Health Care Sector Presents Opportunities for Discerning Investors

By Jason Thomas and Steve Wise

Amid rising living standards in emerging markets and aging societies in developed countries, global health care spending, which stands just under $8 trillion today, is projected to grow more than 6% annually over the next decade, expecting to reach $10 trillion by 2020.[1] This makes the sector an attractive destination for capital in a world searching for growth. However, established providers and manufacturers may not uniformly benefit. Indeed, rising cost pressures—and policymakers' responses to them—are likely to spur innovation in new therapies, technology, and business models that have the potential to disrupt existing arrangements.

How this all plays out varies based on where a particular economy is in its development, including per capita income and the age of its population. Broadly, emerging markets are focused on building out their health care infrastructure, while advanced economies are experiencing a new era of innovation and cost consciousness.

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In countries with lower income levels, health spending centers on communicable disease and childhood conditions, including respiratory infections, malaria, tuberculosis, and HIV/AIDs. As living standards improve, non-communicable diseases (NCDs) like heart disease, diabetes, neuropsychiatric disorders, and cancer start to account for a larger share of health expenditures. Non-communicable or chronic conditions are also much more expensive to treat and tend to impact older people. Increases in life expectancy stemming from improvements in living standards increase the share of income devoted to health care.

Countries experiencing a transition in living standards experience much more rapid increases in relative health spending than economies that have already transitioned. For economies in the $10,000 to $20,000 per capita income range, such as some of the nations in developing Asia and Latin America, income gains could translate into potentially explosive growth in health spending due to the need to build the infrastructure and services necessary to treat chronic conditions. This healthcare infrastructure spending includes not only treatment facilities, but also the diagnostic tools and critical therapeutic methodologies necessary for addressing these conditions. Those economies often require foreign capital and expertise to do so. We have seen this play out through both our global portfolio companies, such as Ortho-Clinical Diagnostics, as well as through a number of local market investments such as RDSL in Brazil, Alloheim in Germany and Medanta in India.

Once a country's disease burden and mortality share has shifted decisively to NCDs, it is aging, rather than income growth, that becomes the main driver of increases in health spending.

In advanced economies, there is a renewed focus on cost management due to the dramatic recent increases in healthcare spending. In the United States, for example, U.S. healthcare spending grew 5.8% in 2015, to $3.2 trillion, or almost $10,000 per person. This amounts to a stunning nearly 18% of U.S. GDP, with projections for it to continue growing by 6% annually, exceeding $4 trillion by 2020.[2]

As a result, there has been a widespread effort underway in the U.S. to move toward "value-based care," a theme generally focused on paying for efficient and quality healthcare provision, rather than paying for volume of care. This movement is being driven by the government, the largest healthcare payer, as it tries to manage the swelling cost burden for the Medicare and Medicaid programs. The Centers for Medicare and Medicaid Services (CMS) appropriated $10 billion for the next 10 years for innovation efforts around value-based care, while the Department of

Health & Human Services (HHS) has set a goal of tying 50% of payments for traditional Medicare benefits to value-based payment models by the end of 2018, all with the goal of lowering the cost of these government sponsored entitlement programs.[3]

This focus on cost management and the implementation of value-based care models are creating significant change in the healthcare marketplace and driving new opportunities for investment. Low- cost-of-care facilities and providers that embrace "at-risk" business models are likely to be the winners in this increasingly cost-conscious world. Urgent care facilities, home health providers and ambulatory surgery centers are likely to see large increases in revenues as payers steer beneficiaries to lower-cost alternatives to hospitals. Shared savings programs place integrated health systems, Accountable Care Organizations (which tie payments to quality metrics and the cost of care), and physician groups "at risk" of loss in the event that total costs exceed a designated benchmark, but also allow these groups to generate significant earnings growth if they can deliver high quality care at lower cost through improved coordination and analytics.

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In these advanced economies, increased cost consciousness will likely slow the rate at which new medical technologies are embraced by providers and payers, while shifting resources into technology designed to track spending and measure health results. Health Care Information Technology (HCIT), including electronic health records and analytics software, has the potential to standardize care, improve outcomes, and reshape how health care is reimbursed. When coupled with the growth of value-based care arrangements and high-deductible health plans (HDHPs), new HCIT-based analytics can lead to new business models that may deliver significantly improved care at lower cost.

As the focus for healthcare changes in advanced economies, private equity firms such as The Carlyle Group can use roll-up acquisitions to create organizations with the necessary scale and resources – and emphasis on coordination and health outcomes – to compete. Private equity can also capture opportunities resulting from realignments in large health care companies' portfolio of businesses. For example, pharmaceutical, medical devices, and medical technology companies are likely to respond to new cost pressures and procurement policies by exiting non-core businesses or outsourcing non-core functions such as manufacturing or certain development functions such as clinical trials. Adding to this trend, large recent pharmaceutical mergers, such as Shire/Baxalta (June 2016) and Bayer/Monsanto (announced September 2016), could result in the sale of entire divisions, or individual drugs, as companies rationalize their portfolios. Private equity can be a buyer and value creator in these instances, with significant expertise in corporate carve-out transactions and organizational transformations.

In this global environment, healthcare industry expertise and local market knowledge are essential in order to appropriately analyze the rapidly changing market place for future investment.

1. IMF, 2016 World Economic Outlook Database. October 2016. Estimate based on fixed-effects regression model using the World Bank's 2015 World Development Indicators data on Health Expenditures.
2. Centers for Medicare & Medicaid Services, NHE Fact Sheet and Projections, December 2016.
3. Deloitte University Press, "The road to value-based care," March 2015; U.S. Department of Health & Human Services, "Better, Smarter, Healthier: In historic announcement, HHS sets clear goals and timeline for shifting Medicare reimbursements from volume to value," news release January 2015

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