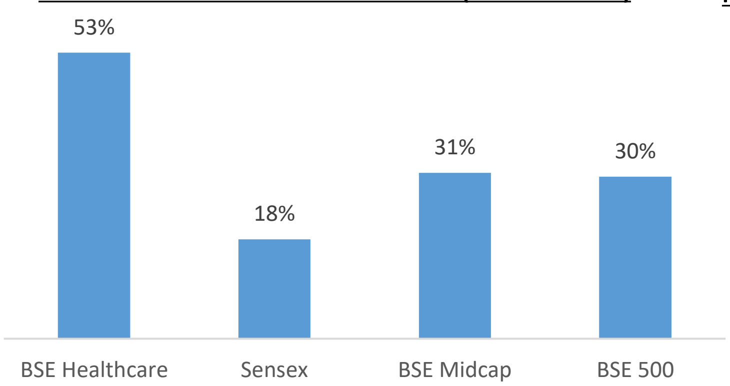
India Healthcare / life-sciences

Sector Has Risen From COVID Brunt

The ongoing pandemic has brought to centre-stage the attention for healthcare and life-sciences sector as a central investing theme for the present decade. The COVID legacy has already resulted in record USD 4.8 Bn private capital inflow in the sector in 2020 and YTD2021. The listed pharma and healthcare universe too has seen tremendous investor interest with the BSE HC index having significantly outperformed the broader indices since the start of the COVID outbreak in early 2020. During this period (Jan 2020 till July2021), the BSE Healthcare index was up 53% vs. Sensex at 18%. Another reflection of positive investor sentiment is seen from Forward P/E valuation of NSE Pharma index which has traded consistently at a premium to the P/E of the broader Nifty 50 index. This heightened investor interest is largely in anticipation of the sector showing earnings resilience compared to other sectors of the economy and investor preference for defensive plays during present turbulent times.

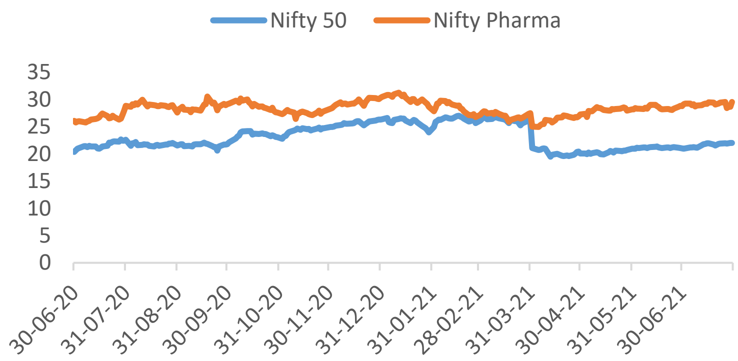
While there is little doubt that the overall sector has seen heightened investor activity, a deep-dive into the financial and valuation performance of the five sub-segments in the listed universe has some key take-aways: 1. All the five segments of the sector have demonstrated recovery over the past quarter, an early indication of the sector starting to shrug off the financial brunt of COVID. 2. Within Pharmas, the 'Big Pharma' margin and valuation resilience continues while mid-cap pharma continues to experience growth stress; 3. Within healthcare services, diagnostic services have staged a sharp come-back in the last few quarters while healthcare delivery has started showing a modest earnings come-back; investor interest in diagnostic services remains at all-time high. 4. Manufacturing plays in pharma have grabbed the spotlight in terms of both earnings and valuation premium. Detail analysis follows..

BSE Healthcare Index vs Other Indices (Jan'20– Jul'21)



Source: *BSE, NSE and Investing.com*

Nifty 50 P/E vs NSE Pharma P/E comparison (1 yr Fwd)



Source: *Venture Intelligence*

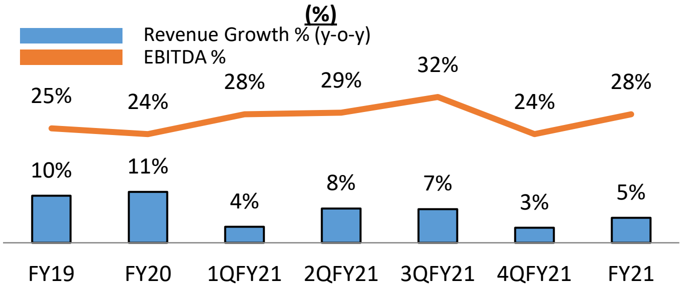
A Look at Sub-Sector Financial & Valuation Impact of COVID

1. Big pharmas have shown margin and valuation resilience all through FY21

A large part of the listed sector significant stock outperformance has been on account of the 'Big Pharma' segment which form over 2/3rds of the universe in terms of market cap. Here, the investor interest is a reflection of the 'big pharma' companies exhibiting remarkable resilience from Covid related financial hit compared to the 'small pharma' companies. Most of these companies have benefited from the cushion of healthy balance sheets and positive currency impact to address business discontinuities arising from the pandemic.

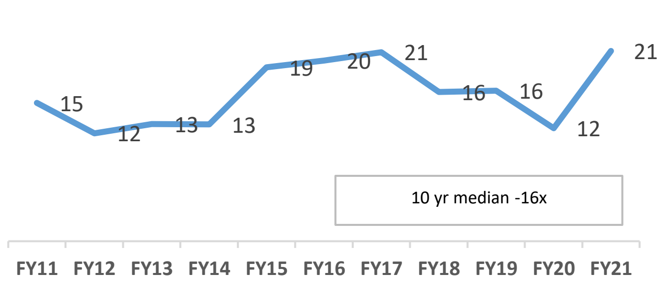
An analysis of this segment's financial performance over all four quarters of FY21 indicates an improving positive growth surge despite massive economic turbulence on account of the pandemic. This is a reflection of the fact that most big pharmas have managed to restart manufacturing activity within a few weeks of the lockdown despite initial disruption. This segment has also managed the supply chain disruptions far more efficiently than the small and mid-size pharmas. The most impressive aspect of this segment has been the good margin resilience during the COVID period which is largely reflective of a nimble cost rationalization measures as well as adopting omni-channel marketing through digital initiatives. This also explains the valuation premium for this segment which is presently trading at significant premium to long-term median valuation in terms of EV/EBITDA metrics.

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



Source: *TCHF Analysis, Duff & Phelps*

Large Size Pharma - EV/EBITDA - 1 Yr Fwd

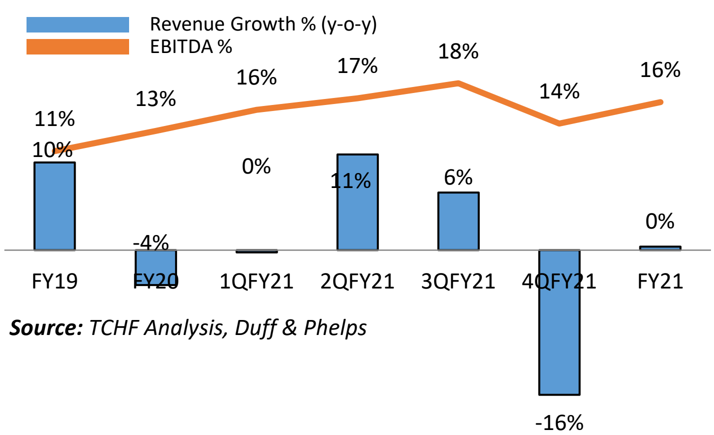


Source: *TCHF Analysis, Duff & Phelps*

2. Growth stress continues in mid pharmas; still some time for normalization

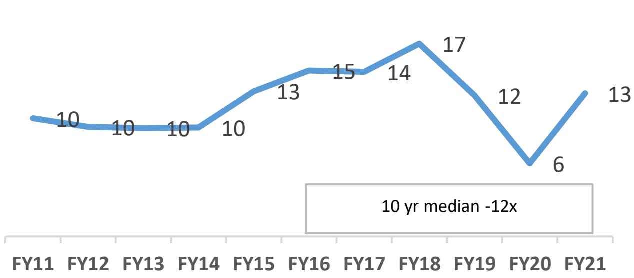
The small and mid-sized listed pharmas have registered significant revenue de-growth in six of the last eight quarters with FY21 registering YoY flat revenues. This performance is reflective of the business uncertainties and vulnerable balance sheet positions especially to deal with the present crisis. However this segment of companies have registered reasonable EBITDA margin improvement which may be the result of forced cost-cutting measures in times of stress. From a valuation standpoint, this segment has seen a significant pick-up in median valuation which may be an optimistic trend to watch out for

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



Source: *TCHF Analysis, Duff & Phelps*

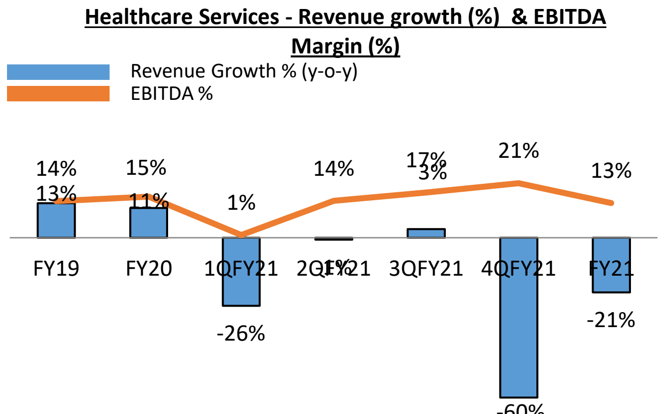
Pharma Mid & Small - EV/EBITDA - 1 Yr Fwd



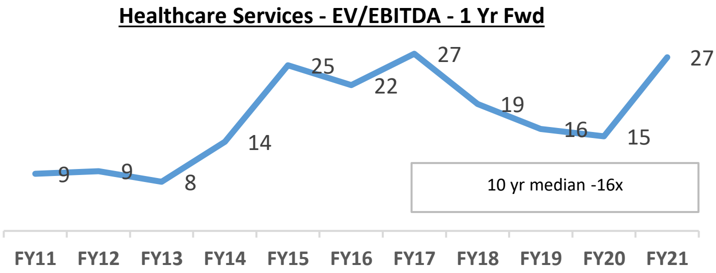
Source: *TCHF Analysis, Duff & Phelps*

3. The severe COVID brunt on Healthcare Services appears to have bottomed out effective 4QFY21

The listed healthcare services stocks have in the last few months recovered from their historical lows in terms of both multiples on Revenue and EBITDA. This segment has faced the sharpest brunt of pandemic related lockdown all through the four quarters of FY21. More importantly, the 4Q period registered a sharp 60% YoY de-growth in revenues and tepid margins. The significant sell-off in the sector reflects the drop in volumes for most healthcare specialties especially the elective procedures like ortho, eye-care etc. Indications at the ground level over the last few months reflect a promising come-back for this segment. We expect the recent stable revenue trend to continue in the coming quarters. Stock prices and valuations seem to be factoring the concern on growth and margin profile which explains the reason for this sector's valuation come-back.



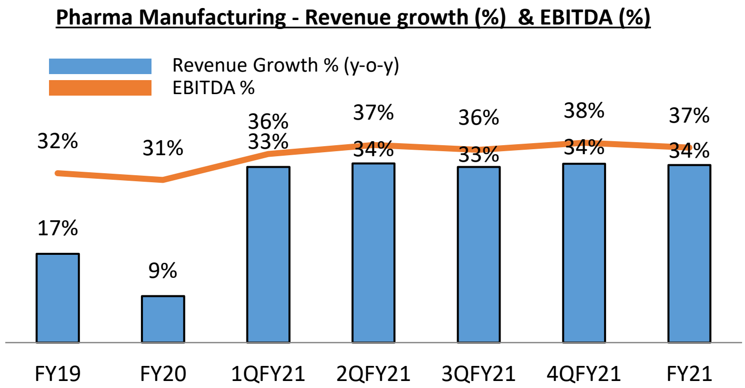
Source: *TCHF Analysis, Duff & Phelps*



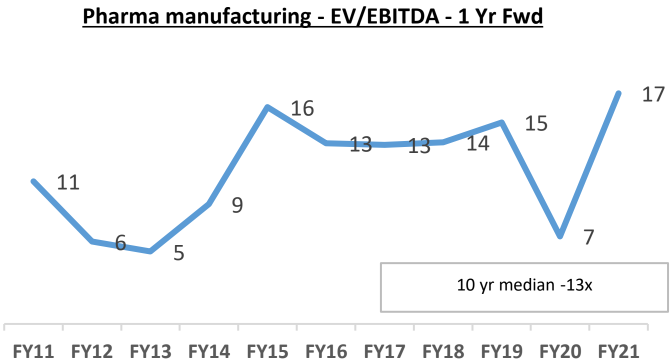
Source: *TCHF Analysis, Duff & Phelps*

3. Pharma manufacturing services retains the spotlight on performance

The specialized segment of pharma manufacturing services accounts for about 10% of the listed sector universe. Valuations in this segment have reached 10 year high even during the present crisis. This segment presently trades at significant 30% premium to 10-year median value in terms of EBITDA multiples. This is a reflection of the continuing positive investor sentiment in pharma manufacturing activity which has further strengthened during the Covid period on account of restriction from Chinese pharma imports among other company specific factors. During all the four quarters of FY21, this segment has delivered record 30%+ YoY revenue growth combined with impressive 35%+ EBITDA margins. This segment is clearly at its fundamental best despite pandemic times.



Source: *TCHF Analysis, Duff & Phelps*

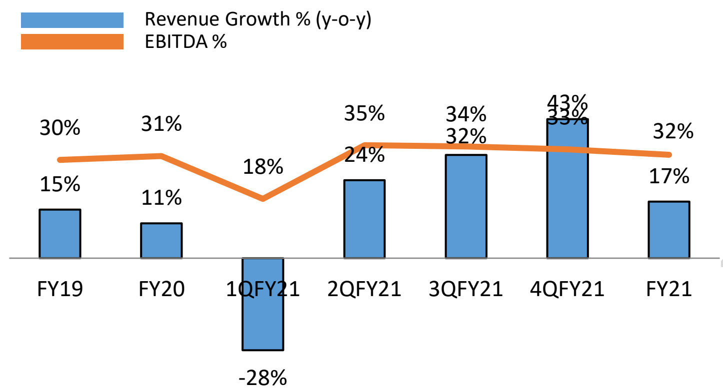


Source: *TCHF Analysis, Duff & Phelps*

5. Sharp come-back for Diagnostic plays; valuations get more expensive

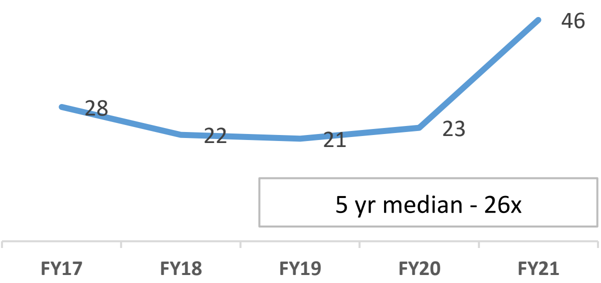
Diagnostic companies have seen their business dynamics change due to social distancing norms. Compared to pre-COVID times where footfalls from walk-ins used to constitute bulk of volumes, the initial lockdown months have disrupted the business due to drying up of business from walk-ins. This is also corroborated by the sharp 28% revenue de-growth for the segment during the 1Q FY21 quarter. However the remaining three quarters of FY21 has witnessed a sharp surge in volumes and the segment has now bounced back better than the pre-covid levels. This segment is now gearing up to driving volumes from home collections and digital offerings. Given the general expectation of likely normalization of operations in the coming months, the valuation of this set remain high and resilient. This set is presently trading at significant premium to their long term median valuation range in terms of EBITDA multiples. This is also on account of scarcity factor combined with low weightage in the listed universe offering. Several of these players are also augmenting digital offerings and have beefed up PPP models to integrate with the Govt. for COVID tests. From a long term perspective, the increasing cost of doing business 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.

Diagnostic Services - Revenue growth (%) & EBITDA Margin (%)



Source: *TCHF Analysis, Duff & Phelps*

Diagnostics - EV/EBITDA - 1 Yr Fwd



Source: *TCHF Analysis, Duff & Phelps*

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 are generally at 5-40% premium compared to the private counterparts.

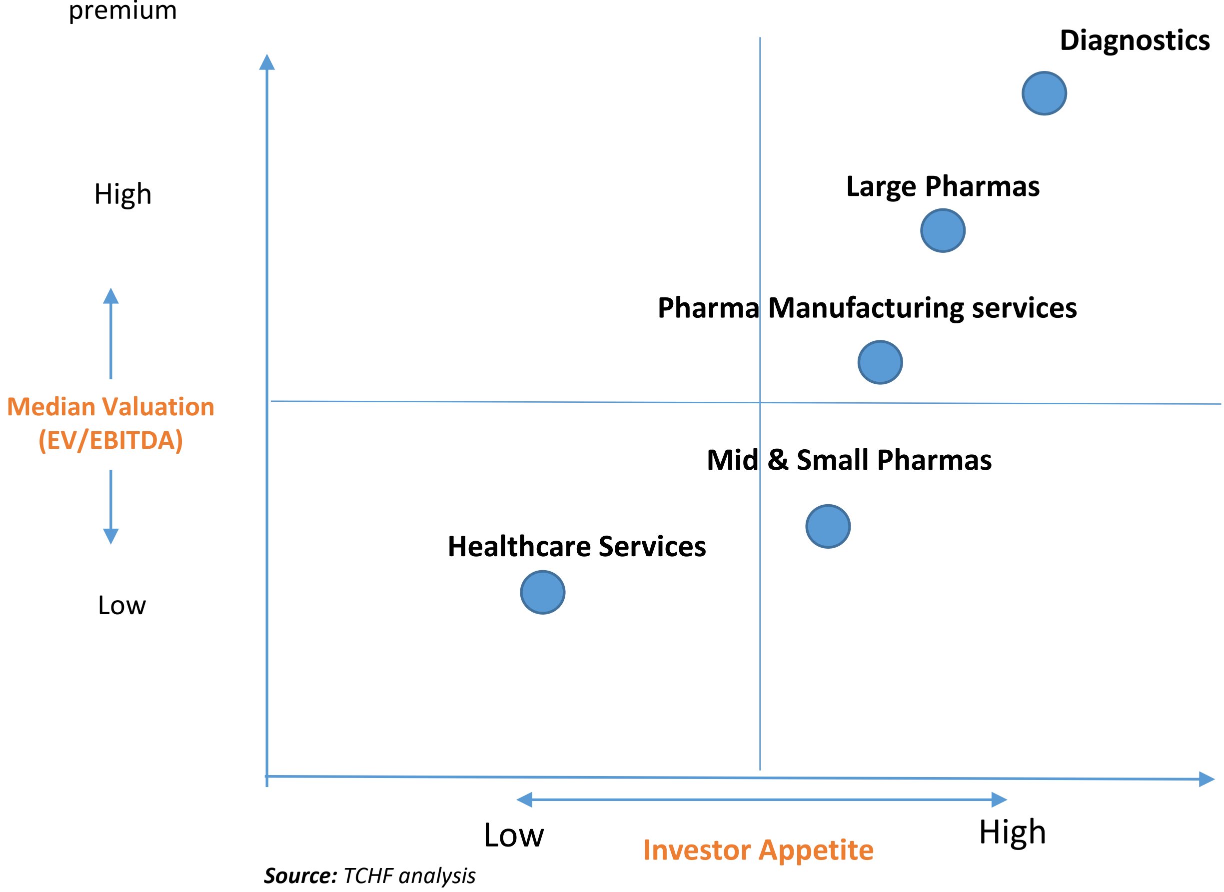
VALUATION COMPARISON	Median EV/EBITDA multiples (Unlisted entities)	Current EV/EBITDA multiples (Listed Entities)	Listed Valuation Premium/Discount to 10yr Median (%)
Large pharma	**16.3x**	**18.9x**	15%
Small and medium pharma	**15.2x**	**12.8x**	(18%)
Diagnostics	**24.3x**	**30.3x**	20%
CDMO/pharma services	**13.6x**	**14.3x**	5%
Healthcare services	**13x**	**18.2x**	45%

Source: *Venture Intelligence database*

Key Conclusions

In conclusion, the sector on an overall basis seems to be fairly well insulated from most types of economic vagaries including an economic black swan event like the present crisis. Another key take-away is that even within the sector, there is significant polarisation in terms of investor preference for select sub-segments as well as preference for sizeable plays. 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. Most segments of the sector have demonstrated recovery over past 2-3 quarters, a key indication of the overall sector having shrugged off COVID impact quite well.
3. Within Pharmas, the 'Big Pharma' margin and valuation resilience continues while mid-cap pharma is yet to demonstrate sustainable come-back in performance. Valuations of 'Big Pharma' have retained their financial stronghold even during the present turbulent times and are presently trending at significant premium to their 5-year median value. This is clearly a reflection of Investors rewarding size and earnings resilience which this segment adequately demonstrates.
4. Within healthcare services, diagnostic services have shown a sharp earnings come-back in the past few quarters and investor interest in this segment remain at all-time high reflecting the growth opportunity arising from present turbulent times.
5. Manufacturing plays in pharma have grabbed 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.