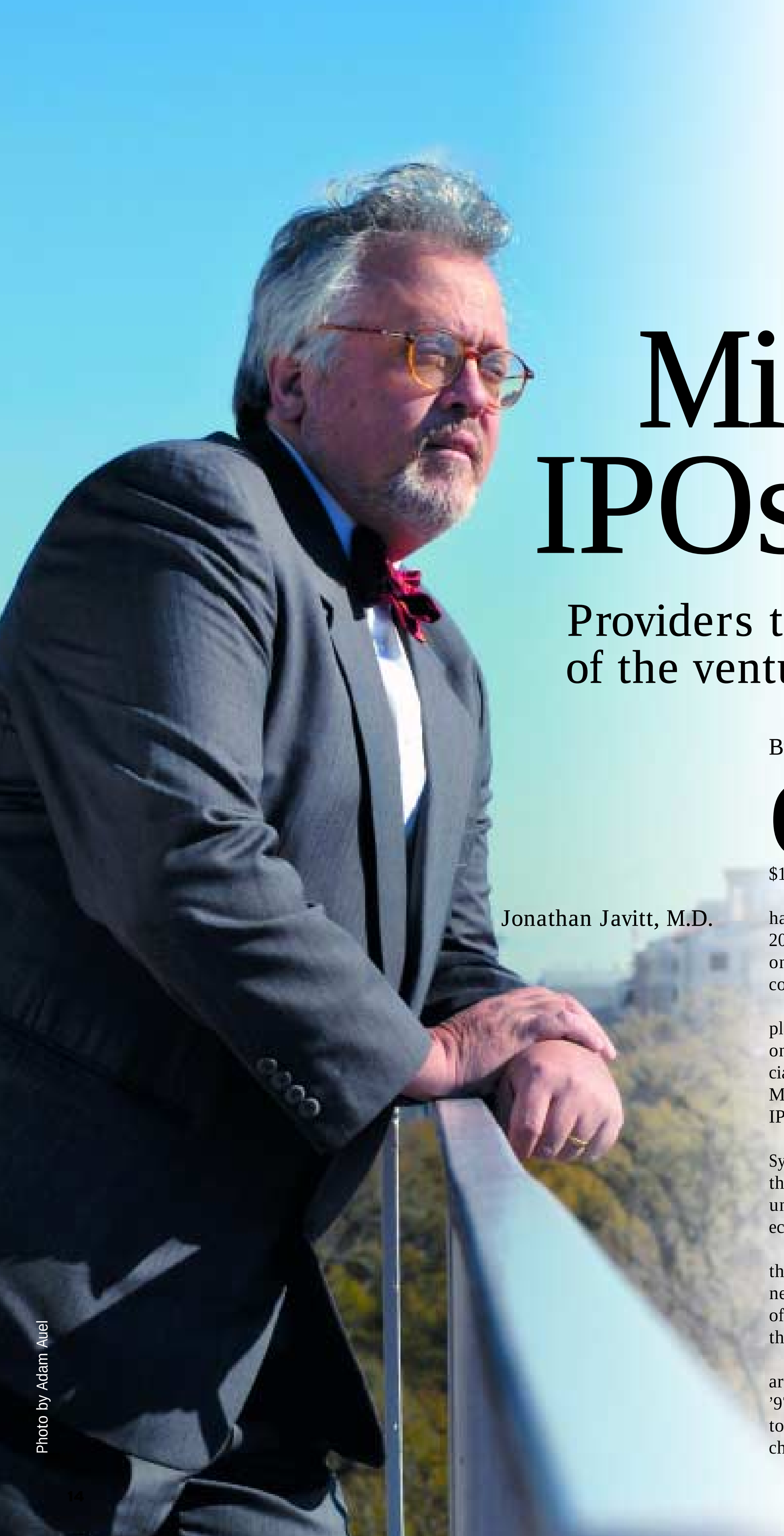
Mission IPOssible

Providers try to lure some of the venture capital flow

By Neil Versel



Jonathan Javitt, M.D.

Photo by Adam Auel

On Nov. 17, ambulatory surgery center operator Symbion filed papers with the Securities and Exchange Commission for a $115 million initial public offering.

The Nashville, Tenn.-based company had wanted to try the public market in 2002, but it withdrew its IPO registration on April 28, 2003, citing poor market conditions.

If Symbion goes through with the new plan, it could be a breakthrough, as only one healthcare services company—physician-run Medicaid managed care plan Molina Healthcare—has had a successful IPO in 2003.

As the year comes to a close, whether the Symbion IPO is a harbinger of better things to come in healthcare finance is as uncertain as the true strength of the U.S. economy.

“I really hesitate to see any filing with the SEC as being the determinant of any new trend,” says Corey Lavinsky, president of healthcare investment watcher Growthink Research, Venice, Calif.

“So few healthcare services companies are getting venture capital since the end of ’97 that there aren’t too many in a position to go public,” says Adam Singer, M.D., chairman and CEO of IPC-The Hospitalist

Healthcare venture capital funding, 3Q 2003, by market segment (in millions)

Biotech/pharma $949.3 | Medical devices $212.9 | Medical software/services $123.3 | Diagnostic/patient care $30.5

Source: Growthink Research

Co., based in North Hollywood, Calif. "We feel lucky to have been able to be funded during that period."

VCs revisit health services

What is abundantly clear is that most of the money in healthcare continues to flow into pharmaceutical and biotechnology companies, raising the level of competition for investment dollars among physician-run enterprises. Indeed, a recent report from Growthink finds 72% of the $1.31 billion in healthcare venture capital funding allotted during the third quarter went to pharma and biotech.

"Service companies have been the hardest companies to get financing for," and not only in healthcare, says Jonathan Javitt, M.D. Javitt is senior fellow of the Washington-based Potomac Institute for Policy Studies, a member of the President's Information Technology Advisory Committee and CMO of the newly established Academy for Homeland Security. He also is a medical informaticist who has founded several companies bankrolled by venture investments.

"The venture markets have really been closed for the last three years," Javitt says.

Things may be picking up, though. Growthink reports that organizations selling healthcare software and services raised $123 million from venture investors in July, August and September—nearly double the $67 million total for the second quarter.

Colella

GE Healthcare Financial Services, the Chicago-based healthcare financing arm of General Electric Co., on Nov. 12 said it will move into lending for physician practices by purchasing Boston-based investing firm HPSC for $72.4 million in stock.

"Obviously, people love biotech, but it's risky. Service is less risky," says Giovanni Colella, M.D., president and CEO of RelayHealth, an Emeryville, Calif., company that provides secure online communication between physicians and patients.

RelayHealth, once known as Healinx, closed on a $6.3 million venture deal during the third quarter, the company's fifth VC round.

"I'm not going to say it was easy to get venture capital, but it wasn't a major effort," according to Colella, a psychiatrist-turned-entrepreneur who joined RelayHealth in March 2000—right as the stock market peaked and the technology bubble burst.

"Until three years ago, we were clearly in the dot-com category," says Colella, noting that venture capitalists and lenders back then were willing to write checks first and ask questions later. "Investors have become more demanding."

However, Colella sees the capital market easing as survivors of the dot-com bust make strides toward profitability.

"And now I'm seeing that the market is changing," Colella says. "People are calling us (offering to invest). Things are much better now, but you have to have a good business."

Alteer Corp., an Irvine, Calif.-based vendor of electronic medical records, practice management and billing software, received $9.4 million in new funding in October 2002 and a follow-up round of $5.5 million in May 2003.

Alteer has reported five consecutive quarters of at least 150% year-on-year sales growth and has 110 employees, up from 30

Exception to the majority rule

When it comes to partnering with hospitals and private investors, physicians consider 51% to be the magic number—most of the time.

"We absolutely needed to have 51% (ownership) so the physicians have control over patient care," says Robert Goodwill, CEO of the Green Clinic, Ruston, La., about the surgical hospital the multispecialty group developed in tandem with Christus Schumpert Health System of Lafayette, La.

Others care more about operational control than ownership.

"Doctors are always concerned with the 51% issue," says G. William Woods, M.D., CEO and president of Fondren Orthopedic Group in Houston, which has a 40% stake in Texas Orthopedic Hospital, a joint venture with HCA. "The secret is in how the agreement is structured."

In this case, the 41-physician practice negotiated the right to call all the shots medically.

"We have total say-so over all aspects of the hospital," Woods says. "You don't need majority ownership to have control."

—N.V.

two years ago, according to CMO and co-founder Frank Rhie, M.D.

But it has taken time not only to find a comfortable niche selling integrated systems to small and medium-sized physician practices, but also to establish a comfort level with investors.

When Alteer started in 1996, a lot of venture capital was going to PPMs and to the early dot-coms.

"When I started the company, we didn't get the investment from venture capitalists," Rhie says. "When the dot-coms failed, we got a lot more attention."

Venture capitalists "are certainly eager to get conversations going," according to Javitt of the Potomac Institute for Policy Studies. However, he cautions, "The time from initial discussions to term sheet is still astronomically long." Plus, Javitt says having a term sheet does not automatically mean the enterprise will get funded.

"A lot of people have gotten burned in this area," Rhie notes.

Venture capitalists put $98 million into electronic medical records vendor MedicaLogic before that EMR company went public, merged with Medscape, filed for bankruptcy and ultimately was purchased by GE Medical Systems Information Technology for pennies on the dollar.

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Rhie

Similarly, venture investors learned expensive lessons in the late 1990s from MediVation, precursor company to iMcKesson, a since-disbanded Internet unit of McKesson Corp., and from Healtheon, which later merged with—and weighed heavily on—WebMD Corp.

IPC-The Hospitalist Co. has grown almost entirely on venture capital by sticking with its core business of inpatient care, according to Singer.

The fourth and most recent fund-raising took place in late 2002.

"Good companies with good management can always get funded," Singer says, though he admits it has not been easy. The healthcare service market, he says, has "been a horrific market to get funded since we started in 1997 at the end of the PPM era."


Singer

Singer says IPC has been profitable for about two years, but he says there is no immediate pressure for an IPO like there might have been around 1999.

"The public markets aren't going for crazy ideas anymore," according to Singer. He says that Wall Street today demands at least $15 million in expected forward earnings and 20% annual growth.

Working toward an IPO also can involve a physician's worst nightmare—loss of control—as underwriters typically try to restructure the company's board to their own advantage, according to Javitt.

"The good news is you have a potential for liquidity," Javitt says. "The bad news is you no longer are the boss."

Joint ventures fill financing bill

Even if venture capitalists favor investing in biotechnology and pharmaceutical companies over healthcare service providers, medical practices and other physician-run enterprises still have an old standby: the joint venture.

And with hospital executives growing weary of fighting with doctors, today joint ventures may be more attractive than ever.

"I think hospital systems are more receptive to the (idea of a) partnership with their own physicians than they used to be," says Flint Beseker, managing director of strategic relationships at GE Healthcare Financial Services, a Chicago-based division of General Electric Co. that serves large health delivery networks.

A case in point: 38 physicians from the Green Clinic of Ruston, La., formed a strategic partnership with Christus Schumpert Health System based in Shreveport, La.,

Christus Schumpert, an affiliate of the Christus Health network of Catholic hospitals, had designs on the Ruston market, some 60 miles out of Shreveport, where the multispecialty Green Clinic was planning to develop a surgical hospital. So Christus Schumpert brought the financing, and the 38-physician group provided the medical staff.

On Oct. 3, they opened the Green Clinic Surgical Hospital, a 31,000-square-foot facility with 10 overnight beds, four operating rooms and a cardiac catheterization laboratory. Physicians own 75% of the surgical hospital.

"There's a vision that this facility will expand," says Green Clinic CEO Robert Goodwill. "Having a large acute care partner makes it more likely that we will be able to expand."

Goodwill adds: "If we had to do it again, we would absolutely choose to partner again."

—N.V.

There's money in the bank

Often, private venture capital is not the best way to go, either, says Javitt, who has sold businesses to Shared Medical Systems—now part of Siemens Medical Solutions Health Services—and to UnitedHealth Group.

Javitt says physicians often make the mistake of going to large investment houses instead of tapping into the government-run venture funds or business incubators available in most states.

Lavinsky, the Growthink Research president, also suggests that capital-hungry physician entrepreneurs apply for a bank loan or explore grants from entities such as the National Institutes of Health and from private philanthropies.

"Physician-run companies looking for capital certainly have other funding options than venture capital investments," Lavinsky says. "It's no secret that interest rates are very favorable right now."

A good idea usually will get the money, though bank loans do carry risks. For one, banks require borrowers to post security, often personal guarantees from each of the partners.

"Docs don't like putting personal assets as collateral," says Tim Schier, a Houston-based principal of Cain Brothers, a New York healthcare investment banking and consulting company.

Physicians who do apply for loans might do better at a local or regional institution with which they have had a longstanding relationship than with a national lender, Schier says.

"Generally I have seen that national banks are not really competitive in the physician space, and they have not been since the PPMs blew up," Schier says

Javitt adds, "Banks are eager to lend money whenever they can, but they are not going to relax their lending rules. If you believe in your product enough to sign your name to guarantee a loan, then that is the way to go."

He explains that financial institutions will not want a say in the business in the same manner an equity investor would.

"Venture capital can be a very dangerous tool," Javitt says.

Though banks do have cash to lend, many healthcare businesses would rather not assume the risk that a straight loan carries. According to an October study from the Healthcare Financial Management Association and GE Healthcare Financial Services, hospitals only obtained 7% of their capital from bank loans in 2001, down from 36% in 1997.

"Banks are really not an effective source of funding today," says Shan Padda, executive chairman of Health Integrated, a behavioral health and care management company based in Tampa, Fla., that secured $5 million in its first round of venture funding this year. "They've gotten very conservative."

To Ronald Pion, M.D., an entrepreneur who now consults on financial matters, this goes to show that investors in any business climate just want to recoup their money as quickly as possible.

"There are not many creative people in the investment world," Pion says. He says that a lot of businesses lost faith in fund managers after the dot-com crash, because many "lemmings" and "me-toos" got in far too late.

What that means is that entrepreneurs just have to look a little harder to find investors, and vice-versa.

"There are excellent venture funds in healthcare, lots of them," Pion says. "The flavor of dollars flowing is very variable, but there is lots of money available." ■

Follow the pa$$ion

Ronald Pion, M.D., has been on both sides of the venture capital equation, first as an accomplished physician entrepreneur and now as healthcare advisor to Lido Capital Holdings, an Irvine, Calif., financial consulting firm that finds investors for emerging companies.

"People are looking for humongous returns on their money if they're available, or they're looking for solutions," says Pion, an OB/GYN who has spent his career looking for new ways to involve patients in the care process.

There is a formula for physicians to get the attention of a healthcare-attuned VC, he says. "Any investor who understands that there are problems with medicine and sees a passionate entrepreneur will get interested."


Pion

Pion himself had a passion about the power of telecommunications in healthcare and got funding for the Hospital Satellite Network to deliver television programs to healthcare workers and patients. Later, he founded Medical Telecommunications Associates and MDtel.com, a physician/patient Web portal for home care and long-term care.

Now, he says, "My interest is in a company that raises the bar on quality."

"I get excited about companies that are small," he explains. "I only look at companies that offer better outcomes for patients someday, better evidence-based literature someday," something that "looks outside the hospital into patients' homes."

Not every good concept needs to become a business, Pion says. Often, he recommends that clients market their intellectual property instead of finding someone to bankroll a new enterprise.

"I think too many people start companies rather than license an idea," Pion says. "Don't start a company if you have an idea but don't know where you want to go with it."

—N.V.