Riding the next wave of payor M&A

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Executive summary

Regulatory changes and economic recession have disrupted the US healthcare industry, threatening to erode the advantages of market leaders. These forces have intensified several industry trends: the rise of individual consumers, the growth in government business, the need for new risk and reimbursement strategies, and the search for adjacent, higher-margin sources of revenue.

In response, US payors have undertaken more than 50 M&A transactions in the past two years. These deals have tended to be larger than earlier payor transactions and have included a wider range of targets. Because M&A is inherently risky, there is no guarantee that these deals will succeed; however, industry headwinds make it likely that payors’ interest in M&A will continue.

McKinsey research into the drivers of performance in multiple M&A situations has uncovered six characteristics that define M&A excellence:

(1) A clear deal thesis and strategy

(2) Distinctive sourcing and screening skills

(3) A carefully defined governance structure

(4) Highly skilled M&A teams to oversee the deal

(5) Robust tools to track and assess the deal’s progress

(6) A tailored approach to integration.
In the past two years, mergers and acquisitions (M&A) in the US health insurance industry have accelerated. In response to both the economic downturn and passage of the Affordable Care Act (ACA), payors have made over 50 M&A transactions.

A surge in healthcare M&A activity during times of regulatory upheaval has precedent: after the Balanced Budget Act of 1997 reduced many types of Medicare and Medicaid payments, a number of industry players made strategic moves—both acquisitions and exits—to react to the new landscape.

This time, payors must cope not only with regulatory uncertainties but also with the downturn’s aftermath, including increasing concern from employers about affordability. These forces have combined to intensify four key industry trends: the rise of individual consumers, the growth in government business, the need for new risk and reimbursement strategies, and the search for adjacent, higher-margin sources of revenue. The result has been a surge in M&A activity among payors looking for growth and diversification.

Payor executives contemplating M&A should proceed with caution, given current industry dynamics. Deals are always challenging, and poorly executed transactions can result in significant value destruction. Developing and executing a strategy in a changing world is also challenging. Furthermore, the current industry landscape and macroeconomic trends have expanded the types of opportunities payors can pursue to achieve scale, acquire capabilities, or otherwise build a competitive advantage. Therefore, getting M&A right is critical, and having the right organizational elements in place to ensure strong deal execution is a prerequisite for success.

McKinsey research into the drivers of performance in multiple M&A situations has uncovered six characteristics that define M&A excellence. Our work with payors convinces us that these characteristics are applicable to them as well. Given the current healthcare industry, two of them are especially important for payors: strong governance practices and rigorous integration efforts.

**Market changes are creating new opportunities**

The twin forces of regulatory changes and economic recession have disrupted the US healthcare industry, threatening to erode the advantages of market leaders. These forces have intensified four trends pressuring all stakeholders as they attempt to secure their positions in the new market. However, these forces are also creating new opportunities for payors looking for growth.

Rise of individual consumers: The ACA will give many consumers unprecedented control in selecting healthcare coverage (especially once the public exchanges open), and the number of employers offering coverage continues to slide. As a result, the individual market could more than double in size by 2019 (from 2012 levels). To win individual consumers—especially those who buy based on price and brand—payors will need new capabilities, including strong consumer insights,
advanced analytics for more robust customer segmentation and product innovation, and a retail enrollment presence.

- **Growth in government business:** Over the next few years, the fastest-growing market segment will probably be the managed Medicare and Medicaid programs. Expected to grow 7 percent annually between 2012 and 2019 (driven by demographics, Medicaid eligibility expansion, and the shift to managed care), this segment is attractive because of both the increase in covered lives and the higher per-member revenues, especially on Medicare Advantage (MA) members and dual eligibles. For many payors, the result could well be higher earnings in this segment that could help compensate for the anticipated lower margins in their commercially insured and administrative-service-only business.

- **Need for new risk and reimbursement strategies:** Currently, risks in the healthcare system are misaligned. Payors are responsible for reimbursing providers yet lack the ability to fully manage provider costs. Although both groups are concerned about quality and costs, they often have different priorities: payors, to discourage inappropriate utilization; providers, to deliver leading-edge therapies. Payors are increasingly interested in transferring some risk to providers, given that the latter are better positioned to manage utilization, quality, and costs. Innovative risk-sharing and reimbursement systems are emerging to enable the two groups to collaborate to deliver quality care at a lower cost.

- **Search for adjacent, higher-margin sources of revenue:** Given current pressures in the healthcare industry, many payors are looking for growth outside their core business. Healthcare IT and analytics, healthcare delivery, physician management, and wellness present natural opportunities for payors to extend into areas that have demonstrated strong growth recently and remain unaffected by regulatory changes.

**Payors are pursuing different M&A paths**

Given the four trends just described and the other pressures buffeting the industry, it is perhaps not surprising that many payors have been pursuing M&A. Both 2011 and 2012 saw considerably more deals than the previous three years (Exhibit 1).

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Riding the next wave of payor M&A

Since 2006, many payors have experienced an increase in book value but a drop in multiples, despite M&A (Exhibit 2). This finding raises two questions: how much value can be gained by current and future M&A activity? And how can payors ensure that they capture that value?

From 2005 to 2008, payors focused primarily on regional consolidation, acquisition of specialty service lines, and medical management. In contrast, the more recent period has been defined by several larger deals and a wider range of targets. Between 2009 and 2012, M&A transactions designed to support care delivery or international expansion accounted for 35 percent of all deals, a significant increase from the 12 percent in the previous period (Exhibit 3).

A closer look at the recent surge in M&A reveals that payors have sought to improve their competitive position by pursuing one or more of these five strategies:

- Extending their geographic presence
- Increasing product diversification
- Adding capabilities (such as data analytics, consumer insights, and care management, among others)
- Pursuing vertical integration with care delivery
- Expanding into noncore growth areas, including international operations

In many cases, a single deal has enabled a payor to pursue two or more of these strategies simultaneously.

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4. Based on publicly available data. Deals reflected here may not be exhaustive.
Some of the reforms that go into effect next year will complicate the difficulties payors already face in expanding through organic growth. Thus, many payors have sought to diversify by establishing operations in new markets. M&A is often used to gain a point of entry in a new region or to become a market leader in a larger part of the country.

UnitedHealth Group, for example, has acquired two senior-focused health plans in Florida and the California-based Monarch HealthCare Group, a health maintenance organization. In announcing these deals, the company said that it wanted to continue to build its local market presence in those states. Other insurers have pursued acquisitions or affiliations to extend into adjacent markets. Two examples from within the Blue Cross Blue Shield system are Highmark, which has established an affiliation with BCBS of Delaware, and Health Care Service Corporation (HCSC), which has announced an alliance with BCBS of Montana.

Payors are also pursuing international targets. Cigna’s proprietary international network, which offers medical, dental, behavioral, vision, pharmacy, personal accident, disability, business travel, and life insurance in 30 countries, grew by 31 percent in 2011—faster than any of its other businesses. To drive further growth in this segment, Cigna has acquired Vanbreda International, which specializes in expatriate benefits and health insurance, and FirstAssist, a UK travel and protection insurance company. UnitedHealth has also expanded its international business through its purchase of FrontierMEDEX, a provider of on-site international medical assistance and case management. In addition, it has taken a 90-percent stake in Amil Participacoes, the top health insurer and hospital operator in Brazil, where a rising middle class is increasing demand for private insurance and healthcare services.

Increasing product diversification

Many payors that have achieved success in specific product categories, such as employer plans, have realized that this concentration may leave them vulnerable in the new environment. Consequently, they have sought to expand their product lines or enter new product categories, particularly the fast-growing government segments such as MA.

5. All information about the deals described in this paper was taken from publicly available sources, such as press releases and investor calls.
WellPoint, for example, bought the CareMore Health Group, an integrated health plan that offers MA plans and physician clinics geared to seniors. With the move, WellPoint strengthened its position in Arizona, California, and Nevada, where CareMore had about 54,000 members. Similarly, the Tufts Health Plan purchased Network Health, a provider of state-subsidized health insurance. The expanded customer base enabled Tufts to extend its reach into managed Medicare and Medicaid products.

An even larger deal was Cigna’s acquisition of HealthSpring, which gave Cigna a greater presence in the growing MA market and access to customers in 12 states and the District of Columbia. The deal came at a premium, however—Cigna paid $3.8 billion, 37 percent above HealthSpring’s previous closing price.

In some cases, payors have joined forces on deals. For example, BCBS of Michigan partnered with Independence Blue Cross to purchase AmeriHealth Mercy as a vehicle for national expansion into the Medicaid market. For the two Blues, the transaction lowered both the cost and risk of expansion.

Adding capabilities

The continued integration of technology into healthcare operations and the rise of individuals as direct purchasers of health insurance offer opportunities for payors to gain competitive advantage by strengthening or acquiring capabilities in these areas. Payors with robust data analytics capabilities, for example, can mine their customer information to develop better care management products for specific segments or launch more targeted outreach programs. Many payors are building capabilities for revenue management and risk adjustment for their individual book of business (Exhibit 4).

Aetna’s recent M&A activity has focused on developing end-to-end customer insight and engagement capabilities. Its acquisition of Medicity, a technology company focused on health information exchange, has enabled it to offer a comprehensive set of technology solutions for physicians, hospitals, and other providers. Aetna has also acquired PayFlex, a developer of web-based benefit administration services, and iTriage, the consumer health application.

Humana has expanded its capabilities in the delivery of complex care by acquiring SeniorBridge, a New York-based chronic care provider best known for delivering in-home care. It has also acquired Anvita Health, a healthcare analytics company, to enhance its capabilities in risk assessment and adjustment.
Pursuing vertical integration

To align incentives more closely with care coordination, some payors have been forging deals with local, network, and specialty providers (Exhibit 5). The deals have included outright acquisitions, as well as joint ventures, partnerships, and other collaboration models. These models attempt to create win-win arrangements for the payors and providers, often through integrated care delivery systems and novel reimbursement methods.

The deals with providers not only enable payors to achieve vertical integration but also afford them more control over care delivery. For example, Humana’s purchase of Concentra, an urgent care and occupational medicine provider, gave it access to 300 medical centers in 42 states.

The long-term goal of this approach is to create a new model of healthcare centered on integrated delivery. Initially, the focus will be on offering high-quality, efficient care to members. As both payors and providers improve their ability to execute an integrated strategy, payors expect to deliver more affordable products that manage medical cost risk and increase administrative efficiency.

Expanding into noncore growth areas

Many payors anticipate that operating margins in traditional business segments will decrease and that overall operating growth is likely to be flat through 2019, except in the government segment. As a result, some payors have decided to diversify by exploring opportunities in less-regulated industries.

Three Blue companies—BCBS of Michigan, HCSC, and WellPoint—have forged a partnership with Bloom Health, a healthcare technology company. The partners have developed a private-exchange and defined-contribution solution for employers to use in managing their health benefit offerings.

Similarly, UnitedHealth Group has increased its investment in Optum, its higher-margin health management, health analytics, and pharmacy benefits management subsidiary, to boost earnings growth. Optum currently has 5 percent of the $530 billion specialty service market, and UnitedHealth is seeking to double Optum’s 2011 operating revenues by 2015.

Exhibit 5
Examples of vertical integration.

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<thead>
<tr>
<th>Integrating organizations</th>
<th>Deal rationale</th>
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<tr>
<td>Concentra + Humana</td>
<td>• Attain physician management platform in occupational health</td>
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<tr>
<td>Monarch HealthCare + UnitedHealth</td>
<td>• Provide some integrated services for greater care coordination</td>
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| CareMore + WellPoint      | • Gain population in senior healthcare market  
|                          | • Fulfill strategic approach of integration between insurers and providers to coordinate care |
| CareSource + McLaren Health Plan | • Gain 34,500 members and expand geographic reach across Michigan |
| FastMed Urgent Care + Blue Cross Blue Shield of North Carolina | • Decrease emergency room (ER) costs through shift to urgent care clinics (non-emergency ER visits represent about 14% of all ER claims paid by the insurer) |

Source: Web search of publicly available sources
Superior M&A capabilities create a competitive advantage

In most cases, it is too early to determine whether the deals described above have accomplished—or will accomplish—their strategic or financial objectives. Nevertheless, payors will likely continue to use M&A as they seek competitive advantage during this time of disruption.

When pursued wisely, M&A can help companies outperform their competitors. McKinsey’s research has shown that those that used M&A to supplement organic growth did better than those that followed a purely organic growth strategy. However, the deals must be undertaken with considerable care because the processes involved (including target selection, acquisition, and post-merger integration) require experience and skill to get right. Our research indicates that successful acquirers share six characteristics (Exhibit 6).

Link with corporate strategy

Companies that succeed with M&A have a clearly defined strategic direction and align their acquisitions closely with it. Our research suggests that programmatic acquirers—companies with a defined corporate strategy and a deliberate, multi-acquisition approach to execute on that strategy—deliver more than 2-percent excess shareholder return when compared with relevant market benchmarks (Exhibit 7).

Programmatic acquirers typically establish procedures that enable them to incorporate lessons from previous M&A efforts into their execution of new deals and their overall corporate strategy. Executives at these companies deepen their understanding of M&A by integrating deal and market trends (from venture capital, academia, and competitors) into their thinking. As a result, they create a continuous feedback loop between their strategic and capital planning and their M&A/integration execution.

The lessons from these successful acquirers are especially important for payors. Many payors may be tempted to take an opportunistic approach by reacting to pitches from investment banks and companies looking for funding. Given the challenges ahead, this approach would be a mistake. Rather, payors should identify two or three key objectives within their corporate strategy that can be supported through M&A. They should then search proactively for deals that meet those objectives.

Exhibit 6
Characteristics of successful acquirers.

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<td>Strategy</td>
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Sourcing and screening

Successful acquirers are exceptionally good at sourcing and screening potential targets, even when a market gets very competitive and assets become scarce. They create the capacity to monitor 50 or more potential targets on an ongoing basis and to evaluate at least 10 of them at a time. (In contrast, most companies evaluate only one or two potential deals concurrently.) In addition, successful acquirers establish a brand that makes them attractive to smaller companies looking for funding, partners, or both. As a result, they are viewed as an acquirer or partner of choice.

To identify a high number of potential targets, successful acquirers leverage a much broader network than other companies do. Responsibility for sourcing M&A ideas is shared by everyone in the company, not just those in business development. Successful acquirers also actively seek out external opinions to supplement their internal business and market insights. They then develop a set of clear evaluation criteria (including whether they will be a better owner) so that they can assess prospective deals objectively. When those criteria are met, successful acquirers proceed with the transaction but make sure they have carefully defined the factors that will drive value as the deal moves forward. When those criteria cannot be met or the price is not right, they have the discipline to walk away.

Governance

Once successful acquirers have identified a strong deal, they focus on closing the transaction quickly. As part of this process, they carefully define the roles and responsibilities of senior executives and board members on both sides and make certain that all decision rights are spelled out. They also ensure that the incentives for all senior executives are aligned with the benefits the deal is expected to produce. Even when profits are not the primary mission (as is the case at some payors), a value creation mind-set that focuses on delivering more affordable, higher-quality care should be at the forefront of governance decisions.
Close oversight of the deals by board members is another trait shared by successful acquirers. These organizations typically have a board committee composed of members with M&A experience. In an industry like healthcare, where M&A is becoming an increasingly important source of competitive advantage, this type of committee can help ensure that the right discussions take place and the right expertise is brought to bear.

In addition, successful acquirers have a deep understanding of all relevant stakeholders (which for payors include regulators and providers), and they make certain that their decision-making processes consider those stakeholders’ concerns. Before a deal is agreed to, they determine how feasible it will be to address those concerns and develop plans to ensure that the issues are addressed.

**M&A/integration expertise**

To capture a merger’s value more quickly, successful acquirers use designated teams to screen potential targets, negotiate deals, and drive integration. These companies know that without highly talented M&A/integration teams, the deals will likely be led by senior executives unable to devote much time to the effort, increasing the risk of failure. Typically, the teams’ capabilities and resourcing flex depending on the stage of the deal, from target identification and screening through to integration.

Successful acquirers staff the teams with rising stars from across the organization—people who bring a range of perspectives and expertise. The types of expertise needed depend on a company’s M&A strategy (e.g., early-stage venture-capital deals versus large integrations). The teams report directly to a C-suite executive to ensure that they have the authority to get the deals done, and they meet regularly with the board committee focused on M&A.

A key question the teams concentrate on is who should be considered the better owner of a given idea, process, or capability. Because so many deals today are undertaken to gain capabilities or expand into new areas, it is no longer appropriate (if it ever was) to assume that an acquired company should always adapt to the acquirer. Instead, the teams should identify the best practices in each organization and ensure that both sides learn from each other. Successful acquirers give the teams dedicated resources to help them accomplish this goal.

Although the teams should have a core set of regular members, participation can vary, depending on the type of deal and stage of progress. Furthermore, the teams’ size can increase at certain times. External support (from bankers, lawyers, accountants, consultants, or others) is brought in as needed.

**Tools and learning**

Successful acquirers establish playbooks tailored to each deal type (e.g., consolidation, new business, geographic expansion) to help the transactions go more smoothly. They also invest in dashboards and other tools to monitor progress during the integration and capture the lessons learned. Although every acquisition is different, having these playbooks and tools available enables the integration to proceed more smoothly.

The performance-management tools include mechanisms to enforce accountability for specific actions and metrics that track the value drivers identified during the due-diligence stage. Thus, progress is measured not by whether certain milestones are met but by whether the deal’s objectives are being achieved. The tools can also be used to support continued financial-performance tracking after the integration is complete.

Successful acquirers capture the lessons learned to establish a culture of continuous improvement. Each deal helps them become better prepared for subsequent transactions.
Integration

Successful acquirers know that once a deal is announced, integration should proceed rapidly in most cases. Delays can lead to business disruptions, talent flight, and ultimately value destruction. However, the need for speed is no excuse for poor planning. Unfortunately, many companies (including many payors) underestimate the need for carefully planning before and during the integration.

Having an experienced team oversee the integration helps avoid this problem by ensuring that the integration proceeds smoothly (and rapidly, when appropriate) and the maximum post-transaction value is captured. Where the team chooses to focus will depend on the merger’s rationale. For example, an acquisition undertaken for scale advantages typically requires a careful focus on achieving economies and cost efficiencies through consolidation of back-office operations, such as IT, distribution, and claims management. In this case, rapid integration is generally preferable. In contrast, when a payor pursues a deal to acquire capabilities, the post-merger integration efforts should often proceed more slowly to concentrate on talent retention, the adoption of new business processes, the spread of intellectual property, and the explicit conversion of the acquired capabilities to value creation.

The unique nature of the healthcare industry increases the complexity of many acquisitions and the resulting integration. For example, because payors and providers have traditionally had different aims, they can find working together in a joint enterprise to be quite challenging. Even within a single payor or provider organization, multiple subcultures, depending on the types of staff members, may be involved. Furthermore, the relevant stakeholders include physicians and other clinicians, and gaining their support is crucial. Especially close attention to the cultural integration process is required—beginning well before the deal is executed—to ensure that the right steps are taken to gain clinicians’ buy-in.

For these reasons, communication and stakeholder management are especially critical for payors undertaking M&A. The spotlight on the healthcare industry is currently intense. Payors often have a high profile, and consumer group and regulatory pressure can be heavy. Without a strong communication and stakeholder management plan, a payor could severely undermine its M&A efforts.

Given the extent of the changes affecting the healthcare industry, it is not surprising that many payors are looking to M&A for growth and diversification. The risks with this approach are considerable, and no exact formula can guarantee success. However, the six characteristics described above can improve the odds considerably and put payors in a stronger position to capture value from M&A.

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Acknowledgments
The team would like to thank Riccardo Andreola, Oliver Engert, Jocelyn Graham, Karen Hardin, Bill Huyett, Tom Latkovic, Theresa Lorrman, James McLetchie, Susan Nolen Foushee, Ellen Rosen, Rob Rosiello, and Shubham Singhal for their support during the preparation of this article.