

European healthcare – a golden opportunity for private equity

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Ageing populations, the drive for better preventive medicines and the increasing reliance on the private sector to help societies pay for ballooning healthcare costs continue to make healthcare a prized sector, with returns higher than in most other industries.

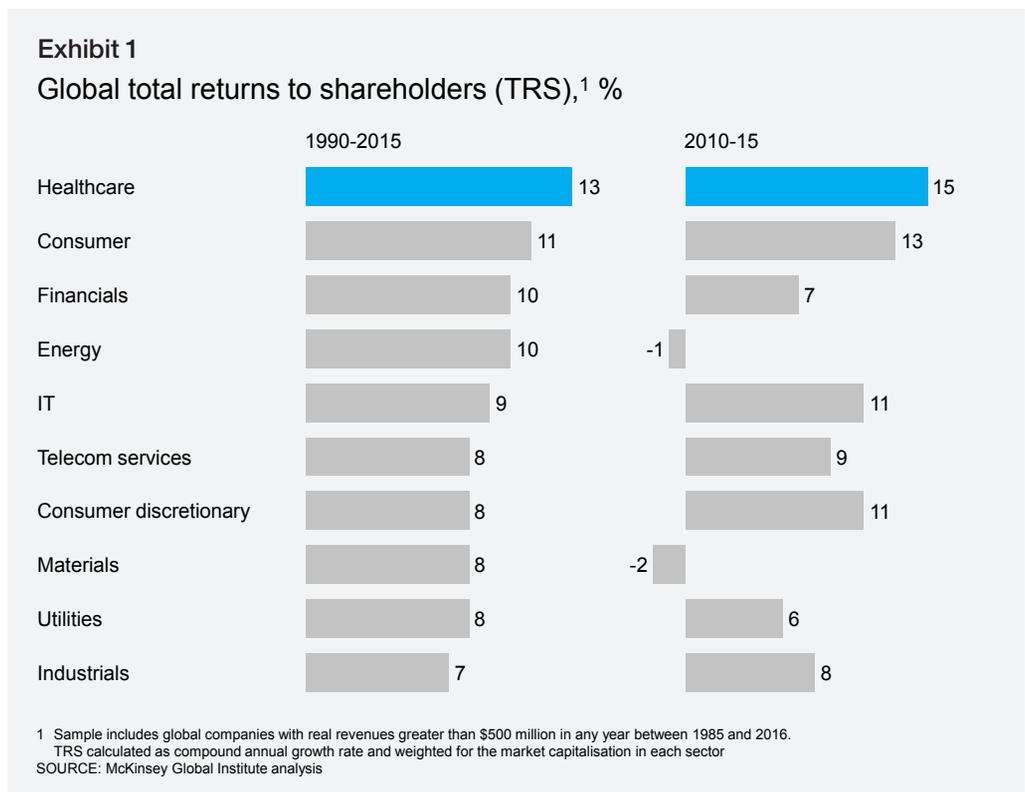
That's as true in Europe as it is elsewhere in the world. Yet private equity (PE) participation in the region remains stubbornly low. PE firms have struggled to find attractive opportunities due to the fragmented and patchwork nature of European healthcare markets as well as strong competition between investors.

How can PE increase its presence in the European healthcare market and reap the rewards from transforming a complex, highly regulated, and in parts inefficient marketplace?

This paper seeks to address that question.

The attractions of European healthcare

Healthcare has outperformed all sectors in the public markets based on TRS, including consumer and financials (both PE favourites), over 25 and 5 years (Exhibit 1). In Europe, when PE investors were able to secure meaningful European healthcare deals above €200 million their returns on exit averaged 32 percent – in line or even above sectors such as consumer goods.



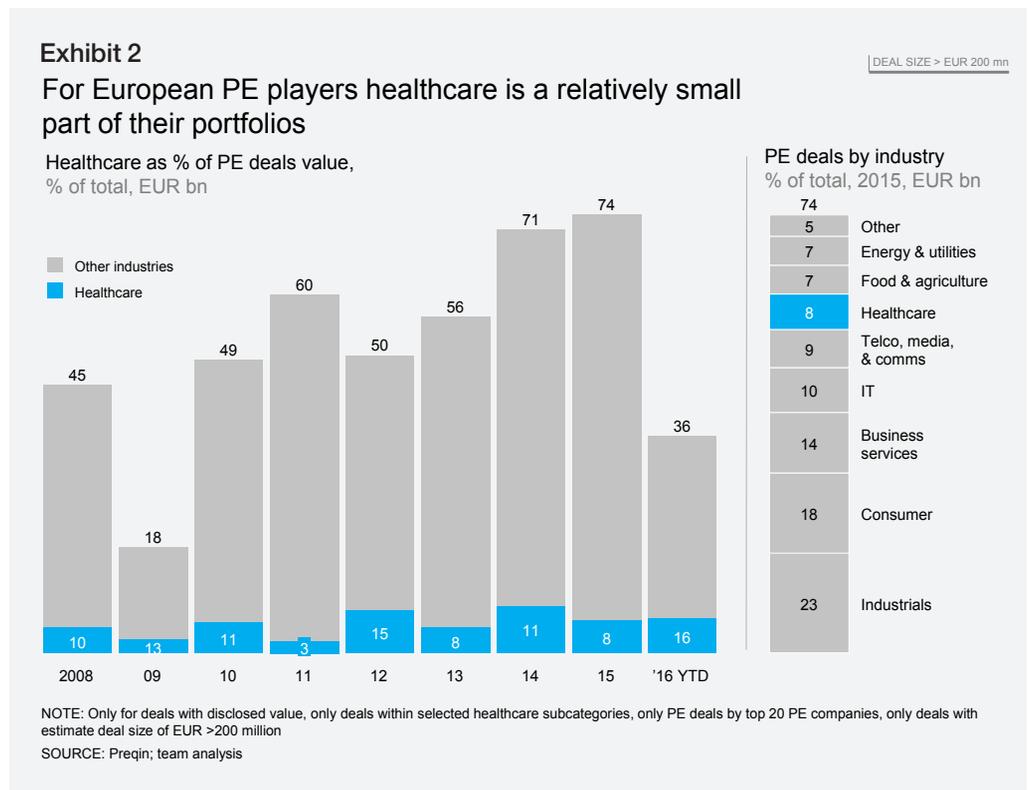
Significant potential remains for PE players to create value. Where other industries such as retail or automotive have been transformed by competition, healthcare has lagged behind due to regulation, localised market dynamics, and high existing margins reducing the pressure to change. Efficiency initiatives, digitisation, portfolio rationalisation, and investment optimisation have started far more recently than elsewhere, and much of the work is still to be done. PE firms can initiate these transformation programmes, install tougher KPIs, provide capital, and facilitate consolidation thus creating and capturing economies of scale.

The value creation opportunities in this changing landscape include both betting on the winning subsectors in the short term, and identifying structural bottlenecks within national systems which the private sector can help resolve.

PE investors are changing their view of the sector’s potential. When we polled 20 leading PE firms invested in European healthcare at the end of 2016, they were optimistic about its prospects: 76 percent expect PE to be more prominent players in healthcare, while 64 percent predicted healthcare would be a bigger part of their portfolios in future.

What has stopped PE from seizing the healthcare prize?

Despite the potential, PE has until now failed to make inroads into European healthcare. Less than 10 percent of companies with estimated revenues over €100 million are owned by PE investors. Also, healthcare accounts for only about 8 percent of assets under management in PE portfolios – lower than industries of a similar size including consumer, with 18 percent, or business services, at 14 percent (Exhibit 2).



To increase PE participation, it is important to understand why exposure has been low.

Low M&A activity as existing owners favour stability over size

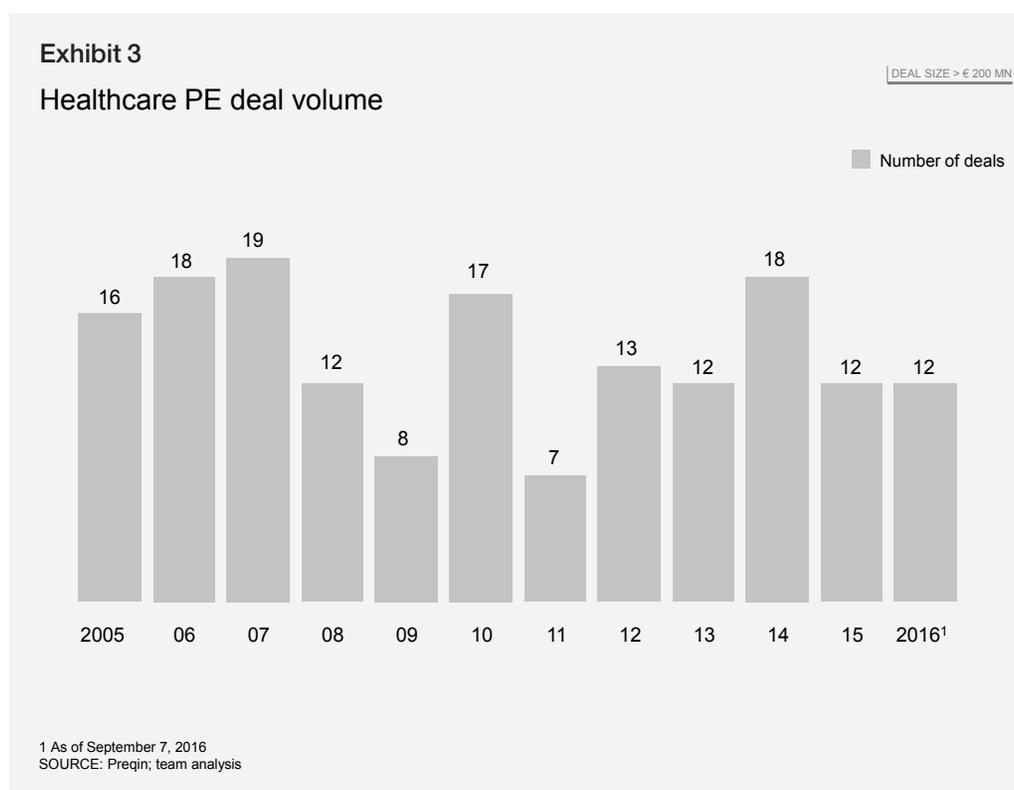
Many healthcare “champions” are family or privately owned companies. These businesses have favoured stable growth in local, niche markets, making them slip under the radar of PE investors. Consequently, M&A activity has generally been lower than in other industries. From 2013 to 2016, there were 50 percent more sizable M&A deals in European consumer than healthcare (78 versus 54).

Corporates have been prepared to overpay

From a PE perspective, big pharmaceutical and medical device companies have overpaid for larger assets to fill a gap in their offering, gain local know-how, or cement important relationships. Two-thirds of assets worth over €200 million were purchased by large listed and privately owned pharmaceutical groups between 2013 and 2016.

Investors have typically competed against other PE firms for assets

The scarcity of deals at prices attractive to PE meant that over the last decade on average only around a dozen of sizable acquisitions were completed by PE investors (Exhibit 3).

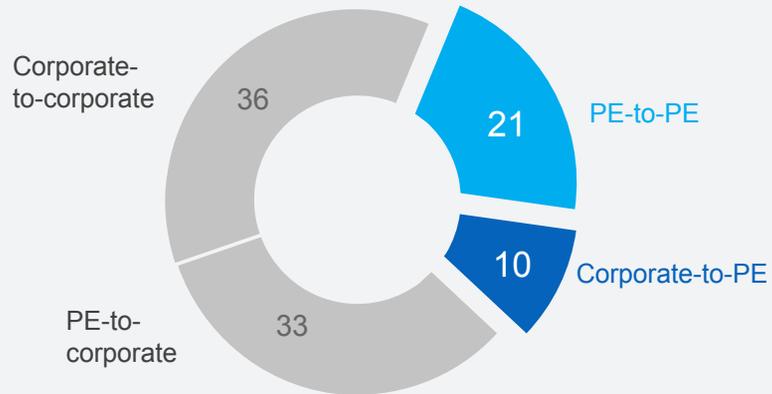


Two-thirds of PE-acquired assets above €200 million have been sourced from other PE investors, as firms have competed for the same businesses. Over time, this has made it more difficult to add value since assets have already passed through the hands of several other PE owners and the “low hanging fruit” has been plucked (Exhibit 4).

Exhibit 4

Sellers and buyers in European healthcare M&A

% of total deals >EUR 200 mn, 2013-2016



SOURCE: Preqin; team analysis

PE investors have struggled to gain access to exclusive assets

A meaningful proportion of mid-sized European healthcare companies are family or privately owned. However, in healthcare the proportion of assets sourced from family owners is half that in European consumer industry. One reason why PE investors struggled to access these more exclusive but still sizable assets is because PE firms do not have dedicated, local healthcare teams developing expertise about how different sub-sectors fit into the healthcare “ecosystem” – though this appears to be changing. Another is that the risk profile of innovative “pure pharmaceutical” businesses that rely on the success of a single drug is too high for PE players.

How can PE firms increase their participation in European healthcare?

For the above reasons, European healthcare has not received its fair share of PE investment. Judged by investors’ increasing optimism, this could be set to change.

To increase deal flow, PE firms should consider changing their investment criteria and focusing on the 90 percent of assets that have eluded them.

Below are five suggestions on how PE investors can rewire their approach and build a significant presence in the attractive European healthcare market:

Concentrate on assets not previously owned by PE

The proportion of “primary” deals has dropped over the past decade. Between 2005 and 2009, around 67 percent of transactions involving PE firms were for primary assets not previously owned by PE. This has slipped to 24 percent over the past two years. Over half of the firms we polled find it difficult to create value in assets previously owned by other funds. PE investors need to build a consensus internally that sourcing primary deals is a priority, and commit resources to this aim.

Adopt a more local approach

These new deals will have a different profile. Over half of healthcare businesses are privately or family owned, often specialising in niche areas. Two-thirds are located in a single country. Accessing these opportunities will require a stronger local focus and a buy-and-build approach.

Consider co-investing or taking a minority stake

With scarce number of healthcare targets available for acquisition in the last years PE houses more chose to invest “solo” and while that offers a bigger gain in case of acquisition it also makes it more difficult to compete as number of investors is bigger. The proportion of deals with PE firms as co-investors has declined from around 70 percent in 2005 to 2009 to below 30 percent over the past two years. However, we are seeing a change in attitude: while only 7 percent of investors polled plan to increase co-investing with other funds, 53 percent are considering co-investment with other types of investors.

Owners of local, mid-sized healthcare companies want to retain significant control over the running of the business. If this happened, they would be more open to accepting PE investors as partners. By taking a minority stake, PE firms can access opportunities that would otherwise be closed to them and can increase their shareholding over time.

Buy and build in unconsolidated niche markets

Consolidating several small companies is a successful way to achieve fast scale-up. For example, in 2011 a PE investor has created IVC by merging three veterinary groups. IVC has since grown organically and through buy-and-build to become one of the largest privately owned vet services platforms in the UK. The company has been recently sold to another PE investor for a significant amount. By replicating this model, PE firms can strengthen their presence in European healthcare.

Form dedicated healthcare teams to gain on-the-ground know-how

Having feet on the ground and developing strong relationships with managers of potential targets will become more important in sourcing primary deals, so that investors can navigate local regulations and market dynamics. This requires dedicated healthcare investment professionals – something most PE firms do not have today.

Investing to benefit from “hot” healthcare trends

We have identified five major trends set to reshape Europe’s healthcare sector. Investors positioned to benefit could see significant growth and value generation.

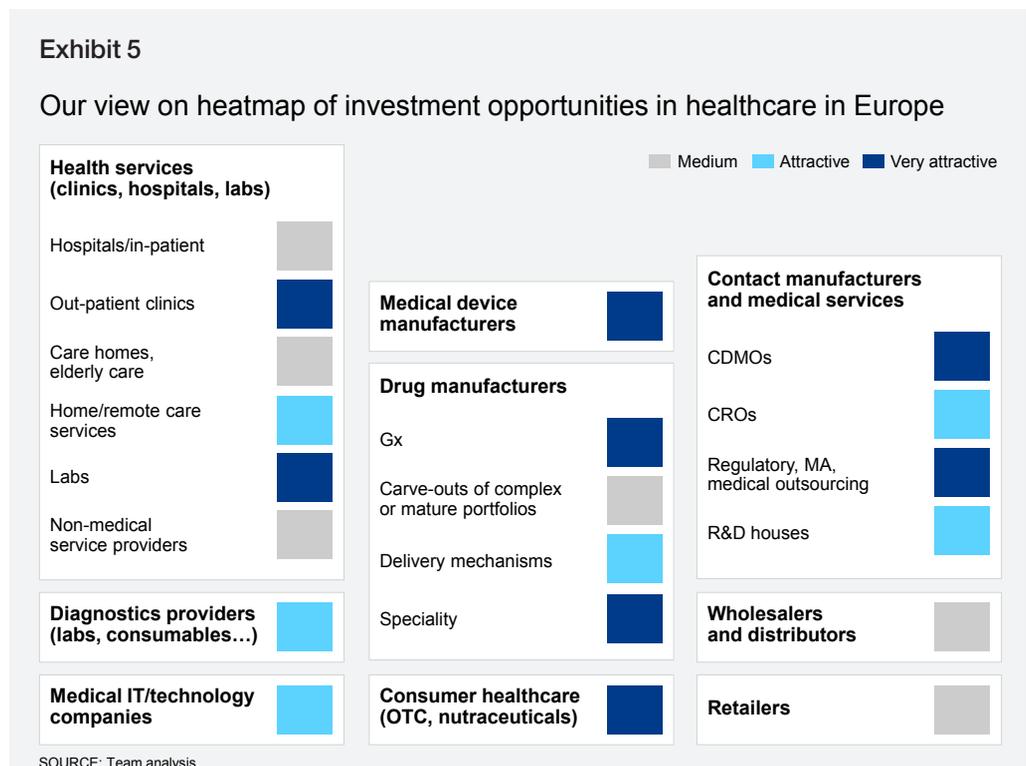
Below we briefly explain each trend and give an example of the type of asset PE could invest in:

1. Healthcare costs have risen on average by 2 percent above GDP growth.

These high costs stem from issues including variable outcomes, low asset utilisation and limited standardisation and automation. Assets solving one of these could present an attractive opportunity.

2. **Payors are increasingly requiring providers and patients to share the cost of treatments.** As a result, patients have more say over the choice of provider. Healthcare providers offering better service and shorter waiting times could be winners.
3. **Payors are taking a bundled, episode-based approach to payments.** This will benefit providers that manage risk across cohorts of patients via analytics and home monitoring. At the same time, healthcare players are using real world evidence (RWE) data to demonstrate outcomes. Contract research organisations with strong RWE capabilities will fare better long term as pharmaceutical firms and OEMs are required to demonstrate their effectiveness using this type of evidence.
4. **Providers are under pressure to analyse vast amounts of data for valuable insights.** Healthcare companies are increasingly relying on businesses with big data analytics capabilities or extensive data sources. Big data also enables continuous patient monitoring and care. Note, however, that we have still to see any sustainable cash-generative assets in this space, though this may be due to national systems not having adapted yet to analytics.
5. **Organisations are transferring best-in-class standards across systems.** Historically, healthcare provision would stay within a country's borders. But that is changing. Companies are increasingly merging assets that operate in several countries, e.g., labs and rehabilitation clinics, and establishing same best-in-class capabilities and practices.

In addition, individual sub-sectors present attractive investment opportunities over a shorter time horizon. The exhibit below summarises, at a high level, the subsectors that, as a result of the trends described above, may become attractive. However, attractive assets can arguably be sourced from structurally less attractive segments as well (Exhibit 5).



For each theme, a unique set of levers creates value. For example, if we consider labs, the biggest value creator is typically automation. This leads to increased asset utilisation and standardisation of operating practices. We benchmarked several similar labs across multiple geographies. We discovered that even the best-performing labs could be significantly optimised on individual parameters, achieving productivity improvements of up to 50 percent.

Clearly, investment themes vary depending on national healthcare systems, local regulations, and market dynamics. As a result, we support a “heatmap” approach enabling PE firms to identify a few attractive segments, before engaging in a more detailed asset scan.

Further information about this publication

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