

Health Care Outlook 2008

An industry veteran provides a holistic view of the health care market, its trends and areas for potential M&A deal flow.

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Frost & Sullivan reports that the U.S. high-acuity care information systems market will grow at a healthy compound annual growth rate of 12.5 percent through the year 2012. According to Irving Levin Associated, Inc., publisher of *The Dealmakers Forum*, there were 991 health care merger-and-acquisition (M&A) deals in 2006 with 471 of those in the health care technology segment. In 2007, there were 1,051 deals announced, a 4 percent increase over 2006 and the highest volume since 2003.

From the perspective of my firm, Virtual CDO, the number of deals will continue to rise as the industry continues to consolidate. However, barring any unexpected market hiccups, the total dollar amount per transaction may decline. We believe that there are too many mega-HIS players and too many niche applications, so the HIT industry is ripe for consolidation. In 2007, we saw a fair amount of consolidation among pharmaceutical, hospital and managed care companies.

Hot segments

We expect the following HIT market segments to be active during the remainder of 2008:

- Wellness/disease management
- BioMed - DNA profiling
- Consumerism
- Surge planning/emergency preparedness
- Local integration/RHIO
- Financial dashboards
- PFP management systems
- Data mining and management
- Staff optimization
- TeleHealth and remote monitoring
- Performance management tools

We also expect the following service areas to be active throughout 2008:

- Ambulatory/outpatient services such as diagnostic labs, respiratory (sleep and DME), rehabilitation, hospice and home health
- Retail clinics and services
- Outsourcing and staffing services
- HSA financial management
- Retail disease management
- Case management
- LTAC/SNF/assisted living

Activity will be driven by the following technology areas:

- Best-of-breed vs. one-size-fits-all
- Integration vs. interfacing
- Language management
- Access management
- Real-time data and decision support

We'll be watching the following buyer categories:

- Financial buyers -- private equity groups and REITs
- Strategic buyers
- International buyers (due to the falling value of the dollar)
- U.S. buyers (due to the rising value of the dollar relative to foreign currency)

And we've noted the following areas of investment concern:

- Credit market hangover
- Presidential election year uncertainties
- Falling value of the U.S. dollar
- Capital gains rate (will it remain at the historically low 15 percent?)

Segment liquidity

Software, biotech, medical devices, health and IT services continue to top the investment lists as detailed in the recent PwC/MoneyTree survey. Most investors require a planned liquidity event before making an investment. Since many of the companies supporting the health care segment are privately held, we expect continued M&A deal flow within the segment. As a medium-term strategy, many of today's investments could liquidate over the next 8-12 quarters.

Healthcare and technology spending

According to Forrester research, in previous years the gross national product (GNP) growth fell between the range of 2 to 3.5 percent. More recently, GNP growth fell to 0.6 percent. That said, Forrester has cut IT spending forecasts for 2008, from 8 percent to five percent. National health expenditures, as a percentage of GDP, are expected to rise to 19.6 percent by 2016. According to HFMA's *Healthcare Finance Outlook*, the two most significant factors over the next 3 to 5 years are the increasing costs of capital and the threatened tax-exempt status of most not-for-profit US hospitals.

Politics

The upcoming presidential elections are causing some uncertainty within the M&A community as well as most industry sub-segments that are heavily regulated or reliant on continued funding by the Department of Health and Human Services and/or the Centers for Medicare and Medicaid Services.

Workforce optimization

Clinical workforce shortages will continue to stimulate the need for efficient processes, workforce automation and marriages with local universities to increase clinical rotations. According to a recent study, U.S. nursing schools turned away over 40,000 qualified applicants from baccalaureate and graduate nursing programs in 2006 due to an insufficient number of faculty, clinical sites, classroom space, clinical preceptors and budget constraints. According to *Healthcare Financial Management* magazine, there is an increased connection between nursing and finance. Although smaller than the currently expanding nursing shortage, there is a shortage of qualified pharmacists due to the growing demand created by the boom in retail outlets. According to the Convenient Care Association, the number of retail clinics will grow from 500 in 2007 to nearly 700 in the first quarter of 2008. The U.S. health care consumer seems to favor the extended hours and no-appointment-necessary approach to low-acuity care. Similarly, insurance companies support the use of retail clinics given the lower reimbursements as compared to similar care provided in higher acuity settings.

According to the U.S. Bureau of Labor Statistics, the number of new jobs created in nursing totals 703,000 during a recent 10-year period. The U.S. temporary health care staffing industry is projected to reach 12 billion in revenue this year. Some of the drivers are the aging population of nursing professionals, legislation surrounding nurse staffing levels, hospitals' willingness to outsource and nursing's desire for job flexibility. During times of shortages, workforce optimization tools will become key to better utilizing the existing workforce.

DNA to the rescue

The industry clinical targets haven't changed dramatically since 2007. Aging populations and chronic diseases such as obesity, diabetes, COPD and others top the lists of having the most potential impact on the health (and therefore costs) of our nation. The HIT industry must make the mental shift from reactive, symptom-based care, to predictive and genetic-based proactive care. A growing knowledgebase of biomarkers influence a disease long before we need to react to an N-Stage condition. Some companies are exploring DNA-driven predictive modeling for preventative care.

Stimulating improvement

Pay-for-performance (PFP) remains a hotly contested sector. The notion of paying bonuses to physicians for certain activities seems counter to the larger movement of consumer-centered health care. PFP has worked well in most industries. One could argue that a clinician should only get paid for doing the correct procedure and the topic of bonuses should only be triggered on

exceptional clinical outcomes. The focus should be on decreasing avoidable procedures, complications, re-admissions, total ownership of patient outcomes and shifting from clinical best practices to better or even world-class practices. If a clinician provides the wrong care, then the industry should shift away from bonus reductions to penalties, full/partial license revocation and/or credentials management. Many providers are deploying scorecards that balance clinical efficiencies, outcomes, patient/family satisfaction and revenue, as a bridge from the new PFP approach and the time-tested sales compensation models of motivation.

PFP and the need for transparency seem to be coupled. PFP programs are expected to grow from 140 in 2007 to over 160 in 2008. Recent analysis done by Premier Inc. and CMS, demonstrate that using financial incentives to reward better quality of patient care avoids complications for the patients. However, PricewaterhouseCoopers (PwC) recently scored U.S.-based PFP programs with an "incomplete" rating. To succeed, PwC suggested that the industry must first agree on a universal set of quality measures. Without such measures, we will never align the priorities of all the health stakeholders.

As CMC continues to trickle out PFP incentives for small/medium-sized primary-care practices to adopt EHRs, this same population of businesses are being sold at a feverish rate. In fact, over the last year, Levin Associates details a 28 percent jump in physician medical group M&A transactions. According to a recent HealthLeaders Fact File, some health care practitioners have questioned whether bonuses and pay incentives are appropriate in medicine, where patient care and adherence to the Hippocratic oath should trump financial concerns.

Finally, a growing body of research and publications support the quality-based payment approach as a savvy next step for PFP. Value-driven health care uses standard quality measures and available transparent pricing, which provides consumers with the ability to make informed health decisions. In order to support PFP initiatives, CIOs across America are being asked to implement systems that satisfy requirements of coupling clinical outcomes to actual reimbursements. A recent survey suggests that CIOs' priorities are now focused on reimbursement, performance metrics and security. It wasn't that long ago that security was No. 1 on the list.

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Consumerism

Managed care is collapsing and driving the new consumer/patient-driven health care model. Hopefully, consumer-centered health care, via its enabler health savings accounts (HSAs), will eliminate the need for PFP. HSAs coupled with cost and quality transparency will arm the patient with the tools to make competitive decisions about their own health. HSAs should change purchase patterns from the current hospital-centered decisions, to primary care providers (PCPs), to specialists in retail outlets located in malls for routine procedures. HSAs will also drive down prices of routine procedures via comparison-shopping and the inevitable competitive pricing.

HRA/HSA financial management services will soon be offered by most financial institutions. The HRA/HSA trend is expected to significantly alter the existing business-to-consumer market. Health Savings Accounts (HSAs) continue to gain momentum in the U.S. largely due to increased consumer awareness triggered by many initiatives including the daily campaign speeches of most presidential candidates. Research suggests that well over 30 million Americans will use HSAs by 2010. According to a recent Harris Interactive report, approximately 117 million U.S. adults use Web tools to research health information and half of them talk to their doctor about their online research.

Transparency

Healthcare consumers, advocacy groups and politicians will continue to push for cost and quality transparency. Personal benchmarking applications will augment transparency initiatives. This data will allow consumers to price-compare and perform their own price/quality analysis, as most do, with all other important decisions.

Insurance

Traditional insurance companies offering employee medical coverage will need to modify their existing product portfolios to include consumer-directed health plans (CDHPs), HSAs and other high-deductible catastrophic coverage. This move may drive down traditional sources of insurance company revenue. Over recent years, financial risk of providing care has shifted from the government and its intermediaries, to insurance companies, to physicians. Defined standards of care and automated protocol compliance will finally become policy within the payer community. Significant amounts of venture capital and private equity money is being poured into companies that automate the reimbursement from payers via an ASP model using artificial intelligence (AI). The technology automatically learns from each denial, updates the rules engine, and instantly provides the new rules engine to all of its subscribers.

Uninsured lives

The Census Bureau reports that there are 47 million uninsured Americans, up nearly 16 percent from last year. According to the Robert Wood Johnson Foundation, 6.6 million children were covered by State Children's Health Insurance Programs

(SCHIP) last year, but nearly 9 million more children remain uninsured. During the third quarter of 2007, the Senate passed a bill to reauthorize the program.

Regulatory reform

The recent exception clauses added to the Stark Laws including modifications for electronic prescribing and electronic health records (EHRs) will stimulate additional data-sharing between practice and hospital systems. Sarbanes-Oxley compliance will continue to hurt profits of publicly traded providers and increase compliance of not-for-profit (NFP) providers.

U.S. hospitals provide more than \$25 billion in uncompensated care annually. Given the 45 million uninsured patients in the U.S., federal regulation is expected to increase the growth rate of charity care. Acuity levels are rising. Year after year, hospitals are treating sicker patients. With increased regulation on the horizon, compliance tool companies will stimulate some M&A deal flow. New reimbursement rules will force hospitals to increase bed turnover, which will drive downstream care such as long-term acute care (LTAC), skilled nursing facility (SNF), home care and others, but U.S.-based clinical shortages will limit capacity.

Divergence away from hospitals

Through the 1990s health care was supposed to converge with managed care leading the charge. In 2007, health care is more segmented than ever. Specialists have flourished. Private practice and other downstream clinical businesses will continue to pull revenue away from the former hospital "mother ship." Doctors are no longer associated with a single health care facility. Some surgicenters are taking market share away from community hospitals, which has prompted some hospitals to build/buy surgicenters of their own.

Vendor's sales quotas are increasing at smaller targets such as doctor's offices and outpatient clinics. CMS is now funding part of the practice management system (PMS) proliferation via quality improvement organizations (QIOs) such as New York's I-Pro.

Sub-acute care

SNFs are adding facilities in many strategic markets and divesting of non-profitable/non-strategic business units. Given the tighter reimbursement environment, most businesses are driving operational efficiencies. Some are considering expansion of service lines, clinical programs, and complimentary offerings such as surgery, rehab and wound care. CMS projects that the U.S. home care industry will grow to a \$150 billion market segment by 2016, for a compound annual growth rate of 6.5 percent.

Ancillary care

Ancillary care, such as lab dialysis, rehab, DME and diagnostic imaging, is responsible for 16 percent of the total \$11.6 trillion annual health care costs. Within the ancillary market segment exists a highly fragmented provider base ready for consolidation.

Capital improvements

HIT spending will continue to rise. Emergency department (ED) visits will continue to rise but ED capacity will limit growth. Hospitals will continue to spend capital funds on facilities improvements, new buildings, mini-clinics, ED overhauls, and appearance projects such as new lobbies and third-party brand installations (e.g., Starbucks and McDonalds) to improve the patient experience. Women and children's care will continue to drive new investments into existing facilities. For-profit facilities will continue to fund capital improvements via the market. Not-for profit hospitals will be able to take advantage of the flat/inverted yield curve to further tap the debt market; however, the recent pause in the Fed Fund Rate will cause some deals to shift from debt to debt/equity mix structures.

Disease management

The management of chronic diseases such as mental health, diabetes, obesity, COPD, asthma, allergy and CHF will continue to drive revenue from hospitals, to outpatient clinics, to doctor offices, to retail (mall-based) health care. These diseases account for nearly 50 percent of all health care costs in the U.S. Insurance companies and employers are expected to offer incentives for healthier lifestyles and other wellness programs. Current disease management offerings will expand into retail settings. Horizontally integrated disease management (DM) programs are gaining significant momentum as multiple providers, across the continuum of care, join forces to manage the patient's plan of health. A study from the RAND Corporation found consistent evidence that DM programs can improve health care quality, increase disease control and reduce hospital admissions for patients with CHF. Disease management is a critical component to lowering overall health care costs.

Wellness

Industry momentum is shifting from a health system to a wellness system. According to MetLife's "Fifth Annual Employee Benefits Trend Study," employees are starting to promote wellness and prevention programs and some are beginning to offer health insurance credits for employees who follow wellness guidelines.

Pharmaceutical industry

The Leapfrog Group, the Agency for Healthcare Research and Quality, and others, will continue to focus on patient safety and medication administration due to reports of tens of thousands of annual deaths due to medication errors. Pharmaceutical companies will be required to manufacture pills in barcoded or RFID-enabled unit dose medication packaging. This will ultimately force robot companies, who currently take large pill bottles and convert them into unit-of-use packaging, to change business models.

Counterfeiting is a large pain point for the pharmaceutical companies. The use of RFID and other tracking technologies to scan an entire pallet of pills to determine its origin, contents, destination and potential tampering will lower theft and compliance. Consumer directed health care will ultimately lower sales of expensive brand drugs and increase sales of over-the-counter or generic equivalents. As mega-patents expire or continued legal pressures force changes in drug usage, we will also see increased licensed technology or full acquisitions of biotech companies by the larger pharmaceutical companies.

Retail care

The local drug store of yesteryear will continue to feel competitive pressure as the large chains continue to improve location, number of stores and service levels. The proliferation of retail-level mini-clinics will continue the erosion of local market share. Overall script writing volume is expected to increase, but margins are expected to decline due to automation, Internet sales and mail-order competition. Compliance systems that ensure the accuracy retail-completed orders will create some M&A deal flow.

Like other clinicians, retail pharmacists may be held accountable for patient outcomes and not simply putting pills in a bottle, a task that several companies have proven that robots are quite efficient at completing. Ironically, several of the pharmacy benefit manager (PBM) companies that administer drug delivery via retail pharmacies own mail-order houses. Since most chronic DM cases require long-term drug usage, most of the retail business will shift to the lower-cost mail-order companies that deliver supplies greater than 90 days.

At the retail health layer of elective procedures, key drivers include HSAs, flex spending and consumer financing options. As an example, TLC Vision expects to complete over 1.4 million refractive procedures this year.

Page 3**Data**

As national databases and benchmarking companies proliferate, the data companies will continue to acquire the smaller data providers, data acquisition firms and data analytics companies.

Hospice care

According to CMS, the number of hospital-based hospice units continues to grow year after year. However, the number of freestanding hospice facilities continues to grow at a double-digit rate.

Distant care

Larger traditional device companies will continue to develop and acquire advances in technology. Some smaller companies that make home monitoring devices will continue to stimulate market activity. Continued investment into the PACS space and the next wave of remote diagnostics/telemedicine venues will allow foreigners to access U.S. care and increase revenues to once-distant businesses. Broadband/fiber to the home and rural areas will increase access to expert care. Advancements in remote control will increase the use of robot care as recently highlighted on several mainstream TV programs. Tele-health and remote monitoring is expected to significantly reduce the cost of home/rural care for chronic illnesses/disease management. The Advanced Medical Technology Association reports that hospital admissions have reduced by 50 percent for severe respiratory patients and by 60 percent for CHF patients when monitored remotely.

Provider consolidation

Not-for-profit hospitals will increasingly rely on philanthropy from local investors, community-based donations as well as government, commercial and private research grants. Given the above-mentioned divergence, hospital M&A is expected to continue in the community markets as CMS reimbursement shifts away from traditional facilities to LTACs, SNFs, etc.

Buy-vs.-build decisions are being made daily in the assisted living market as the wave of baby boomers continue to retire. Consistent with the Levin Associates data, the Center for Studying Health System Change reports that the percentage of solo MD practices dropped from 41 percent in the mid-1990s to 32 percent in just 10 years later.

Health care communities

The number of health care community/social networking tools, are expected to increase, as boomers increase market liquidity and HSAs cross into mainstream consumerism.

In 2005, in the aftermath of Hurricane Katrina, well over 1 million patients lost their paper-based medical records forever. The

Katrina effect will continue to stimulate market activity as emergency preparedness and surge planning continue to secure mindshare of hospital CEOs and community leaders. Furthermore, the economic impact of a potential pandemic/bird flu will drive the increased need for new services, drugs and technology. According to data from the American Hospital Association's annual survey, the average number of ED visits is flattening as the total number of EDs is increasing.

Technical direction

Messaging, mobile information and instant access to data will continue to drive R&D, IT investments and M&A deal flow. Adoption of integrated real-time, evidence-based clinical decision-making is finally surpassing the initial market penetration phase. Large medical device companies will continue buying hospital information system/clinical information system (HIS/CIS) firms to balance their medical offerings. Within the HIS community, more consolidation is expected to occur. Interoperability (linking hospital, outpatient clinic, ambulatory, device and physician offices nationally) will continue to spark deal flow as some players struggle to keep up with evolving standards.

Staff, resource and patient scheduling systems will continue to stimulate deals. As detailed in a report from the RAND Corporation, the widespread adoption and proper implementation of HIT could result in an annual savings of more than \$77 billion. Given this technology platform, the addition of world-class evidence-based disease protocols will greatly improve patient outcomes.

Personal health records (PHRs) and smart card usage continue to make strides, but have not yet hit critical mass.

EMR/EHR penetration

A recent survey suggests that pediatricians are gaining significant momentum in implementing EMRs. However, solo MD practices still lag with only 3.5 percent penetration, while nearly one-third of larger practices have made the technology leap. In recent years, over 800 million outpatient visits were made to small MD practices, compared to over 110 million visits made to larger MD practices.

Case management

Demand for case management (CM) services in both the inpatient and outpatient settings will increase. Since CM services are not reimbursed under current reimbursement rules, most hospital CEOs limit their CM staff. This will change. CEOs should overstaff the CM department with MBA/MHA types that coordinate care, in partnership with emerging hospitalist positions and reimbursement management issues to maximize revenue and promote all services provided by the hospital and associated clinics. Current HIS systems do a poor job of meeting the needs of most CM departments.

Talent management

Recruitment of highly competent staff and development/retraining of existing staff will be key to the long-term growth of the industry. Tools that manage this portion of the human capital balance sheet will stimulate deal flow.

Supply-side management

In many cases, clinical managers are forced to manage supply-side relationships. Many hospitals are billion-dollar businesses, yet most of them do not have enterprise resource planning, just-in-time (JIT) inventory and vendor management solutions that manage the entire continuum of care and supporting logistics. Some vendors are deploying "smart shelf" technology that automatically detects product usage that triggers JIT medical supply chain replacement activity. Other vendors have developed electronic pedigree applications that track supplies through the entire manufacturing and distribution supply chain.

Disparity in the HIS community

HIS firms are continuing to heavily invest into their CPOE and medication administration record (MAR) offerings, which will continue to create deal flow with smaller companies that have nailed the workflow and process automation sequence. Kaiser's \$2 billion non-equity spending spree with Epic caused many within the HIS community to pause and wonder. Moreover, it created a swirl of activity around the free HIS offering offered by the U.S. government. VA hospitals, over the last decade, have developed a system called CPRS/Vista that is a fully functioning HIS with integrated CPOE, PACS, electronic prescribing with complete PM integration. The product is installed in hundreds of paperless facilities around the world, providing instant access to millions of VA patient records with complete interoperability. Since the software was developed using public funds, it is available for free. One has to wonder about hospital board decisions that approve an HIS installation that cost tens of millions of dollars and years to implement, when there are free options available.

National health, local integration

Regional health information organizations (RHIOs) are forming to facilitate the flow and access of medical information to distant clinicians for emergency and other telemedicine needs. To date, RHIOs have received their initial funding from several sources, but have no sustainable business models; however, the Bush Administration's 2014 health care plan and state projects like the \$1 billion HEALNY program are stimulating HIT funding. EMR usage is mandated by 2014 by the US government and 2010 by some states such as Arizona.

Financial dashboards

Financial information systems will continue to evolve as CFOs begin to abandon their green-bar reports and move to sophisticated, real-time, flexible and demand-generated dashboards, in order to run their businesses.

Quality

As Six Sigma and other "quality-de-jour" programs penetrate health care from other manufacturing sectors, quality-related software and service vendors will begin to look attractive to the HIS/CIS players already in the health care space.

Service companies

Outsourcing back-office service lines offshore to India and Ireland will continue to be a growing trend. However, the popularity of outsourcing administration, IT, revenue cycle and supply chain management will continue to be fueled by the large domestic service providers as well as niche and regional firms.

Overall, 2007 was a great year for health care. We believe that 2008 will be another extremely busy year for HIT-focused strategic coaches, mergers and acquisitions teams, their clients, and supporting legal, accounting and tax professionals.

Mr. Brennan, head coach at VirtualCDO, which specializes in engineering corporate growth, governance and M&A for health care companies. He has 20 years of experience in strategy, corporate / business development, sales and marketing management, and international business while deploying software, services and devices. He has successfully led two health care turn-around projects; founded several companies; led the acquisition or sale of numerous health care companies; managed the North American health care team at a Fortune 500 company, which successfully delivered more than 300 health care IT projects, led over 200 people in the U.S. Air Force; launched several mobile computing products; has been quoted in many trade publications; currently sits on the board of two technology/ services firms and has been awarded a U.S. Patent. To date, he has negotiated over 130 technology license and acquisition deals domestically and has worked on projects in Japan, Singapore, India, England, Germany, Austria, France and Poland. Mr. Brennan is a member of HIMSS, HFMA and is a Fellow of the American College of Healthcare Executives. You can reach him at Brennan@VirtualCDO.com or (631) 446-4400, ext. 501.

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