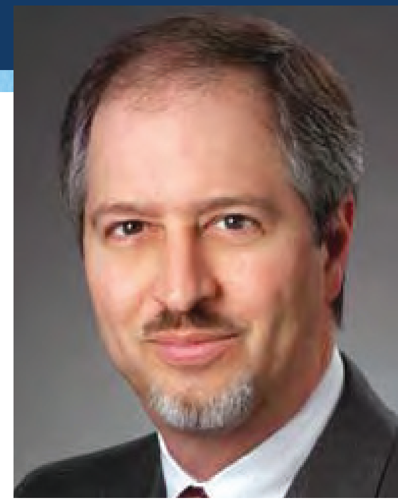
Lions and Tigers and Bears: Next Steps in the Consolidation of the California Market



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Following an intense period of physician group mergers and acquisitions in 2010-2011, we have continued to see significant physician group transactions since the May 2011 CAPG Annual Meeting. Given the continued consolidation activities of market leading payors and hospital systems and the likelihood of new entrants into the California coordinated care market, California physician groups would be well advised to think about the effect of these lions, tigers and bears on their strategic planning and prospects.

Recent Transactions

Significant California recent transactions since May 2011 include (buyer/seller):

- Anthem/CareMore
- Optum/Monarch
- Stanford University Health Alliance transactions with Bay Valley, Affinity and Alliance medical groups
- MemorialCare/Greater Newport Physicians

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Additionally, multiple medium and smaller IPA transactions have been consummated in the past year. We also are aware of multiple transactions in process currently and/or rumored which, if consummated, will place 2012 at or above the 2011 level of consolidation activity.

Transactions are being driven both by payor and hospital system interest in alignment with physician groups. In addition to current active hospital systems like MemorialCare (which completed transactions with Greater Newport Physicians and Bristol Park) and Providence (whose recent physician affiliation offering was heavily oversubscribed) , it appears that other larger systems such as Dignity (formerly Catholic Healthcare West) and Tenet may be considering new physician alignment opportunities, and Hoag recently announced its new medical foundation initiative. Interesting experiments also are being tried, such as hospital system AHMC's recent purchase of Medicare Advantage plan Central Health, together with two IPAs and a management company.

On the payor side, Optum (an affiliate of United Healthcare) has completed six physician transactions in California, with the most recent transaction being with Monarch in Orange County. While the transaction terms have not been publicly disclosed, it is rumored that the valuation was high (perhaps at or above 10x EBITDA) in consideration of Monarch's large physician network throughout most of Orange County, its restricted Knox-Keene license and its positioning for healthcare reform.

Payor reaction to the Optum/Monarch transaction has been strong, with at least one payor in the process of contract terminations and member transfers. Blue Shield recently filed an arbitration proceeding against Monarch for damages in excess of $10 million for breach of contract and other claims, which complaint makes for interesting reading. Additionally, it has been discussed that similar contracting actions are being taken against other entities managed by or affiliated with Optum. We also have seen multiple payors amending their physician group contracts to allow for greater payor rights in the event of a group being acquired by or strategically affiliated with another payor. Physician groups considering payor alignment

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strategies, in light of these recent actions, must now additionally consider adverse payor reactions and negotiate appropriate protections for their physicians.

The Outlook for Valuation

Transaction pricing in 2011 and early 2012 has remained at least at the level of 2010-2011, with some upside outliers as well which may exceed 12x EBITDA. Traditionally, physician group pricing in the managed care sector has seen a historic range of 4-6x EBITDA, with more recent transactions in 2011 and 2012 being priced at least at 6x EBITDA. According to published research reports, the 2011 Anthem purchase of CareMore was priced at an 8.9x EBITDA multiple. Interestingly, such higher multiples currently appear not to be followed by traditional strategic purchasers but are routinely being paid by hospital foundations and other newer market entrants.

Is this a price bubble? While some would say yes, there appear to be an increasing number of competing purchasers who need to align with physicians in specific geographic markets or who need access to sophisticated coordinated care/managed care experience and systems. Such purchasers not only are based in the California market, but also increasingly may include entities that are national or regional and who require population health management expertise as a mission critical skill for their success and survival. They have a "build or buy" decision to make. Add to this the large amount of healthcare focused private equity funds that must deploy capital, and it is our view that, given the finite number of California physician groups of scale, valuation will remain at these higher (or even increased) levels, with individual variability for size, location, membership/payor mix and other factors. Even if there is an adverse determination for the constitutionality of the Affordable Care Act, it appears clear at this time that cost control and quality improvement will be core skills in the next ten years for any healthcare industry participant and will continue to highlight the importance of California physician groups.

Five Other Trends to Watch...

1 *Will growth of narrow networks force more groups to choose to sell or affiliate?*

2 *What alternatives to acquisition will California payors choose for greater physician engagement?*

3 *Accountable care networks (new IPAs) are forming- will they be able to be independent?*

4 *Is there a large-scale national/regional branding opportunity for a coordinated care group?*

5 *Effect of continuing payor consolidation and Humana's recent commitment to California?*

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