Healthcare market proves strong with investors finding returns generally outweigh the risk

Our report from the JPMorgan conference

Healthcare Alert

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In the wake of a tumultuous year for investors, the healthcare industry is poised to receive a record amount of investment in 2019. Understanding industry trends and managing risk assessment will be an integral part of the success for companies in the sector.

That was a key takeaway from a panel moderated by Joshua Kaye, chair of DLA Piper's US Healthcare sector, on the sidelines of the 2019 JP Morgan Healthcare Conference in San Francisco. The third annual panel discussion, "Healthcare M&A Exits: Who's Buying, What Are They Buying, and Why?" also discussed how a company can position itself for a merger and how to appropriately plan for an exit.

Below are the highlights of the discussion, which featured:

- Tom Rodgers, Senior Vice President and Managing Director, McKesson Ventures
- Robert Shepler, Managing Director, Telegraph Hill Partners
- Joseph Siletto, Managing Director, Vivo Capital

Joshua Kaye: What fundamental factors should entrepreneurs consider when partnering with McKesson Ventures? How is partnering with a fund associated with a healthcare company unique or different from a financial sponsor?

Tom Rodgers: We underwrite two fundamental risks – commercial execution and market development. That means we tend to stay away from companies that are still navigating material clinical, technical or regulatory questions. This translates to primarily investing in commercial stage tech-enabled services. We do not promise that McKesson will be a customer or a channel partner up front or an eventual acquirer, and we deliberately shy away from intermingling business development and investment terms. Instead we commit that if there are potential commercial synergies with McKesson or companies in McKesson's large ecosystem, our team will do everything possible to evangelize, facilitate, evaluate and even go so far as helping manage those relationships and collaborations.

Our primary value proposition is that we have deep domain experience and expertise in healthcare and this proposition resonates most with companies and entrepreneurs that are seeking help in calibrating commercial strategies, adoption expectations and overall cash burn. Most of these companies have good solutions aimed at important problems, but if they get this calibration wrong, they won't survive the journey and thrive.

Joshua Kaye: What are some things entrepreneurs should look for when considering a venture capital firm?

Robert Shepler: The first question is whether going the venture capital route is really the best way to achieve an outstanding outcome for the founder? Often, it is not. But if it is, working with a firm that embraces integrity as a core value would be the number one characteristic to focus on. Find a firm that has deep experience in your sector because there are going to be many subtleties that need to be understood and navigated. You'll need introductions, so consider one with a strong network. Understand the firm's business building philosophy to determine if their approach will mesh with yours.

Determine the maturity of the fund as it is a lot better to be an early investment in a fund than the last investment. As your venture capitalist will fundamentally impact the company's ultimate success or failure, do as much due diligence as you possibly can, particularly calling CEO's of portfolio companies of the firm before you decide to proceed.

Joshua Kaye: What happens after that first check is written? How is value, aside from just capital, truly brought from the investor side?

Robert Shepler: At Telegraph Hill Partners, two of our core principles are: 1) We work as a team. Nobody "owns" a deal at THP, the firm owns it. That results in the entrepreneur getting the benefit of a range of talents at the firm and not just the designated board member; 2) While we are measured as investors, we think of ourselves and act as company builders. Consequently, our focus is on building a great business which resonates with management teams. We have found that every time a portfolio company achieves excellence, great investment returns follow.

To that end, building exceptional management teams is probably the most important activity that we target at each of our companies. Assessing capital allocation and initiatives to drive value are two other areas where our expertise and experience are particularly helpful to managements.

Joshua Kaye: There has been an increasing trend of multiple funds partnering together in an acquisition. What are your thoughts on partnering with other firms?

Joseph Siletto: Sometimes it is good to have a team around the table. Partnering firms can offer different strengths and weaknesses bringing a different perspective to the entrepreneurial vision and networks.

When it comes to acquiring a business, there are slight nuances. It is easier to have the governance by one firm with a board of directors versus having multiple people around the table. The exceptions are those that bring a geographical difference. However, we still must understand where we are in our funds life because you must always ensure to generate great returns.

Joshua Kaye: Is the US healthcare market still the key market for entrepreneurs or are there opportunities where an entrepreneur may have better probability of capturing market share abroad?

Joseph Siletto: The answer to this is it depends. If you are a pre-commercial drug or device, the US market is very favorable as we have good reimbursement and pricing. It's also about the capital ecosystem you are in. In China there are plenty of funds, but they don't tend to have the technical lexicon that we have here, with the expertise to help you with drug or device development.

I would say that if you are in the earlier stages, this is the best market. But if it is a service model play or if it some type of rollup addressing a more mature industry, you can find just as good opportunities elsewhere.

Joshua Kaye: VC funding in 2018 continued at an astonishing pace. As we go into the first quarter of 2019, what are your thoughts in terms of the current state of the healthcare markets? Is this a good time to be out there looking for a partner?

Tom Rodgers: I think that if you are strong company with a good team and a differentiated value proposition and narrative and hopefully with some commercial results, it's going to continue to be a great time to raise money for the foreseeable future. If you are less differentiated, or your commercial results are all from pilots, you are still iterating to figure out what your business model is going to be, and it is going to be harder. The investment community is shifting to be more discerning. It is still a good time to be a seller and a frothy time to be an investor or acquirer and that is not going to end necessarily, but things are slowing down and changing tempo, so you want to make sure you are holding the best cards.

Joshua Kaye: How do you decide whether to make investment in earlier stage companies where revenue may not be indicative of the opportunity?

Tom Rodgers: Like other VCs, we focus on market, team, competition, financials and returns potential. However, the biggest diligence thrust for us is usually on the customer front. We want to talk to your customers, ask them what problem they have been solving, what other alternatives they considered, ask them why they chose company X and not Y, what their experience has been and if they plan on continuing or even expanding the relationship. If you don't have any paying customers yet, this is tough.

Joshua Kaye: What are some of the key questions entrepreneurs should prepared to answer when meeting with you?

Robert Shepler: The key objective is to educate your potential funding source. Risk and return are a paradigm in investment. Most people are more focused on telling the return story; however, the extraordinary presenters also talk about risk. They identify what those risks are and how they plan on mitigating them. You must give your investor the confidence that you are going to be a great steward of their capital.

Joshua Kaye: Assuming investment is made, do the metrics change? Now that you are in a partnership, what are the metrics of success?

Joseph Siletto: We think of an investment somewhat like a budgeting cycle for a business. If you are an operational business and you have budget, you are going to work against it throughout the year and measure the success of the company by it. The key objective is to drive value, which is oftentimes measured by what the management team presents to us and gets in return of the investment. We look at how budgets, milestones and timelines developed. Ultimately, we won't see the success until years down the road, but having excellent checkpoints is key.

Joshua Kaye: What are some trends you are seeing in health innovation?

Tom Rodgers: We focus mostly on the long-term undeniable trends, such as shift towards fee-for-value from fee-for-service, shift towards precision medicine, and increased leverage of data and analytics. I think the greatest innovation of this period of time is surveillance. Unfortunately, the healthcare industry hasn't really figured how to take advantage of it yet, but there is a huge opportunity there. Stakeholders are mainly figuring out how to access or organize data but are just scratching the surface on how to drive the optimal clinical and economic outcomes because of analyzing data or accessing new data streams coming from outside the conventional walls of the healthcare system. Doctors will increasingly to be accountable for getting and keeping people healthier, and in order to do so they will need to monitor people for the 360 days they are not in their clinic and intervene before people fall off the cliff rather than rake in the fee-for-service dollars after they have.