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## **Health Care Outlook**

**A holistic view of the market, its trends and areas for potential M&A deal flow.**

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What's the state of the health care information technology (HIT) market as we enter the second quarter of 2007? Frost and Sullivan predicts 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/acquisition (M&A) deals in 2006 with 471 of those in the HIT segment. We believe that the number of deals will rise as the industry continues to consolidate. However, barring any unexpected market developments, the total dollar amount per transaction may decline.

MidMarket Capital, a private investment banking and business broker firm, believes that there are too many "mega" HIS players and too many niche applications, so the HIT industry is ripe for consolidation.

The following sections highlight factors that are shaping the current environment.

### **Divergence away from the hospital**

Through the 1990s health care was supposed to converge, with managed care leading the way. Nevertheless, in 2007, health care is more segmented than ever. Specialists are flourishing. Private practice and other downstream clinical businesses continue to pull revenue away from formerly hospital-centric operations. Doctors are no longer associated with a single health care facility. Some surgicenters are taking market share away from community hospitals, prompting some hospitals to build/buy surgicenters of their own.

At the same time, vendors' sales quotas are increasing at smaller targets such as doctor's offices and outpatient clinics. The Center for Medicaid & Medicare Services (CMS) now funds part of the practice management system (PMS) proliferation via Quality Improvement Organizations (QIOs) such as New York's I-Pro.

### **National and local integration**

Regional health information organizations (RHIOs) 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 lack sustainable business models. However, the Bush administration's push for universal health record access and state projects such as the \$1 billion HEALNY program are stimulating HIT funding. Electronic medical record (EMR) usage is mandated by 2014 by the U.S. government and 2010 by some states such as Arizona.

### **Stimulating improvement**

Pay for performance (P4P) is the latest buzzword in the health care sector, but it may be providing the wrong motivation. The notion of paying bonuses to physicians for certain activities seems counter to the larger movement of consumer-centered care. While P4P works well in many industries, the true motivation with doctors in the clinical arena is not apparent.

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 to the new P4P approach from time-tested sales compensation models.

### **Consumerism**

Consumer-centered health care, via health savings accounts (HSAs), may eliminate the need for P4P. HSAs coupled with cost and quality transparency will arm patients with the tools to make competitive decisions about their own health. HSAs should change purchase patterns from hospital-centered decisions to primary care providers (PCPs) to specialists to 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.

On the consumer side, HSA management services will soon be offered by most financial institutions. The HSA trend is expected to significantly alter the existing business-to-consumer market.

### **Transparency**

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

### **Regulatory reform**

The recent exceptions 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. Additionally, Sarbanes Oxley compliance will continue to impact profits of publicly traded providers and increase compliance of not-for-profit (NFP) providers.

At the same time, 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 over year, hospitals are treating sicker patients. With increased regulation on the horizon (acuity-driven patient care, nurse-to-patient staffing ratios to name a few) 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 facilities (SNFs), home care and others, but U.S.-based clinical shortages will limit capacity.

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### **Capital improvements**

HIT spending will continue to rise. Emergency department (ED) visits will increase but ED capacity will limit growth. Hospitals will spend capital funds on facilities improvements, new buildings, mini-clinics, ED overhauls and "appearance" projects such as new lobbies and third-party brand installations such as Starbucks and McDonalds to improve the patient experience. Women and children's care drive new investments into existing facilities. For-profit organizations will fund capital improvements via the market. Meanwhile, NFP hospitals will take advantage of the flat/inverted yield curve to further tap the debt market (although the recent pause in the Fed Fund Rate will cause some deals to shift from debt to debt/equity mix structures).

### **Insurance**

Traditional insurance companies offering employee medical coverage will need to modify their existing product portfolios to include consumer-directed health plans, HSAs and other high-deductible catastrophic coverage. This move may drive down traditional sources of insurance company revenue. Over recent years, the 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 venture capital/private equity money is being poured into companies that automate reimbursement from payers via an ASP model. The technology automatically "learns" from each denial, updates the rules engine and instantly provides a new rules engine to all of its subscribers.

### **Pharmaceutical companies**

The Leapfrog Group, the Agency for Healthcare Research and Quality and others will focus on patient safety and medication administration. Pharmaceutical companies will be required to manufacture pills in barcoded or RFID-enabled unit-dose medication packaging. This will ultimately force a change in business model for companies

that currently take large pill bottles and convert them into unit-of-use packaging.

The use of RFID and other tracking technologies to scan medication pallets to determine origin, contents, destination and potential tampering will lower theft and help ensure compliance.

Consumer-directed health care will ultimately lower sales of expensive brand drugs and increase sales of over-the-counter or generic equivalents. As major patent expirations or continued legal pressure force change in drug usage, we will also see increased licensing of technology or full acquisitions of biotech companies by large pharmaceutical companies.

### **Retail pharmacies**

The local drug store of yesteryear will continue to feel competitive pressure as the large chains improve location, number of stores and service levels. The proliferation of retail level mini-clinics will erode local market share. Overall script-writing volume is expected to increase, but margins are expected to decline with automation, Internet sales and mail-order competition.

Compliance systems that ensure the accuracy of completed retail 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 robots are quite efficient at completing). Ironically, several of the pharmacy benefit manager companies that administer the delivery of drugs via retail pharmacies own mail-order houses. Since most chronic disease management cases require long-term drug usage, most of the retail business will shift to the lower cost mail-order companies that deliver greater than 90-day supplies.

### **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.

### **Distant care**

Larger traditional device companies will continue to develop and acquire advances in technology. Some smaller companies that make home monitoring devices will stimulate market activity. Continued investment into the picture archiving communication systems (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.

In addition, broadband/fiber to the home and rural areas will increase access to expert care. Advancements in remote control will increase the use of robotic care as recently highlighted on several mainstream TV programs.

### **Disease management**

The management of chronic diseases such as diabetes, obesity, COPD, asthma, allergy and CHF, as well as mental health disorders, will 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. Some companies are exploring DNA-driven predictive modeling for preventative care and patient profiling by insurance companies.

### **Provider consolidation**

NFP hospitals will increasingly rely on philanthropy from local investors and community-based donations as well as government, commercial and private research grants. Hospital M&A is expected to continue in the community markets as CMS reimbursement shift 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.

### **Health care communities**

The number of health care community tools is expected to increase as baby boomers increase market liquidity and HSAs cross into mainstream consumerism.

### **Emergency management**

Well over 1 million patients lost their paper-based medical records in the aftermath of Hurricanes Katrina and Rita in 2005. The "Katrina effect" will stimulate market activity as emergency preparedness and surge planning vie for the mindshare of hospital CEOs and community leaders.

Furthermore, the economic impact of a potential pandemic (e.g., bird flu) will drive the increased need for new services, drugs and technology.

### **Clinical shortages**

Clinical workforce shortages will stimulate the need for efficient processes, workforce automation and alliances with local universities to increase clinical rotations. According to a recent study, U.S. nursing schools turned away 41,683 qualified applicants from baccalaureate and graduate nursing programs in 2005 due to an insufficient number of faculty, clinical sites, classroom space, clinical preceptors and budget constraints.

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### **Technology development**

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 HIS/CIS firms to balance their medical offerings. Interoperability (linking hospital, outpatient clinics, ambulatory, device and physician offices nationally) will spark deal flow as some players struggle to keep up with evolving standards. Staff, resource and patient scheduling systems will stimulate deals.

### **Case management**

Demand for case management (CM) services in both 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-degreed professionals. CM staff will coordinate care, in partnership with emerging hospitalist positions and manage reimbursement 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 (ERP), 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, thereby triggering JIT medical supply chain replacement activity. Other vendors have developed applications that track supplies through the entire manufacturing and distribution supply chain.

### **Disparity in the HIS community**

HIS firms are continuing to heavily invest in their CPOE and medication administration record (MAR) offerings. Such investment will create deal flow with smaller companies that have refined the workflow and process automation sequence. Kaiser's \$2 billion non-equity spending spree with Epic created a swirl of activity around CPRS/Vista, a fully functioning HIS with integrated CPOE, PACS, electronic prescribing and PMS. The product is installed in hundreds of paperless facilities around the world providing instant access to millions of VA patient records. Since the software was developed using public funds, it is available for free.

### **Segment liquidity**

Software, biotech, medical devices, health and IT services continue to top the investment lists as detailed in a recent survey published by PwC/MoneyTree. 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.

### Financial dashboards

Financial information systems will continue to evolve as CFOs 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 programs penetrate health care from other 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

The outsourcing of back-office service lines offshore to India and Ireland will continue to grow. 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.

### A busy year

We believe that the remainder of 2007 will be extremely busy for HIT-focused strategic mergers and acquisitions teams, their clients and supporting legal, accounting and tax professionals.

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