as they might have been in the past. Because specialty pharmacies and institutional pharmacies tend to be fairly large companies, "if people are staying away from larger transactions regardless of industry," then specialty pharmacies and institutional pharmacies will suffer, he explains. There was one specialty pharmacy transaction in the first half of this year that The Braff Group has identified — Riordan, Lewis & Haden acquired The Apothecary Shops in April. That deal was noteworthy not only because it was for a specialty pharmacy but also because the buyer is a private-equity firm, Braff says. He adds that although his company works hard to identify transactions, there may have been other deals that it has not yet identified.

How Might Reform Issues Impact Pharmacy?

So what might the future hold for M&A activity within the pharmacy sector?

"It's not clear how issues around health care reform will affect pharmacy providers," says Braff. Nevertheless, there are a few areas of speculation. Because Medicare does not provide a big portion of these companies' reimbursement, Medicare reform will not have a big impact, he says. And insurance reform could mean that more people are insured, which is potentially good for the firms. But the downside is that "it's unclear what reimbursement will look like," he adds. However, it almost doesn't matter if any health care reform is passed or not — "the market builds in worse expectations than what will happen," he says. "It would be unlikely to me that the worst of what has been put out there is what happens." And if no health reform occurs, then most likely it would be another two or four years before the issue comes up again, according to Braff.

A couple of quarters of economic stability for all buyers would be a boost of confidence to companies in the pharmacy sector, says Braff. "Noise about the

economy and reform has them spooked," he says. "They need to see quarter after quarter of improvements in the economy." Beyond indications that the economy is coming back, "any relaxation of credit will bring private equity back into play," he adds. And, says Braff, the reluctance to make larger transactions will lessen as buyers become more confident.

According to Braff, some non-private-equity buyers within the pharmacy sector have complained that they want to buy but that there is no supply of potential acquisitions. He sees two reasons for this. "The pharmacy services arena in general is much, much smaller now," notes Braff. "It went through a tremendous amount of M&A activity from 2002, 2003 to 2008. There's a shortage of property out there. In relatively small segments when there has been a run-up of activity, there can be a shortage of properties available. We've seen this happen in the hospice arena." In addition, "there is the notion that if you're running a profitable, growing pharmacy, and the economy is not looking that exciting, there is no question that there is external downward pressure on valuations," he says. "So where are you going to go if you're not ready to retire? People who might be would-be sellers are holding on" to their properties because there is a general sense that it's not a good time to sell. But, he adds, the decision is really an individual one that depends on a person's own goals and objectives.

"We would anticipate that activity will continue to rebound...to tick back upwards as we go through the end of 2009 and into 2010," says Braff. "Is it going to be spiked up like in 2006 and 2007? No, I don't think so. It will be a while before we see unbridled enthusiasm, companies flush with cash and really no worries about health care reform." For 2010 and 2011, he projects "there will be valuable opportunities for highly valued pricing."

And even now, he notes, deals still are getting done. By the midpoint of 2008, The Braff Group had done 118 deals, compared with 84 for the first half of 2009. The first quarter of this year dragged the total down, he says, "but the reality is there have been 84 deals. Deals are getting done — this is not a pittance." His company also has tracked eight transactions in the overall pharmacy sector for the first half of this year. That's down from 13 deals for the first half of 2008. "This is a significant drop, but there are still transactions happening...We're still very bullish on pharmacy and health care services in general. All the economic reasons for doing M&A are still there."

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