Historical Review of Mergers and Acquisitions *in Diagnostic Imaging*

From the go-go years to the present, acquisition strategies in the outpatient diagnostic imaging field have not always worked

By Jonathan A. Burklund

As we sit on the precipice of a meltdown in the credit markets, I am reminded of a quote from Winston Churchill: "Those who forget history are bound to repeat it." In 1998, a hedge fund called Long Term Capital Management (LTCM) bought securities using approximately $30 of debt for every $1 of equity, and eventually owned a portfolio valued at $125 billion (not including its assets off the balance).

Later that same year, the Russian bond crisis set off a chain of events that precipitously reduced the value of LTCM's portfolio, quickly eroding its equity value and thereby requiring massive write-offs. The Federal Reserve invited the large Wall Street companies to its headquarters to devise a bailout strategy, for fear that the failure of LTCM would negatively affect the credit markets. Does this sound familiar yet? As a result, 13 companies participated in a $3 billion bailout of one hedge fund.

The only two companies that did not participate, because it was too risky, were Bear Stearns and Lehman Brothers. Had the heads of these two companies dusted off the credit analysis used in evaluating the LTCM bailout and applied it to their own balance sheets in 2008, they might very well be going concerns today.

Merger-and-acquisition activity in the diagnostic imaging industry has often suffered from the same selective amnesia. Perhaps the repetition of some bad history can be avoided through the review of mergers and acquisitions in diagnostic imaging over the past 15 years.

1993—1997

Go-go years

- Stark rules catalyzed the sale of doctor-owned facilities
- Access to debt made it easy for entrepreneurs to acquire centers
- Large companies created in a short period:
  - US Diagnostic Inc
  - Medical Resources Inc
- Little to no true operational integration

1998—2000

BBA and multiple arbitage fallout

- Balanced Budget Act dramatically reduced reimbursement
- Bloated balance sheets plus lower revenues equals restructuring
- US Diagnostics Inc reduced debt by selling off centers
- Medical Resources Inc executed a massive debt-for-equity conversion

Trends in mergers and acquisitions in diagnostic imaging.

The timeline from 1993 to 2008 (see figure) is divided into five distinct periods: the go-go years, the Balanced Budget Act and multiple arbitrage fallout, the days of cheap credit, the DRA and the overbuilding hangover, and the revenge of the operator.

1993 Through 1997

The go-go years: The original Stark law was enacted in 1989 and prohibited self-referrals only in clinical laboratory services. In 1993, an amendment was made to the Stark law (Stark 2) that went beyond clinical laboratory services and into several other health care services, most notably diagnostic imaging. With the stroke of a pen, Congress unwittingly catalyzed the creation of the modern diagnostic imaging industry.

Historically, diagnostic imaging centers had been predominately owned by physicians, many of whom referred patients to these centers. As a result of Stark 2, doctors were required to divest themselves of their interests in these centers, creating a glut in the market. Concurrently, acquisition financing was readily available for energetic entrepreneurs who wanted to roll up the industry. In the early days, before too many players entered the market, valuations were quite reasonable, ranging from three to four times EBITDA.

Two companies quickly emerged as industry leaders: US Diagnostic Inc and Medical Resources Inc. Their darling status in the investment community was primarily the result of their successful financial engineering. US Diagnostic Inc and Medical Resources Inc closed a series of acquisitions at around three to four times the target companies' EBITDAs while maintaining a public market implied valuation of six times EBITDA.

Furthermore, these acquisitions were completed using debt, not equity, which created instant value for the shareholder by improving the earnings per share of US Diagnostic Inc and Medical Resources Inc. This multiple arbitrage strategy worked so well that it allowed management teams to focus less on key fundamentals, such as local market clustering, that would maximize local staff efficiencies and increase negotiating leverage with managed care payors.

As the market heated up, more and more competition developed in the diagnostic imaging markets. Valuations crept up to six to seven times EBITDA, increasing the need for more debt. In a four- or five-year period, US Diagnostic Inc and Medical Resources Inc acquired more than 100 centers each. Not surprisingly, many of the acquisitions were in disparate markets and were poorly integrated.

1998 Through 2000

The Balanced Budget Act and multiple arbitrage fallout: In 1997, Congress passed the Balanced Budget Act, which drastically reduced reimbursement rates for diagnostic imaging. For large diagnostic imaging companies, the Balanced Budget Act, coupled with rapid growth in the previous years, triggered a number of negative consequences, including

2001—EARLY 2005

Days of cheap credit

• During the economic downturn, investors sought recession-resistant investments

• New modalities (such as PET) created promise of increasing growth rates

• Credit was abundant; it was easy to buy or build

Activity highlighted by numerous financial sponsors with access to debt markets

- MedQuest — JP Morgan
- River Oaks — CapStreet
- DIG — Evercore

• Financial buyers typically outbid strategic buyers due to the greater need to deploy capital, the growing leveragability of centers, better access to capital, and greater optimism

LATE 2005—2007

DRA and overbuilding hangover

• Uncertainty surrounding DRA

• Easy credit for new centers during earlier period caused a flood of centers in the marketplace, reducing same-store sales growth for all centers

• Largest strategic buyer was performing poorly

• Independent financing sources reducing exposure to the sector or folding

PRESENT

Revenge of the operator

• Good operators have weathered the storm caused by DRA and are seeking new acquisitions

• Private equity sponsors interested in investing in the sector

• Health care finance companies hoping to finance acquisitions once again

• Hospital companies continue to seek to diversify into outpatient diagnostic imaging

Positive data points

• RadNet's operating performance
• Alliance's performance
• CML's acquisition of ARS
• Memorial Hermann's acquisition of River Oaks Imaging and Diagnostic

On the other hand

• RBMs coming on strong

decreasing revenues (and, therefore, cash flow); bloated balance sheets; geographically disparate centers; and poorly integrated operations.

As would be expected, these factors resulted in poor performance at US Diagnostic Inc and Medical Resources Inc and caused them both to consider restructuring options. In April 2000, after negotiating several waivers, Medical Resources Inc filed a Joint Plan of Reorganization under Chapter 11 in connection with an agreement with its lenders to convert $75 million in debt into 90% of Medical Resources Inc's common stock.

In July 2000, US Diagnostic Inc received shareholder approval for its restructuring plan, in which the company would sell off its centers and distribute the cash from the sales, first to the debt holder and second to the shareholders. Ultimately, US Diagnostic Inc raised $188 million from the sale of several of its centers and significantly reduced its outstanding senior debt. The remaining centers eventually were acquired by PresGar Companies in 2002.

2001 Through Early 2005

The days of cheap credit: This period, which can also be called the onslaught of the private equity investors, saw the greatest number of large mergers and acquisitions, for several reasons. Among them were that during the economic downturn, investors flocked to health care companies, considering them a recession-resistant investment; that new imaging modalities, such as PET, created the potential for increased unit and revenue growth; and that credit was abundant.

On the last point, credit was available not only for acquisitions, but also for new centers. It was as if anyone who could spell MRI was able to get debt financing for equipment and leasehold improvements, as well as for initial operating losses.

Private equity investors liked investing in the diagnostic imaging industry because of its dependence on capital expenditures and, in turn, cheap capital. The rationale went as follows: as an independent company, it would have to finance its capital expenditures and acquisitions with expensive debt, perhaps at an interest rate of 10%. As a portfolio company of a large private equity company, however, with many a bank fawning to do business with it, the same company would enjoy a lower cost of capital (for example, 8%).

As a result, a private equity fund could bring synergies to the table immediately in the form of interest-expense savings; here we go again with financial engineering. In addition, larger diagnostic imaging companies dramatically reduced their activity in mergers and acquisitions, as they remained focused on adapting their operations to the new economic realities caused by the Balanced Budget Act's reimbursement cuts. As a result (see table), private equity companies dominated mergers and acquisitions during this period, typically outbidding strategic acquirers.

Late 2005 Through 2007

The DRA and the overbuilding hangover: On February 8, 2006, George W. Bush signed the DRA into law. This act made sweeping changes to Medicare and Medicaid, most notably in the form of reimbursement cuts in diagnostic imaging. While this legislation was enacted in early 2006, the discussions of the cuts began in

Diagnostic Imaging Comparable Transactions

Date	Target	Buyer	Implied Equity Value (millions)	Latest 12 Months' Revenue (millions)	Latest 12 Months' EBITDA (millions)	Equity Value/ Revenue	Equity Value/ EBITDA
04/30/08	River Oaks Imaging	Memorial Hermann Healthcare System	–	$58.6	–	–	–
12/21/07	American Radiology Services	CML HealthCare	$151	146.4	$22.5	1x	6.7x
07/06/06	Radiologix	Primedix	208.9	254.6	44.4	0.8x	4.7x
10/12/05	PET Scans of America	Alliance Imaging (KKR)	44	20	–	2.2x	–
06/26/05	Comprehensive Medical Imaging	InSight Health (JW Childs)	48.3	–	11.7	–	4.1x
04/05/05	Diagnostic Imaging Group	Evercore Capital Partners	253.7	119	35	2.1x	7.2x
10/29/04	Center for Diagnostic Imaging	Onex Partners	183.5	–	–	–	–
06/23/03	CDL Medical (23 mobile sites)	InSight Health (JW Childs)	66.4	22	10.9	3x	6.1x
03/28/03	American Radiology Services	Advent International Corp	115	–	–	–	–
12/04/02	US Diagnostic	PresGar	53	45	16	1.2x	3.3x
09/06/02	River Oaks Imaging	CapStreet Partners	77	73.4	15.6	1x	4.9x
08/16/02	MedQuest	JP Morgan Capital	411	198.8	52.4	2.1x	7.8x
07/02/01	InSight Health	JW Childs	448.1	214.3	82.5	2.1x	5.4x

Low	0.8x	3.3x
High	3x	7.8x
Mean	1.7x	5.6x
Median	2.1x	5.4x

mid-2005, raising concerns that the rate for IDTFs could be reduced to the hospital outpatient rate and that reimbursement for imaging contiguous body parts might be cut by an unknown amount. These questions created uncertainty and made it impossible to project the future earnings of diagnostic imaging companies.

To make matters worse, the overbuilding of centers led to an oversupply of imaging services and to fierce competition in most markets. Increasing competition had the dual detriments of reducing the same-store sales growth for all centers and emboldening managed care payors to make draconian reimbursement cuts for commercial patients.

As a result of these market dynamics, mergers and acquisitions halted. Many of the private equity companies that invested in the previous era wrote down their investments or received lower-than-expected returns on capital.

The one transaction that was the exception, which was executed at an unusually low multiple of EBITDA, was the Primedix acquisition of Radiologix in July 2006. Since the DRA had been passed by this point, Primedix was able to quantify the impact that such reimbursement cuts would have on the Radiologix EBITDA, thus eliminating the uncertainty relating to future earnings.

2008

Revenge of the operator: The Primedix–Radiologix transaction marked the beginning of a new era in diagnostic imaging mergers and acquisitions: one marked by well-financed, high-quality operators. Good operators have weathered the storm caused by DRA and are now thriving. The two public companies in the sector, RadNet and Alliance Imaging, have been reporting strong earnings growth over the past several quarters.

When looking at an acquisition, the operator first asks whether the target fits into its business strategy. With the ever-increasing influence of radiology benefit managers and continued pricing pressure from managed care payors, diagnostic imaging companies need to cluster their centers in geographically defined markets in order to maintain some balance of power. In addition, hospital companies, hoping to diversify their revenue bases in the outpatient sector, are expanding their footprints within their markets by acquiring diagnostic imaging centers. Financial engineering and multiple arbitrage, while nice to have, no longer drive the acquisition decision. Today, operating strategy and market presence do.

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The need for industry consolidation has never been greater; diagnostic imaging unit growth is increasingly scrutinized, radiology benefit managers are gaining more influence, and reimbursement cuts always loom. To succeed, diagnostic imaging companies need programs of mergers and acquisitions to increase their regional market presence and squeeze operating efficiencies out of the system.

This new era is made evident by the two most notable transactions in the sector this year: Memorial Hermann Healthcare System's acquisition of River Oaks Imaging and Diagnostic and CML HealthCare's acquisition of American Radiology Services. Memorial Hermann, which is one of the largest hospital systems in Houston, acquired River Oaks to increase its presence in the diagnostic imaging market, thereby providing its patients with a greater number of access points. CML, a Canadian company, obtained an important beachhead in the US diagnostic imaging market through the acquisition of American Radiology's cluster of Maryland centers. While financial metrics were important in these acquisitions, they were not the only considerations.

For another bright spot in this era, private equity companies are hoping to re-enter the industry, since they believe in the long-term viability of the industry and its need for consolidation. This time, however, they are focusing their due diligence on operational efficiencies and growth strategies, not just short-term financial synergies.

Conclusion

The need for industry consolidation has never been greater; diagnostic imaging unit growth is increasingly scrutinized, radiology benefit managers are gaining more influence, and reimbursement cuts always loom. To succeed, diagnostic imaging companies need programs of mergers and acquisitions to increase their regional market presence and squeeze operating efficiencies out of the system.

Over the years, there have been acquisition strategies that have worked and others that have not. Those that have not have typically been based solely on financial metrics, such as multiple arbitrage or interest-rate synergies. There has also been a temptation to acquire diagnostic imaging businesses using too much debt. Just because the bank is willing to lend it does not mean it is the proper amount. Remember Lehman Brothers and Bear Stearns.

The companies that will be able to navigate in the ever-changing sea of diagnostic imaging are those that can grow through acquisition, but focus first on operational integration and synergies. If those are done properly, creating value will surely follow over the long term. RBJ

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