

Diagnostic labs: a different, but bright future

India's diagnostic laboratory market is larger than generally believed and is poised for rapid growth. However the case for big-ticket investments in this space remains unclear

Article Summary

India's clinical laboratory market is currently worth over US\$ 5 Billion in annual revenues (2012) and is likely to grow into a US\$ 30-35 Billion market by 2022, driven by durable demographics and economics. Our research however shows that conventional beliefs about the future of this business are either misleading or wrong. The industry is unlikely to undergo dramatic consolidation and business drivers such as technology and economies of scale will become progressively weaker. In our view, given current incentives and under-regulation, the market will resemble international lab markets less and other markets in India more. While there is money to be made, winners will emerge based upon their ability to manage three important stakeholders well: patients, the doctors who refer them and the pathologists that operate labs.

A growing cash cow...

Traditional estimates have placed the lab market in India today at about INR 15,000 Cr annual revenues. However, our research suggests that this is a significant underestimate with the market being worth at least INR 30,000 Crore – twice conventional estimates. The market is expected to continue growing at 15-20% for next 10 years driven by several durable and powerful factors such as extremely low testing rates – particularly in rural areas (Exhibit 1). We estimate that with urbanization, increasing testing and the growth of diseases like diabetes, this market will swell to over INR 180,000 Crore in revenues (US\$ 30 Billion) market by 2022.

In addition to growing in size, the market will also change in composition. Today, routine test segments such as Haematology, Biochemistry, Immunology etc. dominate spending and drive the market. For example, Biochemistry alone accounts for 45% of the market by revenue and 74% by volume. The future, however, is likely to be very different. Fast evolving technology will enable rapid growth of newer testing platforms such as molecular diagnostic and genetic testing that enable diagnosis at genetic levels. This will also enable prenatal and newborn screening for several forms of diseases. Niche testing like molecular and genetic testing will be worth nearly INR 16,000 crore 10

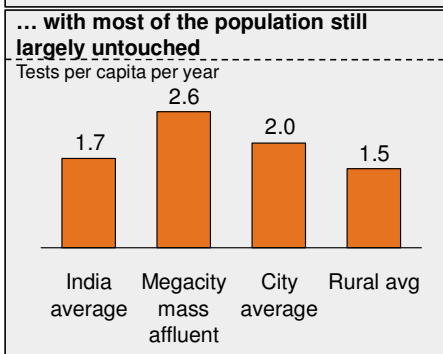
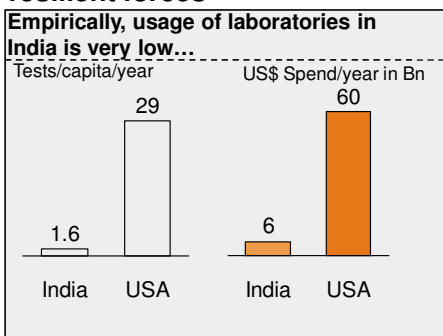
years from now – a mere 10% of the overall market then but nearly half the size of the market today.

In addition to growth, the economics of laboratory medicine are attractive. Costs of tests typically range between 15-25% of their price, providing strong margins. Further, rapid proliferation of technology and the emergence of multiple equipment providers have seen prices of equipment plummet. Virtually all analyser equipment – from small desk-top units to room-sized auto analysers – is now available on reagent rental, driving down set up costs. In addition to being cheaper, newer technologies are virtually ‘touch-less’, and deliver final results with little to no manual intervention. The need for expert pathologists in testing is now increasingly being limited to niches like genetic testing and histopathology. The expectation from pathologists has also changed: they are now required less for testing and more for interpretation, where predictive technologies have not yet replaced decision-making.

As a result, busy laboratories are also very profitable: laboratory medicine is probably the only space in healthcare where an asset-turnover ratio of 3x is routinely achievable. Further, regulatory management and control over the development of laboratories is limited to non-existent, making entry extremely easy.

Exhibit 1

HealthBridge believes that future growth prospects are robust, driven by highly resilient forces



In addition, long-term demand drivers are strong and resilient...

Unassailable demographics

- Population growth and ageing
- Urbanization (+250-300 Mn city dwellers in coming decade)
- Rising incomes

Growth rate likely to exceed GDP growth for the foreseeable future

Changing disease patterns

- The rise of NCD – diabetes in particular
- Increasing use of higher end diagnostics for infectious diseases

Regulations and insurance

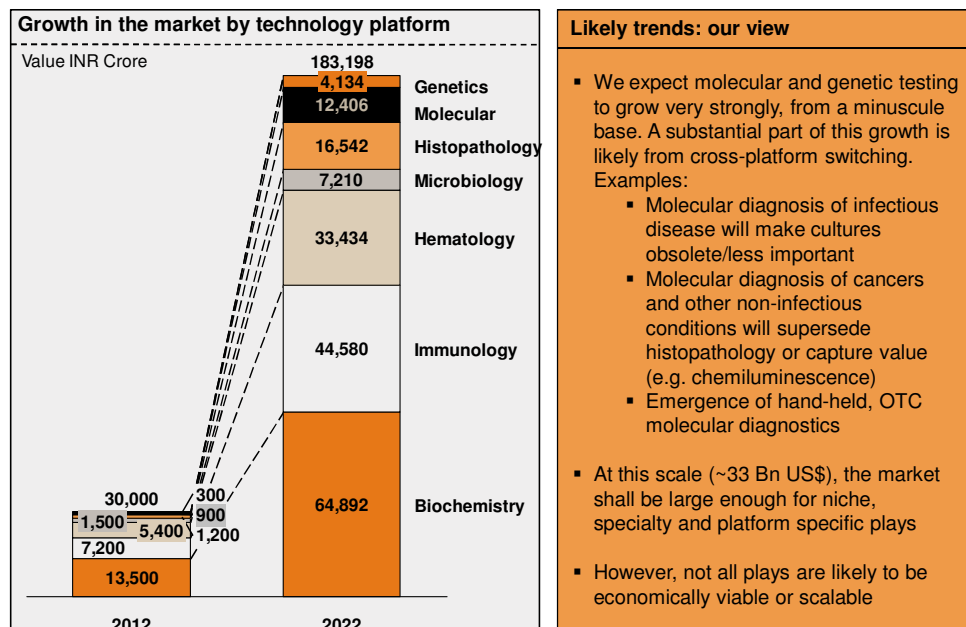
- Rising testing rates, move towards evidence-based payment from payers and regulators
- Mandated screening (e.g. triple test)

Changing technology

- Molecular, genetic testing providing pin-point accuracy in diagnosis of old diseases; ability to diagnose new ones
- Newer testing platforms and devices (e.g. Point of Care, portable automated testing) to increase frequency of use significantly

Exhibit 2

The map of different testing segments will change fundamentally, however biochemistry will continue to remain the mainstay of volumes



Likely trends: our view

- We expect molecular and genetic testing to grow very strongly, from a minuscule base. A substantial part of this growth is likely from cross-platform switching. Examples:
 - Molecular diagnosis of infectious disease will make cultures obsolete/less important
 - Molecular diagnosis of cancers and other non-infectious conditions will supersede histopathology or capture value (e.g. chemiluminescence)
 - Emergence of hand-held, OTC molecular diagnostics
- At this scale (~33 Bn US\$), the market shall be large enough for niche, specialty and platform specific plays
- However, not all plays are likely to be economically viable or scalable

Source: HBA Analysis

The mad rush....

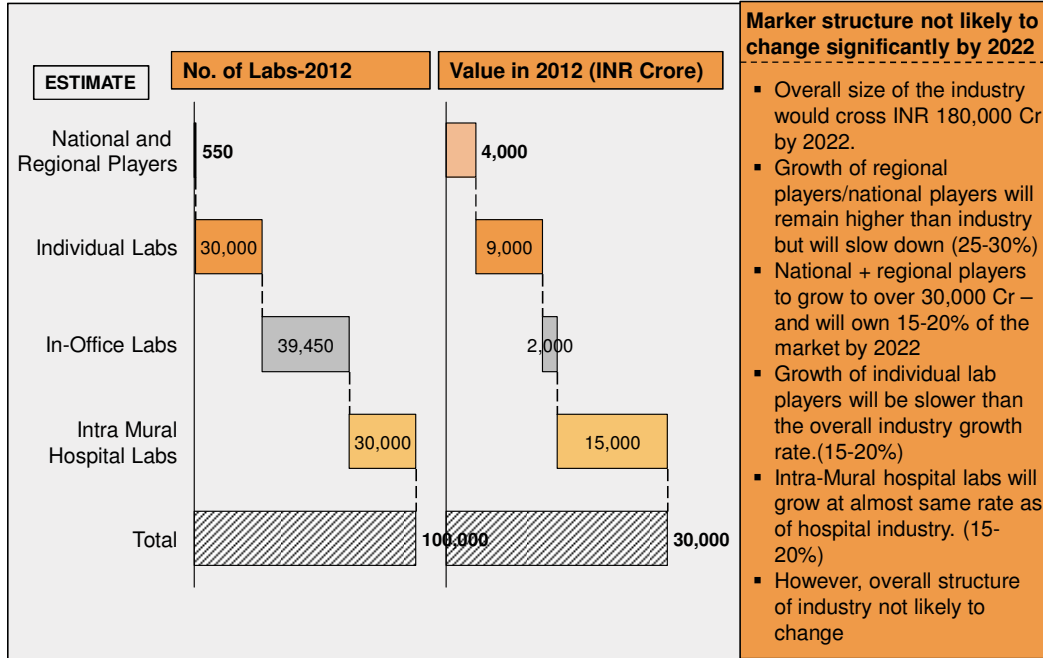
As a result, the space has attracted vigorous interest from all forms of players, particularly in routine testing for biochemistry, haematology and immunology. We estimate that more than 100,000 labs are being run in country today; national and regional players owning less than 1% of these labs but capture about 10% of market in terms of value (Exhibit 3). A number of strong domestic and international investors have also entered this space, pouring in over \$300 million in the last three years alone.

Most plays and investments in this space are based upon a seemingly sound investment thesis: create labs with economies of scale to service samples faster- cheaper and better than everyone else, build out extensive collection networks to funnel demand and lock in referring doctors to capture demand. Driven by rapid investment most players have had a good run acquiring labs and practices, investing in world-class new facilities and building out sprawling collection networks. Revenues have also grown strongly.

However, despite the early boom, cracks have started to show. Scaling up labs has been easier than scaling up volumes. With volumes entirely dependent on referrals (few labs can boast a core “constituency” that walks in without doctor recommendation), the pressure to gain market share to feed sophisticated (and expensive) testing facilities has grown.

Exhibit 3

Current supply structure of labs is not likely to change drastically in a decade from now



Source: Expert Interviews, HBA Estimate

As a result, virtually all players, like online retailers, are buying market share through deep discounting, aggressive doctor incentives, and other moves. These have been variously effective, but have proven unable to “lock-in” referrals. Like value-conscious customers of online retailers, referring doctors are not averse to switching loyalties as incentives change. Buying equipment has been easy, acquiring and maintaining clientele has proved hard. Harder still is generating surplus. As a result, despite efforts, most large networks are heavily dependent upon a handful of labs that enjoy local reputation and boast walk-ins to create most of their surplus. These labs also typically boast strong “promoter” doctors, whose own careers and reputations are inextricably linked to their businesses.

What is surprising though is the fact that even with such strong interest from all sorts of players, there are low supply pockets in different parts of the country suggesting that demand-supply correlation is not very tight. For example, our research for 20 northern cities suggest that market worth over INR 200 crore(about 10% of overall market) is underserved in 5 of these cities.

Time to pause....

HealthBridge’s view is that most players today are driving their growth strategy based upon conventional wisdom: that with growth, consolidation is inevitable as economies of scale, large

automated labs and volume purchasing will dominate. We believe this conventional wisdom is wrong. The market will indeed grow but is not likely to bear out the investment thesis. It will remain largely fragmented and unorganized more like Indian jewellery retail; US-style “walmartisation” is unlikely. This is because, unlike the markets in several developed economies, in the Indian context, powerful centrifugal forces will overpower consolidative forces (Exhibit 4 and Exhibit 5).

For one, the absence of entry barriers makes it very easy for anyone to start a testing facility. With most technology now available on a reagent-rental model, capital cost has reduced drastically further easing entry. Evolving Technology too is a spoilsport, destroying economies of scale. We predict several referring doctors will also “forward integrate” and increasingly offer testing services in house within their clinics.

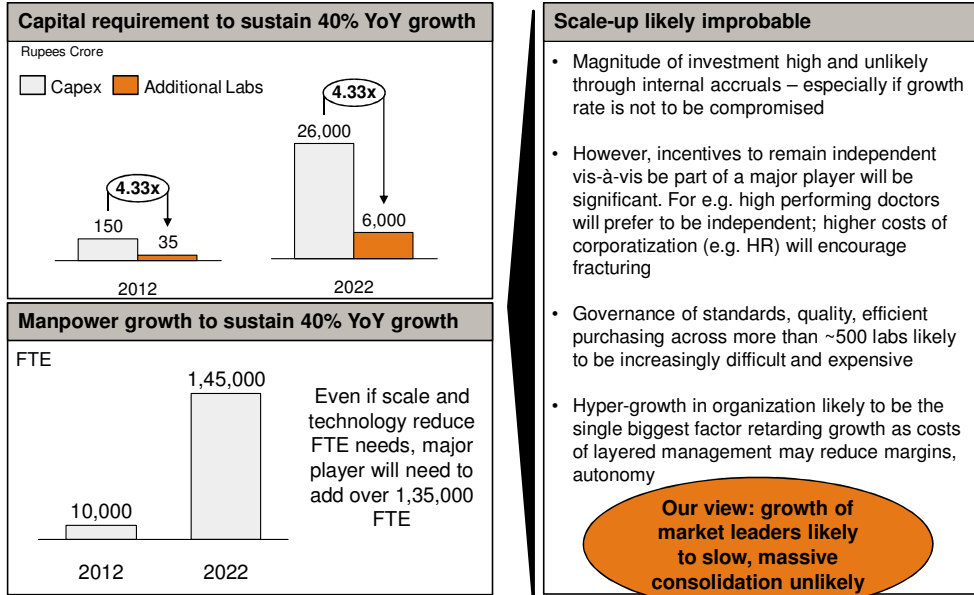
Further, unlike in mature markets, buying will remain a local, individual decision: neither will insurers have the power to consolidate buying nor will doctors refer en masse. Sustainable market share will be captured by players who master their localities through local relationships. Like jewellery purchasing or pharmaceutical referral, share will belong to the players who enjoy local trust among doctors and patients.

Finally, we believe that as the market grows, large labs will find it harder to retain stellar pathologists. Astute pathologists are aware that their own reputations can guarantee a certain patient base-load without resort to incentives. Many will find the temptation to remain professionally and financially independent irresistible. Big labs may contribute to this problem if they start levying overheads for functions such as HR, IT and corporate activities; costs that individual labs seldom incur. Early indicators of this trend: such as overpaying wildly to purchase marquee local pathologists are already visible. We believe that in the near future, many good pathologists may actually “return to entrepreneurship”, taking away significant chunks of business.

In sum, HealthBridge believes that the 40-50% hyper-growth rate being observed by national players in the early growth phase will taper rapidly (Exhibit 4), approaching the market mean of in the coming years. We estimate the market share as enjoyed by organized players to hence rise but probably not cross 25% in the years to come. India’s lab market will likely be an example of distributed value creation: many will become prosperous; few are likely to become extremely rich and powerful.

Exhibit 4

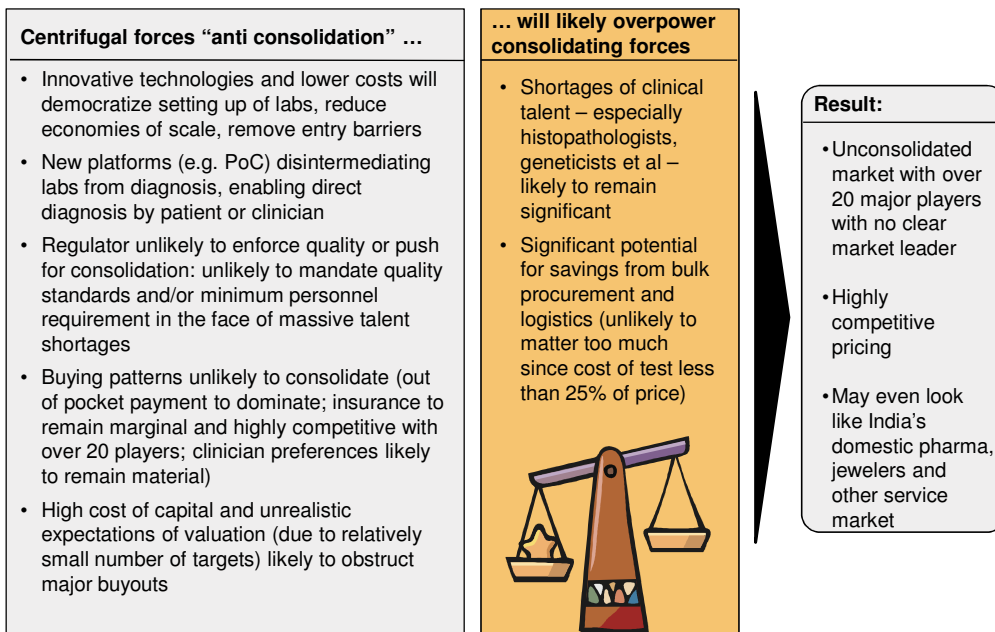
While current market leaders have grown at ~40% YoY for the past 3-4 years, we do not expect this pace of growth to sustain over the longer term



Source: HBA Analysis

Exhibit 5

We strongly believe that major consolidation is unlikely



Think Different...

In our view, this alternate view of the lab market of the future has significant implications for all players.

The biggest implication is for policy makers and regulators. In the current incentive systems, ensuring the primacy of the patient's interests has become difficult to impossible. Neither laboratories nor referring physicians find their incentives in line with those of the patient. Further, with little regulatory control over quality and reliability standards (NABL is purely optional) patients have little by means of access to information or assurances of quality. Regulators must move towards establishing clear standards for laboratories to function within; these must include some form of mandatory disclosure of performance standards, safety systems and quality processes.

Similarly, regulatory bodies, along with the appropriate clinical advocacy groups must frame Indian standards for testing (e.g. for diabetes, heart disease, cancer, others) and to control over-prescription; such standards should be used to encourage buyers of health services (e.g. insurers to move to pay for performance). Regulators also need to move towards requiring quality assurance from mass purchasers such as insurers by holding them accountable for lapses in the quality of providers from whom they may purchase services.

In our view, the goal of regulatory reinforcement must be to ensure patient protection, promote availability of quality labs and encourage their judicious use in ensuring health. Restructuring for consolidation should not be a goal in itself.

For investors and operators of laboratories, the options for building credible laboratory businesses are several. Those with aspirations of building billion dollar lab businesses should proceed with caution: anti-consolidation forces may prevent such scale from ever coming to pass. Promoters also need to think beyond technology and scale: their power is limited and waning.

Laboratories will have no option but to build businesses the good old fashioned way: build customer and referring doctor trust and focus on delivering a superior product (in ways the customer can understand). Unfortunately, there are no short cuts.

Laboratory players who re-shaped themselves to think beyond conventional growth models have seen considerable success in past few years. For example, several midsized regional players have achieved success by focusing on other smaller lab owners as core of their business. They have created a model around a group of specialized tests with not enough volumes to be services at local lab level but high combined demand at regional level. This has been grouped with excellent turnaround time and service quality for the individual lab owners. Similar success has been seen by

some local labs which have built strong relationships with referring doctors through their “star” pathologists. Most of the test volume in such labs is being driven by excellent clinical acumen and clinical interpretation given by these pathologists. Thus we believe the market is poised for rewarding players who disrupt and shape this market, particularly by focusing on changing how labs interact with patients, referring doctors and pathologists. Most existing players have started realizing this and have initiated some reforms to re-position the patient as core of their business. However, in an industry which has been driven by physician referrals for almost a century now, it is easier said than done.

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For more information or queries, you may contact us at

HealthBridge Advisors Pvt. Ltd.
info@health-bridge.in

401-404 Dynasty Business Park,
B - Wing, Level 4
Kanakia Spaces, Andheri - Kurla Road
Andheri (East); Mumbai - 59

Phone - +9122 4254 7001