Outlook on the Private Equity Potential in India’s Health Care Sector Based on Lessons from US

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ABSTRACT

Financial globalization and increasing risk appetite among global investors has given birth to a new genre of financial intermediaries such as the private equity (PE). Growth in savings, abundant liquidity propelled by petrodollars, sovereign wealth funds as well as hedge funds and an accommodative monetary policy that enabled a low interest rate environment accelerated this process further. Moreover, regulatory changes such as pension fund reforms and financial innovations like securitization motivated the growth of alternative asset classes like private equity and more particularly, the leveraged buyout industry since 2000.

India has a population of 1.21 billion, an economy that has grown at an average of around 8% for the past eight years, inadequate and poor state-provided healthcare, a willingness among people, even the poor, to pay for private services over the free or subsidized government variety, and the emergence of a significant number of companies in the space. That is simply a reflection of the deepening healthcare demand because of consumer affluence, changing lifestyles and greater awareness. The Indian model is such that a consumer pays for the service, unlike in some of the western markets (such) as the UK, where the government pays. Therefore, as the consumer is becoming richer, healthcare is increasingly becoming their mainstream agenda after food and housing. The paper discusses about the Growth Of the healthcare Industry in India, Role of Private Equity investors, Learnings from the US market, challenges and opportunities faced by the Private Equity investors in the Indian Market.

KEYWORDS: Private Equity, Healthcare, deals, hospitality sector
UNDERSTANDING PRIVATE EQUITY IN INDIA: GENERAL AND HEALTHCARE SPECIFIC

The India private equity market has grown by leaps and bounds since its humble inception in the late 80’s, becoming the second largest Asian PE capital recipient after Japan less than two decades later.

Despite a relatively young age, the industry has already seen its fair share of ups & downs. In the late 90’s, the dot-com boom in Bangalore fuelled a rapid growth of VC/PE companies, with the bubble bust ending up wiping most of these players from the market. Demonstrating its resilience, the industry recovered from a deal-value low point of $470 million in 2003 to a peak of $19.03 billion in 2007. In line with the increasing needs to improve India’s facilities, the two biggest sectors for PE investment are Real Estate & Infrastructure Management and Telecom. Overall PE deal distribution, however, indicates large investments across varied sectors such as Power, Banking, Pharmaceutical, Healthcare and Media.

Current hot sectors for the Private Equity are:

- **Education**: Highly attractive with an estimated $40 billion market for private institutions. Over $300 million has been invested in Education ventures since 2006, and more than $800 million investment is being planned over the next 12 months.

- **Healthcare**: Significant capabilities in India for clinical research. Low average number of hospital beds will bring in massive investment to build more hospitals throughout the country. Over $686 million investment has taken place during the last 18 months.

- **Clean tech or renewable energy**: Dire need for a more reliable power supply throughout the country. Supportive regulations are providing a boost to clean tech/renewable energy. About $3.5 billion PE investment is expected over the next few years.

Not surprising, limited partners (LPs) are showing increasing caution this year when allocating funds. In fact, 2012 saw 55 funds with a mandate to invest in India, but the total fund value allocated to India was only $3.5 billion, down from $6.8 billion in
2011. All this has been driven by the fact that 2012 was an uncertain year in India both politically and economically. Reported lapses in governance, coupled with a lack of clarity in regulation, raised considerable concerns about India's attractiveness as an investment destination. Despite these challenges, the market is showing signs of maturity with all key stakeholders becoming more comfortable with the idea of private equity (PE) funding. The latter half of 2012 also saw the government become more proactive and bring forward some key pieces of legislation to create greater transparency in the regulatory environment.

The main drivers of growth in the Private Equity Industry are:

- Sustained economic growth
- Rising middle class segment
- Well established public equity market
- Human capital and competitiveness in high growth sectors

HEALTHCARE IS A KEY PRIORITY FOR INDIA’S GROWTH

The Indian healthcare industry, which comprises hospitals, medical infrastructure, medical devices, clinical trials, outsourcing, telemedicine, health insurance and medical equipment, is expected to reach US$ 160 billion by 2017.

The Indian medical device and equipment market is expected to grow to around US$ 5.8 billion by 2014 and US$ 7.8 billion by 2016, growing at a compound annual growth rate (CAGR) of 15.5 per cent, according to a report by Grant Thornton India. India’s medical device market is currently the fourth largest in Asia with 700 medical device makers, and ranks among the top 20 in the world, as per data from India Semiconductor Association.

The hospital and diagnostics centre in India received foreign direct investment (FDI) worth US$ 2,057.29 million, while drugs & pharmaceutical and medical & surgical appliances industry registered FDI worth US$ 11,391.03 million and US$ 720.41 million, respectively during April 2000 to September 2013, according to data provided by Department of Industrial Policy and Promotion (DIPP). The Indian healthcare providers plan to spend Rs
5,700 crore (US$ 916.40 million) on IT products and services in 2013, a 7 per cent rise over 2012 revenues worth Rs 5,300 crore (US$ 852.09 million), as per a report by Gartner.

OUTLOOK ON PE POTENTIAL IN INDIA’S HEALTHCARE SECTOR

Comparison between India and US: The facts

The two largest democracies in the world have similarities as well as differences in their healthcare systems. They both have a mix of private and public, in terms of the delivery side as well as the payment side. And they’re both at inflection points, where there are important policy decisions being made about what the next 5 to 10 years will look like for the health care system. The Indian government is about to make a major investment in health care. In the United States, the passage of the Affordable Care Act represents a major investment on the part of the federal government.

Private equity investment naturally gravitates to industries that are experiencing buoyant demand and pressure to become more efficient. With its steady growth and global pressure to rein in costs, the healthcare sector has all of the symptoms of an attractive PE play. Patient demand is robust worldwide. In emerging economies, broad populations are gaining access to modern healthcare for the first time. And in the advanced economies, governments, health insurers, employers and other private payers are overhauling reimbursement formulas. In the US, where healthcare faces sweeping changes accelerated by the Affordable Care Act, two hot themes in particular have sparked private equity interest. First, PE investors targeted physician management organizations, making serial acquisitions of smaller medical practices that they roll up into larger, more efficient groups. In particular, PE funds are assembling groups of practitioners, both in traditional hospital-centred specialties in such areas as radiology and neonatology as well as in emerging fields of hospital-focused specialization like neurology and general surgery. PE investors are also building independent practice associations (IPAs), or groups of doctors with a diverse range of capabilities who together can provide the all-encompassing patient care and case management services that recent health reform measures try to promote.

The second hot opportunity for private equity investment has been the retail health category, spanning traditional specialties like dental clinics and urgent-care facilities, as well as emerging areas from fertility to cosmetic surgery. Reimbursement terms in many of the health retail categories are attractive, because they are affordable to payers and patients who
pay out of pocket for some services. Also, most segments within retail health are highly fragmented and underpenetrated, presenting opportunities for growth through merger and acquisition as well as organic expansion. Physiotherapy Associates, a leading provider of outpatient rehabilitation, capitalized on the opportunity to roll up practitioners in the physical therapy field. Under PE ownership, the company grew to 700 locations across 35 states. Court Square Capital Partners, a New York–based firm, bought the company last year and has continued the expansion, having acquired one clinic and opened four new ones since the deal closed.

Indian companies signed as many as 655 private equity deals totalling $10.68 billion in 2013, registering an increase of over 12 per cent in value terms over the last year, says a report.

According to data compiled by deal tracking research firm VCCEdge, Private Equity (PE) investments increased 12 per cent to $10.68 billion in 2013 from $9.5 billion in 2012.

A sector-wise analysis shows that the top five sectors in terms of deal value are financials which attracted deals worth $2,771 million, followed by consumer discretionary ($1,812 million), information technology ($1,642 million), health care ($1,264 million) and telecommunication services ($1,264 million).

In terms of the number of deals, information technology attracted 210 deals, followed by consumer discretionary (152), financials (99), health care (73) and industrials (60).

INDIA’S ATTRACTIVENESS AND IMPROVEMENT AREAS

Healthcare sector played true to its characteristics of being a defensive bet for investors in 2013. The sector bucked the overall slowdown in deal making in the country for the second year running by hitting a new high in terms of attracting private equity firms and saw merger & acquisitions (M&As) shoot up with a slew of large transactions across pharma and healthcare services segments.

In the past three years, PE / VC investments in health care has grown about 300 per cent in India. While there were 39 deals worth $312 million in the Indian healthcare sector in 2011 and 65 deals worth $1 billion in 2012, the deal size soared as high as $1.2 billion in 2013, according to VCCEdge data.
The Indian health care market is pegged at $78 billion, growing at an average rate of 11 per cent from 2008 through 2012. According to the World Bank's 2010 estimates, India's per capita spend on health care is $50, trailing China's $221, the UK's $3,500 and the US' $8,400. India's distribution of hospital beds, too, is lower. While India has nine beds for 10,000 people, China has 42 beds, the UK has 33, the US has 30 and Brazil has 24 beds.

**REASONS FOR PERFORMANCE OF HEALTHCARE SECTOR IN INDIA**

Healthcare sector has done better than other sectors for various reasons. One is that the demand supply gap is still very skewed and likely to remain so for the next few years. Others are lack of fierce competition, healthcare still is a consumer led story, people moving to preventive healthcare, increase of accessibility through technological innovation like telemedicine among others.

The family doctor concept is slowly phasing out as migrants in cities look out for a brand rather than visiting a general physician next door. Another attraction is that primary healthcare providers such as outpatient clinics and diagnostic centres are not capital-intensive, so investors don't have to write out big cheques. Also, unlike many restrictive Indian industries, from insurance to real estate and telecoms, there are no limits on foreign ownership in healthcare.

**DIFFERENCES IN PROCESS AND EXECUTION OF DEALS BETWEEN THE US & INDIA**

Our research highlights three key process differences when comparing a typical PE deal in India compared to the US:

1. **Need for assessment of more companies before making an investment**

In general, it takes a lot more analysis to identify a suitable company for a PE investment in India compared to the US. One of the primary reasons for this phenomenon is the deal size,
rather the lack of it. Most of the companies assessed by PE firms in India turn out to be too small for a meaningful investment and provide few opportunities to scale up.

LONGER DEAL TURNAROUND TIME

According to Raj Ayadurai of Navis Capital, a PE deal in India could easily take twice the time to complete when compared to a deal in developed markets. A key reason for this is the need to conduct a more thorough due diligence. The Indian due diligence process often includes a comprehensive promoter background check, as stories abound of con-artists trying to sell their fake shell companies, or serial entrepreneurs who repeatedly sold their run-down companies that appear attractive due to doctored financials.

TENDENCY TOWARDS ALL-EQUITY FINANCING

Reserve Bank of India (RBI) regulations stipulate that PEs cannot purchase companies with a structure that involve part equity and part debt. All transactions have to be an all equity deal. This forces the need to have a large equity base and limits the size of LBO transactions, involving limited or no leverage. Consequently, the financing aspect of the deal is made simpler with the reduced or even non-existent needs for bankers’ involvement to raise debts. Further on the lending side, RBI is not clear whether loans for acquiring huge tracts of land needed by colleges are to be treated as education” or “real estate”.

CHALLENGES FOR PE IN HEALTHCARE IN INDIA

VC/PE funds look out for two key things – People (qualities of the leadership team) and Business (business model, competitive advantages, growth potential). In people, besides competence, they look out for qualities like integrity, persistence, adaptability. From a business viewpoint, VC/PE funds look out for value to the customer (can the customer live without the product?), market growth potential (>30% CAGR), business model (free cash
flow). Processes include screening, due diligence, deal structuring, negotiation, term sheet, and post-investment monitoring. Out of these, bulk of the time is spent on monitoring. VC/PE funds are not passive investors. Interests of the entrepreneur and the funds are aligned. VC/PE funds add value in many ways, for example – providing strategic advice, helping with business development by providing access to new markets and more customers, conducting monthly and quarterly reviews towards ensuring that the business plans are met.

Some of the Challenges faced by the healthcare industry are:

- **Managing a team of doctors**: A prospective private equity acquirer needs to take careful measure of the capabilities of the Doctors, ensuring they have the energy, skills and experience needed to realize the company’s growth potential.

- **Convincing patients**: Overcoming the draw of a trusted doctor may prove harder than it seems, even in a country where healthcare infrastructure is poor, electronic medical records are rare, and the quality of doctors and other medical professionals is patchy. Although branded clinics have potential, they find it tough to pull patients from a strong local doctor. Also, if there is a big hospital in the vicinity, then they lose out on patients. While fees at modern clinics range from 150 to 600 rupees for treatment of routine illness, sole general practitioners charge patients anything between 50 and 300 rupees per visit.

- **The perspective of stakeholders**: Successful acquirers take the temperature of how key stakeholders—particularly patients and clinicians—assess the value proposition the target company offers.

- **Scale**: What is the relative scale the target company enjoys in its local market, and what’s its ability to win additional share?

- **Potential for expansion**: A prospective acquirer needs to weigh the target’s potential to expand—either by opening new clinics or through further acquisitions.

- **High Competition**: Mr Avnish Mehra, Director, Advent, says his firm looks for a strong brand name and good clinical excellence. The demand is huge so also are the growth opportunities. But, the challenges remain. From a sector perspective, competition is always high. Also, there is the need to combine clinical excellence with managerial and administrative capability.
The growth of medical insurance has both positive and negative points. On the positive side, health insurance makes medical care affordable to many more, while it also throws up the risks of litigation. But, in the end, the model has to be adequately tweaked to suit the market conditions. Investing in expensive diagnostic equipment will work in the metros, where the revenue per bed, say, in a Delhi or Mumbai, could be as high as Rs 1 crore. But, in the smaller cities and towns, the need is to provide affordable healthcare without compromising on quality. That is where the growth opportunities lie.

**OPPORTUNITIES FOR PE FIRMS IN THE HEALTHCARE SECTOR IN INDIA**

- **Sound fundamentals for growth:** The healthcare sector presents limited risk, as most growth drivers are macroeconomic and informed by highly reliable data and trends. It's estimated that India is 20 to 25 years behind the US in terms of the maturity of the healthcare sector, and there is growing confidence that India will follow the same trajectory as the US.

- **Established track record of value creation:** Over the last five to seven years, several healthcare businesses have shown attractive growth and margin expansion records.

- **Recession-proof nature:** Given the current uncertain economic climate, it is not surprising that PE and VC investors have focused their attention on healthcare, along with consumer goods or services.

- **Government support:** Across India, state governments are making a commitment to improve the health of citizens. Government support has also
addressed a key issue: the cash transactions, which made PE firms uncomfortable. An improved policy framework and increased insurance penetration mean the industry is seeing more white money, with neater transactions and a more suitable environment for larger investments.

- **New delivery models**: Resource constraints have pushed innovations such as short stay centres and specialised delivery centres through specialist hospitals like Vasan Eye Care or Nephroplus, a renal care unit. As companies offering these new ways of delivering healthcare services seek to stabilise and scale up, their demand for capital is growing.

- **Value addition of VC and PE investors**: Most healthcare companies are run by medical professionals or a family of doctors, who are commercially oriented but often lack strategic vision or a professional management approach. Such firms may have limited business experience and are often looking for skills and competencies that can supplement their technical knowledge: a win-win situation for private equity investors.

- **Track record of exits**: While the number of exits seen in the healthcare sector is in line with the overall exit rate (47 out of 288 investments have exited so far), the value of those exits is more positive. Of the $5 billion invested into healthcare, $2.8 billion has been returned, an improvement on India's overall track record of $30 billion of returned capital from the $85 billion invested.

**GROWTH DRIVERS OF HEALTHCARE SECTOR IN INDIA:**

- Increase in population
- Increase in lifestyle related health problems
- Faster diagnosis leading to early treatment – health awareness & prevention
- Increase of disposable incomes in Indian households
- Better penetration of health insurance
- Medical tourism
- Medical insurance and compulsory wellness checkups by companies
- Government programs and focus on PPP (Public Private Partnership) models in healthcare to reach deeper into rural areas, Rising literacy and growing awareness
CONCLUSION

Although the healthcare industry in India is growing at a fast pace, the government alone cannot possibly cope up with the increasing demand for healthcare infrastructure and quality treatments. Even the private organizations are unable to meet the growing demands in the country. Thus, with 100% FDI being made available in the healthcare sector, India has now become a promising investment destination for healthcare businesses from across the world. The healthcare market in India is estimated to be $78 billion and has been growing at 11%, on average, from 2008 through 2012. That said, India is a highly underpenetrated market. The Worldbank's 2010 estimates revealed that India's per capita spending on healthcare was $50, trailing China's $221, and in a far different league than in the West, where the UK spends $3,500 and the US spends $8,400 per capita. India's ratio of nine hospital beds per 10,000 people is a fraction of those in the West.

Some of the key areas where PE/VC derived the most benefit include help with strategic planning, developing the company vision, guidance on how to scale up and realise the full potential of their current platforms, improvement in all-around performance through significant inputs in marketing and advertising, and, finally, support for the acquisition and training of management talent.

All these factors point to the important role that both venture capital and private equity have to play in the Indian healthcare sector. As the healthcare sector continues its rapid growth, we are likely to see an accompanying rise in the levels of PE involvement. Healthcare is an industry clearly set to grow in India, and one in which private equity and venture capital can play an active role. Entrepreneurs already value PE and VC funds for the skills, expertise and network they bring to the table that other sources of capital are unable to provide. We predict that the next few years will continue to see momentum for deal activity rise in this exciting space.

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