The Rising Tide of Strategic Investing

CORPORATE ADVENTURES IN HEALTH CARE VENTURE CAPITAL

Created in collaboration with
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Health care corporate venture capital (CVC) is on the rise across all sectors of the industry, in terms of number of active CVC groups, deals and dollars invested.

Many new health care CVC players have emerged since the 2008 downturn; many are only 2-3 years old.

New trend toward dedicated funds vs. deal-by-deal from corporate balance sheet.

Key objective is innovation and support of strategy, not solely financial return.

Investment focus is support of core business first; few focus on adjacencies or areas new to the business.

Teams feature more venture experience, greater activism.

Terms have become more similar to traditional venture model, less sponsor-centric.

Challenges persist in migrating startup businesses into operations. CVCs potentially vulnerable to changes in management, economy.

Measurements of success are a work in progress as funds evolve.
CORPORATE VENTURE ACTION GROUP

Corporations and large health care enterprises have become dominant forces in the landscape of health care entrepreneurship and venture investment. **Companies in every health care sector have begun staking out major roles in the financing of innovative new companies.** This includes companies whose primary business is insurance, hospital and health system care delivery, pharmaceutical products, medical technology, retail health, consumer products and health care information technology. Additionally, corporations new to health care, such as general technology and product companies, have begun to invest in the sector as a path to the more than trillion dollar market it represents.

The Health Evolution Summit, with support from Cambia Health Solutions and HCA, Inc., convened a meeting of its Corporate Venture Action Group in Q2 2016; the CVAG is comprised of corporate venture capital leaders from the health care world.
HES also commissioned a concomitant survey of health care CVCs to gain a better understanding of the impetus for the rising commitment to venture investment, the evolving objectives for these programs, challenges and opportunities, and how the field has evolved from its last peak in 2006-2008.¹

This report summarizes what was learned through the survey and the CVAG meeting, as well as the opportunities and challenges for professionals in the field as it continues to evolve.

Please note that the CVCs included in this report do not include those that primarily invest in internally generated ideas, but rather those that invest primarily in external companies run by unaffiliated entrepreneurs.

¹26 distinct CVC entities participated in the survey and 23 distinct CVC entities attended the in-person HES CVC meeting. There was a significant, but not complete overlap between the two groups.
In 2015, CVC groups deployed more than $7.5 billion to the U.S. startup ecosystem through collective participation in 905 deals, accounting for 13 percent of all venture capital dollars deployed and participating in 21 percent of all venture capital deals, according to the PwC/National Venture Capital Association MoneyTree Report. The percentage of deals with CVC involvement has, according to NVCA, risen for nine straight quarters, reaching 23.5 percent of all venture capital deals during the first quarter of 2016, the highest level since before the 2008 crash when CVCs were involved in 24.1 percent of all deals. In Q1 2016, the most recent reporting period, CVCs invested 20.6 percent of the venture dollars, the strongest quarterly showing for CVC in the 21-year history of the NVCA’s MoneyTree Report.

The health care sector has surpassed the overall CVC marketplace as a driver in the financing of entrepreneurial innovation. In 2015, 24.4 percent of all biotech, services and medical technology deals had CVC participation, as compared to 21.8 percent for all segments. And in the digital health realm, which has emerged as a new sector in the past several years, CVCs represented 20 percent of the active investors between 2013-2015; these investors participated in 38 percent of all digital health venture transactions, according to Rick Beberman Consulting. Global Corporate Venturing estimates that CVCs made over $6.6 billion in health care-related venture investments in 2015.

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More Investors, More Diverse Field

The players driving these health care segment numbers are as diverse as can be. While pharmaceutical and medical technology companies have long been active in the CVC world, health systems, payers and health information technology firms have significantly ramped up their involvement, as have consumer product companies and those historically on the outskirts of the health care system. Many traditionally non-health care entities, such as Google, Qualcomm and Hearst, now have dedicated health care CVC activities. CB Insights now estimates that there are over 150 health care-focused CVCs, though their list is significantly understated given that it does not include most of the newer payer and health system CVC entities.

Notably, many of these entities are quite new. Of the CVCs responding to the HES survey, approximately 61 percent have been formed since 2008 and 27 percent were formed in the past two years. An interesting new trend among these investors is the creation of segregated funds. Where most CVCs historically invested deal-by-deal from the corporate balance sheet with board approval (or similar), there are many, including 10 in the CVAG, that now have dedicated funds with set financing amounts controlled by their investment teams rather than the whim of the board. Providence Health and GE Ventures, for instance, are new to the scene with $150 million and $100+ million funds, respectively. See the graphic below for the background and tenure of survey respondents.

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<th>Primary Business Area of Company</th>
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<th>Investment Experience of Company</th>
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1Based on survey respondents only 2Survey respondents were able to indicate multiple investment areas 3UPMC counted twice, once as payer, once as provider, given status as integrated delivery system
For the Love of Money or Innovation?

While 46 percent of the firms surveyed stated that the primary strategic purpose of their venture investment strategy is financial returns, virtually all of the CVAG members and survey respondents agreed that "spurring innovation," "supporting other innovation initiatives" and especially "obtaining strategic insight" were also key drivers. It was generally agreed that true financial discipline and an emphasis on returns is essential to success, but many felt that without an overall connection to the sponsor's corporate business strategy, the exercise would be in vain. As one group member put it, “The way we measure returns is wholistic: enterprise realization of value.” Refer to the graphic on the right for a summary of survey respondent’s primary investment goal.

Additionally, regardless of the primary business of the sponsoring entity, the primary area of investment interest noted by survey and CVAG members was in emerging technology, and particularly where HIT and digital health intersect with services, medical technology and personalized medicine. This is an evolution from earlier days in the health care strategic investment world where the primary investment focus was on businesses that were directly in line with the current core business focus: payers invested in payer start-ups, pharmaceutical companies in new molecules. Today everyone, it seems, is seeking ways to catapult their efforts ahead through new technological evolution. See the graphic on the next page for a summary of survey respondents’ investment areas of focus.

Notably, none of the payers reported investment strategies that include medical technology or genomics/personalized medicine, with the sole exception of UPMC, an integrated delivery system. Similarly, few payer-sponsored CVCs are interested in investing outside the U.S. (Cambia and UPMC are exceptions), while a majority of others queried report interest in both U.S. and international venture opportunities.

1Based on survey respondents only
"We look at it on a sliding scale... As a company gets further from the core, the requirement for financial returns vs. strategic value becomes stronger."

Risa Stack, General Manager, New Business Creation, GE Ventures

Core vs. Adjacent vs. White Space

Interestingly, a majority of survey respondents said their primary investment focus is on companies that enhance the core business of the sponsor. Just over one-third will invest in areas that are considered adjacencies and fewer yet in white space opportunities, suggesting that shorter term strategic return is a primary driver of CVC activity, rather than long-term business model evolution. Twenty-eight percent of survey respondents reported they require the investment target to be in a vendor/partner relationship with the sponsors and another 40 percent said while this is not required, it is somewhat expected. Similarly, 60 percent of respondents said a company business unit must support deals for them to be approved; the balance have autonomy to make investment decisions without such support. This demonstrates the commitment to core-related investing and also offers a short-term value proposition to the startup companies themselves, bringing them immediate value beyond just the equity investment.

1Based on survey respondents only
2Survey respondents were able to indicate multiple investment areas
HEALTHCARE CVC: A STUDY IN EVOLUTION

While CVCs have long been active on the health care scene, there are some notable changes over the period since the 2008 downturn, aside from the growth in the number of entities focused on the sector.

Direct Investing on the Rise

Traditionally many of the current CVC entities, especially the payers and health systems, invested primarily in stand-alone venture funds in order to finance startup-led innovation. Only a few health systems had any major CVC activity 10 years ago—Kaiser, Ascension and Summation being notable examples—while the rest were satisfied to serve as limited partners in other funds while making rare forays into direct investing. In contrast, the vast majority of health care corporations interested in investing in venture-stage companies are making direct investments into those companies today, and far fewer continue on as limited partners in external funds. Of those in the HES survey, 61 percent reported they are only making direct investments into companies at this time; the remainder is doing both direct investing and a limited number of funds. Many entities that historically did participate in external funds have now ceased to make new fund commitments, including Humana, Boston Scientific and Walgreens. This seems to be an increasing trend.
**No Longer Second Class Investors**

Once thought to be “second class investors,” CVCs have been actively enhancing the venture experience of their teams. Ninety-five percent of survey respondents reported teams that included prior venture capital experience or combinations of both health care operations and investment track records. There has been a notable migration of venture capital partners leaving stand-alone funds to work in the CVC world. For instance, McKesson, Cambia, Hearst and Medtronic all have investment teams led by individuals who had previously been partners at independent venture funds.

“Corporate venture can’t be the dumb money anymore… or else, when it gets tough, we won’t be around to provide the strategic value we promised.”

*Robert Coppedge, President, Direct Health Solutions, Cambia Health Solutions*
The New Rules of CVC Term Sheets

Historically, entrepreneurs tended to view CVCs as investors of last resort or as investors best kept for very late/growth stage participation. There was a pervasive conventional wisdom that CVCs would not be committed to long-term venture investing, would have an unfair advantage if exposed to sensitive company details through their information rights, and did not offer competitive terms, favoring instead structures that all but locked entrepreneurs out of other exit pathways. Today this view has changed significantly, as CVCs are well-accepted into the entrepreneurial and innovation communities and have demonstrated an interest in different approaches that are more entrepreneur-friendly.

Today we often see health care CVCs leading deals, which was also rare in times past when they tended only to join syndicates led by independent venture firms. The CVCs are typically willing to lead and price deals today, but also to syndicate with their own kind and eschew the onerous investment terms, such as rights of first refusal, rights of first offer, performance warrants or other special terms. Of the HES survey respondents, only 15 percent require such terms and all of the companies but two are comfortable playing the role of lead investor. In recognition of the long and challenging health care sales cycles, entrepreneurs often welcome the advantage of an investment that is accompanied by a revenue opportunity from those firms that require a customer relationship to make an equity commitment.

It is too early to tell whether a majority of new CVC funds will have the pervasive commitment to their programs to ensure their presence to support early investments with follow-on capital. Many believe that CVC funds are only as stable as the overall economy and that, in times of stock market stress, sponsors will pull back on the capital to fund these programs. This has happened in past times, most recently in the 2008 downturn when many CVC programs disappeared, at least temporarily. Yet with segregated funds and a belief that the venture capital program is essential to ongoing strategic innovation, it is possible that more of these funds will remain active and stable despite turbulent market dynamics. Only time will tell.

“To be successful, a corporate venture team needs to move faster than the speed of their parent organization. Venture speed is much faster than big company speed. And the calibration can be a challenge.”

Tom Rodgers, SVP & Managing Director, McKesson Ventures
New Players, New Playbooks
Clearly the world of health care CVC is still evolving. As companies dive headlong into major investment programs, they are also experimenting with all manner of innovation centers/foundries, accelerators, incubators, novel partnerships and other ways of bringing the entrepreneurial experience to life within their organizations. What appears clear is that for now, absent any major market turmoil that drives back a financial commitment to their programs, health care enterprises of all types have an appetite for venture investment. We are even seeing not-for-profit associations and patient-focused entities, such as the American Medical Association, the Juvenile Diabetes Research Foundation and others form investment programs. Continued diversification and broad scale commitment to venture capital programs are likely to drive a continued increase in the percentage of capital coming from CVC quarters for the foreseeable future.

Does Turnover Mean the Fund is Over?
When asked about what could disrupt this trajectory, survey respondents and group members acknowledge that, aside from external market downturns, a key linchpin in their stability is the stability of the management teams now in place at their organizations. CEO turnover, in particular, can bring into question an organization’s long-term commitment to venture capital programs.

Transformation Not Always Welcome
CVAG members also note, with some irony, that their efforts at bringing transformative innovation to their organizations can meet with significant resistance from those whose jobs may be affected by changing business models, and that this poses its own set of challenges to successful CVC outcomes. Another aspect of this internal challenge comes from the strain on internal resources created by the venture team seeking internal validation of ideas, support in due diligence and, especially, the time, money and resource-drain caused by excessive piloting of new ideas. This “pilot fatigue” is beginning to wear on some business unit operations of CVC sponsors, who wonder how to get their day jobs done while managing this seemingly ever-expanding set of trial programs in support of the venture initiative.

Valuations: A Double-Edged Sword
With many new CVC entities deploying large amounts of capital from 2012-2015, there is also a concern that the current trend toward declining valuations will create a negative shadow on their funds. Since most of these funds consider financial returns a key metric, a spate of write-downs and restructurings could render good ideas into bad investments, giving senior management a jaundiced view of this particular use of capital. On the other hand, several CVAG members identified this as a double-edged sword, as these entities can now also take advantage of the dropping valuations to cut better priced deals, taking advantage of the weaknesses of prior syndicates. This may be especially true where early CVC investors have very small funds that have not planned for follow-on capital support of their portfolio. As one group member put it, “We on the CVC side may turn out to be the vulture capitalists of tomorrow.”
Better Business Beyond the Bubble

HES survey and CVAG members have noted they are quite motivated and excited by the return to rational valuation and deal structuring noted above and that the reduced hype around quick returns will make them more effective at the heads-down work required to turn early investments into great exits. They also note that rapidly advancing changes in the health care system, particularly around reimbursement evolution, the move from hospital to home, the advent of sensors and the Internet of Things, and interoperability, will create even further opportunity for the companies they are backing today.

Making the CVC World a Better Place

Everyone in venture capital has embraced the now overused phrase “Making the World a Better Place!” but there are some major opportunities in front of us to enhance the success and value of CVC entities, both established and new.
Show Me the Money

While CVC teams have become far more experienced and comparable to their stand-alone venture capital firm counterparts, compensation remains a very different affair in the two segments. CVCs rarely align their team’s compensation with the success of their portfolio and, with rare exception, do not pay carried interest or offer the large upside potential available in those external funds. Of the companies responding to the HES survey, less than half had any compensation tied to portfolio performance; most were compensated in accordance with the company’s standard plan, which might include a corporate or individual bonus. As a result, it is sometimes more difficult to attract the best talent or, more often, to retain people for the long term when CVC staff see their independent venture colleagues reap windfalls on companies in which they have both invested. The CVC world has an opportunity to further upgrade by adopting compensation models that create parity with their stand-alone venture capital colleagues if they are going to remain competitive during those cycles when limited partner investment capital flows freely.

Success: An Elusive Concept

Lastly, there is a major opportunity to establish meaningful and standardized metrics for success in the CVC world. While stand-alone funds get judged and compared based on internal rates of return, cash-on-cash returns and other financial metrics, CVCs are rarely subject to the same level of financial scrutiny and are not included in the comparisons with their external fund peers. On the other hand, the returns they create for their sponsoring organizations are often more complex and potentially even more valuable if one considers the growth or efficiency opportunities created by adopting entrepreneur-led innovations. Of the CVCs in the HES survey, only three of the teams are measured based on financial return on investment alone; two are measured based on a combination of financial ROI and revenue creation; while the balance are measured based on a highly diverse and often unspecified set of metrics around deal flow creation, business opportunities created, and other ideas related to the perceived contribution to other strategic innovation initiatives. There is no standardized set of metrics for measuring CVC success even recognizing that sponsor companies enter into these programs with differing goals. Most CVAG members agree that some standard metrics should be adopted to help further the perceived and actual professionalization of the field and to recognize that multiple ways these entities create value for their sponsors beyond financial ROI.

“We are getting real value to the core business and also from exits, but you cannot sacrifice financial discipline as an investor in the pursuit of soft benefits to core operations.”

Will Morrow, Vice President Development/Special Assets, HCA, Inc.
While the role of health care CVCs is at a high point, it is entirely possible that this level of corporate commitment to venture capital will persist for some time and even continue to grow. CVCs have become an essential player in the overall venture investing landscape and are seeking ways to demonstrate value in both financial and strategic terms. By moving further toward industry best practices and expanding their already large networks, CVCs are seeing strong deal flow and delivering a unique proposition to entrepreneurs: reasonably priced capital plus real prospects for shorter term revenue acquisition. Given the number of new CVC entrants to the health care marketplace, it will be interesting to see whether the group can deliver on the promise of innovation expected by their sponsor organizations while balancing the internal and external challenges absent from stand-alone venture capital organizations.

LOOKING AHEAD

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