Surviving and thriving in a tough market: advice for start-ups

Debiopharm
WE DEVELOP FOR PATIENTS

Foreword

by Tanja Dowe, CEO, Debiopharm Innovation Fund

Think about your life at the end of 2019. Perhaps you were planning a roadshow to meet investors and healthcare executives to talk about the benefits your digital solution brings to patients and clinicians. Or maybe you were preparing for the JP Morgan annual healthcare conference; getting ready to meet thousands of your investor peers from around the world in the lively halls of Westin. Little could we imagine how the world would change with COVID-19 in the next few months.

Now fast forward to the end of 2021. A record year of digital health investments, valuations going through the roof, investors putting in long hours to join financing rounds with the nagging feeling of 'fear of missing out' (otherwise known as FOMO). Then, economists' warnings becoming louder about an upcoming financial downturn and, from February 2022, Russia's invasion in Ukraine, speeding up the downward spiral.

Today we are in the middle of a tough market and uncertain economic times. What does this mean to start-ups? Statistics show that growth financing has been in trouble since the beginning of the year, but that earlier stage companies have still been finding money. Regardless, it is now clear that seed and Series A stage companies will also have a harder time building their businesses and raising funds going forward. With longer due diligence timelines and more moderate valuations, we are already seeing the transformation from an entrepreneur's market to an investor's market.

> “We interviewed a number of experienced investors and entrepreneurs who have been through good times and bad, including the 2001 and 2008 recessions.”
>
> **Tanja Dowe, CEO, Debiopharm Innovation Fund**

But even during tough markets, there are ways to succeed for both start-ups and investors. We asked ourselves, how can we identify these opportunities and start-ups that will thrive? What can start-up executives do to ensure they get to the other side of the market downturn? What should investors do to support their existing portfolio companies while achieving their internal rate of return (IRR) goals as well?

We decided to take a deep dive into this topic, with the aim of helping the start-up community by sharing some best practices, helpful tactics, and smart moves. To write this paper, we interviewed a number of experienced investors and entrepreneurs who have been through good times and bad, including the 2001 and 2008 recessions. I want to give my warmest thanks to these incredible minds who shared their time and wisdom with us (see **About the Contributors** section for full details).

I hope you enjoy reading this paper and find some helpful ideas for getting through the next 18 months!

Indicators of a tough market

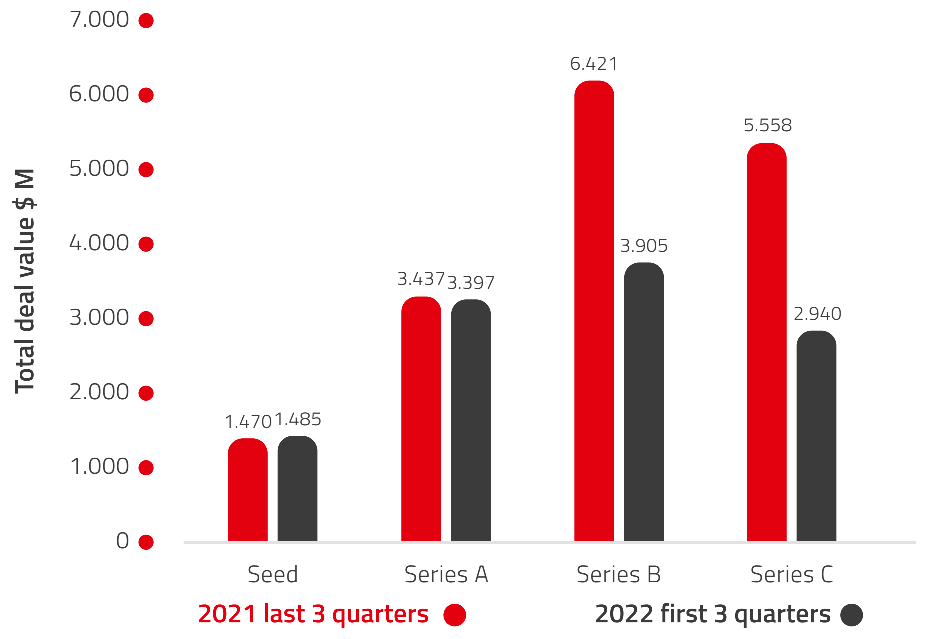
The last couple of years have broken all digital health investment records, quarter by quarter. When COVID-19 started, we saw that investors took a short pause to see where things were heading and to ensure they understood their portfolio companies' risks and the cash impact. However, soon after, things were back in full swing. Even during the pandemic, and perhaps largely because of it, investments in digital health start-ups grew strongly, as the need for digitalisation of healthcare went from nice-to-have to must have.

At the beginning of 2022, things changed. The funding for digital health and artificial intelligence (AI) for drug discovery totalled $14.5 billion in the first six months of 2022, down from $17.9 billion in the first six months of 2021 (a 19% decline in total deal value), and $5.8 billion in Q2 2022 (a clear decline from the first quarter). However, the biggest drop seems to have come in Q3 of 2022, with up to a 40% drop in Q3 funding compared to Q2, depending on the funding stage.

The tough funding climate is not evenly experienced by different stage start-ups. Within the fields of digital health and AI for drug discovery, we see that late-stage investments have taken the biggest hit, whereas the year-to-date total investments in earlier stage rounds are still comparable to the previous three quarters. The tipping point is at Series B, as demonstrated in the chart below.

The funding for digital health and artificial intelligence (AI) for drug discovery totalled $14.5 billion in the first six months of 2022.

Funding by stage - 2022 YTD vs previous period



Source: Data on file. Debiopharm Innovation Fund, 2022.

Although seed and Series A investments kept growing in the first half of 2022, with Q3 data coming in, we now see that earlier rounds are no longer immune to the declining trend. It seems that early stage investors are also taking time to estimate the impact of the climate on their portfolio companies: what are their cash runways, how far can that be extended, does the business plan or model need to be adjusted, and does the investor need to reserve more follow-on capital to ensure the company gets over the economic downturn? After this thought process has taken place, most of the early-stage investors should return to new investments, but certainly with more cautious valuations and more disciplined due diligence than before.

Those who are able to use cash with discipline will be able to navigate through these turbulent times.

Examining the current exit market climate

A big reason behind lower valuations is that investors are trying to balance their IRR goals with a slow-down in the exit market. Digital health initial public offerings (IPOs) and special purpose acquisition companies (SPACs) became virtually non-existent from the beginning of 2022. Mergers and acquisitions (M&As) in digital health and AI for drug discovery in the first six months of 2022 versus that of 2021 look good at first sight, with the total deal value increased from $32 billion to $71 billion. However, three mega deals drove that growth: Cerner acquisition by Oracle for $28 billion, Nuance by Microsoft for $20 billion, and the Athena Health buyout for $17 billion. Remove these three outliers, and we have $6 billion left in M&As for the first half of 2022. When you look at the number of transactions (48 in the first half of 2022, down from 93 in the first half of 2021), a decline of 49% spells out the state of the M&A market.

At the time of writing this paper, we don't believe that we will see a quick improvement in investment and exit trends, due to continued negative economic predictions from financial institutions and deepening geo-political uncertainty. The International Monetary Fund's (IMF) July 2022 outlook forecasts a drop in the global economic growth from 6.1% in 2021, to 3.2% in 2022, and 2.9% in 2023. Russia's invasion in Ukraine has brought uncertainty to energy, mineral and agriculture markets, and has spun inflation to new heights – according to the IMF's forecast, the global inflation rate will hit 8.3% for 2022. In September 2022, the US Federal Reserve raised the interest rate to 3.25% to combat inflation. This is the highest borrowing cost in the US since 2008.

The impact of tough markets on venture capital investments

	Venture capitals	Start-ups
POSITIVES +	Lower valuations for new investments "Buyer" market to secure significant equity at a discount Renewed investment discipline (due-diligence, fundamentals)	Record-high dry powder still available ($290 billion according to Pitchbook) Renewed focus on cash efficiency, profitability glidepath, "default alive" mindset, and consolidation
NEGATIVES -	Lower access to new capital - institutional dollar shifting to fixed income asset class Lower IRR for recent vintage years due to longer exit cycles Flat or down rounds risk on existing portfolio Start-ups shifting to non-dilutive financing, such as venture debt	Higher dilution or lower raises Higher costs (inflation) reducing runway Difficult to retain/attract customers and reach growth milestones in case of a recession

Surviving: managing cash burn and maintaining growth

Understand that things will change and adjust your business plan accordingly

As the saying goes, what doesn't kill us makes us stronger, and it all starts by having a shared vision of what's ahead of us and adjusting to this new external environment. The first step for surviving tough markets is to take a long hard look at your scope of activities in the context of the market landscape and reprioritize. If you are involved in several types of initiatives with different time frames and payback horizons, you might want to decide which ones are worth pursuing now and which should be put on hold to decrease the burn rate as quickly as possible.

Once you have decided your priorities, look for ways to generate cash faster – for example, in the software world, you can usually sell services alongside software licenses, which are typically one-time payments that create cash immediately.

While maintaining growth should remain your goal, the execution perspective may need to become more long term. As Jaakko Ollila, an entrepreneur, business angel and the former CRF Health co-founder puts it, "if we originally set goals for the next 12 months, we may have to acknowledge together with the board and investors that we can't target those goals as aggressively as before. We maintain the big vision and growth plan, but instead of trying to reach operational milestones in 12 months, we acknowledge that it will take 24 or 36 months before we get there, as there's a risk that customers' buying behaviour will change in times of uncertainty."

Be smart with your cash

Choppy waters may be ahead, but those who are able to use cash with discipline will be able to navigate through these turbulent times. Here are some examples on how to reduce spend:

- Change your payment structure with customers, suppliers and contractors
- Extend your R&D runway by leveraging R&D tax credits or government programs
- On the clinical side, check if you can get investigator-initiated trials, as opposed to you being the sponsor for trial
- Look at operational expenses and identify areas where you can cut (eg, travel, outsourced work, headcount, physical office space)

Another strategy to look after your cash is to review your pricing, either to increase or decrease it. It might be that you are not capturing as much value as you are delivering. Could you grow your existing customer accounts by offering services on top of your products? Or by increasing the number of product users per customer? Getting new customers is always more expensive, so expanding current customer accounts and making sure to reduce churn should be at the top of every entrepreneur's mind.

Tough times can also bring up a whole new level of creativity in your team.

"We figured out new ways to validate our product that saved tens of millions of dollars. We had to do everything differently, and there was a new level of 'grit' within the company," says Sally Daub, Chairwoman of Altis Labs and early-stage investor.

The best way to reduce dependence on investors is to become profitable as quickly as possible. But if you do need to raise funds during a tough market, start talking to investors early. If you start less than 12 months before you are out of cash, you are already on the defensive. Keep an eye on your cash and assume that the next round of financing will take longer and close at a lower level than you expect.

"We figured out new ways to validate our product that saved tens of millions of dollars."

Sally Daub, Chairwoman of Altis Labs and early-stage investor

Manage people effectively, including your investors

Working with investors is a key responsibility for CEOs. It is important to be transparent and keep your investors engaged. A shared vision and robust plan for getting through the hard times will create trust that the long-term value is still there.

We believe it is critical to continue to invest in sales and marketing as key functional areas. The marketing team's messaging and branding expertise is needed for gaining new business, and "the last thing you want to cut is sales and customer-facing personnel," says Karl Schweitzer, Chairman of Oncomfort and an industry veteran. "They carry long-standing relationships and understanding of customers; you don't want to lose that, because the downturn won't last forever."

If you need to reduce headcount, do it quickly. Layouts or a fear thereof creates anxiety – you will want to minimise the impact on people. The first step is to reduce the number of open positions, then stop hiring, and the last option is to cut positions. Whatever you do, have a clear plan and avoid a situation where you hire people and then lay them off.

> "The last thing you want to cut is sales and customer-facing personnel."
>
> **Karl Schweitzer, Chairman of Oncomfort**

Thriving: securing investment in a competitive market

The investor perspective

"The best dollars deployed are the ones that are deployed during a downturn, because valuations are most attractive. The rate of activity stayed fairly consistent through the recent economic downturns, but the quality of the deals got a heck of a lot better," Bob Saunders, General Partner of OCA Ventures – and an expert with over three decades of investment experience – explains.

While customer acquisition typically slows down during economic downturns, value generation at start-ups is not just about revenue. Investors will look at other value creation points – like clinical data and presence in certain key markets – when considering the attractiveness of a new investment or of a follow-on investment in a portfolio company.

Lee Shapiro, Managing Partner at 7wireVentures and a long-time healthcare information technology executive, proposes to seek advice from investors, board members, or other trusted sources who have been through economic downturns before: "For people who haven't been through an economic downturn, they may not have the tools or the experience that allow them to address the situation appropriately. Learning from those who have done it before, and then thinking about what those lessons were and how they translate to your current circumstances, is helpful. It doesn't mean that everything that happened in the past will repeat itself in in the current times, but certainly there are lessons to be learned that may."

Maintain focus on your long-term vision

Remember that the macro-level industry trends and fundamental shifts will remain constant despite a downturn. If the fundamental trends and fundamental market dynamics have not changed, you should stick to your big vision. By continuing to execute, working with existing customers and making sure that they are happy, your customers will continue to invest.

The increased demand for more efficient, accessible, and patient-centric healthcare is not going to fade away. "You're still seeing more shifts in care delivery from hospital to home, or remote patient monitoring and telehealth becoming more mainstream. There's no doubt that the market will continue to embrace these kinds of digital health solutions," says Pierre Leurent, Founder and CEO of Voluntis and President of Digital Health at Aptar Pharma.

By sticking to macro trends rather than buzzwords, you create a sustainable vision, which helps you through good times and bad times.

Adapt your expectations for valuation amounts

During a tough market, funding and valuations may be less than a start-up leader would expect in normal economic times. Be open with your board about adjusting down the expectations. You may have to get comfortable with a smaller funding amount than in the previous round, flat valuations or even down-rounds. You need to pick your battles – rather than spending lots of time pushing for higher valuations that may be hard to accomplish, be realistic and avoid distraction. As Bob puts it, "there is always capital for something that deserves capital. All that will vary is the price at which the capital is available."

Be opportunistic

While maintaining a clear idea of the large market that the start-up is going after, any good entrepreneur must be opportunistic. You can look for opportunities among your customers and partners. If they are large corporations and you are of strategic interest to them, they may invest in your company as a part of their corporate venture activity. There is no single model to engage with these groups and there can be open dialogue to optimize the way you do business.

"The market will continue to embrace these kinds of digital health solutions."

Pierre Leurent, Founder and CEO of Voluntis and President of Digital Health at Aptar Pharma

A lot of capital was raised into venture capital funds in the past couple of years, and a lot of that money has not yet been deployed. "My view is that the money is there, it's just a matter of timing and finding the right door," Philippe chambon, Chairman of Novadiscovery, entrepreneur and venture capital veteran, points out. "At the end of the day, investors are in the business of investing; they won't sit on their hands for 18 months waiting to invest. I think the dynamics for entrepreneurs are not that bleak, it's just about patience and choosing the right people to interact with."

Investors' focus has not changed, they are still looking for great founders. You need to motivate an investor by telling them you are going to solve a major problem, and why you are uniquely positioned to solve it. Investors look for resilience and creativity, and it's during challenging times that these characteristics are tested.

There are plenty of professional institutional investors who are trying to find attractive deals in today's environment. If a new investor finds a company that really has solid fundamentals, but for some reason still needs money, it might be a great opportunity.

The valuation reset has created an opportunity for investors, but also for companies that have raised larger rounds just before the market got into trouble. If you have sufficient capital to weather the storm, you can make investments and acquire other businesses at reasonable valuations, that puts the company in a better position to grow as the economy improves.

> "The money is there, it's just a matter of timing and finding the right door."
>
> **Philippe Chambon, Chairman of Novadiscovery**

Advice for entrepreneurs: Stay focused

"Being an entrepreneur isn't easy. You have to keep at it, recognize your value, and make sure you continue to improve as you talk to more investors and potential customers."

Sally Daub, Chairwoman, Altis Labs; Managing Partner, Pool Global Partners

"Have patience, practice strong cost management, and focus on what's essential."

Philippe Chambon, Chairman, Novadiscovery

"Stay focused on building your business. Focus on the fundamentals and think carefully about being capital efficient."

Bob Saunders, General Partner, OCA Ventures

"Don't overreact; stay flexible, nimble and forward looking."

Karl Schweitzer, Chairman, Oncomfort

Maintain positive morale and optimism to keep your team, investors and customers engaged

"Keep a sense of optimism, even if times are extremely complicated. It's the entrepreneur's role to keep infusing a positive mindset in the company during this time. Keep excellent communications with the team and the board. The difficult times don't last forever. In these times the most resilient entrepreneurs and teams will be the ones succeeding."
Pierre Leurent, CEO, Voluntis; President of Digital Health, Aptar Pharma

"Believe in what you are doing and keep helping your customers. Downturns will come and upturns will follow. Have a longer-term perspective and carry on to the next upturn."
Jaakko Ollila, Entrepreneur and Business Angel

"Three things: 1) Put your arms around your customers; 2) Put your arms around your team; 3) Focus solely on the key aspects of your business that are the most important for your future. And if you have a short cash runway, raise only the capital that you need to help you navigate the next 18 to 24 months until the financial markets are more favourable."
Lee Shapiro, Managing Partner, 7wire Ventures

About the contributors, and why we interviewed them for this paper

- **Sally Daub, Chairwoman, Altis Labs; Managing Partner, Pool Global Partners**
  Sally was the Founder, President and CEO at ViXS Systems during the recessions of 2001 and 2008.
- **Philippe Chambon, Chairman, Novadiscovery (CEO, EG427); Entrepreneur and Investor**
  Philippe was Managing Director of the venture capital Sprout Group during the recession of 2001, and Founder and Managing Director at New Leaf Venture Partners during the recession of 2008.
- **Pierre Leurent, President of Digital Health, Aptar Pharma**
  Pierre was Co-founder and CEO at Voluntis during the recessions of 2001 and 2008.
- **Jaakko Ollila, Entrepreneur and Business Angel**
  Jaakko was Co-founder at CRF Health during the recessions of 2001 and 2008.
- **Bob Saunders, General Partner, OCA Ventures**
  Bob was Managing Director at Chrysalis Ventures during the recessions of 2001 and 2008.
- **Karl Schweitzer, Chairman, Oncomfort; Entrepreneur and Board Professional**
  Karl was Vice President of Neuromodulation at Medtronic during the recession of 2008.
- **Lee Shapiro, Managing Partner, 7wire Ventures**
  Lee was President of Allscripts during the recessions of 2001 and 2008.

About the author

Tanja Dowe is the CEO of Debiopharm Innovation Fund, based in Lausanne, Switzerland. Prior to joining Debiopharm, Tanja was the Managing Partner at Innomedica Ltd and founder/CEO at BioSolutions INT. In her years in strategy consulting and investment, Tanja has worked with more than 80 medical and healthcare companies globally, giving her a broad view into innovative product development, commercial strategies, and building winning teams. Tanja is an experienced board member and chairwoman with a track record of successful M&A exits. She holds an MSc in Applied Microbiology and Biochemistry from Helsinki University of Technology.

About Debiopharm Innovation Fund

As Debiopharm's strategic corporate fund, the Debiopharm Innovation Fund invests in digital health start-ups with an ambition to improve the cancer patient journey and transform pharmaceutical R&D. With 150 million CHF under management, the fund focuses on late seed or series A stage companies and participates typically with an initial ticket of 3-5 million. Find out more about seeking digital health start-up funding.

Debiopharm™
WE DEVELOP FOR PATIENTS