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2022: A Terrible, Horrible, No Good, Very Bad Year (For Digital Health)

By: Jon Swope • Published March 1, 2023

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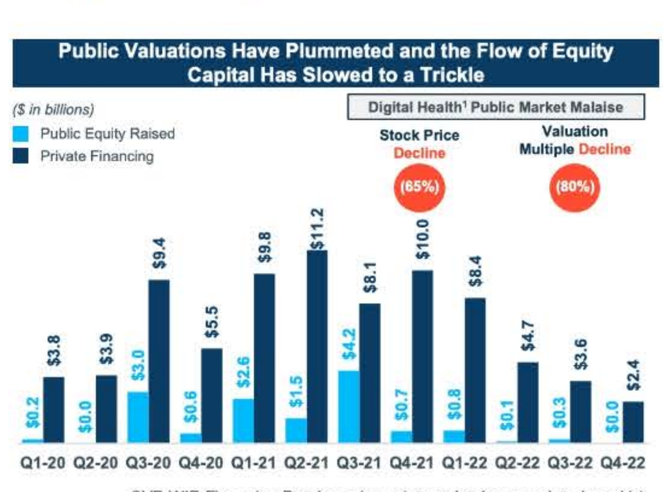
Two years removed from market highs, the reality of the Digital Health Downturn has set in. The public digital health companies have collectively traded down 65% since the highs experienced in early 2021. As valuations remained compressed, trading 3x[1] revenue on average throughout the year, the flow of new capital into the sector continued to decelerate. The fourth quarter of 2022 represented the lowest level of equity financing activity in more than 3 years. Companies have been forced to reorient their business models and rein in costs as the focus turns to profitable growth rather than growth at all costs. Given the overhang of macro uncertainty tied to inflation and interest rate environment, transaction activity across Digital Health will remain constrained in near-term. However, growing investor dry powder and pent-up demand for action from companies and investors will support green shoots of activity in 1H 2023.

Sharp Deceleration in Equity Financing Activity

As valuations across Digital Health have dropped 80% from peak levels, both public and private financing activity have slowed to a trickle. The bid/ask spread between companies' expectations and investor demand has resulted in limited new capital infusion. This impasse has contributed to a decline in Digital Health private financings of more than half in 2022, decreasing from $39bn in 2021 to $19.1bn in 2022. The sequential quarterly declines during the year show the snowballing effect of a risk-off mentality by investors. This tightening of capital activity also reverberated in the public markets as 2022 represented the first year since 2018 without a Digital Health IPO. Public equity raised in digital health experienced a nearly 90% decline with no quarter realizing more than $1bn of new fundraising activity.



SVB WIR Financing Database (proprietary database updated weekly)

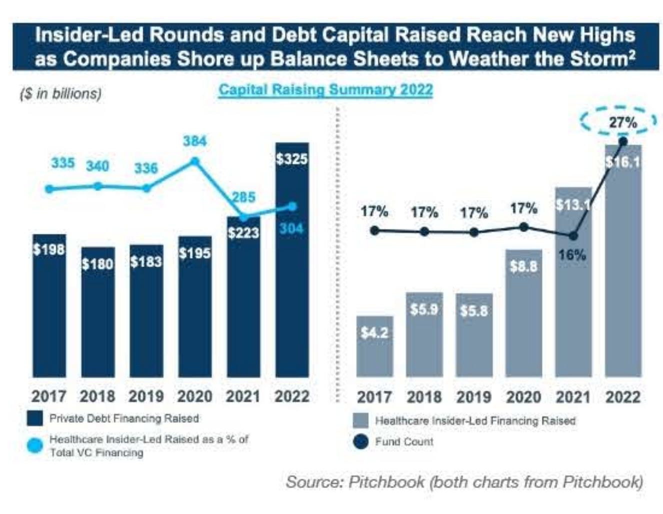
Key Takeaway:

As equity funding has become more limited during the past several quarters, a recalibration is required between internal valuations and investor appetite amidst the current macro backdrop.

[1] Represents median NTM multiple

Insiders and Debt Funds Have Been Key Sources of Capital as Companies Prepared to 'Weather the Storm'

As the equity financing environment proved to be challenging, Digital Health companies increasingly relied upon existing investors as well as private debt sources to provide the necessary capital to support their ongoing operations and prepare for a potentially challenging period ahead. Companies have turned to less dilutive and less valuation-dependent funding sources to shore up their balance sheet. Private debt financings grew more than 46% in 2022 to $325bn, a massive increase relative to the 5-year trend. Similarly, insider-led financing rounds grew to a new high of $16.1bn for healthcare financings. Most notably, this represented 27% of total capital raised, a jump from the 5-year average of 17%. These private debt financings and insider-led rounds have enabled companies to defer setting new valuation marks, and an opportunity to grow into their valuations.



Source: Pitchbook (both charts from Pitchbook)

Key Takeaway:

Given the challenging market backdrop, companies are eagerly looking to secure capital but hesitant to mark their equity due to unfavorable valuation benchmarks. As an increasing number of companies delay pursuing equity financing from new investors, there will be opportunity for investors to 'pick their spots' as valuations recalibrate and conditions improve.

The Focus on Path to Profitability and Reduced Cash Burn Have Resulted in Tough Decisions

The tightening of financing markets has led companies to closely evaluate their cost structure and make changes to accelerate path to cash flow breakeven. In line with announcements by the Big Tech companies, including Amazon, Facebook, Salesforce, Microsoft and Google, corporate restructurings initiatives (read: "layoffs") have become prevalent across Digital Health. These initiatives have been widespread with dozens of Digital Health companies publicly announcing layoffs over the past 12 months, including several of the largest operators across the sector. Boards have become wary of the uncertain economic environment, encouraging management teams to rein in costs to reduce cash burn and accelerate the path to profitability.

Source: Axios, Fierce Healthcare, Modern Healthcare

Divestiture Activity Expected to Continue as Companies Re-Align their Strategies

Companies continue to refocus their strategies given the evolving macro backdrop. The increased focus on cost controls will extend beyond personnel initiatives to include portfolio reviews. Companies will continue to focus on their core operations and optimize profitability. During 2022, multiple divestiture initiatives were announced and divestiture activity is expected to continue to be prevalent.


Divestitures To Re-Focus Strategy Will Also Continue

babylon	In Process	• Selling Meritage Medical Network
sharecare	In Process	• Selling life sciences and provider business
GoodRx	11/11/22	• Sale of backend virtual care technology
Allscripts	7/1/22	• Sale of hospital EMR business
TabulaRasa HealthCare	3/3/22	• Sale of PrescribeWellness

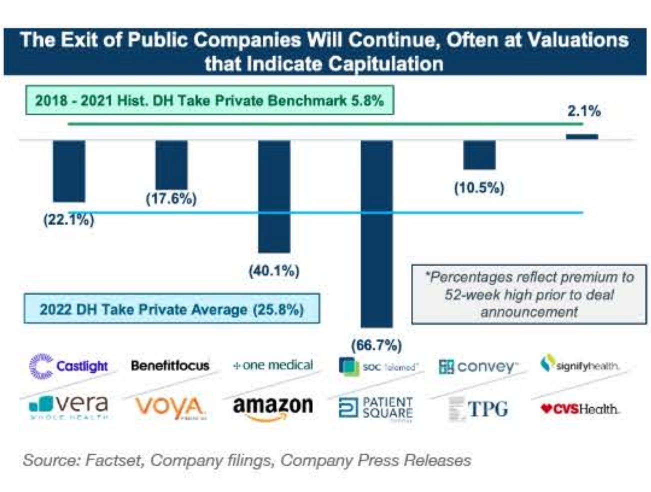
Source: Company Press Releases

Key Takeaway:

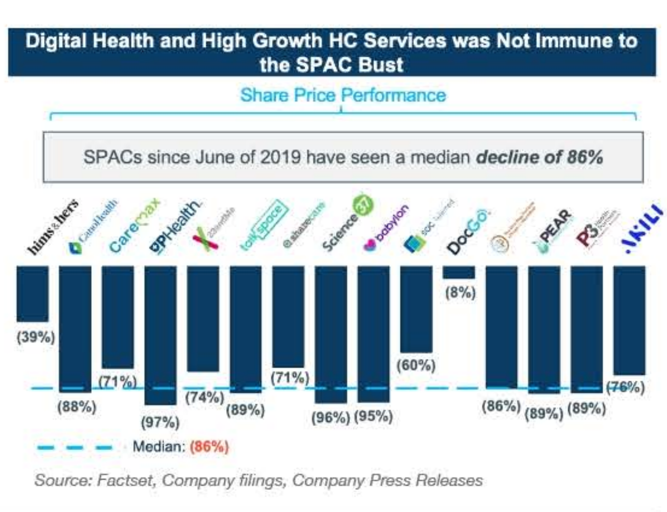
The market's increased focus on profitability will force operators to adjust their strategies, shifting away from the 'growth at all cost' approach that marked the exuberance of the Digital Health run-up. Given the renewed focus on profitability, companies have turned to restructurings, including headcount reduction and divestitures to refocus their businesses and create more sustainable cost structures.

Public Market M&A Activity expected to Continue despite Depressed Valuations

Take-private deals continued throughout the year despite company valuations trading at meaningful discount to the highs experienced during 2021. While Digital Health take-private transactions have historically come at a premium, the 2022 Digital Health transactions were on average a 26% discount to the company's 52-week high. The willingness of public company boards to agree to deals below peak pandemic highs reflects the capitulation to a new normal. This re-setting of expectations could lead to further transaction activity in 2023. Relatedly, Digital Health companies have not been able to avoid the fallout from the SPAC market bust with Digital Health SPACs representing potential take private candidates in the coming year.



Source: Factset, Company filings, Company Press Releases



Source: Factset, Company filings, Company Press Releases

Large Strategics Remain Active Investors for Companies Seeking Capital

Large Strategics have taken advantage of the environment to invest through their corporate venture arms. Given growing cash on their balance sheets, strategics remain dedicated to identifying opportunities to deploy capital across strategies that align with their key priorities. They have also become increasingly important participants in mega rounds in a number of notable financings including those for Monogram Health, Dispatch Health, Maven, Biofourmis and CareBridge. The validation provided by strategic investment has supported increased participation from a broader investor set. Over the coming year, strategics are expected to remain active investors and opportunistic acquirors as they look to take advantage of a softened valuation environment and less competition from pure financial investors.


Cash-Rich Strategics Will Continue to Act as Investors

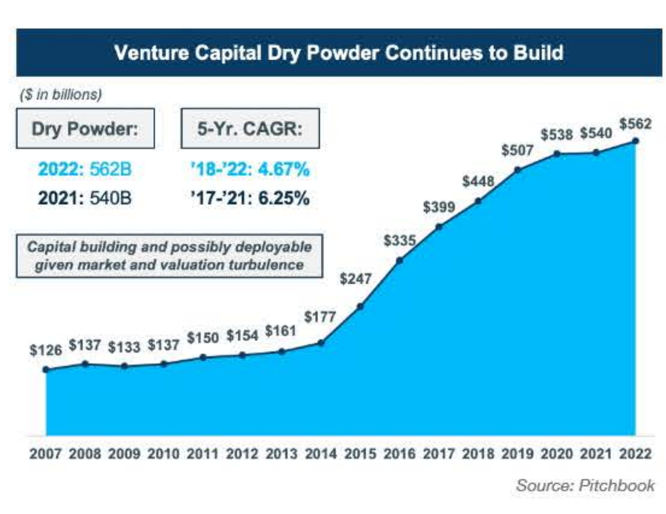
($ in billions)

Acquiror	Target	Date	$ Raised
CVSHealth, Cigna Ventures	monogram health	1/8/23	$375
Optum	dispatchhealth	11/15/22	330
CVSHealth	MAVEN	11/14/22	90
CVSHealth	biofourmis	9/27/22	320
MultiPlan	abacus insights	6/16/22	28
CVSHealth	CAREBRIDGE	6/7/22	140
Cigna Ventures	flume health	4/8/22	3
Cigna Ventures	RYSE HEALTH	3/3/22	30

Source: Company filings, FactSet, Capital IQ, PitchBook, Rock Health, Cambridge Associates.

As Activity Slowed, the Pool of Venture Capital Dry Powder Has Deepened

Dry powder reached an all-time high of $562 billion at the end of 2022. The pent-up demand for opportunities to deploy capital will continue to increase as activity remains tepid for new financings. While market uncertainty continues to constrain activity, additional clarity on the broader economic outlook will drive a convergence of buyer and seller demands creating a more favorable environment for activity, with green shoots of activity firming up support for improving conditions as soon as mid-year 2023.



Source: Pitchbook

Conclusion:

In conclusion, the 2022 year represented a particularly challenging period for Digital Health companies as financing activity significantly decelerated. Executives have been faced with difficult choices in order to extend their cash runway by restructuring costs and prioritizing profitability. During 2022, companies increasingly relied on existing investors and alternative financing sources to help bridge any funding gaps and minimize dilution related to raising capital at unfavorable valuations. Public market activity indicated a capitulation to a new normal as companies realizing liquidity events traded at significant discounts to their peak pandemic highs. Despite the more moderate deal environment, strategics remained active investors capitalizing on softened valuation expectations and reduced competition from financial investors.

Going forward, Digital Health deal activity is likely to remain subdued during 1H23 as both companies and investors wait for clarity on the broader economic backdrop. However, the increasing amount of financial investor dry powder plus growing cash balances at larger strategics will help catalyze green shoots of activity. Despite challenging market conditions, growth prospects across Digital Health remain high offering an attractive opportunity for new and existing investors in the year ahead.

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[1] Represents median NTM multiple

[2] Data for 2022 annualized from 11/8/2022

[3] Scaled and weighted based on reported percentage of total workforce at time of announcement

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Disclosures: