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Repeat prescription

An assortment of healthcare-focused GPs – most of them in China – have emerged to leverage rising domestic consumption and nascent medical innovation. Does domain expertise mean better deal access?

JAMES HUANG RECENTLY COMPLETED his journey from specialist to generalist and back to specialist again. He joined KPCB China from healthcare investor Vivo Ventures in 2011 and has spent the last six years adding a healthcare practice to the firm's existing technology, media and telecom (TMT) coverage. Last month, Huang decided to go solo, establishing sector specialist GP Panacea and launching a debut fund with a target of $150 million. He continues to manage the existing KPCB China vehicle.

The firm differentiates itself from others in the space by focusing on incubating life sciences companies ahead of their first institutional funding rounds. But Huang's rationale for setting up a sector fund is the same as everyone else: to tap into rising consumption in China. At present, healthcare expenditure amounts to 5.6% of GDP, well below the US level of 17.1%, and these specialist investors want to help close the gap.

"As healthcare expenditure as a percentage of GDP continues to expand, the healthcare market in Greater China will grow beyond everyone's imagination," says Huang. "That's why it's good to be healthcare. It is one of the fastest-growing sectors of the economy that you can't ignore it."

It is estimated that 360 healthcare-focused firms – including captive VC units – have been set up in China in recent years. There are also a handful of sector specialists active in other markets across the region, addressing a similar emerging demand dynamic. While the opportunity is undeniable, it remains to be seen whether every specialist can generate sustainable deal flow and build a long track.

Asia's healthcare market is said to be expanding at a rate of 15% per annum, putting it on course to be worth $4.3 trillion by 2030, more than the current scope of the US and Europe combined. Rapid economic growth, an emerging middle class, and an ageing population – as well as government support and deepening industry talent pool in some cases – are the key driving factors. Business Monitor International projects healthcare spending in China to reach $1.8 trillion by 2026, up from $663 billion last year. India will expand from $113 billion to $342 billion over the same period.

Total private equity investment in Asian healthcare stands at $9.2 billion so far this year, up from $5.4 billion in 2016. The record high of $12.2 billion came 12 months earlier, although the $3.3 billion privatization of China-based WuXi PharmaTech accounted for more than one third of the total. The average of the previous five years, excluding 2015, is $5.5 billion across 230 transactions, half of them early stage.

China has consistently proved to be the most active market, followed by Australia, India and Japan. More than $3.4 billion has been deployed this year – more than three times and 25 times the India and Southeast Asia totals – in nearly 100 deals. The five-year average, excluding 2015, is about $2.4 billion.

"Money follows opportunity. China is a large market with clear demographic trends and visible needs in healthcare. As a result we have seen a proliferation of specialists. The composition of such firms is varied and includes sector team spin-outs from generalist funds and investment teams led or assembled from within the healthcare industry itself," says Chris Lerner, head of Asia at placement agent Eaton Partners.

AVCJ Research has records of six established healthcare specialists – Lyfe Capital, C-Bridge, Eight Roads, OrbiMed, Lilly Asia Ventures (LAV) and HighLight Capital – closing US dollar-denominated funds of $250-551 million over the past six months. There are also a number of new entrants in the market, including a team from generalist VC investor Legend Capital.

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Evolving ecosystem

The shift from generalist to specialist in the healthcare space is a response to the need for greater expertise to address the complexities that have accompanied medical innovation.

For example, it is hard to accommodate TMT and healthcare investments within the same fund structure because the investment cycles, risk profiles and technology focus can be markedly different. The barrier to entry for consumer internet plays is typically scale, whereas healthcare start-ups distinguish themselves based on degree of innovation, which takes longer to develop. As a result, several healthcare investors have left generalist platforms in China and set up their own shops.

Qiming Venture Partners is exceptional in it how it has maintained healthcare, TMT and cleantech practices for over a decade. "We are a generalist fund, but we were very sector-focused from day one," says Nisa Leung, a managing partner at the firm. "A generalist fund platform allows us to understand different technologies and make cross-sector investments. For example, teams can conduct joint due diligence on the application of artificial intelligence technology in healthcare."

Global private equity firms have developed deep healthcare practices in the US or Europe, but it can be difficult to leverage this expertise in Asia's developing markets. Quadria Capital is looking to occupy this void in Southeast Asia and India by constructing a sector ecosystem that comprises companies from different points on the healthcare spectrum.

"The depth of knowledge that you need to develop as a specialist investor – all the way from R&D, to manufacturing, to regulatory approvals, to sales and marketing – is very difficult for a generalist to develop to an equivalent level within their firm," says Abrar Mir, the Singapore-based firm's managing partner.

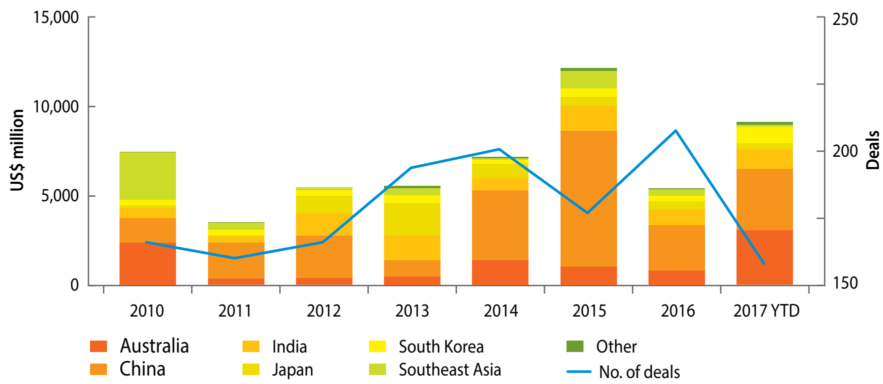
Entrepreneurs, who more often than not are scientists with big pharma experience, are highly selective when working with financial investors. It is important that a prospective investor, whether working for a generalist or specialist GP, can demonstrate entrepreneurs an understanding of the industry as well as the unique value preposition they can provide. These values are expected to translate into better entry valuation of certain deals for the GPs.

"When we spoke to some CEOs, they said: 'If I talk to a GP and they don't understand the technical aspects or mechanics behind what I do [be it healthcare or enterprise-based], I have less incentive to continue the conversation because I have to explain so much for relatively little value add.' If a GP has a medical background or connections to hospitals that could make a difference in terms of communication efficiency and effectiveness," says Jireh Li, chief representative for Asia at Commonfund Capital.

Specialists also come equipped with experience derived from regular engagement with practitioners in their sector. For India-focused Invascent Capital, frequent investments necessitate a breadth of coverage that few others can match. The GP aees the sweet spot in the middle market where entrepreneurs need help improving operational efficiency and financial performance. Rather than writing $50-100 million per check across a handful of deals – as generalists do – Invascent commits $10-30 million a time to multiple companies.

"Several larger Indian PE firms have built internal healthcare teams, but they only look at one or two industries, like pharmaceuticals. While they are addressing a slice of the market, we invest in multiple growth industries across the sector at lower valuations," says Hari Buggana, managing director at Invascent. "There aren't many $50 million-plus in Indian healthcare, maybe 2-3 per year. They are typically auctioned, which attracts global private equity firms, pushing up valuations."

PE investment in Asia healthcare



Source: AVCJ Research

Areas of activity

The sector is usually broken down into four segments: pharmaceuticals and drug discovery; medical devices; healthcare services; and IT and mobile technology. The first two segments are highly technical with an emphasis on intellectual property (IP) – which means they are dominated by sector specialists – while the others attract generalists because they are consumer-oriented and easy to scale. Hospital and clinical services-type investments, for example, tend to be asset-heavy and revenue-generating, allowing PE players to deploy large amounts of capital.

Activity in these segments also varies by market. Drug manufacturing and healthcare services have attracted a lot of attention from specialists in India partly because global pharmaceutical companies increasingly look to the country as a low-cost R&D and manufacturing based for genetic treatments that are exported globally. Sunny Sharma, an India-based managing director at OrbiMed, notes that about one quarter of generic drugs consumed in the US by market value are made in India.

Regulation is another geographical variable. "It's difficult for a team sitting in one geography to really understand the emerging risks and opportunities in the other countries," adds Buggana. "On the other hand, the companies we back in India are addressing global markets. So by investing in such companies located in India, we are getting exposure to global opportunities."

In addition, Quadria's Mir contrasts his firm's strategy in Southeast Asia with that of China-based healthcare GPs. Drug manufacturing and healthcare services are the primary targets, with the proviso that the companies are growth stage and cash-generative. "We don't do early-stage VC investments with binary risk. For example, we wouldn't invest in a company that is developing treatments to cure cancer, because it's a case of cure or nothing," Mir explains.

China's healthcare sector has already made the transition from commoditized to more innovative solutions, driven by a growing number of overseas-trained professionals who return home and set up companies in the life sciences space. With connections with global pharmaceutical companies and local operational know-how, they are buys licensing pre-clinical findings from the West to develop drugs in China or setting R&D laboratories to develop new drugs on their own.

"In life sciences, China historically didn't have many exciting early-stage R&D companies. There were no biotech players finding innovative, first-in-class molecules. As a result, healthcare GPs naturally focused more on growth equity and later-stage VC. A new class of innovative life sciences companies is now emerging. The level of innovation in China is really starting to ramp up and this is attracting VC capital," says Carter Neild, a US-based partner at OrbiMed.

The firm used to concentrate solely on growth-stage investments in Asia, but its most recent fund – which closed at $551 million earlier this year, will address early-stage opportunities as well. Up to 20% of the corpus has been earmarked for pre-revenue drug discovery in China.

Despite this progress, the US remains the dominant global player in life sciences, and so another investment strategy has emerged involving the export of technology from the US to China. OrbiMed and Vivo, both of which are US-based, play a role in this space alongside China-centric Qiming, LAV and C-Bridge. The latter three GPs have opened offices in the US and recruited investment professionals locally, while Qiming is currently raising its debut US-dedicated healthcare fund.

It confirms the sector's status as a true global play: whether it requires advanced technology to develop a product or distribution channels to distribute it overseas, the fortunes of an Asia-based company may ultimately rest on an international strategy.

"There are very few companies these days only focused on one country," says Judith Li, a partner at LAV. "The reason is very simple: IP is global. If it's a truly revolutionary product, it has to be global at some point, and licensing could flow both ways. For example, if the first-in-class IP is developed in China, it could be sold anywhere. When overseas licensing partners come and want to get the right for that IP, the Chinese company becomes an international company."

LAV's investments range from greenfield projects – incubating life science companies with entrepreneurs – to pre-IPO rounds. Its connections with Eli Lilly and other global pharmaceutical companies have helped the GP build up a strong pipeline of deals. Unlike TMT, where start-ups tend to opt for the minimal amount of strategic capital, nascent healthcare businesses are capital-intensive and hence very synergetic with large corporations.

"In healthcare, it takes so much capital to get regulatory approval," adds Li. "Due to the infrastructure required to sell a drug, many companies will work on partnerships with large pharmaceutical companies at some point. For

Quadria Capital: A rising regional player

Founded in 2008, Singapore-based Quadria Capital didn't start out as a dedicated healthcare GP, even though its two founders, Abrar Mir and Amit Varma, have strong investment and operational expertise in the sector. Mir was formerly global head of healthcare investment at Religare Capital Markets, while Varma was a critical care physician.

The firm's $100 million debut vehicle – in which Religare and Indian GP Milestone Capital Advisors participated as LPs – closed the same year with a mandate to cover education and media as well as healthcare. After recording strong returns on its investments, most of them India-based, Quadria raised $700 million for a second fund in 2010. Religare was one of two institutional backers, and the main target geography was Southeast Asia.

Following the sudden death of Milestone founder Ved Prakash Arya in 2011, Mir and Varma decided to buy out the Milestone-Religare healthcare franchise and formally rebrand. As such, Fund III was fully independent, closing at $304 million in 2015, although it has deployed some $450 million to date including co-investment. About 60% of the corpus has been deployed in Southeast Asia and the rest in India. With $1.6 billion in assets, Quadria claims to be the largest healthcare PE firm in Asia.

The GP focuses on growth equity investments in three areas: healthcare services, pharmaceuticals and associated services within the ecosystem such as insurance. "Sector specialization is an important factor in unlocking superior returns for investors. It's a technical sector and it's important to have a deep understanding of the market. It's not just about seeing the opportunity, but also understanding the challenges of healthcare in these markets," says Mir.

Healthcare spending in India and Southeast Asia is growing at double-digit pace; by 2026, it is expected to reach $342 billion and $273.7 billion, respectively. People are getting older and richer, but demand is largely unmet because the healthcare services infrastructure in these markets is underdeveloped and there is a shortage of suitably trained medical professionals. For example, while a large portion of Indonesian patients suffer from cardiovascular diseases, less than 50% of the doctors in the country are interventional cardiologists.

Quadria is looking to address these shortcomings – it recently backed Singapore-based MWH Holdings, which operates heart, stroke and cancer centers, in support of a regional expansion plan – other investments are designed to avoid these developmental bottlenecks. For example, one of the GP's Indian portfolio companies, healthcare services provider Healthcare At Home, requires a lower level of medical specialty.

Moving forward, the GP may also pursue selective investments in China and North Asia, allocating 15-20% of its next fund to those markets. "The question is – are we able to execute successfully in China as we are in India and Southeast Asia? That's something we are working towards," Amir says.

While there are an increasing number of healthcare-focused funds emerging in Asia – spanning India, China and Southeast Asia – in recent years, Amir believes relatively few will prevail in the long term. This is due to the high level of domain expertise required to be successful in the sector, as well as the need for an integrated investment approach that combines global perspective on industry trends with local execution capabilities.

"There are certainly more early-stage healthcare players right now in China than in Southeast Asia and India, but I would say equivalent industry expertise is required across all these markets," he adds. "We will probably see 3-4 players emerge as pan-Asian healthcare investors."

the early-stage companies, it's also a very nice validation factor to have partnerships with the global partner."

A bifurcating market

With many healthcare specialist GPs turning their attention to early-stage R&D and product development in China, newcomer C-Bridge has moved in the opposite direction. The firm focuses on late-stage growth and buyout opportunities, having established a reputation for generating substantial amounts of co-investment for LPs in companies with a clear path to commercialization and monetization. About half of C-Bridge's latest $400 million fund will be deployed in pharmaceuticals and the rest in medical devices and healthcare services.

> "A new class of innovative life sciences companies is now emerging. The level of innovation in China is really starting to ramp up"
> – Carter Neild

Wei Fu, founder and CEO at C-Bridge, expects China's healthcare investment space to evolve along similar lines to that of the US, with successful sector specialists carving out niches at either end of the spectrum: incubation and buyouts. ARCH Venture Partners is an example of the former while KKR, which recently launched its first healthcare growth equity fund, characterizes the latter. "Valuations are actually very high at the Series A round, but that's where most Chinese healthcare venture capital GPs are concentrating right now," adds Fu.

Indeed, some Chinese healthcare start-ups have been known to pitch for early-stage rounds at valuations of $400 million before they've even started clinical trials. "We shy away from these deals, because even we make a decent investment, our return multiples might not be justifiable," says Qiming's Leung.

It is also worth noting that healthcare investment is cyclical. The US has experienced several boom-to-bust cycles since the early 1990s: When the market was hot, numerous TMT-focused VC and PE generalist funds flooded into the space; when it turned, they departed. China's currently crowded healthcare sector might see a similar adjustment. Healthcare across emerging Asia is a fledgling state but as the investment landscape develops, GPs with true domain expertise are expected to persevere and ultimately prevail, winning more than their fair share of deals.

"Over the past few decades, some generalist and IT-focused VC firms in the US have been tourists in healthcare. During bull markets they hire a life sciences team, then during the inevitable bear markets they retreat. Some brand-name GPs have done this two or three times now," says OribMed's Neil. "But over the years, healthcare specialist GPs have become increasingly dominant, as they have more commitment and staying power through the downturns."