

Challenging Private Equity's Role in Healthcare Innovation

(April 22, 2014 ZUERICH) This month, INSEAD Alums challenged a panel of healthcare industry executives, institutional investors, board members, and venture capital professionals about private equity's continued role in healthcare. Polls taken by moderator Arul Ramadurai (INSEAD J'05) at the beginning of the panel discussion, revealed divided views about a growing role for PE in healthcare. Skepticism about PE's role is driven by the ways that pharmaceutical and biotechnology markets have evolved of late. It seems like the "golden days" of healthcare's more predictable private equity returns are a thing of the past. Write downs have been more common than write ups, especially in biotech. The cost of R&D has ratcheted upwards, along with clinical, regulatory and approval-related costs, and yet drug prices are falling as a result of growing pressure from care providers and insurers, not to mention the regulatory and reimbursement hurdles that are emerging.

These trends are changing the world for investors and innovators, according to Juergen Raths, (former CEO of Arpida and Correveo). "It has added complexity to a sector that was even in the golden days a lucky gamble for investors," said Raths.



The panelists (from l to r): Alain Nicod, [INSEAD MBA '83], Managing Partner, VI Partners Juergen Raths, Executive Insight; Arul Ramadurai [INSEAD MBA J'05] CEO of ExcellGene SA; Thomas Rinderknecht, Badertscher Rechtsanwälte AG, and Romain Boichat, Senior Vice-President, Genolier Swiss Medical Network SA

The PE industry has also changed, but it is not clear if it has kept pace. "Private equity is much more organized and driven by large funds now. Twenty years ago it was much more private. But the challenges for PE remain the same. There is a constant tension between the two acronyms IRR and R&D," said Thomas Rinderknecht, a board member of Basilea and several other Swiss life science companies.

In an attempt to avoid such tensions, some investors are taking a longer term view to still benefit from Healthcare industry mega-trends, such as higher demand for medical services by aging baby boomers in developed markets and hospital privatization. They are doing it by investing in medical real estate and clinics. "It may initially involve losses like you see in private equity's biotech or pharma investments, during the consolidation and optimization phase, but the long term returns are more predictable," said Romain Boichat of Genolier Swiss Medical Network (GSMN), a subsidiary of publicly-traded AEVIS Holding, which has been acquiring hospitals in Switzerland to become the owner of the second largest group of private clinics here. Boichat says it is an investment thesis

proven in neighboring Germany where privatization is more advanced. Other examples of the trend are Fresenius and Hirslanden, groups that have become multi-billion dollar medical networks.

Despite the challenges, a significant amount of capital is pursuing healthcare acquisitions, creating greater competition and driving up valuations. Some PE funds are acquiring business that will give them lower returns just to be able to deploy capital, according to Arul Ramadurai, CEO of ExcellGene SA (pictured left), who moderated the event on behalf of the INSEAD Alumni Association Switzerland. Others are eyeing higher returns by taking on more risk, investing in companies that have real regulatory, reimbursement or technology risks.



The stiffer competition is noticeable in the US market but also in Switzerland. “It has gone from the happy few here back in the nineties, when we could invest in whatever we wanted, to a more competitive environment with US and UK investment groups sourcing deals here,” said

Swiss venture capitalist, Alain Nicod.

A Troubled Ecosystem

In favor of PE’s continuing role (regardless of the competition) is an improvement in divestment opportunities. On the exit front, activity has picked up again in the past two years and will remain good for at least another two, according to Nicod. But there are some worrying trends. Pharma was traditionally willing to acquire a biotech at the beginning of Phase III trials, which happily provide an exit to early stage investors. In the meantime, acquirers have been waiting until the end of the Phase III trials.

“We had quite a few years of a buyers’ market. The ecosystem was not working that well. Acquirers now are rarely making any moves until the results of Phase IIA and Phase IIB and even Phase III are in hand,” said Thomas Rinderknecht. When that happens, it creates a gap, and the need to support with risk capital an expensive R&D phase, as well as extending the time before returns can be reaped.

In other words, venture capital investors have to wait longer than expected for an exit. “It causes biotechs and their backers to do what they are not really meant to do. Founders who are research-oriented are forced to do development and venture capital investors get pushed to put in a lot more than they had expected, or they have to expand the investor circle and risk getting diluted,” said Nicod.

Raths agreed on this particular challenge, pointing out that the skills and business models are quite different, not to mention the risk profiles. Drug discovery is different from clinical development, which in turn is very different from building a brand and operating a commercialization business, traditionally the territory of Big Pharma. “Each of these types of companies has a risk distribution inherent to the type of business. Investors have to understand that,” said Raths.



With these trends freshly described by the panel, Swiss venture capital investor, Chandra Leo (INSEAD ’02), Partner, HBM Bioventures (pictured left), spoke up from the audience, asking the panel why not eschew biotech and pharma targets, in favor of investing in consumer healthcare sub-segments, which have a shorter R&D cycle and are less regulated? “Over the counter drugs and other consumer healthcare have fewer hurdles, no doubt. The capital outlays are smaller and affordable. Consumer gave us one of the best multiples realized so

far,” responded Nicod. But he cautioned that it would be unwise to rely only on consumer products. “There is no guarantee that it will work every time. Besides, biotech may have given us a lot of losses, but it is actually a biotech venture in our portfolio, a company called Moderna, based in Boston, that has a breakthrough platform for developing healing proteins. It is potentially going to give us our best return ever, if it continues to do well.”

Private equity has to keep pace with the shifts in medical science technology and business dynamics to have even a modicum of success in healthcare, according to the panelists. “PE has made a lot of money with financial engineering, but that is a not a strategy of any relevance in healthcare, particularly in biotechnology. What is required from PE professionals is that they understand the path to exit and have the specialized knowledge to manage the many risks and setbacks that can occur in biotech,” said Juergen Raths.

Raths called for specialization amongst investors, particularly an ability to assess the underlying business models, potential income sources, and related risk/returns for the various types of biotech and pharma businesses that are seeking capital. “If the risk components are addressed by knowledgeable management teams, costs can be managed, and returns will live up to their potential. It will be a success. And then a bit of luck will always be part of it too,” said Raths.

“In biotech R&D, fifty percent is luck,” agreed Thomas Rinderknecht. But saying that luck is involved is not the same as saying it is purely a gamble: “You can do a lot as a team to be on the winning side of that 50 percent. “Human excellence is driving success, excellent people with experience, and intelligent and outstanding scientists, especially in biotech,” he said.

One point that all agreed on was that there is a direct correlation between a high level of board involvement and failure. Nicod suggested that investors “remain humble” in their board participation, particularly if they are not scientists themselves.

Current Opportunities for PE in Healthcare

Besides making founders wealthy and providing above-average returns to institutional investors, one of the roles granted PE and venture capital, not just in healthcare, but in our society as a whole has been to foster academic and industrial innovation, enabling its adoption and spreading its benefits. The panelists talked about alternatives to having PE in this role, such as public spending, grant-making organizations, and Big Pharma’s deep pockets for internal R&D.

The conclusion was that public funds are not sufficient or savvy enough for pharmaceutical and health technologies, and the established pharmaceutical industry does not have a tremendous track record in innovating, especially once it becomes “Big Pharma”.



“Is private equity doing any better than Big Pharma at fostering innovation, particularly with its IRR and the track record of losses in biotech?” asked Dorothee Deuring (INSEAD ‘96D), UBS, Corporate Finance Advisor (pictured left), from the floor, adding that “investors are not charitable organizations”.

“Selecting the right people, being specialized, with an ability to select the right targets, and business models are all part of PE’s valuable resource,” responded Ramadurai, turning the question over to Juergen Raths. “Ratios for biotech have only been poor in recent times. These things are cyclical and are dependent on major breakthroughs in science and technology. There was a golden time – who would not have wanted to invest along with the venture capitalists in Amgen? The ultimate value is always in innovation but it may not all be in prescription drugs,” said Raths.

“There is a much wider scope for private equity in healthcare than those discussed so far,” agreed Rinderknecht, encouraging investors to go beyond mainstream biotechnology and pharmaceuticals

and look at technologies, therapies and services associated with the prevention of disease. His discourse was interrupted by Romain Boichat, inserting a bit of skeptical humor. “Is this one for private equity? Isn’t it already solved? It’s pretty clear what can be done to prevent disease. Exercise, eat right, and moderate smoking and drinking activities,” said Boichat.

“There are still plenty of R&D problems to solve,” continued Rinderknecht. For example, the intertwined issue of patient compliance and patient profiling, “It is a huge one, and ways must be found to stem the losses incurred due to a mismatch between treatments and patient profiles and between responders and non-responders to therapies. There’s also a need for general technology to advance in clinical studies. You can do the soundest science, but if you do not have the right genome profile for your drug, most of it will just be wasted,” he said.

The discussion was drawn to a close with another set of polls, asking the same questions posed at the beginning. A show of hands acknowledged some change in sentiment. There is indeed still a role for private equity in healthcare, according to the Alums and guest who listened to the panel discussion. It could very well be that sentiment was swayed by Alain Nicod’s candid closing remarks, which drew a round of spontaneous applause. “Venture capital has a role to play in fostering innovation. Yes, the numbers are quite small if you compare the total venture capital pool in Switzerland to the R&D budgets of Roche and Novartis, and the risk reward may not be the best, but I think it is part of our collective responsibility. I went to a great school, had a good education and I have had some means. Wouldn’t you rather be active in venture capital than spend your days trying to squeeze out 2 basis points on a transaction and shuffle paper? I have dedicated my life to it [venture capital] and consider it meaningful work,” said Nicod.

A Note from the INSEAD Alumni Association Switzerland: *This report contains only a snapshot of the informative and passionate interchange that took place on April 2, 2014 at the historical Zunfthaus zur Waag in Zürich. The event offered the audience of forty five INSEAD Alumni Association members and their special guests the kind of insider knowledge, delivered with a level of sincerity and candor, which is hard to find at most other private equity industry or healthcare investors events. You are invited to attend the next event in this series on May 15 in Geneva with Marvella Sullivan, Global Head M&A Novartis; Michele Ollier, LifeSciences, Partner, Index Ventures and Jean-Philippe Rosat, CEO, Aleva NeuroTherapeutics, for a panel discussion moderated by Laurence Capron, INSEAD professor and author of *Build, Borrow, Buy* (More details [here](#)). It is followed by another Zurich event on June 5, 2014 where executives from Oetker Collection, LVMH Hotels, Peninsula Hotels, CBRE and more will share their views and experience on the latest trends in Hotel Property Investment (More details [here](#)).*

