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Internet VCs Circle Health Care

Silicon Valley investors helped reinvent everything from sharing photos to buying books online. Now can they fix health care?
By Deborah Erickson

Some prominent venture capitalists are betting that the Internet strategies that created giants such as eBay and PayPal could reshape the ailing U.S. health-care system. That system currently devours 18 percent of the world's largest GDP while delivering mediocre health results.

In August, the online health marketplace ZocDoc, which lets patients look up doctors by specialty and zip code and make appointments over the Internet, raised $50 million from the investment fund of Russian billionaire Yuri Milner, who in the past has backed companies like Facebook, Twitter, and Groupon.

The idea behind ZocDoc and other startups getting funding is that our costly, paper-based health-care system is ripe for the same technological fixes—such as data visualization, cloud computing, and mass-market self-service concepts—that have transformed industries such as consumer banking and travel.

However, many venture investors say that investing in health-care IT (HIT) isn't as easy as putting money behind, say, the latest social-media company. Health care is more complicated, more regionalized, and subject to more government rules. The U.S. Food and Drug Administration surprised many software entrepreneurs this summer when it said it planned to regulate some health software apps for phones.

"A lot of venture capitalists *say* they are investing in HIT, but right now, there seems to be more education going on than investing," says Rebecca Lynn, a partner at Morgenthaler Ventures, based in Menlo Park, California.

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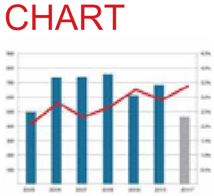

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According to Dow Jones VentureSource, venture investments in HIT rose about 20 percent in 2010, to $460 million, or about a fifth of the $2.3 billion that venture capitalists invested in all health companies, including biotech firms.

Jessica Canning, research director for VentureSource, says half the deals counted in 2010 were seed-stage or first-round financings. She called that "very promising at a time when VCs are struggling to keep their existing portfolios alive. It means a pipeline is being built in HIT."

Even so, many entrepreneurs are running into difficulty finding investors who understand both the heavily regulated health-care industry and software innovation, says Sonny Vu, cofounder of Agamatrix, which manufactures a diabetes monitor for the iPhone. "On the one hand, you have people raising money who know nothing about regulation or reimbursement codes; on the other, a bunch of health-care guys who think Zynga is some kind of fruit. There is truly a chasm between world views."

Some investors also question whether the venture capital model of plowing money into risky early-stage companies will pay off in HIT. "Relatively few VCs have sufficient depth of expertise with both the health system and IT," says Barbara Lubash, a managing director at Versant Ventures, also in Menlo Park. "But the usual reason HIT doesn't get funded is because the opportunities aren't large enough."

One reason is that most large hospitals have already sunk hundreds of millions of dollars into legacy IT systems built in-house or developed by dominant players such as Siemens, or Midwestern companies like Cerner or Epic, and are unlikely to move to new offerings. As a result, many entrepreneurs are looking for underserved niches in HIT, such as health apps meant to run on mobile devices. But those kind of inventions have limited appeal for professional investors, says Lubash: "We look for opportunities that are reasonably large, capital-efficient to pursue, and positioned to achieve sustainable competitive advantage. There aren't a lot of those models in HIT."

Some of the most aggressive investing in HIT is being done by specialized funds outside of Silicon Valley run by people with medical backgrounds. Among them is Santé Ventures, based in Austin, Texas. "I truly believe if you start with a massive pain point and provide a real-life solution, you'll be successful" as an investor, says Santé cofounder Joe Cunningham, who was formerly chief medical officer for the Providence Health System, part of Ascension Health, the country's largest nonprofit health provider.

One Santé investment is Rise Health, a startup that runs call centers where doctors and nurses with electronic medical records triage patients, treating some "virtually" while ensuring that others get basic care. Rise is targeting health systems that both insure patients and provide their health care, such as Kaiser Permanente, with promises to limit costs while improving patient care.

Other startups have been receiving investments from large IT companies who see health care as an important new market. In 2010, both Intel and mobile chipset maker Qualcomm participated in an $11 million funding round for Sotera Wireless, a San Diego company developing a wrist-watch-sized version of the wall-mounted medical monitors common in hospital rooms.

For Qualcomm, the investment was a bet on the growth of remote monitoring—the idea that people can use mobile devices to continuously monitor their well-being while at home, says Nagraj Kashyap, vice president of Qualcomm Ventures, a $500 million in-house venture fund established in 2000. While the remote monitoring market might take a decade or more to develop, Qualcomm doesn't face as much pressure as typical VC funds do to cash in on investments, Kashyap says: "We can take the long view and be patient. Our goal is to make sure that wireless technology gets embedded in health care."

Other investors believe HIT is now poised to explode. Among them is Robert Kocher, a former partner at consulting firm McKinsey & Company and one of the architects of President Obama's health-reform bill. This May Kocher signed on as an investor with venture capital firm Venrock Partners, in Palo Alto, California.

Kocher, who calls himself "wildly optimistic about the potential for positive change in the health-care system," believes changes will be largely driven by data.

Health-care reform legislation and other recent federal policies, Kocher says, are beginning to make a huge amount of medical data available for free to anyone who thinks they can use it. In 2012, for instance, the federal Medicare program plans to open its massive trove of claims and billing data. The impact of having more information on prices, drug use, and health outcomes is "game-changing and underappreciated," Kocher believes.

Venrock is investing in companies trying to leverage such data to help consumers and employers make rational health-care choices. For instance, Venrock is a backer of Castlight Health, a startup that offers Internet-based tools to help consumers compare prices offered for medical procedures using information it has culled from paper insurance forms.

Kocher thinks a transparency on medical pricing and results could have a big effect on health care. "Data is what creates functional markets. It lets suppliers differentiate offerings, and [buyers] understand relative trade-offs," he says. "The problem we've had in the medical system is that money has been made without value creation. That is finally at the point of changing."