The McDonald's of healthcare- Vasan's ballooning anomalies

About the industry

All human beings need to take good, proper care of their eyes. With age, it becomes imperative to take precautions for managing good eye sight. Vision is of paramount importance; be it surgery for cataracts or eye diseases, eyesight correction or plain vanilla spectacles. A World Health Organization report published in 2012 stated that India has an estimated 12 million blind people and an additional 456 million people who require vision correction. Further, the report states that 80% of blindness in India is avoidable. The business case for an eye care hospital in hindsight looks excellent and attractive. Healthcare hospitals are broadly classified into two types- Single speciality hospitals and Multi-speciality hospitals. Single speciality hospitals as the name suggests focuses on one aspect of healthcare viz., eye-care, dental, women, child etc. whereas, multi- speciality hospitals provide a gamut of healthcare services all under one roof. These hospitals at times will have to render peripheral services. Single speciality segment in the healthcare delivery space offers low capex business models which are asset-light and easy to replicate and requires less floor space (carpet area) when compared to multi- speciality hospitals. In 2008, single specialty healthcare in India was estimated to be an $80 billion mark. Experts believe that there is a high demand-supply gap in the country and over time at least 25 per cent of all people who need eye-care will shift from multispecialty to single specialty hospitals. There is also a backlog of cataract operations to be done in India especially with the advent of new procedures like LASIK and the unit economics are quite attractive in this segment given the high proportion of surgical income and consumable income.

Eye care has also made a successful transition from a hospital setting to an out -patient setting and thanks to a positive shift in insurance regulation where many insurers are reimbursing ambulatory care services; has allowed single speciality chains to benefit as insured

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patients can avail themselves of the medical insurance benefits without going to a large hospital.

Eye care hospitals are of three types—tertiary (large centre, takes about Rs.8-10 crore to set up), secondary (medium sized centre, takes about Rs.4-5 crore to set up) and primary (small centre, takes about Rs.1-3 crore to set up). All centres can do cataract operations. All of them sell spectacles and lenses, the so-called optical business. Complicated surgeries go to secondary and tertiary centres. Margins on the smallest to the most difficult surgeries and the optical business is anywhere between 30% and 50%. According to a health care leader at PwC, the EBITDA margins of eye-care chains are 5-10 per cent higher than other single specialty and multispecialty players. An eye-care hospital in steady state would have an EBITDA margin of 25-35 per cent compared with a multispecialty player, which would be 18-28%. The reason for this is unlike multispecialty hospitals, eye-care chains have relatively lower operational costs and higher revenue margin which comes from surgeries. A simple cataract operation on one eye costs about Rs.18,000. Purely at an EBITDA (earnings before interest, tax, depreciation and amortization) level, a hospital can make about Rs.5,000 per eye for a surgery. For 10 cataract surgeries, every day of the year, for one eye: Rs.1.8 crore. For instance, 50 surgeries every day of the year, for one eye: Rs.9.1 crore and this looks quite attractive for investors to invest.

About the entrepreneur and business

Vasan started out as Vasan Medical Hall, a pharmacy store, in 1947 in, Trichy, Tamil Nadu. Vasan ran pharmacies and multi-specialty centres where it conducted lab tests, such as ultrasound and endoscopy. Upto 1988, the business was run by Mr.Murugaiah, Mr.Arun's father. Upon the demise of his father, Mr.Arun started dabbling in other related ventures after inheriting a chain of pharmacy stores. In 2002, the company entered into a technical collaboration with Dr. Agarwal's Eye Hospital, a renowned eye clinic in Chennai that was set up in 1994. The collaboration resulted in an eye care hospital in Trichy. Soon enough, Arun figured out that it was the eye care business that excited him the most and the one with the brighter future. Therefore, he started expanding it, opening more centres. In the next six years, Vasan set up seven new centres. In March 2007, the company entered Chennai, the home turf of Dr. Agarwal, by acquiring Prem's Eye Clinic (a premier eye clinic) for Rs.3.5 crore. Arun convinced K. Premraj, the founder of Prem's Eye Clinic, to come on board as chief mentor. He consented and as a team they started the massive expansion of the business. By March 2008, Vasan had clocked revenue of Rs.45 crore, with a network of 14 centres, almost all of them in Tamil Nadu and Kerala.

Expansion and financing deals

The Venture Capitalists (VC) and the Private Equity (PE) Investors were fascinated with the potential of single speciality hospital and eye care sector. More importantly, they were excited with the growth of Vasan Eye Care (VEC) and its bright future. Sequoia Capital, a venture capitalists came calling VEC. The VC was very much impressed with the business model of the VEC. The business called for low capital investment, very few requirements for beds and lavish infrastructure, high margins in eye surgeries and selling spectacles and lens, a bootstrapped start up, a grass root entrepreneur and a good mentor (Dr.Premraj) to manoeuvre the business. In September 2008, Sequoia initiated due diligence. It brought in Grant Thornton to audit the books, Amarchand Mangaldas for legal and Ernst & Young for commercial diligence. At the same time, it commissioned a consumer survey to understand the demand for eye care and VEC's perception in the market. As part of the due diligence exercise, Sequoia also carried out a KYC (know your customer) check on large shareholders in Vasan. The name Advantage Strategic Consulting Pvt. Ltd cropped up—promoted by an individual named Chinnabala Nageswara Reddy and two other directors (Ravi Visvanathan and Padma Visvanathan), the firm held a 5% stake in the company. Their association with Vasan went back a few years to when Arun was running the pharmacy business. No red flags were raised. Everything checked out fine; Sequoia was excited by the business model and the entrepreneur. After due diligence, which lasted about four months, in February 2009, the firm invested Rs.50 crore in VEC. Sequoia's Bharadwaj was named to the board. Arun was motivated by the fact that he hadn't expected even in his wildest dreams that a marquee VC firm like Sequoia would invest in his company. With Rs.50 crores in his kitty, he started dreaming big and became more ambitious. The top management team devised a strategic plan and decided to expand to 100 centres by 2015. Sequoia's appetite for the company grew with VEC adding every centre. It expanded to Andhra Pradesh and Karnataka and started going deeper in Tamil Nadu and Kerala. In February 2010, West Bridge Capital India Advisors Pvt. Ltd (formerly part of Sequoia) invested Rs.50 crore in VEC. K.P. Balaraj of West Bridge was named to the board.

By March 2010, VEC's revenue grew to Rs.158 crore (compared with Rs.95 crore in March 2009). The company recorded a handsome EBITDA of Rs.54 crore. Profit after tax (PAT) was Rs.25.6 crore. In October, 2010. Sequoia reached out to Advantage Strategic Consulting Pvt. Ltd to buy out its equity stake in VEC. Advantage wasn't interested to sell a part of its stake in the company. After a few rounds of negotiations, Advantage sold a partial stake (30,000 of the 150,000 shares it held in the company) to Sequoia at Rs.7,500 per share—a significant premium, considering that Advantage had acquired the shares at Rs.100 each.

VEC was investing massively in marketing with great impetus to sustained television channels. Patients started flocking to its centres. For instance, on the first day that Vasan opened a centre in Ramanathapuram (Tamil Nadu) and Thalassery (Kerala), more than 100 patients showed up. People had heard of Vasan from their relatives in the big cities, or seen the TV advertisements. Centres in Dindigul and Ramanathapuram in Tamil Nadu and Thalassery in Kerala reached EBITDA break-even in just two months of opening. It was a similar story for the other centres, most of them registering an EBITDA break-even in less than a year. Buoyed by the potential of single speciality hospitals, VC firms started investing heavily in eye care business. New Delhi-based Centre for Sight raised funding from Matrix Partners. Eye-Q Vision received funding from Helion Venture Partners and Nexus Venture Partners. Watching from the side lines, Arun was wondering whether he has left the North India territory to its competitors and felt that it would be a setback if competitors entered into this industry. He wanted to grow and go after the competitors and at this time, it was thought to be right by the board and the entrepreneur because VEC's aggressive growth had played out well. In March 2011, Vasan's revenue doubled to Rs.310 crore. EBITDA, too, grew 2X to Rs.96 crore. PAT was Rs.37 crore. Arun also strengthened the composition of the board of the company by bringing in Alagappan, a director with Murugappa Group, Chennai. In Arun's mind, the logic for expanding to the rest of the country was simple. Once a Vasan centre was opened, patients would come. The network would grow. The brand would grow. The revenue would grow and valuation would increase and everyone would make money. The investment from WestBridge and the company's EBITDA only increased Arun's confidence. The target of 100 centres was within reach. He wanted to get there as quickly as possible. In October 2011, VEC entered east India, opening two flagship centres at Salt Lake City and Howrah in Kolkata.

Arun and the existing investors started wondering if the theme of single specialty hospitals would play out in other fields, such as dentistry. Arun and Premraj took it upon themselves to prove that it would work out well. Almost immediately, a plan was drawn up to open Vasan dental hospitals. Not one but 11 of them and so, even as VEC was entering new territories, it entered a completely different line of business. VEC was facing shortage of cash and to bridge the shortage in capital, the firm started borrowing—mostly short-term loans from banks and non-banking financial institutions and Arun would pledge his assets as collateral. He was confident that the repayments would be on time as the new centres would achieve EBITDA break even similar to the established centres. The mood in VEC was celebratory in 2011 as the then Prime Minister Dr.Manmohan

Singh inaugurated VEC 100th eye care centre at Karaikudi in Tamil Nadu.. Doctors from Chennai travelled to every new centre to conduct the first surgery. Arun himself would be on calls with his operations team in the field almost all the time, working late into the night. It was around this time that VEC found interest from another marquee investor, GIC. By March 2012, VEC had grown into a giant in the eye care business. That year, it recorded revenue of Rs.451 crore, EBITDA of Rs.79 crore, and PAT of Rs.9.5 crore. That was 4X growth in revenue in just three years. It had a network of 103 eye hospitals and 27 dental centres.

GIC was excited to come on board. And it wanted to invest $100 million (around Rs.500 crore then). At the time, $100 million was the largest private equity investment in healthcare. Arun and VEC became the toast of the town. Less than 20% of GIC's investment finally came into VEC only. Both Sequoia and Arun saw GIC's investment as an opportunity to make some money for themselves. Both did a secondary sale, selling their shares to GIC. No fresh shares were issued. Sequoia and Arun pocketed Rs.170 crore each. A few top officials and doctors, who had equity stock options, also cashed out. Of GIC's Rs.500 crore investment, only Rs.90 crore made its way into VEC. Arjun Gupta of GIC was named to the board.

Life for few of the people at the helm at VEC had become increasingly stressful. Dr. Premraj, who had turned 60 and was in the habit of flying to every new centre to conduct the first surgery, started feeling that he was getting too old for that life. "My stomach was full," he said. "I had worked for 35 years; my children were settled abroad, so when I turned 60, I could feel my age. My body couldn't take the travel anymore, going to distant centres, staying there for four or five days, it was getting very tiring and therefore, decided to retire." Initially Arun resisted, asking Premraj to hang on for some time but in January 2013, Premraj moved to Coimbatore and this was the first setback for Arun.

Meanwhile, VEC kept growing. In the period between March 2012 and March 2013, the company added 40 new eye care centres, expanding to Delhi, Punjab, Haryana, Gujarat and Maharashtra. The company also went international, opening centres in West Asia (Dubai and Abu Dhabi) and Sri Lanka. By March 2013, VEC had grown to a total of 170 centres. With very little equity capital at hand (and this is where the GIC investment would have helped, had it come to the company), VEC was relying almost entirely on debt to fund the expansion. As of March 2013, VEC's debt ballooned to almost Rs.800 crore. Figure I show the statistics of number of centres opened by VEC.

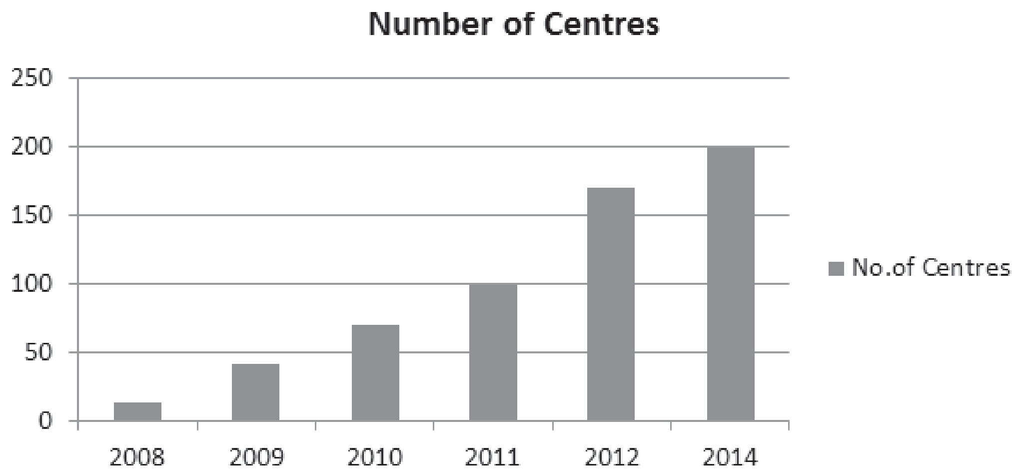

Figure I

(Source : www.livemint.com/Vasan-Healthcare; Descriptive of the above figure done by the Author)

Mr.Arun did not heed to the advice of the board of 'No more expansion' and continued his expansion through continuous borrowing of debt. Even as all this was happening, investors started getting the feeling that VEC had a much graver challenge than debt. Its centres in the north, east and west were taking a much longer time to break even. Quite a few had been around for a year and they were far from being EBITDA-profitable. The investors dug deeper and realized that most of the new centres had been built at a far higher cost compared with the centres in south India. The cost of rentals, cost of putting up the furniture and decor was far higher, even as fewer patients were coming in. As of March 2014, VEC's revenue grew to Rs.728 crore. EBITDA was Rs.131 crore. But the company made a loss of Rs.(50.3) crore and it had 200 centres. The total debt had ballooned to Rs.1,200 crore. Figure II shows a snap shot of VEC's financials.

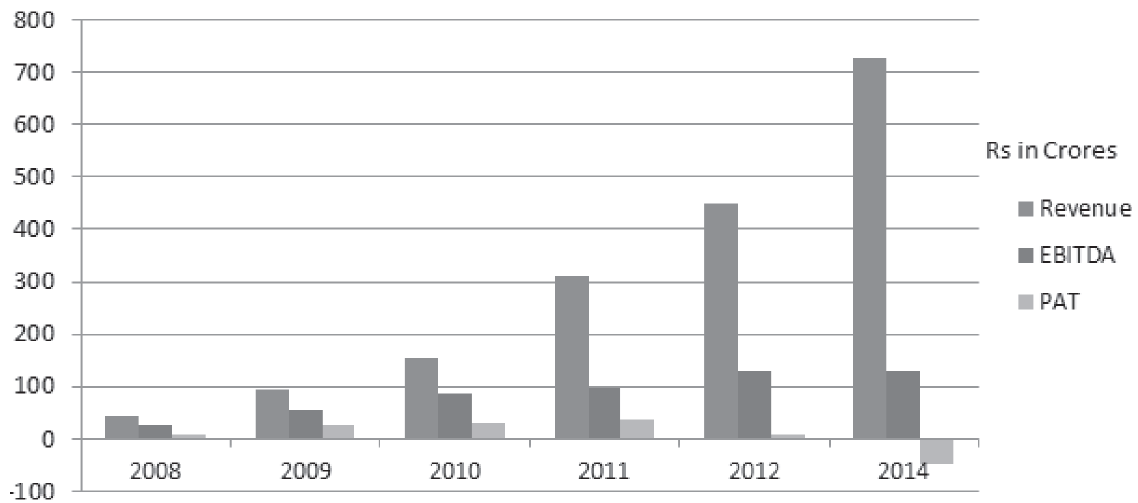

Figure II

(Source- www.livemint.com/Vasan-Healthcare; Descriptive of the above figure done by the Author)

By mid-2014, it was clear that VEC needed intervention. At Rs.1,200 crore, the debt was too high. It had started affecting the company. It was so much that Arun was spending almost all his time juggling finances and fire-fighting on repayments. In May 2014, the board decided to do something about it and arrived at a decision to go for a rights issue. Arun pumped in Rs.170 crore, Sequoia Rs.80 crore and GIC Rs.100 crore. VEC was valued at Rs. 3,000 crores. The investors had a simple plan in mind. They would use the money to retire a major part of the debt with a leading bank and get the collateral released from the bank. The collateral will be sold subsequently and the money would be invested back to the business. The plan backfired because VEC had borrowed working capital loan from the same bank. At this stage, VEC was looking at some of the strategic options for resolving the issue. In the words of one of the board members 'After all, it is a promoter-driven company' was holding good.

A few senior board members who had cautioned Mr.Arun to stop expanding beyond 100 centres were disappointed with the entrepreneur's high handedness in decision making. The board members were of the view that such aggressive expansion and diversification coupled with high financial leverage might have repercussions to the company in the days to come and in protest to this, a senior member of the board resigned. It was widely speculated that the other members will also follow the footsteps of the veteran. One really wonders what could be the consequences of leverage, expansion and diversification.

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