# VIEW

## Update on Healthcare Venture Capital

Over the last decade, the healthcare industry has experienced significant innovation, reform and expansion, which in turn has created an environment and engine for continued business formation and growth. Venture capital investors thrive in such environments and healthcare, broadly speaking, is one of the most dynamic sectors in venture capital investing.

### *Industry Sub-Sectors*

The healthcare venture capital industry can be classified into several sub-sectors:

- **Biotechnology and Pharmaceuticals** - Companies that participate in drug (small molecules and biologics) discovery, production, and commercialization.
- **Medical Devices** - These include companies that create, manufacture, or distribute medical instruments, implants, or other related items that are intended for use in the diagnosis or treatment of disease and other health conditions.
- **Healthcare Providers and Services** - Organizations that provide preventive, curative, promotional or rehabilitative healthcare services in a systematic way to individuals, families or communities. This category also includes healthcare administration services as well as insurance providers.
- **Health Care Information Technology** - Companies involved in the application of information processing involving computer hardware, networks, and software that deal with the storage, analysis, retrieval, sharing, and other use of health care information.
- **Diagnostics** - Companies that participate in the investigation and identification of diseases through techniques such as medical imaging, molecular diagnostics, biopsies, and other types of tests.

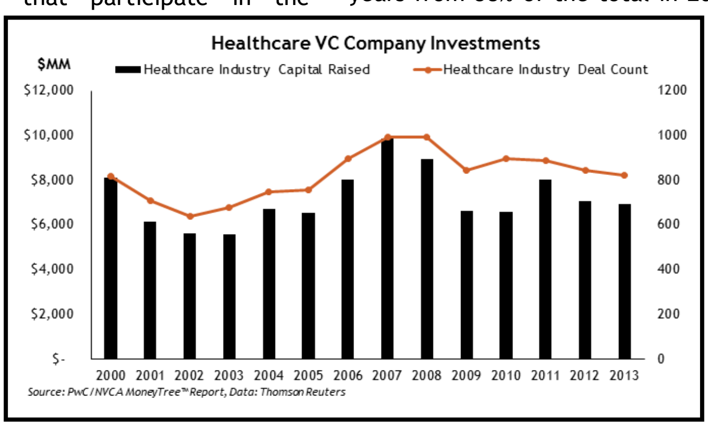
Each of these sub-sectors is affected differently by the macro-environment in ways that can be leveraged by astute investors. The demand characteristics for each sub-sector is driven by a unique combination of the aging US demographics, advances in medical care and technology, and changes to the current regulatory environment. The profitability of individual companies is largely dependent on their ability to create innovative and disruptive technologies, while maintaining efficient operations.

### *Fund Raising*

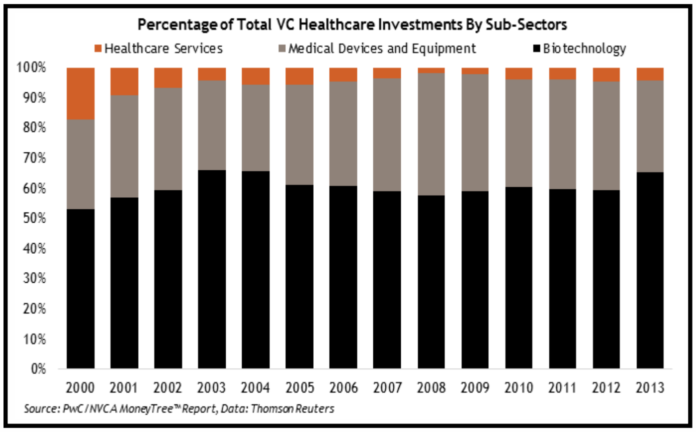
The venture capital healthcare industry has faced a decrease in available funding in recent years. After reaching a peak of nearly $10 billion in 2007, healthcare venture capital financing has seen a significant correction, dropping by nearly 30% to $7 billion in 2013. This drop is not simply a consequence of the 2008 financial crisis but represents a change in investor appetite for the sector, as healthcare's share of total venture capital financing fell from 31% to 24% between 2007 and 2013.

This observation of reduced capital flows to the healthcare VC space is echoed by the fact that venture firms have struggled to raise healthcare specific funds. According to a 2013 report by Silicon Valley Bank, between 2005 and 2008 there were 99 healthcare dedicated venture capital funds actively investing capital. From 2009 to 2012 the number dropped by 34% to 65 active funds. We believe the current number of funds is even lower as there are several funds that exist primarily to manage out their existing portfolios and are unlikely to raise a follow-on pool of capital.

While the absolute amount of capital invested has dropped across all of healthcare, the pain has been felt unevenly across sub-sectors. The share of healthcare venture capital dollars going to biotechnology has increased over the last five years from 58% of the total in 2008 to 65% in 2013 and this likely reflects biotechnology's attractiveness relative to the other sub-sectors. Medical devices, on the other hand, have experienced a drop from 41% to 30% of the total in the same time period, likely a reflection of the challenges in generating returns in this sub-



sector, driven in some part by changes in the Food and Drug Administration (FDA) rules regarding device approvals. Due to increased scrutiny of the FDA's accelerated 510(k) registration process, device manufacturers are now more likely to face the far more stringent premarket approval process (PMA) when bringing a new deceive to market. The healthcare services sub-sector has seen a relative increase in funding, albeit from a low level that followed a severe correction in the early 2000s. We believe that the renewed interest in the services space is due to the opportunities provided by the Affordable Care Act, as well as favorable US demographic trends.




## *Performance*

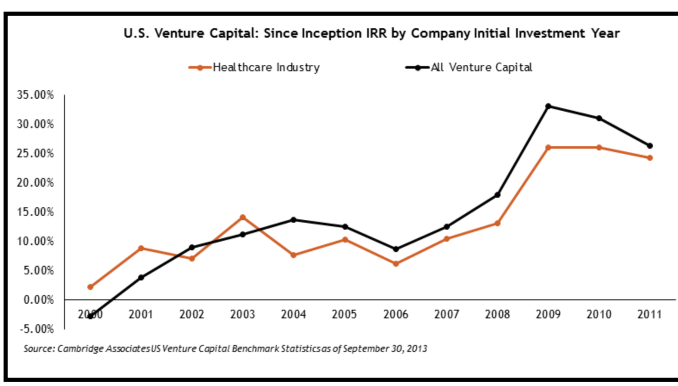
The main driver of the drop in healthcare venture capital investing has been historical performance, which has trailed that of other areas within venture capital, including information technology. The underperformance can be attributed to several factors that include: a difficult FDA approval regime that has lengthened the investment cycle for drugs and devices; a perception, connected to the aforementioned FDA issues, that it takes significant capital to build healthcare companies but they remain subject to binary outcome risk with abrupt evaporation of value if they land on the wrong side of an FDA decision; payer and managed care pressures from the drive to contain costs in healthcare; and the fact that many of the major diseases with large groups of affected individuals – e.g. hypertension, hypercholesterolemia, peptic ulcer disease – now have effective generic treatments available at fractions of the cost of their name brand counterparts, making it more difficult to develop blockbuster drugs.

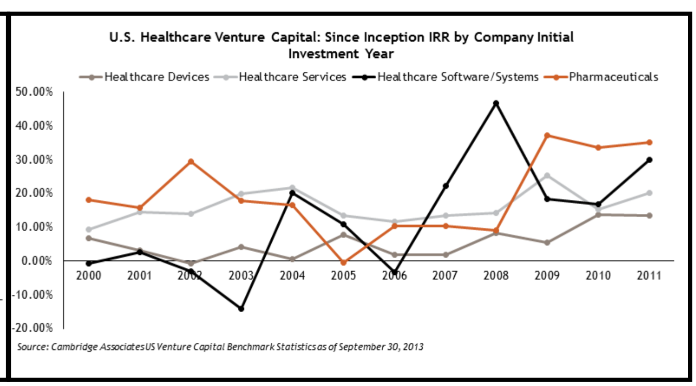
Healthcare's collective relative underperformance masks the fact that some managers have been able to source and develop lucrative companies within the industry's subgroups. For example, investments in venture-backed pharmaceutical companies (as a sub-set of overall healthcare) produced substantial gains in 2009, 2010, and 2011 of 37%, 34%, 35% respectively, besting the average for the broader venture capital market in each year according to data provided by Cambridge Associates. Healthcare Software/Systems outperformed similarly in 2008. Additionally, as in other types of venture capital, there is wide dispersion between the bottom and top performers in healthcare with the latter group able to produce results that rival the performance of many of the top information technology funds.

## *Signs of Revitalization*

Many market trends point to a stronger US healthcare investment opportunity going forward. For starters, healthcare venture capital firms have adapted by placing more emphasis on areas of greater unmet need such as cancer and severe metabolic diseases. They have also begun to drive the utilization of discoveries made in the genomics revolution, targeting rare diseases with genetic abnormalities where successful treatments can be life altering and garner stronger reimbursements. Firms that focus on devices have also adopted to the more stringent FDA requirements. This added barrier to entry should make devices a more exclusive area, and potentially more rewarding for future investments. The reduction in the number of viable firms has also created a situation where the "haves" are better able to target the best opportunities and the best teams, with a lower risk of copycat companies diluting returns.

The public market environment has also been quite favorable, despite a recent swoon towards the end of the first quarter of 2014. 2013 was a robust year for the US IPO market, with 220 different companies going public.



Healthcare was a huge contributor to this total with 54 offerings, the most since 2000 and more than four times the 2012 total of 12 offerings. Of the 54 healthcare firms that went public, the average return was 50.2% during the year. Only nine ended the year below issue price, according to an analysis by Renaissance Capital. Notable venture backed healthcare offerings included Veeva Systems, a provider of industry-specific cloud-based software solutions for the life sciences industry, and OncoMed Pharmaceuticals, which focuses on discovering and developing monoclonal antibody therapeutics targeting cancer stem cells.

Despite the surge in IPOs, acquisitions continue to be the most popular exit path for VC-backed healthcare companies. According to Health Care M&A News, 2012 was the most active year for healthcare acquisitions on record with 1,091 deals representing $143.7 billion in capital. Although 2013 showed fewer deals announced (1,002), the amount paid was significantly higher with a total of $163.5 billion committed. This suggests that even though acquirers are being more selective with their capital, they are still willing to pay a premium for top quality deals. This is not surprising as many large pharmaceutical companies have significantly pruned their research and development staff and expenses, and seem to view smaller biotechnology companies, many VC-backed, as “outsourced R&D.” With the predicted patent cliff of Big Pharma now a current reality, and with many of the larger biotechnology companies aggressively participating in acquisitions, we expect this favorable M&A environment to continue.

### *Sustainability and the Future*

Several underlying factors lead us to believe that the recent positive trends in healthcare are sustainable. One major trend is demographics. Research by the Centers for Medicare and Medicaid Services shows that healthcare spending is projected to grow at an average rate of 5.8 percent from 2012-2022, 1.0 percentage point faster than expected average annual growth in the GDP. It also states that at a projected sum of $5 trillion dollars, healthcare spending will be 19.9 percent of GDP by 2022. A large part of this anticipated growth is driven by population growth and the aging of America.

Furthermore, the advancement in medical innovations, especially the fruits from deciphering the human genome, is only in its early chapters. According to the National Human Genome Research Institute, it cost $100 million to sequence a genome in 2000. That cost has been cut exponentially in just the last five years and is now below $10,000. As gene-based drugs, testing and services have gained traction, investors have taken note. In a report issued by venture capital database PitchBook, it is stated that capital invested in genomics-related companies roughly tripled from 2008 to 2012, expanding from $269 million to $760 million. We are optimistic that over the next few years, several diseases, including certain cancers and inherited genetic diseases, will be treated by manipulation of genomic material in-vivo or ex-vivo, a paradigm shift in the annals of therapeutics akin to the introduction of penicillin to treat infections.

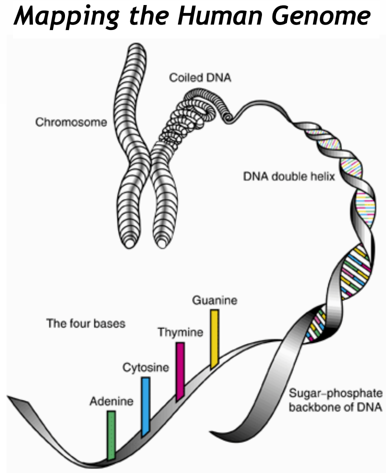
The US regulatory environment could also prove to be a catalyst for the healthcare industry. 2012 saw the most applications and approvals of New Molecular Entities (a new drug that has never been approved by the FDA or marketed in the US) in over 15 years with 39 approvals and 41 applications. It is our observation that the degree of tightness in the FDA approval process swings like a pendulum between an extreme focus on risk or on potential benefits. This swing is often driven by events like the AIDS epidemic in the 1990s – which drove an increased tolerance for risk given the huge unmet need – or the Vioxx recall in the 2000s, which drove the pendulum in the other direction. It appears to us that the pendulum is now well-balanced between these two extremes and we believe this augurs well for the industry.

Finally, the potential effects of the landmark regulatory overhaul known as the Affordable Care Act (ACA) have only begun to surface. The changes in the regulatory environment brought by the ACA will likely create opportunity for services that reduce costs or manage resources more efficiently; on the other hand, it may adversely impact the pricing power of pharmaceutical companies, given the streamlining of care and the increased power of the counterparties they negotiate with, as more providers bear risk for costs through accountable care organizations and other integrated healthcare delivery models. According to the Centers for Medicare and Medicaid Services, by 2022 the ACA is projected to reduce the number of uninsured people by 30 million, add approximately 0.1 percentage-point to average annual health spending growth over the full projection period, and increase cumulative health spending by roughly $621 billion. The revolution in healthcare delivery from this Act will provide opportunities (as well as challenges) for all areas of healthcare investing.

### *Fairview Position*

Fairview continues to invest in healthcare through dedicated funds and through more diversified funds that have healthcare as a part of their investment strategy. We believe the opportunities for healthcare investors remain large and are still growing. This will allow the best managers to continue to generate attractive returns in the healthcare venture capital industry for the foreseeable future.

***Mapping the Human Genome***




*Source: DOE Joint Genome Institute*

### *About Fairview Capital*

*Fairview Capital Partners is a leading private equity investment management firm specializing in demanding segments of the market. Founded in 1994, Fairview provides innovative, intelligent, investment solutions and services to institutional investors. Fairview manages $3.5 billion through funds-of-funds, customized separate accounts and other innovative structures. The firm's areas of focus include venture capital / growth equity, small to mid-market buyout, emerging managers and frontier markets.*



**Fairview Capital Partners, Inc. ▪ 75 Isham Road, Suite 200 ▪ West Hartford, CT 06107 ▪ (860) 674-8066**

**www.fairviewcapital.com**