
HEALTH PLAN WEEK

VC Firms See Potential in Health Services, But Investments Under Reform Are Risky

The health reform law — and the year leading up to its enactment — put a big chill on venture capital (VC) investments in the health services sector. But there appears to be at least some thawing, VC firms tell *HPW*. And that could be good news for health insurers if new technologies can help them reduce administrative costs, boost efficiencies and improve patient outcomes.

In the third quarter of 2010, venture capitalists plugged \$128 million into the health services sector — triple the amount invested in the previous quarter and 12 times the amount seen in the year-ago period, according to a quarterly survey of VC investment trends conducted by the National Venture Capital Association (NVCA) and PricewaterhouseCoopers. Just three of the 17 sectors cited by the study experienced investment increases between the second and third quarters. A NVCA spokesperson tells *HPW* that it's too early to know what caused the spike or whether it is sustainable. The percentage of VC dollars dedicated to businesses in the health services sector has been declining for the past several years, and made up less than 1% of total VC investments in 2009 (see chart, p. 2).

VC firms “are starting to look for new opportunities and maybe the time has finally come where they can make some money in this space,” says Tracy Leteroff, global managing partner in PWC’s Life Sciences Industry Services division. But, he warns, health services is one sector where VC firms have historically found it difficult to turn a profit. And while the reform law has created an enormous need for innovation, it’s nearly impossible to determine which types of companies will thrive.

David Brailer, M.D., Ph.D., who served as HHS’s first National Health Information Technology Coordinator, says VC firms are more reluctant to invest in companies that offer provider-based services — such as inventory management or disease management — due to a fear that reimbursement cuts in Medicare will mean hospitals and physician groups have less money to invest in technology. And tools that health insurers might use to manage populations or run disease management programs could be negatively affected by the reform law provision that requires health plans to maintain certain medical loss ratio (MLR) floors. Such

programs, he cautions, could wind up counting toward overhead rather than patient care. Moreover, while many innovations used by Medicare Advantage carriers (e.g., population management software or programs to improve the use of home health services) came from VC-backed companies, there is concern that MA companies will have less money to spend on technology due to reimbursement reductions called for by the reform law.

“If the Obama administration and Congress intentionally wanted to make it harder for investors to support innovative companies in the health care industry, they couldn’t be more effective than they are right now,” quips Brailer, now chairman of Health Evolution Partners, a San Francisco-based VC firm.

While VC firms that tend to “dabble” in health services are likely to tighten their purse strings, companies that know the nuances of the industry could see new opportunities due to the reform law, Brailer adds.

“I see a ton of opportunity,” says David Jones, chairman and managing director of Chrysalis Ventures, a Louisville, Ky.-based VC firm that invests in health care services and media firms.

‘Tremendous Interest’ in IT Companies

With calls for improved technology woven throughout the reform law, the most obvious area for growth within the health services sector is IT. “Venture funds right now are trying to figure out how to build a business around that...and determine whether funding might be available,” Leteroff tells *HPW*.

Lisa Suennen, a cofounder and managing member of Psilos Group, agrees that there is “tremendous interest” in IT among VC firms. She also agrees that it’s unclear how a company would be reimbursed for technologies such as patient telemonitoring, condition tracking or automated systems aimed at improving patient health. Psilos, a New York City-based health care-focused VC firm, invests in health care services, health care IT and medical technology.

Anecdotally, Suennen tells *HPW* that she’s seeing more business plans than she did a year ago. She’s also had numerous inquiries from VC firms that typically invest in biotechnology and medical devices that have

newfound interest in the health care IT sector. The medical technology sector has recently become less attractive to VC firms, partially because the reform law has imposed a 2.9% excise tax on the sale of medical devices beginning in 2013. Moreover, manufacturers will need to abide by new safety and comparative effectiveness research requirements. Those factors could drastically curtail investment in medical devices. Brailer agrees that investors seem to be fleeing the medical device sector, which he says is also the result of stricter regulatory actions by the FDA.

“Now that money is looking for new places to go and the place to go looks like health IT and services,” Suennen says.

But Brailer cautions that it can take years for a health IT company to become profitable. “They’re not going to become billion-dollar companies overnight. There’s still a very long slog to build up a real innovative health IT company.”

VC Investments Could Cut Insurer Costs

Here’s a look at several areas where VC companies see some investment potential:

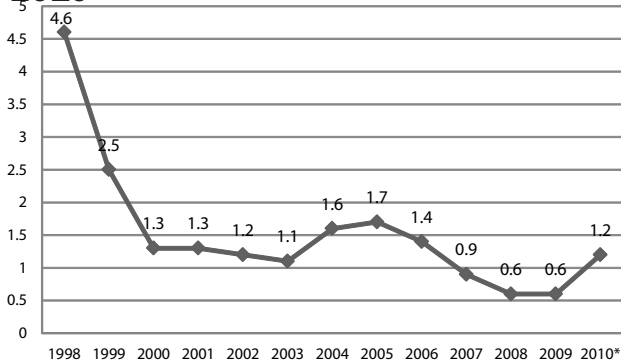
◆ **Automated sales:** A reform law provision that requires health insurers to maintain an 80% MLR for individual and small-group products could translate to opportunity for firms that can automate sales. Health insurers “are going to have to look much more aggressively at outsourcing, and there is real opportunity in that,” Jones says. “If you look at the individual and small-group plans, as much as 8% to 12% of the cost of the premium is going to agent commissions. With a 70% MLR, health plans can bear that cost, but when

you move it to 80%, that just won’t work.” A company in Chrysalis’ portfolio, Connecture, Inc., automates sales for health insurers through the carrier’s website “or whatever the health insurer’s front end is,” says Jones, who adds that the company’s pipeline of sales opportunities is “exploding.” Connecture has contracts with 11 of the top 20 health insurance companies and more than 40% of the nation’s Blues plans, he says. Moreover, Jones says the state insurance exchanges, which are slated to be operational by 2014, could offer even more opportunity for firms that automate sales.

◆ **Patient safety:** Another area with some potential is patient safety, particularly around innovations that can reduce medical errors, says Suennen. Such technology could become very important to hospitals as public and private payers reduce or prohibit reimbursement for hospital-acquired conditions (i.e., never events). CMS implemented its hospital-acquired condition reimbursement reduction methodology in 2008, and many health insurers made similar reimbursement adjustments to their hospital contracts. Early this year, the Blue Cross and Blue Shield Association said it implemented a systemwide policy that prohibits its licensees from reimbursing contracted hospitals for preventable errors.

◆ **The newly insured:** Many of the estimated 30 million people who are now uninsured don’t have a primary care physician, which prompts some of them to seek care at the emergency room. While an expanded Medicaid program and subsidized private insurance

Percentage of Venture Capital Dollars Spent on Health Services, 1998 to 2010



*Does not include fourth-quarter data

SOURCE: PricewaterhouseCoopers/National Venture Capital Association MoneyTree Report, October 2010.

Venture Capital Investments in Health Services Firms, 1998 to 2010

Year	Amount Spent on Health Services	Total Venture Capital Spending	Health Services Venture Capital Deals	Total Deals
1998	\$916.9 million	\$19.6 billion	154	3,694
1999	\$1.3 billion	\$51.4 billion	158	5,555
2000	\$1.3 billion	\$100.0 billion	165	7,979
2001	\$520.2 million	\$38.2 billion	107	4,546
2002	\$348.6 million	\$20.8 billion	71	3,158
2003	\$211.4 million	\$18.9 billion	70	2,991
2004	\$365.3 million	\$21.8 billion	59	3,146
2005	\$401.6 million	\$22.6 billion	67	3,194
2006	\$362.8 million	\$26.1 billion	50	3,748
2007	\$278.7 million	\$30.0 billion	55	4,029
2008	\$181.3 million	\$28.0 billion	52	4,014
2009	\$108.4 million	\$18.2 billion	37	2,916
2010*	\$196.0 million	\$16.7 billion	31	2,497

* Does not include fourth-quarter 2010 data.

SOURCE: PricewaterhouseCoopers/National Venture Capital Association MoneyTree Report, October 2010.

is expected to shrink that number dramatically beginning in 2014, the newly insured might not know how to find a provider. MyHealthDirect, Inc., a company in Chrysalis' portfolio, gathers information about available appointments — at physician offices and other clinical settings — and makes it available to patients and providers. A triage nurse at a hospital, for example, might determine that a patient would be better served in a doctor's office. The software helps the caregiver identify openings and book appointments. If, for example, the patient speaks only Spanish and doesn't have a car, the software would identify Spanish-speaking providers near the hospital or close to a bus line, Jones explains. The application, he says, is similar to OpenTable.com, an online restaurant reservation system.

◆ **Retirees:** Rather than investing in new firms, Psilos is spending most of its time right now on growing businesses already in its portfolio. One of them, California-based Extend Health, Inc., operates what Suennen describes as a private insurance exchange for retirees. The company, which works primarily with large employers and unions, helps employers transfer

their retirees from group coverage to private Medicare plans. It generates about \$40 million in annual revenues.

◆ **Medicaid enrollees:** Some VC firms are eyeing Medicaid as an area with some opportunity. But despite the expected increase in Medicaid enrollment of as much as 20 million beginning in 2014, there is concern that state budgets will place pressure on Medicaid companies to spend on services needed immediately, rather than investing in products or services that are going to improve member health, Brailer says.

◆ **Accountable care organizations:** Although there is a lot of interest in ACOs among VC firms, particularly with regulations due out soon from CMS outlining ACO requirements in Medicare, not much money is flowing because there isn't yet a clear model to invest in, says Brailer. "No one knows what an ACO is going to look like."

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