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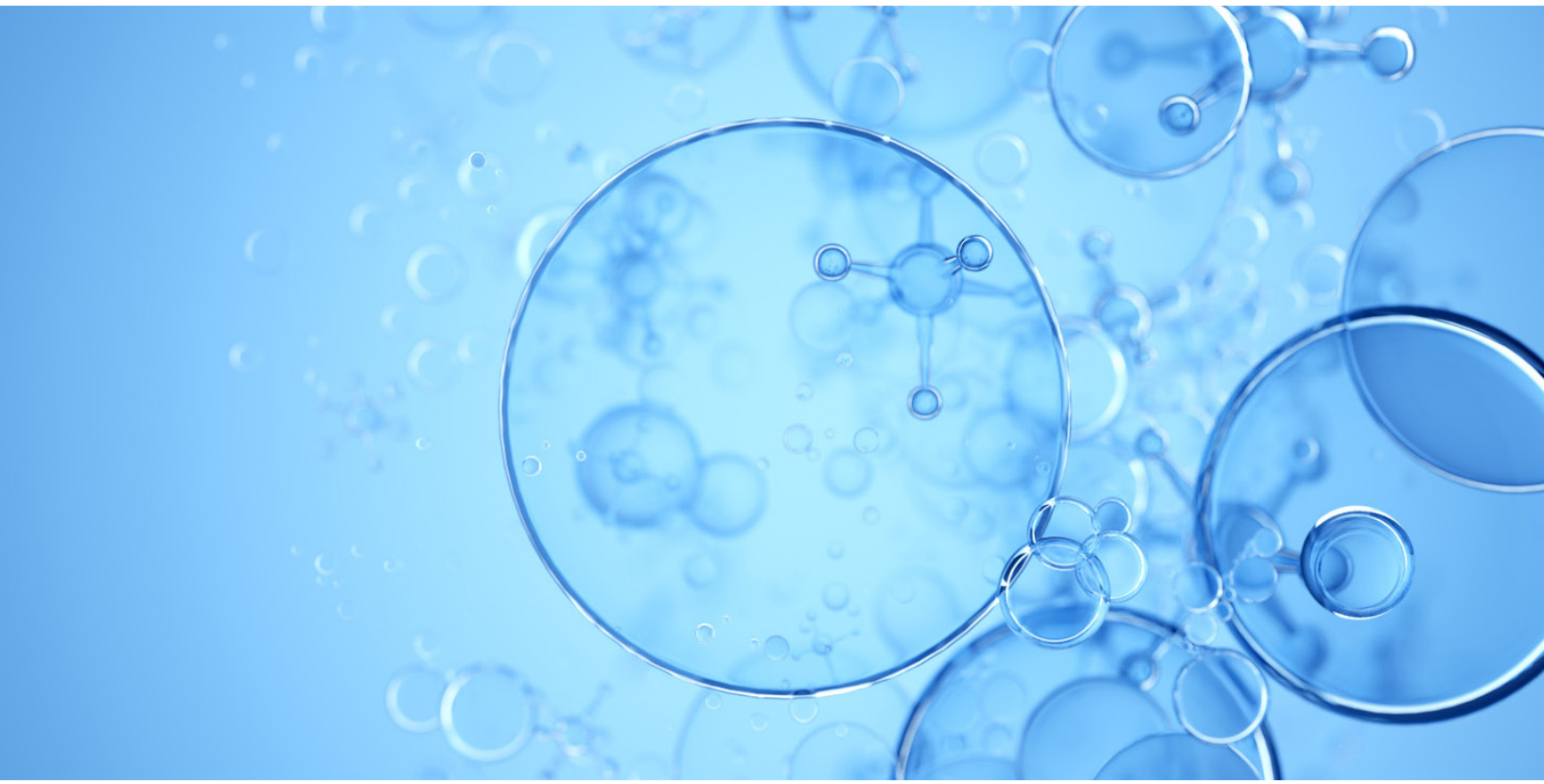
Healthcare Practice

The future of US healthcare: What's next for the industry post-COVID-19

Shifts in profit pools will accelerate, spurring likely business model changes in three areas—diversification, vertical integration, and new business building.

by Shubham Singhal and Neha Patel



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Two years of the COVID-19 pandemic have shifted the dynamics in the US healthcare value chain. The years from 2020 through 2021 were challenging for payers and providers. At the same time, innovation and growth continued unabated in services. Prospects over the next few years seem favorable, although persistent inflation in consumer prices could dent the outlook.[1] Recovery in profitability partly explains this positive outlook. Another reason for optimism is the potential for scaling up innovation that was prompted by pressure the pandemic put on the healthcare system. Also, acceleration of value-based care models and increasing application of technology across the healthcare industry are likely to continue in the long term.

Variability in growth across different parts of healthcare persists and, in some cases, has become more pronounced. For example, government lines of business continue to account for the largest growth areas for payers. Care-delivery services outside the hospital are the fastest growing businesses for providers, given the continued shift to the non-acute setting. Meantime, the progression of value-based care and related risk payments as well as digitization of the value chain is shifting value creation across, rather than within, traditional healthcare subsectors.

The marketplace has begun to address the patient's full health journey, leading to improved affordability, quality, access, and experience.[2] Many players, spurred by significant investment, are innovating their business models to create value and capture some of it in enhanced margins. In this article, we will review the shifts in healthcare profit pools, look ahead to how they might evolve, and examine how the pandemic has stimulated changes in industry business models.

Shifts in profit pools continue to accelerate

Healthcare industry EBITDA grew 5 percent pre-COVID-19 (between 2017 and 2019) and remained flat over 2020 and 2021. We estimate post-COVID-19 (between 2021 and 2025) growth at 6 percent (Exhibit 1). If the industry achieves this rate of growth, it could add about $31 billion in profits[3] between 2021 and 2025. We have not factored in the potential impact from macroeconomic headwinds, including persistent consumer inflation, in these estimates; profits could decline by more than $70 billion during this period if inflation continues unchecked.[4]

The post-2021 recovery and shifts in profit pools are likely to be driven by several factors, including the following.

Evolving payer mix

Payer profit pools are expected to shift substantially toward government segments, led by the growth in the over-65 population and popularity of Medicare Advantage over traditional fee-for-service Medicare. Further, as the economy recovers from the impact of COVID-19, we estimate that payers' mix of business could shift from Medicaid to commercial (the share of commercial lives in total enrollment could increase by one to 1.5 percentage points during the 2021 and 2025 period, with the majority of the shift coming from Medicaid), thus increasing average reimbursement rates and improving margins for providers.

Shifts in sites of care

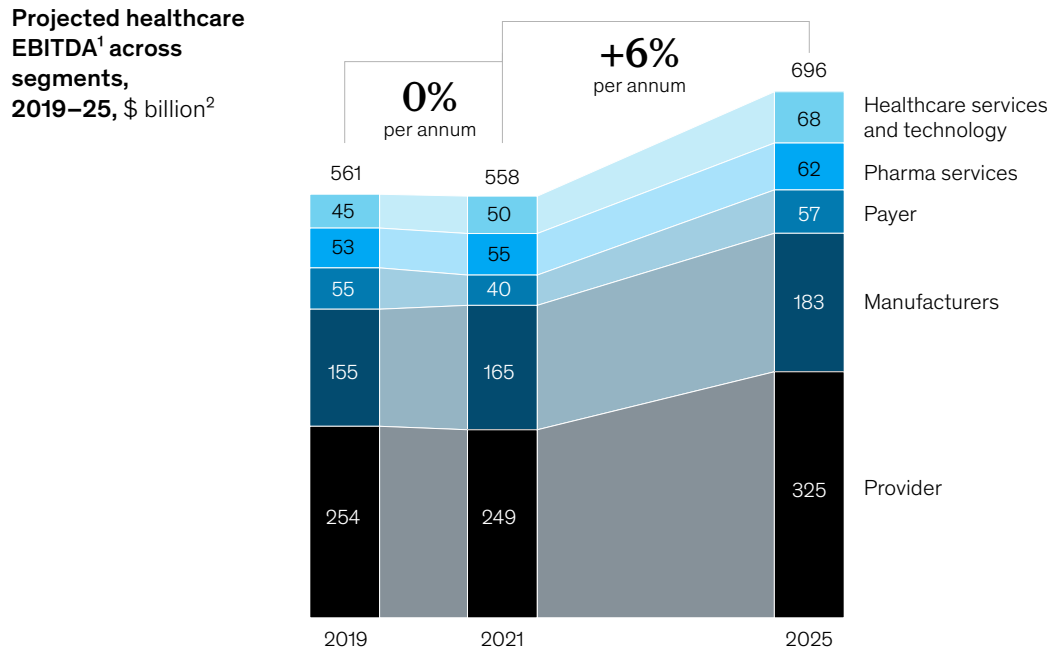
The COVID-19 pandemic has accelerated the movement of care from high-cost acute and post-acute sites to lower-cost freestanding and non-acute sites, including increased demand for home-based services and virtual care.[5] Non-acute sites have lower costs and higher EBITDA margins, 15 to 25 percent compared to 8 to 10 percent for acute and post-acute facilities.

We estimate that hospitals' share of overall provider revenue could decline from about 47 percent in 2019 to about 44 percent by 2025, while the share of home and ambulatory sites will increase by one to two percentage points each over the same period. This shift could increase overall margins for the provider sector (although outcomes will diverge, depending on a provider's business mix) while simultaneously reducing overall cost of care,

[1] Shubham Singhal and Aneesh Krishna, "Consumer prices are rising fast, and healthcare isn't far behind," McKinsey, February 11, 2022.
[2] Shubham Singhal, Mathangi Radha, and Nithya Vinjamoori, "The next frontier of care delivery in healthcare," McKinsey, March 24, 2022; Shubham Singhal and Cara Repasky, "The great acceleration in healthcare: Six trends to heed," McKinsey, September 9, 2020.
[3] We use EBITDA as a measure of profitability. By definition, not all of this amount is net profit, as a portion of these profits go back to making needed investments in healthcare.
[4] Shubham Singhal and Aneesh Krishna, "Consumer prices are rising fast, and healthcare isn't far behind," McKinsey, February 11, 2022.
[5] Shubham Singhal, Mathangi Radha, and Nithya Vinjamoori, "The next frontier of care delivery in healthcare," McKinsey, March 24, 2022.

Exhibit 1

Healthcare profit pools are expected to show a strong recovery post-COVID-19, with payer and services segments growing fastest.



[1]Earnings before interest, taxes, depreciation, and amortization.
[2]Figures may not sum to 100%, because of rounding.
Source: McKinsey Profit Pools Model

thereby potentially improving payers' margins as well. For example, reimbursement for surgeries performed at ambulatory surgery centers is 25 to 50 percent lower than at hospitals, according to claims data.[6]

Exacerbation of chronic conditions

The chronic disease burden has been rising for years and will continue as the number of older people grows. During the pandemic, many patients delayed or skipped necessary care, including physician visits and medical tests. In addition, many reported an increasing number of challenges related to their mental health.[7] Cost of care was expected to rise by about $10 billion in 2021 (0.4 percent of provider revenue) as a result of worsening chronic conditions as well as higher prevalence of conditions like chronic obstructive pulmonary disease in severe COVID-19 patients. These increases should slow but we estimate that cost of care could still be higher by about $7 billion by 2025, accounting for natural disease progression for patients with chronic conditions.[8]

How healthcare profit pools will evolve

In this section, we discuss how profits pools for payer, provider, healthcare services and technology (HST), and pharma services are likely to evolve in coming years based on our projections.

Payers: A shift toward government segments

Payer profit pools have fallen, from $54.7 billion in 2019 to $40.1 billion in 2021, but are expected to rebound by 2025 to $57.4 billion. The next few years could see a return to pre-COVID-19 profitability, with payer profit pools rising at a 9 percent CAGR.

However, the mix of overall payer profit pools is likely to continue to shift toward government

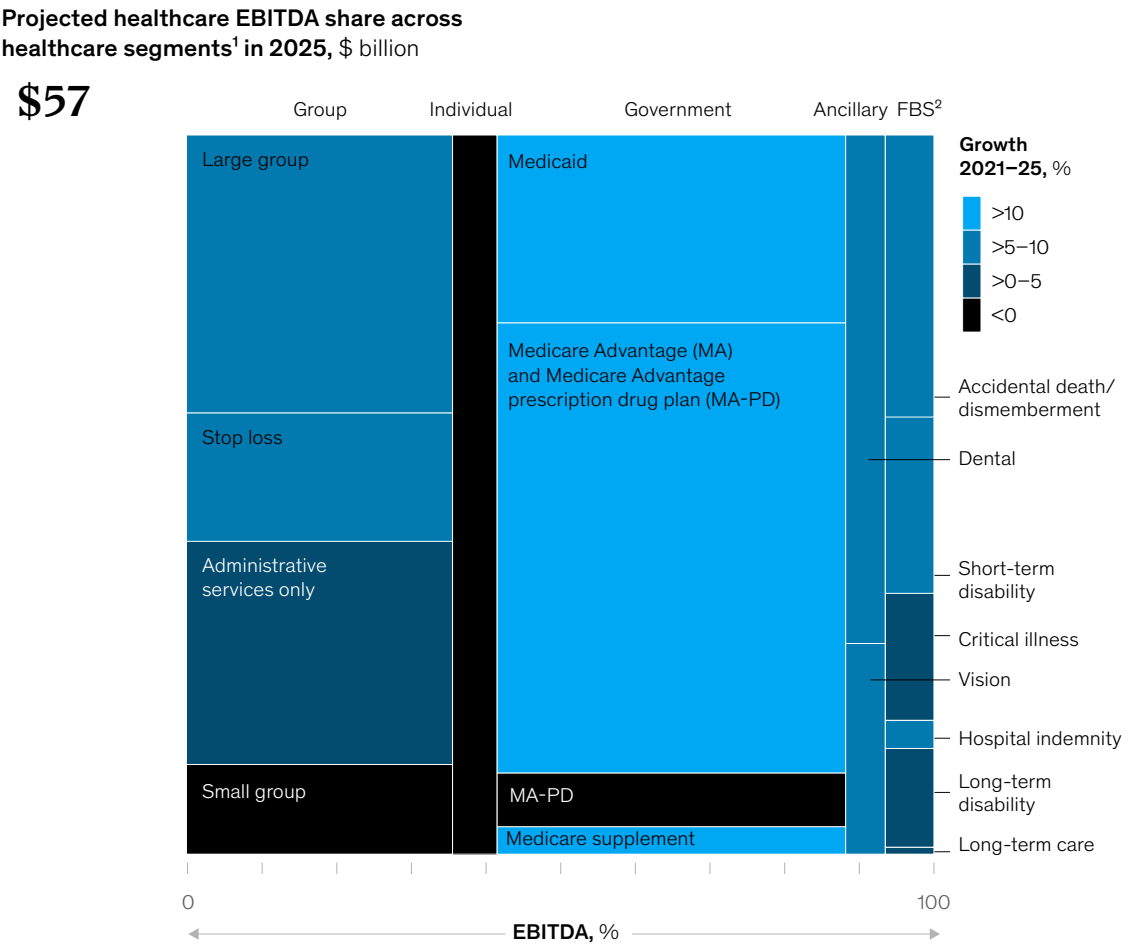
[6] IBM Market scan Truven claims data, Medicare FFS LDS claims data.
[7] "Moving the needle on burnout: What does the data say?," McKinsey Health Institute, June 1, 2022.
[8] These estimates are inherently uncertain; we are conducting further research as more information becomes available.

segments. Rapid growth in the over-65 population and its increased adoption of Medicare Advantage could account for this change (from 43.6 percent in 2021 to about 52 percent penetration in 2030 in the Medicare population) as well as improved profitability of managed Medicaid due to more coordinated and integrated care (Exhibit 2).

As the labor market recovers post-COVID-19, substantial enrollment is expected to move from Medicaid to individual and commercial markets but is likely to be more than offset by growth in managed Medicaid. We estimate that annual managed Medicaid revenue growth will be 5.3 percent between 2021 and 2025 compared with 3.7 percent between 2017 and 2019. The future growth is expected to come from the overall continuing shift from fee-for-service to managed care, as well as an increase in premiums per member from growth of membership with more complex care needs (for example, managed long-term services and support programs).

Exhibit 2 A

Growth in payer profit pool continues pre-pandemic trend toward government lines.

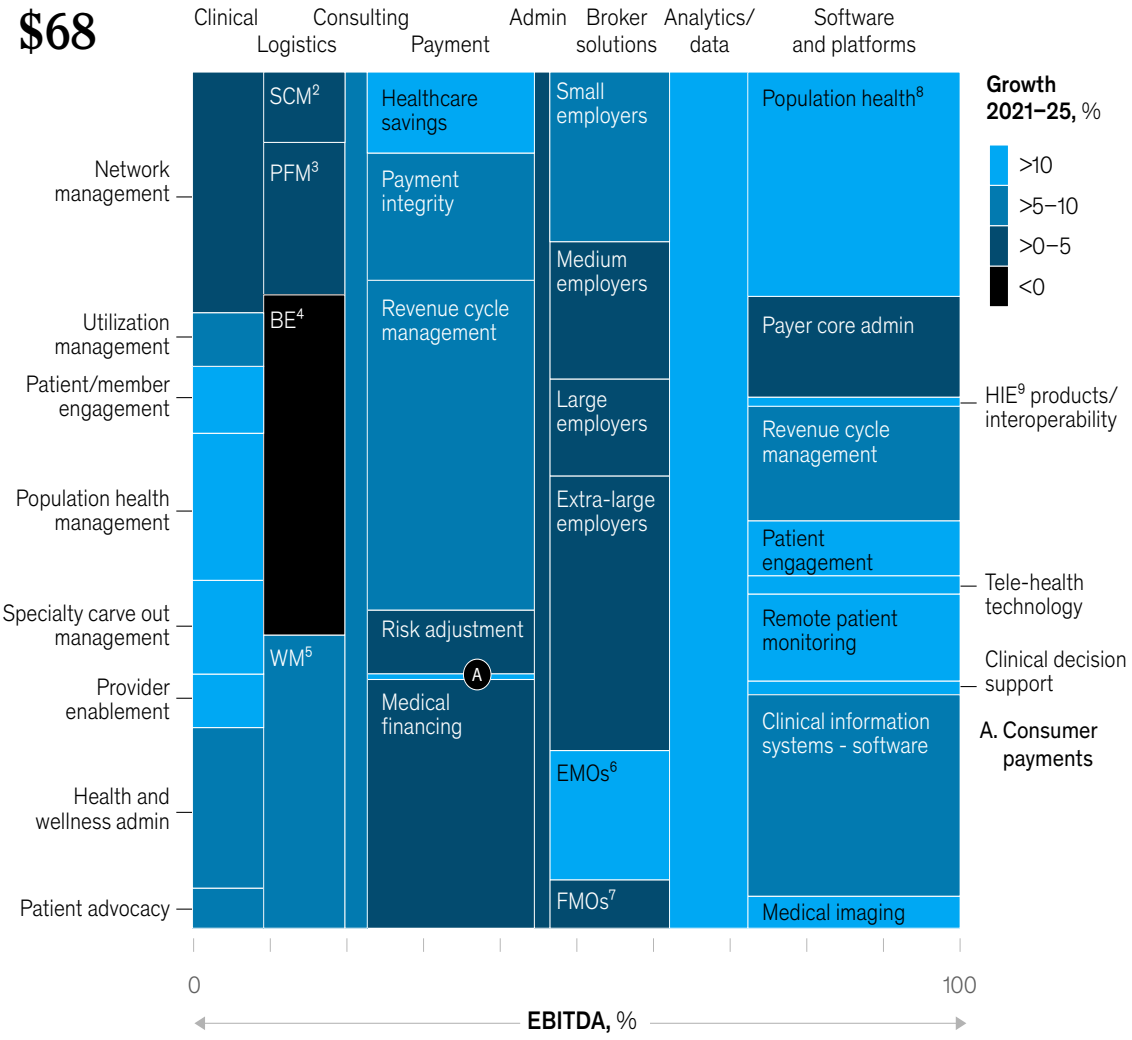


[1]Scenario A2: Economic growth accelerating from Q3 2020. GDP returning to pre-pandemic level between ~Q1–Q2 2021 vs 2019 Q4. Forecasted GDP growth for 2021 = 7.0%, and for 2022 = 3.2%.
[2]Fixed-benefit and supplemental (excluding losses from long-term care insurance, total profit in fixed-benefit and supplemental products is $10.0B; the width of the vertical represents this amount).
Source: McKinsey Profit Pools Model

Exhibit 2 B

Healthcare services and technology segments continue to power ahead.

Projected healthcare EBITDA share for healthcare services and technology segments[1] in 2025, $ billion



[1]Scenario A2: Economic growth accelerating from Q3 2020. GDP returning to prepandemic level between ~Q1–Q2 2021 vs 2019 Q4. Forecasted GDP growth for 2021 = 7.0%, and for 2022 = 3.2%. [2]Supply-chain management. [3]Provider facility management. [4]Biomedical engineering. [5]Workforce management. [6]Electronic marketing organizations. [7]Field marketing organizations. [8]Includes private equity, case management, and disease management solutions. [9]Health information exchange.
Source: McKinsey Profit Pools Model

Estimated profit pools for the government segments will be about 20 percent larger than commercial segments by 2025; they are about 10 percent lower today. The individual market is likely to experience the largest absolute decrease in EBITDA margin due to higher medical-loss-ratio rebates payouts and increased competition.

Providers: Rising profits but shifts from acute sites of care

Provider profit pools dropped due to loss of volume and shift in payer mix from commercial as a result of falling employment during the pandemic. But CARES Act funding helped to support provider results. Profit pools fell from $254 billion in 2019 to

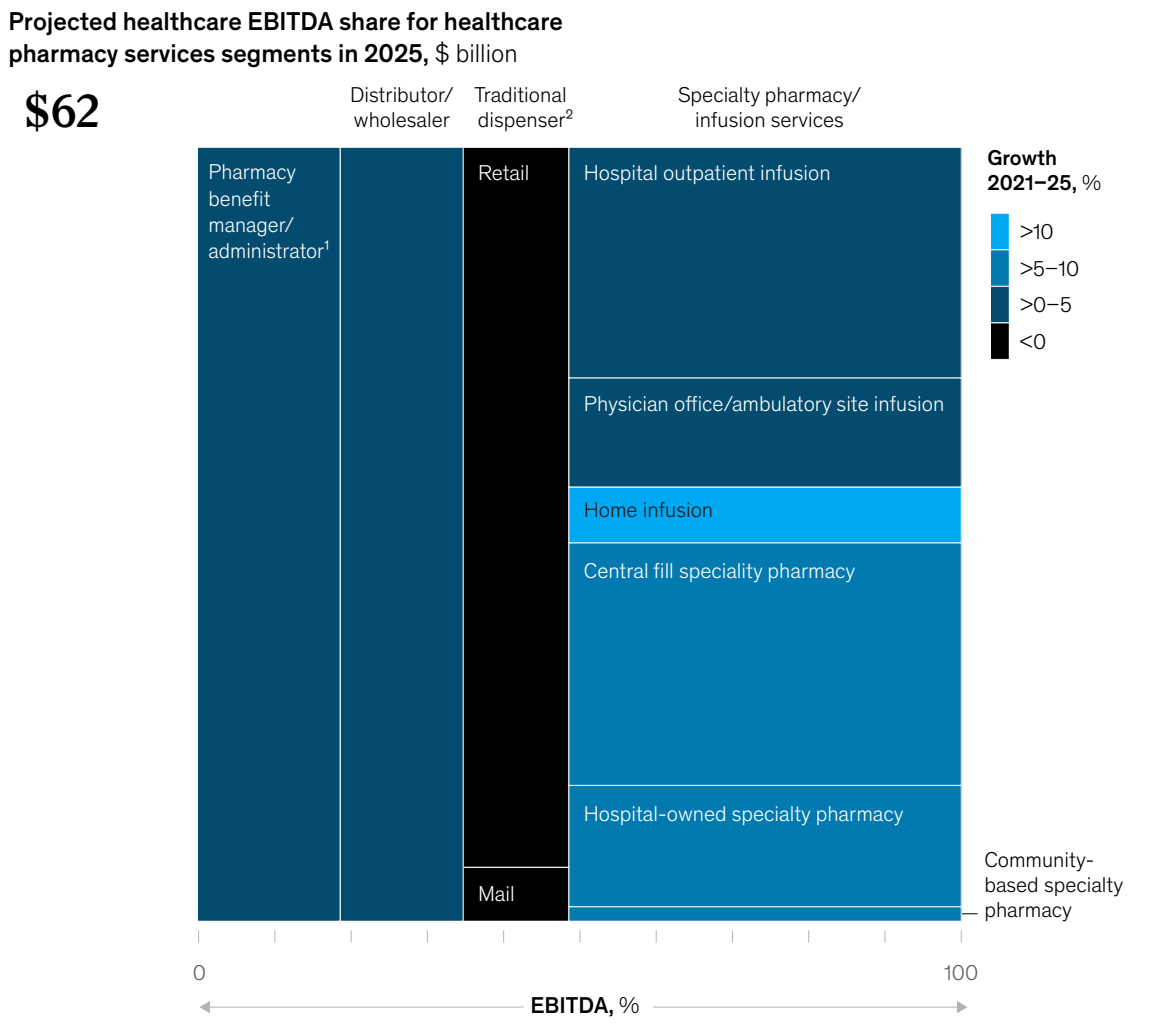
$250 billion in 2021. The provider outlook is positive, with profits expected to rise to $326 billion in 2025, a 7 percent CAGR.

We estimate that there will be overall patient volume increases, spurred by the aging population. The number of people above 65 is expected to grow 3 percent from 2021 to 2025 compared with about 0.5 percent for the population as a whole.[9]

Providers are likely to see a shift in payers, a change that could affect reimbursements. For example,

Exhibit 2 C

Pharmacy services growth is being driven by specialty pharmacy.



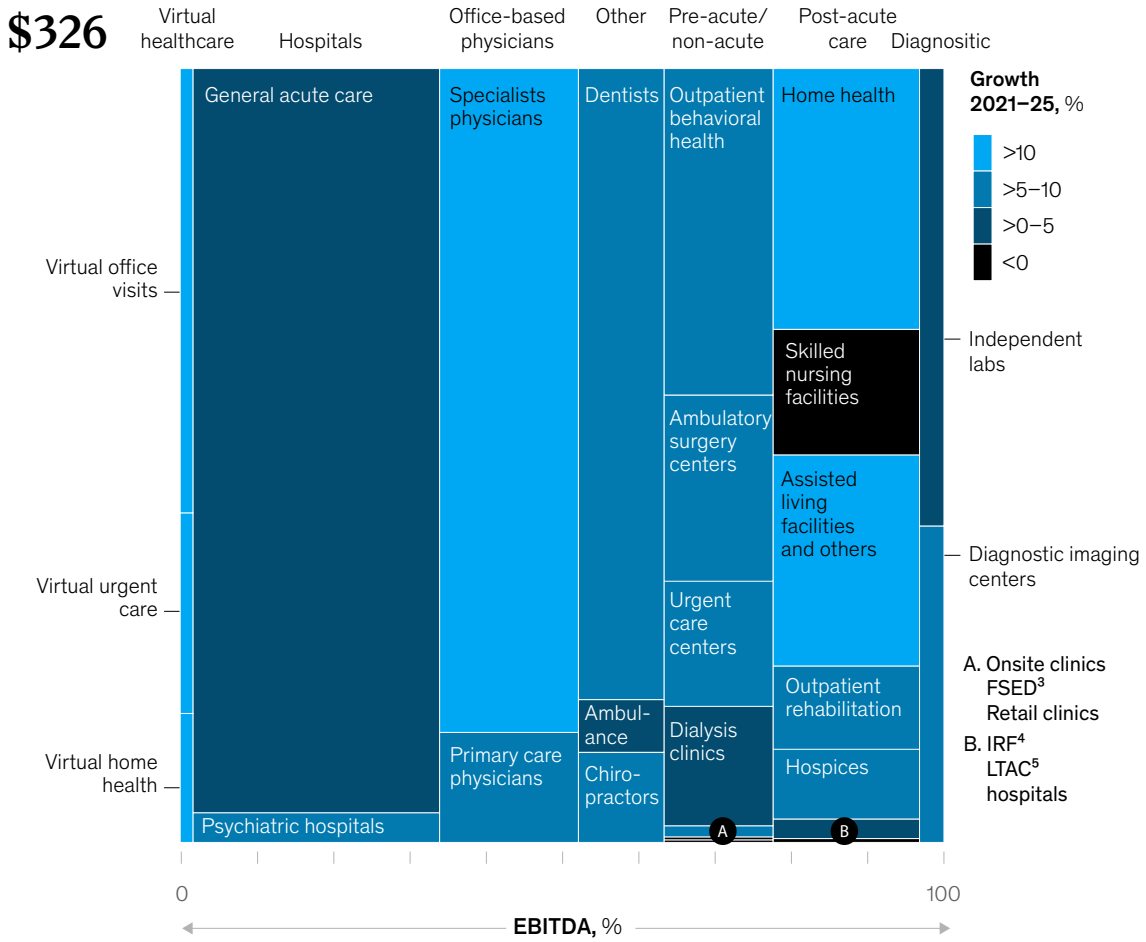
[1]Pharmacy benefit management/pharmacy benefit administration non-dispensing services; non-dispensing services exclude profits earned by PBM-owned specialty pharmacies and mail order facilities which are captured under Central fill and Mail order respectively.
[2]Excludes specialty pharmacy dispensing, which is contained in the specialty pharmacy/infusion services subsegment.
Source: McKinsey Profit Pools Model

[9] Moody's population forecast.

Exhibit 2 D

Provider profit pools continue the shift away from facilities.

Projected healthcare EBITDA share for delivery provider services segments[1] in 2025, $ billion



[1]Scenario A2: Economic growth accelerating from Q3 2020. GDP returning to pre-pandemic level between ~Q1–Q2 2021 vs 2019 Q4. Forecasted GDP growth for 2021 = 7.0%, and for 2022 = 3.2%. [2]Includes palliative care centers. [3]Freestanding emergency department. [4]Inpatient rehabilitation facilities. [5]Long-term acute care.
Source: McKinsey Profit Pools Model

many aging workers will move from commercial plans into Medicare, resulting in a reduction in overall reimbursement by about 0.5 percent of absolute EBITDA dollars. That change will likely be balanced in part by the movement of people from Medicaid into commercial—we estimate that the percentage of Americans on Medicaid is likely to fall from 25 percent in 2021 to about 22 percent in 2025 due to redetermination of beneficiary eligibility.

A less obvious development is the shift from acute sites of care, which have lower margins than most other sites of care outside of the hospital. Non-acute sites have lower costs and EBITDA margins two to three times higher than the acute care setting. The pandemic has driven the shift to non-acute settings, given the hospital backlog and patient and doctor preference for more convenient and virtual care. We have also seen underlying business shifts such as the accelerated adoption of value-based care. Many value-based players could deliver lower costs and better outcomes as well as realize margins of more than 15 percent in primary care and specialty models.

Healthcare services and technology: Long-term growth supported by software and platforms

The HST segment has been a long-term growth story. HST continued its growth trajectory during the pandemic, with profit pools rising from $45 billion in 2019 to $50 billion in 2021. The outlook continues to be positive. We estimate that the segment will grow at an 8.2 percent CAGR between 2021 and 2025, to about $70 billion by 2025. That would likely make it bigger than the payer profits pool by 2025.

HST has had broad overall growth but software and platforms and data and analytics have performed especially well, with CAGRs of 10 percent and 17 percent, respectively. Business model shifts for payers and providers account for much of that growth.

The rapid adoption of data and advanced analytics and software is spurring innovation in areas such as population health management, revenue cycle management, and patient engagement. Furthermore, virtual health—take-up of which increased substantially during the pandemic but since stabilized—is accelerating care-model innovation and technology solutions.

Pharma services: More spending, led by the specialty drugs

Pharmacy services have undergone major changes in recent years, including new models of patient engagement, establishment of partnerships across stakeholders, and the entrance of new digital pharmacy models. Drug spending has increased, with dispensing revenue growing from $450 billion in 2019 to $500 billion in 2021. The growth was primarily driven by specialty drugs, which now account for 40 percent of dispensing revenue.[10] Continued innovation in drug development could expand specialty profit pools further; these are expected to increase at an 8 percent CAGR from 2021 to 2025.

Hospital-owned specialty pharmacies have expanded their participation, with nearly 40 percent of provider-owned pharmacies attaining accreditation.[11] In infusion-related value pools, COVID-19 accelerated site-of-care shifts, enabling growth in home infusion as patients reduced in-person visits to hospitals. Additionally, payers are becoming more directive in shifting infusion therapies from hospital outpatient settings to lower-cost sites of care such as the home and ambulatory infusion centers, further accelerating volume shifts.

Traditional drug dispensers such as retail and mail pharmacies continue to face margin pressure, leading to a contraction of profit pools. New technology-enabled pharmacies have emerged, featuring direct-to-consumer models with digital prescription management, automated workflows, and faster home delivery services. Although these players have not yet reached substantial market share, they are growing quickly, spurred by substantial private equity investment. Competition from these players could promote innovation around convenience and experience in the business models of larger retail and mail pharmacies as well, creating potential margin upside.

The wholesaler segment continues to benefit from increased drug spending. We estimate that drug distribution revenue is likely to increase at a 5 percent CAGR from 2021 to 2025; wholesalers' profit margins from drug distribution are expected to remain flat over the coming years.

Outside of overall specialty growth, the pharmacy benefit managers (PBMs) segment is under pressure for more transparency into rebates and network spread pricing from payers and sponsors. Employer demand for cost containment and predictability has given rise to a wave of new and innovative pricing models. Specialized players (such as specialty drug managers, therapy management, benefit optimizers, and pharmacy benefit administrators) are now taking on some PBM functions. In the face of these trends and commoditization, PBMs have launched group purchasing organizations (for example, Ascent Health Services, Zinc Health Services, and Emisar

[10] Adam Fein, *The 2022 Economic Report on U.S. Pharmacies and Pharmacy Benefit Managers*, Drug Channels Institute, 2022.
[11] Ibid.

Pharma Services) to better negotiate with drug manufacturers. They continue to invest to improve employer and employee experience and ramp up efforts to better manage medical benefit specialty drugs.

The growth in drug spending, including the rise of specialty drugs, has focused increasing attention on the role of pharmacy in coordinating care for patients. Of particular interest is the use of pharmacists and patient services in promoting greater adherence to medication regimens and providing medication-related counseling. Payers, PBMs, and dispensers alike are focusing on reducing the total cost of care and pursuing enhanced patient outcomes and experience.

Evolving business models

These shifts in industry economics are prompting business model change in three areas—diversification, vertical integration, and new business building.

Diversification

As the industry profit pools diversify, healthcare players are reviewing the scope and scale of their business lines. They are expanding their scope of services to adjacent segments as well as building businesses to monetize capabilities.

Hospital systems have been expanding across the care continuum, accumulating assets in ambulatory sites, virtual and digital health, primary care, and post-acute care. A majority of the net patient service revenues of the largest 50 hospital systems are now outside inpatient care. In addition to outright acquisitions, hospital systems are pursuing partnerships with innovators in these spaces, including primary care disrupters, risk-bearing management services organizations (MSOs), and virtual care companies.

Others in care delivery are moving to diversify as well. For example, home health and hospice companies are expanding into more sophisticated care delivery like hospital-at-home. Pharmacy players are scaling their primary-care businesses with acquisitions of physician and clinic assets, including value-based physician players. Announced investments seem to suggest a substantial expansion into primary care and value-based care well beyond the retail clinics space they have entered previously.

As players build new capabilities, they are recognizing that these capabilities can become large, profitable businesses in their own right. Many payers have created HST businesses of their own to both serve their core payer business and sell these services to other healthcare players. For example, payers are building MSOs to take a much more active role in managing the care of their patients. This kind of diversification has two benefits: it addresses new value pools while potentially creating value for the core payer business by reducing total cost of care through more robust analytics and reporting and improved care coordination to more effectively look after patients.

Also, several provider systems have launched venture funds aimed at diversifying the core business into attractive revenue pools such as data and analytics; some have created start-up incubators to build a range of digital health products and services. Other health systems are starting and expanding specialty pharmacies. About 20 percent of accredited specialty pharmacies are now owned by health systems and hospitals. Hospital-owned pharmacy programs have unlocked a new, growing revenue stream while demonstrating improved patient outcomes and experience through their integrated care programs, highlighting faster time to therapy and improved adherence rates among its specialty patient population.

Vertical integration

The continued rapid expansion of value-based care models is leading to realignment across the healthcare value chain. The realignment is in pursuit of models that can better deliver affordability, quality, enhanced access, and experience of care but also holds the promise of superior economic returns. Payers, for example, are innovating their Medicare Advantage business to move beyond providing just the health plan to ownership and

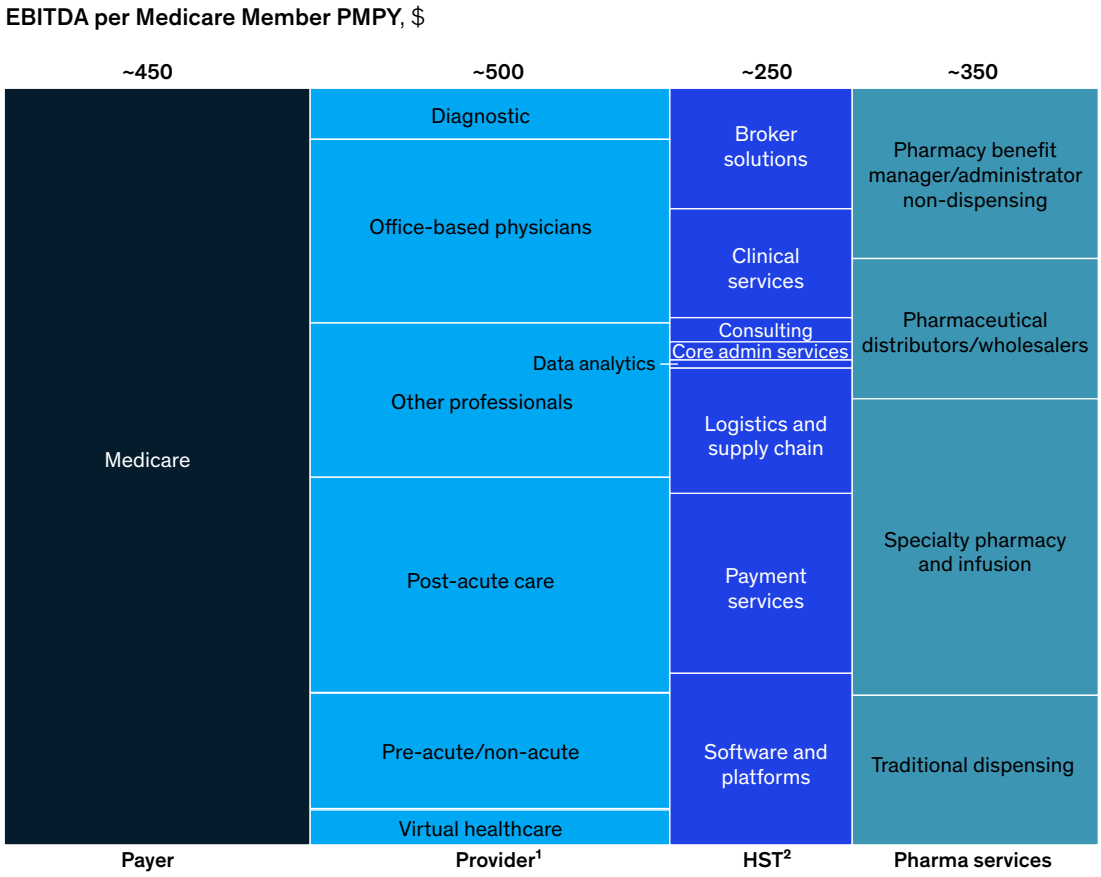
orchestration of care models inclusive of physician practices, virtual care, home care, and pharmacy as well as care management, medication adherence, and other enablement services. These models are increasingly powered by data- and analytics-enabled clinical services such as care coordination and enhanced member engagement. Such an approach may offer superior care to members while expanding the profit pool available to payers by two to three times (Exhibit 3). To access these capabilities, payers are pursuing acquisitions, minority investments, and partnerships with private equity firms.

New business building

Private equity and venture capital players are continuing to increase investment in healthcare; in 2021, they invested over twice as much as they did seven years ago. "Platform creation" is the investment thesis for many of these healthcare investments—identifying opportunities to create value beyond the immediate asset through M&A and business building (Exhibit 4). The financial sponsors are building the business, then leveraging a platform to create a more expansive set of offerings. In many instances, this approach ends up transforming the underlying business.

Exhibit 3

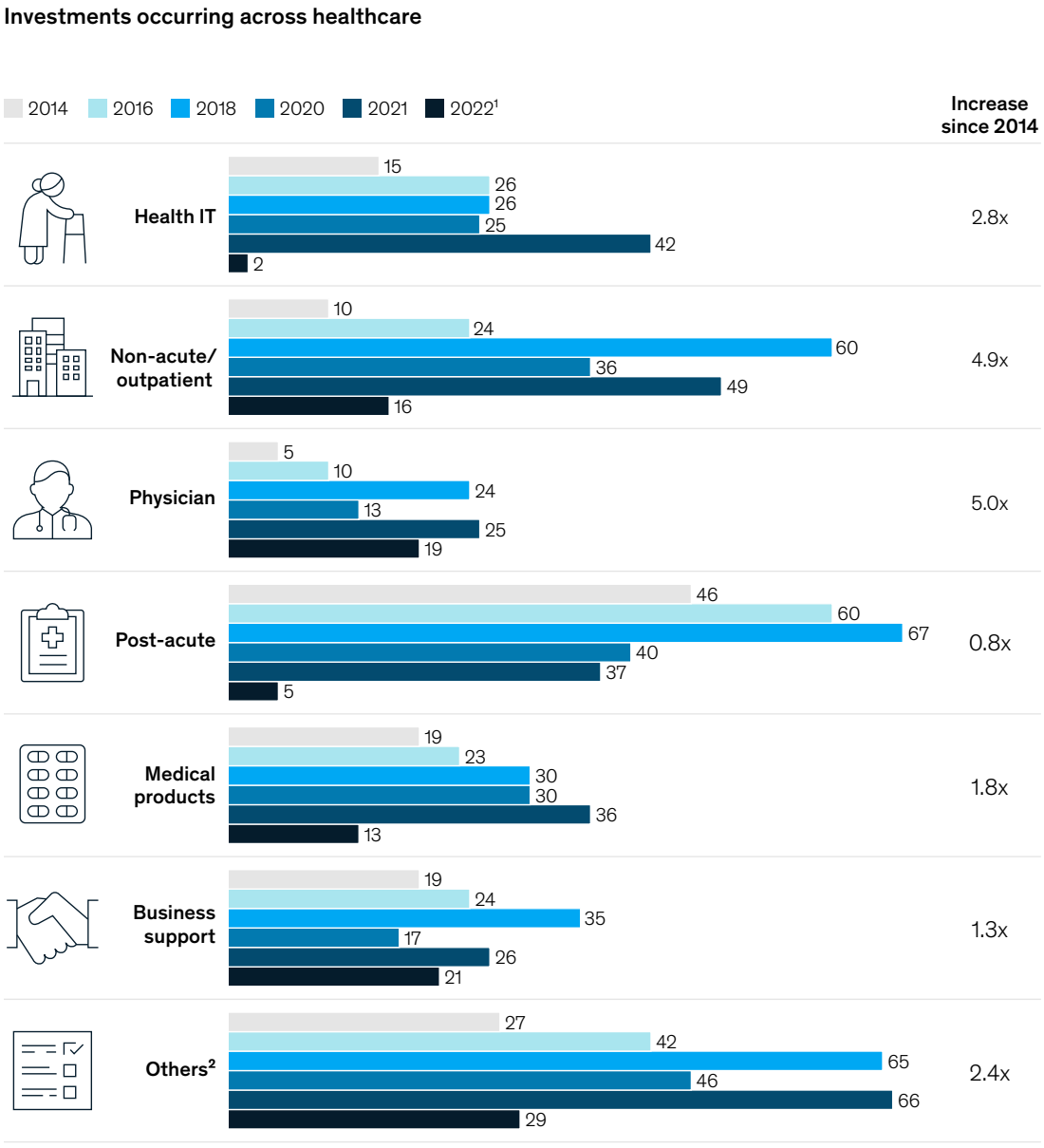
On average, Medicare Advantage can create substantial value, which can be reinvested for members.



[1] Acute care estimates as no EBITDA as shown given cross-subsidization across lines of business.
[2] HST, healthcare services and technology.
Source: McKinsey Proft Pools Model

Exhibit 4

Private equity and venture capital deals in 2022 across the healthcare ecosystem.



[1] June 2022 YTD.
[2] Medical support, CROs, health plans, hospitals, REIT, pharma, dental, emergency medical transportation, staffing company.
Source: CapIQ, Dealogic, Levin

For example, during COVID-19, a private equity-owned, home-based provider built out a clinical trial within a few months to facilitate vaccine trials, enrolling five times the number of diverse participants compared to normal approaches, based on our experience. In another case, a provider of non-emergency medical transportation expanded into nutritional meal-delivery services for high-need and high-risk patients.

This high speed of innovation is upending the incumbent healthcare players' traditional approach of transforming or incrementally adding to existing business models. Instead, business reinvention

has become a critical priority.[12] While the approach includes making anchor acquisitions, it must also often rely on high-speed business building to take advantage of incumbent assets and fast scale-up to make a difference to their business. Many are pursuing this model. For example, one pharmacy services player created a digital pharmacy from scratch within a year. In another instance, a large healthcare player built an entire value-based care business in 18 months.

As financial conditions have tightened, we are seeing a pullback in healthcare investment from business models not yet delivering measurable outcomes. At the same time, there's an aggregate increase in investment appetite to help scale innovative models that are showing positive results. Recent healthcare-focused fundraising for private equity continues to display substantial momentum. This bodes well for funding innovative models in newer areas such as specialty value-based care, as well as scaling innovation in more established segments such as primary-care-centered, value-based care and HST.

The competencies required to operate these business models are new and often quite different from those needed to run the core business. Healthcare leaders may want to carefully consider how to enhance their organization's capabilities to carry out their business model reinvention plans. New competencies include:

— *Programmatic M&A.* Most innovative companies in healthcare are small to midsize and often focused on relatively narrow solutions. As such, programmatic M&A is important for building new businesses, diversification, or vertical integration. No healthcare organization has the bandwidth of talent or scale of capabilities required to organically build these models in a timely and effective fashion. Indeed, across industries the programmatic M&A approach delivers the most value creation, according to McKinsey research.[13]

— *Effective integration.* The thesis of programmatic M&A is the rapid scale-up of innovative business models and not traditional synergy capture.[14] As such, the integration approach adopted by acquirers likely needs to enable rapid scale-up of the core operations of the acquired company, incorporate the capabilities of the acquired entity with the core business, and enable integration of multiple acquisitions into a broader "platform business." Programmatic acquirers develop an "always on" integration capability compared with the bespoke integration infrastructure in most large deals. Developing a programmatic integration competency is increasingly important.

— *Rapid-fire business building and scaling.* Business-building capability is a key component to succeed in this new environment. New businesses often need to be built when an appropriate acquisition option does not exist or is not economical. Repeatable, successful innovation requires a dedicated engine that can build promising ventures into growing businesses.[15] In our experience, the leadership team and talent in these new businesses are key differentiators. Parent company management can appreciate that these businesses often have different economic models, types of employees, and nature of operations. Therefore, the governance of these businesses should be meaningfully different than a business unit within the core.

The COVID-19 pandemic has had a profound effect on the healthcare industry, from shifting profit pools to a spike in innovation to the creation of new business models. Payers, providers, HST players,

[12] Shubham Singhal and Ari Libarikian, "Leap to the future of healthcare: Reinvent through business building," McKinsey, April 9, 2021.
[13] Paul Daume, Tobias Lundberg, Patrick McCurdy, Jeff Rudnicki, and Liz Wol, "How one approach to M&A is more likely to create value than all others," *McKinsey Quarterly*, October 13, 2021; Robert Uhlaner and Liz Wol, "Programmatic M&A: Winning in the new normal," McKinsey, March 21, 2022.
[14] Robert Uhlaner and Liz Wol, "Programmatic M&A: Winning in the new normal," McKinsey, March 21, 2022.
[15] Philipp Hillenbrand, Dieter Kiewell, Ivan Ostojic, and Gisa Springer, "Scale or fail: How incumbents can industrialize new-business building,"

and pharma services firms are facing big decisions about what kind of companies they want to be in the coming years. Even as the pandemic continues, now is the time to make strategic choices and potentially big bets. Acquisitions and new business building will increasingly be key success factors.

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