HEALTHCARE GROWTH PARTNERS

HGP 2018 Health IT Private Equity Survey

Abstract

HGP surveyed hundreds of private equity funds across all stages and received 105 responses. Responses concentrated toward Growth Equity and Venture Capital investors, who respectively invest in early and earlier stage companies. The distribution of responses across the stages of investing is consistent with the distribution of investment activity across the company lifecycle. The majority of institutionally funded health IT companies are receiving venture and growth investments, with relatively fewer buyout transactions. This investment distribution pattern is consistent across almost any growth industry.

It is important to note that our survey likely has selection bias, which we cannot fully assess given the confidential nature of the survey response data. Anyone with a propensity to respond to a survey about investing in health IT is likely to have stronger interest in health IT than those who did not respond to the survey. Furthermore, we are more likely to generate responses from individuals who are familiar with HGP, and HGP generally interacts with investors interested in health IT transactions. It is safe to conclude that our survey findings have a bias toward respondents who are more interested in health IT investments than not. However, we believe that the data set is broad enough to be meaningful and deliver insights, particularly in mapping out the priorities and criteria of active health IT investors.

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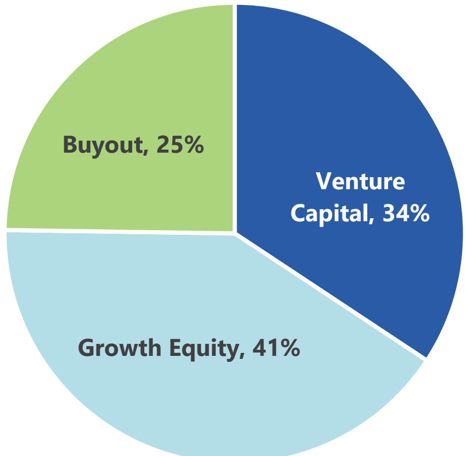
Please feel free to contact us with your feedback and questions.

~Healthcare Growth Partners

HGP 2018 Health IT Private Equity Survey

Results and Commentary

Q1: What type of fund do you manage?



Q2: What is the size of your most recent fund?

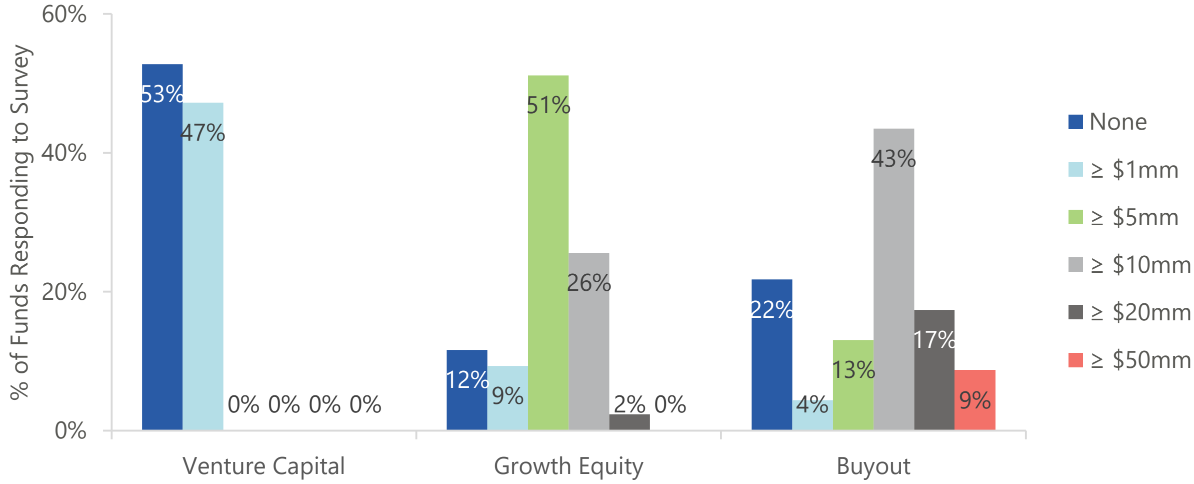
	Most Recent Fund Size				
	< $100mm	$100mm - $500mm	$500mm - $1B	> $1B	*Total*
Venture Capital	21	13	1	1	*36*
Growth Equity	4	19	11	7	*41*
Buyout	3	12	6	4	*25*
Total	*28*	*44*	*18*	*12*	*102*

**3 respondents did not answer this question*

Q3: Do you seek a certain revenue threshold for your investments?

The response to this question highlights the key distinction of revenue criteria between each investor category. 100% of Venture Capital respondents have a revenue threshold under $5mm with 53% having no revenue threshold at all. This result shows a shift from the 2016 survey results which showed 13% having a $5mm threshold. This news appears exciting for young companies as it indicates that the vast majority of Venture Capital funds having low thresholds and potentially a large share are willing to invest in companies under $1mm. However, it is important to note that as the revenue threshold shifts to being entirely $1mm or none, the opportunity (aka, competitive) set grows larger. Institutional funding for pre-revenue companies remains nearly impossible – with funding odds increasing with the proven background and credentials of the entrepreneur.

Q3: Do you seek a certain revenue threshold for your investments? (Continued)



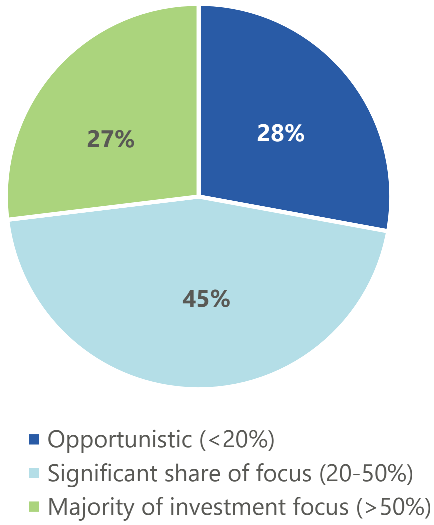
On the other hand, 79% of Growth Equity investors require revenue in excess of $5mm which is consistent with the 83% from the 2016 survey results. However, just over a quarter reported a threshold greater than $10mm, which is a drop from over half in 2016. This drop is consistent with what we saw among venture investors and is in-line with our perspective that investors across the board are stretching into the lower end of their investment criteria to put capital to work in health IT.

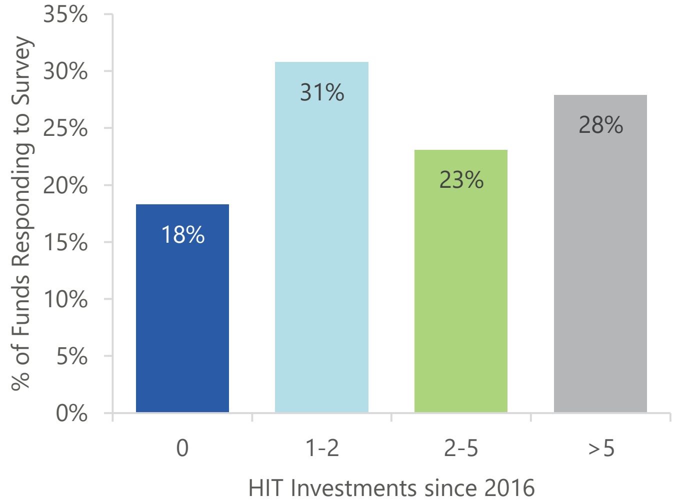
While $10mm in revenue no longer appears to be a key threshold for Growth Equity investors, it remains key for Buyout investors, with 69% requiring $10mm as a threshold (exactly the same as 2016). What differentiates Growth Equity from Buyout is control and profitability. Buyout investors typically make control investment by buying out the interests of existing shareholders (secondary purchase), often with the help of debt (or leverage) which generally requires profitability to borrow against. Growth Equity investors may buy some secondary shares, but they mostly deploy cash into newly issued shares of the company that is then utilized to make investments in growing the team, expanding the product, or making acquisitions.

The data on revenue thresholds underscore the continued immaturity of the health IT market as well as the vast amount of capital chasing a still relatively small sector. Venture Capital and Growth Equity investors continue to shift towards lower revenue thresholds allowing low revenue companies to choose from an increasingly wide array of investors. This relatively low revenue threshold is undoubtedly bolstering valuations, heightening competitive dynamics across investor classes, and creating opportunity for large returns for early stage companies and investors who can grow into this highly sought investment tier. On the other hand, the large number of well-funded vendors makes for a very competitive market landscape.

Due to the scarcity of larger platform investments relative to the supply of capital seeking those investments, many buyout investors are making investments near or even below their minimum investment threshold. This has several implications. For one, buyout investors are competing with Growth Equity investors, resulting in competition that may raise valuations. When reaching downstream, buyout investors are making smaller platform investments but still have the need to deploy capital, which may result in a desire to put additional capital to work through follow-on acquisitions by the platform investment. The latter point is driving significant M&A activity. Private equity backed platforms present an excellent landing spot for earlier stage companies to exit, especially if those early stage companies might consider a deal that involves a portion of the transaction consideration to be paid in the form of rollover equity or earnout.

Q4-5: How do you prioritize Health IT as an investment vertical? Approximately how many platform (excluding add-on) Health IT investments has your fund made since 2016?



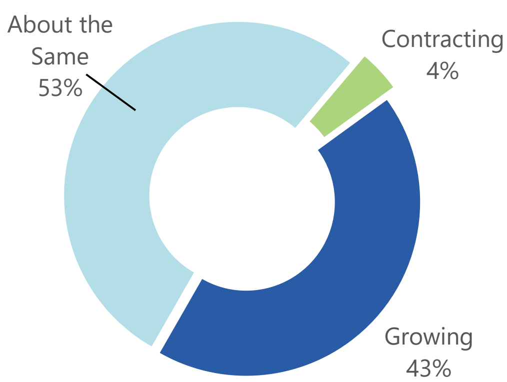


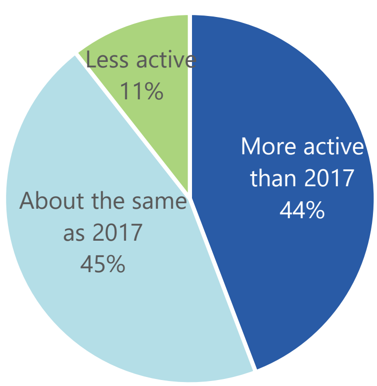
We broadly define Health IT as any health software, data, information, consulting, or technology enabled outsourcing company that may serve providers, payers, pharma, employers, or consumers. This includes both health software and health business services.

Of the 105 responses to our survey, a little more than ¼ focus the majority of their investments on health IT, a similar share are opportunistic (<20% directed toward health IT), and the remaining 45% focus between 20-50% of efforts on Health IT. This distribution is similar to that of the 2016 results, with a minor shift away from majority to significant focus. In line with our 2016 results, over half of the respondents have completed more than two health investments since 2016, and the percentage completing more than 5 has slightly increased.

While there is some bias in our survey findings, this bias means that our respondents are likely to be more knowledgeable of the health IT space than the typical investor. In our opinion, this makes the following responses more valuable and meaningful to companies in the space.

Q6-7: Is your investment focus on Health IT growing or contracting? How does your Health IT deal pipeline (aka, deal flow) in 2018 compare to 2017?

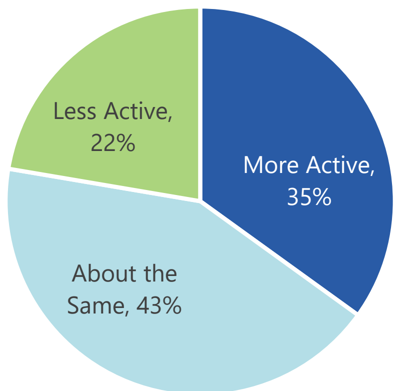




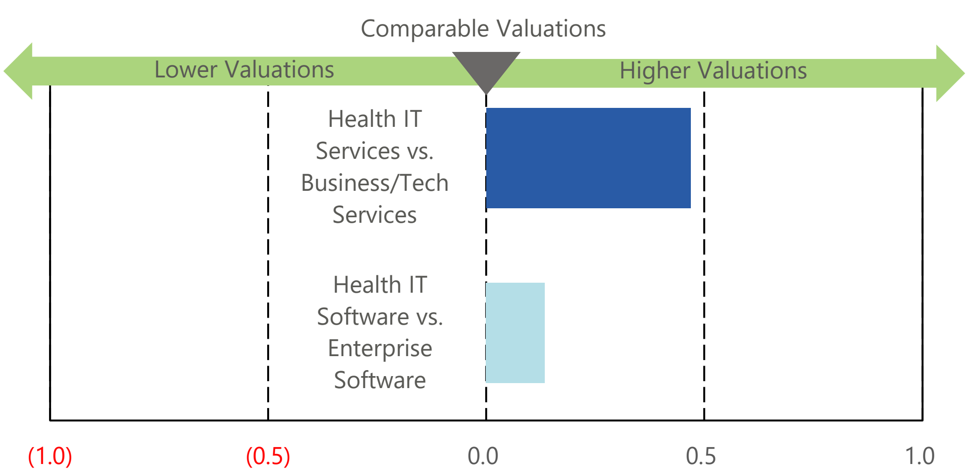
Q6-7: Is your investment focus on Health IT growing or contracting? How does your Health IT deal pipeline (aka, deal flow) in 2018 compare to 2017? (Continued)

Of the 105 respondents, 43% reported a growing interest in health IT investing and only 4% reported a contracting interest, consistent with 2016 results. 44% reported a more active deal flow and only 11% less deal flow, compared to 38% and 20% in 2016. This understated question is an incredibly positive signal for the health IT industry. Investors across all classes, Venture, Growth, and Buyout, are showing more interest and seeing more deals in health IT. Effectively, one could interpret this to mean that supply of capital is generally trending upward along with demand for that capital.

Q8: How does your Health IT deal flow compare to other sectors?



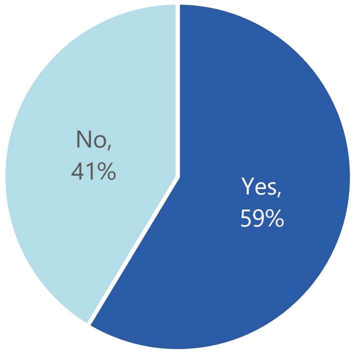
Q9: How do Health IT valuations (or valuation expectations) compare to other comparable software or information/business services sectors that you evaluate?



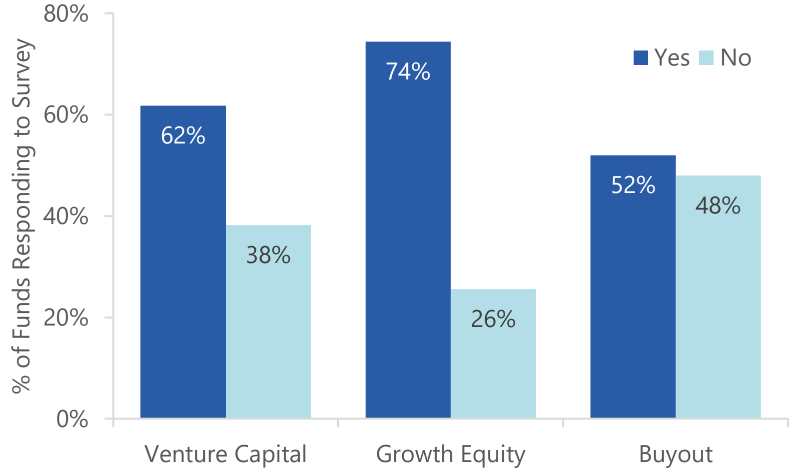
Survey respondents were asked whether Health IT Software and Health IT Services valuations are lower, comparable, or higher than their counterparts in enterprise software and business/ tech services, respectively. With regards to Health IT Services valuations, 55% of respondents claimed higher valuations, 36% comparable valuations, and 8% lower valuations in Health IT Services versus Business/ Tech Services. With regards to Health IT Software valuations, 34% of respondents claimed higher valuations, 45% comparable valuations, and 21% lower valuations in Health IT Software versus Enterprise Software. The premium for IT-enabled healthcare services is consistent with our 2016, however health IT SaaS is increasingly coming inline with its counterparts in enterprise software.

Q10: Do you have strategic LPs that can serve as potential commercial relationships or business opportunities for your Health IT portfolio companies in a meaningful way?

The market for strategic investments is rapidly evolving. Strategic investing may take many forms in varying degrees of strategic influence. Responses to this question mirror those of 2016 in which 44% of respondents answered "no" and 56% answered "yes". This slight uptick in funds having strategic LPs shows a continuation of the trend we saw in 2016. Key to this trend is greater forgiveness in the market for the conflict-of-interest that a strategic investment may create. Strategic investors include a cross section of corporate venture capital, healthcare organizations (payers, providers, pharma), and an active mix of institutional private equity with a strong base of strategic limited partners.



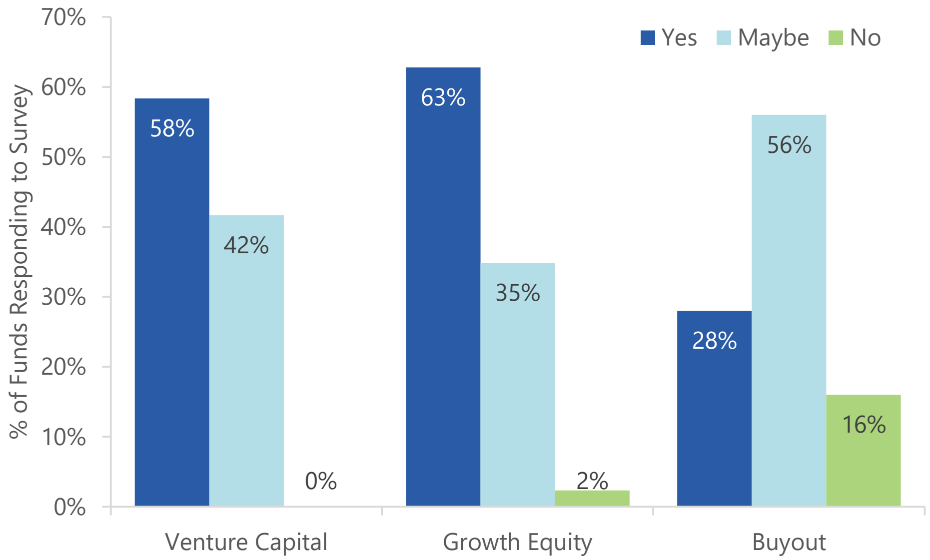
Q11: Do you frequently use structure as a strategy (eg, participating preferred) to lift valuations to be more competitive in transactions?



Although some very early stage venture and later stage buyout funds invest in the form of common stock, the majority of minority and partial control investments involve a preferred security. The 2018 results mirror those of 2016, with the exception of buyout shifting more towards "yes", signaling a drop in the use of common stock. Governance preferences that come with preferred securities typically include board seats, investment rights, and operational controls. Financial preferences generally include an array of liquidation rights, such as payment of dividends, anti-dilution, liquidation preferences, and participation. Any and all of these rights juice returns for investors and provide downside protection, sometimes at the expense of other shareholder classes, or worse, at the expense of misaligning the interests of all shareholders on the cap table. However, risk equals return, and whether the risk is in the form of taking on an early stage investment or paying an inflated price, investors will often structure preferences that compensate for the risk they undertake. Structure is frequently used to bolster valuations, a trade that shareholders are often willing to make.

It is admitted a challenge to create perfect alignment across shareholders who invest at different valuations at different stages of the risk cycle. We advise a thoughtful analysis to best align transaction structure with shareholder incentives across all investors and founders, both considering upside and downside scenarios. These models and general common sense should help red flag situations that may cause shareholder misalignment.

Q12: Is your Health IT investment strategy living up to expectations?

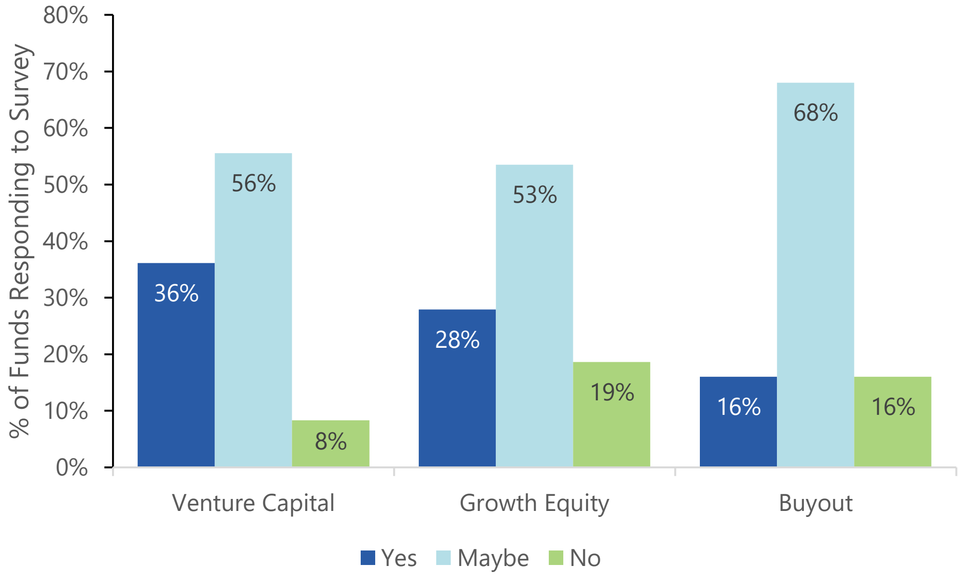


Investment interest, deal flow, and valuations in health IT track higher than comparable software and business services sectors. We are certain that dozens if not hundreds of private equity investors have set aside larger capital allocations to health IT investing. These trends beg performance questions about the strategy. Overwhelmingly, investors across all classes are satisfied by the performance of their health IT investment strategy and portfolio, more so even than they were in 2016.

As a whole, only 5% of respondents reported being dissatisfied, a slight drop from 2016. Growth Equity investors had the highest satisfaction, with 63% reporting a health IT investment strategy that lives up to expectations and 35% responding maybe, followed closely by Venture Capital with 58% “yes”, 42% “maybe”, and 0% “no”. Buyout investors showed less conviction, with 56% responding maybe, but only 16% indicating that their health IT strategy is not living up to expectations. Notably, there was an increase this year in Buyout respondents answering “maybe”, though results are overall in line with those in 2016. Either investors are delusional, or health IT is proving to be a sound investment thesis.

Q13: Do you think Health IT is in a bubble?

As previously discussed, bubble sentiment has changed little in recent years. Investors have a modest weighting toward bubble sentiment, however these results nearly mirror those from our 2016 survey. Bubble sentiment declines as investors progress further along the growth curve, with venture investors reporting bubble behavior at a much higher rate than buyout investors.



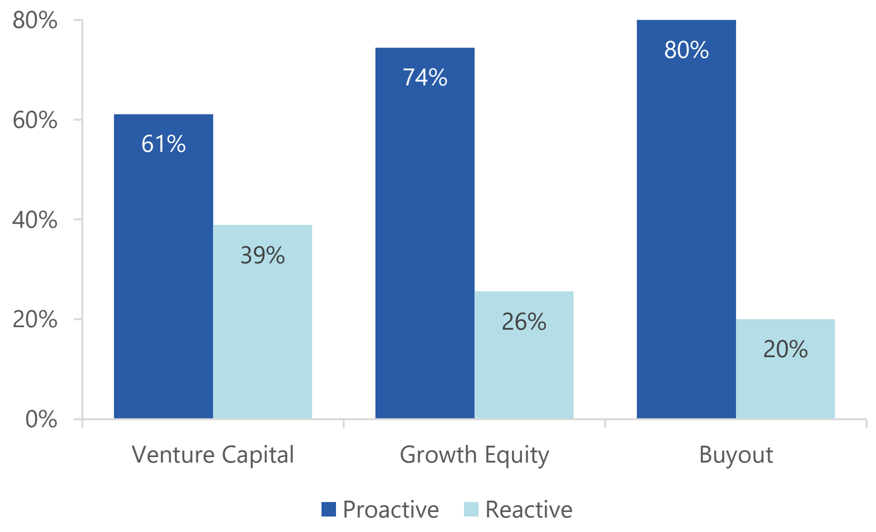
Q14: If you haven't made as many Health IT investments as you'd like, what is a common cause?

The responses from this open-ended question generally cut across four themes: challenging business models/ lack of high quality assets, deal sourcing, competition from strategic investors, and valuation. It is notable that in addition to the detailed quotes outlined below, 17 firms simply responded with "valuation" (or a similar variation of this) as to why they have not made as many Health IT investments as they would have liked. Notable responses are included on the following page.

Q14: If you haven't made as many Health IT investments as you'd like, what is a common cause? (Continued)

Category	Fund Comments
Business Model	"Not that many high quality assets out there; lots of gimmicky point solutions with inexperienced entrepreneurs; the high quality companies are going for valuation that will make it tough to have an OK return given the sizable risk still bound to these assets."
	"Few high quality assets out there, lots of noise; those companies that are notable have insane valuations."
	"Lack of investible business models"
	"The stage is too early for us (e.g. the go-to-market plan missing, the product is not yet ready, no initial pilots/customers)."
Deal Sourcing & Investment Strategy	"Limited resources and time spent elsewhere."
	"Flow of appropriately sized opportunities"
	"Not seeing enough deals, minimal specialization internally."
	"Didn't have an operating partner focused on that sector"
	"Focus on more innovative tech-enabled services models that may or may not have better valuations."
	"Finding quality deals that meet our investment requirements at a reasonable valuation."
	"We invest non-control structured equity stakes, and sellers are often times looking for a complete exit given the high multiples."
	"Lack of knowledge about the specific niche industry."
	"Round sizes are increasing in size and moving earlier, so that many "Series A" deals that historically would be post-recurring revenue are now during pilot trials or even pre-pilot."
Strategic Competition	"Competitive deal environment makes it difficult to win."
	"Competitive strategics."
	"Competition and associated high valuation multiples result in low chance of signing up a deal."
Valuation	17 funds responded "valuation" (responses below are in addition to the 17)
	"Inflated valuations - there is a lot of money to go around the market right now. It's definitely an entrepreneur's market."
	"Valuation expectations relative to financial performance."
	"Valuations are too high at the A, B and beyond ranges (vs seeds that are OK). Given dearth of venture scale exits, it becomes hard to justify investments and there are other sectors where the $ can go with better success."
	"Finding the right quality assets at the right price."
	"Valuations are also significantly higher than years past."

Q15: Do you proactively develop a thesis for investing in specific market verticals or do you take a more general, reactive approach to investment opportunities as they present themselves?

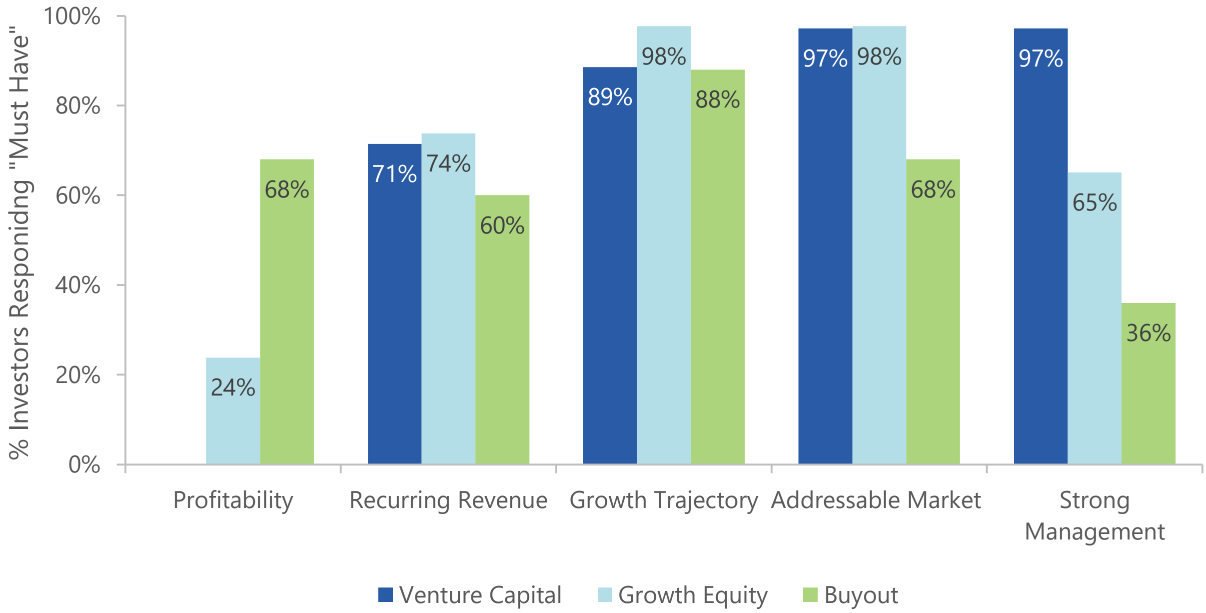


A proactive strategy is defined as an investment strategy that targets specific investment opportunities based on a preconceived investment thesis that addresses specific market and competitive dynamics. True proactive investors will filter investment opportunities that do not meet their investment thesis. In order to not limit themselves, proactive investors generally require multiple theses across multiple segments in order to ensure active and diverse deal flow. On the other hand, reactive investors tend to focus less on a market thesis and more on opportunism. In some respects, it is hard to say that the two strategies are mutually exclusive. A reactive investor generally will not make an investment unless it stands up to a strong investment thesis, which may be consciously or subconsciously the rationale behind the positive reaction to the investment. However, the approaches tend to be different. Proactive investors generally pursue a more aggressive outbound campaign of identifying and contacting potential companies that meet their thesis.

On occasion, HGP makes select investments, and despite our sharp industry focus, we are often reactive investors. As a generalization, two criteria make us react. First, strong, trustworthy, and ideally proven management teams. Second, regardless of market segment or size, we look for companies that offer a go-to market and pricing strategy capable of shortening the sales cycle and aligning value across the conflicting stakeholder incentives that are unique to this complex market. The complexity of the healthcare market makes delivering value and designing a go-to-market strategy around the value proposition as critical and complicated as ever. In this market, it is easy to be misled by theoretically sound solutions that are practically difficult to implement.

The 2018 survey results were overall in line with those in 2016. Venture capital swung towards being more reactive (39% in 2018 vs. 20% in 2016) and growth equity and buyout swung the opposite direction showing a slight increase in proactive responses.

Q16: How important are the following characteristics when assessing an investment?



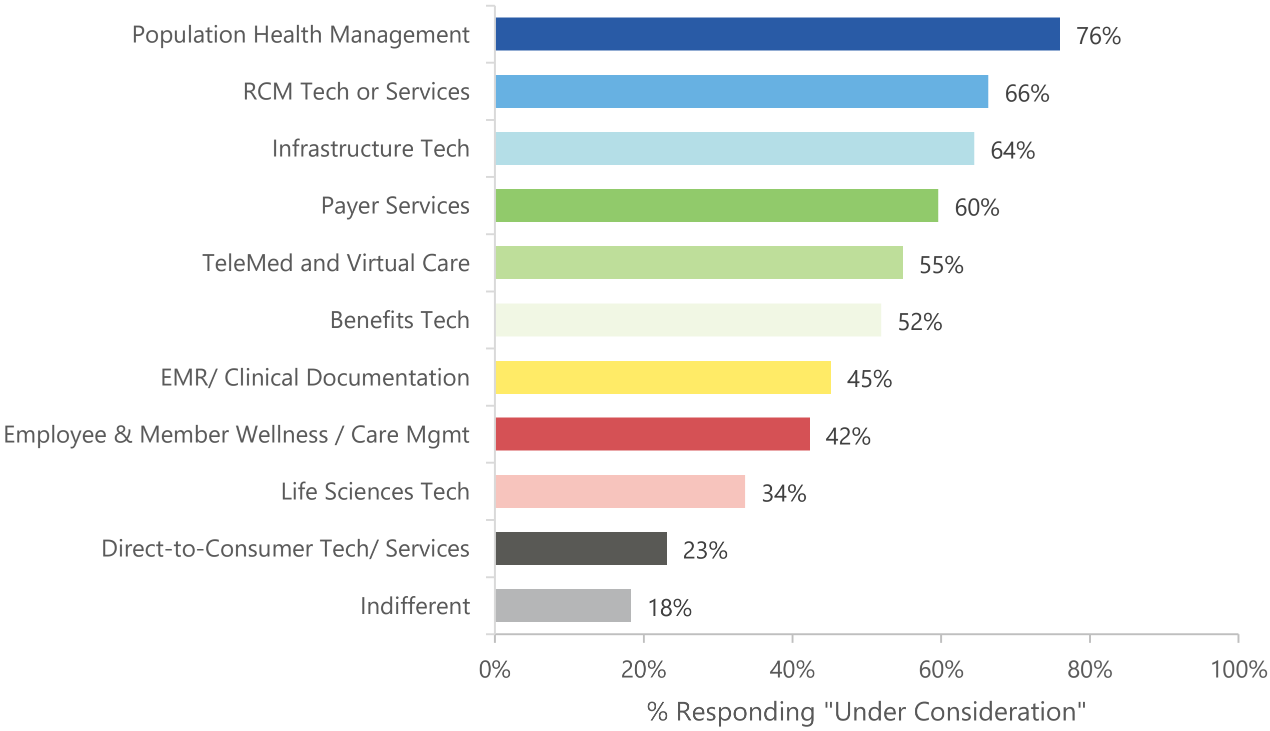
Investment criteria varies widely by stage of investment. In order of priority, Venture Capital investors seek strong management, a large addressable market opportunity, growth, and recurring revenue. This order of priority is consistent with the 2016 results, though there was a notable increase in the number of respondents assigning recurring revenue as a must have (71% vs. 48% in 2016). Profitability is not a requirement for Venture Capital with zero respondents assigning it as a must have, but obviously a path to it and the ability to demonstrate scale is important.

Living up to their categorical name, Growth Equity investors rate growth and addressable market at the top, followed closely by recurring revenue, then strong management. Profitability was of lower importance to Growth Equity investors; however, we believe that most Growth Equity investors will be less forgiving about losses than their Venture Capital counterparts.

Finally, Buyout investors scored growth trajectory highest, followed by addressable market, profitability, and recurring revenue. There appears to be a larger emphasis on growth trajectory this year than in the past. It is no surprise that profitability is of high priority for these investors as they typically prefer to borrow against a company's profits – as much or more than 6x EBITDA. Similar to 2016, strong management came in last, with only 36% marking it as a must have. This is most likely due to the fact that management shareholders may sell during a recapitalization or buyout transaction, and in many cases, the Buyout investor will install their own executive leadership at the time of investment.

We did not ask what investors avoid. We would guess that most investors avoid companies with large losses with a challenging line of sight to profitability. Second to operating losses would be a low gross margin that makes scalability a challenge. Significant losses even with impressive revenue growth may cause a significant drag on valuation or simply make a company un-fundable or unable to sell.

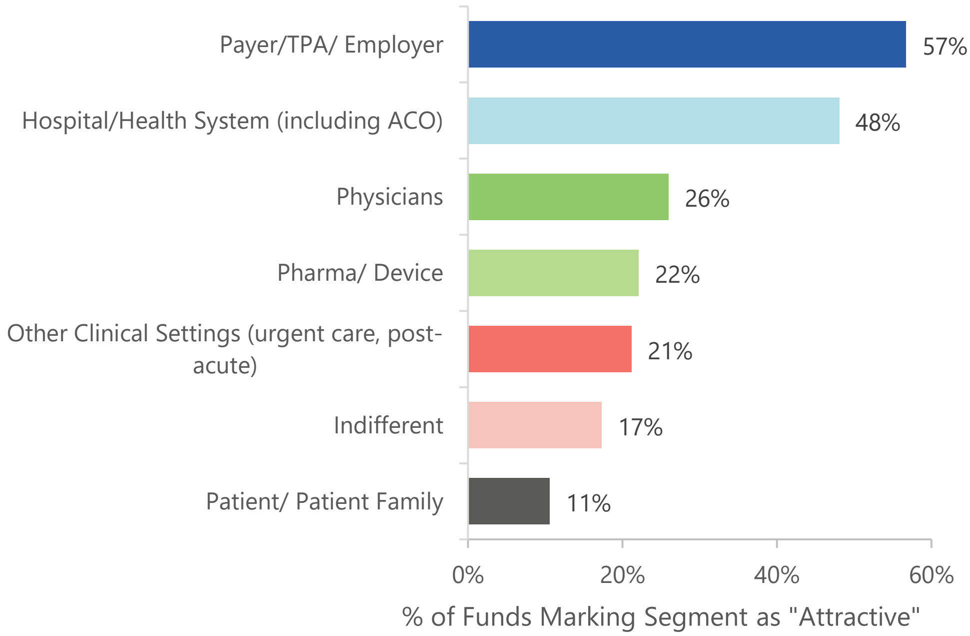
Q17: WITHIN HEALTH IT, WHICH SECTORS OR THEMES ARE UNDER CONSIDERATION FOR INVESTMENT?



Consistent with our 2016 results, the sector of highest interest is Population Health Management, which generally encompasses technologies and services that support value-based care delivery models as well as the decentralization of care. Revenue Cycle Management is the second most favored sector, closely followed by Infrastructure Technology. We imagine the interest in RCM encompasses both payer- and patient-based payments based on the transaction themes over the last year. RCM leaped from 50% to 66% between our 2016 and 2018 surveys, the largest swing in any subsector.

Additional detail about the sector/theme definitions was provided in the survey question. The survey further defined Population Health Management to include analytics, care coordination, and patient engagement; Infrastructure Tech to include resource management, supply chain, and compliance; and Benefits Tech to include insurance portal, enrollment, and exchanges. Approximately 18% of respondents said they were indifferent (these are probably funds that categorize themselves as Reactive investors), and several investors submitted write-in responses which included clinical coding, digital therapeutics, and data integration amongst others.

Q18: What is the most attractive customer segment represented by Health IT companies you evaluate?



Payer/TPA/Employer took over the top spot in our 2018 survey, with 57% of respondents viewing it as a "Most Attractive" segment. This marks a change from our 2016 survey, which reported Hospital/Health System (including ACO) as the most attractive segment, with 62% of responses. Payer/TPA/Employer received 48% of responses in 2016.

We speculate that Payers/TPA/Employer took over the top spot as a result of the increasing number of self-insured employers since implementation of the ACA. In 2017, 79% of employers with over 200 employees self-insure their health benefits, and 91% of employers with over 5,000 employees are self-insured. The employer is effectively the largest insurer in the United States, and unlike a traditional health insurance company, they are not equipped with the tools required to manage patient populations. And since employers are keenly focused on maximizing profits and enhancing employee satisfaction and retention, this is an extremely attractive customer segment for dynamic companies that offer solutions capable of bending the healthcare cost curve such as population health management, telemedicine, advocacy, care management, predictive analytics, benefits administration, patient engagement, and worksite health.

About Healthcare Growth Partners

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Our passion for healthcare inspires us to not only create value for our clients, but to also generate broad, overarching improvements to the functionality and sustainability of health. With our focus, we deliver knowledgeable, honest and customized guidance to select clients looking to execute high value health IT, health information services, and digital health transactions.

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