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Finding untapped potential in European healthcare service providers

European healthcare service providers are complex and fragmented, but with niche market knowledge and a creative approach, investors can create substantial value.

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Healthcare has long been an attractive investment area. Returns over the past 15 years led all industries.[1] In Europe, the market's attractiveness is underpinned by fundamental tailwinds—for example, population growth, aging populations, and an increase in incidence of chronic disease. Further, Europe's predominately public-led healthcare systems suffer from poor access to capital and are increasingly willing to accept private investment in care delivery to improve care efficiency, effectiveness, and access.

Of course, with high performance comes intense competition. European healthcare is no longer the exclusive hunting ground of private equity. Hot opportunities are attracting new investors who have traditionally not invested in healthcare, including infrastructure investors, other long-term investors (pension funds), and ex-Europe funds (Asian funds or sovereign wealth funds), to name only a few.

Even with more competition, many services, such as oncology and fertility clinics, are largely untapped by investors. Some of these remain untouched because the market remains too fragmented and assets fall below investment thresholds for revenues and earnings, while others have been deemed too risky by investment committees owing to heavy exposure to a single reimbursement system or a single regulatory body.

In our experience, however, these internal restrictions, while established for good reason, can prevent investors from accessing considerable untapped value. With niche knowledge and some creativity, it is possible for investors to bring comfort to their various committees. To do so, intrepid investors must follow a set of rules to identify the most promising acquisition targets. In addition, investors can use more novel value-creation strategies to roll up businesses and unlock any as-yet unclaimed value. Our research has revealed valuable insights into potential attractive subsectors, allowing us to explore how investors might identify and unlock value in untapped niches.

Gaining a deeper knowledge of European healthcare provision

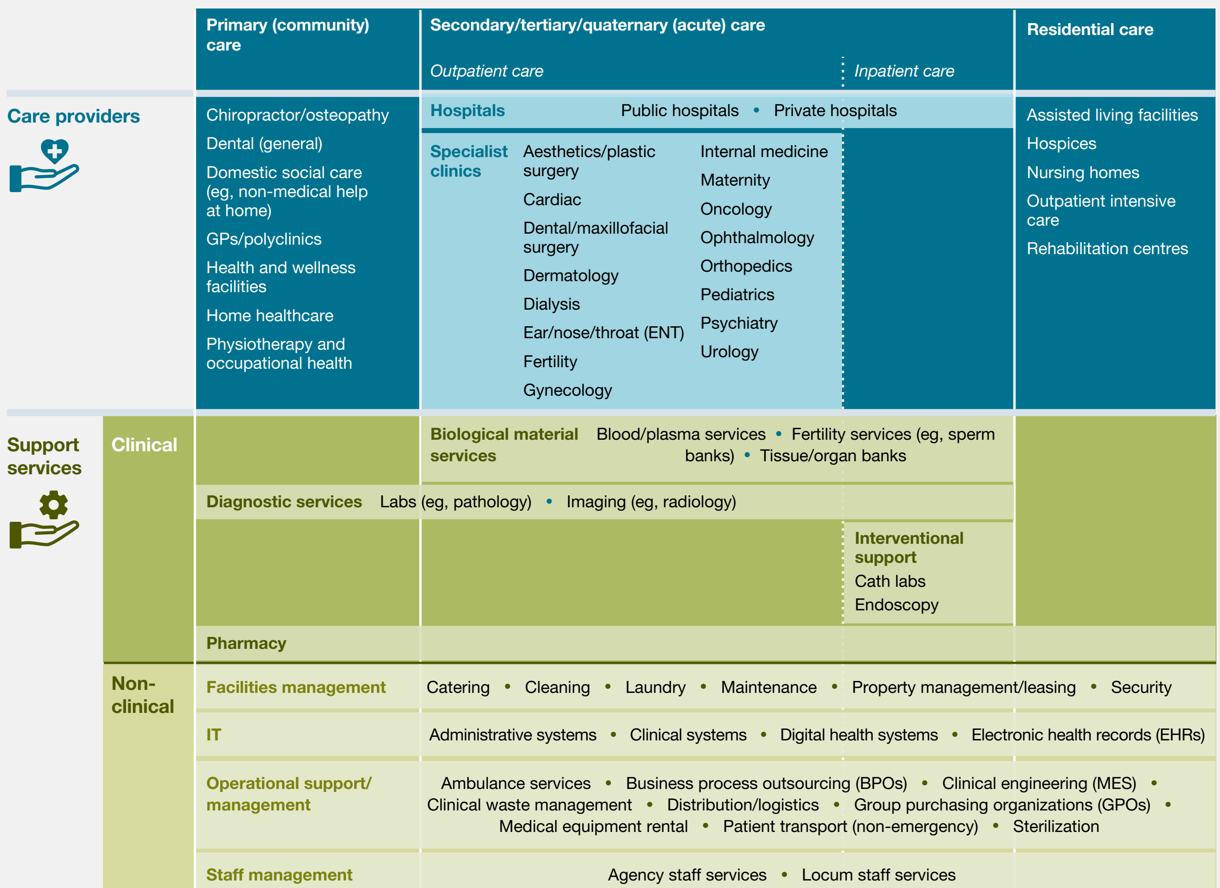
The private (nongovernment) European healthcare service provider market is vast—Western Europe alone is more than $460 billion—and highly fragmented.[2] Europe has literally thousands of providers across dozens of specialties, in direct care delivery and supporting clinical and nonclinical services (Exhibit 1).

Despite this complexity, the market has grown steadily but modestly at approximately 1 percent per annum since 2013, and our analysis suggests that low-single-digit growth, around 2 to 3 percent per annum, will continue over the next five years.[3] Although that's a little lower than growth in other healthcare segments—pharmaceutical services in Europe are forecast at around nearly 8 percent per annum through 2023—considerable value is accruing in high growth and high potential niches.[4] Firms that are willing to consider smaller targets and take a more hands-on approach to building a business stand to win big.

European veterinary clinics are a fantastic example of where this hands-on approach has been done well. In June 2014, Nordic Capital announced its acquisition of AniCura, a leading European veterinary chain. During Nordic's four years of ownership, AniCura grew fourfold, increasing (organically and inorganically) its number of clinics to 200 from 50, its employees to 4,000 from 1,000, and its pro forma revenues to about $370 million from $100 million.[5] In June 2018, Nordic announced its sale to Mars Petcare. Financial details were undisclosed, but the sale values AniCura at close to €2 billion (or $2.3 billion) and is reported to have delivered Nordic Capital an impressive sevenfold return, according to a source familiar with the deal.[6]

What Nordic has achieved is a great example of the value that can be created when a large but highly fragmented market is actively rolled up by an investor.

Exhibit 1 **The European healthcare system comprises thousands of care providers and support services across dozens of specialties.**



Similar strategies would play out well in other market niches where capital investment and a strategic mindset is much needed—so long as investors account for the nuance among different sectors and geographies.

Equally, many of these niches present similar challenges to investors. For example, strict regulation that is often closely linked to public care provision and varies significantly among countries, can create challenges in taking business across borders. Reimbursement schemes can be complex and include payment from governments, private health insurers, and patients themselves. High fragmentation across areas of care provision, particularly in the outpatient clinic space, and political as well as reputational sensitivities in the minds of the public, politicians, and the media, are additional risk considerations.

Still, many investors are attracted to the untapped potential in healthcare services, which broadly correlates to the level of fragmentation in each subsegment. Exhibit 2, which is based on our experience, shows a qualitative analysis of the relative opportunity and fragmentation aggregated across Europe.

Exhibit 2

The level of fragmentation in each subsegment broadly correlates with the amount of attractive opportunities within that subsegment.

The challenge is knowing where to spend time looking, and where an investor's unique edge might help beat the competition in an increasingly competitive market. A set of rules can help determine where to find attractive opportunities.

Seven rules to effectively identify investment targets

Precisely where and how to enter this market will depend on an investor's appetite for return, risk, and effort. Regardless of these factors, all investors should follow seven rules when seeking acquisition targets:

Rule 1: Be clear on your investment parameters—but don't be afraid to challenge them in creative ways. When we talk with investors, we are often surprised by how whole market segments are written off as too fragmented, too risky, or unattractive—essentially tarring the whole segment with the same brush. In some cases, investors are probably right to avoid a nascent industry with a lot to prove. However, this approach leaves potential gems on the table, including businesses that fail on just one criterion but that could be quickly "fixed" with a suitable bolt-on to diversify risk, for example. Investors should therefore be clear on their investment parameters, then look again at sectors they have previously written off to see if there is a hidden gem. In some cases, creative investing and a novel approach can create value in a business that almost works.

Rule 2: Build a deep understanding of your starting market. It's no secret that opportunities are highly market specific. To truly create value, investors must have a detailed understanding of local market dynamics—especially in regulation, reimbursement, and political sensitivities—and the opportunities and restrictions those dynamics could place on creating value. Investors weighing going deep versus going broad would typically be best served by going deep. Identifying an attractive subsector and geography and then working toward a deep understanding of the value-creation potential is preferable to looking broadly across subsectors or geographies.

Rule 3: Understand the incentives created by the target's surrounding ecosystem and consider those in determining scalability. Taking a successful business model from one region to another can seem attractive, but more detailed examination often reveals that the conditions in one location—such as highly specific regulations and reimbursement practices—are too different to make a cross-border move viable. The critical factor here is how those conditions create incentives on the decision makers along the value chain (for example, a referring physician), and so while the exact regulations and reimbursement may not be identical across regions, by looking at the incentives they create, investors can find similar regions that could present potential future expansion opportunities.

Rule 4: Look for "unofficial networks." As previously noted, finding sufficiently large targets in more fragmented subsectors can be challenging. However, what we would term "unofficial networks"—affiliated individual clinics that are separate businesses but operate as a network—may provide opportunities to purchase at once what are essentially minichains of multiple businesses. Such networks often go undetected and often require on-the-ground market intelligence to find.

Rule 5: Select targets wisely—and be patient. Sourcing in this market primarily means looking at individual businesses or small chains. Persuading individuals to sell a business they have spent their entire career building can be a time-consuming endeavor. Identifying the right businesses to acquire is a combination of finding the right fit with your value-creation strategy and identifying purchases that can actually be completed. Seeking out businesses with owners who are likely to retire soon can speed the roll up of a market. One investor looking to acquire ophthalmology clinics in Germany performed an exhaustive scan of clinic owners and practitioners, collating data from multiple sources to identify owners approaching retirement age. An initial list of more than 4,500 facilities was filtered down to 11 clinics that met size requirements, and had an owner aged 55 or older with no obvious offspring or heir in the business to pass it on to, significantly streamlining their search efforts.

Rule 6: Attract the right talent into the organization. One of the major benefits of building scale is the ability to attract and inspire talent; however, this in addition to identifying and executing acquisitions—requires strong leadership. The existing leadership of a small platform organization is unlikely to have the necessary capabilities. Therefore, when considering a challenging roll-up within a particularly fragmented industry, it is best to find the right leadership team early, preferably before the first acquisition.

Rule 7: Be flexible with your proposed operating and ownership model. Providing the right operating model option can be an important criterion for persuading a founder or owner to sell. Especially in clinical care, investors often need the founding physician to stay on in a clinical capacity, and physicians will have different requirements as to how they want to do this. Some may want to only do clinical work on a fixed salary, while others may want to maintain a stake in the business and be more hands-on in expanding it. We have seen this approach put to particularly good use in a European dental chain expansion, where the private equity owners were flexible in how newly acquired practices could be governed, dramatically increasing the independent owners' propensity to sell.

Of course, the ability to unlock this potential will ultimately come down to an investor's appetite for each subsector, their value creation strategy, and, crucially, their ability to execute and roll up to a sufficient scale and realize synergies.

Multiple options to create value

Traditional value-creation methods that work across sectors, such as consolidating back-office functions to reduce costs, also often work for European healthcare providers. However, there are a number of other scale synergies, some unique to healthcare providers, which investors should consider.

Horizontal expansion

In many public health systems there is growing unmet demand for access to preventative and primary care. Much of this is low-acuity (in other words, low clinical complexity) work, such as vaccinations, basic health advice, and access to simple diagnostics and over-the-counter (OTC) medications. Traditionally, much of this demand has been handled by the primary care physician (PCP). However, with PCPs under increasing demand to treat more severe complaints, regulators are trying to push the bulk of the lower-acuity care into other settings. As a result, pharmacies, diagnostic centers (such as blood collection points), health and fitness centers, and even workplaces are picking up this slack. The strategy of expanding service delivery to help meet this unmet demand works in subsectors such as pharmacies and elderly care where there is a high footfall of customers or patients and a clear unmet need in the broader health system for that patient group.

Vertical integration

Care providers are often able to make margins on care delivery, while some costs—most notably for highly priced drugs—are passed through to the payor with no markup. In some areas, such as oncology, providers have no control over most costs. However, providers that have achieved adequate care-delivery volumes can create significant value by working with pharmacies. Vertical integration (combining delivery care with pharmacies) allows the care provider to negotiate better prices for its drug purchases while achieving more consistent, high-quality care by standardizing prescribing drugs for common conditions across physicians. Similarly, renal dialysis clinic chains are able to offer competitive care costs because they take advantage of their immense scale to achieve better terms with drug manufacturers. This strategy works especially well in subsectors where there are high pass-through costs.

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Cross-selling

In many of the more fragmented care delivery sectors, clinics are still managed by their founding physician, whose primary focus is on clinical care rather than building the business. As a result, significant unmet patient demand could exist for additional products or services, if a more commercial mindset were taken. Recent roll-ups of veterinary clinics have highlighted the value of this approach, with large chains offering additional services, including grooming, pet-hotel services, and access to specific products through a small shop in the clinic. This strategy works well in subsectors, such as veterinary, dental, and aesthetics (laser hair removal, for instance) where payors or patients spend significant sums on related products and services outside the clinic.

New digital channels

In some fragmented subsectors, investors have opted for more disruptive value-creation strategies—for instance, using technology to provide new channels that capture unmet demand from patients. In many countries, for example, the aging population and public spending constraints have resulted in long waits to see a primary care doctor. Entrepreneurs and investors are now offering teleconsultations using video chat applications on smartphones, tablets, and PCs to take advantage of this unmet demand. Subsectors, such as primary care, and other nonmedical care, such as elderly social care, are particularly ripe for this approach. These subsectors tend to have high unmet demand and limited capacity to meet it. Similarly, there is increasing demand for easier access to care for those with busy lifestyle considerations—say, career-focused consumers—presenting entrepreneurs and investors with further untapped potential to unlock.

Improving care value with automation and digital tools

Healthcare has traditionally been slow to adopt new technologies. This is a consequence of a number of factors, including limited access to capital, complex processes, underinvestment in staff development and digital capabilities, and competing priorities. However, this reluctance creates an opportunity for canny investors to disrupt existing workflows by applying cutting-edge automation and digital technologies. This strategy works particularly well in areas where there are highly repeatable and automated tasks, such as pathology or radiology. There are numerous attempts already underway—for example, the remote reading of scans to improve turnaround times and also to create automation by allowing AI robots to concurrently read scans and learn from their human counterparts.

Medical tourism

Not all care is available locally and not all care is cost effective for patients. In areas with high out-of-pocket costs, such as aesthetics or fertility, or in those with a particular criticality to the patient (also fertility or oncology), patients are often willing to travel to receive higher-quality or lower-cost care. For example, proton beam therapy for cancer care was not widely available in most of Europe until recently, so many patients traveled to the Czech Republic, among other places, to obtain it. Similarly, the European market for IVF is particularly booming in Spain, Ukraine, and the Czech Republic, where care costs are significantly lower than the other EU nations and regulation is favorable.

Cutting capital costs by outsourcing services

Today, many product manufacturers, including those in medical products and devices, are recognizing the opportunity to change their revenue models from one-off sales to more attractive recurrent streams. This approach can also generate value for providers, allowing them to get out from under certain burdensome capital costs. Consider specialist services, such as catheterization, radiology, and pathology, in a generalist hospital. In many cases, an external party could run them more effectively. Imaging product manufacturers have shifted away from simply selling equipment toward managed equipment service contracts, in which they provide the equipment, maintenance, and staff for a fixed cost at a guaranteed uptime or throughput. This structure reduces the burden on the hospital and ensures that patients receive the highest quality of care from specialist providers.

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Certainly, the amount of untapped value in the healthcare provider services sector should be exciting for investors. But it's exciting for another reason as well: their investments could very well help to improve the quality of care, access to services, and patient experience—all at a lower cost for individuals, insurers, and governments. The pace of consolidation is accelerating. Investors who want to enjoy first-mover advantage should act soon to enter the right market niches and create new, hands-on strategies to unlock huge amounts of untapped potential. ■

[1] For more on the attractions of European healthcare, see Yair Erez, Justas Grigalauskas, Dima Podpolny, and Thomas Rudolph, "European healthcare—A golden opportunity for private equity," June 2017, McKinsey.com.

[2] For more, see *Health Care Services in Europe 2018,* Healthcare Business International, healthcarebusinessinternational.com.

[3] Numbers are based on information provided by the World Health Organization (2016), BMI Healthcare (2016), and McKinsey analysis.

[4] Numbers are based on information provided by the World Health Organization (2016), BMI Healthcare (2016), and McKinsey analysis.

[5] Nordic Capital press release.

[6] Darragh Riordan, "Nordic capital makes 7x return on AniCura sale to Mars Petcare," *Real Deals,* June 11, 2018, realdeals.eu.com.

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