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Excited about investing in a promising early-stage healthcare company?

As a VC, if you start thinking about commercialization until after you've made the investment, then you'll need a lot more than just good luck to make these investments generate a good return.

By VISHAL JAIN

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2021 was the largest healthcare fundraising year ever.

Despite the market tumult, global funding to private companies clocked in at $61 billion in February, the fourth hit above the $60 billion mark in the last 12 months. What's more, close to $3 billion was invested globally at seed last month, and startup investors spent another $18 billion at the early stage and just over $40 billion at the later stage and technology-growth stage, according to Crunchbase data.

Healthcare funding set new records. Venture fundraising hit new heights. New venture funds allocated to healthcare almost doubled 2020's record. Investment into companies exceeded $86 billion–a 30% jump. Every sector hit new highs, punctuated by a 157% increase in healthtech investment.

The rapid pace, coupled with increasingly quick turnaround from first venture investment to exit, has propelled firms to deploy capital faster than ever, and the frothy market has firms increasing fund size and doubling down on perceived portfolio winners. What's not to be excited about?

Wait … not so fast.

Yes, healthcare investment has more than doubled every two years since 2017. From $16 billion to $34 billion to $86 billion in 2021; but 2021 saw a decrease in investment in 2H and Biopharma saw the most precipitous drop with a 24% decrease from Q1 to Q2, 17% from Q2 to Q3 and 9% from Q3 to Q4.

Exuberance is natural when the space is active and might be a safe haven when interest rates rise, but venture investing is a long-term business. The key exit drivers go far beyond valuation and current market dynamics.

For most venture investments the exit is through an IPO (highly dependent on macroeconomics and driven by interest rates and geopolitical dynamics that are uncontrollable), or through a strategic sale with features like a licensing deal, milestone-based payments, or indication-specific structures.

The large wins in the healthcare sector are attractive. But just one biotech being acquired for a handsome amount, doesn't mean the next company targeting that same indication will be.

Commercialization is key

Many parameters can affect whether your investment will lead to a successful exit. Most important is strong commercialization; a function of core technology, management and TAM, and also regulatory, pricing, marketing, and other considerations. A strong handle on these key parameters, substantially increases the likelihood of an exit.

One healthcare area that garners investor and buyer interest is oncology; it's easy to make an impression with promising pre-clinical and clinical data. But things can go wrong. Clinical trials are increasingly complex, and oncology trials are especially vulnerable to enrollment challenges, protocol deviations, and burgeoning amounts of data that add months to the timelines.

Three phases in oncology trials can take 14 to 18 months longer each, lasting almost 12 years compared to eight years for non-oncology trials. Oncology trials typically involve more countries and investigative sites and require more patient visits. What's more, the number of investigational oncology drugs has nearly quadrupled since 2000, from 421 to 1,489 trials in 2021.

A shift toward precision medicine, new molecular targets, and improvements in genetic sequencing technologies, makes fitting selective patient criteria difficult. Especially challenging in phase 2; only 14 percent of participants screened enroll and eventually complete the trial compared to 54 percent in non-oncology trials.

Even when enrollment hurdles are overcome, activities are completed in parallel, and regulatory reviews are shortened, it is a challenge to find the right buyer. Of the 249 healthcare (not just biopharma) M&A deals over $1 billion announced in the US and EU since 2017, only 19 were for targets with less than $25 million in revenues. More than half of those deals were done by just 4 Big Pharma companies. Unless the big companies are interested, it's a challenge to find an exit for limited partners. Over 2,500 deals were done in the healthcare sector in 2021, but it is anyone's guess how many will see a reasonable exit. Add the 2020 and 2019 vintages, and the problem expands.

sdrawkcab kroW (Work backwards)

Working backwards helps to evaluate the likelihood of a given Seed or Series A investment being "commercializable." A reasonable time frame is around 5 years for most biopharma companies and the potential comes from straight revenues (HealthTech or diagnostic companies), from licensing, or through a strategic sale or IPO.

M&A is defined globally as all-private, venture-backed deals with at least $75M upfront. The current public markets further demonstrate the importance of revenue as an indicator for commercialization. For the best performing healthcare companies–defined in US and EU as at least 50% price increase since the pandemic and $1 billion+ market cap–the median revenue growth rate was 33% and the growth rate was over 58% for the top 10. The worst performing companies–the ones with at least 50% drop in price–the median revenue growth rate was 10.6% and the growth rate was -17.5% for the worst 10.

Applying this quick performance assessment quickly identifies the best prospects for commercialization, the offerings that present the highest likelihood for a successful exit.

The key is to focus on the unmet need that is indeed unmet. Marginal improvements like 2-month OSR (overall survival rate) for cancer patients, 10% lower cost for your next hospital equipment, or your next weight-loss health app can sound interesting at the outset, but you need to ensure you have the physician buy-in or pharma buy-in for your cancer drug; you have a big MedTech company ready to deploy your equipment; and a large distribution platform willing to accept your app on their platform. And if these don't exist, you need to work harder to get them in place or have visibility on when and how you can onboard them. As a VC, if you start thinking about commercialization until after you've made the investment, then you'll need a lot more than just good luck to make these investments generate a good return.

Vishal Jain

Vishal Jain, managing partner at Eckuity, has 20 years of venture capital, investment banking and management consulting experience in many industries including medical devices, biopharma and technology. Vishal has executed over $100 billion in M&A transactions and has raised debt and equity capital and has provided strategic advice to large as well as small corporations with respect to M&A, public offerings & capital markets, divestitures and spin-offs. Vishal has gained an in-depth knowledge of the complex healthcare ecosystem in the United States. He has worked on transactions across multiple sub-sectors of healthcare including large pharma, biotechnology, diagnostics, healthcare instruments and devices, healthcare services and healthcare IT.

Vishal has a degree in Electronics Engineering from the National Institute of Technology in India and an MBA from Cornell University.

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