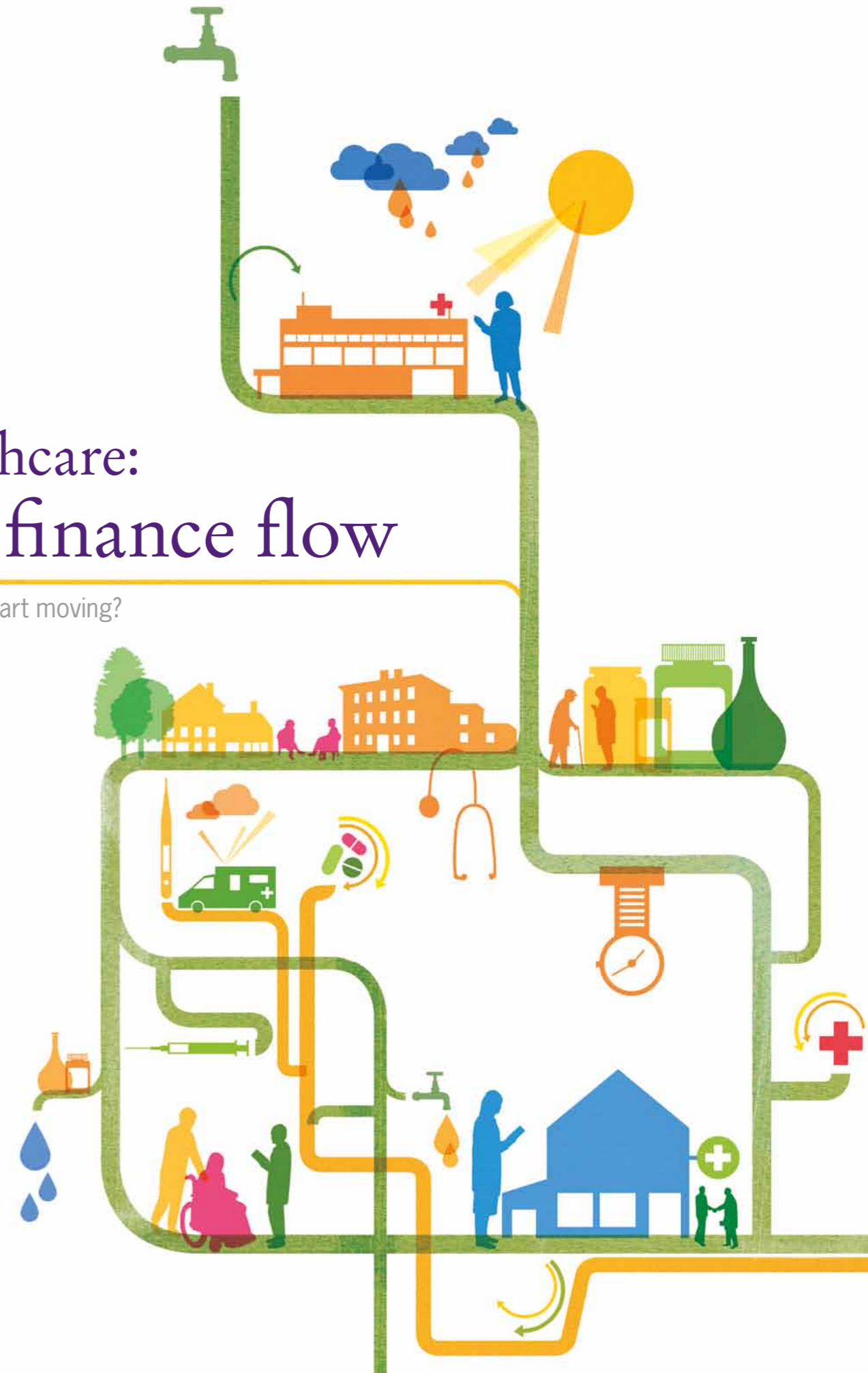


Healthcare: The finance flow

Will money start moving?





Foreword

Across the UK, businesses in most sectors are struggling to get back on the growth track after the sharpest downturn in living memory. Despite the economy having officially emerged out of recession, it is barely registering positive growth. But within this gloomy picture there are some areas of British industry that are coping better with the conditions, and one of these is clearly the healthcare industry. Underpinned by the changing demographics of an ageing population and a government health service that is increasingly looking to the private sector to shoulder the burden of care, there are many areas within the healthcare sector that should demonstrate above average growth in the coming years.

Of course, the industry is not without its challenges, and some niches within the sector are finding conditions harder than others, hit by pressure on fee income and instability in the property markets. The ability to withstand the market pressures is also directly linked to size, and some of the smaller companies lack the scale to compete efficiently. What this does mean, though, is that there remains a healthy M&A market in the healthcare sector and this, combined with a truly creative approach by many businesses and pockets of capital available for expansion, means that the industry is perhaps the best prepared to navigate through what is looking like being a long journey out of the economic downturn.

The findings of this survey into financing trends within the healthcare sector present a unique insight into one of the strongest prospects for growth in British industry, and Grant Thornton would like to thank all those senior executives who gave up their time to make this survey possible.

Mark Naughton
Corporate Finance Director
Grant Thornton UK LLP



About the survey

During the first quarter of 2011, Remark, the research and publications arm of the Mergermarket Group, carried out a third major survey of mid-market opinion on behalf of Grant Thornton. On this occasion, 200 CEOs and CFOs of UK businesses with turnovers in the £25-250 million range were surveyed. All answers were treated confidentially and have been reported in aggregate. The statistics relating to the healthcare sector are drawn from this national sample.

Contents

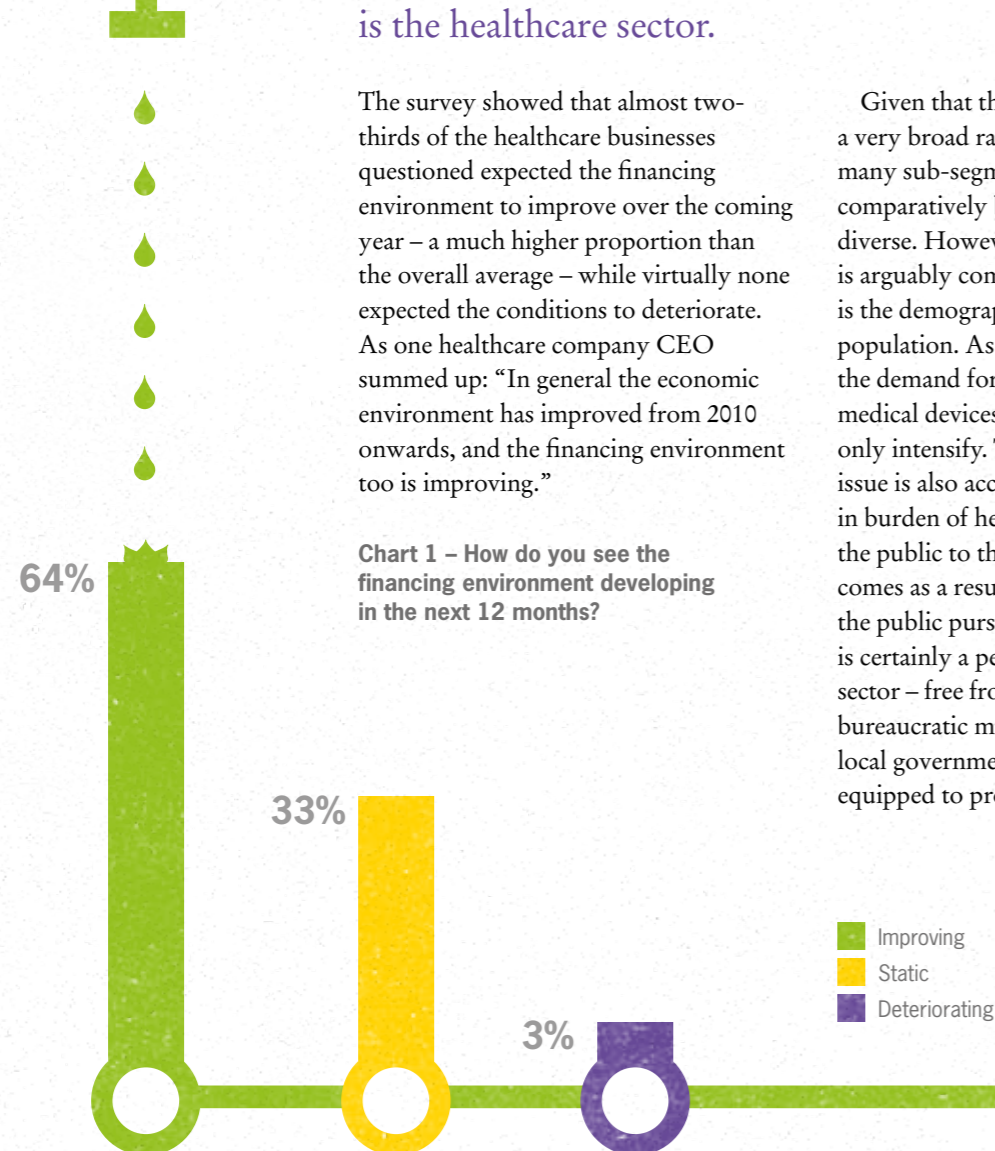
Foreword	2
Financing outlook	
More bullish than most	4
But not immune to the downturn	5
Banking issues	6
Strategy	
More aggressive growth strategies	8
Creative angles	10
Exploring funding options	12
Closing remarks	
Opportunities and funds are out there	14
Contact us	15

More bullish than most

The financing environment remains challenging across most sectors of the UK economy, hindered by near stagnant growth levels, swingeing public spending cuts, subdued consumer spending and rising inflation. However, as is the case in other Western European markets, there are some brighter spots within the industrial landscape. And, according to a survey of British mid-market businesses carried out in the first half of 2011, one of these is the healthcare sector.

The survey showed that almost two-thirds of the healthcare businesses questioned expected the financing environment to improve over the coming year – a much higher proportion than the overall average – while virtually none expected the conditions to deteriorate. As one healthcare company CEO summed up: “In general the economic environment has improved from 2010 onwards, and the financing environment too is improving.”

Chart 1 – How do you see the financing environment developing in the next 12 months?



Given that the healthcare sector covers a very broad range of businesses across many sub-segments, the drivers of this comparatively bullish outlook are diverse. However, the key factor that is arguably common to many of them is the demographic issue of an ageing population. As this trend continues, the demand for healthcare services, medical devices and pharmaceuticals will only intensify. The broad demographic issue is also accelerating a gradual shift in burden of healthcare provision from the public to the private sector. Partly this comes as a result of the severe squeeze on the public purse, and partly because there is certainly a perception that the private sector – free from the cumbersome bureaucratic machine of national and local government – is often better equipped to provide certain services.

■ Improving
■ Static
■ Deteriorating

But not immune to the downturn

However, the picture is not entirely positive, and for a significant minority of businesses across the sector the immediate outlook is less than rosy. Almost half of the respondents that rated the financing environment as static or deteriorating do not expect any improvement until 2013 or beyond; this is among the most pessimistic forecasts from any sector within the overall survey.

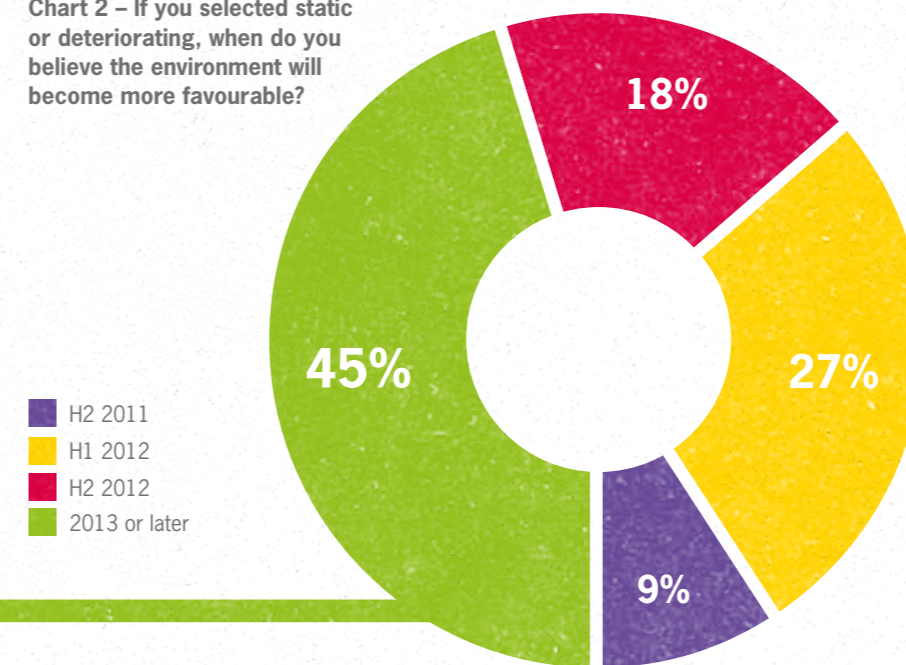
Again, the balance between optimism and pessimism is highly dependent on a number of factors, including size of business, the niche in which it operates, and other leasing and property related issues.

The negative element is perhaps not surprising in some cases: the same public sector spending cuts that are providing opportunities to some healthcare providers are clearly putting pressure on others in the private sector. While the most specialised operators, such as

high-dependency care providers, are relatively well placed to withstand this pressure, other more generalist private sector businesses are struggling. Some groups are facing a squeeze on the fees paid by the NHS of up to 10%.

At the same time, many healthcare providers are tied into lease or rental arrangements with landlords that have incremental rises baked into the contracts and this, combined with the downward pressure on fees, is creating a ‘perfect storm’ situation for some.

Chart 2 – If you selected static or deteriorating, when do you believe the environment will become more favourable?



■ H2 2011
■ H1 2012
■ H2 2012
■ 2013 or later

Expert comment:

Mark Naughton
Corporate Finance Director
Grant Thornton UK LLP

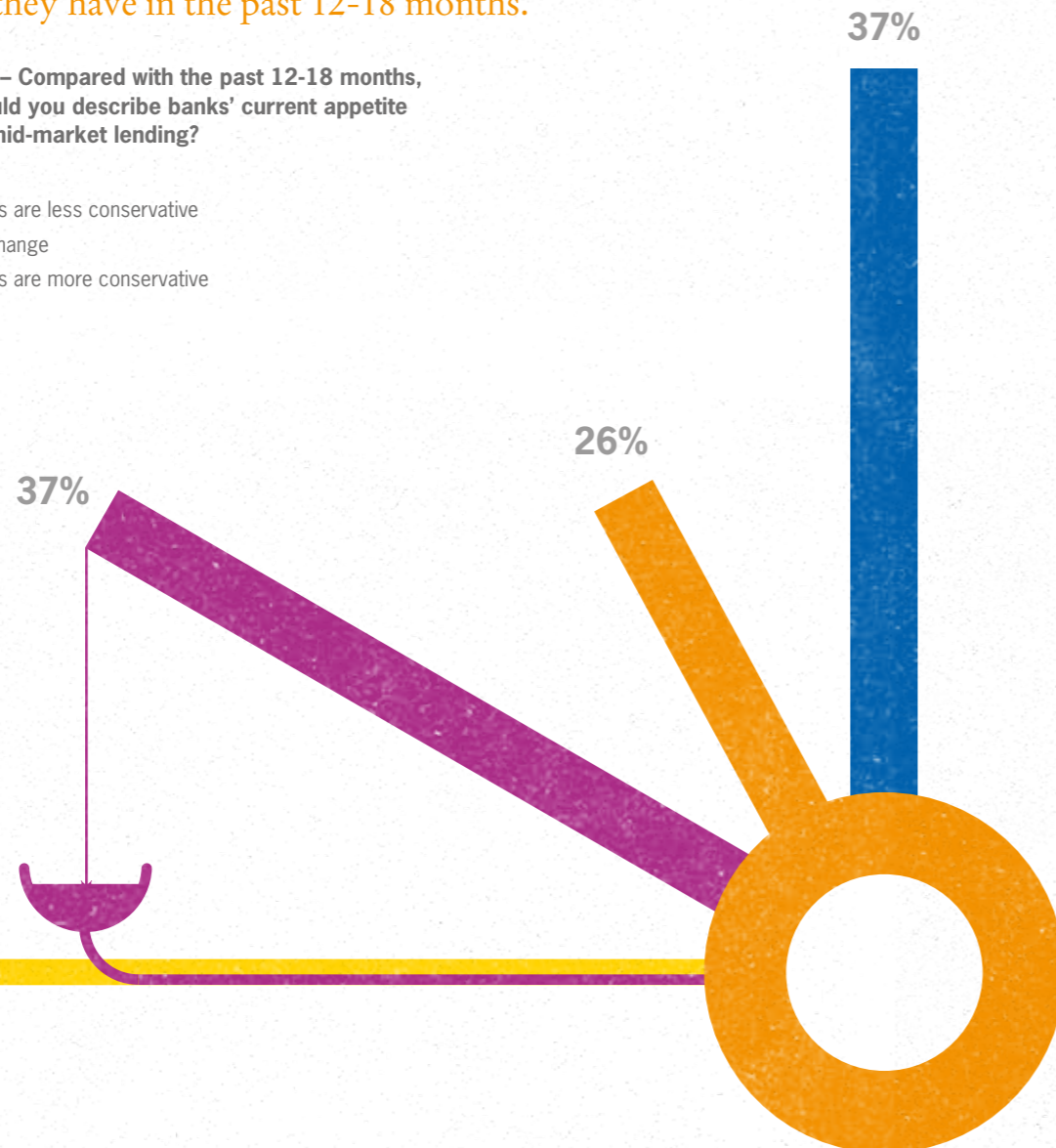
The increasing challenges in the sector are encouraging businesses to take a long, hard look at their medium to long-term strategy – whether to invest and pursue growth, seek joint ventures or alliances with complementary businesses or indeed, in many cases, exit. Of course, while these strategic reviews can lead to difficult decisions for many businesses, they are playing an important part in maintaining the flow of new M&A opportunities, especially consolidation plays, coming through in the healthcare sector.

Banking issues

Also somewhat at odds with the generally more positive outlook for the sector is the fact that there was no evidence to suggest healthcare respondents are any more positive about the banks: in fact, 63% of healthcare respondents rated the banks as being at least as conservative as they have in recent times (versus 61% of the whole sample). Only 37% believed the banks to be less conservative than they have in the past 12-18 months.

Chart 3 – Compared with the past 12-18 months, how would you describe banks' current appetite for UK mid-market lending?

- Banks are less conservative
- No change
- Banks are more conservative



Again, the fact that banks seem to be as cautious about lending to healthcare businesses as they are to other sectors is perhaps not so much of a surprise in the current, risk averse environment. One of the key factors behind this – and a significant concern for many banks looking at the healthcare market – is related to property: many operators in the sector require significant investment in property and therefore remain open to the vagaries of the property market. The turbulence in these markets over the past few years shows little signs of settling down, which would easily explain banks' sensitivities to lending.

Another factor is simply one of size, as it is in other areas. The lack of scale in an often fragmented market offsets the fundamental attractiveness of the sector as a whole, and banks are keen to avoid exposure to smaller healthcare providers, even if they are performing well and have strong cash flows.

However, with nearly 40% of respondents showing some optimism where the banks are concerned, the outlook is not all bad. As the MD of one company states: "I think we're all holding our breath to see the result of this government's skirmishes with banks. How flexible they are with respect to covenants and how much they lend to mid-market corporations will determine whether things will improve."

Expert comment:

Paul Birley
 Head of Healthcare and Public Sector,
 Barclays Corporate

Banks are very much open for business, and those operators who have been able to demonstrate good quality care, alongside strong financial performance, have had little trouble securing funding on competitive terms, and this will continue. The healthcare industry has experienced a turbulent year notwithstanding the economic climate, and the impact of the Spending Review, but also the ongoing changes to the Health and Social Care Bill which are further muddying the already uncertain environment. What has and will remain consistent, however, is the need for good quality care, and those operators who can demonstrate this will continue to get the funding support they need.

More aggressive growth strategies

Despite the obvious difficulties being experienced by many businesses in raising new bank funding, more aggressive, expansive strategies are far more common in the healthcare sector than in almost any other, with almost a third of respondents rating consolidation/M&A as a high priority.

Furthermore, although more defensive measures such as cost savings are still an important strategic goal for many operators in the sector, it is listed as the top priority by far fewer respondents than in the overall sample.

This statistic is reflected in the comparatively strong levels of M&A activity that are still being seen in the healthcare segment currently, but the drivers are not exclusively bullish. In reality, the activity is partly being driven by the inability among some

smaller firms to adjust their business models to cope with the current negative market drivers, such as fee pressure and increased regulation. That said, it is also clearly a feature of a market where more aggressive, well-funded businesses are able to seek scale through consolidation in fragmented areas. Overall, some 73% of healthcare respondents indicated that they are expecting to undertake a significant transaction over the next year (versus 59% of overall sample).

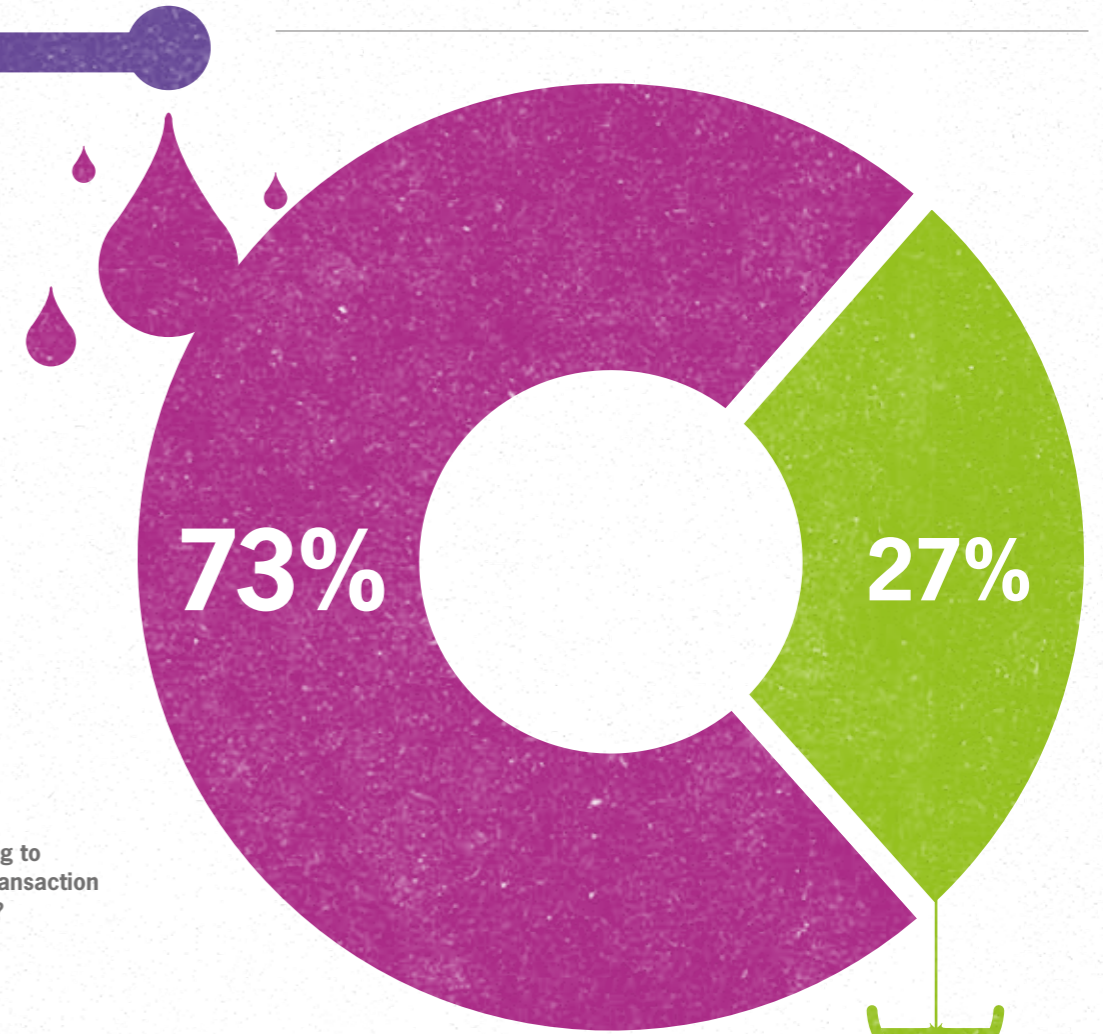


Chart 4 – Are you planning to undertake a significant transaction in the coming 12 months?

■ Yes
■ No

Expert comment:

Brian Cooney
Chief Executive Officer, Canford Healthcare plc

The care home segment is a good example of an area within the wider healthcare industry that has seen both winners and losers in the current climate. There is a clear divide opening up in the sector between high quality operators targeting the private-pay fee revenues and those deriving the majority of their fee income from the social services segment. For the latter, fee incomes are falling while staffing costs continue to rise.

For our part, despite some pressure from the Primary Care Trust, we have been able to maintain our fee levels because of the quality of the service we provide, both in terms of the facilities we offer and the high level of care. It is important to appreciate that the care home market is not a simple business in which to operate: staffing issues and a constantly changing regulatory environment mean that a lot can go wrong. The ability to provide a consistently high level of quality care in a facility that is effectively 'future-proofed' means that you can protect fee income, because both private and public clients appreciate the high quality of service.

The environment is clearly having an impact on strategy, though. Despite maintaining a strong working relationship with the banks because of a strong balance sheet and proven track records, we are struggling to find enough quality acquisition targets. While this is partly a feature of the polarisation in the market, it is also heavily influenced by the wider economic conditions: the ultra low interest rate environment is discouraging quality operators from putting their assets on the block and there is a real shortage of good targets. Nevertheless, while the current market conditions have clearly impacted our business, we are still more bullish than many in the industry.

Creative angles

What is certainly a strong current trend, given the squeeze in overall funding, is that businesses in the healthcare sector have had to find more creative and imaginative angles to maximise their growth potential without raising significant capital from the mainstream lenders.

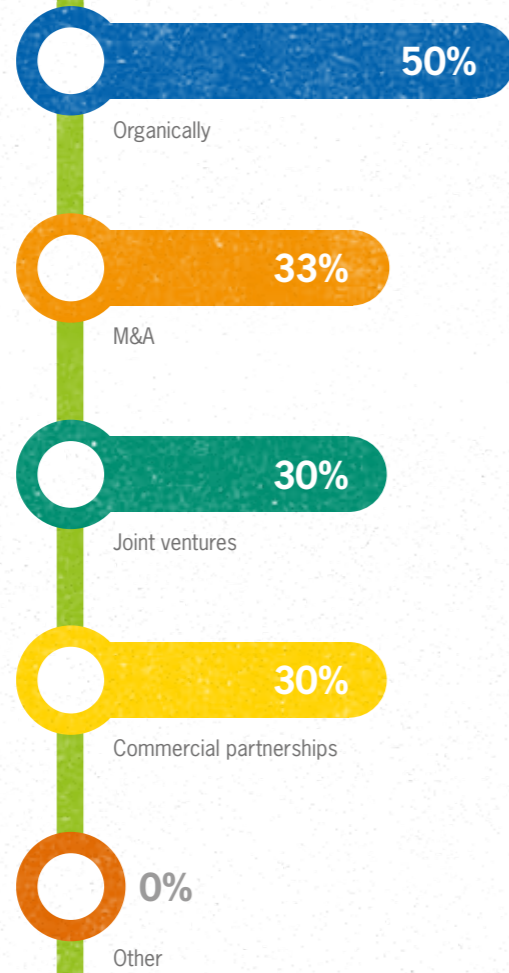


Chart 5 – If expecting to grow, how do you expect to do this in the next 12-18 months?

This is clearly reflected in the fact that around a third of those expecting to grow in the next 12 months expect to do so via M&A, joint ventures or commercial partnerships. According to one company CEO: “The next 12 months is going to be about doing things differently. Therefore we are going for restructuring and possibly JVs or strategic alliances.”

This trend is resulting in some especially creative tie-ups. For instance, it is not uncommon for healthcare businesses to seek joint ventures with property and land businesses to create a viable business opportunity that does not need large-scale funding. Other care providers – particularly in the non-acute area – are even taking over mothballed NHS premises for nominal rental sums and using them to provide a service that can be sold back to the NHS. This has the additional benefit of taking patients out of the mainstream health services and freeing up beds for more urgent or acute care.

Expert comment:

Lakhbir Jaspal
Deputy Group Chief Executive
Accord Group

The Accord Group, which is one of the largest providers of healthcare and social housing services in the Midlands, is a non-profit organisation. In many respects this affords us the luxury of a longer-term financing horizon and a more flexible assessment of risk, but we have not been entirely protected from the challenges facing the healthcare market in recent years. By far the greatest hurdle to overcome in 2010 and 2011 has been the pressure on fees. Even where these have remained static, the trend for margins is sharply downward: the combination of a high inflation environment and substantial labour costs means that many healthcare businesses would need to see increases in fee income of up to 2.7% just to stand still. In addition to the fee pressure, many healthcare businesses are facing significantly reduced grant funding for the development of new residential care facilities, and as a result there has been a marked shift away from residential care services to home-based care. What’s more, given the continuing caution in the lending community, the shortfall in grant funding cannot be made up by bank facilities and the net effect will be a significant reduction in the supply of new, purpose-built care facilities. For existing facilities, meanwhile, tighter eligibility criteria imposed by local authorities is resulting in longer referral periods, and this leads to greater void periods and void costs for healthcare providers.

Nevertheless, while the environment generally is presenting major challenges for many healthcare businesses, some in the sector, such as providers of high acuity care, mental health and learning disabilities services, are faring better. And healthcare businesses that are able to generate greater efficiencies, innovate services and offer a better choice to the customer, should continue to see opportunities.

Exploring funding options

Despite the difficult conditions, it is clear that there is still a relatively healthy amount of funding available for healthcare businesses with the right scale and balance sheet capacity – after all, it remains an attractive sector for the reasons already outlined. And this seemingly includes the mainstream lenders: although the vast majority of healthcare respondents are expecting to keep their gearing the same or to reduce borrowing, some 20% expect to increase borrowing and become more highly geared over the next year. This is almost double the average across the whole sample.



Chart 6 – Do you envisage changes to your company's debt/equity ratio over the next 12 months?

- Become less highly geared
- Become more highly geared
- Gearing to remain the same

Expert comment:

Mo Merali
 Head of Private Equity
 Grant Thornton UK LLP

It is true that the healthcare sector in the UK is facing some challenges, particularly in those areas linked to the public sector, but private equity investors remain keen and committed to the sector. With their longer-term funding horizons and commitment, they have the proven ability to innovate and add value. What's more, the challenges faced by the public sector are likely to create opportunities for well-funded private operators. But we believe that the nature of private equity involvement in the sector will change. Gone are the days of highly leveraged, property-dependent deals: going forward, businesses with niche offerings and added value services will command premiums from private equity investors, and innovations requiring growth capital and earlier stage investors will also benefit from investors' ability to identify and nurture high quality people and intellectual property.

But this statistic may be somewhat misleading. In the current market, bank funding is much more typically aimed at the larger end of the healthcare sector, while further down the scale mainstream funding is tougher to secure and businesses and companies are more likely to have been seeking to pay down debt.

Nevertheless, the healthcare sector remains a key area of activity for other types of investors. Many private equity players, in particular, have specialist teams focusing on the area, attracted by the main positive drivers – demographic change, strong visibility into future earnings and, in some areas, the potential for top quality IP rights to generate cash flow further down the line. Other parties, such as family offices and other high-net-worth investors, are also drawn to the sector by the same factors.

As a result it is unsurprising that almost three-quarters of healthcare respondents have looked into alternative sources of funding, and nearly a third have pursued that avenue (about twice as many as the whole sample).

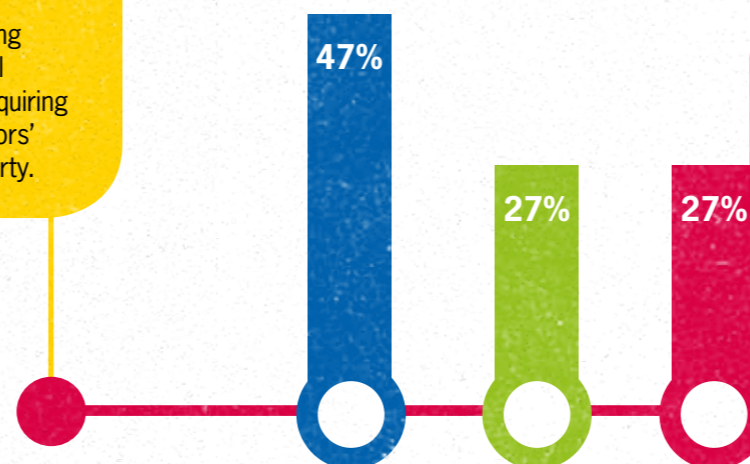


Chart 7 – Have you explored alternative sources of finance?

- Yes, but we decided against it
- Yes, and now we use alternative sources of finance
- No, but under certain circumstances we would

Expert comment:

Matthew Caffrey
 Director
 ISIS Equity Partners

Isis Equity Partners has a long history of investment in the UK healthcare sector, having backed 10 high-growth entrepreneurial businesses and made over 20 bolt-on acquisitions across primary care, secondary care, social care and education. This gives us a unique insight into the market, particularly in the context of current reform.

With the new Health and Social Care Bill, change is inevitable, although the speed and scope of implementation remain under discussion. The devolvement of commissioning from PCTs to GP consortia is a huge challenge, especially when placed in the context of £20bn efficiency savings the NHS has been tasked to make by 2014-15. The lack of clarity and uncertainty creates a challenging environment for businesses to navigate and one theme is dominating the sector, namely cost-down commissioning.

Within our portfolio in the secondary care market, we have seen cost pressure on medical devices, implants and consumables, combined with a slow-down in procedures which has inevitably pushed waiting lists out. Similarly, the much more fragmented social care segment is also facing severe cost-down pressures through static or falling fees and this is making it increasingly difficult to build strong, efficient platforms that are able to deliver value without compromising on the quality of care provided. Although the fragmented nature of the market continues to lend itself to buy-and-build operations, the focus has to be on delivering quality: simply bolting together multiple smaller operators and integrating them successfully is challenging in a cost-compromised environment.

In our view, conditions in the healthcare sector will remain challenging for the next three to five years, driven by huge regulatory and legislative change. However, it is our expectation that successful entrepreneurs will continue to spot the opportunities that change inevitably creates, and we remain keen to invest in the sector. Our focus continues to be on building businesses that deliver good pricing and value without comprising quality and outcomes. This approach, allied with deep sector expertise, strong entrepreneurs and an open-minded, flexible approach to investing, should prevail, even in a rapidly moving market.

Opportunities and funds are out there

While it is clear that a sector as diverse as the healthcare industry cannot be wholly without its problem areas, the broadly positive results of the survey carried out earlier in 2011 paint a picture of a sector that is striving hard to capitalise on the strong fundamental drivers that exist.

Approached with vision and creativity, there are clearly opportunities for UK healthcare companies to grow, be it through consolidation and the pursuit of scale or through more creative joint ventures and other initiatives. And, while the funding to help expansion plans will surely be more difficult to raise than it

was pre-crisis, there are still obvious pockets of capital and appetite to fund the right businesses with the right business plans.

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