Health Systems & Venture Capital: Adapting To an Evolving Market

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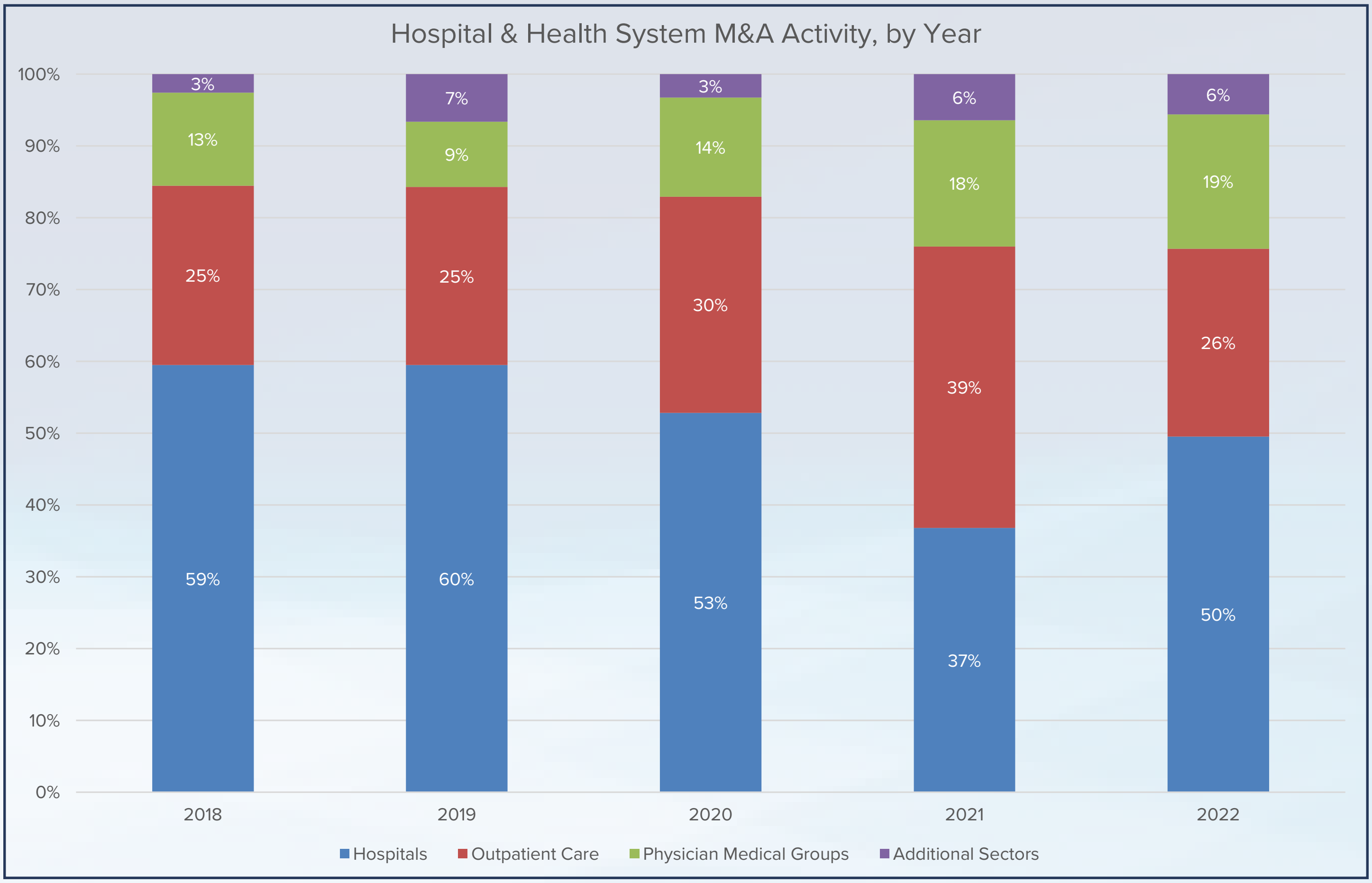
Introduction

For decades, health systems and hospitals generated stable revenues from inpatient care offerings. The best path to growth was increasing total bed counts and hospital networks, and the healthcare M&A market reflected that simple reality. In 2018, 60% of hospital and health system M&A activity targeted hospitals, adding 326 hospitals and more than 33,000 beds, according to M&A data captured in LevinPro HC. The M&A data mirrors the breakdown of the market at large. According to an analysis completed by Deloitte[1], inpatient services accounted for more than 50% of the total revenue for U.S. hospitals in 2018. However, since then, hospitals and health systems have shifted their M&A strategies to other markets. In 2021, hospital acquisitions only accounted for 37% of their total investment activity, a five-year low. According to data captured by LevinPro HC, that resulted in an exchange of only 249 hospitals and barely 20,000 beds. The investment focus on hospitals was renewed in 2022, but in the first half of 2023, a majority (54%) of health system and hospital acquisitions were in other markets and verticals.

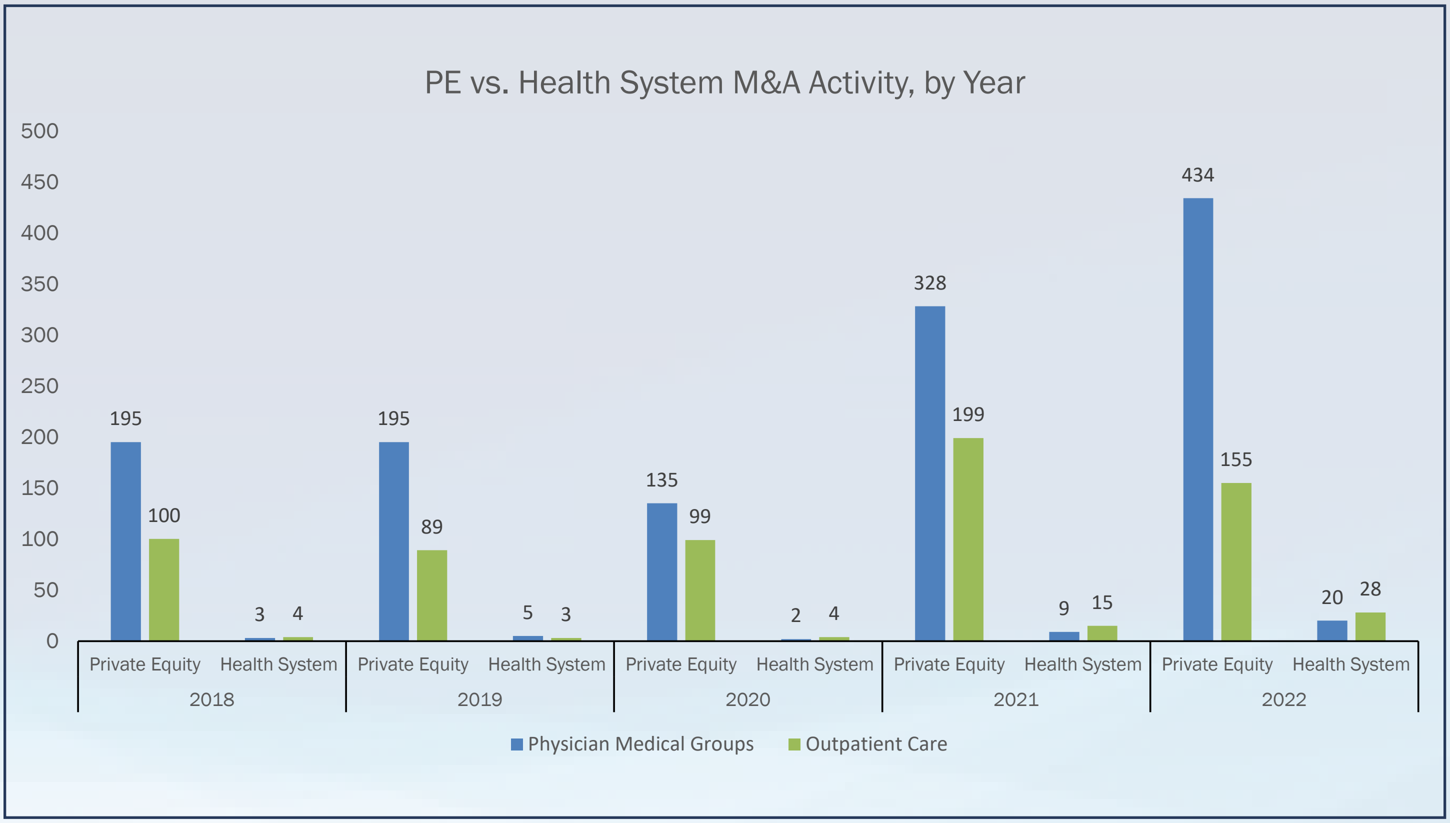


Source: LevinPro HC, August 2023

1 https://www2.deloitte.com/us/en/insights/industry/health-care/outpatient-virtual-health-care-trends.html (Accessed August 8, 2023)

There are several market forces driving this new strategy. Research from Deloitte[2] shows that between 2011 and 2018, outpatient revenue grew at a compounded annual rate of 9%, to 48% of total hospital revenue, while inpatient care saw its revenue grow at a compounded rate of 6%. Shifting demographics and patient preferences in the United States has created a surge in demand for outpatient care offerings, and with payors seeking to move healthcare reimbursement toward value-based models, these trends are only going to accelerate in the next decade.

And even though health systems have been pushing into the outpatient care market, there is tough competition. Major retailers like **CVS** and **Walgreens** have invested significant capital to expand their outpatient service lines, and their scale and reach already make them significant players in the healthcare continuum. And it would be remiss not to mention private equity, which has permeated every vertical in the healthcare market. Data captured in LevinPro HC shows their dominant presence.



Source: LevinPro HC, August 2023

Although health systems and hospitals have increased their M&A activity into new sectors and markets, private equity has already swarmed the industry and begun consolidating those sectors. Not only do private equity firms offer better valuations, but they also tend to offer better deal terms to physicians and other business owners looking to sell, with much better management structures. The M&A numbers highlight the difficult spot health systems and hospitals find themselves. Inpatient revenues are diminishing, but new markets are already crowded with higher valuations.

Some health systems have decided to merge with each other instead, relying on scale to remain competitive. In the first six months of 2023, seven health systems managed to reach a definitive merger

2 *Ibid*

agreement, but even that approach has its difficulties: talks could take months or years, and regulatory challenges could disrupt the entire process. **Fairview Health Services** and South Dakota-based **Sanford Health** called off their merger talks in late July 2023 after Minnesota Attorney General Keith Ellison asked for more time to review its potential impact. Fairview and Sanford first announced an intent to merge in November 2022, and even after nine months, they were unable to cross the finish line. With increased government scrutiny, merging with another system is a risky path.

Venture Capital

To help create long-term financial viability, some health systems, especially non-for-profit entities, have turned to their venture capital funds to invest in emerging companies and products. Some health systems have held venture capital funds and platforms for decades; **Cleveland Clinic**, a not-for-profit academic medical center, established its venture fund, **Cleveland Clinic Ventures**, more than 20 years ago, for instance. However, funding and investment levels have hit staggering numbers in the past few years, reaching nearly $3 billion in 2021 compared with $284.5 million in 2010, according to research by CB Insights. Health system venture funds are primarily focused on digital health services that scale well with their network, aiming to lower costs as the country shifts to more value-based care reimbursement model. But like any venture capital fund, they are also aimed at returning an investment down the line. Here is a list of some of the most active venture capital firms established by a health system.

Digital Health-Focused Funds

Ascension Ventures:

Ascension Ventures is the venture fund for **Ascension**, one of the nation's leading non-profit and Catholic health systems, but several other health systems participate in the fund, including **Trinity Health**, **Mercy** and **Catholic Health Initiatives** (part of **CommonSpirit Health**). According to the company's website, it has more than $1 billion in capital under management. Over its lifespan, the fund has invested in more than 65 companies that make medical devices, clinical software, tools to improve clinical staff and resource optimization, pharmacy management, population health and remote care solutions. In June 2023, one of its portfolio companies, **Strive Health**, secured $166 million in Series C funding in a round led by **NEA** and five new investors, including **CVS Health Ventures**. Joining them in the round were existing investors **CapitalG** (**Alphabet**), **Echo Ventures**, **Town Hall Ventures**, **Ascension Ventures** and **Redpoint**.

Ascension Ventures has some other major companies in its portfolio, including **Help at Home**, **NaviHealth**, **Omnicell**, **R1 RCM**, **Stereotaxis**, **Syapse** and **United Surgical Partners**.

Intermountain Ventures:

Intermountain Healthcare, one of the largest health systems in the western United States, established Intermountain Ventures in 2019. The fund is primarily focused on digital health and healthcare IT, with a minimum investment of $1 million, a target of $3 million to $5 million over the life of the portfolio company and the majority in series A to C rounds. In early 2022, Intermountain Ventures participated in a

$200 million Series C investment for **Transcarent**, a digital health company for self-insured employers founded by former **Livongo** CEO Glen Tullman. There were approximately a dozen participating investors, including other health systems such as **Northwell Health** and **Rush University Medical Center**.

Cleveland Clinic Ventures:

Since 2000, Cleveland Clinic Ventures has launched more than 80 startup companies and has achieved a market rate of return on exited companies. The group has invested more than $41 million in funding since 2021. Cleveland Clinic Ventures' is focused on driving intellectual property development at the Cleveland Clinic, as well as supporting companies in areas like patient experience, caregiver engagement, population health management and the shift to value-based care, precision medicine and telehealth solutions.

Kaiser Permanente Ventures:

Created by **Kaiser Permanente**, this fund has invested in more than 65 companies over its 20-year history. It targets health information technology (enterprise solutions), digital health, healthcare services, medical devices and diagnostics and precision medicine. In 2019, the organization closed its fifth investment fund at $141 million, bringing the total assets under management to more than $500 million. This most recent fund includes financial commitments from Kaiser Permanente and a diverse group of new and returning external strategic investors including **Tufts Health Plan**, **Henry Ford Health System** and **Highmark Ventures**, a subsidiary of **Highmark Health**. Some of its key portfolio companies include **Health Catalyst**, **IntelyCare**, **Leiters** and **Rock Health**.

Life Science-Focused Funds

Mass General Brigham Ventures:

Mass General Brigham Ventures is an early-stage venture capital firm founded in 2008 to advance new life science technologies emerging from **Mass General Brigham**, one of the United States' most renowned health systems for medical research. According to the company's website, it has more than $450 million in capital from internal and external sources. Unlike some other funds, Mass General Brigham Ventures invest primarily in biotechnology firms. Some notable companies in its portfolio include **Affinia Therapeutics**, **Amolyt Pharma**, **Lyndra Therapeutics** and **Scorpion Therapeutics**.

Mayo Clinic Ventures:

Mayo Clinic Ventures was formed by **Mayo Clinic** to focus on evaluating and protecting intellectual property, funding and developing new technologies and forming startups. Along with the health system's business development team, Mayo Clinic Ventures has helped form 312 startups using Mayo Clinic technology and deployed $281 million in capital for joint ventures, collaborations and equity investments (with a return of $903 million). The group provides up to $5 million in venture capital funding or $20 million growth capital total investment per company.

Healthcare Services-Focused Funds

Advocate Aurora Enterprises

Advocate Aurora Enterprises (AAE) is a subsidiary of **Advocate Aurora Health**, one of the 12 largest not-for-profit, integrated health systems in the nation. The fund is meant to help the health system expand in the home health and personal wellness market, and it has announced three acquisitions in the past two years. In April 2022, AAE acquired two remote patient monitoring firms, **Clear Arch Health** and **MobileHelp**, for a total of $290.7 million. And a year prior, the investment arm purchased **SHF Holding Company** (**Senior Helpers**), a home health operator with more than 320 franchised and corporate-owned locations in 44 states, for $183.6 million. The price resulted in a valuation of 6.9x Senior Helpers' 2021 revenue.

Is This Strategy Working?

Moving into the venture capital market to prop up narrowing margins is risky. According to an analysis by VCAdventure[3] completed in 2020, "65% of investment rounds fail to return 1x capital and only 4% return greater than 10x capital." This reality seemed to hit health systems hard in 2022.

In its 2022 consolidated financial statement, Intermountain Healthcare reported nearly $1.6 billion in investment losses during 2022, a steep decline from the $1.5 billion in investment income it generated in 2021. And Intermountain was fortunate in 2022; it closed its merger with **SCL Health** in 2022, which provided $4.1 billion in affiliation contributions. Other health systems saw similar results. In 2022, Ascension Health saw a $2.1 billion rise in operating expenses and $1.2 billion in net losses from investments, giving the company a total net loss of $1.8 billion, according to the organization's consolidated financial statement.

There is no shortage of health systems that had a rough year in 2022, including Cleveland Clinic, Providence, Mass General Brigham and others, but the investment losses are hard to absorb when revenues are down, and expenses are increasing. This is even before calculating the rising cost of labor, a very significant headwind in the healthcare market, and one that could affect what sectors these health systems will target in the future. There's no clear next step or alternative solution to the challenges that health systems are facing. Maybe these risks will be worth it in the long-run, but for now, health systems are going to have to tread carefully as the market continues to evolve.

About the Sponsor:

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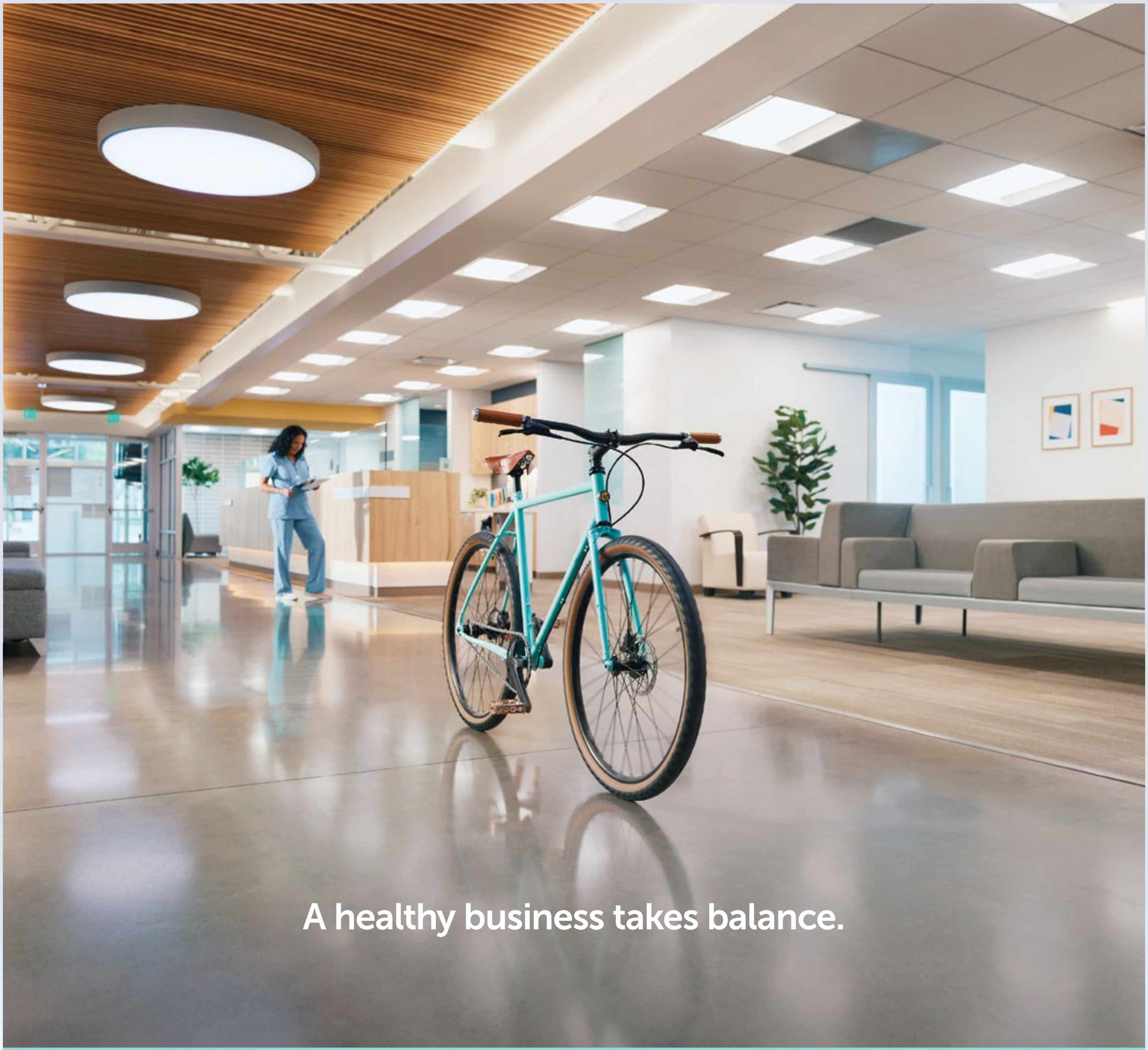
3 https://www.sethlevine.com/archives/2020/10/vc-fund-returns-are-more-skewed-than-you-think.html (Accessed August 8, 2023)


A healthy business takes balance.