E X P E R T Q & A

The cost of US healthcare is going up but outcomes are getting worse – the venture community is at the heart of the search for innovative solutions, says Luke Düster, chief investment officer at CRG

Lending to the healthcare disruptors

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Q How would you describe the market opportunity for private debt in the healthcare sector?
Our focus is on the hyper growth segment of healthcare private credit, working with the innovators and the disruptors, which represents only 1 percent or less of the total healthcare market.

If you are growing slowly, you can predict a lot, you have control over your expenses and you can manage your payors, so you are generally easy to lend to. If you're growing fast, though, you are consuming cash and it is difficult to predict your account receivables – you might have positive EBITDA but your cashflow may be negative. Our focus is on the latter, but we don't underwrite binary risk. We don't invest in companies unless they have FDA approval, and they are in the market, delivering revenue and growing.

Traditional private credit tends to lend based on a spreadsheet – we like to get into the company, analyse the industry, the management team, the supply chain and so on. We do the same due diligence as private equity, because the cashflows we are looking at are so volatile. We want to lend to the companies that are going to make the system better, improve outcomes, reduce costs and increase access for patients.

In terms of the current market opportunity, in the US, healthcare accounts for around 17 percent of GDP, so it is a huge market and one of the largest industry sectors. About $4.5 trillion is spent each year, with half of that paid by the US government. There are public and private payors in healthcare and both are complicated to understand because they have different incentives.

It would be hard to find a large private credit manager without exposure to healthcare, as it accounts for a sizeable component of most private credit allocations. Still, 99 percent of that capital currently goes to what I would

Q What does the future look like for private credit in healthcare?

In our segment, the future looks really good because we have all those tailwinds driving change. There has to be a shift in the cost structure, and that is forcing people to adopt new technologies and try out new business models.

It is less clear what will happen for the behemoths of private credit looking to lend to more mature companies. Generally, private credit is having its moment in the sun, and those moments come and go. Allocators come in and out of asset classes but private credit is here to stay unless there is some massive deregulation in the banking sector, which seems highly unlikely in my lifetime. The issue, though, is that the asset class gets top-heavy, which could lead to fee compression and downward pressure on returns in traditional direct lending.

What we do is exciting, and the market can sustain itself because it is a less competitive space with higher barriers to entry. We feed off venture debt and the truth is that if companies have loans that they cannot repay, that creates a refinancing opportunity. So, the more loans that are made, the more private credit opportunities there are down the line.

Private credit is now institutionalised and well embedded in the healthcare space, and that is not going to change. Our niche can generate higher returns in a differentiated way, and that will continue to be appealing to investors moving forward as the healthcare industry undergoes a period of significant transformation.

term the dinosaurs – inefficient larger companies that do not evolve quickly.

In pharma, for example, R&D budgets have gradually become smaller over the last 30 to 40 years and those big companies now outsource innovation to the venture community. The same is true in medical devices and healthcare services, creating an opportunity for growth equity and venture to invest in innovation. This market was booming until 2022.

With the collapse of the venture debt market in 2023, M&A down, IPOs down and SPACs off, all the things we were competing against in 2021 are gone, so the market opportunity for lenders has never been so good. We are seeing an amazing opportunity in the 1 percent of the market we are targeting, and there is materially less competition.

Q What are the attractions of the asset class for LPs?

LPs like this strategy because the spreads are high. We are in a returns business, and returns are higher here than in traditional private credit. You can get similar returns in traditional private credit by using a lot of leverage, but here we can achieve those returns without that. So, for LPs, this is a different way of achieving an attractive return profile. In addition, there are all the usual things that make traditional private credit attractive: great downside protection, good recurring cashflows, low volatility and always the first money out.

If you compare private credit with the equity in some of the companies we are lending to, equity is going to be a bit more volatile, with winners and losers. We mitigate that volatility by being senior secured and we are indifferent to the size of the ultimate exit, unlike the equity.

For a lot of LPs looking for healthcare-specific investments that make a positive impact on society, with good returns and low volatility, this is very compelling.

Q What benefits are there for lenders in being a sector specialist?

In order to do what we do, you cannot be a tourist. You have to be absolutely here, living in the world of healthcare, so that you understand the reimbursement environment, the regulatory landscape and the competitive environment.

A sector specialist is never going to have a trillion-dollar fund but they will be able to find bespoke deals. If you have been in the industry a long time, you have a different sourcing mechanism. We have never done a syndicated loan, for example – almost everything we do is proprietary, and we are always the sole lender.

We are typically investing in companies that we have been tracking for at least three years, so it is about developing relationships from an early stage. We might get to know a management team before a product gets approved, then monitor whether they secure approval, evaluate if they can effectively manage their supply chain, execute on their sales force buildout and so on. We look at their key performance indicators for success and that gives us a critical advantage when it comes to making the right decisions on what goes into our portfolio.

An example is Oura Health, which is a Finnish health technology company founded in 2013 that created the world's first wellness ring that links to an app. We identified that opportunity early, evaluated the product, saw they were doing the right thing and reached out to them, so that when they were looking for a lender, they came to us. We will likely be taken out of that investment by a traditional lender at some point, but it takes a non-traditional sector specialist to identify that initial opportunity.

Q What are the current trends driving the growth of the opportunity set?

The trends are primarily about trying to fix what is broken. In Western healthcare, that is spending enormous sums of money, but not getting great outcomes. In the US, the cost of healthcare is going up but outcomes are actually getting worse, not better, creating an incentive for governments and private insurance companies to do better for patients and reduce costs.

The other challenge is increasing access, because one of the things that leads to higher costs is you may have a patient at home who catches a cold, is 85 years old, has diabetes, and that cold leads to pneumonia, which then triggers a heart attack. That patient ends up in an intensive care unit, costing the system thousands of dollars a day, when it would have been so much better to reach them early and get them antibiotics before they became critically ill.

Furthermore, there is also a huge trend towards value-based care. Right now, we have a fee-for-service model where doctors get paid based on how many surgeries they do rather than whether or not those surgeries are the best thing for the patient. What we need is all parties to collaborate and determine what is best for the patient in terms of outcomes instead of procedures.

That is going to be the long-term macro trend but it will not be easy. It is going to require new business models, new technologies, advancement in care and huge data analytics to measure outcomes across patient populations. Right now, the system is focused on treating symptoms and we need to move upstream to help people avoid becoming symptomatic. That will need innovation and a lot of work, but it is absolutely necessary.

Q Are there any headwinds facing lenders to the healthcare space?

The real challenge is talent. On the credit side, we are competing with private equity for talented healthcare specialists because it is not people with traditional credit backgrounds that we need. We need people with a deep understanding of the sector, able to analyse the companies from a standpoint of what they are worth, and that is a different skillset.

Additionally, we are a small fund with limited resources, competing with big groups for fundraising, so that can be challenging. And then, of course, the biggest challenge for lenders is to be patient and remain disciplined in the face of numerous deployment opportunities. ■

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