

## Not Invented Here is Not an Option for Healthcare Information Technology Companies

## By Dave Kauppi, CBI and James R. Brennan, CHE

As an M & A advisor, we regularly dialogue with the top executives in the industry. We have to chuckle when we reach a decision maker with a large HIT company and he says, "We have a corporate policy that we do not buy companies." Does this guy read the industry publications? Did he miss the latest HIMSS Conference? Things on the first floor of the San Diego Convention Center were pretty much the same – the usual suspects. The convention, however, had grown to 1100 exhibitors and the overflow required almost the entire second floor.

That was fun. What energy. It kind of reminded me of the old dot com days. Lots of money, talent, ideas, hope, energy, and potential successful businesses. This is the innovation environment in HIT and any large company that feels it can keep pace with this force through internal development efforts alone is headed down the path of extinction.

Almost everyone will agree that information technology will be a primary driver of controlling costs in the healthcare industry. There is, however, a huge paradox in this market. The institutional buyers of that technology are relatively conservative late adapters. This prevents the expected innovation and commercial success that should naturally follow the resources and passion of these HIMSS innovators.

These entrepreneurs respond to a market need and achieve encouraging initial success from the early adopters. They soon hit the wall and are not able to "cross the chasm" from a small group of early adaptors to general market acceptance from the conservative majority. There is little economic value created when good technology is in the control or a failing company and the technology never reaches broad acceptance.

Most of the blockbuster new products are the result of an entrepreneurial effort from an early stage company bootstrapping its growth in a very cost conscious lean environment. Think of some of the new developments from PACS companies. The big companies, with all their seeming advantages have a very high internal cost structure for new product introductions and the losses resulting from those failures are substantial. Don't get me wrong, there were hundreds of failures from the start-ups as well. However, the failure for the edgy little start-up resulted in losses in the \$1 - \$5 million range. The same result from an industry giant was often in the \$100 million to \$250 million range.

For every IDX or eMerge there are literally hundreds of companies that either flame out or never reach a critical mass beyond a loyal early adapter market. It seems like the mentality of these smaller business owners is, using the example of the popular TV show, Deal or No Deal, to hold out for the \$1 million briefcase. What about that logical contestant that objectively weighs the facts and the odds and cashes out for \$280,000?

As we contemplated the dynamics of this market, we were drawn to a merger and acquisition model that is used in the networking technology market by Cisco Systems. We believe that model



could also be applied to great advantage in the Healthcare Information Technology industry. The giant networking company, is a serial acquirer of companies. They do a tremendous amount of R&D and organic product development. They recognize, however, that they cannot possibly capture all the new developments in this rapidly changing field through internal development alone. Cisco seeks out investments in promising, small, technology companies and this approach has been a key element in their market dominance. They bring what we refer to as smart money to the high tech entrepreneur. They purchase a minority stake in the early stage company with a call option on acquiring the remainder at a later date with an agreed-upon valuation multiple. This structure is a brilliantly elegant method to dramatically enhance the risk reward profile of new product introduction. Here is why:

## For the Entrepreneur:

- 1. The involvement of Large HIT Investor resources, market presence, brand, distribution capability is a self fulfilling prophecy to your product's success. The halo of the big secure company helps you cross the chasm to the conservative majority institutional customer.
- 2. For the same level of dilution that an entrepreneur would get from a VC, angel investor or private equity group, the entrepreneur gets the performance leverage of "smart money." See #1.
- 3. The entrepreneur gets to grow his business with Large HIT Investor's support at a far more rapid pace than he could alone. He is more likely to establish the critical mass needed for market leadership within his industry's brief window of opportunity.
- 4. He gets an exit strategy with an established valuation metric while the buyer/investor helps him make his exit much more lucrative.
- 5. As an old Wharton professor used to ask, "What would you rather have, all of a grape or part of a watermelon?" That sums it up pretty well. The involvement of Large HIT Investor gives the product a much better probability of growing significantly. The entrepreneur will own a meaningful portion of a far bigger asset.

## For the Large HIT Investor:

- 1. Create access to a large funnel of developing technology and products.
- 2. Creates a very nimble, market sensitive, product development or R&D arm.
- 3. Minor resource allocation to the autonomous operator during his "skunk works" market proving development stage.
- 4. Diversify their product development portfolio because this approach provides for a relatively small investment in a greater number of opportunities fueled by the entrepreneurial spirit, they greatly improve the probability of creating a winner.
- 5. By investing early and getting an equity position in a small company and favorable valuation metrics on the call option, they pay a fraction of the market price to what they would have to pay if they acquired the company once the product had proven successful.

MidMarket Capital has created a Healthcare M & A practice that combines 20 years of industry experience with the investment banking experience to structure these successful transactions. We



can either represent the small entrepreneurial firm looking for the "smart money" investment with the appropriate growth partner or the large industry player looking to enhance their new product strategy with this creative approach. This model has successfully served the technology industry through periods of outstanding growth and market value creation. Many of the same dynamics are present in the Healthcare Information Technology industry and these same transaction structures can be similarly employed to create value.

David Kauppi and James Brennan are principals with Mid Market Capital, Inc. MMC is a private M&A Advisory firm specializing in providing corporate finance and intermediary services to entrepreneurs and middle market corporate clients in healthcare and information technology. The firm counsels clients in the areas of mergers, acquisitions and divestitures, private placements of debt and equity, valuations, corporate growth and turnarounds. Dave began his high tech Mergers and Acquisitions practice after a twenty-year career within the information technology industry. Jim brings a broad background including telephony, information technology and healthcare.