

# Capitalising on healthcare

Who will the winners be?



# About the report

Over the course of the summer of 2010, Remark, the research and publications arm of The Mergermarket Group, canvassed the opinions of 50 executives from UK-based healthcare businesses. The businesses were involved in social care, primary and secondary care, as well as healthcare outsourcing. Their turnover ranged from £5m-£100m.

Respondents were asked to give their opinions on a number of issues relating to how they go about financing their strategy in the current market environment, the impact of the new government and its expected spending cuts, corporate strategy and growth plans.

All answers were confidential and results have been reported in aggregate.



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## Foreword

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While it is clear that businesses in the UK's healthcare space are bullish about their future prospects, we have to ask is it sustainable in the current environment, and can operators respond to the expected changes?

They identify funding as the biggest challenge to corporate development; yet also say that they are able to fund their growth strategies using existing internal cash flow. The conclusion we have to draw is that many of the businesses in the space are able to support their day-to-day operations through internal cash flow, but that the lack of external bank funding is holding them back from larger, transformational moves.

This may be sustainable throughout a crisis when there is little movement in the market. However, now that the market is recovering and businesses are jockeying to take advantage of corporate development opportunities is this approach sustainable?

The winners in the space are likely to be businesses that have either scale or niche; those that have both the financial and the managerial resources to take advantage of the opportunities resulting from, for example, increased NHS outsourcing. Operators that can promote themselves as operating in partnership with local authorities will also see growth.

The successes will be those players who can step out of the shadow of the financial crisis, work with banks and other providers of finance to secure funding and use it wisely to capitalise on the opportunities that the market offers.



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**Mark Naughton**  
Corporate Finance Director  
Grant Thornton UK LLP

# Cautious optimism

While talk of the global financial crisis is slowly taking a back seat, the impact of it will reverberate through the world's economic and global financial systems for years to come. It also continues to pose challenges and impact on businesses' development strategies.

However, compared to other sectors, the UK's healthcare space has traditionally been viewed as robust and counter-cyclical. In fact, the survey shows that companies in the sector are eager to exit a period of system-imposed survival mode and target growth anew.

M&A is once again expected to play an important role, but businesses in the space are also considering launching new products and services, as well as expanding into new regional and international markets to ensure growth.

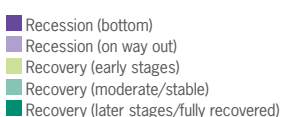
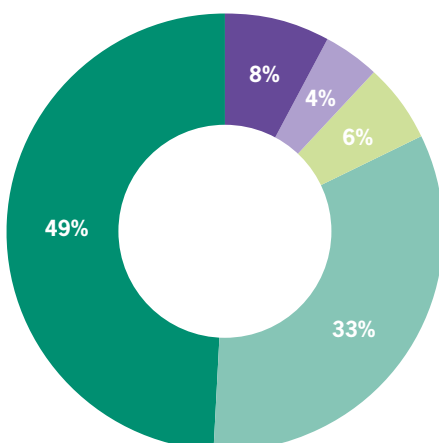
Policies introduced by the new coalition government are set to create opportunities, most notably through accelerating the shift towards increased outsourcing by the NHS.

Meanwhile, as the still depressed market conditions are driving weaker players in the space into distress, stronger players are planning to engage in buy-and-build strategies. Also, as scale continues to become increasingly important, smaller firms may well feel the pain which could lead to a round

of consolidation in this highly fragmented industry.

Against this broadly positive backdrop it is nevertheless notable that healthcare firms have faced a number of significant challenges in recent months. They continue to be faced with a still difficult financing environment, particularly those businesses that are not asset-backed. In addition, they will have to tackle more sector-specific issues, largely relating to expected government spending cuts and immigration legislation

In terms of recession or recovery, how would you position your sector today?





The sector remains robust in comparison to others as the underlying demand for healthcare services is strong. However, there remains considerable uncertainty over the future not only as a result of the macroeconomic outlook, but also the changes afoot as a result of the coalition government's plans for the provision of care in the future.

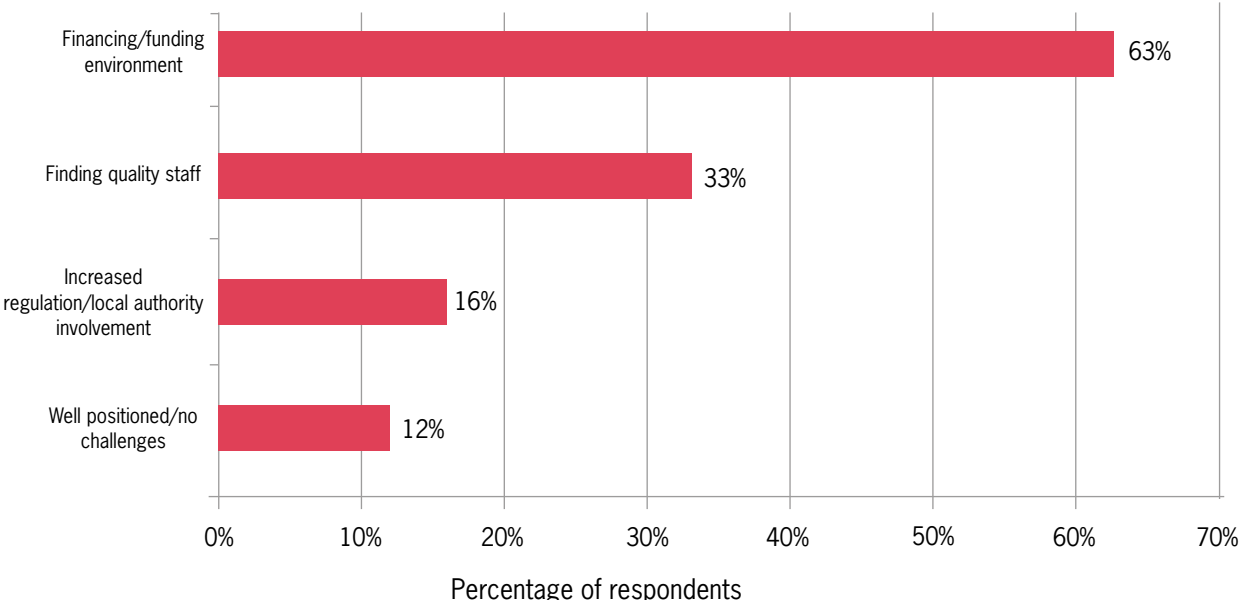
Mark Naughton,  
Corporate  
Finance Director,  
Grant Thornton  
UK LLP

which will impact on staffing availability.

Despite the challenges businesses are facing, respondents recognise there are a number of outright opportunities and say they are planning to capitalise on them in the months to come. They are therefore exceptionally bullish about their future.

The winners in the space will be those that are able to adjust to the challenges and turn them into growth opportunities.

In terms of running a healthcare business in the current market environment, what are the main challenges your company faces?



# Banks and businesses

Even as the economy is picking up and the market is showing signs of sustained recovery, the overwhelming majority of respondents (63%) name the financing and funding environment as the main challenge their business is facing in the current market. One such respondent states that “Considering the current economic situation, it is difficult to secure funds and there is always some uncertainty,” while another notes that things have become “very difficult and it has been the most challenging time in the last 40 years of my business activity in the UK.”

While financing remains a key challenge, the sector would appear to be in a position of strength. Of those surveyed, 92% say they will be funding their business via internally generated cash. In fact, the overwhelming majority of respondents (98%) say that they are able to meet their current funding needs via traditional means. One respondent says that “We try at all costs to keep out of the debt market and fund our business through internal cash,” while another says, “We are self-financing our business as we have strong cash flow and essentially no longer require bank support.” A third goes on to say; “If we are not able to meet our financing needs from internal cash, only then do we look towards bank finance.” One respondent sums up the status quo very effectively

saying that “We can no longer depend on the banks for financing our needs and we have looked upon other sources of income.”

However, for many, internal cash is likely to only support their current day-to-day strategy. Looking forward, the changing market environment presents many opportunities for growth (M&A, joint ventures, and government outsourcing are explored later in this report), and it is debt finance that will be required to realise the full potential.

Of those surveyed, it is a positive sign that 75% say that the relationship with their bank hasn't changed, although many are now required to spend more time dealing with the banks.

A significant number of respondents, (25%), state that they have had to

renegotiate terms with their banks. Funding has become more expensive and it is taking more time to gain approval for lending, appears to be the consensus. One respondent notes that “It has become costly and difficult to finance our business,” while another notes that “Banks are more thorough and cautious when it comes to lending.”

For the time being, the majority of respondents (56%) feel that there is little movement in the current funding environment. One respondent sums up the state of play by saying that “Lending activity from the bank has dropped to a minimum,” and goes on to explain that “The government has put in strong restrictions, targets and control measures.”



It is to be expected that the healthcare sector would not sink as deeply into the recession as certain other sectors, and it is clearly a positive that respondents to this survey are now anticipating more favourable conditions. Many businesses in the sector appear to have enough cash to be self sufficient for now, but the real challenge is how to get to the next stage in their evolution should bank funding not be available.

Giles Newman,  
Partner,  
Grant Thornton  
UK LLP

We have found our bank to be supportive over the last twelve months, but being a healthcare business we have probably been one of their better clients. We are confident that we can finance our growth plans through existing cash and shareholder resources, and with external bank finance if needed.

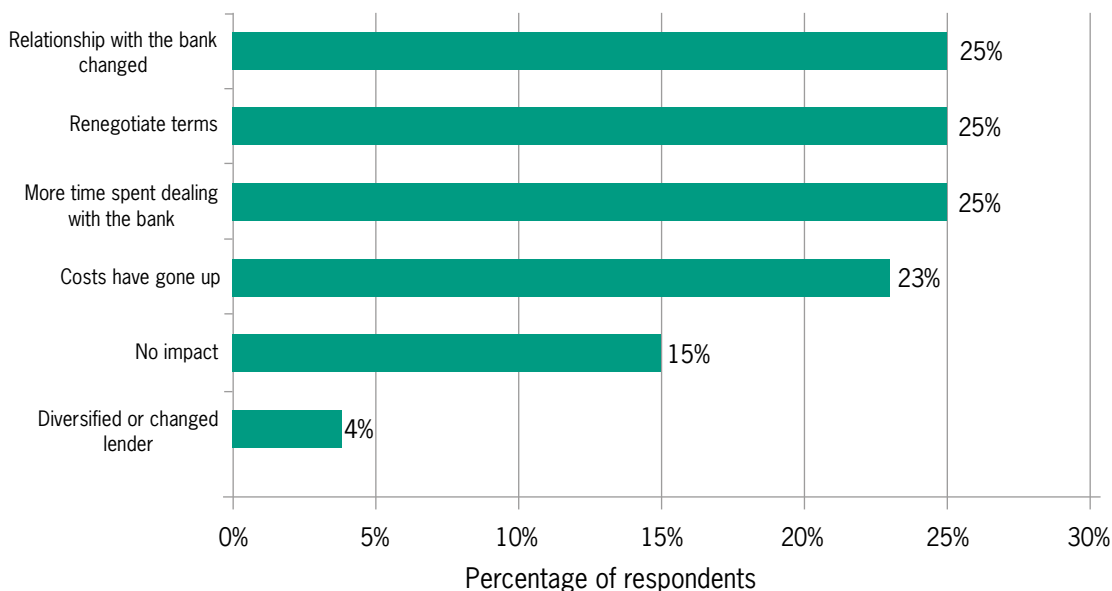
Richard  
Compton-Burnett,  
CEO, Capstone  
Foster Care

Has your bank become more difficult over covenants, LTVs or the level of management information needed?

Yes, they have become much more difficult, but given what has happened I can understand why.

Roger Booker,  
Chief Executive,  
Sevacare

What impact has the financial crisis had on your experiences of funding and banking requirements?



# ...Banks and businesses

However, businesses in the healthcare space are detecting light at the end of the tunnel, as close to three-quarters of the respondents are expecting the funding environment to improve and become more favourable to businesses over the course of 2011 – 46% expect this to happen in the first half of 2011 and 27% expect it to occur in the second half of the year. “As the economic situation is getting stable and banks are ready to lend, by 2011 the funding situation should improve,” one respondent explains. Another says that “It seems as if the government is going to force the hand of banks to lend to small businesses.”

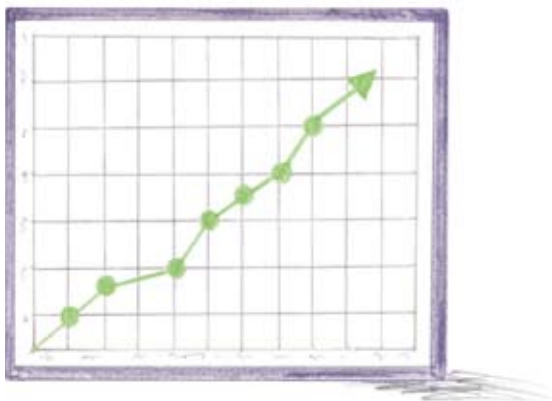
These results present an interesting comparison with the sector-wide Financing Your Strategy report, published in May 2010. Respondents to that survey, conducted in the first quarter of the year, expected an earlier recovery. In it, 19% expected more favourable financing conditions in the second half of 2010, while a combined 61% expected it over the course of 2011 – 41% in the first half of the year and 20% in the second half.

Throughout the underlying survey of this report, at a number of points, respondents mention the increased cost of funding and the challenges this presents to their business.

One respondent states bluntly that “Prices have gone up,” while another states that “It has become more expensive to fund our business.”

Many firms have already had to renegotiate the terms of their lending and 80% of respondents expect not to need to refinance their business within the next 12-18 months, giving evidence that many have, in fact, already refinanced.

Looking ahead, what are the alternative sources of funding that UK healthcare businesses are considering? Again, a large percentage of respondents (32%) say that they are looking at internally generated cash. At the same

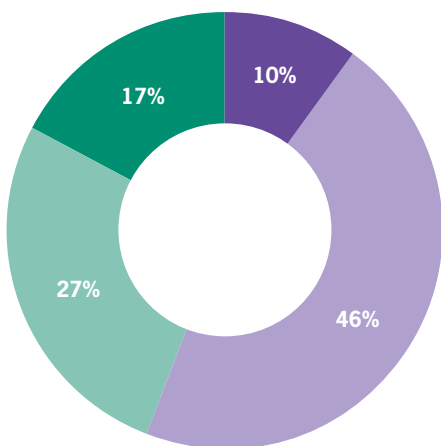


time, 38% say that they are looking at bank loans and overdraft facilities. Surprisingly, given the great interest that private equity funds have in this sector, a mere 12% of respondents say that they are looking at private equity investment.

It should also be considered that a notable number of respondents state that they are happy with their current funding structure and would not be looking for any alternatives.

“We will stick with our funding structure for now,” one respondent says, with another echoing these sentiments stating; “At this moment we are not looking to any other alternative.”

When do you believe the funding environment will become more favourable?



■ H2 2010  
■ H1 2011  
■ H2 2011  
■ After 2011



We have very little debt, but anecdotes from other executives in the space... yes, it's a case of jumping through more hoops. This does not apply to us; in our case they are in fact trying to lend us more.



Philip Whitecross,  
CEO, InHealth



While the relationships between banks and UK healthcare corporates are strained, much as any corporate's relationship with banks is these days, businesses remain bullish about their future and their growth prospects. They are meeting the challenges posed by the lack of available bank funding head-on and are developing alternative sources of funding.



Mark Naughton,  
Corporate Finance  
Director,  
Grant Thornton  
UK LLP

# Findings

## Insight

The healthcare sector is an attractive market for the banks and we remain keen to support good propositions. It is encouraging to see that 75% of the respondents say that their relationship with their bank hasn't changed. We have been through unprecedented times and we seem to be entering a period of uncertainty in the sector, which means that banks and their customers will need to work even more closely together. Continued dialogue will therefore become even more important to ensure that everyone is clear on what can be done.

The key in any lending proposal is the strength of the cashflow, and therefore the business's ability to repay any debt is fundamental. As money has become scarcer, its cost has increased. However, it's worth remembering we are still in an extremely low-cost environment when compared to historic rates.

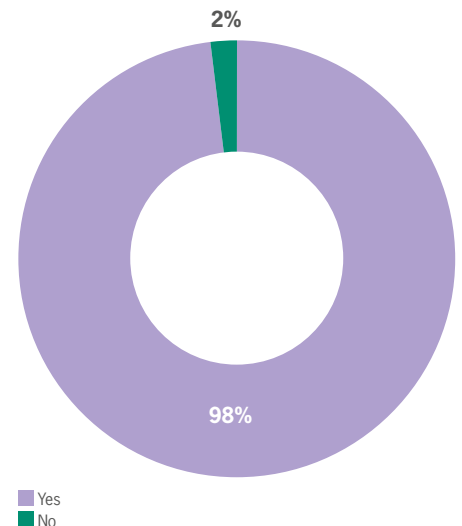
It is encouraging that many are expecting the funding environment in 2011 to improve, which is in accordance with our expectation on the basis that many operators will have had a couple of years to build up capital, so that as quality assets come to the market they will be in a good position to grasp the opportunity.

The last couple of years have seen leverage levels reduce to levels last seen in 2000/2001, which to many operators has seemed like a tightening of bank policy. This is not the case however, as the need for additional equity has resulted in stronger businesses with a capital structure that is more robust to meet the challenges ahead.

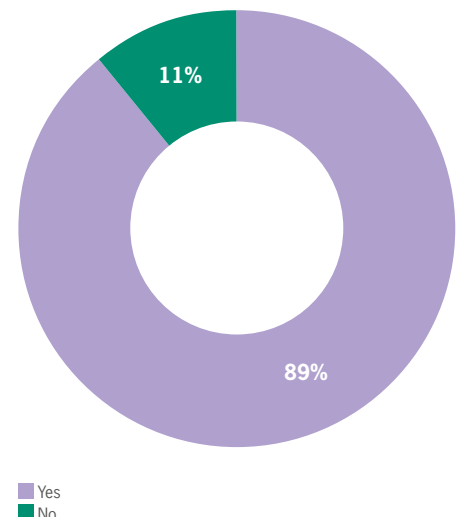
Many operators have put in place facilities with us that give them the capacity to expand and grow in the next few years. The sector remains robust in comparison to others as the underlying demand for healthcare services is strong. There remains however considerable uncertainty over the future not only as a result of the macroeconomic outlook, but also the changes afoot as a result of the coalition government's plans for the provision of care in the future.

**Paul Birley,**  
Head of Healthcare and Public Sector,  
Barclays Corporate

Are you able to meet your current funding needs via traditional/conventional means?



Will you be able to pursue your growth strategies via your existing funding structure?



## Findings

# Staffing

While staffing is the biggest cost factor to a healthcare business, accounting for up to 50% of its overall cost base, employing high quality staff is key to providing exceptional service and ensuring revenues.

Throughout the survey, respondents point towards the crucial role that people play in the success of businesses in the healthcare space. Indeed, 33% of respondents state that finding qualified staff is one of the main challenges facing their company in the current market environment.

One such respondent summarises the situation very succinctly by stating that “The lack of staff is the main challenge to healthcare businesses.” A second goes into more detail saying that the “government clamp-down on immigration has made it more difficult to find quality staff,” pointing out that “healthcare has relied on immigrant workers.” One of these respondents’ peers notes that “The government has put in strict restrictions on staff placements from outside the UK and European Union. This has made it difficult to find the required quality of, as well as affordable, staff.” Finally; “The restrictions imposed by the government on the recruitment of foreign resources has optioned out quality staff from Asian and other countries who come at low cost,” another healthcare executive mentioned.

This challenge is faced both by social, primary and secondary care providers, as well as by the suppliers servicing the industry. An executive from a recruitment service provider to the healthcare sector says that “As the government has imposed strict norms towards recruitment, we are facing a significant amount of difficulty in providing the services to our clients to our best abilities.”

Meanwhile, respondents recognise that investing in their employees is a way of dealing with the challenges stemming from the impact of the financial crisis and the overall changes to the market environment. Of those surveyed, 26% say that providing clients with a better

service and increased training of their existing staff is one way of the dealing with these challenges.

“Providing better training to existing staff,” says one respondent, “is crucial to addressing the current challenges their business is facing.” Others make more indirect references to the importance of highly qualified staff and ongoing training by saying that they are “trying to keep the quality of our services high” and that they are “continuously improving the quality of our services.”

Another puts their initiatives in a broader context, explaining that “We are keeping the level of our service’s quality higher than our clients’ expectations; this ensures our competitive position in the market.”

We are seeing a number of conflicting factors at play. The recession has led many public sector staff to remain in situ, reducing supply. Quality and registration requirements set staff to patient ratios which limit the sector’s ability to respond by improving efficiency. Accordingly, businesses have placed a heavy reliance on access to non-EU staff, meaning the immigration cap has had a significant short term impact.

Neil Routledge,  
Partner,  
Grant Thornton  
UK LLP

Government policy has impacted on us in many ways. For example, the web-based care finder initiative was tremendously helpful and had a strong positive impact on our ability to recruit staff.

On the flip side, the expected cuts to local authority funding are a serious negative. We are also concerned about raising the minimum wage at this time, which will put further pressure on the wages we pay our staff, as well as government plans to facilitate GPs commissioning services – GPs have no experience and a period of stability for the sector is required right now.

Roger Booker,  
Chief Executive,  
Sevacare

One of the key trends we have seen is the amount of time and effort spent in training staff in that it is a key method of improving retention and resident satisfaction levels.

Paul Birley,  
Head of Healthcare  
and Public Sector

Private sector operators are investing in a range of activities to help retain quality staff. These include structured training and qualification programs, clearer career progression and better financial incentives that reward success. These initiatives not only improve the quality and efficiency of a business but also help to retain staff.

Mark Naughton,  
Corporate  
Finance Director

It [staffing] is very important, particularly as a way to differentiate yourself from the competition.

Philip Whitecross,  
CEO, InHealth

# The UK healthcare sector and the government

The impact of the government on UK healthcare businesses is twofold: on the one hand, government-imposed regulations and legislation have historically governed how the sector operates and will continue to do so in the future; on the other, the expected spending cuts will place overall pressure on the sector. However, there is an expectation that these cuts will offer strong players in the space significant development opportunities; either via outsourcing opportunities becoming available, or the consequent possibility of acquiring weaker/distressed operators of healthcare services.

The exact impact of these two factors on businesses in the space is not yet clear. Nevertheless, 60% of respondents to the survey say that government policy and the expected spending cuts have influenced the formulation of their growth strategy for the future – a clear indication that businesses in the space are already preparing for the challenges to be faced. A number of those surveyed commented that their firms are continuing with the current business model, but at the same time are making significant changes to their financial and operational structure. Other respondents say that they are considering diversification into new product areas;

the involvement of private equity as a funder; and price cuts as a result of the expected regulatory, legislative and funding changes.

Talking firstly about regulation and government legislation, respondents to the survey recognise the negative impact that these could have on their business, with 80% mentioning it as a significant obstacle to growth.

A key reason for this, as mentioned in the previous section, is due to the government's policy on immigration, creating difficulties in hiring quality staff.

Meanwhile, a number of respondents express the hope that the regulation of the sector will in fact be eased under the

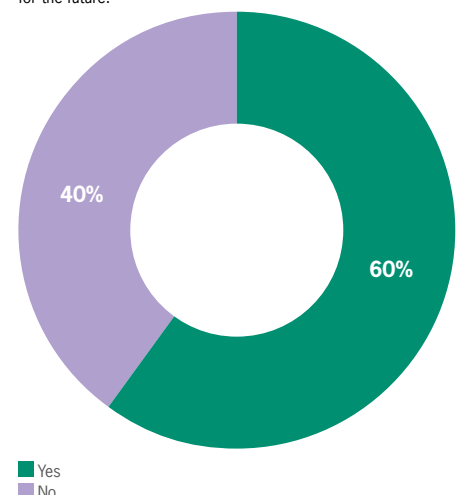
coalition government and that it will adopt a more pro-active and business-oriented approach towards businesses operating in the space. Indeed, 20% of respondents stipulated that less regulation will be one of the main strategic opportunities for businesses in the healthcare space in the next 12 months. One such respondent summed it up by saying that “Less regulation would have a positive effect on our sector.”

Another stated that “Outsourcing NHS services will be a major part of the new legislation,” indicating that this could bring a host of opportunities to UK healthcare providers.

Certain operators may struggle if there is excessive pressure on fee levels; this may lead to further consolidation. We also expect smart operators to quickly identify where the cost savings can be made in the NHS and offer a commercial solution that benefits both the NHS and the private operators.

Mark Naughton,  
Corporate  
Finance Director,  
Grant Thornton  
UK LLP

Has government policy and the expected spending cuts influenced the formulation of your growth strategy for the future?



One respondent from a small primary care provider states that “The government is supporting advancements and innovation in the sector, which is very helpful.”

Aside from regulation and legislation, more recently, and most certainly in the future, the government will become involved in the sector via spending cuts. These are expected to squeeze many of the sector’s players, but also offer stronger care providers opportunities to develop. Businesses in the space are very much aware of these upcoming opportunities and challenges, and have prepared themselves in a variety of ways.

Common approaches among businesses in the space are: looking for

alternative sources of funding; developing alternative revenue streams via new service lines and new client bases; as well as rigorous cost cutting measures. Taking a slightly different approach, two respondents, both from small social care providers, stated that their businesses recognised charity events as a good source of income.

It should be noted that a surprising number of respondents commented that the prospective cutbacks in government expenditure would not affect them.

Having said all this, despite the expected changes to regulations and the possibility of increased legislation governing the space, coupled with predicted spending cuts, UK healthcare

Local authorities provide a major revenue stream to the private sector, which gives them a strong position of influence over operators. While local authorities are taking innovative approaches to find solutions in the private sector, they do tend to work independently of each other which can dilute their influence. If they act in a more co-ordinated manner, more effective solutions may result.

Mark Naughton,  
Corporate  
Finance Director,  
Grant Thornton  
UK LLP

businesses remain bullish. Indeed, a mere 16% of respondents feel that increased regulation and local authority involvement would be the main challenge that businesses would face in the months to come.

Similarly, the continued uncertainty with regards to legislation and regulation, as well as what the expected spending cuts will actually entail, have not had a negative impact on the growth expectations of businesses. Respondents’ comments throughout the survey suggest that they consider themselves well positioned to take advantage of the opportunities that the changed market environment has to offer.

I would simply urge the need to create a simple and transparent regulatory environment. The star ratings work for exactly that reason, because it is simple and as objective as it can realistically be.

Roger Booker,  
Chief Executive,  
Sevacare

# The public sector view

Simon Hackwell is the Commercial Director and Director of Research and Development at the Heart of England NHS Foundation Trust. The trust is one of the largest in England and includes Birmingham Heartlands Hospital, Solihull Hospital, Good Hope Hospital and Birmingham Chest Clinic.

In an interview, Mr Hackwell discussed the role of the private sector in the NHS. While increased private sector involvement is anticipated going forward, Mr Hackwell outlined the some of the obstacles and challenges that exist in the healthcare sector. He was speaking in a personal capacity.

## Do you expect the private sector to play an increased role in the public sector going forward?

Looking ahead, I would expect the private sector to become more involved in the NHS. Normal logic dictates that when the wider economy is going through tough times, organisations from all sectors look to reduce their overhead costs. Clearly, outsourcing certain operations and sub-contracting is seen as one option for achieving this.

In addition to these general economic drivers, there is also an increasing amount of political pressure with the new coalition government setting targets around overhead cost reduction across all parts of the public sector, including the NHS. In short, there is certainly significant potential for increased private sector involvement in the NHS.

The economics make sense, although it is important to recognise that significant obstacles persist.

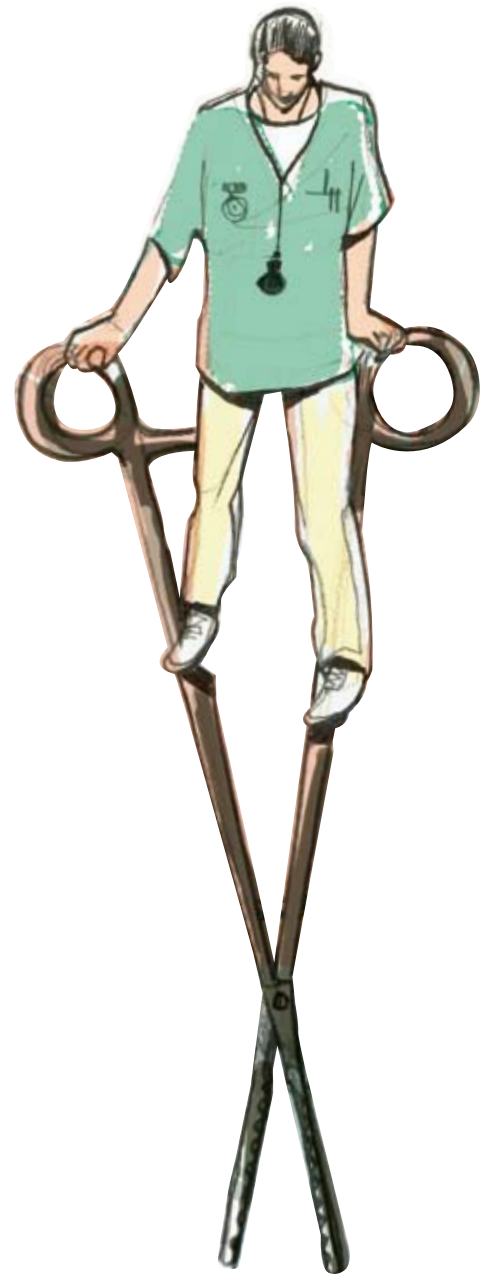
Many of our clients are now talking about the relentless cost pressure from the government as a significant challenge, although my experience of the sector tells me that this is something good care operators have been very adept at managing, through adapting their services to meet the changing needs and demands of the sector.

Paul Birley,  
Head of Healthcare  
and Public Sector,  
Barclays Corporate

## What do you consider to be the main challenges when it comes to NHS outsourcing opportunities?

When it comes to outsourcing, service providers generally look to create value primarily through wage arbitrage and standardising business practices. This approach doesn't sit particularly well with a lot of NHS organisations where practices such as offshoring call centres are viewed as unappealing. TUPE can negate value from employment terms, certainly in the initial years of a contract, but, that aside, standardising business processes is a difficult cultural shift for the NHS. Personally I would question the wisdom of trying to eliminate variation from demand, and the reality is that a lot of public sector organisations just find it hard to work within this constricted environment. You can't move from a flexible system around accounts payable or recruitment to just one process overnight. As I say, I am not even sure we should be aspiring to this anyway, but strip all the PowerPoint slides away and often that is the proposition on the table from outsourcers.

It is also important to recognise that for large parts of the NHS it is still relatively new to outsourcing, even when it comes to back office operations. The default position for most has been to keep in-house, but I doubt whether many organisations have given this position a good shake to see if this is the best way going forward. This lack of experience means that there is still a degree of ignorance and caution around the potential benefits that



private sector service providers could bring to the table.

Rightly or wrongly, there is also a concern that private sector firms will come in and extract all the value for themselves. There need to be shared risk/benefits in place in order to appease the NHS and make outsourcing sufficiently attractive. I have talked to many private sector organisations about this, but with most of them I still get the impression that the benefits are biased towards them. In this regard, private firms face a challenge in that they have to adapt when dealing with the NHS – they have to be flexible and understand these concerns.

**Where do you see particular opportunities for private sector healthcare providers?**

I have mentioned back office and support services, but I also think there is scope in the delivery of clinical services. I don't think we are going to see much more movement in the acute/secondary care sector post the Independent Treatment Centres, but there is much potential in the space around community care. In this area, there is a huge opportunity for service providers to manage the treatment of illnesses in the community, such as diabetes and respiratory diseases.

I see strong long-term growth in the management of chronic diseases and care within people's own homes. Do expect to see 'COPD r us' and the like emerging as care transfers not only from hospitals but also from residential homes to domestic settings. The area where there does not appear to be a market response, sadly, is in the over-85s – patients who have multiple needs.

You might see some opportunity around commissioning, but I am sceptical about this market; there is nothing to date to suggest a move in this direction.

**Is the private sector good for the quality of care?**

Yes, because I believe in competition. I think it provides answers and if managed properly will lead to an increase in quality and efficiency. The problem is, in my view, that we don't manage it properly in the NHS.

I would like to see streamlining of the overall procurement process, which right now takes too long. I would also like to see the barriers to early innovation broken down. But this may require a change in EU procurement, and I do not expect that to happen any time soon.

Philip Whitecross,  
CEO, InHealth

In conclusion, good operators with strong margins are not that phased by the potential changes from the NHS White Paper and possible funding cuts. The likely impact is a shakeout of operators that can not meet the required care standards or are experiencing financing challenges coupled with falling margins.

Mark Naughton,  
Corporate Finance  
Director,  
Grant Thornton  
UK LLP

**Are you looking at joint venture/ strategic partnership opportunities with the private sector?**

We are looking at certain opportunities and there are ongoing negotiations. The NHS is a managed system and it is difficult for the private sector to get market entry and build on this. The solution for them is to talk to existing providers and to try and co-create value with them. It can be difficult to compete with incumbent NHS providers, so the strategy should be one of collaboration. I am interested in talking to private sector organisations that can genuinely offer a shared risk/benefit proposition; too often the risk seems to just be on one side.

There is no doubt that government reforms are starting to place NHS providers and private sector providers in the same space. The extent and the pace of reform will be difficult to judge, but the door is beginning to open for the private sector to get more involved in the provision and running of health services than ever before. The White Paper released in July 2010 entitled 'Equality and excellence: Liberating the NHS' outlines that Monitor (the independent regulator for foundation trusts) will now become an economic regulator and therefore take a role in both promoting competition and regulating prices. Soon it will be the case that anyone, not only foundation trusts, will be able to register, and so with this accessibility there are certainly opportunities to be had for the private sector.

Giles Newman,  
Partner, Grant  
Thornton UK LLP

# Growth strategies – the M&A outlook

After avoiding the worst effects of the economic downturn, UK healthcare firms are now well placed to take advantage of growth opportunities going forward. In this regard, firms will primarily be looking to access new revenue streams by entering new markets, both in terms of geography and service offering. Clearly, M&A remains a principal method of strengthening existing areas of expertise, as well as accessing new niches. Furthermore, well placed firms will also look to scale-up in response to the increased pressure being exerted on revenue and fees, and it is notable that survey respondents believe M&A will continue to return to the corporate agenda in the coming months.

This is underlined by respondent sentiment: 45% expect dealmaking to increase over the next 12 months and 44% are actively looking to undertake an M&A deal over this timeframe.

So what will drive the predicted uptick in UK healthcare M&A? Survey respondents recognise that the sector remains fragmented, while on the buy-side, there are a number of cash-rich firms which are looking to undertake deals. One respondent remarks that there are "...many companies sitting on a lot of cash," while another states that "There are still a number of companies which are struggling and which have not been able to shrug off the impact of the financial crisis. Cash-rich corporates

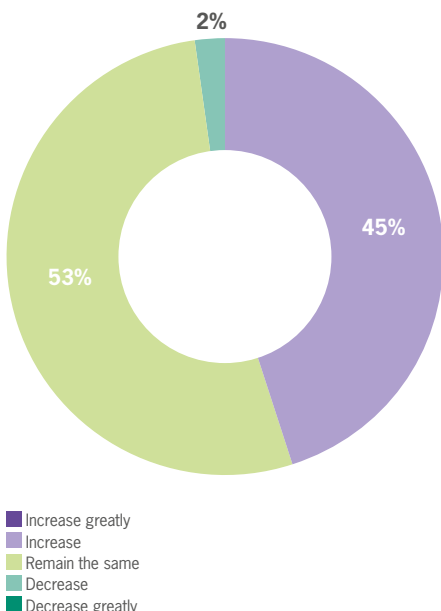
could look to acquire such assets." Furthermore, while corporate valuations have started to slowly trend upwards, respondents recognise that a number of potentially attractive assets remain: "There are some targets that represent good value for money, especially if financing becomes more readily available," one respondent adds.

Elsewhere, a number of other sector-specific factors are likely to drive corporate activity in the coming months. Indeed, the significant increase expected in NHS outsourcing will result in larger contracts being awarded to established players with a proven track record of success. This will result in cash-strapped firms at the bottom of the market

struggling to compete, and turning into potential acquisition targets themselves. Perhaps the most high-profile outsourcing example can be seen in Cambridgeshire where Serco Group and Circle Health are competing in a bid to become the first private company to run an NHS hospital, with the East of England Strategic Health Authority looking to find a partner to run services at the indebted Hinchingsbrooke hospital in Huntingdon.

Unsurprisingly, such recent developments are attracting an increasing number of foreign firms to the UK market. A number of US-based firms, such as Humana and United Health, are reportedly interested in winning

What do you expect to happen to the level of M&A activity in the UK Healthcare sector over the next 12 months?





The healthcare sector in the UK can be broadly segmented into two levels of operators. Firstly, large corporates or private equity backed business seeking growth opportunities, particularly through acquisitions, and secondly, smaller entrepreneurial businesses growing to reach a critical mass before often pursuing an exit. With good valuation drivers in the sector including a clear market demand for healthcare, strong cash generation by operators and visible future revenues, the two-tier market structure has led to a high level of M&A activity.

This looks set to continue with valuation multiple levels remaining relatively stable, allowing vendors to realise their capital.

Mark Naughton,  
Corporate Finance  
Director,  
Grant Thornton  
UK LLP

contracts that could be created from the proposed GP commissioning system. While this will put further pressure on smaller players and drive a degree of consolidation, an increase in outsourcing opportunities could also lead to dealmaking in related sectors outside of healthcare. Indeed, IT firms could turn into acquisition targets for healthcare service providers as they look to address the significant back office IT burden.

The fragmented nature of the market will create opportunities for financial investors, and it is telling that 33% of respondents expect private equity to play a greater role in dealmaking in the healthcare sector over the next 12 months. Private equity houses have already started to return to the market after a number of notable deals announced over the first three quarters of 2010. The top deal saw Bridgepoint Capital take private social care provider Care UK in a transaction valued at £442m, after previously failing twice to acquire the company in 2009. Going forward, private equity houses are set to continue to eschew riskier investments and mainly target non-asset backed firms on the services side of the sector.

The healthcare sector also represents a chance for private equity investors to undertake buy-and-build strategies. Scope remains for private equity to create value in existing portfolio company investments by consolidating the

bottom-end of the market, particularly as exit conditions remain challenging. A number of funds have been looking at buy-and-build opportunities, with Sovereign Capital's Q3 2009 £18m buy of City & County Healthcare a case in point. Post-deal, the buyout house committed £25m to City & County Healthcare as part of its strategy and the company has since undertaken two additional bolt-on acquisitions, including the acquisition of Sterling Homecare in April 2010.

As a further example, August Equity-backed Enara has expanded via bolt-on buys, acquiring Beech Nursing and Care Agency, Companions Care and Country Care to name but a few. Despite positive sentiment and increased announced activity, it is important to note that respondents recognised that the healthcare sector is unique and therefore presents a set of unique challenges for private equity investors. Regarding this issue, one survey respondent comments: "If anyone is to get M&A moving, it will be private equity. However, it will cost them and they will have to look at any deals as long-term projects rather than get-rich-quick investments," while another notes: "The healthcare sector is a safe investment location for private equity, but they would have to keep in mind that there will not be the huge short-term gains that they often look for."

# Growth strategies

**Where do you see the opportunities? 98% expect M&A levels to remain the same or increase.**

**Roger Booker, Chief Executive, Sevacare:**

I completely agree. M&A activity has always been very buoyant due to the fragmented nature of the sector. The price squeeze that many businesses in the space currently have to deal with now acts as a deal driver. We are very much interested in doing deals, but it depends on the availability of funding.

**Philip Whitecross, CEO, InHealth:**

M&A will definitely increase, driven by overleveraged targets – there is already evidence of that. If prices are low enough, M&A is also something we would consider.

**What multiple levels are you seeing? Have vendor expectations fallen?**

**RB:** Valuations have fallen from 11x EBITDA at the height of the boom to a much more reasonable 4x EBITDA. At the same time, vendor expectations have fallen in line with the market.

**PW:** Multiples have halved from the 12x EBITDA multiples we saw pre-crisis. In the cases of private hospitals they were at 17x EBITDA. The vendor expectations have understandably not fallen by as much.

**Is consolidation good for the healthcare sector – can quality be maintained?**

**RB:** Consolidation is good, as long as the consolidators behave responsibly. But we have seen businesses run into problems when they do too many deals

too quickly and are unable to fully integrate and manage them. In addition, consolidators in recent years have been underpricing contract bids in order to retain business previously acquired.

**PW:** Yes, as long as time and resources are allocated to ensure integration, then quality can be maintained.

**Would private equity add value to your business?**

**RB:** Yes, it would, as it would provide us with the funds we are having difficulty to secure from the banks.

**PW:** Not at the moment, they offer money but have also resulted in many companies getting into trouble through high leverage. They can provide development capital, but we don't require additional capital at the moment.

**Would you consider joint ventures with other healthcare operators?**

**RB:** Yes, we would, and the circumstances under which we would depend very much on what kind of speciality they have to offer. I have in the past engaged in a partnership with a housing provider which worked very well with them providing housing, and the care provider supplying the care in the home, something our partner could not offer. A partnership like that brings benefits to both parties and is definitely something we would consider again.

**PW:** Probably, only if they would allow us to provide an integrated care offering as right now we have only part of the care pathway.

**What strategies are you employing to expand?**

**RB:** Our recent acquisitions have expanded our geographic footprint. Expanding into new service areas is also something we are interested in, and usually comes as a progressive move and evolves organically.

We have progressively developed from supporting mainly old people to working with people with learning disabilities, which has now developed into more specialised areas, such as supporting people with autism.

**PW:** We are primarily looking at an organic expansion strategy.

In the past, private equity has driven some of the changes seen in the sector. However, the market has changed. Some comment that it is not an area for short-term gains, and that is certainly our experience.

The most successful PE houses are those that have a long-term strategy to grow the business by driving significant improvements in the way the business is run, and adding value that way.

Paul Birley,  
Head of Healthcare  
and Public Sector,  
Barclays Corporate

# Radical strategy in action

Housing 21 is a not-for-profit (NFP), residential, social and health services provider with an annual turnover of £130 million and an asset value of over £600 million.

In September 2009, Grant Thornton UK LLP advised Housing 21 on a takeover of Claimar Care – an AIM-listed provider of nursing care to individuals living in their own homes. The acquisition of Claimar offered Housing 21 the opportunity to achieve a large part of its five-year corporate plan for older people's services in a single transaction. Specifically, the acquisition enabled Housing 21 to:

- Position itself as a principal provider in the community care sector, delivering over 80,000 hours of home care and a range of other care services
- Offer integrated housing, health and social care to more older people
- Expand the range and location of specialist care services
- Achieve greater efficiencies and reduced operating costs in an environment of challenging public expenditure.

The takeover valued the equity of Claimar Care at £19.5 million and gave it an enterprise value of over £40 million. Housing 21 funded the transaction using existing bank debt facilities.

The deal was the first of its kind in the UK where a NFP organisation has completed the full acquisition of a publicly quoted corporation, and symbolises an increasing commercial outlook for NFP organisations to better meet the increasing needs of their beneficiaries.

The transaction posed the unique challenge of balancing the objectives and philosophies of a social enterprise with the requirements of a corporate transaction under the Takeover Code.

Stephen Baker,  
Corporate Finance  
Partner,  
Grant Thornton  
UK LLP

In my view this type of transaction is likely to become more prevalent as organisations look for more innovative ways of working to meet the needs of their beneficiaries.

Carol Rudge,  
Head of Not for  
Profit,  
Grant Thornton  
UK LLP

## Findings

# Other strategic initiatives to deal with the new market environment

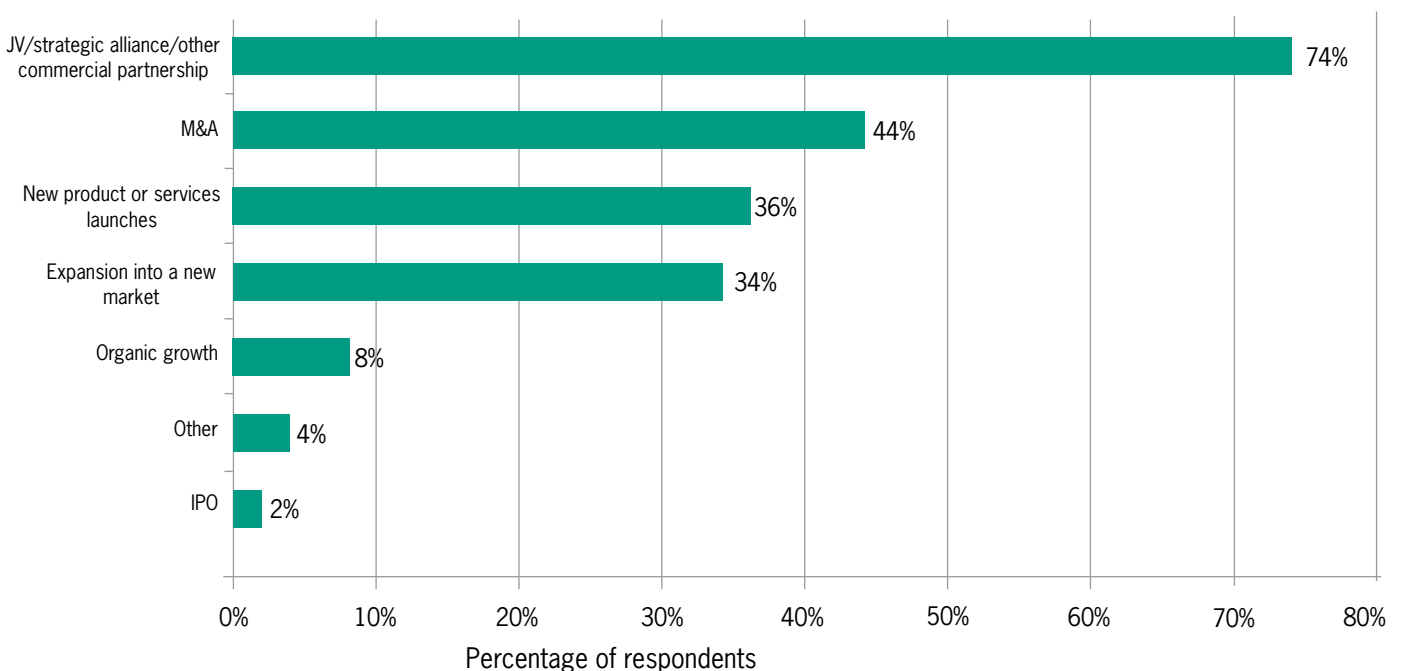
Outside of the M&A space, the survey results suggest that UK healthcare firms are increasingly looking towards growing their business through joint ventures and commercial partnerships. Remarkably, 74% of respondents plan to undertake a joint venture at some stage in the coming 12 months, with NHS partnerships tipped to be the primary driver of activity. There is certainly a recent precedent here as the first quarter of 2009 saw Guy's and St Thomas' NHS Foundation Trust and Serco Group agreeing to form a 50:50 joint venture, GSTS Pathology, for an undisclosed consideration. The alliance, which employs around 550 people, provides pathology services under a 10-year contract for approximately £250m to Serco.



The market has seen three way commercial ventures in the social care sector for the development and provision of care. Property developers provide the land, specialist construction companies develop the property to meet care requirements, and specialist care operators then partner to provide the services to residents. Such structures have helped bridge the funding gap and ensured deliverability through the expertise from each partner.

Mark Naughton,  
Corporate Finance  
Director,  
Grant Thornton  
UK LLP

Which of the following growth strategies is your company considering over the next 12 months?





Looking ahead, the proposed commissioning system and further empowerment of GPs could also hasten an uptick in the number of partnerships between GPs and healthcare services providers. Well established firms, such as 75% Virgin-owned Assura Medical, have already been active in this space, undertaking numerous joint ventures with GPs to provide primary care services. Latitude also exists for the formation of partnerships between individual service providers, driven by the need to adapt to the proposed new system and ensure that their overall service offering is sufficiently attractive to local authorities. “We have already entered into a number of commercial partnerships to provide the most efficient and best quality services to people,” adds one respondent.

Potential for strategic partnerships also exists elsewhere in the sector, particularly in the construction of new healthcare premises. The likes of Carillion and Balfour Beatty-owned Consort have firmly established themselves in the space, working with NHS trusts on a number of projects as part of the UK government’s Public Private Partnership initiative.

We are seeing a number of healthcare companies undertaking studies to identify and assess new market opportunities, many in specific, niche areas, in a rush to capture the early bloomers of a recovering market. Many healthcare operators could also benefit from an improved approach to innovation – for example, enhancing the end user experience, which can be a cost effective strategy and a ‘quick win’ when differentiating your product or service offering.

Lushani Kodituwakku, Head of Strategy and Commercial Due Diligence, Grant Thornton UK LLP

We have heard our clients talk about joint ventures and collaborations a lot recently and therefore the survey results are not surprising but encouraging. The key is how the private and public sector make these partnerships work for everyone’s benefit, as in the past this hasn’t been easy to achieve. Nevertheless, the current conditions mean it is a necessity.

Paul Birley, Head of Healthcare and Public Sector, Barclays Corporate

The market has seen three-way commercial ventures in the social care sector for the development and provision of care. Property developers provide the land, specialist care requirements and specialist financial support from an equity investor. Care operators then partner to provide the services to residents. Such structures have helped bridge the funding gap and ensured deliverability through the expertise from each partner.

Mark Naughton, Corporate Finance Director, Grant Thornton UK LLP

# Who will the winners be?

The UK healthcare sector continues to undergo a period of significant change, and despite the robust nature of the space, the financial crisis and subsequent economic downturn have had a huge impact on trading conditions.

The financing environment remains challenging, with the survey results showing that firms are predominantly bypassing the banks and largely using internally-generated cash to finance their day-to-day operations. In this regard, it is clear that large cash-rich companies are

best placed as size matters now more than ever. Looking ahead, it would seem that healthcare firms must either possess scale or specialisation in order to prosper in the new economic reality.

While sector players have had to contend with the impact of the financial crisis, the 2010 NHS White Paper will have a more telling and long-lasting impact upon companies operating in the space. Indeed, the newly released plans will fundamentally change the landscape of healthcare in the UK, particularly

with regards to the level of private sector involvement. Under huge cost pressures from the new coalition government, the NHS now desperately needs private sector involvement to boost efficiency levels.

Certainly, there is a huge opportunity here for service providers to offer attractive and cost-effective solutions to the public sector. The winners will be the firms that can demonstrate and convince that they can provide a high quality of care, deliver positive outcomes to patients

With spending cuts and price pressure among the majority of service lines, it is likely that many of the early winners will be those companies that have expanded into sub sectors or new niche markets which are positioned to catch the revival of consumer spending, or accommodate new products that innovate the delivery of healthcare services. In such a dramatic economic climate, the need to diversify into new markets and redefine business models is vital in not only spreading

risk of budget cuts, but also in embracing this evolving market.

As healthcare providers ask themselves the tough questions on how best to move forward, the decisive factor is a concise strategy that not only builds on core strengths, but also positions it to develop the right skills to address the markets of the future. One must not simply identify a good growth strategy for a company, but also ensure that the plan includes a clear

understanding of the market dynamics and competition, the internal changes that must take place, and the service offering required to be successful.

Importantly, operators should be wary of any evolution which may alienate their existing customer base.

Lushani  
Kodituwakku,  
Head of Strategy  
and Commercial  
Due Diligence,  
Grant Thornton  
UK LLP

and provide an efficient alternative. In this regard, firms must have resources in place, and while financial muscle is an important part of this, it is equally vital that an innovative and highly-skilled management team is in place. In order to grow, management figures will need to possess foresight and understand how and where the NHS will develop in the future, with a view to positioning their service offering accordingly.

The overall scale and scope of change in the healthcare sector is tremendous,

and while this represents a new set of challenges for businesses, it is important to not lose sight of the fact that there are significant growth areas. Firms will also continue to assess the viability of tapping into new revenue streams; either through geographic expansion, or by broadening their service offering in new areas of care to complement their core business. Clearly, the winners will be those healthcare firms that strike the balance between controlling costs and executing such a growth strategy.



In a market where there is so much opportunity, you would expect there to be winners and losers. There is undoubtedly an unprecedented opportunity for the private sector to take part in the health of the nation. The winners will be those who innovate, adapt and move fast; the winners will be the first to market, the first to seize the opportunities: coming second will be too late.

Giles Newman,  
Partner,  
Grant Thornton  
UK LLP

We are in a period of unprecedented change – the winners will therefore be those firms that can adapt faster to the changing conditions and they, in our experience, will be the leadership.

Paul Birley,  
Head of Healthcare  
and Public Sector,  
Barclays Corporate

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