

Representation and Warranty Insurance Continues to Support the Security and Stability of Healthcare M&A Dealmaking





Introduction

While the broader merger and acquisition environment has been challenged by geopolitical events, inflation, rising interest rates, tighter credit and regulatory uncertainty, the healthcare provider sector has shown relative resilience compared to other industries. Though wage inflation and resulting margin pressures have had a disproportionate impact on healthcare businesses in the post-COVID world, 2022 was the second most active year on record for healthcare private equity according to the [Bain & Company Global Healthcare Private Equity and M&A Report 2023.](#)

Healthcare is a dynamic industry with unique characteristics that support dealmaking in the provider and services sector. Not only is spending less discretionary, leading to a counter-cyclical and recession resistant industry, the long-term tailwinds underlying healthcare demand are an aging population and an increase in the incidence of chronic diseases. The industry continues to be highly fragmented despite the amount of consolidation that has taken place, supporting private equity's buy-and-build strategy to capture operational scale efficiencies and multiple arbitrages. The vertical integration of payors and providers to bend the cost curve with better patient care coordination and expand the continuum of care from the clinic to the home has also been supported by this environment. As a result, consolidation activity continues to occur across provider types, from physician practices to ancillary services, home health, hospice, and hospital networks.



Trends driving dealmaking

There has been a shift from traditional fee-for-service revenue models to value and risk-based care models to decrease the cost of patient care, especially with primary and chronic care providers. The Centers for Medicare & Medicaid Services has been pushing healthcare cost containment efforts and shifting patients away from traditional fee-for-services towards these models. In addition to traditional players such as commercial payors, private equity, and health systems, dealmaking under this trend has seen nontraditional players such as Amazon's acquisition of One Medical, CVS Health's acquisitions of Oak Street Health and Signify Health and Walgreens' investment in Village MD with acquisition of Summit Health-City MD, which has also helped drive the use of technology to improve patient care and decrease administrative costs. Investment in healthcare information technology (HCIT) is now critical to achieve cost efficiencies, coordinate patient care and maximize revenue. As a result, healthcare providers are investing in technology and data analytics to support these goals, driving deal activity across the HCIT landscape, including operations management, electronic health records (EHR) revenue cycle management (RCM), cybersecurity, and telehealth.

This landscape makes for a difficult deal environment, presenting dealmakers with the more challenging task of managing the risks inherent in the healthcare industry with long term goals and returns. While the strategic use of insurance capital to transfer risk away from buyers is being widely used in other industries, adoption has been slower in the healthcare space due to the historical challenges of insuring these types of transactions given the exposure to government payors and the resulting regulatory risk. However, the insurance market for these deals is now deeper and more robust. Insurers have stretched their risk appetite to cover representations and warranties within a healthcare deal due to the overall slowdown in M&A activity and the insurers' need to put capital to work. While year-end 2021 was one of the most challenging times for placing representations and warranties insurance on healthcare deals, those challenges abated in 2022 given the slowdown. In Q4 2021, carriers that underwrote healthcare transactions either ran out of capacity due to the number of healthcare transactions they underwrote or chose to underwrite targets in less risky industries given the record-breaking transaction volume.

Key Considerations in Healthcare Deals

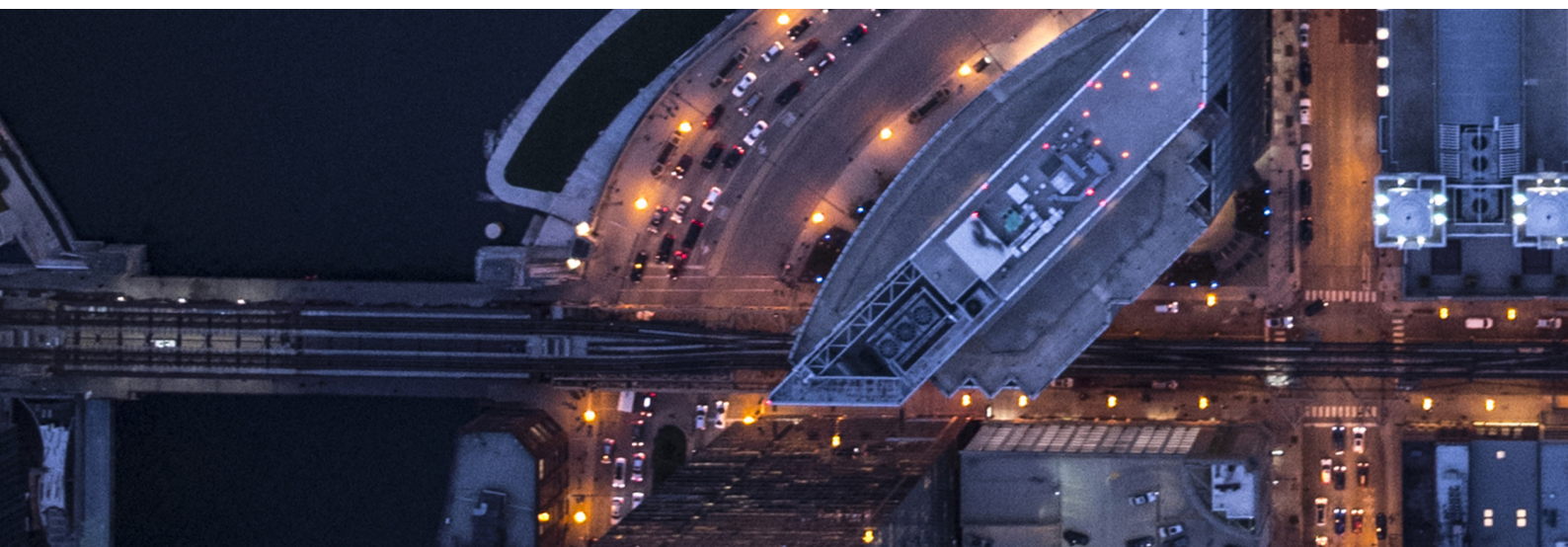
While a market exists for a broad range of healthcare deals, a specific carrier's interest will depend on a few factors, including:

- Type of healthcare provider or service
- Amount of government payor revenue
- Revenue model
- Size and scope of the operation
- Target's healthcare regulatory compliance history and infrastructure.

Specialist providers, such as ophthalmology, gastroenterology, dermatology, cardiology and other specialty physician practices and ancillary service providers, including urgent care, medical imaging, labs, and physical therapy are more attractive given the focused set of healthcare services. While still insurable, providers with a higher level of regulatory oversight, such as home health and hospice, are more challenging. Hospitals and health systems fall on the more challenging end of the spectrum given the number of services they provide. Value and risk-based models are also more challenging given the more unique financial and accounting aspects compared to standard fee-for-service revenue models.

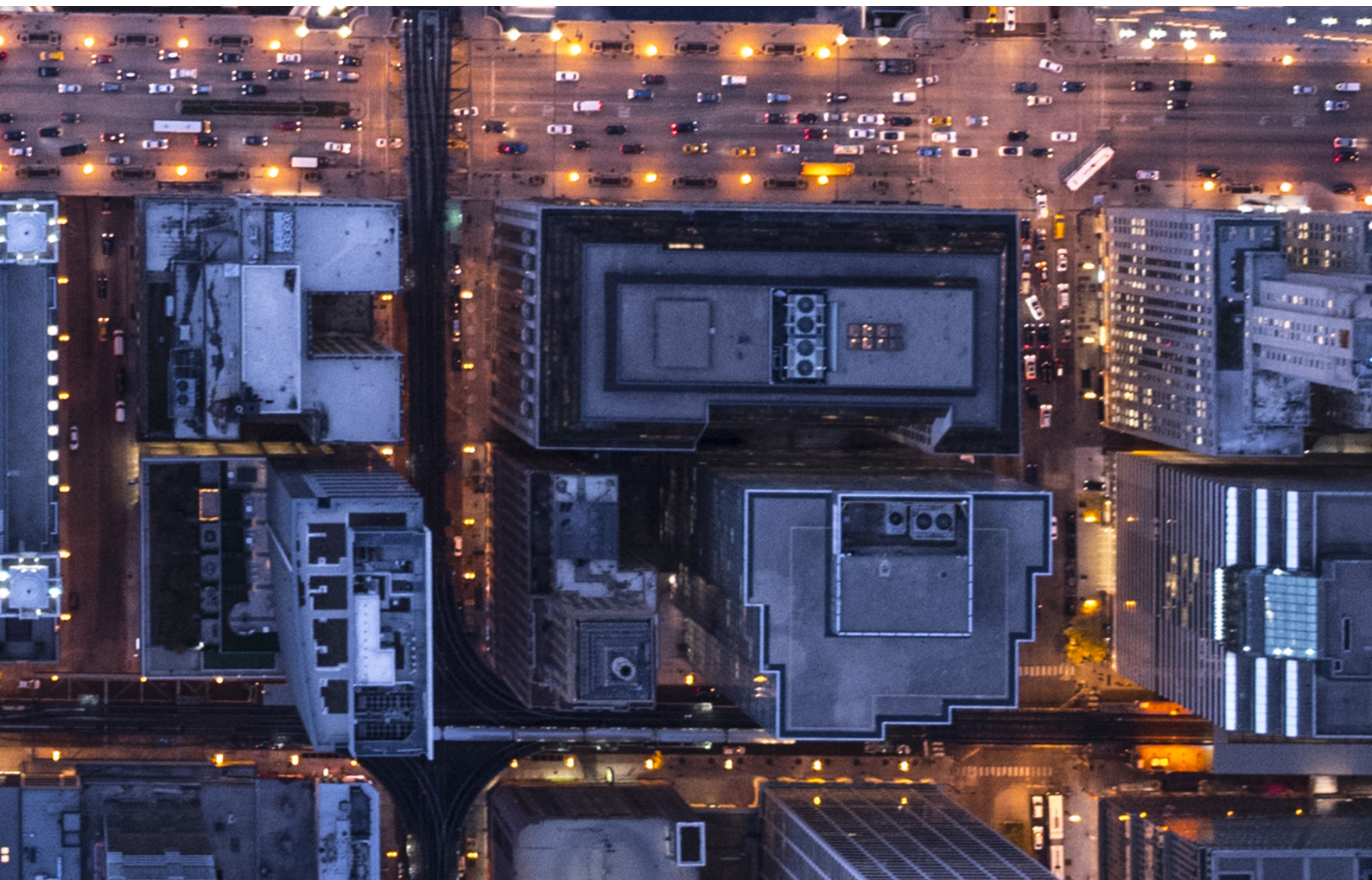
Buyers of healthcare provider businesses face a myriad of risks compared to other industries. The healthcare industry is highly regulated as a significant source of revenue for healthcare providers are government payor programs such as Medicare and Medicaid. For healthcare providers to treat these patients, they must adhere to multiple regulations including compliance with healthcare fraud and abuse laws, such as the False Claims Act and Anti-Kickback Statute, and adherence to government billing and coding requirements. Whistleblower and qui tam actions are also common in the healthcare industry given the government involvement.

In addition to the above regulatory risks, healthcare providers are exposed to cyber breaches and data privacy risks given the amount of patient data they manage and must comply with both general data privacy regulations and regulations protecting health information such as HIPAA. Adding to the risk landscape, the industry employs a number of independent contractors, leading to risks around employee classification and wage and hour matters. Accounting and financial risks vary across revenue models. Risk-based arrangements are more complicated from an accounting standpoint than the standard fee-for-service model.



These unique risks are in addition to the standard risks inherent in any acquisition such as historical financial performance and accounting, customers, suppliers, tax, litigation and environmental. The confluence of these risks makes healthcare provider transactions challenging. Dealmaking in this industry requires successful risk allocation for investment goals to be achieved post-closing. While comprehensive due diligence can mitigate risks by uncovering known risks, the way in which unknown risks associated with acquisitions are allocated and transferred needs to be considered. Representations and warranties insurance is a tool used to achieve successful risk transfer of unknown exposures. Shifting this risk allows parties to successfully negotiate and consummate a transaction while protecting both sellers and buyers against the unknown. Though representations and warranties insurance is no substitute for comprehensive due diligence, it provides an additional layer of protection against unanticipated complications that could materialize later on.

While healthcare transaction activity has decreased this year, the underlying industry dynamics continue to support deal-making and the industry is positively positioned for when the economic outlook clears. A diverse buyer universe, abundant dry powder, shifting business models, a fragmented industry and demographic tailwinds are factors underpinning this positive environment. The representations and warranties insurance market has proven resilient despite a downturn in M&A activity and has not seen significant carrier exits from the healthcare industry. Moreover, private equity activity in the industry should make these businesses more attractive upon exit as they bolster and formalize processes, further supporting the representations and warranties insurance market's interest in these deals. As carriers broaden their risk appetite and gain experience and expertise in underwriting healthcare transactions, representations and warranties insurance can continue to serve as a risk shifting and mitigation tool, and improve deal outcomes.





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