



BASS BERRY  SIMS PLC

CENTERED TO DELIVER.

HEALTHCARE & LIFE SCIENCES M&A OUTLOOK





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METHODOLOGY

Bass, Berry & Sims PLC commissioned Mergermarket to interview 50 US-based corporate and private equity respondents in the healthcare and life sciences sectors to gain insight regarding their expectations about M&A activity in these sectors. All responses are anonymous and results are presented in aggregate.

FOREWORD

Bass, Berry & Sims PLC is pleased to present the *Healthcare & Life Sciences M&A Outlook*, a survey published in association with Mergermarket. Based on a series of interviews with healthcare and life sciences professionals and investors, this survey analyzes the expected trends in M&A as well as the factors that will be driving them in the coming months. Also, we provide a detailed forecast for specific subsectors within healthcare and life sciences.

The healthcare industry is ripe for mergers and acquisitions. As healthcare companies and providers consider the implications of the Affordable Care Act (ACA), the recovering economy and the demand for capital and IT improvements, many entities will look to mergers and acquisitions as a means to bolster their resources and further their integrated delivery models.

According to Mergermarket data, M&A activity in the US healthcare and life sciences sectors decreased year-over-year from 463 deals worth US\$124 billion in 2012, to 394 deals worth US\$97 billion in 2013. Four of the top five deals for 2013 were by biopharmaceutical companies, with one transaction between two hospital systems.

Our survey results indicate that we can expect increased deal activity, as an overwhelming majority of survey respondents believe that activity for both strategic and financial buyers will continue to rise in 2014, reversing last year's downward trend in transactions.



ANGELA HUMPHREYS, MEMBER,
BASS, BERRY & SIMS PLC

Our survey's predictions of active M&A are attributed in large part to implications of the ACA. Despite the initial setbacks in the implementation of the health insurance exchange marketplace, leaders in the industry agree that healthcare reform will put pressure on companies to do more, better, for less.

Providers are adjusting to or planning for value-based payment models, Medicare reimbursement cuts, readmission penalties, HITECH Act mandates, ACO development and many other factors. Moreover, companies in all subsectors of healthcare are facing changes and increased demands for efficiency and quality. As the implementation of the ACA continues, larger entities will be better positioned to leverage capital resources and a stronger infrastructure to benefit from the changing reimbursement and regulatory landscape. These factors point toward continued consolidation.

Our survey includes predictions for the remainder of 2014 and investigates the driving factors for M&A within specific subsectors of healthcare and life sciences. In addition to examining the impact of the ACA and other related regulations on the prospective buyer's appetite for M&A transactions, this survey examines expected motivators of M&A in specific industry subsectors and highlights the game changers that could alter the course of dealmaking this year and beyond.

BULLISH EXPECTATIONS

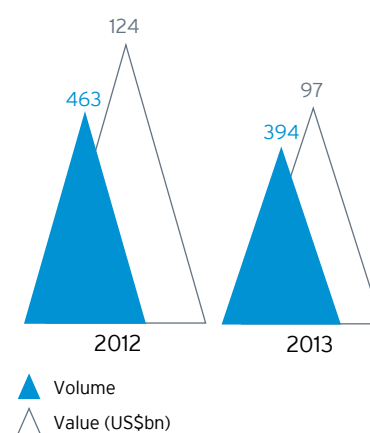
An overwhelming number of respondents believe that M&A in healthcare and life sciences will rise in 2014. This optimism defies the decrease seen in 2013. The decline witnessed during this period was partly due to the regulatory uncertainty stemming from the implementation of the ACA, which officially started enrollment on its health exchanges in October 2013. With improved clarity as to how the ACA will affect businesses and their customers, more healthcare and life sciences M&A activity is expected in the remainder of 2014 as companies seek growth in the face of a new industry paradigm.

“Companies are looking to consolidate to build infrastructure, get access to new technology and increase market share. Consolidation among mid-sized firms with a strong balance sheet will help them gain operational excellence and scale. M&A is a way for these companies to achieve growth strategies and meet new legislation provisions,” says a principal from a US-based private equity firm.

PRIVATE EQUITY

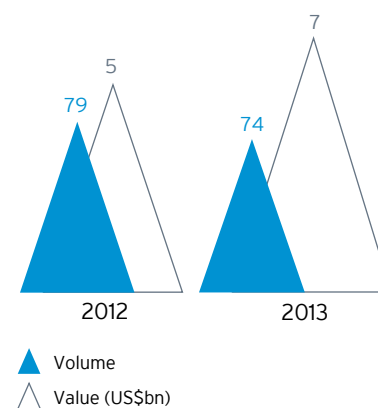
Overall volume in private equity buyouts decreased in 2013 versus 2012 to 74 deals from 79, but deal value increased significantly to US\$7 billion from US\$5 billion. There has traditionally been an 80-20 division in M&A activity between strategic and private equity buyers in the healthcare sector. However, respondents expect this ratio to change in favor of private equity over the coming months. In terms of the healthcare sector, 84% of respondents expect private equity activity to increase in relation to strategic M&A. Roughly two-thirds of respondents (66%) say the same of private equity activity in the life sciences space.

Overall M&A Activity in Healthcare and Life Sciences 2012-2013



Source: Mergermarket.com
Data as of May 29

Private Equity Buyout Activity in Healthcare and Life Sciences 2012-2013



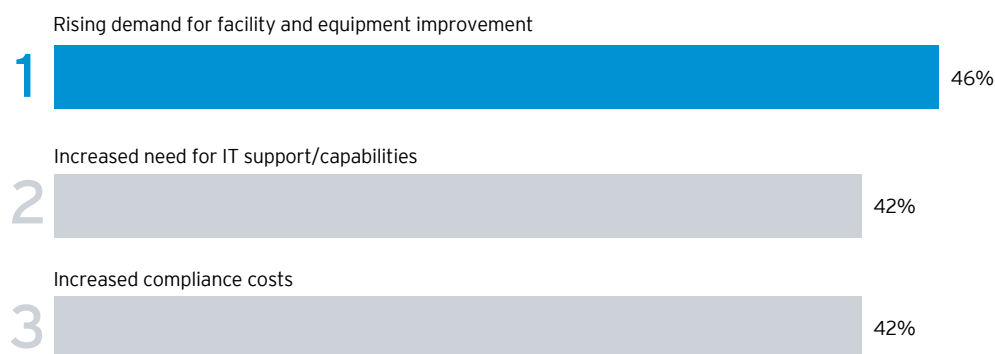
Source: Mergermarket.com
Data as of May 29

CONSOLIDATION IN HEALTHCARE



The rising demand for facility and equipment improvement is cited as a top strategic driver of M&A, according to **46%** of respondents. A large portion of respondents, **52%**, say long term care centers will feel the brunt of reimbursement cuts.

Top Strategic Drivers of Healthcare M&A



Although various factors are driving the anticipated rise in overall healthcare M&A, survey respondents identify three main deal drivers for the coming months: increased demand for facility and equipment improvement, the need for IT support/capabilities, and rising compliance costs.

Generally, increased regulation and competition have compelled healthcare companies to adopt advanced technology, carefully comply with government mandates and gather comprehensive data on patients.

As competition among healthcare providers intensifies, offering better facilities and equipment to patients becomes a differentiating factor and gives these companies a competitive edge over their peers. Moreover, since the ACA is largely based on a managed care delivery system in which providers typically receive a lump-sum payment for various services rendered instead of a fee-for-service model, healthcare companies are compelled to treat patients as effectively and quickly as possible to maximize profits. The push to develop more productive and cost-efficient systems can lead to increased M&A as healthcare payors search for value.

Respondents identify the need for IT support capabilities as a major strategic driver for M&A in the near term. In this vein, the Health Information Technology for Economic and Clinical Health Act (HITECH), which is part of the American Recovery and Reinvestment Act of 2009, requires healthcare providers and doctors to implement both electronic health records (EHR) and the Centers for Medicare & Medicaid Services' (CMS) meaningful use (MU) rule under which healthcare providers must demonstrate that they are making "meaningful use"

TOP DRIVERS OF HOSPITAL AND HEALTHCARE PROVIDER M&A:



ACCESS TO CAPITAL FOR INDEPENDENT HOSPITALS



SEEKING ECONOMIES OF SCALE/ COST-CUTTING MEASURES

**MOSTLY LIKELY TO
SEE CONSOLIDATION:**



**HOSPITALS AND
HEALTHCARE PROVIDERS**



HEALTHCARE IT AND SERVICES

of their certified EHR technology. The current focus is on the second stage of MU's implementation involving the use of technology in advanced clinical processes such as requirements that relate to electronic prescribing. The need for advanced information technology to implement these changes has driven healthcare companies to augment their IT capabilities through acquisitions.

Another factor that is expected to drive overall healthcare M&A is increasing compliance costs. One of the reasons for the mounting expenses is the rising utilization of EHR systems, which has pushed companies to overhaul their record-keeping processes while striving to maintain patient privacy. The significant number of patients added under the ACA will further exacerbate this problem. The Health Insurance Portability and Accountability Act (HIPAA)'s omnibus rule also became effective in 2013. Requirements under this new rule include providing patients with an electronic copy of their medical records. The rule also has new restrictions on the use of patient data for marketing. The HIPAA violations come with hefty fines so non-compliance will significantly increase costs for healthcare companies.

Within the healthcare sector, there are two types of companies that respondents rank as most likely to see consolidation: hospitals and healthcare providers, and healthcare IT and services.

“Consolidation is driven by a desire to achieve economies of scale and enhanced bargaining power. The Affordable Care Act’s roll out has accelerated this trend as the law demands accountable care and cutting edge technology at lower reimbursement rates.”



LEIGH WALTON, MEMBER,
BASS, BERRY & SIMS PLC

HOSPITALS AND HEALTHCARE PROVIDERS

Respondents believe that hospital and healthcare providers is one of the top two subsectors that will see the most consolidation. They say that the two major drivers for these mergers are access to capital for independent hospitals and the quest for economies of scale. One of the reasons why standalone hospitals feel the need to consolidate is the new reimbursement systems that favor clinical integration. Gaining economies and efficiencies of scale through consolidation helps hospitals cope with rising compliance costs and decreasing reimbursements from government programs. Providers will become more profitable if measures are taken to increase efficiency.

Increasingly, hospitals and health systems are considering consolidation with other hospitals. Due to pressure from the ACA and other related regulations, these companies now have to find ways to run more efficiently, cope with shifts in reimbursement policies and replace depleting inpatient revenues. Hospital systems also have to find growth areas by creating more diversified and far-reaching service platforms including expanding their capabilities in outpatient services. In this vein, there were two high-profile M&A deals in 2013 involving hospital/health systems - Community Health Systems' purchase of Health Management Associates for roughly US\$7billion and Tenet Healthcare Corp's purchase of Vanguard Healthcare Systems valued at US\$4.1billion.

Also on the rise are M&A deals involving retail clinics. The demand for these clinics is expected to increase along with the number of insured patients seeking more economical healthcare options. Many of these patients have to pay out of pocket before meeting their high deductibles. More hospitals are also expected to bring these clinics on as additional points of care as a way to respond to currently rising urgent care needs.

TOP HOSPITALS AND HEALTHCARE PROVIDER CONSOLIDATIONS:



HOSPITAL/
HEALTH SYSTEMS



RETAIL CLINICS

“Last year the government recovered nearly US\$3.8bn from civil cases involving fraud. Its continued focus on fraud and abuse enforcement, and lack of flexibility under such laws in the context of innovative payment models, such as accountable care, bundled payments, and other performance based payment methodologies are additional factors driving consolidation.”



DANIELLE SLOANE, MEMBER, BASS, BERRY & SIMS PLC

REGULATORY CHANGE WITH MOST IMPACT ON HEALTHCARE:



CUT IN MEDICAID AND MEDICARE PAYMENTS TO CERTAIN HOSPITALS AND OTHER HEALTHCARE PROVIDERS

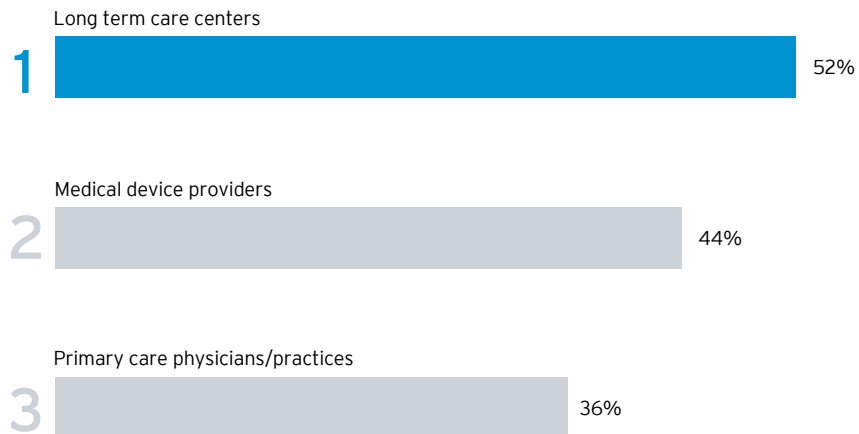
THIS WILL CAUSE: PROVIDER CONSOLIDATION MORE ALLIANCES

REGULATION'S ROLE IN HEALTHCARE M&A

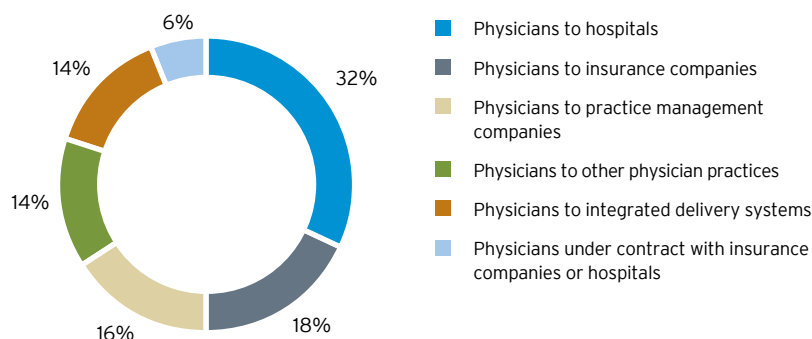
Regulation plays a key role in M&A activity within healthcare. Reimbursement cuts from government programs that determine the viability of hospital and other healthcare providers have been particularly impactful, causing companies to join forces in order to offset reimbursement-related revenue decline. Over a quarter of respondents choose Medicare and Medicaid reimbursement cuts as the regulatory change that will most impact the healthcare industry. These cuts are expected to prompt the greatest increase in certain types of healthcare M&A; respondents believe alliances and provider consolidation will be the most common transactions spurred by changes in healthcare legislation in the remainder of 2014.

Not all healthcare providers will be affected equally, however. Long term care centers will feel the brunt of the effects of the reimbursement cuts, according to the majority of respondents. Cuts in Medicare and Medicaid reimbursement to long term care centers that rely on government funding have hit the industry hard, especially given the rising demand from aging baby boomers and increasing costs of care that have left older individuals unable to pay for their own care out of pocket.

What businesses will feel the brunt of reimbursement reductions?



Areas where physician consolidation is expected to happen:



PHYSICIAN GROUPS

Twenty percent of respondents say physician groups will be a top area of consolidation. This consolidation is most likely to occur with hospitals and insurance companies, according to 32% and 18% of respondents, respectively. Mergers can serve as a good avenue for physician groups trying to upgrade their business models. It is important for these companies to have enhanced IT capabilities and efficient systems to coordinate care as the industry moves toward risk-based contracts and these groups deal with the changes to CMS reimbursement policies. Merging care coordination capabilities removes the need for physician groups to spend money on these improvements and allows the merged entity to fully utilize the coordination of their resources.

Respondents expect most physician group consolidation to occur with hospitals and insurance companies. Hospitals, which possess a more solid organizational structure and significant resources that smaller physician groups do not have, are consolidating with physician groups as a way to more closely integrate care coordination. Meanwhile, the second most common merger is with insurance companies. While physician groups need the capital to improve their technological and clinical capabilities, insurance companies will be able to gain additional points of care for their members and have control over referrals through these mergers.

Cardiology and dermatology are specialties most likely to see the greatest number of consolidations. Although both types of survey respondents agree on the top two areas, more corporate respondents pick dermatology while more private equity respondents choose cardiology.

20% of respondents say physician groups will be a top area of consolidation over the next 12 months

THIS WILL OCCUR MOST BETWEEN:



PHYSICIANS AND HOSPITALS

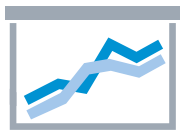


PHYSICIANS AND INSURANCE COMPANIES

TOP HEALTHCARE SERVICE AREAS FOR CONSOLIDATION:



HEALTHCARE HARDWARE AND SOFTWARE

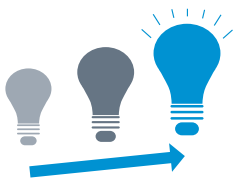


DATA ANALYTICS

TOP DRIVERS OF HEALTHCARE IT AND SERVICES M&A:



COMPANIES SECURING BUSINESS INTELLIGENCE AND DATA ANALYTICS TO PROMOTE CLINICAL WORKFLOW



VENDORS EXPANDING THEIR SOLUTIONS

HEALTHCARE IT AND SERVICES

Along with hospitals and healthcare providers, respondents expect healthcare IT to be the other top subsector to witness a spate of consolidation activity, much of which will center on patient information delivery and data storage. Healthcare providers are updating their services through improving their remote patient monitoring capabilities, complying with EHR requirements as well as developing mechanisms for real-time feedback. These technological advancements help in increasing the quality of care while also putting firms in a better position to manage the problem of diminishing resources. Technology vendors are also trying to boost their product offerings through acquisitions.

In this subsector, the top two areas of likely consolidation are hardware and software and data analytics. Respondents believe the greatest drivers of M&A in these spaces will be twofold: securing business intelligence and data analytics to promote clinical workflow as well as the increase in information sharing and interoperability. Data analytics also will be used increasingly to develop and measure quality metrics, which are key to accountable care.



Problems of escalating costs, which can partly be attributed to the uncoordinated way care is administered, have plagued the industry. The discord happens when patients consult with several doctors with no single repository for their records to keep track of procedures, resulting in redundant treatments and tests that add unnecessary expenses. A key regulation affecting healthcare IT is HITECH, which is striving for the “meaningful use” of electronic health records. HITECH ties payments to the actual improvements in patient outcomes by using medical records.

OTHER SUBSECTORS

Although respondents believe consolidation will occur predominantly among hospitals and healthcare providers and healthcare IT and services in the remainder of 2014, respondents also expect to see a fair share of M&A in other healthcare subsectors, including healthcare payors, disease management and preventive wellness and behavioral health.

In terms of healthcare payors, respondents name health maintenance organizations and healthcare service contractors as areas most likely to see an increase in M&A. Mergers in these segments will respond to the cost pressures and administrative burdens resulting from the ACA. Large insurers will buy regional companies for scale as well as customer base and product diversification.

Health food and alternative medicine manufacturers are the top areas of likely consolidation in the disease management and preventive wellness subsector. With heightened public awareness of the relationship between health and quality food products, acquirers are increasingly drawn to M&A in the health food and alternative medicine markets. Despite their low profits, buyers are attracted to these businesses because they cater to a growing health-conscious consumer base.

For behavioral health, more than a third of respondents pick outpatient behavioral health facilities as the most likely area of consolidation. Some politicians have talked about deficiencies in state-run mental health systems, which might present opportunities for growth in this subsector.

FURTHER AREAS OF CONSOLIDATION IN HEALTHCARE SUBSECTORS:



HEALTHCARE
PAYORS



DISEASE
MANAGEMENT
& PREVENTIVE
WELLNESS



BEHAVIORAL
HEALTH

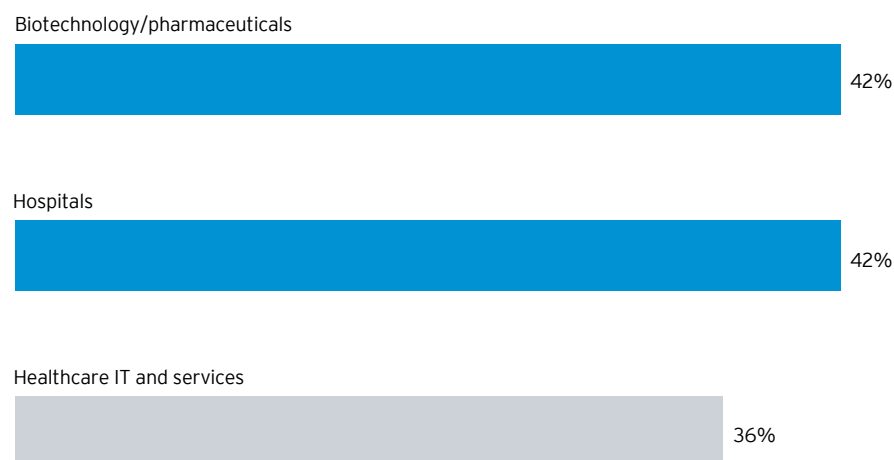
Respondents expect to see the most significant consolidation among bio/pharma businesses and generics/biosimilars firms as well as strategic mergers between biotech firms and between pharmaceutical firms. There is increasing interest in dealmaking in the generics sector specifically since branded generics companies are easier to acquire from a valuation standpoint and have more predictable cash flows. The large pharmaceutical companies have already experienced the majority of their patent cliffs and loss of exclusivities and will be focused on finding deals that offer new products or technology platforms. Large pharmaceutical firms are also going through a period of decreasing sales and limited organic growth opportunities, compelling them to resort to M&A. These companies have been plagued with lukewarm drug launches and the need to improve their R&D pipelines. Consolidation can help them address gaps in R&D development and achieve cost efficiencies aimed at boosting margins.

Along with hospitals, survey respondents think that biotechnology/pharmaceutical will be one of two subsectors in which private equity will be most interested. One of the key attractions to this segment is the ability of private equity firms to price the related risks, specifically on the more mature part of the pharmaceutical industry such as over-the-counter drugs, which offer predictable income flows.

**MOST COMMON DEAL TYPES
IN LIFE SCIENCES M&A:**



Private equity will be most interested in:



TOP DRIVERS OF MEDICAL DEVICE OR EQUIPMENT MANUFACTURERS/ SUPPLIERS M&A:

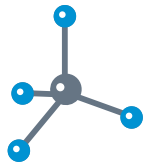


ACCESS TO NEW AND EMERGING MARKETS



ACCESS TO NEW PRODUCTS/ TECHNOLOGIES

TOP AREA OF CONSOLIDATION IN MEDICAL DEVICE OR EQUIPMENT MANUFACTURERS/ SUPPLIERS:



MEDICAL DEVICE SUPPLIERS/ DISTRIBUTORS

MEDICAL DEVICE OR EQUIPMENT MANUFACTURERS/ SUPPLIERS

For medical device or equipment manufacturers/suppliers, access to new and emerging markets is cited as the top driver of M&A followed by access to new products/technologies. There were also major deals in this area announced in 2014 including Zimmer Holdings’ roughly US\$13billion acquisition of Biomet, which combines two of the country’s major orthopedic medical device manufacturers and GE Healthcare’s roughly US\$1billion purchase of Thermo Fisher Scientific Inc’s gene modulation, HyClone cell culture and magnetic beads businesses.

Consolidation among medical device suppliers/distributors will be the most common deal type in the medical device or equipment manufacturers/suppliers subsector going forward, according to respondents.

One of the reasons for the expected activity in this subsector is the ACA’s expansion of the competitive bidding program for certain types of durable medical equipment. Under the program, medical device distributors have to compete for Medicare reimbursement contracts that CMS awards. The resulting pricing from the bidding process takes the place of the traditional fee schedule. The significant reductions in Medicare reimbursements due to these changes are expected to prompt industry consolidation as smaller suppliers struggle to remain competitive.



BIOTECHNOLOGY/PHARMACEUTICAL M&A

The leading drivers for M&A in this subsector are access to new and emerging markets and access to new drug pipelines/niche products. In 2013, there were a few key deals in this vein. Last year also saw the world's biggest biotech firm Amgen's roughly US\$9billion purchase of Onyx Pharmaceuticals, which gave Amgen full rights to a lucrative blood cancer drug. The most recent example is the joint bid of activist investor Bill Ackman and Valeant Pharmaceutical to purchase Botox manufacturer Allergan as a way to gain access to the profitable beauty treatment brand.

Aside from the "patent cliff" that was mentioned earlier, other factors are causing these companies to resort to M&A. The larger pharmaceutical companies are looking for smaller drug developers that are targeting specific diseases and population groups. For instance, the rising numbers of patients with chronic conditions have pushed companies to seek new medical and pharmaceutical advancements through acquisitions. The industry trend of restructuring R&D units is also expected to spur more acquisitions and divestitures in the next 12 months.

"The lack of R&D productivity and pricing pressures are resulting in M&A activity within the sector," a senior vice president in strategy says.



TOP DRIVERS OF BIOTECHNOLOGY/PHARMACEUTICAL M&A:



ACCESS TO NEW AND EMERGING MARKETS

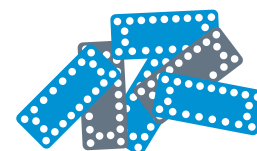


ACCESS TO NEW DRUG PIPELINES/NICHE PRODUCTS

TOP AREAS OF CONSOLIDATION IN BIOTECHNOLOGY/PHARMACEUTICAL:



BIOPHARM DEVELOPERS



DRUG MANUFACTURERS

CHALLENGES



72% of corporate respondents bought representations and warranties insurance versus **60%** of private equity respondents in 2013. In 2014, nearly **90%** of all respondents will purchase representations and warranties insurance.

“Healthcare entities and investors participating on both sides of M&A deals are increasingly purchasing representations and warranties insurance to supplement and/or replace customary escrows, and to aid in indemnification negotiations.”



RYAN THOMAS, MEMBER,
BASS, BERRY & SIMS PLC

While regulatory changes are a big M&A driver for healthcare, they also present challenges to players who are planning transactions. The top challenges in M&A deals in the healthcare and life sciences sectors are regulatory compliance, financial due diligence and antitrust issues, according to survey respondents. Respondents are split on whether self-disclosure to government agencies will increase in the coming months, which could potentially delay or derail M&A deals.

“With the passage of healthcare reform legislation, given the corresponding implementation regulations and increased scrutiny from both state and federal enforcement agencies, healthcare M&A has additional risks and pitfalls now,” a private equity principal says.

Healthcare reform has also resulted in a significant amount of oversight and enforcement by various government agencies including CMS and OIG. The added complexity brought on by new legislation makes due diligence harder given the number of factors in transactions that must be assessed. Aside from the usual financial and legal aspects of due diligence, in-depth due diligence must be undertaken with respect to regulatory and compliance issues.

With the ACA driving the collaboration between different healthcare companies and providers to achieve cost savings and scale, antitrust risks have escalated. The increased scrutiny from the Federal Trade Commission, which has won several rulings against hospital mergers, has caused companies planning healthcare M&A transactions to exercise caution to avoid the risk of violating any of these laws.

As a testament to the mounting challenges in healthcare dealmaking, coupled with a seller favorable trend in indemnification terms, more of this survey’s respondents will be purchasing representations and warranties insurance, rising to 88% in 2014 from 44% in 2013.

Due to the healthcare industry’s increasingly complicated regulatory regime, together with the active enforcement environment, deal parties benefit from obtaining representations and warranties insurance relating to the other parties’ compliance with healthcare regulations to bridge the gap in indemnification and risk allocation negotiations.

TOP CHALLENGES TO M&A DEALS IN HEALTHCARE AND LIFE SCIENCES:



REGULATORY COMPLIANCE



FINANCIAL DUE DILIGENCE



ANTITRUST ISSUES

“The Affordable Care Act’s population health model is forcing healthcare entities to shift focus from amount of care to quality of care and subsequently encouraging M&A as a means of integration. We are also seeing increasing openness to for-profit and not-for-profit consolidation as community systems face major facility and IT improvements and lower reimbursement.”



JIM JENKINS, CHAIR OF HEALTHCARE PRACTICE,
BASS, BERRY & SIMS PLC

Respondents mention several factors that can potentially alter the course of dealmaking in healthcare and life sciences in the remainder of 2014 and beyond.

Not surprisingly, many of them mention the economy as a driver that underpins overall industry growth. “Many healthcare and life sciences companies will be experiencing operating momentum as the economy recovers and the industry adopts technologies at unprecedented rates, shifting the momentum to positive in 2014,” says a principal at a private equity firm.

The ACA and related regulations are expected to transform the M&A landscape in the various subsectors of the industry, forcing companies to focus on a more integrated approach to patient care. As one private equity partner says, “I expect there to be an increase in M&A activity as companies strengthen their value proposition by transacting for scale, convergence, and to meet rolling ACA milestones.”

Another area that respondents cite is new technologies that can potentially alter dealmaking in these sectors. “Technologies related to mobile reach are some of the most innovative and sought-after ones, which will change the level of M&A in 2014,” a chief financial officer says. These drivers are gaining momentum from the purchasing power of cash-rich strategic and private equity buyers.

Other software innovations allowing remote or online access to physicians for consultation are gaining ground. These innovative approaches have become more popular since they are able to facilitate doctor-patient interactions. “Telecare and telehealth are emerging as a new innovative form of service, which even governments are endorsing. M&A activity targeting new innovations is always high and can make dealmaking different in 2014,” says a partner at a private equity firm.

A confluence of factors ranging from regulatory changes to technological advances will come into play in the various healthcare and life sciences sectors and alter the M&A dynamics.



DIVERSIFICATION MAY RECONCILE FLAT ADMISSIONS, DESIRE FOR INTEGRATION

ANGELA HUMPHREYS, MEMBER, BASS, BERRY & SIMS PLC
LEIGH WALTON, MEMBER, BASS, BERRY & SIMS PLC

In 2013, Community Health Systems announced the acquisition of Health Management Associates for \$7.6 billion, and Tenet Healthcare acquired Vanguard Health Systems for \$4.3 billion. It was the year of the blockbuster hospital system transaction. With some notable exceptions, 2014 may become the year of the bolt-on transaction as providers look towards same sector and cross sector acquisitions in select markets to enhance their existing service offerings.

This article will focus on trends impacting M&A transactions involving hospitals and health systems, ambulatory surgery centers, urgent care, hospice and home health, with particular emphasis on developing trends as health care providers move towards increased volume and increased acuity in the outpatient and post-acute settings.

HOSPITALS

While hospitals will continue to be at the center of healthcare M&A activity, we predict they will likely grow through market-driven strategic acquisitions and expansion of outpatient services rather than the mere addition of facilities based on a “numbers for numbers sake” approach. Although hospital companies predict that they will perhaps materially benefit from the ACA through increased revenues and a reduction in bad debt, the shift of care outside the acute care setting continues to intensify. Few hospitals reported year-over-year growth in overall admissions in 2013. This is the weakest growth in a decade, signaling that the era of “grow by growing admissions” may be over.

Instead, hospital companies will try to better position themselves in select markets through acquisitions or strategic alliances to gain economies of scale and widen their service offerings in response to drivers such as the bundling of payments for episodes of care, decreases in overall reimbursement and the need for enhanced technology and compliance capabilities. In addition to strategic acquisitions, hospital systems may buy or joint venture other service lines such as urgent care, hospice and home health. In addition, as the trend toward more

highly acute post-inpatient care continues, we may see the repurposing of large inpatient facilities over the next few years.

AMBULATORY SURGERY CENTERS

Operating in what most would characterize as a mature industry, ambulatory surgery center (ASC) companies are looking for continued opportunities for diversification in order to achieve growth. Large players are diversifying into areas such as anesthesia, physician practice management, outsourced hospital services, pharmacy, laboratory and other ancillary services. The most recent example is AmSurg’s acquisition of anesthesia provider Sheridan Healthcare, announced on May 29, 2014. Standalone ASCs and smaller ASC companies will continue to look to form joint ventures and strategic affiliations with hospitals to ensure participation in narrow networks. Whether through a joint venture of a standalone ASC or an outright acquisition and conversion of a surgery center into a hospital outpatient department, hospitals and health systems continue to be competitive with ASC management companies for transactions.

URGENT CARE

Although the urgent care space remains ripe for continued consolidation, M&A activity in this sector is trending toward smaller, strategic deals. Many investors in the initial platform companies have recently exited their investments, leaving little room for the current acquisition of companies of significant size. For deals on the horizon, expect new players to drive increased competition. Hospitals have targeted urgent care centers to divert patient traffic from the high cost ER setting. The result is increased competition from hospitals for urgent care transactions in certain markets. Urgent care companies, however, are increasingly seeking to join forces with hospitals and health systems to joint venture individual or multiple urgent care centers. Following the lead of HCA/TriStar and CareSpot, we are likely to see a new set of hospital and urgent care company joint ventures in the coming months.

In the absence of joint ownership, urgent care companies are looking to form strategic affiliations with hospitals and health systems as the preferred provider of an ER alternative solution. Urgent care companies are also augmenting their core service lines as a result of increased reimbursement pressures. Most notably, in response to concerns over upcoding, beginning in fiscal 2014, Medicare payments for outpatient clinic visits will be reimbursed at a single rate based on the statistical averages for the five levels of severity from 2012. With commercial payors expected to follow, urgent care companies are expanding into areas such as physical therapy, workers compensation and occupational health. These expansions will put added market pressure on small players trying to compete with limited resources and also may be likely to drive additional M&A activity.

HOSPICE

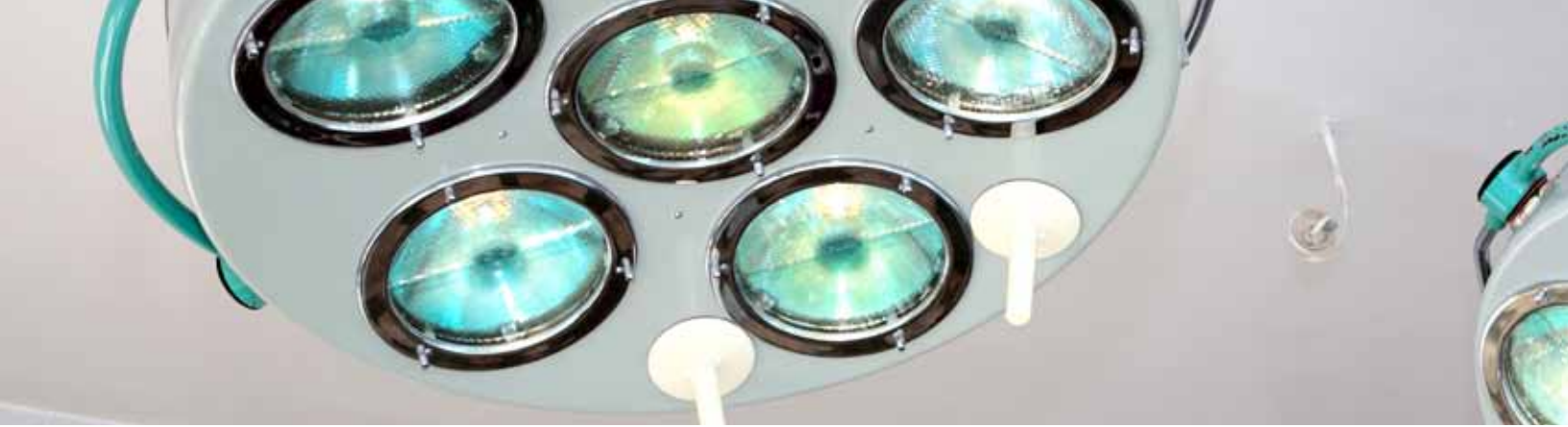
The rapid development of the for-profit hospice industry is consistent with the overall goal of enhancing the cost effective delivery of healthcare by providing care in the least acute setting possible and controlling costs for end of life care. With an aging U.S. population and essentially the entire cost of hospice care for individuals over 65 covered by Medicare, continued growth can be expected. Providers, including hospitals and health systems, are incorporating end of life care into their models, whether through direct ownership or the addition of hospice providers as participants in their accountable care organizations. Hospice care continues to be dominated by small, non-profit, community-based organizations, leaving the industry poised for further consolidation. We may be approaching a point at which smaller providers are having difficulty managing their businesses in a low-volume environment. Thus, the hospice industry will move towards fewer, larger providers. With hospice care being driven largely by relationships in local markets, acquisitions may prove to be a quicker, more effective means of accessing referral networks than de novo development.

HOME HEALTH

Home health has suffered more than its share of hard knocks in recent years. Nonetheless, it continues to play a valuable role in the overall healthcare delivery system. Although many analysts assert that we have seen the golden age of M&A activity in the home health industry, we believe consolidation should continue, although perhaps at a slower pace. First, the ownership of home health agencies remains fragmented with many smaller agencies operating at negative margins. Second, home health continues to be the low cost post-acute alternative. Third, overall spending in home health is expected to continue, with over 80% of home health services paid by Medicare and Medicaid. But, cuts in reimbursement and the implementation of care coordination and bundled payments leave the future uncertain for home health. Funding has been reduced by over 20% since 2009. Going forward, base rate reductions will be phased in over four years beginning in 2014 with the maximum cumulative reduction expected to be approximately 7%. All of these factors favor continued consolidation and larger players who can weather the reimbursement storm.

CONCLUSION

The implementation of the ACA is fully underway, and healthcare providers are seeking to further develop increased scale and integrated delivery models that will allow them to span the continuum of care in order to meet both reimbursement and regulatory changes dictated by the ACA. Hospitals also need to deal with flat admissions, so they may look to other service lines. ASCs and urgent care centers are likely to diversify their offerings to compete with hospitals and healthcare systems. Buyers are interested in hospice and home health because they are cost-effective providers, largely covered by Medicare, serving an expanding demographic and currently run by many small providers. Buyers will need to be cautious because of increasing fraud concerns in the hospice and home care sectors. Many predict higher acuity post-acute care to be a “big winner” as providers roll out these strategies.



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HEALTHCARE M&A ATTORNEYS

Scott Bell
Member
sbell@bassberry.com

J. Page Davidson
Member
pdavidson@bassberry.com

Kevin Douglas
Member
kdouglas@bassberry.com

B. Riney Green
Member
rgreen@bassberry.com

Michael Holley
Member
mholley@bassberry.com

Angela Humphreys
Member
ahumphreys@bassberry.com

J. James Jenkins, Jr.
Chair, Healthcare Practice
jjenkins@bassberry.com

Howard H. Lamar III
Member
hlamar@bassberry.com

Andrew L. McQueen
Member
amcqueen@bassberry.com

J. Allen Overby
Chair, Corporate & Securities Practice
aoverby@bassberry.com

Cynthia Y. Reisz
Member
creisz@bassberry.com

Danielle M. Sloane
Member
dsloane@bassberry.com

Ryan D. Thomas
Member
rthomas@bassberry.com

Leigh Walton
Member
lwalton@bassberry.com



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Part of The Mergermarket Group

www.mergermarketgroup.com

330 Hudson St. FL 4
New York, NY 10013
USA

t: +1 212.686.5606
f: +1 212.686.2664
sales.us@mergermarket.com

80 Strand
London
WC2R 0RL
United Kingdom

t: +44 (0)20 7059 6100
f: +44 (0)20 7059 6101
sales@mergermarket.com

Suite 2401-3
Grand Millennium Plaza
181 Queen's Road, Central
Hong Kong

t: +852 2158 9700
f: +852 2158 9701
sales.asia@mergermarket.com

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