April 14, 2022

Cain Brothers House Calls

Fishing for Returns in Turbulent Waters:

Healthcare Investors Adapt to New Competitors and Greater Risk

Cain Brothers House Calls

Fishing for Returns in Turbulent Waters:
Healthcare Investors Adapt to New Competitors and Greater Risk

by Mile Elizondo, Stacy Guffanti and David W. Johnson

Listen to the House Calls Podcast online at [Key.com](), [iTunes](), [Spotify]() or [Stitcher]().

Private equity and venture capital continues to flow into almost all healthcare sectors in abundance, despite a wide variety of economic and geopolitical headwinds. Stratospheric health tech investments get the headlines. Yet, investment activity in more established and mature healthcare business sectors is robust with few signs of abatement. Consolidation, innovation and business model transformation are the most prevalent investment themes as the industry demands adaptation to consumerism, commodification and new competitors.

Non-traditional healthcare investors (including generalist- and technology-focused funds) have joined the funding scrum, contributing to sustained high valuations and large capital raises. Despite the frenetic pace of investment activity, uncertainty has returned to the capital markets. Concerns related to persistent inflation, supply chain challenges, alarming labor shortages, and the Russian war in Ukraine have not (yet) had a material impact on valuations and investment appetite in most healthcare verticals.

To assess how these changing dynamics are influencing seasoned healthcare investors, Cain Brothers and 4sight Health interviewed several leading private equity (PE) and venture capital (VC) firms. We wanted to know whether and/or how they are adapting their investment theses, risk parameters and market positioning.

Our hypothesis entering these conversations was that competition for investment opportunities has forced healthcare investors to expand their risk parameters with investments in smaller, earlier stage companies at high valuations. We also posited that investors are making those decisions more quickly due to the velocity of capital deployment.

We spoke with healthcare investors from the following companies:

Vestar Capital Partners
Founded in 1988, Vestar has invested in more than 80 companies with a total value of more than $46B. As a growth-oriented investor, the firm focuses on companies with strong management teams, and specializes in partnering with founder- and family-owned companies. Vestar's 16 healthcare investments focus on tech-enabled companies, new delivery models, and businesses that leverage data and analytics.

Managing Director **Jim Elrod** is the founder of Vestar's healthcare investment efforts.

Newlight Partners
Newlight Partners is a growth-focused middle market private equity firm that builds businesses in partnership with exceptional founders and management teams. Newlight's thematic investment approach focuses on identifying and addressing marketplace opportunities in rapidly growing subsectors. In healthcare, the firm is focused on investing in and supporting value based care models.

Partner **Srdjan Vukovic** leads healthcare investments.

Heritage Group
Heritage Group is a Nashville-based, healthcare-focused private equity fund with over 35 years of experience financing and operating healthcare companies across healthcare services and healthcare IT. The firm has over $700 million of assets under management and an LP cohort of strategic investors that include some of the leading healthcare organizations across the country, including 15 health systems, 9 health plans, and other large health businesses in various sectors.

Partner **Lauren Brueggen** joined Heritage Group in 2018 and was named one of GrowthCap's Top 40 Under 40 growth equity investors in 2017.

Transformation Capital
Transformation Capital is a growth equity firm with $800 million under management dedicated to supporting commercial-stage digital health and novel healthcare service companies that are focused on improving health and the sustainability of the healthcare system. They focus on driving growth through deep industry and operational expertise and through their extensive industry connections.

Partner **Scott Rosen** joined Transformation Capital in 2020 with extensive corporate M&A and investing experience.

Our individual conversations with this group of senior healthcare investors coalesced around three themes:

1) The changing character of funding dynamics
2) The importance of alignment with management teams and founders
3) The continued appeal of value-based business models

As usual, reality informs theory and sharpens it. Our interviewees confirmed elements of our thesis while challenging components of it.

Funding in Frothy Seas

In 2021, a flurry of capital raises, funding deals, acquisitions, IPOs and SPAC investments expanded healthcare valuations, deal-sizes and deal-rounds. Venture investments in digital health and healthcare services almost doubled 2020 levels ($29.1 vs. $14.9 billion), which in turn almost doubled 2019 levels ($8.6 billion). In their well-cited report on digital health funding in 2021, Rock Health noted that intense competition between investors for early-stage deals (seed, Series A and Series B) had pushed valuations higher:

> *From 2020 to 2021, the average Series A round grew 38% to $18M, while the average Series B grew 23% to $43M—just $3M less than 2019's average Series C. The year also saw a record number of mega ($100M) early-stage deals, including ten mega ($100M+) Series B raises and one mega Series A round (EasyHealth). To compare, 2020 had six mega B rounds, and we've only seen one other mega Series A since we started tracking funding in 2011 (Insitro in 2018).*[1]

Exemplifying that trend, premier PE investor, Welsh, Carson, Anderson & Stowe recently established Valtruis, a platform for investing in earlier-stage companies outside Welsh Carson's traditional investment mandate. Notably, Valtruis will focus on companies that "transform healthcare through what is truly value-based care."[2]

We began our conversations with investors by noting that traditional PE and venture capital firms increasingly find themselves in competition with generalist tech investors with limited healthcare expertise. This shift suggests

[1] https://rockhealth.com/insights/2021-year-end-digital-health-funding-seismic-shifts-beneath-the-surface/

[2] www.valtruis.com

that non-traditional healthcare investors are eager to participate in healthcare's upside potential as the industry undergoes the kind of rampant innovation and technology adoption that have redefined other sectors of the economy.

"We're seeing exactly what you describe," Lauren Brueggen of Heritage Group said, "which is more capital chasing investment opportunities, and more of the generalist funds looking to invest and play a more meaningful role within healthcare. The result tends to be an increase in valuation levels."

Others agreed. Jim Elrod of Vestar added that some of the tech funds believe they understand immature, fast-growing companies and wrongly assume those same dynamics apply in healthcare:

> "The good ones are reasonable, prudent competitors. But there are some that are missing the market and paying more than they should because they don't understand the knock-on effects of reimbursement or regulatory complexities. They're acting rationally in the universe they know, but not in this one. And they're going to experience some hard lessons."

Scott Rosen of Transformation Capital added that it's not just the generalist investors contributing to the heated environment, but traditional later stage funds and strategic corporate venture arms are also deploying more capital to earlier stage companies. There is some structural justification for the rising investor interest as, "the pace of buying cycles with strategics clients are accelerating and the executives responsible for innovation initiatives have more defined organizational processes and budgets to do so."

Nevertheless, our interviewees suggested that their investment strategies have stayed the course. According to Srdjan Vukovic of Newlight Partners, "All sectors of the market feel too high but fundamental secular drivers haven't changed. We've just de-prioritized areas where it feels like a lot of people share the same thesis."

Brueggen agreed: "[The competition] certainly impacts us, and we're hyper aware of it, but increased competition hasn't changed our investment philosophy. We've remained disciplined in our approach because we know it makes us successful. And with our strategic LP base, we have an advantage in terms of being able to identify the sub-sectors within healthcare and particular companies that are positioned to grow faster."

Elrod advised caution to new ventures accepting higher valuations. "If folks come out of the gate slowly, let alone fall on their faces, the whole model built around double-digit growth collapses awfully quickly. That's just part of why there's more risk now all around versus five years ago."

Alignment with Leadership

Elrod and Brueggen believe that entrepreneurs seeking funding should focus on getting the right backers, not the highest valuation. Investment partners with deep sector knowledge can help founders navigate turbulent times and introduce them to the right strategics and buyers.

To that end, there continues to be a clear desire for meaningful founder / management equity rollover, which is seen as a vote of confidence in a company's long-term growth prospects. "We want to be aligned with founders and management teams," Brueggen said, "so they really get value out of our partnership." Elrod added, "Our biggest concern is to make sure we've got like-minded people on the board, and there's enough room on the board for real industry experts."

Where management teams lack specific expertise, investors can augment it. Rosen notes, "We back a lot of first-time entrepreneurs. Not deliberately, but it's not a reason to avoid backing a good company concept with product market fit. As a healthcare innovation focused fund, we leverage operating experience and deep industry networks within our investment team and operating partner model that can supply the functional skill sets and commercial introductions that help drive success. So, we’re less worried about domain expertise than entrepreneurial quality and other factors.”

Elrod believes, however, that the current frothy marketplace has led some investors to accept management teams less capable of driving long-term growth. “These are completely self-inflicted wounds because it’s clear from the beginning the team doesn’t have the experience to get to the next level. But it’s harder today during the courtship period to make those leadership changes.”

Elrod adds, “I think we’re returning as an industry to what used to be called ‘bootstrap financing’. You get on the boards and bring teams the resources they need as a value-added partner. We used to orchestrate well just by being smart. Now we often need to be both the producer and the director of the movie.”

The Future is in Value

While the industry’s vested interests cling to volume-based business practices, our interviewees uniformly believe that value-based care delivery will shape the industry’s future supply-demand dynamics. This is based on belief that better outcomes, lower costs and improved customer experience are essential for long-term success.

Srdjan Vukovic says Newlight Partners is all-in on value. “Our primary focus is around the implementation of value-based care. We spend a lot of time looking at opportunities and thinking, does this actually make the system better? Is it creating better outcomes at less cost? Are the incentives aligned? Does it make the consumer experience better? We want to build companies for a different paradigm.”

Vukovic adds, “The government has done a reasonably good job with setting policy and providing the right framework for value-based care. As investors, we want to back the management teams that are intentionally building for this framework and delivering on true value-based care.”

Scott Rosen observes that employer-based markets are a rising source of demand stimulating payment innovation. “In the next five years, a variety of new models will continue to emerge despite uncertainty around the pace of adoption, but we do know employers are increasingly willing to adopt new performance- and outcome-based pricing models, particularly in the middle market, where self-insured groups are often more concentrated geographically. So, we continue to have conviction in that segment.”

As value-based models proliferate, investors increasingly focus on niche or specialist market segments. As Brueggen put it, “We’ve spent a lot of time thinking about how value-based care impacts different specialties or particular conditions.”

Conclusion: Staying Calm Amid the Storm

At the second half of 2021 and into 2022, many of the high-flying healthcare “disrupters” in the public market experienced sharp declines of 50+% in valuations.

Yet, each of our investors noted that, in the long-term, market fundamentals point to continued growth for healthcare companies. Increasing demographic-driven demand for care services, the adoption of value-based payment models, accelerated sales cycles and continued consolidation give seasoned investors confidence in their funding strategies.

Competition to fund promising companies has clearly increased over the last five years, and investors are seeking earlier-stage opportunities in their quest to find targeted investment returns. In that sense, the lines between private equity, growth equity and venture investing are blurring.

Cain Brothers House Calls

Despite the increased turbulence, experienced healthcare investors are expanding their portfolios in measured fashion even as less experienced investors up the stakes for bad decisions. Paraphrasing "If", the famous Rudyard Kipling poem, seasoned investors seem to be keeping their heads when many about them are losing theirs.

Contact: Mike Elizondo
415-962-2951 melizondo@cainbrothers.com

Contact: Stacy Guffanti
212-981-6925 sguffanti@cainbrothers.com

Contact: David W. Johnson
312-560-0870 david.johnson@4sighthealth.com