PART 2 OF A FOUR-PART SERIES

Private-equity primer for health care organizations

The appetite and need to innovate in health care have never been greater. Private equity is playing an integral role in innovation by providing capital, strategic advice and operational know-how to companies from founder-led startups to large, professionalized health care organizations.

In this article, we summarize what health care providers need to know about private equity as they explore innovation investing. We define private equity as an asset class, describe how its underlying strategies differ from one another and explain how private-equity firms can help health care organizations innovate. We also offer an overview of how health care providers can evaluate prospective private-equity partners.

This is the second article in a four-part series on innovation investing in health care. In the first article, we covered the forces driving health care innovation and the ways health care organizations are approaching the opportunity.

Private equity, explained

Private equity simply refers to capital investments made into companies that are not publicly traded. The capital comes from a wide variety of entities, including companies, foundations, family offices, high-net-worth individuals and university endowments. Reputable private-equity firms offer more than just financing. Their professionals generally have deep experience in the

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Health care costs, accounting for approximately 20% of U.S. GDP, are a major force driving innovation in the field.

sectors in which they invest, and they share their expertise and network to help companies develop and innovate.

Health systems and payers are key components within the health care private-equity ecosystem. In addition to capital that they may invest directly or through private-equity funds, health systems are valuable investors as they can provide real-world proving grounds with ideas and feedback as the end-users for many products.

Private equity is an umbrella term that includes several substrategies. The main ones relevant to heath care innovation are venture capital, growth equity and leveraged buyouts.

• Venture capital

Venture capital is a private-equity strategy that focuses on early-stage businesses in their formative years. In addition to providing capital in return for a minority ownership stake in a business, venture-capital firms help guide founders and entrepreneurs in transforming a vision or idea into a marketable product or service. Venture capital is generally seed stage/early stage, and focused on the process of early commercialization.

Venture capital requires a unique skill set. Successful investors must have expertise in evaluating nascent ideas that could become successful enterprises. Because the products and services are generally unproven in the venture stage, venture capital entails greater risk,

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**

Growth-equity investors typically take a minority ownership stake in a company and help it attract talent, assemble an effective board and expand client services and sales capabilities.

and investors seek a higher long-term return for each underwritten opportunity.

- ## Growth equity

Growth-equity investors specialize in companies that have graduated from the venture-capital phase. At this stage, the innovation tends to be more advanced, and the company typically has a product or service that is ready for scaling.

Scaling a company is a challenging process that often lies outside the core skill set of founders, who may partner with a private-equity firm for its know-how, network and resources. Many founders remain closely involved in running the business, while others step aside in favor of professional management. Growth-equity investors typically take a minority ownership stake in a company and help it attract talent, assemble an effective board and expand client services and sales capabilities, among other focus areas.

In the growth stage, a private-equity firm's network can be a vital asset, bringing commercial relationships that accelerate the company's growth, shorten the sales cycle, lending credibility and advancing the innovation that is being pursued by the company.

- ## Buyout strategies

Buyout-oriented, private-equity firms generally focus on larger, more mature businesses. The strategy typically involves taking a controlling ownership stake (i.e., acquiring a greater-than 50% ownership stake) in companies and adding value by continuing to professionalize and grow the business.

Buyout firms often specialize in a certain strategy. For instance, some focus on restructuring businesses that are in distress. Others acquire businesses as part of a platform development strategy and execute on acquisitions to grow the business and harness synergies. Buyout firms often target profitable businesses that support the use of leverage, which can be an effective financing strategy to accelerate growth, improve margins or strengthen the balance sheet in an effort to create value in anticipation of a potential exit.

Choosing a private-equity partner

Private-equity firms have a lot to offer in health care innovation. It can be difficult for health care organizations to attract the investment talent needed to perform due diligence on innovative ideas and deliver support after the deal. Successful private-equity firms are more nimble, decisive and accustomed to working at the speed required by rapidly growing enterprises —

Private-equity firms are incentivized not only to earn profits for their stakeholders, but also to ensure that their portfolio companies and employees have a positive experience.

attributes that generally aren't easy to replicate in large health care organizations. Reputable private-equity firms are in business for the long term. They are incentivized not only to earn profits for their stakeholders, but also to ensure that their portfolio companies and employees have a positive experience. A private-equity firm's network and reputation are paramount to its success; without them, private-equity firms wouldn't be able to raise future capital for their next fund or build their network of executives, board directors and partners, which are critical to their value creation.

3 key questions to ask

To choose an appropriate private-equity partner, health care executives need to ensure that their organization's interests are aligned with those of the private-equity firm. Initial key questions to ask include:

1. **Does the firm have a strong reputation and a positive relationship with its portfolio companies?**
2. **Is it clearly in business for the long term? How does it balance earning money for its stakeholders and creating value?**
3. **What kind of outcomes has it achieved?**

A lot of work goes into successful health care innovation investing. It isn't just about writing a check and showing up at board meetings. The firm needs to sort through thousands of companies, vet them for the diamonds in the rough, compete effectively to be selected as the investor, structure the investment and support the company for years before the eventual investment exit.

To learn more about the key drivers of success in health care innovation investing, explore Part 3 in our series. ●

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.