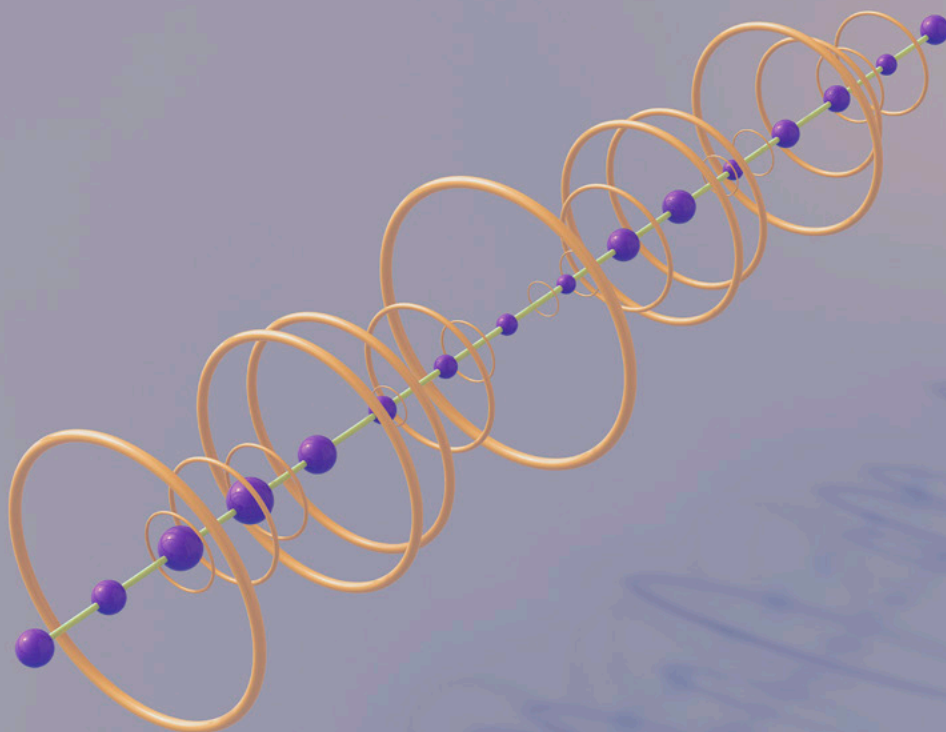


Healthcare Systems and Services Practice

The future of healthcare: Value creation through next- generation business models

While the consumption of healthcare services will likely continue to grow, it is unclear that industry profit pools will expand over the next three years given the impact of the COVID-19 pandemic. Healthcare players who develop new and innovative business models will create disproportionate value in this environment, even as they face long-term challenges.

by Emily Clark, Shubham Singhal, and Kyle Weber



The healthcare industry in the United States has experienced steady growth over the past decade while simultaneously promoting quality, efficiency, and access to care. Between 2012 and 2019, profit pools (earnings before interest, taxes, depreciation, and amortization, or EBITDA) grew at a compound average growth rate of roughly 5 percent. This growth was aided in part by incremental healthcare spending that resulted from the 2010 Affordable Care Act. In 2020, subsidies for qualified individual purchasers on the marketplaces and expansion of Medicaid coverage resulted in roughly \$130 billion^{1,2} of incremental healthcare spending by the federal government.

The next three years are expected to be less positive for the economics of the healthcare industry, as profit pools are more likely to be flat. COVID-19 has led to the potential for economic headwinds and a rebalancing of system funds. Current unemployment rates (6.9 percent as of October 2020³) indicate some individuals may move from employer-sponsored insurance to other options. It is expected that roughly between \$70 billion and \$100 billion in funding may leave the healthcare system by 2022, compared with the expected trajectory pre-COVID-19. The outflow is driven by coverage shifts out of employer-sponsored insurance, product buy-downs, and Medicaid rate pressures from states, partially offset by increased federal spending in the form of subsidies and cost sharing in the Individual market and in Medicaid funding.

Underlying this broader outlook are chances to innovate (Exhibit 1).⁴ Innovation may drive outpaced growth in three categories: segments that are anticipated to rebound from poor performance over recent years, segments that benefit from shifting care patterns that result directly from COVID-19, and segments where growth was expected pre-COVID-19 and remain largely unaffected by the pandemic. For the payer vertical, we estimate profit pools in Medicaid will likely increase by more than 10 percent per annum from 2019 to 2022 as a result of increased enrollment and normalized margins following historical lows. In the provider vertical, the rapid acceleration in the use of telehealth and other virtual care options spurred by COVID-19 could continue.⁵ Growth is

expected across a range of sub-segments in the services and technology vertical, as specialized players are able to provide services at scale (for example, software and platforms and data and analytics). Specialty pharmacy is another area where strong growth in profit pools is likely, with between 5 and 10 percent Compound Annual Growth Rate (CAGR) expected in infusion services and hospital-owned specialty pharmacy sub-segments.

Strategies that align to attractive and growing profit pools, while important, may be insufficient to achieve the growth that incumbents have come to expect. For example, in 2019, 34 percent of all revenue in the healthcare system was linked to a profit pool that grew at greater than 5 percent per year (from 2017 to 2019). In contrast, we estimate that only 13 percent of revenue in 2022 will be linked to profit pools growing at that rate between 2019 and 2022. This estimate reflects that profit pools are growing more slowly due to factors that include lower membership growth, margin pressure, and lower revenue growth. This relative scarcity in opportunity could lead to increased competition in attractive sub-segments with the potential for profits to be spread thinly across organizations. Developing new and innovative business models will become important to achieve the level of EBITDA growth observed in recent years and deliver better care for individuals. The good news is that there is significant opportunity, and need, for innovation in healthcare.

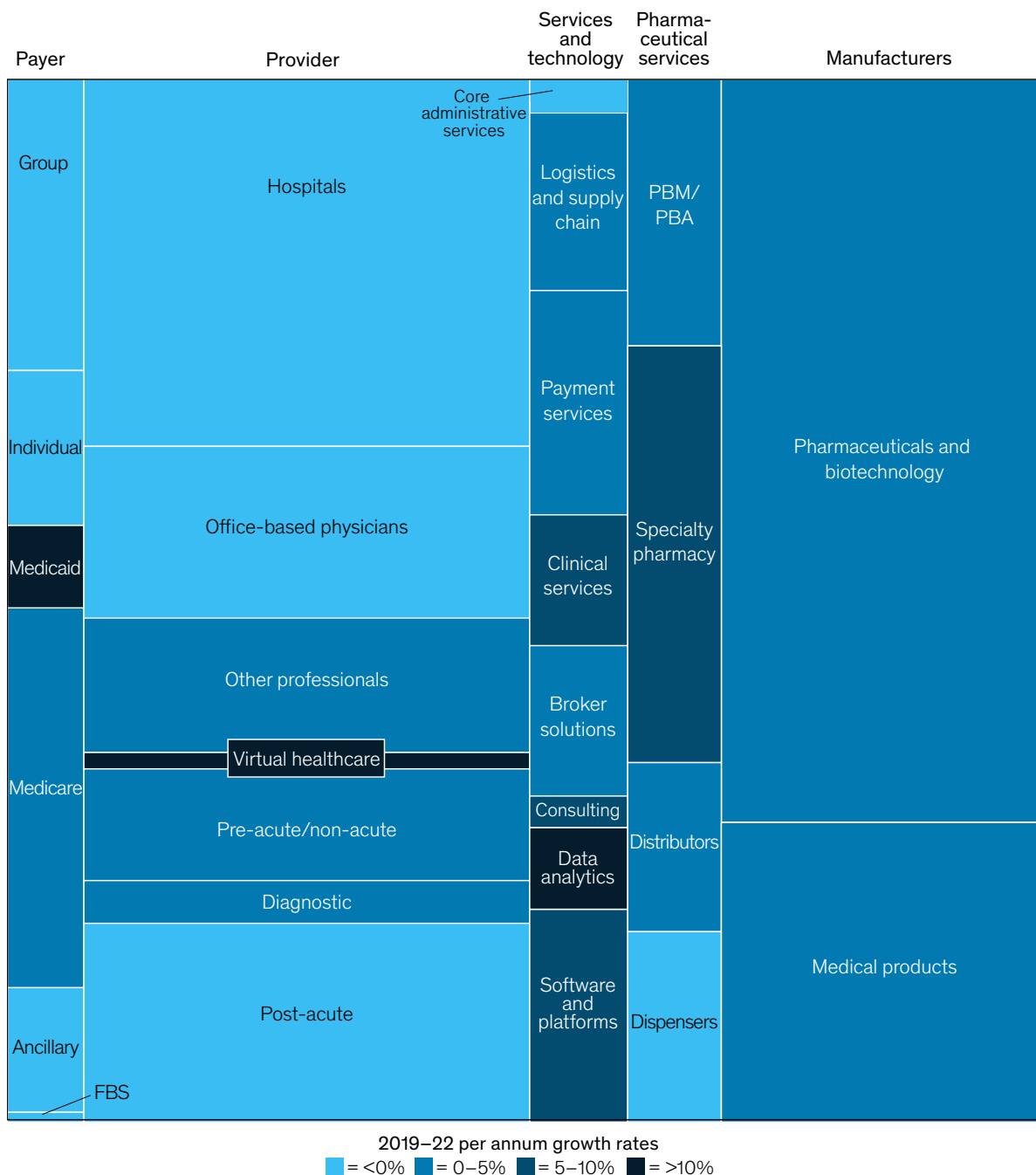
New and innovative business models across verticals can generate greater value and deliver better care for individuals

New and innovative business models are beginning to show promise in delivering better care and generating higher returns. The existence of these models and their initial successes are reflective of what we have observed in the market in recent years: leading organizations in the healthcare industry are not content to simply play in attractive segments and markets, but instead are proactively and

Exhibit 1

Medicaid, virtual healthcare, and data analytics are among segments offering potential for outpaced growth.

Distribution of projected healthcare EBITDA across healthcare segments, 2022, %

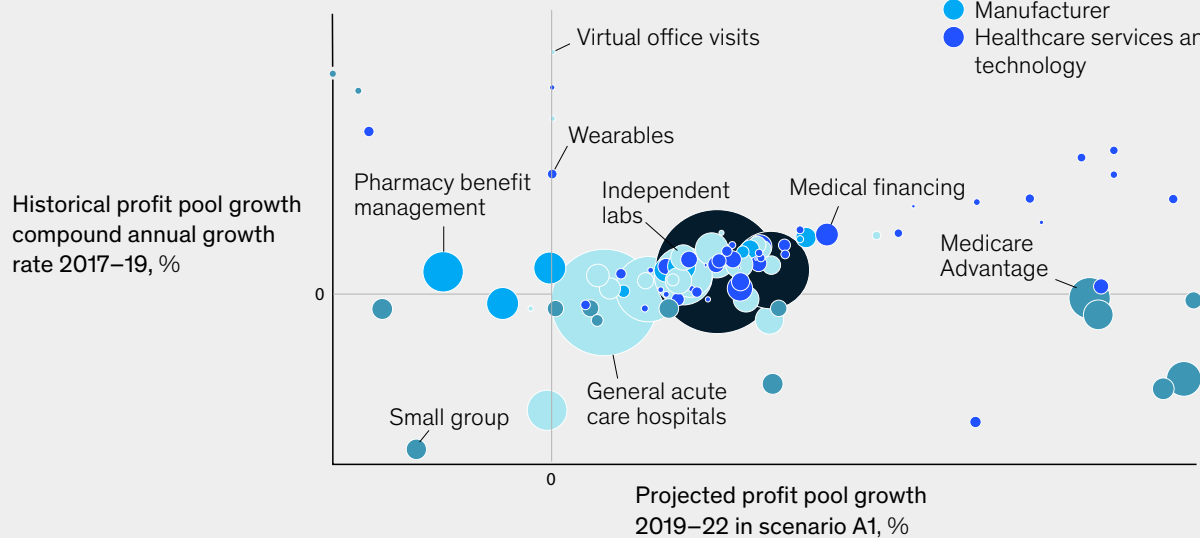


EBITDA, earnings before interest, taxes, depreciation, and amortization; FBS, fixed-benefit and supplemental; PBA, pharmacy benefit administrator; PBM, pharmacy benefit manager.
 Source: McKinsey Profit Pools Model

We project that changes in profit pools for each of 101 distinct sub-segments will vary significantly over the next three years. In general, historic profit pool growth appears to be loosely correlated with projected profit pool growth (exhibit); however, there are a few conspicuous exceptions (for example, the Payer—Individual segment). In addition, many of the sub-segments where we project significant growth tend to be relatively small. At the same time, many of the traditionally large sub-segments are projected to grow relatively slowly (for example, the Provider—General acute care hospitals segment).

A glimpse into the sub-segment profit pool growth potential.

- Payer
- Provider
- Pharmaceutical services
- Manufacturer
- Healthcare services and technology



— **Payer—Small Group:** Small group has historically seen membership declines and we expect this trend to continue and/or accelerate in the event of an economic downturn. Membership declines will increase competition and put pressure on incumbent market leaders to both maintain share and margin as membership declines, but fixed costs remain. **Payer—Medicare Advantage:** Historic profit pool growth in the Medicare Advantage space has been driven by enrollment gains that result from demographic trends and a long-term trend of seniors moving from traditional Medicare fee-for-service programs to Medicare Advantage plans that have increasingly offered attractive ancillary benefits (for example, dental benefits, gym memberships). Going forward, we expect Medicare members to be relatively insulated from the effects of an economic downturn that will impact employers and individuals in other payer segments.

- **Provider—General acute care hospitals:** Cancellation of elective procedures due to COVID-19 is expected to lead to volume and revenue reductions in 2019 and 2020. Though volume is expected to recover partially by 2022, growth will likely be slowed due to the accelerated shift from hospitals to virtual care and other non-acute settings. Payer mix shifts from Employer-sponsored to Medicaid and uninsured populations in 2020 and 2021 are also likely to exert downward pressure on hospital revenue and EBITDA, possibly driving cost-optimization measures through 2022.
- **Provider—Independent labs:** COVID-19 testing is expected to drive higher than average utilization growth in independent labs through 2020 and 2021, with more typical utilization returning by 2022. However, labs may experience pressure on revenue and EBITDA growth as the payer mix shifts to lower-margin segments, offsetting some of the gains attributed to utilization.
- **Provider—Virtual office visits:** Telehealth has helped expand access to care at a time when the pandemic has restricted patients' ability to see providers in person. Consumer adoption and stickiness, along with providers' push to scale-up telehealth offerings, are expected to lead to more than 100 percent growth per annum in the segment from 2019 to 2022, going beyond traditional "tele-urgent" to more comprehensive virtual care.
- **HST—Medical financing:** The medical financing segment may be negatively impacted in 2020 due to COVID-19, as many elective services for which financing is used have been deferred. However, a quick bounce-back is expected as more patients lacking healthcare coverage may need financing in 2021, and as providers may use medical financing as a lever to improve cash reserves.
- **HST—Wearables:** Looking ahead, the wearables segment is expected to see a slight dip in 2020 due to COVID-19, but is expected to rebound in 2021 and 2022 given consumer interest in personal wellness and for tracking health indicators.
- **Pharma services—Pharmacy benefit management:** The growth is expected to return to baseline expectations by 2022 after an initial decline in 2020 and 2021 due to the COVID-19-driven decrease in prescription volume.

fundamentally reshaping how the industry operates and how care is delivered. While the recipe across verticals varies, common among these new business models are greater alignment of incentives typically involving risk bearing, better integration of care, and use of data and advanced analytics.

Payers—Next-generation managed care models

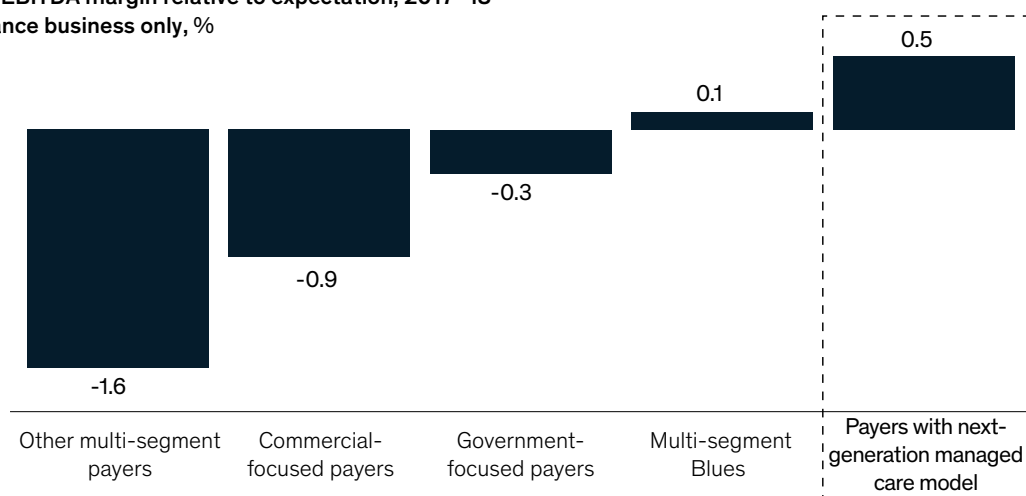
For payers, the new and innovative business models that are generating superior returns are those that incorporate care delivery and advanced analytics to better serve individuals with increasingly complex healthcare needs (Exhibit 2). As chronic disease and other long-term conditions require more continuous management supported by providers (for

example, behavioral health conditions), these next-generation managed care models have garnered notice. Nine of the top ten payers have made acquisitions in the care delivery space. Such models intend to reorient the traditional payer model away from an operational focus on financing healthcare and pricing risk, and toward more integrated managed care models that better align incentives and provide higher-quality, better experience, lower-cost, and more accessible care. Payers that deployed next-generation managed care models generate 0.5 percentage points of EBITDA margin above average expectations after normalizing for payer scale, geographical footprint, and segment mix, according to our research.

Exhibit 2

Payers using a next-generation care model could be positioned to better succeed.

Payer EBITDA margin relative to expectation, 2017–18^{1,2,3}
Insurance business only, %



EBITDA, earnings before interest, taxes, depreciation, and amortization.

¹Does not include administrative services only, Individual, or Medicare stand-alone prescription drug plan.

²Weighted average on premium for excess gain across all lines of business.

³Does not include Kaiser.

Source: McKinsey Payer Financial database

The evidence for the effectiveness of these next-generational care models goes beyond the financial analysis of returns. We observe that these models are being deployed in those geographies that have the greatest opportunity to positively impact individuals. Those markets with 1) a critical mass of disease burden, 2) presence of compressible costs (the opportunity for care to be redirected to lower-cost settings), and 3) a market structure conducive to shifting to higher-value sites of care, offer substantial ways to improve outcomes and reduce costs. (Exhibit 3).

Currently, a handful of payers—often large national players with access to capital and geographic breadth that enables acquisition of at-scale providers and technologies—have begun to pursue such models. Smaller payers may find it more difficult to make outright acquisitions, given capital constraints and geographic limitations. M&A activity across the care delivery landscape is leaving smaller and

more localized assets available for integration and partnership. Payers may need to increasingly turn toward strategic partnerships and alliances to create value and integrate a range of offerings that address all drivers of health.

Providers—reimagining care delivery beyond the hospital

For health systems, through an investment lens, the ownership and integration of alternative sites of care beyond the hospital has demonstrated superior financial returns. Between 2013 and 2018, the number of transactions executed by health systems for outpatient assets increased by 31 percent, for physician practices by 23 percent, and for post-acute care assets by 13 percent. At the same time, the number of hospital-focused deals declined by 6 percent. In addition, private equity investors and payers are becoming more active dealmakers in these non-acute settings.^{6,7}

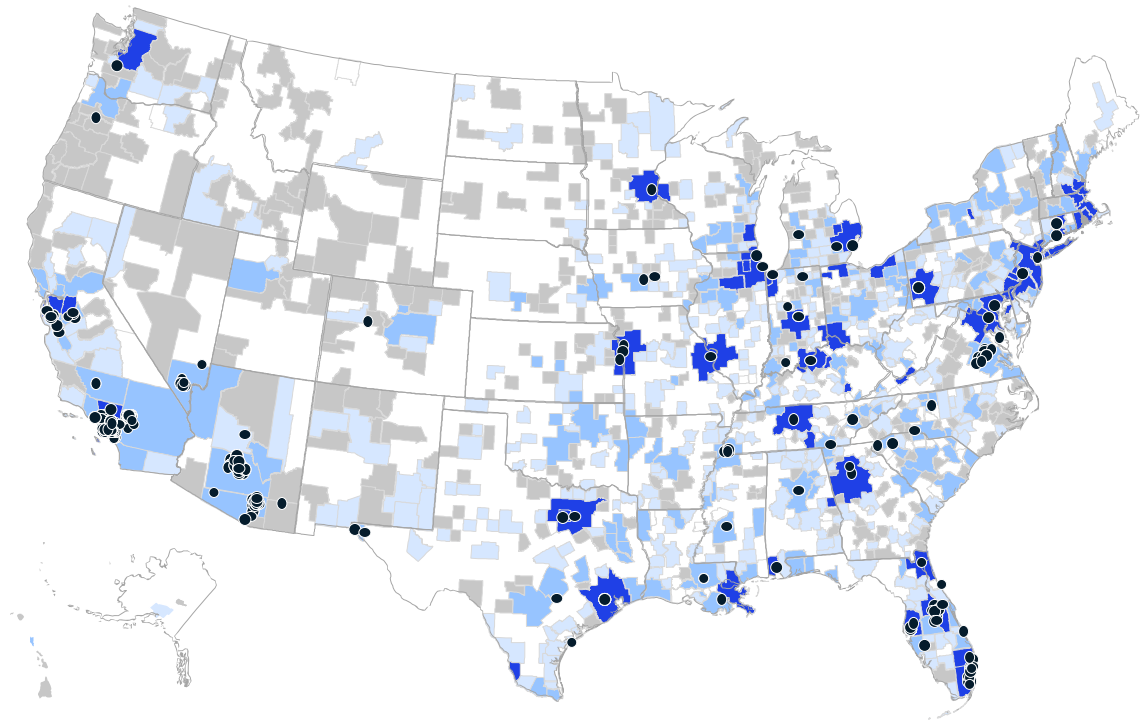
Exhibit 3

Payers have aligned next-generation care models with specific markets to deliver value.

Markets with meaningful activity include cities along the Northeast corridor and in Florida.

Attractiveness ranking (percentile)
 0–25% 25–50% 50–75% >75%

● Select physician groups owned by payers



Source: American Hospital Association; CMS Geographic Variation Data; Robert Wood Johnson Foundation; Truven

As investment is focused on alternative sites of care, we observe that health systems pursuing diversified business models that encompass a greater range of care delivery assets (for example, physician practices, ambulatory surgery centers, and urgent care centers) are generating returns above expectations (Exhibit 4). By offering diverse settings to receive care, many of these systems have been able to lower costs, enhance coordination, and improve patient experience while maintaining or enhancing the quality of the services provided. Consistent with prior research,⁸ systems with high market share tend to outperform peers with lower market share, potentially because systems with greater share have greater ability

not only to ensure referral integrity but also to leverage economies of scale that drive efficiency.

The extent of this outperformance, however, varies by market type. For players with top quartile share, the difference in outperformance between acute-focused players and diverse players is less meaningful. Contrastingly, for bottom quartile players, the increase in value provided by presence beyond the acute setting is more significant. While there may be disadvantages for smaller and sub-scale providers, opportunities exist for these players—as well as new entrants and attackers—to succeed by integrating offerings across the care continuum.

Exhibit 4

Health systems that integrate across alternative sites of care could be better positioned to succeed.

The bottom quartile of the acute market may face challenges.

Health system EBITDA margin relative to expectation,^{1,2} %

	Acute focused ³	Present across the continuum ³
Top quartile share ⁴	3.3	3.6
Bottom quartile share ⁴	-3.3	1.1

EBITDA, earnings before interest, taxes, depreciation, and amortization.

¹Includes the largest health systems by revenue (approximately 110 systems), excluding Kaiser.

²Expected EBITDA based on scale, as measured by number of admissions.

³Diversification represents the ratio of acute to non-acute assets (acute focused players have ratios in the bottom 25th percentile, players that are present across the continuum have ratios in the top 75th percentile).

⁴Share represents the average in-county share for each health system.

Source: American Hospital Association 2017 financial and admissions data; Definitive Healthcare sites of care data

These new models and entrants and their non-acute, technology-enabled, and multichannel offerings can offer a different vision of care delivery. Consumer adoption of telehealth has skyrocketed, from 11 percent of US consumers using telehealth in 2019 to 46 percent now using telehealth to replace canceled healthcare visits. Pre-COVID-19, the total annual revenues of US telehealth players were an estimated \$3 billion; with the acceleration of consumer and provider adoption and the extension of telehealth beyond virtual urgent care, up to \$250 billion of current US healthcare spend could be virtualized.⁹ These early indications suggest that the market may be shifting toward a model of innovative tech-enabled care, one that unlocks value by integrating digital and non-acute settings into a comprehensive, coordinated, and lower-cost offering. While functional care coordination is currently still at the early stages, the potential of technology and other alternative settings raises the question of the role of existing acute-focused providers in a more integrated and digital world.

Healthcare services and technology—innovation and integration across the value chain

Growth in the healthcare services and technology vertical has been material, as players are bringing technology-enabled services to help improve patient care and boost efficiency. Healthcare services and technology companies are serving nearly all segments of the healthcare ecosystem. These efforts include working with payers and providers to better enable the link between actions and outcomes, to engage with consumers, and to provide real-time and convenient access to health information. Since 2014, a large number and value of deals have been completed: more than 580 deals, or \$83 billion in aggregate value.^{10,11} Venture capital and private equity have fueled much of the innovation in the space: more than 80 percent¹² of deal volume has come from these institutional investors, while more traditional strategic players have focused on scaling such innovations and integrating them into their core.

Driven by this investment, multiple new models, players, and approaches are emerging across various sub-segments of the technology and services space, driving both innovation (measured by the number of venture capital deals as a percent of total deals) and integration (measured by strategic dollars invested as a percent of total dollars) with traditional payers and providers (Exhibit 5). In some sub-segments, such as data and analytics, utilization management, provider enablement, network management, and clinical information systems, there has been a high rate of both innovation and integration. For instance, in the data and analytics sub-segment, areas such as behavioral health and social determinants of health have driven innovation, while payer and provider investment in at-scale data and analytics platforms has driven deeper integration with existing core platforms. Other sub-segments, such as patient engagement

and population health management, have exhibited high innovation but lower integration.

Traditional players have an opportunity to integrate innovative new technologies and offerings to transform and modernize their existing business models. Simultaneously, new (and often non-traditional) players are well positioned to continue to drive innovation across multiple sub-segments and through combinations of capabilities (roll-ups).

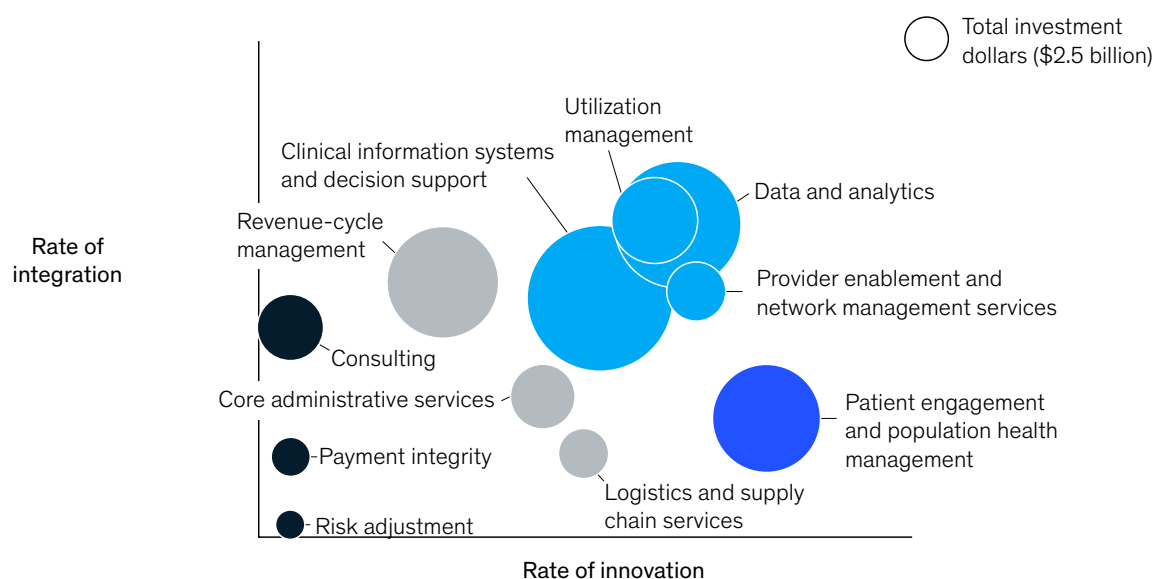
Pharmacy value chain—emerging shifts in delivery and management of care

The profit pools within the pharmacy services vertical are shifting from traditional dispensing to specialty pharmacy. Profits earned by retail dispensers (excluding specialty pharmacy) are expected to decline by 0.5 percent per year through 2022, in the face of intensifying competition and the maturing generic market. New modalities of care, new care settings, and

Exhibit 5

Rate of integration and innovation vary by sub-segment.

Data and analytics and clinical information systems tend to have higher rates of innovation and integration.



Source: PitchBook Data; McKinsey Healthcare Services and Technology Domain Profit Pools Model

new distribution systems are emerging, though many innovations remain in early stages of development.

Specialty pharmacy continues to be an area of outpaced growth. By 2023, specialty pharmacy is expected to account for 44 percent of pharmacy industry prescription revenues, up from 24 percent in 2013.¹³ In response, both incumbents and non-traditional players are seeking opportunities to both capture a rapidly growing portion of the pharmacy value chain and deliver better experience to patients. Health systems, for instance, are increasingly entering the specialty space. Between 2015 and 2018 the share of provider-owned pharmacy locations with specialty pharmacy accreditation more than doubled, from 11 percent in 2015 to 27 percent in 2018, creating an opportunity to directly provide more integrated, holistic care to patients.

A new wave of modalities of care and pharmaceutical innovation are being driven by cell and gene therapies. Global sales are forecasted to grow at more than 40 percent per annum from 2019 to 2024.¹⁴ These new therapies can be potentially curative and often serve patients with high unmet needs, but also pose challenges:¹⁵ upfront costs are high (often in the range of \$500,000 to \$2,000,000 per treatment), benefits are realized over time, and treatment is complex, with unique infrastructure and supply chain requirements. In response, both traditional healthcare players (payers, manufacturers) and policy makers (for example, the Centers for Medicare & Medicaid Services¹⁶) are considering innovative models that include value-based arrangements (outcomes-based pricing, annuity pricing, subscription pricing) to support flexibility around these new modalities.

Innovations also are accelerating in pharmaceutical distribution and delivery. Non-traditional players have entered the direct-to-consumer pharmacy space to improve efficiency and reimagine customer experience, including non-healthcare players such as Amazon (through its acquisition of PillPack in 2018) and, increasingly, traditional healthcare players as well, such as UnitedHealth Group (through its

acquisition of DivvyDose in September 2020). COVID-19 has further accelerated innovation in patient experience and new models of drug delivery, with growth in tele-prescribing,¹⁷ a continued shift toward delivery of pharmaceutical care at home, and the emergence of digital tools to help manage pharmaceutical care. Select providers have also begun to expand in-home offerings (for example, to include oncology treatments), shifting the care delivery paradigm toward home-first models.

A range of new models to better integrate pharmaceutical and medical care and management are emerging. Payers, particularly those with in-house pharmacy benefit managers, are using access to data on both the medical and pharmacy benefit to develop distinctive insights and better coordinate across pharmacy and medical care. Technology providers, together with a range of both traditional and non-traditional healthcare players, are working to integrate medical and pharmaceutical care in more convenient settings, such as the home, through access to real-time adherence monitoring and interventions. These players have an opportunity to access a broad range of comprehensive data, and advanced analytics can be leveraged to more effectively personalize and target care. Such an approach may necessitate cross-segment partnerships, acquisitions, and/or alliances to effectively integrate the many components required to deliver integrated, personalized, and higher-value care.

Creating and capturing new value

Before the COVID-19 pandemic, our research indicated that profits for healthcare organizations were expected to be harder to earn than they have been in the recent past, which has been made even more difficult by COVID-19. New entrants and incumbents who can reimagine their business models have a chance to find ways to innovate to improve healthcare and therefore earn superior returns. The opportunity for incumbents who can

reimagine their business models and new entrants is substantial.

Institutions will be expected to do more than align with growth segments of healthcare. The ability to innovate at scale and with speed is expected to be a differentiator. Senior leaders can consider five important questions:

- How does my business model need to change to create value in the future healthcare world? What are my endowments that will allow me to succeed?
- How does my resource (for example, capital and talent) allocation approach need to change to ensure the future business model is resourced differentially compared with the legacy business?
- How do I need to rewire my organization to design it for speed?¹⁸
- How should I construct an innovation model that rapidly accesses the broader market for innovation and adapts it to my business model? What ecosystem of partners will I

need? How does my acquisition, partnership, and alliances approach need to adapt to deliver this rapid innovation?

- How do I prepare my broader organization to adopt and scale new innovations? Are my operating processes and technology platforms able to move quickly in scaling innovations?

There is no question that the next few years in healthcare are expected to require innovation and fresh perspectives. Yet healthcare stakeholders have never hesitated to rise to the occasion in a quest to deliver innovative, quality care that benefits everyone. Rewiring organizations for speed and efficiency, adapting to an ecosystem model, and scaling innovations to deliver meaningful changes are only some of the ways that helping both healthcare players and patients is possible.

¹ *Federal subsidies for health insurance coverage for people under age 65: 2016 to 2026*, Congressional Budget Office, Washington, DC, March 2016, [cbo.gov](https://www.cbo.gov).

² Includes adults made eligible for Medicaid by the ACA and marketplace-related coverage and the Basic Health Program.

³ *The employment situation—October 2020*, US Department of Labor, November 6, 2020, bls.gov.

⁴ Smit S, Hirt M, Buehler K, Lund S, Greenberg E, and Govindarajan A, "Safeguarding our lives and our livelihoods: The imperative of our time," March 23, 2020, [McKinsey.com](https://mckinsey.com).

⁵ Bestsennyy O, Gilbert G, Harris A, and Rost J, "Telehealth: A quarter-trillion-dollar post-COVID-19 reality?" May 29, 2020, [McKinsey.com](https://mckinsey.com).

⁶ CapitalIQ, Dealogic, and Irving Levin Associates.

⁷ In 2018, around 40 percent of all post-acute and outpatient deals were completed by an acquirer other than a traditional provider.

⁸ Singhal S, Latko B, and Pardo Martin C, "The future of healthcare: Finding the opportunities that lie beneath the uncertainty," January 31, 2018, [McKinsey.com](https://mckinsey.com).

⁹ Bestsennyy O, Gilbert G, Harris A, and Rost J, "Telehealth: A quarter-trillion-dollar post-COVID-19 reality?" May 29, 2020, [McKinsey.com](https://mckinsey.com).

¹⁰ Includes deals over \$10 million in value.

¹¹ Analysis from PitchBook Data, Inc. and McKinsey Healthcare Services and Technology domain profit pools model.

¹² Includes deals over \$10 million in value.

¹³ Fein AJ, *The 2019 economic report on U.S. pharmacies and pharmacy benefit managers*, Drug Channels Institute, 2019, drugchannelsinstitute.com.

¹⁴ Evaluate Pharma, February 2020.

¹⁵ Capra E, Smith J, and Yang G, "Gene therapy coming of age: Opportunities and challenges to getting ahead," October 2, 2019, [McKinsey.com](https://mckinsey.com).

¹⁶ Centers for Medicare & Medicaid Services, "Medicaid program; establishing minimum standards in Medicaid state drug utilization review (DUR) and supporting value-based purchasing (VBP) for drugs covered in Medicaid, revising Medicaid drug rebate and third party liability (TPL) requirements," *Federal Register*, June 19, 2020, Volume 85, Number 119, p. 37286, [govinfo.gov](https://www.govinfo.gov).

¹⁷ McKinsey COVID-19 Consumer Survey conducted June 8, 2020 and July 14, 2020.

¹⁸ De Smet A, Pachthod D, Relyea C, and Sternfels B, "Ready, set, go: Reinventing the organization for speed in the post-COVID-19 era," June 26, 2020, [McKinsey.com](https://mckinsey.com).

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