Healthcare

Sector coverage · Healthcare · interview preparation summary

INT.BC.2.a · Healthcare

Classify a healthcare business by who pays, what repeats, what is scarce and what could change overnight, and say what that means for valuation, financing and buyers.

A healthcare coverage banker starts with four questions: who pays, what repeats, what is scarce and what could change overnight. The answers sort a sector that looks uniform into models with very different economics. In most of healthcare the end user does not pay, because a government programme, a national health service or an insurer does. That makes tariffs, coverage rules and reimbursement decisions the largest single source of risk, and one announcement can move earnings. Pharma and biotech sell intellectual property. A patent typically gives around a decade of exclusivity after launch, gross margins are often above 70%, and value falls sharply when exclusivity ends. Medical technology sells systems, then the consumables and service that repeat on the installed base. Services and providers sell clinician time and beds, so margins are thinner and the scarce input is staff. Tools and life sciences companies sell instruments and consumables to laboratories and drug makers, so demand follows research budgets and production volumes. Contract research and manufacturing firms rent expertise and capacity to drug developers. Demand is largely non-cyclical because patients rarely defer a prescription or an urgent operation. It is not immune, because elective procedures slip in a downturn, biotech funding follows equity markets and public budgets tighten after a fiscal squeeze. Regulation runs through everything, since approval, clinical evidence and pricing decide what can be sold and at what price. The classification matters because it sets the valuation method, the debt a business can carry and the likely buyers. A drug company is a set of products with expiry dates, so the banker values products and the pipeline behind them. A hospital group is an earnings stream built on staff and property, so the banker values EBITDA and may separate the property. A common mistake is to call a business healthcare and apply one sector multiple. A strong answer names the model first, then the payer, then the event that could change the numbers overnight.

WORKED EXAMPLE: SORTING CALDERWICK HEALTH INTO ITS MODELS

Calderwick Health is an invented listed group with 800m of revenue. Branded drugs bring 320m, and 60% of that comes from one product whose patent ends in two years. Diagnostics brings 280m, of which 80% is paid by the state. Clinics bring 200m, of which 70% is paid by the state. Sort the group with the four questions, size the two exposures a banker would raise, and say how to value it. Convention: the state exposure counts the diagnostics and clinics segments only.

Answer: Calderwick is three models in one group. 24.0% of revenue depends on one patent and 45.5% depends on state tariffs in its two services segments, so the group should be valued as a sum of the parts, not on one sector multiple.

> **Interview tip:** Say it aloud in this order: the model of each part, the payer, the date or decision that could change the numbers, then the valuation method. Give the two percentages, not adjectives.

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Read the first metrics for each healthcare model and say what a normal and an abnormal figure looks like.

Each healthcare model has its own first metrics, and a banker who quotes the wrong ones is quickly found out. For a drug company, start with sales by product, the share of sales from the lead product and the date exclusivity ends. Gross margin is typically 70% to 85%, and research and development often takes 15% to 25% of sales in a research-led business. Then check the gap between gross and net sales, because rebates and discounts can take a large share of list price. Price and mix = (1 + net sales growth) ÷ (1 + volume growth) − 1. A negative figure while volume rises points to rebate pressure or adverse mix eroding the net price of the brand. For a medical technology company, split revenue into systems, consumables and service. The recurring share, meaning consumables and service as a percentage of revenue, shows how much repeats once the installed base is built. Installed base, utilisation per system and procedure volumes explain the consumables line. Gross margin is often 55% to 70%, and it dips when system placements grow because systems carry a lower margin than consumables. For services and providers, same-site growth strips out acquisitions and new openings. Same-site growth = (current revenue − acquired revenue − new-site revenue − prior revenue) ÷ prior revenue. Then check occupancy or utilisation, payer mix and staff cost as a share of revenue, which is often 50% to 65% in labour-heavy care. For contract research and manufacturing, backlog, book-to-bill and capacity utilisation come first. Book-to-bill = bookings ÷ revenue. A ratio above 1.0 means backlog is growing, but only firm, non-cancellable backlog counts as cover. For tools and life sciences,

read organic growth and the share of revenue from consumables and recurring service. For every model, finish with cash conversion, meaning operating cash flow after capital spending as a share of EBITDA. Typical ranges are guides and never a pass mark, because a figure is only normal for its own sub-sector. The usual mistake is to cite growth and margin alone, with no sense of what drives them.

WORKED EXAMPLE: READING ORRIN SURGICAL'S RECURRING REVENUE AND MARGIN

Orrin Surgical is an invented surgical systems maker. It starts the year with 3,000 systems installed and sells 600 new systems at 0.30m each. Each installed system, measured on the average base for the year, generates 0.045m of consumables and 0.012m of service. Gross margins are 45% on systems, 80% on consumables and 40% on service. Build revenue, the recurring share and gross margin, then test a downturn in which system sales fall 30% and the installed base is unchanged. Convention: average base is the mean of opening and closing systems, and figures are in millions.

Answer: Orrin has revenue of 368.1m, 51.1% of it recurring, and a gross margin of 58.6%. A 30% fall in system sales cuts revenue by 14.7% and gross profit by 11.3%, so earnings are cushioned but not immune.

> **Interview tip:** Quote the recurring share first, then show what happens to revenue and gross profit when the capital line falls. A margin that rises in a downturn is a mix effect, so say so.

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Choose the valuation method for a healthcare business and defend a range using rNPV, forward multiples, precedent premiums and a sum of the parts.

Valuation in healthcare follows the economic model, so the banker first decides what the cash flows are made of. For a mature services, tools or medtech business, enterprise value to forward EBITDA is the main trading multiple, and peers should share growth, margin and payer exposure. Price to earnings is common for large pharma, where earnings are stable and analysts quote it. For fast-growing medtech or recurring businesses, enterprise value to sales is used alongside, adjusted for gross margin and recurring share. For a drug company, a discounted cash flow built product by product is the anchor. It models launch, peak sales, patent expiry and the steep erosion that follows. A trailing multiple misleads when exclusivity is close, because it capitalises earnings that are about to disappear. For a clinical-stage biotech with no sales, use risk-adjusted net present value. rNPV = probability of success × present value of cash flows if approved − present value of remaining development costs. Probability of success multiplies the odds of passing each remaining phase, and it is typically lowest in early phases and highest at filing. Peak sales multiples are a cross-check and not a method. Precedent transactions add a control premium, often 30% to 50% over the undisturbed price in a public deal, and the multiple must be read against the target's growth and exclusivity. Large pharma deals for a single asset are priced on that asset's expected sales, not on group multiples. A sum of the parts is common where a group mixes models, such as a branded pharma business, a consumer health arm and a laboratory arm. Each part takes the multiple of its own peers, and the gap between the total and the group's market value is the apparent conglomerate discount. Property-owning operators need care, since a hospital group that owns its sites and one that rents them cannot be compared on EBITDA alone. Adjust with lease-adjusted enterprise value and EBITDA after rent, or value the property separately by yield. A banker also checks that each part of the football field uses the right method, and does not average a DCF, a multiple and a precedent without comment. The usual mistake is to use one sector multiple, or to apply a mature multiple to a business that is losing its lead patent.

WORKED EXAMPLE: RISK-ADJUSTING A PHASE III ASSET AT VERRANE BIO

Verrane Bio is an invented clinical-stage company with one asset in Phase III. The chance of passing Phase III is 55% and of then gaining approval at filing is 90%. If approved in three years, the cash flows from launch are worth 1,500m at the launch date. The remaining trial and filing costs have a present value of 150m, and the discount rate is 10%. Peak sales are forecast at 800m. Find the risk-adjusted net present value, the effect of a 10 point rise in the Phase III chance, and the value as a multiple of peak sales. Convention: costs are incurred whether or not the drug succeeds.

Answer: Verrane's asset is worth about 408m on a risk-adjusted basis, and each 10 points on the Phase III chance moves it by about 101m. That is about 0.5 times peak sales.

> **Interview tip:** State the formula, the probability and the discount rate before the answer. Then say which assumption moves the value most, which here is the Phase III chance.

INT.BC.2.d · Healthcare

Explain what drives M&A, ECM and DCM activity in healthcare, size financing capacity on post-expiry earnings, and bring a pitch idea.

Activity in healthcare is driven by a handful of recurring problems that a coverage banker learns to spot early. Large pharma faces patent cliffs, which are dates when a major product loses exclusivity and revenue falls sharply. Its main answers are to buy late-stage assets, buy commercial products, license, and cut costs, so M&A is the staple. Typical sellers are venture-backed or listed biotechs with data that a larger company can commercialise better, and typical buyers are large and mid-sized pharma with cash and a gap. Medtech activity is driven by scale in sales forces, adjacent product lines and the premium paid for recurring consumables. Services and providers consolidate through buy-and-build, because small sites bought at low multiples are worth more as a group, and sponsors are frequent buyers and sellers. Large groups also separate businesses, for example by spinning off consumer health or a laboratory arm, to close a conglomerate discount. Equity capital markets activity follows the data. A biotech typically lists in an open window, then raises through follow-ons after positive trial results, when the share price reprices and risk falls. Convertibles suit companies that are growing but not yet profitable, since the coupon is low and dilution is deferred. Investors in an IPO ask about probability of success, cash runway, the milestone calendar, the evidence package and who will pay. Debt capital markets work for companies with stable cash flow. Large pharma and medtech issue investment grade bonds, often to fund an acquisition, and agencies look at leverage on earnings after the next patent expiry. Leverage capacity = maximum net debt multiple × EBITDA − existing net debt. Lenders and agencies test that sum on earnings that include expected losses from expiry and tariff cuts. Service groups and sponsor-owned businesses use leveraged loans and high yield, with sale and leaseback of property as a further source. Pitch ideas follow from these drivers: a bolt-on to fill a gap, a carve-out of a non-core arm, a royalty monetisation, an accelerated bookbuild after data, or a refinancing ahead of a tariff review. The usual mistake is to suggest a deal with no view of what the buyer can pay or how it will be financed.

WORKED EXAMPLE: SIZING THE PATENT CLIFF AT MARROWFIELD PHARMA

Marrowfield Pharma is an invented group with EBITDA of 1,050m, net debt of 2,100m and a market value of 6,300m. Its lead product Duravan has sales of 1,200m and loses exclusivity in year three, after which 75% of sales disappear at a 70% margin. Lenders and agencies want net debt of no more than 3.0 times EBITDA. A candidate target, Sevran Therapeutics, has sales of 300m growing 25% a year at a 40% EBITDA margin and could be bought at 12 times year-one EBITDA. How large is the gap, and can one deal fill it? Convention: year-three figures are used for capacity and the deal is financed by debt or new equity only.

Answer: The cliff removes 630m of EBITDA and takes leverage from 2.0 to 5.0 times. Sevran refills only 37% of it and could not be debt financed, so the pitch should combine smaller deals, a disposal such as consumer health, and a royalty or partnership sale with an equity raise.

> **Interview tip:** Lead with leverage on post-cliff earnings, because that is how lenders and agencies will look. Then show that one deal cannot close the gap and say what you would combine.

INT.BC.2.e · Healthcare

Spot the cycle, event and accounting risks in a healthcare business and run a compact end-to-end analysis on clean earnings.

Healthcare has little classical cycle, but it has event risk, and an adviser must know the events. Elective procedures, dental and cosmetic care slip when household budgets tighten, and hospital capital spending slows when budgets are cut, so systems sell later than consumables. Biotech funding follows equity markets, so IPO and follow-on windows open and close with sentiment. Drug makers face patent expiry, trial failures, price negotiation and safety actions, each of which can reset value in a day. Services face tariff reviews, wage inflation and staff shortages, and they have little power to pass on costs when the payer sets the price. The accounting traps cluster in a few places. Capitalised development costs raise EBITDA and move cash spending out of the income statement, so check earnings after capitalised development. Gross-to-net deductions such as rebates, returns and discounts are estimates, and a change in the estimate moves reported sales. Channel stuffing, meaning pushing stock into wholesalers ahead of demand, inflates one quarter and reverses in the next. Acquired intangibles and contingent consideration create large charges and credits that adjusted measures often remove, so check both. Add-backs for restructuring or integration that appear in every year are recurring costs and not exceptional items. Lease accounting lifts EBITDA by taking rent below the line, so compare operators on EBITDA after leases. Clean EBITDA = adjusted EBITDA − recurring add-backs − lease payments − capitalised development. A compact end-to-end analysis follows a fixed order. Name the model, then check organic growth, then margins and their drivers, then cash conversion and leverage on clean earnings. Next state the valuation range and the event that could break it. Finish with the transaction idea, its financing and the main risk to the client. The usual mistake is to take management's adjusted figures and leverage at face value. A good answer says what the clean number is and why it differs from the headline.

WORKED EXAMPLE: CLEANING THE EARNINGS OF PELLAM CARE GROUP

Pellam Care Group is an invented operator of care homes. Revenue rose from 440m to 500m, and 35m of the increase came from acquired homes. Management reports adjusted EBITDA of 80m after lease accounting, which includes add-backs of 14m, of which 9m is restructuring that has appeared in each of the last three years. Lease payments are 28m, capital spending is 30m, and net debt excluding leases is 240m. Management says leverage is 3.0 times. Test it. Convention: the other 5m of add-backs are accepted as genuine one-offs.

Answer: Organic growth is 5.7%, not 13.6%, and leverage on clean earnings is 5.6 times, not 3.0 times. With 30% cash conversion, this is not a credit for a conventional investment grade or crossover bond, and the client needs equity, disposals or a property transaction.

Interview tip: Show the bridge from the headline number to the clean number in three steps and name each adjustment. Then say what the corrected figure means for the financing route.

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Place any healthcare company in its sub-sector and state its demand driver, economic model, first metrics, the usual misread and the product groups that meet it.

This map places any healthcare company in a sub-sector, so name the sub-sector first, then the driver, then the numbers. Branded pharma sells patented medicines paid by insurers and states, so read sales by product, exclusivity dates and pipeline first, because today's earnings are most often misread as durable, and bolt-on M&A and investment grade bonds are the usual products. Generics and consumer health sell off-patent or over-the-counter products on volume, price and distribution, so read volume, price erosion and gross margin first, because a launch is easily mistaken for lasting growth, and carve-outs and leveraged finance are common. Biotech turns science into assets with little or no revenue, so read cash runway, the phase of each programme and the next data date, because a probability of success is easily mistaken for a certainty, and equity markets, convertibles and licensing dominate. Medtech sells systems, then consumables and service on an installed base, so read recurring share, procedure volume and gross margin first, because a margin dip on new placements is often only mix, and strategic M&A and investment grade debt are common. Diagnostics sells tests and imaging at reimbursed prices, so read test volume, price per test and utilisation first, because one tariff review can remove a large share of earnings, and sponsors and lenders meet it through sales and leveraged loans. Services and providers sell clinician time, beds and care to payers, so read same-site growth, payer mix, occupancy and staff cost first, because acquired growth is easily mistaken for organic growth, and buy-and-build, sale and leaseback and leveraged finance are usual. Contract research and manufacturing rent expertise and capacity to drug developers, so read backlog, book-to-bill and utilisation first, because cancellable backlog overstates cover, and M&A, IPOs and leveraged finance all appear. Tools and life sciences sell instruments, consumables and software to laboratories and drug makers, so read organic growth, consumables share and book-to-bill first, because one customer group's spending boom can look like a trend, and portfolio M&A is common. Healthcare IT and distribution sell software and logistics to providers and pharmacies, so read recurring revenue and retention for software and volume and margin per unit for distribution, because low-margin distribution revenue is often blended with software revenue. In an answer, say which sub-sector, then the demand driver and the economic model, then the two or three numbers, then the risk and the product group. Practice differs on whether generics, consumer health or healthcare IT are separate sub-sectors, so state the grouping you are using.

WORKED EXAMPLE: PLACING THREE INVENTED COMPANIES ON THE MAP

Classify three invented companies and read each with its first metrics. Dunmere Research rents drug-development capacity: backlog 1,200m, revenue 480m, bookings 1.15 times revenue. Kestrel Laboratories runs clinical tests: 40m tests at 18.00 each, EBITDA 130m, and a state tariff review may cut the price 5%. Harrowgate Instruments sells laboratory instruments and consumables: revenue rose from 900m to 1,008m, of which currency added 18m and an acquisition 36m, and consumables are 70% of sales. Convention: the tariff cut falls straight to EBITDA and costs are unchanged.

Answer: Dunmere has 2.65 years of backlog cover to be tested for firmness, Kestrel loses 27.7% of EBITDA to a 5% tariff cut, and Harrowgate grows 6.0% organically against a 12.0% headline.

Interview tip: Name the sub-sector before any number, then give the one metric that matters most for it. A candidate who leads with the right metric shows they know the map.