CAUTION: CONSTRUCTION AHEAD -- HEALTHCARE ORGANIZATIONS USE PRIVATE EQUITY INVESTMENTS TO SUPPORT INNOVATION

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Executive Summary

As healthcare organizations look to drive down costs and improve care, they are increasingly looking at strategic private equity investments as another means of gaining access to new technology and efficiencies. Their efforts come amid a shifting landscape veering towards a fee-for-value model from the traditional fee-for-service one. This shift is fueling necessity for innovation as healthcare providers try to stay relevant and competitive. As they take the driver's seat, this journey into private equity is not without its detours. Given all the competing goals of healthcare organizations, pursuing these efficiencies can feel similar to roadwork on a well-traveled highway – everyone agrees the gains will be beneficial and the work is necessary, but it comes at a cost, causes potential disruption, and takes time and effort. This balancing act is a central issue for any healthcare provider looking to pursue these strategies. In this paper, we focus on how different organizations, at various points along the path of strategic private equity investing, are navigating the issue of governance and their approach to investing for innovation.

While each organization may enter into private equity with a different set of goals in mind, the benefits can be wide-ranging, as shown in the graphic below.

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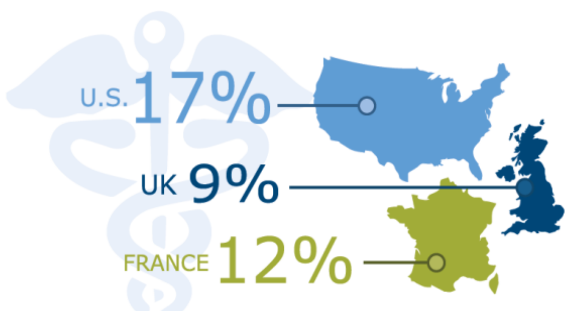
Much like road construction projects, private equity investment initiatives among healthcare organizations vary in size and scope -- with some organizations having substantial experience and others just beginning. Healthcare organizations have been gaining exposure to private equity by:

- Direct investments in private companies, often led by the strategy/ innovation team within a healthcare organization
- Becoming a strategic limited partner in a venture capital fund with active participation by the treasury/ investment office
- Pursuing a combination of both paths

Most healthcare institutions face similar challenges when making a strategic investment in a private equity program, even though there is little dispute that the US healthcare industry needs to change — it currently accounts for over 17% of the GDP of the United States, compared to approximately 12% for France and 9% in the United Kingdom[1] .



Healthcare GDP Percentages

A primary challenge is the complex coordination that is needed to straddle the two very separate worlds of medicine and finance in order to optimize outcome. To this end, a robust governance structure can help ensure the effective implementation of procedures and processes and the efficient monitoring of the performance of stated objectives.

NEPC's Takeaways

The relative infancy of the industry's initiatives into private equity make gaining a broader industry perspective difficult in terms of best practices. That said, we present the following takeaways from our conversations with some leading healthcare providers:

[1]Organization for Economic Cooperation and Development

1. **Strategic investments in innovation–including the role of private equity investments–are evolving and specific to each organization**: Execution strategies vary meaningfully, with approaches ranging from tentative, initial first steps, to bold and transformative initiatives.
2. **Strategic investing is a part of the broader innovation strategy**: Investing with outside organizations is one piece of the overall innovation solution designed to complement internal initiatives.
3. **Direct investing in companies is increasingly the focus for large healthcare systems**: Internal staff is driving this process with the goal of gaining access to technology, products and services aligned with organizational needs and priorities. Less emphasis is being placed on investments in private equity or venture capital funds to meet these needs.
4. **Senior management is very active in overseeing direct investments**: The clinical/ patient side of the business is driving investment priorities with treasury, legal and other areas acting in supporting roles.
5. **The role of the Board will likely increase over time**: Board involvement within healthcare organizations varies with the Board often approving a budget for direct investments or delegating the decision-making process to senior management. Board oversight will likely increase with the growing impact from direct investments.
6. **Measuring success is a work in progress**: Usually, organizations have a keen insight into the goals and objectives of their strategic investing program with a strong linkage to their mission; however, measuring success is consistently noted as a challenge, particularly for more subjective, non-financial metrics.
7. **Don't go it alone, leverage the experience of others**: A number of organizations said when seeking to find a specific solution, they prefer to undertake a direct investment in a company in partnership with other healthcare systems as it provides learning opportunities, synergies and helps avoid missteps.
8. **Commitment and coordination**: It is vital objectives are clearly defined, and both sides—medical and finance—are committed. Resources should be properly allocated and managed and key metrics should be identified early and measured and monitored.

Coordination can be complex, given the need to straddle the two very separate worlds of medicine and finance in order to optimize outcome. To this end, sound governance paves the way for a well thought-out evaluation process and implementation plan.

Strategic Private Equity Programs for Healthcare Systems

Each healthcare organization has its own unique story of how its strategic investment program came into being. For one organization, innovation has been part of its investing culture for the past three decades and has continued to evolve; for another, its strategic investing initiative was fueled by an increasing number of opportunities for which additional resources were needed to assess them.

The following describes some of the ways in which private equity investments can differ among participants in the healthcare industry:

Type of Strategic Investment
Generally speaking, there are two styles to strategic investing: the top-down and bottom-up approaches. The top-down method involves an investment in a private equity or venture fund with a healthcare focus where the private equity sponsor is viewed as a strategic partner and can provide access to companies that have technology that may be of interest. In this instance, the healthcare organization seeks to invest in a private equity fund with exposure to companies with compelling products such as medical devices, which are aligned with the priorities of the healthcare organization; the treasury/ investment office of the healthcare provider often serves as the point of contact with the private equity manager.

On the other hand, the bottom-up approach is an internally driven process where a healthcare provider evaluates investments with the goal of identifying and investing in a company that can solve a clinical problem or fulfill a patient need, for instance, technology that facilitates the remote diagnosis and treatment of patients through telemedicine. In this case, the clinical side of the health system is responsible for identifying the need, the innovation/ strategy group is responsible for selecting and evaluating companies, with the treasury/ investment office playing a supporting role. This approach has become increasingly popular with larger healthcare systems.

Scope of Strategic Investment
Our conversations with industry participants show that the scale of strategic investments differs broadly. For instance, one organization emphasized innovations in digital technology; another balanced its focus between direct investments in an array of companies specializing in information technology, medical devices and drugs, invested in healthcare private equity funds with reputed managers, and worked with its own venture capital and innovation teams to build businesses around its intellectual property and license its proprietary technology.

Some organizations expressed a preference for partnering with others to address common challenges, for instance, creating a tool to facilitate the scheduling of patient appointments and follow-ups. Working with others creates a more robust evaluation of the product or solution being tested and can help support acceptance of the innovation in the marketplace.

Source of Funding
Funding sources for these strategies are also varied. Investments using the top-down approach in private equity funds are most likely made through a portfolio or pool of assets within an established governance structure such as an investment committee, which oversees an endowment or operating pool.

For the bottom-up approach, internal investments are typically funded from the balance sheet or housed in a limited liability company or similar type of entity set up specifically for innovation-related initiatives; this entity is generally established with a set amount of capital and may be viewed as the equivalent of an internal private equity fund. As such, several of the healthcare systems we spoke to treated these direct investments as business decisions with those granting approval (usually a committee of five-to-10 individuals) including senior executives—such as the dean of the medical school, the chief executive officer, the chief financial officer, the chief medical officer and/ or the leader of the strategy or innovation team—in the decision-making process.

Also, one organization noted grants as a source of funds, while another organization self-funded its strategic investments through the monetization of its intellectual capital.

It is worth noting that a few healthcare organizations sponsor private equity funds that third parties can invest in. Also, the term ‘fund’ can be used loosely and can describe internal funds or an internal pool of capital set aside for strategic investments.

Managing and Monitoring a Program

Integral to the oversight of any strategic private equity program is the evaluation and measurement of its effectiveness. Some organizations are watching over a few strategic investments, while others may be tasked with oversight of multiple investments/ projects in different stages of completion.

Measuring **financial results** can be straightforward when investments in a private equity fund are covered by a well-established governance structure supported by treasury staff and overseen by an investment committee. In this instance, fund performance can be compared to peers and industry benchmarks. Monitoring performance of investments in individual companies that are on the healthcare provider’s balance sheet is less uniform and is, in some cases, a work in progress. In one instance, the responsibility for venture-related investments fell under the CFO, while another grouped its direct investments into a separate business unit. Many of these initiatives are new and, therefore, have varying degrees of financial impact on the healthcare provider, which can influence the amount of structure in place.

Monitoring **non-financial results** relative to objectives is seen as a greater challenge. One interesting approach was the use of scorecards, with each investment ranked on a scale of one to 10 with different metrics; this approach was accompanied by a stoplight grading system. Another method was to evaluate the success of direct equity investments using case studies. Measuring the results for projects in various stages of their life cycle was noted as a particular challenge, as well as balancing the amount of time and resources associated with one or a handful of investments.

Concerns around **potential conflicts of interest** also came up. One individual expressed a desire to act as a facilitator to introduce the clinical/ technical teams involved with solving a problem to a company or select companies that were in the best position to resolve the issue. However, the individual did not want to be part of the decision-making team greenlighting the investments because of a potential conflict of interest and felt being removed from the approval process made his/ her work easier with external firms. Some healthcare providers are also mulling the addition of an **independent, external party**—for instance, board members or a consultant with relevant experience—to add value.

In terms of **Board oversight**, involvement in direct investments may not always be a requirement, but it may often include negotiating observer rights to access a Board seat. Overall, there is greater emphasis on gaining some form of Board access for direct investments than being involved in the governance of private equity funds.

Benefits of Strategic Investments in Innovation

Private equity investments to spearhead innovation offer the potential for more than just financial returns to the healthcare industry. The organizations we spoke with sought to align these investments to their mission; benefits they seek to achieve include:

i. *Improved patient care and access to care, and enhanced customer engagement:* Every point of contact with the patient is reviewed to assess how technology can be applied to improve scheduling of meetings, the process of follow-ups after procedures, and enhance the billing process to improve ease.

ii. *Promoting professional growth of employees and the ability to recruit talent:* The best and brightest medical minds often want to perform research and are eager to see that research successfully applied. To this end, an innovation program within a healthcare system can serve as a platform to attract and retain talent.

iii. *Establishing equitable partnerships:* One healthcare industry participant pointed out that its organization is in a position to provide revenue to a start-up firm and also help refine or enhance the start-up firm’s product. In turn, the healthcare organization seeks to share in the company’s financial success through an equity position that recognizes its value in the partnership.

iv. *Gaining recognition and prowess:* Developing a reputation for being able to apply and integrate new technology can help attract groups with know-how that can seek out the organization, further cementing its leadership position.

v. *Financial growth and returns:* While the financial benefit is a consideration for all healthcare providers, there are different return expectations. For instance, one group felt a return premium should be realized on direct investments, given the risk factors associated with a single investment; others had a lower return threshold if they also enjoyed some of the other benefits mentioned earlier.

Conclusion

Healthcare organizations are increasingly undertaking strategic investments in private equity as the industry seeks innovative solutions to improve care and reduce costs. To this end, a typical portfolio of venture capital companies may have one or two very successful investments, a meaningful number of investments with modest positive or negative results, and several companies that will fail. It is important that strategic investments made by a healthcare system be supported by a process that can tilt the odds of success in their favor. Also, there will be inevitable roadblocks that organizations will run into from time to time, underscoring the need to adapt and learn from mistakes in order to optimize outcomes.

This paper is second in a series of write-ups on the growing trend among healthcare organizations to invest in private equity. Earlier this year, NEPC published *Thinking Ahead to Stay Ahead: Strategic Private Equity Investing in Healthcare.* Our next paper in this series will discuss how healthcare organizations can partner with private equity managers to support their innovation efforts.

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- Past performance is no guarantee of future results.

- All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

- The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.

- The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.

- This report contains summary information regarding the investment management approaches described herein but is not a complete description of the investment objectives, portfolio management and research that supports these approaches. This analysis does not constitute a recommendation to implement any of the aforementioned approaches.

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