

Angel Healthcare Investors: A Product of Environment, People, and Process

Robyn C. Davis, Mary C. McNamara, and Geoff Maletta

In New England, myriad businesses have emerged that are focused on all segments of the health care industry, from services to medical devices to biotechnology. Driven by the increasing pricing pressures of the early 1980s, a boom in health-care-services companies met a large unmet market need with increasingly creative solutions. Moreover, technical discoveries at such institutions as MIT, Harvard, and Boston University provided the innovations that launched pioneering medical-device businesses. These nascent New England companies ushered in an age of innovation that eventually spread across the nation and the world.

Following a series of successes in the 1980s, the early 1990s was a boom period for biotechnology firms. New England accounted for success stories such as the “Billion Dollar Molecule” (FK-506 for immunosuppression) at Vertex, Avonex (muscular dystrophy) at Biogen, and Renagel (renal disease) at Genzyme. Metro Boston emerged as a fertile environment for discovering, creating, and commercializing technologies that were both breakthroughs as well as the building blocks of the next generation of drugs. This biotech explosion in New England can be traced back to several favorable conditions in the region’s health care industry: proximity to the leading educational institutes and teaching hospitals; a large pool of talented scientists and professionals both produced and attracted by those institutions; a fully integrated value chain from suppliers to services; and healthy access to both government funding and venture capital. Today there are some 280 biotech companies in Massachusetts, more than three times the number ten years ago.¹

Whether biotechnology is a direct offspring or distant cousin of the medical device and health-care-services industry that flourished in New England during the 1980s can be debated from economic, demographic, and legislative perspectives. How much did the success of Boston Scientific, Tufts Health Plan, the ADS Group, Lincare, and Lifeline contribute to the boom in biotech? What is clear is that the past 20 years of health care and biotech success in the area has created: abundant investment opportunities in early-stage health care and biotech entities, an infrastructure reasonably evolved to nurture those entities into commercial technologies and/or profitable service models, and a vibrant capital market willing to fund new ventures.

Fueling this health care and biotech activity were hundreds of seasoned, knowledgeable industry professionals—executives, scientists, and investors. Many of the success stories of the last two decades created personal wealth for a talented group of men and women who have moved on from their original employers such as Alkermes, Serono, Thermo Electron, or Children’s Hospital. From major firms and teaching hospitals, these industry pioneers exploited their experience or used personal gain to create new technologies, therapeutics, and service solutions. New England has birthed a thriving community of these professional entrepreneurs who are in pursuit of the next blockbuster platform or therapeutic. Coupling their resources with

¹ Massachusetts Biotechnology Council and The Boston Consulting Group, “MassBiotech 2010: Achieving Global Leadership in the Life-Sciences Economy,” 2002.

the overall growth in U.S. capital has allowed companies such as AbioMed, Infinity Pharmaceuticals, and ViaCell to tap into an incredible array of intellectual, human, and financial capital.

Historically, seed-stage investment from these professional entrepreneurs had been a critical yet somewhat invisible component to launching a health care start-up. These individual health care and biotech angels, originally acting alone, were the genesis of more organized angel investing in New England.² Be it a few colleagues such as Boston Medical Investors or a larger group like Angel Healthcare Investors, organized angel investing has become an increasingly important source of private equity investing in the region. At the outset, organized angel investing filled a capital gap that venture funds were unintentionally creating.

While many venture funds are early-stage investors, statistics demonstrate that the absolute number of seed-stage investments made by venture funds is small. For venture funds from 2000 to 2001, the number of seed deals and the amount of funds invested in those deals decreased by 23 percent and 50 percent, respectively.³ Funding needs of \$100,000 to \$1,000,000 could be filled by organized angel groups and then offered to larger funds for subsequent financings. While this is still partially true in 2003, the deterioration of the public equities market and overall economic uncertainty has created new opportunities for organized angel groups to fund or participate in later-stage deals. Both early-stage companies and institutional investors have sought the involvement of credible angels in rigorously evaluating business models, building stronger management teams, and leveraging industry and regulatory connections. As a result of adding value early on, angel participation is often welcomed in subsequent rounds.

The Birth of Angel Healthcare Investors, LLC

Angel Healthcare Investors, LLC (AHI) was founded on September 26, 1999, as a result of 20 years of friendship, business success, and a renewed commitment to support the creation and growth of successful companies in the health care sector. The founders—the late Susan Bailis, Alan Solomont, and Chester Black—and the original members shared a legacy of professional success in health care: they played major roles at ADS Group, HPR Inc., IDX, Lincare, National Development, and Visualization Technologies, among others. Perhaps more important, they also shared the belief that creating a community of collegial, well-connected, and talented health-care professionals could yield both economic and social benefits in the rapidly changing industry. In many ways, this coalescence occurred somewhat accidentally. Many of the original members found themselves, as a result of their professional success and subsequent exit, without a company to run and seeking a new community of peers. Also, entrepreneurs were approaching the members individually because the members had time, money, and expertise. These factors provided the common ground on which AHI was formed.

The founding members agreed to pay a membership fee to support the infrastructure needed to develop an efficient and sustainable organization. Individual involvement was not demanding. AHI met monthly in the conference room of a member's company. Each month, two

² For more information on the evolution and state of angel investing, see “Business Angel Investing Groups Growing in North America” at http://www.hcangels.com/Angel_Summit_Report.pdf.

³ Data provided by Jeffrey Sohl, Center for Venture Research (U. of New Hampshire).

companies were invited to present to the group, and group consensus was needed to move ahead with an opportunity. A critical mass of volunteers supported due diligence. If the deal was deemed to have merit, it would be offered to members for their individual investment consideration. At the first meeting, the group funded a \$1 million deal brought by one of the members; this investment effectively cemented the group. By December 1999, members were reading business plans referred by colleagues and acquaintances while the three founding members tried to determine which companies should be invited to present. Quickly, it became apparent that professional staff would be required to create an objective system to evaluate plans and to manage the increasing administrative tasks. In January 2000, AHI retained the services of two M.B.A.s to share the role of managing director. Coincidentally, the two new hires had been friends for 20 years and were looking to do something professionally together while they were raising their families. These managing directors brought a broad range of experience in strategy, analytics, financial services, and investments as well as in managing clients and teams. Their early goals for AHI were to create an objective, rigorous process to evaluate investment opportunities and to develop an infrastructure and approach that would allow AHI to become a credible, sustainable investment presence for many years to come.

Building an Investment Community

In order to fulfill the founders’ vision of a collegial investment community, the members and professional staff set out to design an efficient process and infrastructure to support the investment cycle, establish a culture within which the group would evolve and thrive, build credibility for the group as a single entity rather than as a sum of its parts, and promote a sustainable and valuable experience for its members, staff, and network.

Designing the Process. During AHI’s first six months, the managing directors and members worked together to create a straightforward process that would allow each investment opportunity to be evaluated in a timely manner through a series of filters. Each filter would add an additional dimension of analytics and expertise from the staff, the members, and their industry networks.

Angel Healthcare Deal Flow and Investment Process

	I. Evaluate Business Opportunity	II. Evaluate Investment Opportunity	III. Structure and Execute Deal	IV. Monitor Investment Portfolio
Activities	<ul style="list-style-type: none"> Review opportunity Have “pushback” discussion Solicit expert opinion Share opportunity at planning meeting 	<ul style="list-style-type: none"> Present to Angels Interview management Test pro-forma reasonableness Conduct due diligence with sub-committee 	<ul style="list-style-type: none"> Develop deal parameters with finance sub-committee Negotiate terms with company Coordinate funding Invest 	<ul style="list-style-type: none"> Review investment progress and ongoing financials Present to Angels with remarks
Decisions (decision maker)	<ul style="list-style-type: none"> Retire/Proceed (Staff) Retire/Proceed (Planning Mtg.) Retire/Proceed (Network) 	<ul style="list-style-type: none"> Retire/Proceed (Planning Mtg.) Retire/Proceed (Subcommittee) 	<ul style="list-style-type: none"> Investment amount (Investors) Deal structure (Finance sub-committee) Legal structure 	<ul style="list-style-type: none"> Modify investment situation (Investors) Influence business situation (Investors)
Outcome	<ul style="list-style-type: none"> Attractive 	<ul style="list-style-type: none"> Valuation 	<ul style="list-style-type: none"> Completed 	<ul style="list-style-type: none"> Updated, accurate

	investment opportunity for further due diligence	<ul style="list-style-type: none"> • Summary of opportunity • Individual investment consideration 	transaction	information on holdings
Time frame	<ul style="list-style-type: none"> • 2 to 4 weeks 	<ul style="list-style-type: none"> • 2 to 4 weeks 	<ul style="list-style-type: none"> • Variable 	<ul style="list-style-type: none"> • Ongoing/quarterly

The process became the mechanism for tracking opportunities and comparing and contrasting deals from a variety of sources and industry segments. By default rather than design, the process also became the framework for a virtual organization where staff, members, entrepreneurs, and alliances could work together quite easily using electronic distribution, conference calls, and shared Web sites. Moreover, the streamlined, virtual organization set the foundation for a cost-efficient business model. Technology supplanted administrative personnel, and value-managed relationships were aggressively pursued. This framework supported substantial growth from 1999 through 2003. Including follow-on investments, the group closed on 5, 10, 8, and 8 deals in 2000, 2001, 2002, and 2003 (YTD - August) respectively.

Establishing a Culture. The initial culture that developed was a product of the three founding members’ personalities and experiences, combined with the financial acumen of the volunteer CFO—a highly respected financial adviser to high-net-worth individuals. As mentioned earlier, the founders were seeking to create a community of people who wanted to mentor and fund health care entrepreneurs. Because these four individuals were entrepreneurs themselves, they sought an investor-company relationship that would be mutually productive with aligned incentives.

To accommodate increased membership and logistical needs, the group moved to a business meeting venue for its monthly gatherings. The atmosphere at the monthly meetings has been and is one of intellectual curiosity, spirited discussion, and, often, straight-from-the-gut advice to entrepreneurs. Purposely scheduled as an early morning breakfast meeting, the gathering members are alert and engaged. The group enjoys being together, and many members socialize outside of the monthly meetings. The first summer, a founding member hosted a social outing at his seaside home and invited a health care expert to speak to the group. This outing has become an annual event and serves as an opportunity for members to spend time in a more relaxed environment. The group also enjoys an annual dinner meeting held in an elegant setting, which provides an opportunity for the professional staff to present investment and business performance. The dinner also allows the entire group to discuss future goals regarding deal flow and membership.

Because the group has added new members primarily through word-of-mouth referrals, subsets of members can be found supporting a wide variety of causes, as well as sharing leisure time. Because new members are brought to the group by close friends or colleagues, AHI’s culture has been shaped by many shared events. The passing of founder Susan Bailis, the loss of mutual friends on September 11, 2001, and the subsequent economic downturn were evident in the atmosphere and dynamics of the monthly meetings. The members have shared good news as well: new children and grandchildren, a member’s successful IPO, and honors and accolades to members, spouses, and children.

The group has evolved into a thriving community of almost 50 members, sharing opportunities, challenges, and successes. The sense of community is interwoven through the group process and the activities of the members and makes for a rich experience.

Building Credibility. Gaining individual credibility in the New England health-care-investment community was not a priority for the founding members. Because many of them had been successful as CEOs and individual investors, they were focused on finding attractive investments in which the members could participate as a group.

However, with the addition of professional staff, the founders realized that while the members’ individual accomplishments lent the group credibility in working circles, AHI needed to build its own relationships, reputation, investment track record, and brand identity. Given the staff’s experiences in the financial services industry combined with members’ health care credentials, it was relatively easy to develop business objectives for the organization and to create metrics to measure performance over time. There was consensus that achieving superior performance in member quality, growth, deal flow, investment activity, and investment return would build AHI’s credibility in the larger investment and health care environment. In the early years, members agreed that all membership and deal flow goals would be met through word-of-mouth referrals and member and staff activities rather than publicity. The group believed that premature publicity would not ultimately help performance because it might create an influx of unqualified investment opportunities and requests to join the group that would burden the streamlined management structure.

As the staff and membership focused on building a professional environment embracing tenets of confidentiality, trust, and compliance, it was also fortunate that the group’s ninth investment, made in March 2001, achieved liquidity five months later. This event provided members with a favorable return and increased AHI’s visibility.

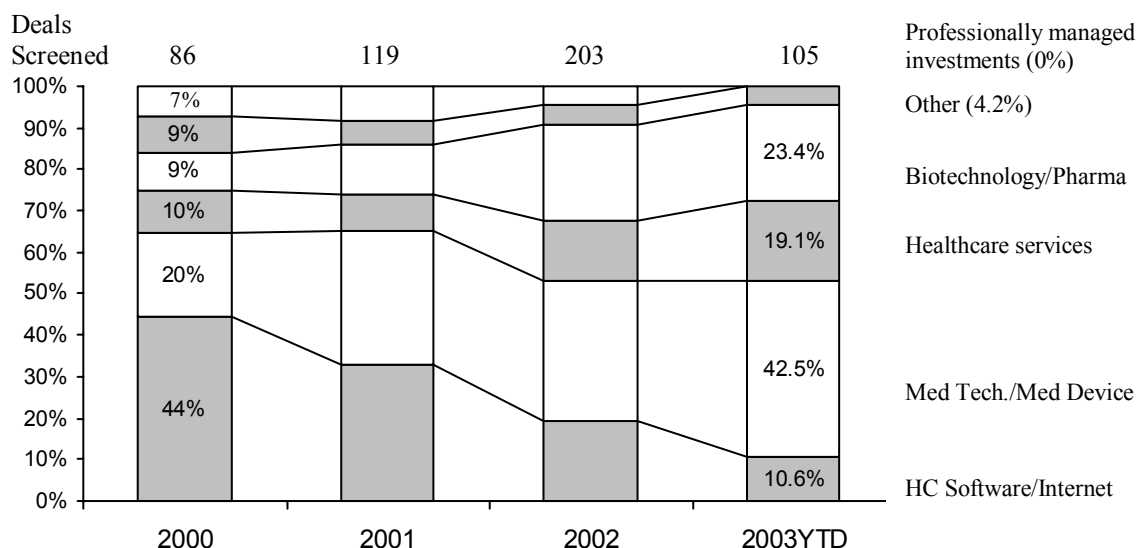
Promoting Sustainability. The final objective of the professional staff and founding members was to create an angel group that was sustainable. By developing clear processes and systems, supporting an emerging culture and building traditions, and educating and communicating both within the group and in the marketplace, the group evolved into an organization that was innovative, responsive, cohesive, and ultimately respected.

Specific Tactics to Promote Sustainability

Processes	Traditions	Communication
New Member Packet	Annual Meeting	Investment Memos
Deal Flow Process	Summer Meeting on the Cape	Angel Healthcare website
Subcommittee Process	Member Spotlight	Meeting Minutes
Investment Process	Member Breakfasts	Portfolio Updates
Secure File Sharing	Annual Staff Outing	Guest Speakers
Monthly Planning Meeting	Henderson House Meetings	AHI Box Score
Monthly Member Meetings	Member Booklet	Secure member website

This charter created a framework for expanding the breadth and depth of the membership, exploring new and emerging areas of health care and biotech, and institutionalizing incentives and fees to ensure consistency and alignment of interests.

Deal Segmentation Shifts as Markets Change ⁴



In addition to creating a sustainable infrastructure, it was also important to understand AHI's benefits and advantages compared with other investment vehicles available to high-net-worth individuals in the health care sector. From the beginning, the group sought to complement larger institutional players by offering a niche, focused investment vehicle allowing individuals to evaluate and selectively participate in a broad array of health care opportunities. By managing costs tightly and leveraging members and their networks, these opportunities could be pursued at a relatively low cost. And while "healthcare" is in the group's name, AHI is always open to opportunities that create value for its members (such as investments in hedge funds, large real estate syndications, and venture funds). This strategy allows for access to investments that would otherwise not be available to some members as individuals.

Ultimately, sustainability will depend not only on infrastructure and incentives, but also on returns. Given the difficult economic environment, investing in early-stage private equity requires patience, capital, and expertise. Certainly, health care—from services to life sciences—continues to be a strong growth industry. Demographics and disruptive innovation will remain the cornerstones for new products and services for at least the next 20 years. If angel groups such as ours can leverage their money and knowledge selectively, financial returns should exceed the returns from investments based on market and sector indices.

Investment Experiences

During the first months of AHI's existence, the staff and members agreed that the group needed to create a set of investment criteria as well as a standard investment structure. Both the criteria and structure would act as a starting point against which to filter opportunities and evaluate deal terms yet would also be somewhat flexible depending on the particular investment opportunity or macroeconomic factors.

⁴ "Professionally Managed Investments" includes venture funds, hedge funds, and real estate transactions.

A standard investment structure evolved that included a preferred security, dividends where applicable, preemptive rights, antidilution protection, and board observation rights. The main objective of the structure was to protect the early-stage investment as much as possible from future dilution or, in some cases, disintegration. At the same time, the standard terms were designed to be simple and clean, encouraging proper incentives for management to achieve milestones and for subsequent institutional investors to participate in a straightforward follow-on financing. All investments were made through one investment “vehicle” reflected as a single line on the Cap Table as opposed to individual participants writing checks directly to the company. This reduced the administration for the entrepreneur and the need to communicate with individuals from our group. Each investment had a designated portfolio monitor—either a staff person or a member—to observe the investment and communicate to the group. In addition, members and staff were asked to join the boards of directors or advisers of some of the portfolio companies. Board involvement was treated as a separate activity and any compensation was directed to the individual participant. Of course, members and staff acting in board or observer roles enhanced AHI’s contribution to the company.

As the group evolved, the investment criteria became more specific. AHI sought opportunities in all areas of health care and life sciences whose potential rewards would be commensurate with identified risks. Members agreed that promising opportunities would demonstrate a blend of strong intellectual property, positive future cash flows, solid revenue and exit potential, and a valuation supporting an attractive return on investment. Investment returns were never bracketed as 10X, 5X, 3X, as they often are in the venture community. The group was open to annuity returns, short-term acquisitions, and longer-term home runs through IPOs. More important was the relationship between recognized risk, potential reward, and expected time frame.

Most of AHI’s investments are in the Northeast. Occasionally, the group considers opportunities outside New England or outside the health care industry. Typical investments range in total between \$250,000 and \$750,000, and promising situations may be supported by follow-on capital. While the investment environment has changed significantly since the group’s inception, average individual investment has shifted from close to \$30,000 to \$22,000 and back towards \$30,000. Many of the more attractive deals, where the business or its management team may be a known quantity, are brought to the group by its members. In general, attractive investment opportunities share the following attributes:

People

- Exceptional management team with demonstrated track records
- Directors and advisers who actively advance the company
- Ability to attract co-investment and follow-on capital

Market

- Clear intellectual-property strategy or position
- Defensible competitive position in an emerging or growth market
- Clearly articulated value proposition
- Achievable exit in the next three to five years

Financial

- Market-validated equity valuation
- Year five revenues projected to exceed \$30 million
- Investment that offers a preferred or protected equity position

During our first three years, a booming economy became uncertain and depressed. The collapse of major corporations due to accounting fraud and overzealous analysts, and the setbacks from September 11 and the war on terrorism combined to make early-stage investing particularly challenging and even more risky than it had been just a few years before.

As mentioned earlier, the group had the good fortune to be invited into a deal developing therapeutic compounds for a very narrow disease target (“orphan drug”) that offered a liquidity event within five months of investment. This created some excitement in the group. While that particular therapeutic remains attractive, many others were derailed by lack of capital or failed clinical trials. AHI had to write down a couple of investments as well—primarily in the handheld/telemedicine space—as the market adoption rates took much longer than anticipated.

Overall, however, many of AHI’s early investments have exited with a modest gain, offer recurring distributions, or continue to develop toward revenue generation. AHI participated in several follow-on investments in its portfolio companies during 2001 and 2002—a time when new capital was elusive. An investment in a medical device incubator has spawned product spin-offs to major corporations as well as three new companies in the medical device sector. A cheaper, better, faster platform to perform molecular diagnostics through a smarter box is on track to be adopted by industry leaders. An invitation to participate in the purchase of a large portfolio of nursing home real estate has provided a steady stream of income at a very attractive annual yield. The group has also participated in two specialty health care funds: a leading life sciences hedge fund and a public equities fund focused on underfollowed, micro-cap medical device companies.

Each of AHI’s investments has its own merits and challenges. In the current investment climate, it continues to be difficult to raise institutional capital unless the opportunity is extraordinary. Compared to the feeding frenzy of two to three years ago, when investors were afraid of getting shut out of a deal, current investing occurs on an exception basis, and investors are in no hurry to fund start-up companies, even the more attractive ones. Because of the harsh fund-raising environment, the ability to bootstrap a company to a major milestone has become significant. Any company that needs to raise more than \$1 million before demonstrating some measure of value will incur scrutiny. While many biotech and life science investments will eventually require tens of millions—even hundreds of millions—of dollars, there is still much focus on those early achievements and what it costs to prove or disprove a potential innovation.

Benefits Beyond the Investment Experience

The professional staff and the founding members endeavor to participate in investment opportunities with above-market returns and to attract and retain high-quality members from all areas of health care. These goals are intertwined and have created benefits that extend beyond the formal mission of AHI. Not only have many of the members developed friendships, but also several have created new businesses together outside of AHI. Two of the original members joined with two later members to launch a specialty pharmaceuticals company that has the potential to reshape the value chain of drugs coming off patent. One founding member joined with a newer member to create a fund of hedge funds investing in non-health-care companies and offered the fund to members and other high-net-worth individuals.

Some members are also involved in shaping health care policy through the creation of a specialized institute to promote the business interests of major biotech and pharmaceutical players in New England. Others have achieved noteworthy careers advising presidents, governors, and industry leaders on the impact of changes to public- and private-sector regulation. Each member has been and is actively involved in many aspects of health care through business, intellectual, and philanthropic interests. Several shared philanthropic interests have emerged since the group was founded. The Susan S. Bailis Breast Cancer Research Fund (named for AHI's deceased founder) has strong financial support and draws its leadership from the group. A recent example is the endowment of a chair at a well-known local university to acknowledge the contributions to the school and to health care nationwide by a member of AHI. Members are drawn to these initiatives not for the networking potential but because of personal affection. While AHI's monthly meetings provide an opportunity to evaluate specific investment opportunities, the real value of membership seems to extend beyond the breakfast buffet.

What's Next for Angel Healthcare?

Since inception, AHI has moved with the market—expanding its membership and portfolio from health care services to technology and, most recently, to life sciences. What started as a collection of personal networks has evolved and—through business development activities—grown into a network available to all members and portfolio companies. The group has moved from a transaction-based business, as many investors were several years ago, to a relationship-driven organization. Both individually and collectively, AHI has become increasingly sophisticated in the way it evaluates, funds, and monitors opportunities. Because of the respect for the national reputations of many of its members, AHI will continue to increase its membership cautiously, appreciating simultaneously the importance of fit and breadth of experience.