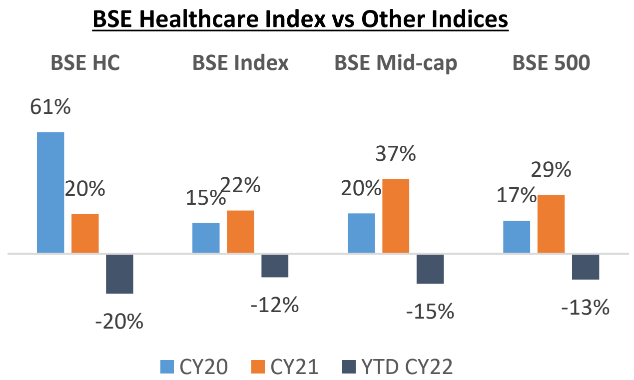
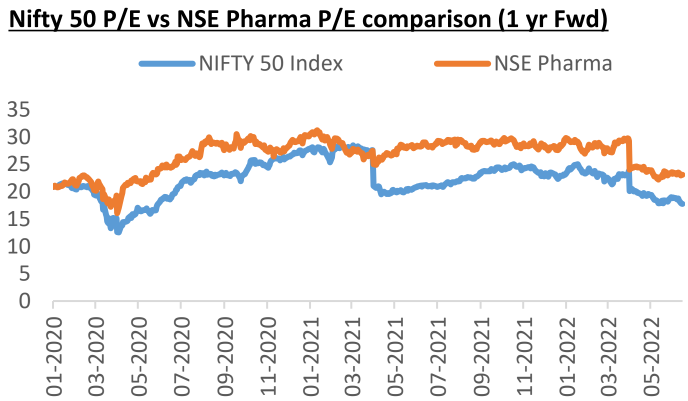
India Healthcare / life-sciences

Taking note of sector's financial and valuation trends

The pandemic has exacerbated the inadequacy of our country's health systems and has brought to centre-stage the healthcare and life-sciences sector as a central investing theme for the present decade. The COVID legacy has already resulted in record USD 26Bn private capital inflow in the sector since 2020. Since the start of the COVID outbreak, the BSE HC index had well outperformed the broader indices in 2020 and 2021. Starting 2022, like in all emerging economies, with the Indian equity markets witnessing a significant market correction, the listed Indian pharma and healthcare sector too have seen profit taking by investors leading to the BSE HC index underperforming the broader index YTD2022 (BSE HC index: -20% vs BSE index: -13%). The sector's private capital market continues to witness heightened deal activity.

A deep-dive into the financial and valuation performance of the five sub-segments of the sector in the listed universe has some key take-aways: (a) All segments of the sector have demonstrated a complete recovery based on FY22 numbers demonstrating the overall sector having shrugged off COVID impact quite well; (b) Within Pharmas, the 'Big Pharma' margin and growth resilience continues and mid-cap pharma too have now registered a smart come back; (c) The diagnostic services valuations have come-off from their all-time high and are presently trading at their historical median; competitive intensity in this segment is heightening; (d) The healthcare delivery segment has posted strong growth and margin expansion which should continue well into FY23; (e) manufacturing plays in pharma continue to grab the spotlight in terms of both earnings and valuation premium. Detailed analysis follows.





Source: *BSE, NSE and Investing.com*

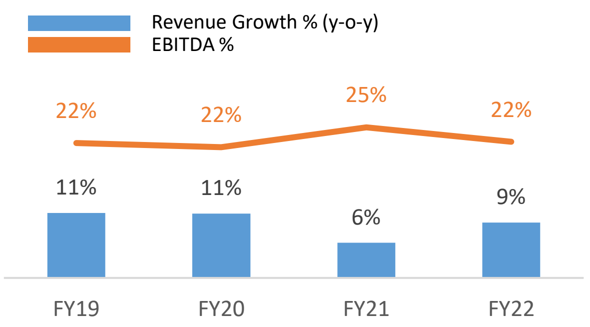
A Look at Sub-Sector Financial & Valuation Trends

1. Big pharma is facing beaten valuations despite financial resilience

All through the economic turbulence of the two-year pandemic period (FY21 and FY22), the big pharma segment has shown remarkable financial resilience having smartly addressed business continuities through their healthy balance sheets and positive currency impact. The improved revenue growth trend of 9% YoY and 22% median EBITDA margin for this segment in FY22 is close to pre-covid levels. This segment has also managed the supply chain disruptions efficiently compared to the smaller companies.

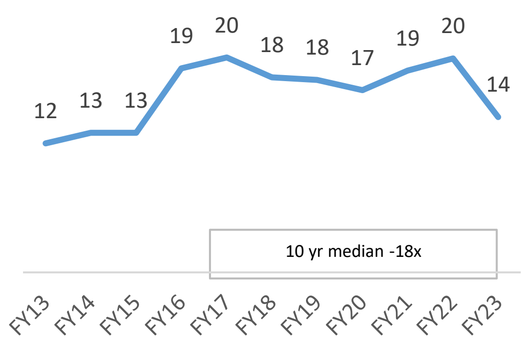
From a valuation perspective though, the big pharma segment has let go the significant outperformance trend of last several years. The segment presently trades at median EV/EBITDA of 14x which is well below the 10-yr median multiple. The beaten valuations is largely a reflection of the significant market correction owing to tightened macro conditions rather that sector related factors.

Large Size Pharma – Revenue growth (%) & EBITDA Margin (%)



Source: *TCHF Analysis, Bloomberg*

Large Size Pharma – Median EV/EBITDA

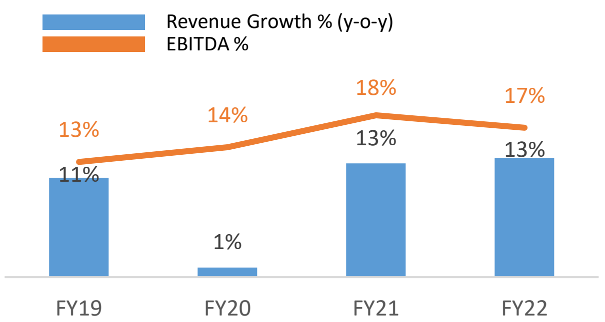


Source: *TCHF Analysis, Bloomberg*

2. Small and mid-size pharma too have normalized to pre-covid levels

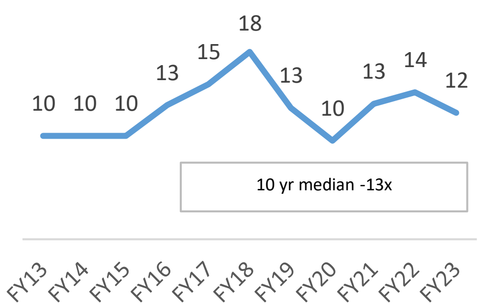
After a turbulent period in FY20, the small and mid-sized listed pharma have come out of the initial business uncertainties and supply chain bottlenecks. In FY22, this segment has registered a healthy 13% YoY revenue growth and 13% median EBITDA margin which is back to pre-covid levels. From a valuation standpoint, this segment presently trades at median EBITDA multiple at 12x, near to ten year average.

Mid Size Pharma – Revenue growth (%) & EBITDA Margin (%)



Source: *TCHF Analysis, Bloomberg*

Mid Size Pharma – EV/EBITDA

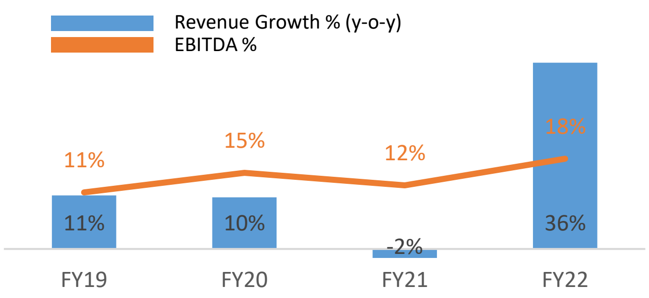


Source: *TCHF Analysis, Bloomberg*

3. Healthcare Delivery sector has made an impressive comeback

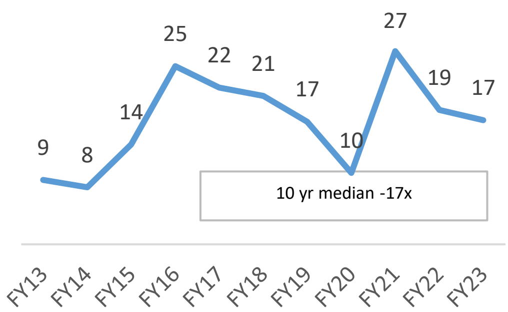
The listed healthcare delivery stocks have now fully financially recovered from the effect of covid in terms of financial performance. This segment has faced the sharpest brunt of pandemic related lockdown all through FY21 and partly in FY22. In FY22 this sector saw a sharp 36% YoY revenue growth and 18% median EBITDA margin reflecting an impressive comeback to normalcy. The outlook for FY23 continues to be a strong year for this segment with electives like ortho, eye-care and similar procedures showing a good surge in volumes. While the fundamentals for the segment has regained strength, the valuations too have made a good comeback from last two year historic lows. The sector presently trades at median EV/EBITDA of 17x which is at the 10 year median level.

Healthcare Services – Revenue growth (%) & EBITDA Margin (%)



Source: *TCHF Analysis, Bloomberg*

Healthcare Services – EV/EBITDA

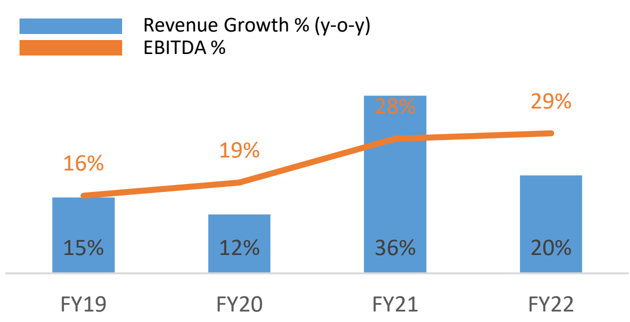


Source: *TCHF Analysis, Bloomberg*

3. Pharma manufacturing services has come off the peak performance

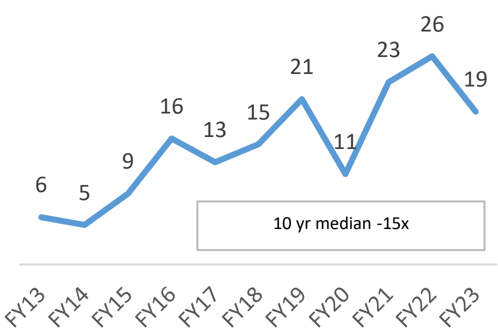
The specialized segment of pharma manufacturing services accounts for about 10% of the listed sector universe. Valuations in this segment had reached 10 year high even during the covid crisis. In FY22 20% YoY revenue growth remains healthy despite the high base of FY21 and FY22 EBITDA margins at 29% reflects the strong fundamentals of this segment. This segment presently trades at significant 30% premium to 10-year median value in terms of EBITDA multiples. This reflects the continuing positive investor sentiment in specialized pharma manufacturing activity which has further strengthened during the Covid period on account of restriction from China pharma imports and other company specific factors.

Pharma Manufacturing – Revenue growth (%) & EBITDA Margin (%)



Source: *TCHF Analysis, Bloomberg*

Pharma Manufacturing – EV/EBITDA

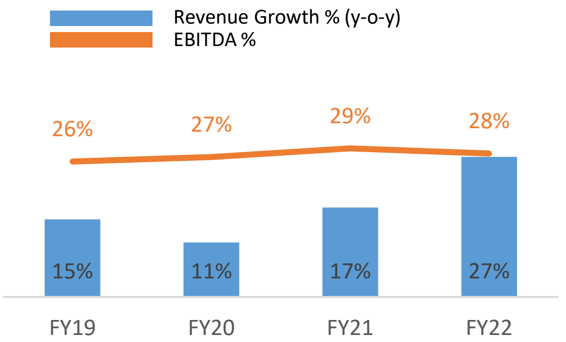


Source: *TCHF Analysis, Bloomberg*

5. Sharp valuation correction in the diagnostic services segment

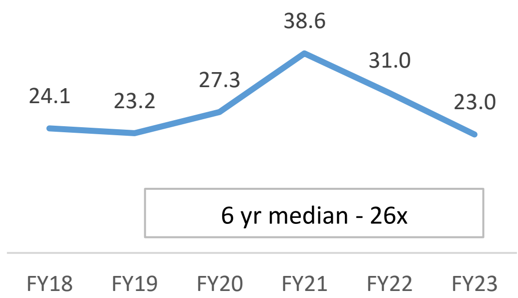
Diagnostic companies have seen their business dynamics change due to social distancing norms. Compared to pre-COVID times where footfalls from walk-ins used to constitute bulk of volumes, the initial lockdown months have disrupted the business due to drying up of business from walk-ins. In FY22, diagnostic companies recorded strong Y-o-Y growth at 27% while maintaining high median margins at 28%. This segment is now gearing up to driving volumes from home collections and digital offerings. The segment saw a lot of investor interest in 2021 which drove the valuations to record highs, however the valuations have come off with the median EV/EBITDA presently at 23x vs 31x a year ago. The valuations have reverted to their long term median valuation range in terms of EBITDA multiples. There has been significant private capital invested in diagnostics in the last 2 years both to traditional players and digital first players. The increased competitive environment from new market entrants may lead to margin contraction especially for smaller players giving way to the much needed industry consolidation which will also have a bearing on valuations for this small segment.

Diagnostics – Revenue growth (%) & EBITDA Margin (%)



Source: *TCHF Analysis, Bloomberg*

Diagnostics – EV/EBITDA



Source: *TCHF Analysis, Bloomberg*

6. Private capital Investor preference at contrast to the listed counterparts

A comparison of transactions between listed and private companies are as per table below. We find that the listed segments of the sector such as pharmaceuticals and diagnostics are at a discount to the private market valuations, but CDMO and healthcare delivery segments are trading at 30-40% premium compared to the private counterparts.

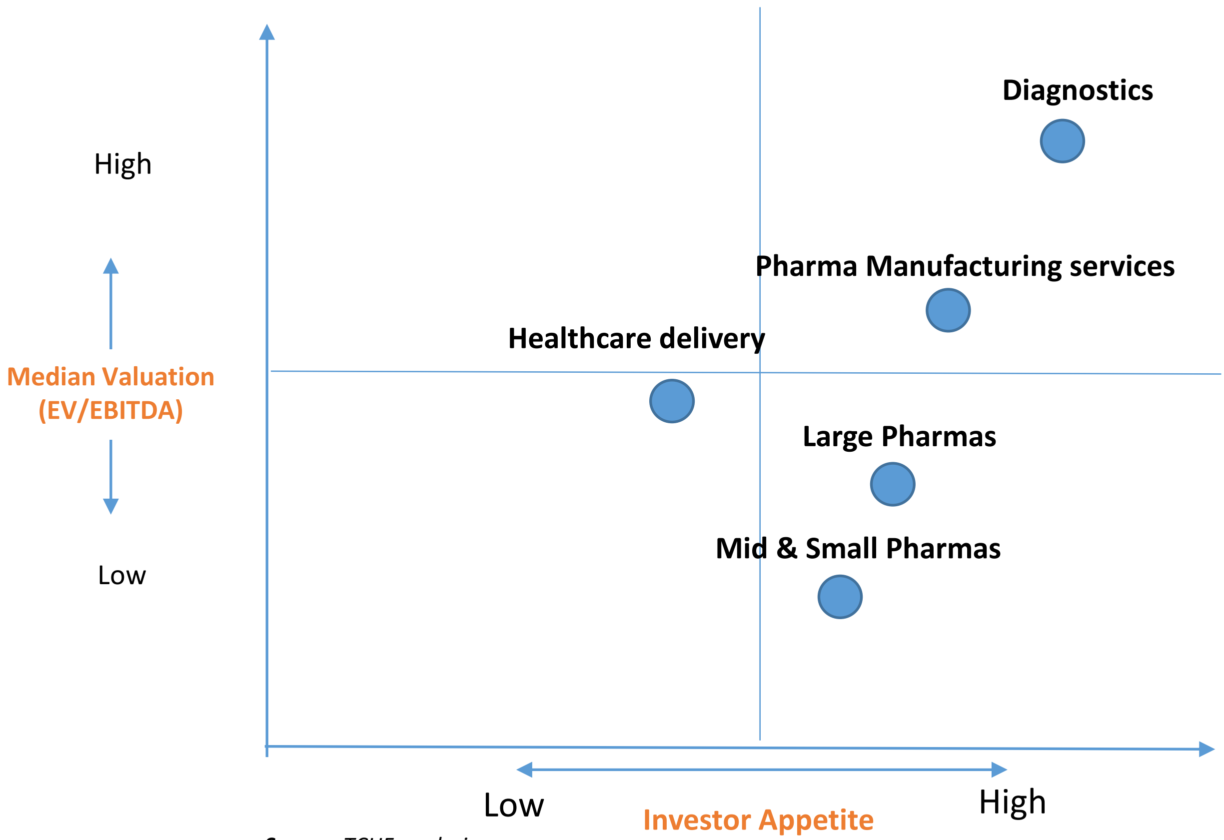
VALUATION COMPARISON	Median EV/EBITDA multiples (Unlisted entities)	Current EV/EBITDA multiples (Listed Entities)	Listed Valuation Premium/Discount to 10yr Median (%)
Large pharma	**16.3x**	**14.5x**	(11)%
Mid - pharma	**15.2x**	**12.3x**	(19)%
Diagnostics	**24.3x**	**23.0x**	(5)%
CDMO/pharma services	**13.6x**	**19.4x**	42%
Healthcare services	**13x**	**17.4x**	34%

Source: *Bloomberg, Venture Intelligence database*

Key Conclusions

In conclusion, the sector despite the drop in valuations has demonstrated strong fundamental financial performance. A detailed dissection of the five key sub-sectors of the listed universe and their private market comparable provide long-term valuation insights and investor preferences even within the sector. Some key take-aways are:

1. Public market investors have preferred to back size over discounted valuations
2. All segments of the sector have demonstrated a complete recovery based on FY22 numbers demonstrating the overall sector having shrugged off COVID impact quite well
3. Within Pharmas, the ‘Big Pharma’ margin and growth resilience continues, and mid-cap pharma too have now registered a smart come back
4. The diagnostic services valuations have come-off from their all-time high and are presently trading at their historical median; competitive intensity in this segment is heightening
5. The healthcare delivery segment has posted strong growth and margin expansion which should continue well into FY23
6. Manufacturing plays in pharma continue to grab the spotlight in terms of both earnings and valuation premium



Source: *TCHF analysis*

Note -

1. *Total sample – 239 (listed companies) & c.30 (private market transactions)*
2. *Listed Large Pharma defined as > INR 5000 Cr Enterprise value*
3. *Listed Mid and Small Pharma as < INR 5000 Cr Enterprise value*
4. *Valuation criteria taken into consideration is EV/ EBITDA and includes most recent historical and actual financials*

This thematic has been conceptualized and written by the investment team at Tata Capital Healthcare Fund (TCHF), a growth oriented private equity fund primarily focused on the healthcare and life Sciences sector in India. The investment team of TCHF can be contacted at info.tchf@tatacapital.com.