STRATEGY

# Choosing the healthy option

With stock markets fluctuating wildly, private sources of capital may be favoured by healthcare companies – bringing further growth to the nascent debt financing segment. **Andy Thomson** reports

For small but growing healthcare companies worried about raising capital on increasingly turbulent public markets, Edouard Guillet, a partner at European healthcare debt financing firm IPF Partners, has a reassuring message: "Our source of financing is as an attractive alternative to equity in uncertain equity capital markets. More potential borrowers come to us as a secure source of finance amid the growing volatility."

IPF Partners claims to have been the first healthcare debt-focused fund manager in Europe when it launched in 2013, closing its debut fund on €105 million. While equity investors had been backing European healthcare companies for around 15-20 years, it was only by the time of IPF's launch that the kind of companies the firm wanted to back had grown to sufficient maturity to take on debt finance.

"We solely focus on commercial-stage companies with our existing funds, unlike venture debt, which also invests in healthcare companies at the development stage," explains Guillet. "We focus on areas like medtech, healthcare IT, pharma and diagnostics, not biotech so much. At the clinical stage, there is the risk of not gaining approval for the product, and that's more of an equity risk. We don't want that risk, we want to back firms with products already approved for sale."

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**Edouard Guillet**

In the US, as in other areas of debt finance, healthcare lending has been around for a while longer than in Europe. Matthew Evans, managing director of healthcare at Chicago-based fund manager Monroe Capital, says his firm has been active in the space ever since it was founded in 2004 – but that a lot more investment units have been created on both the equity and debt side over the last 10-12 years.

Evans says there are various approaches including cashflow and asset-based lending, but Monroe's focus is "looking at the EBITDA and enterprise value and calculating the appropriate level of debt".

While healthcare debt lending is still relatively nascent, there is considerable optimism about the future. Over the years the fundamentals have improved considerably, maintains Aris Constantinides, a general partner at London-based growth investor Kreos Capital. "The amount of equity going into healthcare in 2007 was a fraction of what it is now," he says. "In recent years you have had lots of companies raising capital successfully, including through IPOs, and it all points to big growth ahead."

Evans says that one of the reasons for the growing popularity of healthcare investment is that the sector has performed well through tougher periods for the economy. Moreover, healthcare as a proportion of overall GDP has continued to grow from around 14 percent seven years ago to around 20 percent now. "It's now more of a must from an investor viewpoint that you have healthcare exposure," he says.

Guillet thinks there are now a greater number of companies coming to maturity with ground-breaking new products, creating a stronger deal pipeline for firms such as his.

"We give preference to unique products catering to serious pathologies and which are making a difference over existing standards of care, and have a lot of interest in those targeting chronic diseases," he says.

Moreover, he adds, there is a growing population suffering from chronic diseases in countries where the ability to afford therapies is much higher than it used to be, such as China. That said, Guillet acknowledges that effectively navigating

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and penetrating emerging markets can be "very challenging".

But while the opportunity set is growing, is healthcare debt lending something that generalists could easily transition to or is it so different that only specialists stand a chance of making a success of it?

Constantinides says the healthcare product at Kreos is a senior secured amortising debt product – the same as for other industry sectors the firm lends to. The need to develop strong relationships with sponsors and to fully understand and evaluate the nature of the asset base are also traits shared with other sectors.

But he also thinks healthcare can be different: "With life sciences you take security on the IP, not just on revenues or accounts receivable. Growth in companies comes from meeting development milestones and we often lend towards those milestones. At the end of a clinical trial for example, a company's valuation can increase by say 50 percent or even 200 percent. That's something you don't generally see in the tech space where growth is usually more smooth and linear. It's a different philosophy of lending – you have to structure the debt in a slightly different way, the security and sponsors are different and you have to understand the underlying business and its risks."

### BLURRED LINES

Healthcare is different for other reasons, too. Payment at the point of treatment typically comes from insurance companies or government "so you have to be cognisant of the reimbursement and regulatory landscape", says Evans. In addition, companies not associated with healthcare are being seen as potential disruptors. For example, a recently announced alliance between Warren Buffett's Berkshire Hathaway, Amazon and JPMorgan Chase is aiming to try and find a way to bring down healthcare costs.

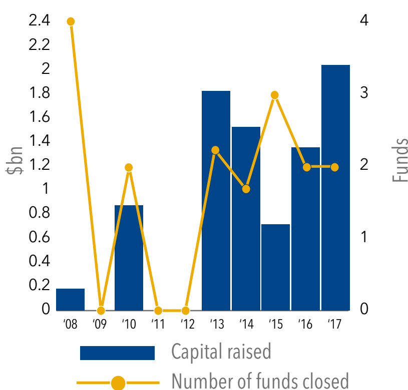
"The lines are becoming blurred with the likes of Amazon infiltrating the space

**Evans: resilient to downturns**

as well as payors and providers merging," acknowledges Evans. "But the companies we finance are not necessarily the 800-pound gorillas in any one sub-sector, they're the strongly growing small to medium-sized ones. We're always cognisant of macro trends, however, because they can influence our companies' profitability. The main focus for us is on management teams and their ability to navigate a particular sub-sector, sustain and grow."

## POSITIVE PROGNOSIS

*Fund-led healthcare debt financing is still at modest levels, but showing signs of growth*




*Source: PDI*

When it comes to sourcing healthcare debt deals, some firms rely on sponsors. "It's a small world we operate in," says Guillet. "The equity sponsors we see on deals are very often the same ones and management teams often move from one company to another. That network of investors and managers is the main source of investment opportunity for us."

Plus, "we monitor companies through our database. When they grow to a certain maturity, it might be the right time for debt finance."

Kreos also taps its sponsor relationships, but Constantinides points out that around 30 percent of the firm's deals across sectors are re-ups: ie, reinvesting in companies the firm has backed previously, and this is similar in healthcare. "The re-up aspect has grown substantially," he says. "One of our portfolio companies, Kiadis Pharma, we lent to before it went public in 2015 and then we did another, bigger loan afterwards and once it was public to allow it to grow further."

Evans points out that Monroe participates in non-sponsored as well as sponsored deals and focuses on deal sourcing relationships with a range of actors such as investment banks, consultants, lawyers and CFOs. "We participate in M&A deals, but also provide capital for other reasons, including refinancing, growth capital, minority ownership and other types of transactions," he says.

With its ability to ride recessions, healthcare is a good anti-cyclical play for investors. It also delivers income as well as capital gains. "We bring significant yield and return cash quarterly which attracts pension funds and insurance companies," says Guillet.

Targeted returns for many GPs are typically in the mid to upper teens. The idiosyncrasies and complexity of healthcare investing make it a challenge for some investors, but coming from a relatively low base – at least from a debt perspective – further growth looks assured. ■