PART 3 OF A FOUR-PART SERIES

Innovation investing in health care: Keys to success

On the surface, clinical and administrative expertise and industry knowledge would appear to perfectly position health care organizations to underwrite startups developing new digital health solutions. Over the last decade, many health care organizations have tried this on their own and without the help of professional investors. Some larger and well-resourced organizations have succeeded, while others have learned how complex and demanding it is to develop a successful private-investment program. Meanwhile, many organizations have yet to pursue innovation investing due to the challenges involved.

So, what does it take to build a successful innovation investing program in health care? This article summarizes critical but frequently underappreciated performance drivers.

This is the third article in a four-part series about innovation investing in health care. In the first article, we covered the forces driving health care innovation and the ways health care companies are approaching the opportunity. In the second article, we offered a primer on private equity.

1 | Invest systematically

To succeed in private investing, it is essential to invest systematically, diversifying risk over time. For example, a private-equity fund with a systematic approach may invest in three or four companies per year over a four-year period. Newcomers, in contrast, often try to invest opportunistically and on a one-off basis. That sort of investing carries greater risk for two main reasons.

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First, there are many uncontrollable variables in private investing. In competitive markets, it is difficult for an organization to consistently underwrite strong performers with favorable terms. Some investments may generate a 30x return on capital, while others may result in a complete loss. Keep in mind that companies that eventually thrive may not deliver for their investors for various reasons, including if an investor overpays for the deal in the first place. A private-investment portfolio should be large and diversified enough to smooth out surprises and disappointments.

Second, even if you could consistently close attractive deals, investment performance varies widely depending on the prevailing market conditions. Timing the private markets is notoriously difficult — arguably more so than timing public markets. It is challenging to know if the price you're paying will be too high years into the future. This matters a lot, given the relatively large size and small number of deals that private investors underwrite. If an investor buys at the peak of a cycle and/or exits at the bottom, an investment may do poorly regardless of its inherent quality. This shows how critical investment expertise is — investors with extensive experience in underwriting private investments across market cycles have a better chance of investment success.

2 | Invest in what you know

Health care organizations have unique insight into the solutions that are needed but not currently being provided by the commercial market. Even for private-equity investments, health care leaders should heed Warren Buffett's admonition: "Don't invest in something you don't understand." Health care private-equity strategies enable health care organizations to use

Our Series on Health Care Innovation Investing

Through this series, the American Hospital Association and Concord are seeking to provide more information to hospitals and health care providers about innovation investing and deepen their understanding of the various private-equity strategies that are involved, including venture-capital, growth-equity and buyout strategies.

Topics in the series

PART 1 | **The Rise of Innovation Investing**
PART 2 | **Private-Equity Primer for Health Care Providers**
PART 3 | **Ingredients for Success in Health Care Innovation Investing**
PART 4 | **Growth-Equity Investing in Health Care**

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their unique perspectives to pursue investments that aren't just attractive from a financial perspective, but also may directly benefit their organizations and the broader field.

In practice, investing in what you know means working in partnership with private-equity firms and management teams who know the health care market — or at the very least are willing to learn it. It also means investing in funds and fund managers focused on hospital-based care and committed to improving it.

3 | Maintain a deep funnel

To invest systematically, you must develop a deep and consistent investment funnel. Doing this requires time, resources and extensive, deep relationships. The best private-investment sourcing programs leverage a large network of entrepreneurs, investment bankers and potential clients to review as many potential deals as possible.

Fortunately, all this legwork brings additional benefits. In addition to helping you identify potential investments, it allows you to understand the market and better parse opportunities. It also helps build a network of potential executives, board members and advisers to support your portfolio companies.

At the top of the investment funnel, organizations typically screen hundreds of companies, selecting a small proportion — perhaps 10% to 20% — for further engagement. At that point, rigorous evaluation comes into play. This due-diligence stage requires strong investing and industry expertise. You must identify which prospects have solid management teams, favorable financials and an attractive product with strong commercial potential. You need to evaluate the technology and regulatory risks and figure out which companies would be a good fit for your organization and its current portfolio mix.

4 | Leave room for value creation

At the bottom of the funnel, an investment firm may negotiate with one out of 10 companies with which it has engaged. Negotiating is not merely a matter of contacting the founders and writing a check. The best businesses have ample capital chasing them. The underwriting process is extremely competitive and more art than science. So how do you win a top-tier investment? Pricing is an obvious factor. Businesses, of course, want to raise capital at a favorable valuation. But it is a mistake for investors to try to compete strictly on price, because overpaying will hurt returns. The goal is to price a deal effectively to win it while leaving yourself enough opportunity to earn upside as the business continues to grow.

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Even more critical is the overall value-add that the investor offers after a deal is signed. Savvy entrepreneurs seek not just financing, but also the vital soft skills that will help the company prosper. As an investor, being able to add value lets you differentiate yourself and compete on service rather than price. You want to invest in areas where you have some real advantages that will directly drive outcomes.

5 | Commit for the long term

While pre-investment screening, due diligence and underwriting are demanding processes, the real work begins after the deal is signed. Top-tier investors remain committed to their portfolio companies and are closely involved in driving the strategies that will build value over time.

Strong investor-entrepreneur relationships can be a deciding factor for the success of a company. For example, during COVID-19, many private investments outperformed expectations, thanks to assistance from institutional private-equity partners with experience in previous crises. These partners helped entrepreneurs — many of whom otherwise would have faced the crisis alone — in areas like obtaining capital, preserving resources and adjusting their strategic priorities. Because companies across the portfolio were grappling with the same challenges, such as remote work, cybersecurity and health protocols, investors were able to share ideas and solutions to help entrepreneurs avoid getting stuck.

6 | Seek a partner or fly solo?

Investing in health care innovation may appear enticing given the high-profile success stories and the apparent synergies with clinical and administrative expertise. Health organizations interested in developing a private-investment program have a choice: They can partner with a professional manager or invest the time and resources to build on their own. Choosing to go it alone and pursue direct investing means having to develop the resources described in this article in-house. By partnering with a manager, on the other hand, health care organizations can tap into the expertise, networks, sourcing capabilities and general know-how that has been developed over many years of experience with a fund manager.

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When formulating your approach to private investing, you need to consider which strategies your organization is best-positioned to pursue. In Part 4 of this series, we provide a deeper dive into growth equity and why we feel it is such a strong fit for health care innovation. ●

General Disclosures: This material is provided for educational purposes only and should not be construed as investment advice or an offer or solicitation to buy or sell securities. Private equity investments are speculative, highly illiquid, involve a high degree of risk, have fees and expenses that could meaningfully reduce returns, and subject to the possibility of partial or total loss of fund capital; they are, therefore, intended for experienced and sophisticated long-term investors who can accept such risks. Investments with private equity sponsors typically are not transferable without consent of the sponsor, involve conflicts of interest, often involve leverage and limited partners have little to no ability to influence decisions.