PRIVCAP REPORT/

INCLUDES:
- Anatomy of a PE Healthcare Team
- PE Healthcare in Emerging Markets
- IP Commercialization

The Healthcare Opportunity

How private capital and innovation are combining to build value in a changing market

With Expert Insights from:

Baird Capital
Cleveland Clinic
Siguler Guff
Quadria Capital

Healthcare's Appeal Grows

The healthcare industry provides an investment opportunity that both repels and attracts PE players.

On the one hand, highly regulated sectors do not appeal to many private equity GPs, because they often place the fortunes of portfolio companies beyond the control of financial backers—and in the hands of fickle rulemakers. It's hard to plan for value creation when the rules can change unexpectedly and for political reasons.

On the other hand, healthcare can make for winning PE investments—it's being profoundly disrupted by new technology and business practices; global spending is growing, in part because of aging populations in developed countries and a rising middle class in emerging economies. Healthcare entrepreneurs need capital, and guidance, to help them navigate these opportunities. The best PE firms are positioned to provide both.

Starting with this special report, Privcap will be upping its coverage of healthcare and opportunities for PE investment in the sector.

A significant amount of private capital has already found its way to the healthcare industry; it's clear the sector will occupy a growing spot in many institutional PE portfolios. This means investors will need to better understand the underlying strategies, and medical innovators will be pushed to better understand investor appetites and how to source private capital.

Best,

David Snow
CEO & Co-founder
Privcap
@SnowsNotes

In This Report

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Investing Across the Healthcare Spectrum

Baird Capital's Mike Liang and Michael Bernstein discuss why the firm focuses on both early-stage and mature healthcare companies

THE EXPERTS

Mike Liang
Partner,
Baird Capital

Michael Bernstein
Partner,
Baird Capital

BIO

Liang is a partner at Baird Capital, focusing on healthcare. Previously, he was a venture investor with Advent Venture Partners and had an operating role as director of R&D at spinal orthopedics company Cortek. Liang is on the board of directors of Amphora Medical, GenomeDx Biosciences, Insightra Medical, Veniti, Zurex Pharma, and Integrated Diagnostics. He received degrees from the University of California Berkeley and Stanford University, as well as a postdoctoral fellowship at Harvard University.

BIO

Bernstein is a partner at Baird Capital's U.S. private equity team, focusing on healthcare. He was a former executive-in-residence at Baird and previously served as president and CEO of the firm's portfolio company, Medical Education Technologies, Inc. After it was sold to CAE, he became president of CAE Healthcare. He has also held several other senior executive management roles. Bernstein received a B.A. from the University of California and a J.D. from the McGeorge School of Law.

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Privcap: You both invest in the healthcare sector, but at different ends of the spectrum: earlier stage and late stage. Walk us through your respective goals and viewpoints when you're investing in healthcare.

Michael Bernstein, Baird Capital: I invest out of the U.S. private equity fund. We're a classic middle-market buyout fund, perhaps lower-middle-market buyout fund. We usually take a controlled position in companies with $30M to $100M in revenue and $5M to $15M in EBITDA, at appraised value of $30M to $150M.

Mike Liang, Baird Capital: I'm on the U.S. venture capital side, so we are investing early and growth-stage businesses. We're cross-healthcare; what that means is often pre-revenue businesses or in the early stages of commercialization—a U.S. headquartered business that may have an international focus.

How do you come up with your themes? And when you vet a company and think about whether or not to invest in it, what attributes does it have to have?

Liang: In terms of what we look at, it has to be hyper-growth, often intellectual-property-protected opportunities on the product side. On the services angle, it's an interesting time within healthcare for unique models of coordinating care.

Hospitals and providers are very focused on that. We specifically focus on medical technologies, the tools and diagnostic side, and, importantly, healthcare IT and services. Each of those has unique dynamics in terms of opportu-nities as well as challenges

Bernstein: Both of our funds focus on businesses that are empowered by the Affordable Care Act [ACA]. So our businesses have common themes, but they're at different stages. One's germinating and emerging, and the other needs to be given a lift to get through the ceiling to its full fruition.

How do you look for opportunities to put larger amounts of capital to work when the landscape has a lot of challenged, mature companies?

Bernstein: Well, we don't invest in mature, challenged companies. We invest in fleet-footed businesses, both the early stage and later stage. So even in private equity, our businesses are the disrupters. These are businesses that are going to enable hospitals to re-create a margin when it's wiped out by the ACA. It's going to help providers develop systems to live in an accountable-care world.

Liang: Mike brings up a good point, in terms of where they focus in terms of the lower middle market. You're getting the more mature businesses that are EBITDA-positive but still have good growth potential and can still capitalize on that.

You're both interested in the healthcare challenge, or rather the opportunity of infection prevention. First, talk about what that means, and then how you came up with that as a thesis to go after.

Bernstein: I've been tracking [infection rates] for a while. I came to the conclusion that writ large, patient safety is too big, but infection prevention is an ideal size and still has the societal gravitas that you would really like to be in if you were an investor with a conscience.

Liang: I thought it was an interesting area, where providers weren't getting paid for people who had been diagnosed with hospital-acquired infections and had to treat them out of their own costs. It's going to be a big concern. The estimates are north of $30B, at a time when everyone's trying to figure out how to save costs. It seems like a natural area for investment.

> "On the services angle, it's an interesting time within healthcare for unique models of coordinating care. Hospitals and providers are very focused on that."
>
> –Mike Liang, Baird Capital

A metaphor that I've heard from healthcare executives recently is that healthcare companies are going to evolve along the same line as bank branches that you go into just to use the ATM or do something online. Do you think that's credible, and does that inform any part of what you're thinking about?

Liang: People won't always be going to the hospital, right? You have more people who are insured looking for care, and hospital systems can't do that, just given their tight operating margins. And so the question is how you start getting delivery of care outside of the hospital.

Bernstein: Retail medicine is here. It's a very big idea, and it has a lot of money behind it. When healthcare becomes retail, brand is going to matter for the first time, so we like brand plays. We like businesses like ad agencies that spe-

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cialize in payers and providers and are going to help them develop a brand for the first time. The Mayo Clinic, Cleveland Clinic, Johns Hopkins are good examples of those already selling their brand worldwide. But we have new brands in healthcare, and they're going to have to build those up. They're going to need help to do that.

Is there an appetite among limited partners for co-investment in healthcare opportunities, and are there opportunities at the earlier stage for them to do so?

Liang: It's one of the things that differentiates us. We do have the opportunity to invest across stage and also geography in ways that most other independent funds don't necessarily do. We've talked to our LPs a lot about if there's the right opportunity that fits for whatever reason across different funds and it makes sense to add value to it, absolutely do it. The only cross-investing we've done so far was a healthcare-services business between

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> –Michael Bernstein, Baird Capital

their U.S. venture team and our U.S. private equity team. It ended up being our best return. It was north of a 40x return for us.

How does your firm handle co-investing?

Liang: This will usually fit into that kind of early-cash-flow, positive-type business that might still have that venture growth component to it, with maybe a majority-controlled transaction.

Bernstein: LPs are interested in co-investing in healthcare. It allows us to go a little higher up on the value scale with an LP investor without relaxing our control orientation. I think we're going to see a lot of it. They have very deep, strategic relationships, both on the start-up side and also on their exit side. They have relationships with big names and strategics, and I'd like to see some strategic co-investment in our businesses. And with a big idea like infection prevention, if we do this together I wouldn't be surprised if we had LP or strategic co-investment. ■

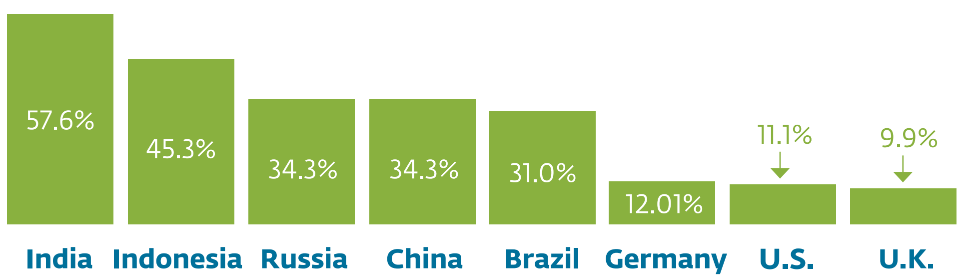
Healthy Opportunities in the Emerging Markets

A growing middle class and increasing rates of lifestyle-related diseases make emerging markets a prime target for PE healthcare investments

BY AINSLIE CHANDLER

The healthcare sector in the world's emerging markets is ripe for private equity investment. The rapid growth of middle-class markets such as China, India, and Brazil, combined with increasing levels of lifestyle-related diseases like diabetes and hypertension, means demand for quality healthcare, and the capacity to pay for it, has never been stronger.

Out-of-Pocket Expenditure as a Percentage of Total Healthcare Spending



Source: World Bank, 2012

THE DATA

In the report *Healthcare in the Emerging Markets: A Compelling Private Equity Opportunity*, private equity firm Siguler Guff estimates that in Brazil, Russia, India, and China (the BRIC countries) the healthcare delivery, services, devices, diagnostics, pharmaceuticals, and life sciences markets are worth a combined $850B, a figure that is growing at an annual rate of 9.1 percent, far exceeding GDP growth in these countries. If the basket of countries is expanded to include other global emerging markets, the figure is closer to $1.3T, growing at a rate of 6.8 percent.

Given the relatively underdeveloped nature of the healthcare systems in BRIC markets, there is strong potential for growth in the coming 10 to 20 years, Siguler Guff predicts in the report.

And there are few sector-specific funds targeting the opportunity. While there are more than 300 healthcare-focused fund managers in the United States, only 10 to 15 of them are focused on the emerging markets. Most of the existing private equity investments in emerging markets have been made by sector-agnostic funds, which generally target an 8 to 10 percent healthcare allocation, according to the Siguler Guff report.

THE OPPORTUNITIES

One of the report's authors, Praneet Singh, a managing director in Siguler Guff's New York office and a senior member of the firm's emerging markets investment team, told Privcap the firm has deployed about $2B in the emerging markets. The The emerging markets healthcare sector is well suited for private equity investment, he says, given the size of the companies involved and their need for the kind of expertise that PE firms can offer.

According to the Siguler Guff report, "Healthcare in the emerging markets… is driven by a localized practicing doctor model. These [markets] offer attractive opportunities for consolidation at discounted valuations. Interestingly, operating margins across most of the industry subsectors are surprisingly high, making them appealing when compared to similar businesses in the developed markets."

Singh says the sector is highly fragmented, with about 50 subsectors under the healthcare banner. Of these, each has its own unique opportunities and challenges. Furthermore, each country has a particular set of needs and opport-unities within the healthcare space.

For example, in India, where the healthcare system is consumer-focused and based on walk-in clinics, the pharmaceutical and diagnostics subsectors are offering good growth and profit margins.

Another of the report's authors, Siguler Guff investment associate Shaun

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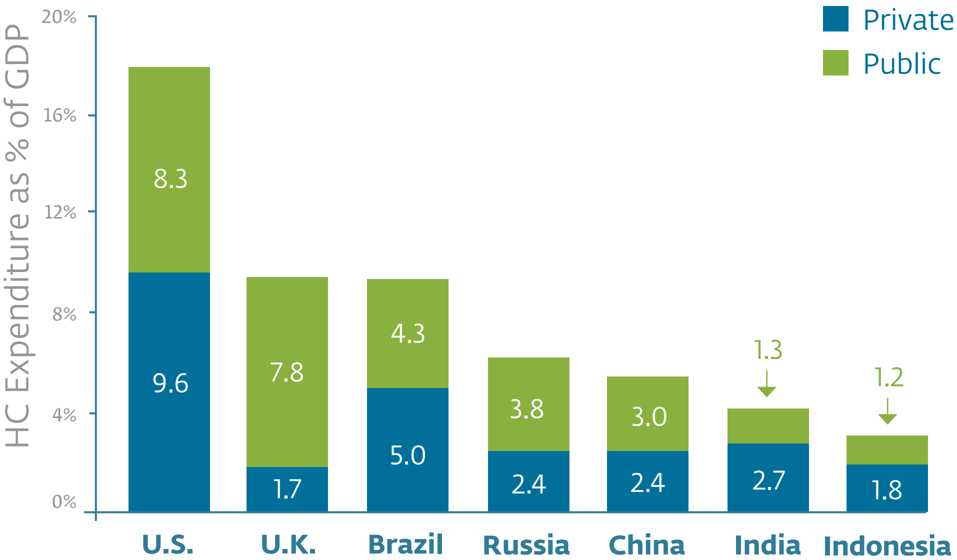
Healthcare Expenditure as a Percentage of GDP



Source: World Bank, 2012

Khubchandani, told Privcap that in Brazil, where insurance levels are higher and the market is more structured than in other emerging markets, there are opportunities in the asset-light healthcare retail distribution chainsv. However, there are fewer opportunities in healthcare delivery and hospitals, because of the country's regulatory system.

QUADRIA'S EMERGING MARKET STRATEGY

Singapore-headquartered Quadria Capital is one of the few fund managers dedicated to healthcare in the emerging markets.

The firm has a $350M fund, which held its first close in October 2013, targeting healthcare in India and Southeast Asian countries and focusing on four specific areas: healthcare delivery, life sciences, healthcare services, and retail.

Quadria managing partner Amit Varma says these diverse countries, which have a combined population of around 2.4B, have some similar attributes, including no universal healthcare and low insurance levels.

"The reason we chose this geography: In spite of the fact it's a diverse arena, in these different countries the problems in healthcare are remarkably similar," Varma says. For this reason, Quadria does not target China, a market he says has different attributes, including a high concentration of publicly owned hospitals.

In most parts of the countries Quadria targets, the risk of dying of acute infections has fallen markedly. However, lifestyle-related diseases like obesity, hypertension, and diabetes are becoming commonplace. And as more people in the region enter the middle class and have more disposable income, they are likely to expect better healthcare and to be prepared to spend more to get it. Quadria deploys $50M to $100M in each deal, investing in growth equity and debt.

In the first quarter of 2015, Quadria is set to invest $40M in an Indian hospital chain that is expected to expand from two hospitals to eight in the coming few years.

Varma says the firm liked that particular opportunity because the existing management had already done a good job of expanding the chain but had not spent much on its back-end processes, so there was scope to improve things like purchase efficiency.

The opportunity was also appealing because the company is based in India's east, a mineral-rich area that is experiencing strong GDP growth and has had relatively little healthcare investment, compared to the country's northwest region.

INVESTMENT RISKS

Investing in a new market is never without barriers. Or risk. One simple barrier to investing in these emerging markets is the lack of managers operating in the space and the lack of expertise among those who are.

While some sector-agnostic funds are putting money into these markets, Singh says that they may not have the operational expertise to add value to these particular investments.

Since many of the fund managers targeting emerging markets healthcare investments are new to the game, with little or no experience managing such a vehicle, Singh says they may also find it hard to enhance their investments. "Our belief is that sector expertise makes a difference," he says.

The *International Finance Corporation's Guide for Investors in Private Health Care Markets* identifies a lack of market information, a high level of fragmentation, a lack of transparency, ethical concerns surrounding practitioners, government policy, and a lack of human resources as among the barriers facing investors in the sector.

Khubchandani says investors need to be mindful of investment duration when investing in emerging markets healthcare. Projects like greenfield hospitals have a high level of construction risk, so it's more effective to target brownfield developments.

However, Varma says demand for healthcare in Quadria's target countries is so strong that he is not concerned about "micro" risks such as regulation. Regulators have become "far more conducive to investment" in recent years, he adds. In terms of macro risk, Varma says sectors like healthcare and education tend to be shielded from the worst effects of major economic events. ■

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Commercializing Healthcare Innovations

Cleveland Clinic Innovations' Gary Fingerhut explains how the clinic commercializes and develops healthcare innovations with VC and PE investor support

Gary Fingerhut
Executive Director,
Cleveland Clinic Innovations

→ BIO

Fingerhut joined the commercialization arm of Cleveland Clinic in 2011. Previously, he had senior positions at Axentis, which he co-founded, and was a senior executive at Complient and CEO of Business Technologies Inc. He's on the board of directors of several companies in the healthcare technology sector.

Privcap: At Cleveland Clinic, you're helping private capital to discover the innovations that are developed in your network, and to turn them into real companies. Can you give some background about what the clinic is and how it interfaces with private capital?

Gary Fingerhut, Cleveland Clinic: We're an academic medical center, our main campus being in Cleveland, Ohio. We have a location in Las Vegas, and we have a location soon to open up in Abu Dhabi [and existing clinics] in western Florida, in Toronto, and a few other places.

In what circumstances would the Cleveland Clinic interface with private capital?

Fingerhut: Our objective—and I speak on behalf of Cleveland Clinic Innovations—is to commercialize the ideas of our caregivers, which can be from any area within the Cleveland Clinic. So we are responsible for protecting the intellectual property and for taking those ideas to market. And we do that in a couple of different ways, typically through some type of royalty-bearing license or a spin-off company. To date, we've had about 70 spin-off companies. Those spin-off companies require

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> –Gary Fingerhut, Cleveland Clinic Innovations

us to raise capital very early, whether it's seed investment or even at the prototype level, so that we can foster the companies for growth. Those companies are in the areas of HIT [health information technology], therapeutics and diagnostics and medical devices, as well as delivery solutions.

Are there also processes invented at the Cleveland Clinic that could be adopted by a more mature healthcare company?

Fingerhut: With the change in healthcare, we are actually seeing a tremendous growth in process-oriented technologies. Those lend opportunities to HIT as well. There's typically some kind of a system behind it. We now take to market a tremendous amount of our more process-oriented technologies, including things related to better communication between patients and physicians.

What are the kinds of investment firms that will take a Cleveland Clinic idea forward?

Fingerhut: The majority of it is venture capital, but we're [getting a lot more interest from] foundations. A lot of global corporate venture money is coming our way. With people very interested in limiting their risk, we're holding on to these technologies a lot longer within our own incubators, and we're combining the technology so that we have a better strategy. In the past, a typical commercialization or tech transfer from an academic medical center would be one technology at a time.

In addition, we are now really leveraging capital, both human and financial, from corporate alliances, meaning other organizations that don't typically play in the healthcare space. They have technologies that they are able to combine with ours to make a more successful program.

I guess your organization often retains a stake in these companies, and if there's a monetization event down the road, that goes back into your coffers.

Fingerhut: Very much so. Our core objective is to make a difference in patient lives. Our second core mission is to provide excellent customer service or inventor satisfaction. We are a service organization for our physicians, our scientists, all of our caregivers. The money that is driven by the monetization—or exits, if you will—is used to do further product development.

What are some of the biggest challenges in the intellectual-property commercialization process?

Fingerhut: The most difficult [thing, from] an inventor's perspective, is that often they would give their ideas away to industry. We don't allow that to happen, because we want to make sure that their ideas, if they're good, get to the market to make a difference in patient lives.

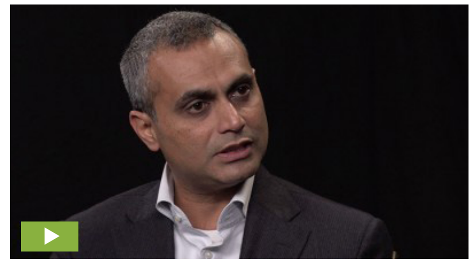
I don't know if you are able to estimate this, but how much capital would your organization have to put into a good idea to get it to a certain stage?

Fingerhut: It starts at about $50,000 to really take an idea to the next level. I'm talking about HIT, or maybe a medical device without a lot of regulation around it. A therapeutic [technology] would certainly cost more, but we'll typically invest in tranches of $50,000 until we get to a certain level, before we go out to raise capital. We've been bringing in organizations from both private equity and the corporate world so that they can get a view of our pipeline early and can track it, have some type of right of first review. We've been doing that with foundations as well. These private investors are the ones who have a vision. They see something that they think is going to make a difference, and they're very passionate about it. If you align that with our inventors, it works out well. ■

From the Archives

Sectors & Strategies

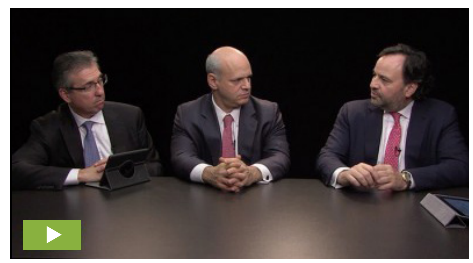
BDCs: Ripe for Consolidation
The U.S. business development company (BDC) market has grown in recent years. Now there could be consolidation, says Oak Hill Advisors' Glenn August.



Healthcare in Southeast Asia
Southeast Asia's huge population, health issues, low insurance rates, and lack of universal healthcare mean investment opportunities, says Quadria Capital's Amit Varma.

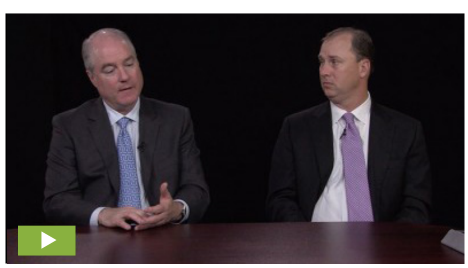
Fundraising & IR

Ramped Up IR in Troubled Times
After the financial crisis, The Blackstone Group increased its IR staff and the granularity of information it reports to LPs, says the firm's Matthew Pedley.



The Realities of Raising Capital
Experts from Catalyst Investors, Blue Wolf Capital Partners, and MVision discuss what happens behind the scenes on a fundraising.

Dealmaking



Encap's PennEnergy Partnership
A partner at energy-focused firm EnCap Investments and the CEO of PennEnergy Resources discuss their partnership to build a valuable oil and gas company.

Why Baird Backed Insightra
Baird Capital's Mike Liang describes his firm's investment in Insightra Medical, which makes devices to help patients with hernias.