Checking the Pulse I A Deep Dive on Healthcare Specialist Funds
Q2 2018

Jefferies Prime Brokerage I Capital Intelligence

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Overview

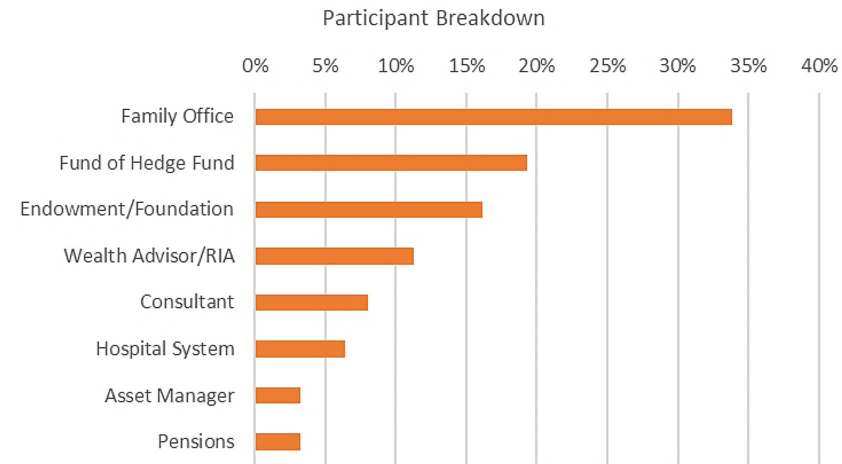
In **1Q2018**, the Jefferies Capital Intelligence Team interviewed and researched **nearly 70 alternatives allocators with active investments in healthcare specialist funds**.

Specialist, sector or niche searches make up about **40%** of allocators' open and active Equity strategy searches – of which healthcare is a material percentage.[1]

Checking the Pulse: A Deep Dive on Healthcare Specialist Funds explores the backdrop for these investments and digs into the broad and diverse levers that can convert interest into allocation.

PARTICIPANTS

- We explored the holdings, attitudes and outlook across Single- and Multi- Family Offices, Funds of Hedge Funds, Endowments/Foundations, Wealth Advisors/RIAs, Consultants, Hospital Systems, Asset Managers & Pensions
- Allocators spanned the **U.S.** (Tri-State, Mid-Atlantic, Midwest, West Coast, Texas and Boston), **Canada**, and **Europe** (London, Switzerland)
- Each allocator had a **minimum of 2 allocations** to healthcare specialists
- Sources included **in-depth interviews** with senior decision makers, **publicly available data** (board minutes, etc.) and **Jefferies Capital Intelligence proprietary data**
- All information has been aggregated and anonymized
- Incorporated those with long-term holdings in the sector, as well as more recent entrants
- Jefferies Capital Intelligence team is focused on **actionable intelligence** to more effectively understand what moves the needle when it comes to making an allocation to the healthcare space



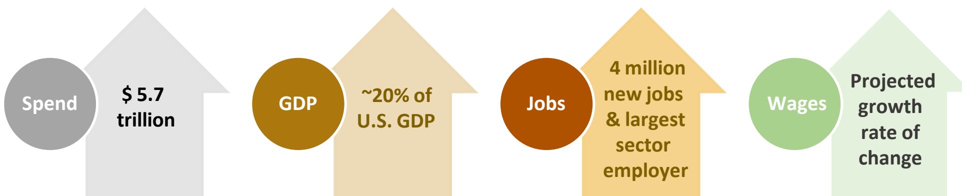
1 Jefferies Prime Services

Checking the Pulse | Potential Forward Drivers for Healthcare

The Capital Intelligence team published a white paper in May 2018 which outlines the evolution of healthcare specialist investing. Many allocators report a shift in how they view the sector, given broader demographic, economic and global trends. Key highlights below.

Forces that will shape the next chapter of healthcare specialist investing

Health Dashboard: Topline U.S. Healthcare Projections Through 2026



Source: Bureau of Labor Statistics, Centers for Medicare & Medicaid

Projected Capital Markets Activity Also Constructive

- Current sector conditions include: near **record cash** levels, potential future benefits of **tax repatriation**, **large cap** names that may need to grow via **acquisition**, and an explosion of smaller, more innovative firms working to **bring new drugs, therapies or devices** to market
- 2018 has already witnessed **year-to-date record-breaking M&A** in pharma – $275 billion by May 1st
- The complex network of health care research, development and delivery in the U.S. may lend itself to continued consolidation (Cigna/Express Scripts, CVS/Aetna) – with myriad layers to collapse and improve upon
- Heightened deal making YTD, considerable number of large cap companies that will likely need to grow via acquisition, and increasing number of small and innovative firms could point to **ongoing capital markets activity** in the years ahead
- And, as always....what will Amazon do in this space?

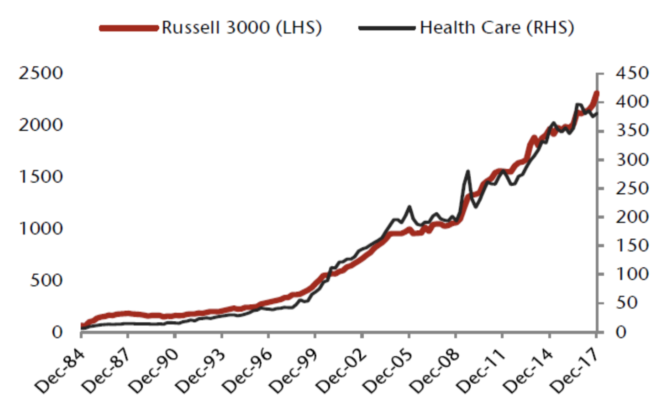
Secular Trends Are Prompting Allocators to Reexamine Healthcare Exposure in Their Portfolios

Given the increase in **healthcare as percentage of GDP**, a number of allocators report re-examining current sector exposures across their portfolio.

"There is simply no other sector with the same projected directional drivers as healthcare for the next decade – from spend to job and wage growth, it's increasing across the board."

Simultaneously, **a clinical trial's probability of success (PoS)** has increased on the back of innovations like immunotherapy and biomarkers – nearing 14% overall.

Cash Levels Near Record in Health Care



Source: Jefferies

Checking the Pulse | Recent Performance of Healthcare Specialists

The Capital Intelligence team published a white paper in May 2018 which outlines the evolution of healthcare specialist investing. Many allocators report a shift in how they view the sector, given broader demographic, economic and global trends. Key highlights below.

Active management is valued in a sector where performance is solid, but can be volatile

Healthcare Performance Across Large and Small Caps (2007 – present)

	Large Caps					Small Caps				
		Health Care		Biotech			Health Care		Biotech	
Year	**R1000**	**Return**	**Contribution**	**Return**	**Contribution**	**R2000**	**Return**	**Contribution**	**Return**	**Contribution**
2007	5.8	7.5	0.9	-4.8	-0.1	-1.6	13.5	1.6	14.7	0.5
2008	-37.6	-23.4	-2.6	12.2	0.1	-33.8	-28.0	-3.9	-25.7	-0.9
2009	28.4	22.8	2.5	-0.6	-0.1	27.2	23.9	3.3	39.4	1.7
2010	16.1	5.4	0.7	4.9	0.1	26.9	18.7	2.4	16.5	0.5
2011	1.5	11.4	1.2	20.3	0.3	-4.2	3.6	0.4	7.0	0.2
2012	16.4	19.6	2.2	43.7	0.6	16.3	18.5	2.4	23.1	1.0
2013	33.1	42.1	5.0	71.5	1.3	38.8	51.8	6.5	71.4	2.5
2014	13.2	25.4	3.3	32.7	0.8	4.9	19.2	2.8	35.7	1.6
2015	0.9	7.2	0.9	8.2	0.2	-4.4	8.0	1.1	12.5	0.6
2016	12.1	-2.6	-0.5	-13.1	-0.6	21.3	-7.4	-1.9	-19.4	-1.8
2017	21.7	22.2	3.1	19.6	0.6	14.6	35.6	4.6	54.5	2.5
YTD	**3.3**	**4.3**	**0.5**	**8.1**	**0.2**	**3.4**	**12.3**	**1.9**	**14.4**	**0.9**
Cumulative	**149.1**	**236.8**	**18.3**	**432.6**	**3.5**	**134.6**	**307.0**	**22.9**	**579.2**	**9.3**

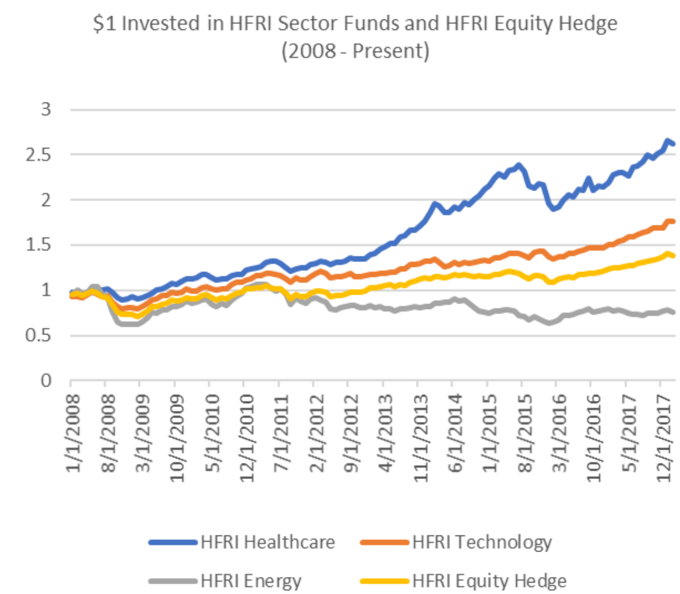
Source: FactSet, FTSE Russell, Jefferies (as of 3.14.18)

- Most respondents indicated they seek healthcare exposure via **alternative products** (over or in addition to passives) because of the: i) volatility and binary outcomes defining some corners of the industry and ii) the heightened scientific or technical expertise they feel solid performance requires in a constantly evolving and innovating space
- *"The sector has become* ***too big*** *a part of GDP* ***to ignore****. So we analyzed our holdings, and found healthcare only comprised 3% of names,* and *we found the generalists that provided this exposure struggled to perform in the sector. So we looked to add specialists."*
- A number of LPs reported **healthcare is one of two** (**sometimes three**) **sectors** they felt need specialists for – other common specialists that came up were for TMT, Energy or regional focus (typically China)
- *"We have healthcare in our* ***uncorrelated opportunities bucket****, alongside royalties, aviation, and litigation finance.*

Considerable Analysis to Decide How to Gain Healthcare Exposure

Passive or active? Indices, public equity, private equity, venture capital…or all of the above?

- The majority of our LPs (obviously) pursue the active route
- A material number raised healthcare as "one of the more inefficient sectors" – *requiring* specialization, particularly for those trafficking in biotech or other deeply technical corners of the industry – and pointed to perceived outperformance of healthcare specialists vs. those in other sectors



Checking the Pulse: Let's Start With the 'Why?'

Healthcare is a diverse sector – and we found that there are more dimensions governing the LP / manager relationship for healthcare specialists than many other strategies.

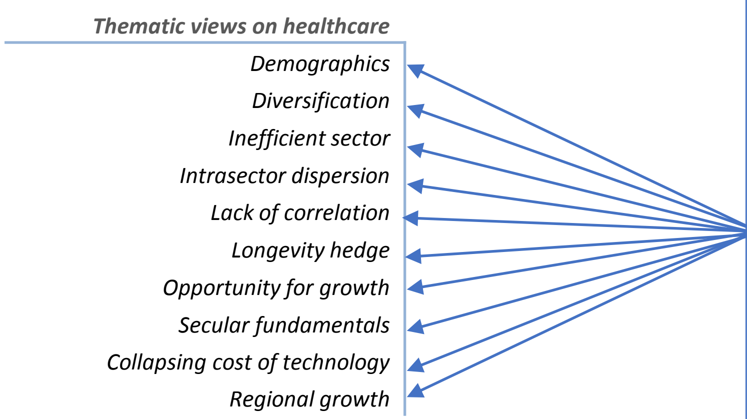
At the broadest level, diversity of allocator portfolio objectives leads to diversity of primary investment drivers

The majority of allocators invest in healthcare specialists because of a top down view on the industry. What these top down views *are* varies widely, based on LPs' objectives. In some cases, allocators explicitly disagreed with one another around projections for upward spend and industry expansion, potential collapsing cost of technology, and others.

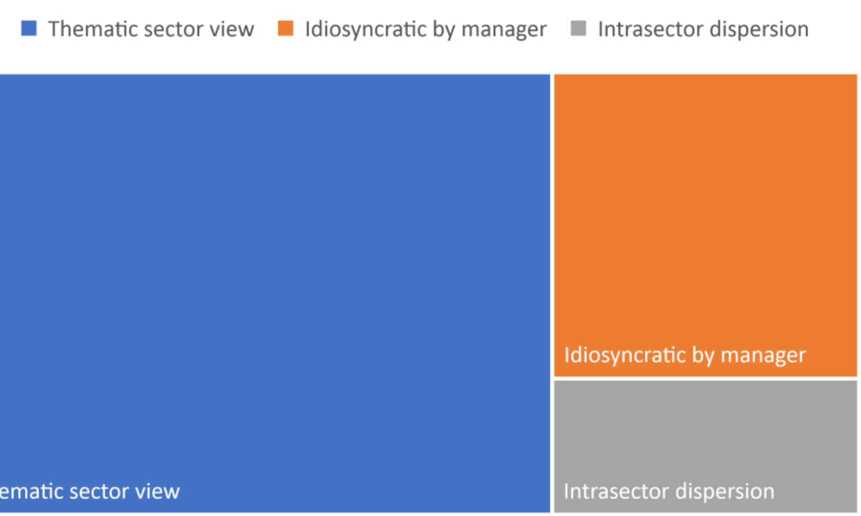
- The diversity of individual allocator portfolios underlies the variation in primary drivers for investing in healthcare specialists

- "We see this as a hedge against our retirees living longer."
- "If you cure cancer, any other macro factors stop mattering; people will want to buy your product."
- "There are few other sectors with as many underlying bullish indicators for continued growth over the next decade."
- "It's depressing, but a lot of people – baby boomers – will be getting older in the next 20 years. They aren't going to drive healthcare costs *down*."
- "In addition to higher than average dispersion among specialist managers, the collapsing cost of technology is going to improve the overall success of clinical trials.

Deeper Dive on *Which* Thematic Sector Views



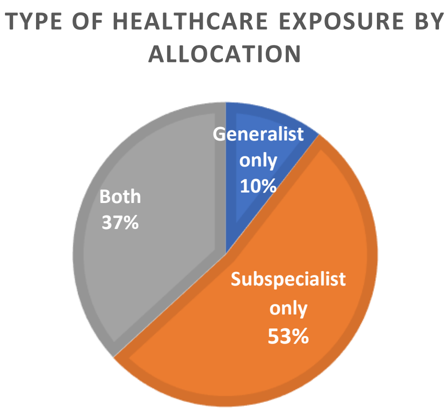
Primary Driver for Investing in Healthcare Specialist



Checking the Pulse: Moving to the Who

The “Who,” as it turns out – is nearly as important to allocators as why. “Who” as in strategy focus (generalist vs. substrategist), and “who” in terms of leveraging advanced technical and scientific expertise.

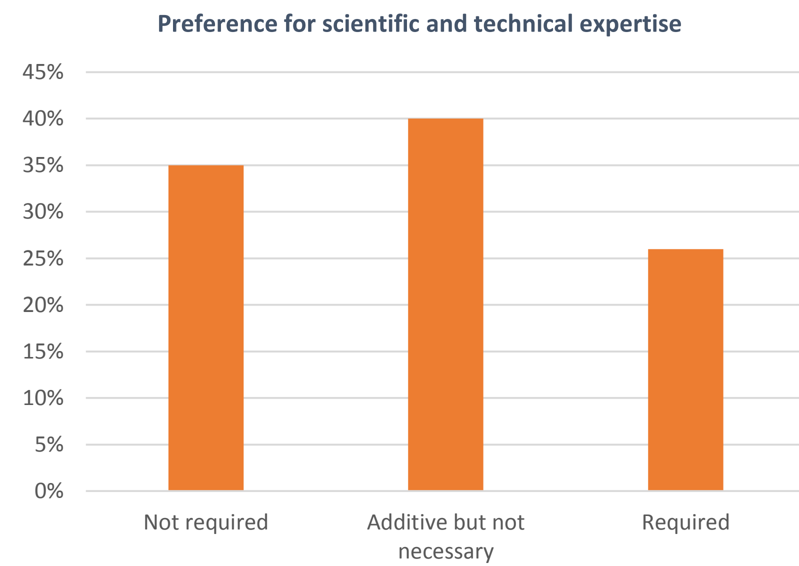
Substrategists in vogue; preference for advanced scientific or technical expertise varies



When we started to dig into what types of allocations have become more common – a clear pattern arises. Allocators are **not** spending much of their time seeking out healthcare generalists.

- The vast majority of our allocators have more than 2 investments with HC specialists, with a typical range of between 2 – 5 managers in their portfolio
- Only about 10% of the time does their exposure come through healthcare generalists
- One-third of the time, allocations are split to balance a generalist with subspecialist focus (this typically happens when the LP has both a bullish long term sector theme, as well as a more specific draw, either to SMID biotech, regional healthcare exposure – typically China – or, a niche approach via royalties
- **More than half the time**, allocators are combining different subspecialists across their portfolio

- While allocators remain focused on *specialists*, they don’t necessarily seek out *scientists*
- LPs report a variety of views on whether the ultimate decision maker holds an advanced medical or scientific degree, or has additional technical experience – like a clinical trials specialist
- In some cases, allocators **don’t want** “scientists in those seats,” preferring instead the ultimate decision maker have long term risk management and investing experience
- In others (particularly in some technically-intensive corners like biotech), “**scientists just make sense**…they’ll have **better personal networks** to get behind the science.”
- **Ultimately**, allocators are seeking “**a deep bench**” – where the ultimate decision maker is a long term investor, but she is complemented by other senior personnel with scientific or technical expertise



Checking the Pulse: What…And How Much

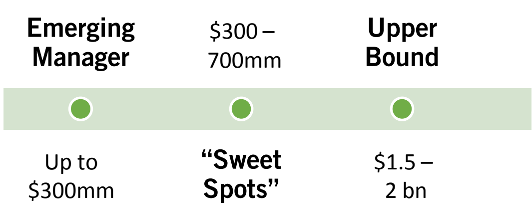
Capacity emerged as a material issue for many allocators – with more than 10% reporting a redemption when a manager's AuM has grown too large. Terms and fees, on the other hand, came up much less…and when they were discussed, fees are headline higher, but allocators were willing to pay the same or more than in many other strategies.

Capacity is a Huge Factor

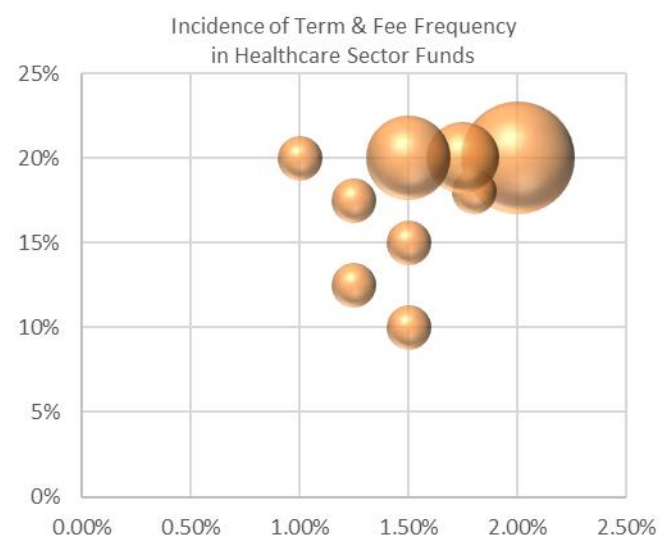
Nearly 70% of allocators raised capacity as a driving issue for both allocation and redemption. **10%** reported redemptions on the back of managers getting too big.

There was no unanimity as to what officially constitutes "too big," but most LPs want to hear clear, concise plans for organic growth, leverage, capacity and capital return.

And some feel there is no upper bound. *"I'm bullish on sector growth. If I want long bias, I don't have an upper bound."*



Terms and Fees….Less So



Terms and fees were less of an issue than capacity for the majority of allocators.

"Healthcare isn't where we're focusing our fee sensitivity. These guys tend to pay for themselves with net returns."

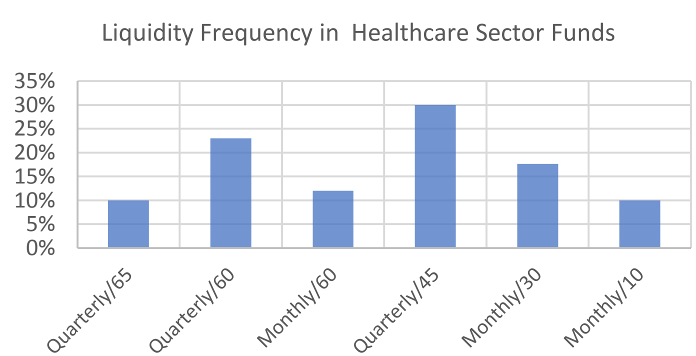
On average, headline fees are on the upper range between 1.75%/20% and 2%/20%.

A material number of LPs reported gaining fee breaks because of ticket sizes or locking up capital.

Managers offer: fee breaks, hurdle rates, delayed crystallization, and various liquidity structures.

What About Liquidity?

- Somewhat more standardization – nearly two thirds of managers we examined have a one year soft-lock
- Quarterly liquidity is most common, split across 45- or 60- day notice periods
- Monthly liquidity is somewhat less common, with either 30- or 60- day notice periods
- Allocators report willingness to lock up capital for longer with their healthcare managers – particularly if they take advantage of a private offering, or have taken a directional view on the sector



Levers of Alignment: Correct, Accurate or Precise?

It was clear through our conversations with allocators that there are *more* levers to align between healthcare specialists and potential LPs, to close the sales cycle, than with certain other strategies. This is in part due to the diversity of the sector, to the diversity of allocators' portfolio objectives and the technical aspects of some corners of the industry.

Levers of Alignment: ***With less net new capital flowing into hedge funds, it has become critical to*** **precisely** ***align your value proposition with LPs needs***

Topline Drivers

- Sector bullish
- Downside protection in volatile sector
- Intrasector dispersion
- Idiosyncratic manager appeal and alpha generation
- Avenue for hedging other dimensions of the portfolio

Generalists vs. Subspecialties

- Generalists
- Biotech
- Healthcare technology
- Devices
- Services
- Equipment
- Royalties
- Pharma

Types of Internal Technical Expertise

- Technical expertise agnostic
- Advanced scientific or medical degree (MD, PhD)
- Traditional investment or risk management experience required (PM, CFA, CPA)
- Other technical expertise required (clinical trials, epidemiology, regional, etc.)

Term and Fee Profile

- Term and fee agnostic
- Lower management fee
- Lower incentive fee
- Alpha share
- Crystallization timing
- Hurdle rate
- Less liquid
- Founders share class

Fund Capacity

- No preference
- Under $1 bn
- $1 - 2 billion

Exposure

- Market Neutral
- Long Bias

- We counted nearly **30 possible levers of alignment** between healthcare specialists and their LPs
- **The permutations are nearly endless.** An LP could be looking to hedge another part of their portfolio via a sub $2 billion AuM fund, that is primarily managed by someone with an advanced scientific degree OR, an allocator could be seeking market neutral exposure from a generalist, with fees of under 1.5% management and with a hurdle rate.
- In a world of increasing options and information – it is important for a manager to ensure their value proposition more precisely so that it aligns with the objectives of your LPs

What Does This Mean for Me?

The Capital Consulting team published a white paper at the start of 2018 which outlines the evolution of the traditional Capital Introductions model in an era of ubiquitous information. Our conclusion is that firms need next generation intelligence – to comb through all the new data and options – identifying patterns, relationships and opportunities to create smarter, more productive, and more efficient organizations for the next decade.

Capital Intelligence: *Working to better align managers and allocators' needs*

Start with where you are. Methodically plan where you want to go.

- **Review your current LPs**
  - Why am I a part of their portfolios?
  - Does it differ by region or allocator type?
- **Review your performance profile**
  - Does my value proposition shift, depending on different drivers for allocation (i.e. - What does the fee profile look like when fees don't crystalize for 24 months? What does my crowdedness score look like vis-à-vis others directly in my space?)
- **Review your pitch – update your value proposition if your story has evolved**
  - The healthcare sector is always changing. Why you *then*, why you *now*, and why you *for the coming years*?
  - Get specific!
- **Take "the healthcare story" to allocators who may not be open to investing today**
  - How many allocators know what percentage of their portfolio represents healthcare exposure?
  - How are those names performing versus having a specialist (if they are not with a sector specialist)?
- **Build a pipeline** and be vocal about your sector
  - What are you known for? What are your competitors known for? Why are you different?
  - Focus on education, engaging warm relationships and closing the sales cycle
- **Precision, precision, precision**
  - What are the multiple ways I can fit in an LPs portfolio? As a hedge? A complement to generalist exposure? Lower fee but lower vol general industry exposure? Route for growth?
  - *"Would I rather own a railroad or a company with 5 drugs in the pipeline?"*

HOW JEFFERIES CAN HELP

Systematized, proprietary database

Next generation intelligence requires data driven systems and processes that result in real time updates (think the "if you liked Stranger Things, you might like The Crown") mapping market and industry data.

Ongoing strategic market intel

We provide clients with the tools and information they need to make strategic insourcing/outsourcing decisions, assistance on developing organizational culture and building teams.

Tactical Content

We have knowledge of the healthcare sector by virtue of the Jefferies healthcare franchise

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