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VCs weigh pros and cons of health care

By Constance Loizos

Among the issues of concern is an excise tax at the point of sale for every medical device company.

The health care bill that President Barack Obama signed last week looks like a boon for a lot of health care startups, and potentially ruinous for others, according to VCs who've been following the debate.

David Jones, founder and managing partner of Chrysalis Ventures in Louisville, Ky., says that some of the bill's biggest beneficiaries will be "young startup health care companies that make information more cost-effective and accessible."

Jones adds that Chrysalis made six new health care-related investments just last year, including Cleveland-based CerviLenz. The company produces an FDA-approved disposable device that is used to predict the risk of preterm birth in pregnant women. If diagnosed early, doctors can use progesterone suppositories to prevent some of those early births, and save billions of dollars in health care expenses, Jones points out.

CerviLenz has raised \$2.1 million in venture funding from Chrysalis, Arboretum Ventures and Jumpstart Inc.

"I can't say [the health care bill] is an unmitigated great thing, but money will begin flooding in, and in the context where everyone knows that costs are running out of control, we expect a lot more demand for the productivity enhancing products and services that are our bread and butter," Jones says.

Other health care startups, including those with long FDA approval processes, may not be so lucky, suggests Alan Frazier, founder of Seattle-based Frazier Healthcare Ventures.

"One can make the argument that we on the VC side should be thinking of low-cost type products that provide better diagnostics or cheaper therapeutics, but the FDA isn't going to give us much of a break," he says. "They want us to do trials that show cost-effectiveness, but it's hard to come up with cheap products that do great work and that will still fit in this [new] system."

Medical device companies, in particular, may be hardest hit by health care reform, says Lisa Suennen, the Corte Madera, Calif.-based co-founder of the health care-focused venture firm Psilos Group. The problem, she says, is the Medical Device Company Excise Tax, a provision in the new health care bill that, beginning Jan. 1, 2013, will impose a 2.9% excise tax at the point of sale for every medical device company, big or small.

"For medical device companies that are truly better from a clinical outcome standpoint and can reduce the cost to the health care system or reduce costs per procedures," the new bill is largely a positive, Suennen says.

On the other hand, she adds, "they're also taking it hardest from a tax standpoint. A nearly 3% tax on revenue—not on profit—is going to be fairly onerous for small companies, which will one of two choices: raise more capital to operate their business or raise their prices."

Suennen says she doesn't "think that's what was intended," calling the health care bill "pretty flawed." Designed to revamp the \$2.5 trillion U.S. health care industry, which accounts for one-sixth of the country's economy, the health care law will extend health insurance to 32 million Americans who lack it. It will bar practices like insurers' refusing coverage to people with pre-existing medical conditions, expand the Medicaid government health insurance program for the poor and impose new taxes on the wealthy.

Obama acknowledged the bill was "not perfect," but listed what he saw as numerous benefits, such as tax breaks to help Americans buy coverage.

In the wake of the newly signed health care law, investors interviewed by PE Week do not plan to heighten their commitments to finding health care opportunities.

John Steuart, managing director Claremont Creek Ventures in Oakland, Calf., says that the firm is "staying the course.

"I wouldn't say the bill is going to encourage us to put more dollars to work in [health care], but it won't discourage us," he says When Claremont goes shopping next, he adds, it will look not just atstartups providing better care, but "better value care."

Steuart says that one Claremont portfolio company that could potentially draft off the new health care legislation is Mountain View, Calif.-based Tibion. The company accelerates recovery time

cheaply, through a robotic device that promotes rehabilitation, including helping knee-surgery patients. Steuart points out that Tibion's products are designed to replace occupational therapists. The eight-year-old company has raised \$6.64 million in VC funding from Claremont and Saratoga Ventures.

Meanwhile, Jones of Chrysalis—which divides its portfolio evenly between IT and health care companies—says that he and his firm have actively sought deals, even as many health care investors were waiting out the reform debate.

"We made six new health care investments last year that center on productivity and efficiency," he says. "Our view was that anything being talked about in Washington, D.C., would make these issues more important and that even if the overhaul didn't happen, the cost problem was still going to be out of control."