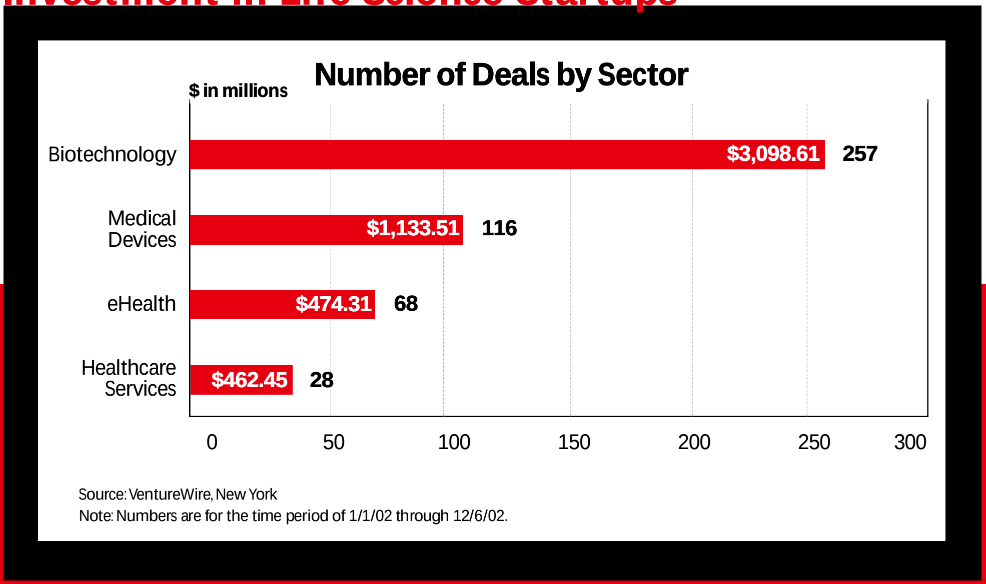
BY TAREN GROM

VENTURE CAPITAL: CAUTIOUS investment

Venture-capital firms are sitting on massive funds and are still doing deals, but their energies are focused on reinvesting in portfolio companies and safer late-stage deals. As a result, it has **never been harder for the early-stage pure startup to get funded**.

Investment in Life-Science Startups



IN THE VAULT ...

KEN ANDERSEN. Editor, VentureWire, Technologic Partners, New York; VentureWire Lifescience is a daily newsletter that covers biotech, healthcare, and device startups and life-science venture-capital investors. For more information, visit venturewire.com.

BOB BUCKLEY. Coordinator, Empire State Venture Group Inc., Troy, N.Y.; Empire State Venture Group is a collaboration between the Science and Technology Law Center at Albany Law School and other organizations in the private and public sectors to promote the development, success, expansion, and general welfare of technology entrepreneurship in the Northeast. ESVG's guiding goal is to encourage entrepreneurs in the technology sector to remain in the Northeast as they grow and to assist those entrepreneurs in gaining access to the services and education they need to continue their growth. For more information, visit esvg.org.

NELSON CAMPBELL. Senior VP, Friedman, Billings, Ramsey Group Inc., Arlington, Va.; FBR is a financial holding company for businesses that provide investment banking, institutional brokerage, specialized asset management, and banking products and services. FBR focuses capital and financial expertise on six industry sectors: financial services, real estate, technology, energy, healthcare, and diversified industries. For more information, visit fbr.com.

ALISON DE BORD. Principal, Alta Partners, San Francisco; Alta Partners is a venture capital firm investing in information technology and life-sciences companies. For more information, visit altapartners.com.

ANTHONY DENNIS, PH.D. President, Omeris, Columbus, Ohio; Omeris is a non-profit organization supported by the Thomas Edison Program of the Ohio Department of Development; its mission is to grow and develop life-sciences companies and to foster a strong business climate for the expanding life-sciences industry cluster in the state of Ohio, to benefit the state's economy, and improve the public health. For more information, visit omeris.org.

DAVID C. DLESK. CEO and director, Recovery Pharmaceuticals (formerly Addiction Therapies Inc.), Wayland, Mass.; Recovery Pharmaceuticals is a specialty pharmaceutical company dedicated to developing and marketing medi-

The VC space

LAVINSKY. It's no secret that venture-capital investments in private, U.S.-based companies have experienced a significant decline over the past two years. In the first quarter of 2001, companies raised more than $14 billion. Currently, funding has dropped to less than $5 billion per quarter and some investors have chosen to return money to their limited partners rather than invest it in new ventures. Despite the decline, however, the healthcare sector (including biotechnology, pharmaceuticals, medical devices, and medical software and services) has fared well. At the beginning of 2001, less than 10% of the funding had been invested in healthcare ventures. The percentage now is closer to 25%. Specifically, healthcare companies raised $1.1 billion of the $4.9 billion invested in the third quarter of 2002.

CAMPBELL. The bar has been set pretty high, I don't think that's just the biotech industry, but everywhere. The pendulum has swung to the extreme — from extreme greed to extreme fear. Everybody is looking for risk-continuation. Investors are looking to do deals at very low valuations or looking to do very late-stage deals, where a lot of the technology risk has been taken out of the investment and it is a simple execution risk.

> There continue to be deals that get done very quickly, with relatively clean terms and step ups. **THE BEST COMPANIES ARE CONTINUING TO GET FUNDED RELATIVELY QUICKLY,** though investors are definitely doing their due diligence and paying more attention to details.

BUCKLEY. The VC market on the whole is tight. I haven't seen a lot of activity. The ven-

Alison de Bord

cations to treat people with addictive disorders. For more information, visit recoverypharma.com.

CHRIS EHRLICH. Venture partner, InterWest Partners, Menlo Park, Calif.; InterWest Partners is a diversified venture capital firm with $1.6 billion in assets under management, which provides valuable industry, strategic, and corporate development expertise, as well as capital resources, to help young companies succeed. For more information, visit interwest.com.

COREY LAVINSKY. Director of market research, Growthink Inc., Venice, Calif.; Growthink is a consulting firm that develops business plans, financial models, and investor presentations for companies looking for venture capital. For more information, visit growthinkresearch.com.

RUSSELL LAMONTAGNE. President and founder, Corinth Group Communications, New York; Corinth Group Communications is a communications consulting company that specializes in working with emerging healthcare companies on business development and media relations. Since 1999, Mr. LaMontagne has been a primary organizer of the Healthcare Outlook and Lifescience Portfolio meetings, healthcare private equity conference sponsored by VentureWire. For more information, visit corinthgroup.com.

EDWARD M. RUDNIC, PH.D. President, CEO, director, and treasurer, Advancis Pharmaceutical Corp., Gaithersburg, Md.; Advancis is a privately held specialty pharmaceutical company focused on the development and commercialization of anti-infective therapeutics. Advancis has developed a once-daily drug-delivery technology, Pulsys, which delivers rapid sequential pulsatile dosing of antibiotics for the purpose of improving drug efficacy. For more information, visit advancispharm.com.

EDMUND M. RUFFIN. VP for business development and emerging companies, Biotechnology Industry Organization, Washington, D.C.; BIO represents more than 1,000 biotechnology companies, academic institutions, state biotechnology centers, and related organizations in all 50 U.S. states and 33 other nations. For more information, visit bio.org.

TIMOTHY J. WILLIAMSON. President and CEO, Advagen, Annapolis, Md.; Advagen was established in 2002 through a combination of new equity investment, an acquisition of the assets of DirectGene, and a partnership with Johns Hopkins University School of Medicine. Advagen is focused on developing targeted molecular medicines to kill cancer cells, primarily those of the breast, prostate, and pancreas. For more information, visit advagen.com.

STEPHEN T. WILLS, CPA, MST. VP and CFO, Palatin Technologies Inc., Cranbury, N.J.; Palatin Technologies is a biopharmaceutical company engaged in the drug design and development of innovative therapeutics. Palatin's patented drug-discovery platform, Midas, streamlines the drug design process with an efficient approach to identify lead compounds from protein targets for drugs. For more information, visit palatin.com.

ture community has a lot of money that it is looking to invest, but with everything that is going on with the economy and the market, VCs are hesitant and haven't been as quick to come forward as they may have been five years ago. The pendulum swung from where VCs were throwing money at companies to way over to the other side where they are being very selective.

LAMONTAGNE. VCs are doing fewer early-stage deals and they are reluctant to do deals alone. They are doing a lot of deals where they see other people going in. This gives them a sense of security. VCs are doing more late-stage, safer deals.

ANDERSEN. In the past six months, we've seen a significant change in the funding environment for life-science startups across the board. Specifically, in drug discovery and drug development, to a lesser extent in device company startups. In the last year and a half, investment in those sectors has been driving the entire venture industry. And that shifted downward in the second half of 2002, which was part of several larger shifts. One such shift was that so much money had gone in, investors had to step back and digest some of it. Two, changes in the public market cooled the momentum of people rushing in to make biotech investments. The environment is different now than it was a year ago in terms of raising money.

WILLIAMSON. When a company is working in a wholly novel area, for example gene therapy, the venture capitalists seem to be even more reluctant to invest. The venture capitalists don't seem to be particularly venturesome.

RUFFIN. From our Washington perspective, clearly there is concern about the lack of an IPO market and follow-on market for companies right now. But despite this, we are upbeat about the opportunity for companies to raise venture money long term. The fact is that there is money out there for good companies. On the venture side, they wouldn't be continuing to raise the money for their funds if they didn't think that there was a good opportunity to invest in quality companies in healthcare. A number of venture capital firms have raised large amounts of money in the last year, which I think bodes well, at least for the capital that will be available. But there also are a number of smaller funds that will place bets on the early-stage companies and make their investments there and manage a smaller portfolio of companies.

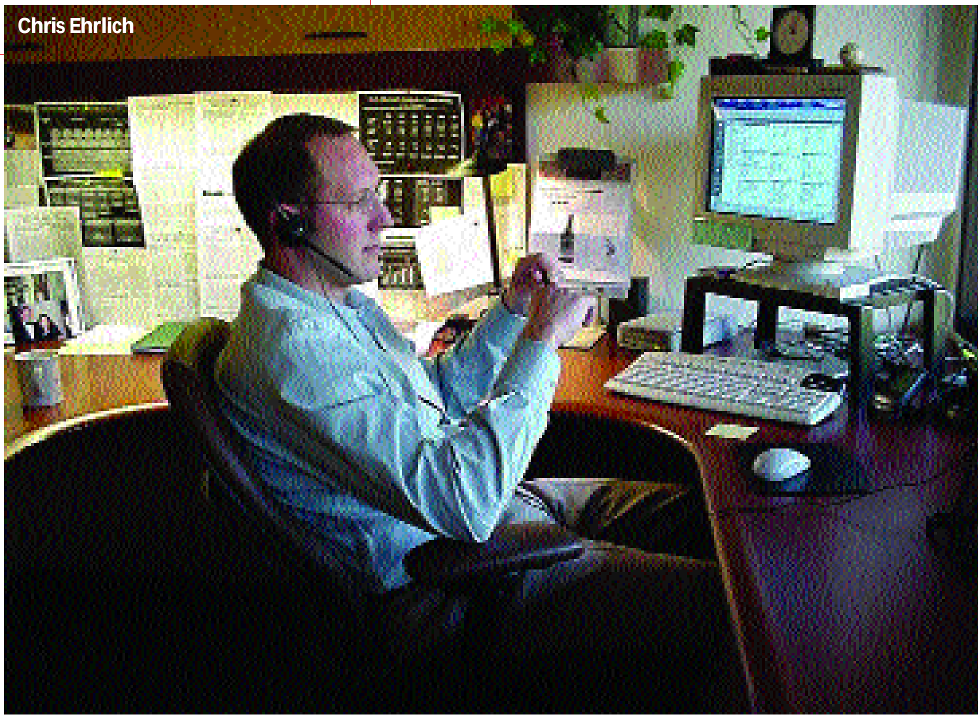
WILLIAMSON. It seems very clear that the venture capitalists are most interested in late-stage companies, not early-stage companies. That makes it very difficult for companies such as mine, which is an early-stage company that is still preclinical.

BUCKLEY. I had someone tell me the other day that VCs are almost like banks now. Most VCs are looking for companies that have products that already are on the market and showing revenue. This is beyond what we used to consider VC money, where they would fund a venture and get it going. In the early stages, most of the funds want to know whether the company has a product and does it have revenue. VCs are not being as flexible as they used to be and are taking a different role. I preach to companies that VCs are the last people that they want to go to. There are lots of other traditional sources of money that companies tend to overlook. In New York state, we have Empire State Development and there is a lot of grant money around. Also, there are loans available. The angel community — it's hard to get a handle on where they are and what they are doing because they don't like to be recognized — is funding a lot of companies especially in upstate New York. I try to encourage companies to look to those sources first.

DE BORD. It's very difficult to generalize about the space, but the best deals with truly breakthrough technologies or late-stage clinical products have a lot of traction. Valuations are all over the map. There are definitely some companies that are having trouble raising their rounds and may take up to nine months to close a financing. On the other hand, there continue to be deals that get done very quickly, with relatively clean terms and step ups. The best companies are continuing to get funded relatively quickly, though investors are definitely doing their due diligence and paying more attention to details.

RUDNIC. People have no appetite at the current time for stories on platform technologies that need many years to mature into products that will have significant revenue. They are relatively impatient,

With the biotech index down almost another 40% this year alone, investors, particularly those newer to the sector, **ARE AFRAID TO CATCH A FALLING KNIFE**.


Chris Ehrlich


Edmund M. Ruffin

> We are upbeat about the opportunity for companies to raise venture money long term. **THE FACT IS THAT THERE IS MONEY OUT THERE FOR GOOD COMPANIES.** On the venture side, they wouldn't be continuing to raise the money for their funds if they didn't think that there was a good opportunity to invest in quality companies in healthcare.

and investors are looking for companies that have a real prospect for profitability in the near term. We have that type of a story, so it's been easier for us. But I have noticed that it is much, much more difficult now than it has been over the last three years to raise money. We are having success at raising money, but I think we are an exception.

WILLS. There's no question that there is more money than ever before, but VCs are being a lot more particular. We have a good story, and I'm sure we could have gotten money from the VCs, but their money comes with more strings. We think we have some very good products and very good science, and we're a lot further along than some other companies.

EHRLICH. In today's extremely challenging financing environment, VCs are taking a closer look than in recent years at company fundamentals before investing. In particular, more attention seems to be focused on a company's stage of development and proposed business model. This has significant implications for both which companies are able to raise money and, for those that can, the price at which that money is made available. With regard to the former, what is interesting to me is that for really late-stage companies that have extensively developed platforms or products, there appears to be a market, albeit one in which the prices aren't very attractive to entrepreneurs or the parent companies from which they are derived. We are starting to see a number of Series E, F, and G deals being considered at what we used to consider Series B and C prices. We also are seeing a fair amount of activity in the big pharma "spin-out" category. Not surprisingly, there also appears to be renewed interest by VCs in very early-stage, cutting-edge technologies, which have been the traditional focus of our business. Companies for which fundraising may be slightly more challenging are those positioned between two categories. My guess is that this is the result of the fact that many of the mid-late stage funding sources have cut back on their investment activities as a result of their affiliation with organizations that may be suffering from the general economic downturn. As a result, while VCs continue to back the early-stage research they always have supported, they now are happy to step up to invest in well-developed, late-stage companies at attractive, early-stage prices. Those in the middle may be receiving less attention.

VC criteria

ANDERSEN. The VCs are very selective now, so the startups can't go out with just a game plan. They need hard data in hand before they can get any kind of valuation these days. That's a significant change from a year ago, when investors were clamoring to get into biotech. What was maybe the best environment for raising money in 10 years has almost evaporated, and now it's back to companies having to prove they are on the right path.

WILLIAMSON. I am somewhat optimistic in that I heard from one of the venture-capital groups that while all the VCs would like to invest in late-stage companies there aren't enough late-stage companies to go around, and the valuations of later-stage companies are too high. Thus, VCs will invest in early-stage companies, if it is the right early-stage company. I won't go to the VC community for funding again until I close the collaboration with Johns Hopkins University School of Medicine. The next hurdle to get over is the VC's due diligence on the technology. I am confident, though, because I obtained opinions on the new technology from the sort of people the VCs will look to.

DENNIS. We recognize that one of things that is problematic for the Midwest is that it is hard for us to attract VCs. The problem they have is the logistics. In the Bay Area, a VC could be exposed to 100 deals in two days. In the Midwest, they have to go to Cleveland for a day, Columbus for a day, Cincinnati for a day, Indianapolis for a day, Minneapolis for a day, Chicago for two days, etc. To address this, eight Midwestern states have formed a consortium and we have contracted with BIO to set up an investment conference in Chicago on April 3 and 4 that will showcase companies from all the eight participating states.

RUFFIN. A lot of venture-capital firms have been burned. Especially those firms that during the bubble two or three years ago, were investing a lot of money into platform companies that had no near-term prospect for generating product revenue. That's the challenge today for VCs with platform companies in their portfolios — how do they manage them and look toward an exit when there is no near-term prospect for an IPO market or the ability to sell these companies at anywhere close to the valuations at which they raised money? The challenge for these companies is determining what their long-term commercial strategy is going to be if products are a long way away, and they don't have a lot of cash. It's tough for these companies — they need to conserve cash as best they can, reduce their burn rate, focus on their core competencies, and look for partners.

DENNIS. There is still money out there for really good, emerging ideas. Companies that have not been oversubscribed, companies that represent new opportunities, so while it's a tough marketplace people are still getting excited about things that have significant promise and that are new.

EHRLICH. These days, more than ever before, VCs are paying closer attention to companies' long-term business models when considering an investment. Companies with therapeutic products either in the clinic or on the immediate horizon are still able to attract considerable investor interest. This also goes for drug-discovery companies with integrated platforms that can yield multiple drug-development candidates. Where companies appear to be struggling a bit more to raise money is in the discovery tool space or even the drug-discovery space, when the platform itself does not present a clear path to generating drugs.

IT HAS NEVER BEEN MORE IMPORTANT FOR COMPANIES TO ACCURATELY AND REALISTICALLY POSITION THEIR BUSINESS MODELS. Every venture capitalist has seen hundreds of "next-generation solutions" and "paradigm shifts" that didn't solve or shift anything.


Russell LaMontagne

VC opportunities

ANDERSEN. The window was open for about 18 months. It was quite amazing between the second quarter of 2002 and third quarter of 2002 how things just closed down. Probably the most immediate cause of that was the way public market stocks were getting battered. Investors that were trying to come in as momentum players got spooked. And then all of sudden we're back to the core group of VCs that have made a lot of investments already, and they are the ones that know what they are doing, so from a startup perspective they really have to prove their story.

DE BORD. What is interesting in my space is the growing number of companies that are being spun out of pharmaceutical companies. A pharmaceutical company may have a compound that it just doesn't have the ability to focus on at this time, so a management team will approach the parent company to develop a compound and they will start a company around it. We've seen a lot of those types of companies recently and they remain very interesting. (We funded one recently, Biovitrum, an operating business that was spun out of Pharmacia.) In the past 12 months, this concept has really taken off. The drug may not be a billion-dollar drug so it will fall below the radar of a pharma company, but for a small biotech company a drug that has the potential for $200 million in sales is very interesting. And they can build a business around one or two late-stage compounds. They can concentrate on other potential indications for the compound as well.

DLESK. The funding mostly is going to existing portfolio companies. Companies looking for a Series A investment or a first institutional round are having difficulty, unless it is a spin out from an existing entity or it has Nobel Prize type science credentials behind it. In the third quarter of 2002, according to some statistics, there were the fewest number of Series A fundings since 1994.

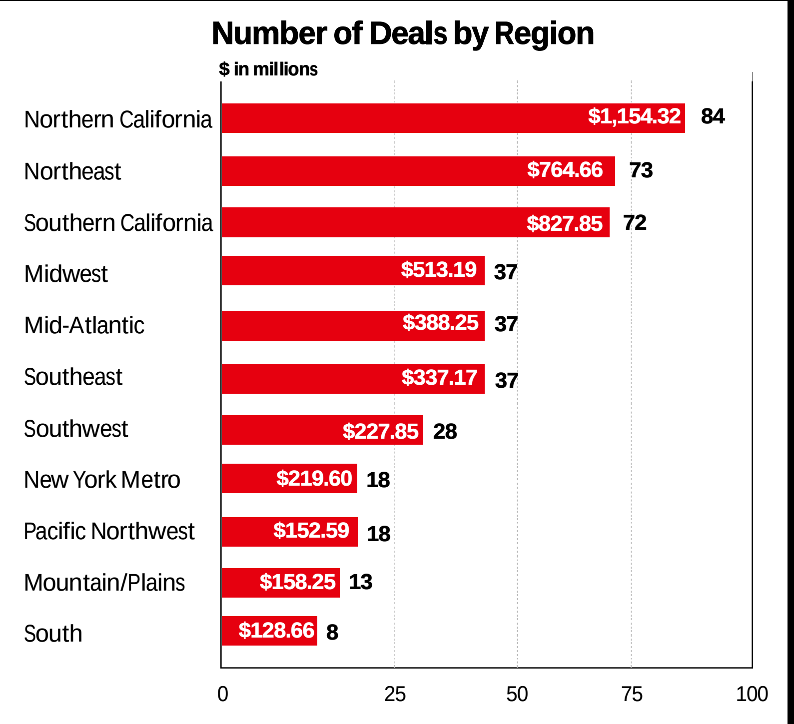
WILLS. We went through a recent series of financing in a tough landscape. We were actually down to $2 million, burning $1.2 million per month, when we raised $11.5 million. We were able to target existing investors and then institutions. Of the $11.5 million we raised, 75% was with existing shareholders, while the other 25% was with new shareholders, institutional funds. We talked to the VCs, but to be frank those deals are a lot more onerous to the shareholders. The last four deals we've done have been pipes at market. We've been given what we think is reasonable warrant coverage. To be fair, the VCs have come around and are willing to do pipe-type deals — either preferred issuance, some type of reset mechanism, or convertible security. We were successful as a result of what the company is, where it is, and where it's going. For the past 18 months, VCs have been looking for the short-term, mid-term, and long-term. They don't want to put money into the preclinical or even the Phase I companies. They want to see revenue dollars within a year — that's the short term. After that they want to know what's coming next — that's mid-term, then they want long-term guarantees. Regarding our shareholders, we have to be cognizant to try and balance the factors of dilution versus being able to advance our programs and not run out of money.

VC startups

LAVINSKY. Every early-stage company looking for funding needs a solid business plan with an attainable revenue model, competitive barriers to entry, and a strong management team. Despite the drop in venture-capital funding, investors are still very interested in companies that offer them an opportunity to get a great return on their investment. If a company looking for funding cannot write a business plan that clearly conveys the excitement and potential of the investment opportunity, it is critical that the company retain the services of an experienced firm to assist in the process. Companies looking for funding also must conduct thorough research before sending out their business plans to prospective investors. Different investors have different investment criteria, and often one venture capitalist will invest in a company that another investor will have no interest in. Companies also should consider presenting at regional venture fairs and forums where they can pitch their ideas to large audiences of potential investors.

CAMPBELL. The world has changed pretty dramatically in last couple of years, which is not news to anybody. But what is inter-

Investment in Life-Science Startups



Source: VentureWire, New York
Note: Numbers are for the time period of 1/1/02 through 12/6/02.

esting is that the companies that are having the most difficult time are the ones that are in the middle. By that I mean, investors seem to be taking a bar-bell strategy. They are investing in very, very early-stage companies or they are investing in very, very late-stage companies. This includes venture capitalists that used to be "early-stage" investors.

EHRLICH. The good news for companies is that there is more private money available for investment in biotech than ever before. The more frustrating news may be that it is not being deployed as generously or as rapidly as many would expect. Perhaps one of the key reasons for this is that there are very few investors who appear to be willing to "step up" to set the price of new rounds these days. With the biotech index down almost another 40% this year alone, many investors, particularly those newer to the sector, are afraid of "catching a falling knife," and thus would prefer to wait for someone else to say what an opportunity might be worth before investing. One need only look at the number of deals that have been done this year at very low pre-money values with larger than normal amounts of capital raised to see evidence of this phenomenon. I expect this trend to continue in 2003.

ANDERSEN. Startup companies are stretching out their fundraising process as long as possible so they can get good clinical data or meet some milestones, which will then help boost the valuation. That means either running a real lean operation, really cutting down the burn rate to try to get some concrete results that they can then take back to their investors, or maybe raising some bridge financing from existing investors just to keep it going before they go out for a formal round. Companies need to have some concrete data in hand before they can go out to get new investors on board, if they want to have any kind of valuation. Startups increasingly go toward government grants and grants from state programs. That's always been the case, but the competition has increased. Even if a company only gets a couple hundred thousand dollars, that could be enough to get it to a point where it could go out and raise that next venture round.

WILLIAMSON. Much of what is Advagen primarily existed as DirectGene. We, like various other companies that are struggling, are reorganizing and restructuring. With the approval of the DirectGene shareholders we formed Advagen, acquired the assets of DirectGene, and are entering into a strategic collaboration with a university, which encompasses a license agreement to some very novel technology — the kind that materially advances a field. I formed a new board, we've gone from eight persons to five, with two seats empty, and we are looking for board members who have more clout or reputation with the venture-capital community. DirectGene had been funded exclusively by angels, but at a much higher valuation than can be obtained today. A perception of high valuation is one of the things that gets in the way with the venture-capital community; they feel like they would rather not have to come in and be "the messenger" of the reduced valuation. We've imposed upon ourselves a greater

> VCs are putting ugly deals on the table. And **IN MANY CASES, COMPANIES ARE TRYING THEIR BEST TO HOLD OUT UNTIL THE ENVIRONMENT GETS BETTER, BECAUSE THE DEALS ARE INJURIOUS.** As is typical in the U.S., if the VCs make the decision to step back, somebody else emerges. That's a good thing — it's not totally dead space.

Every early-stage company looking for funding needs a solid business plan with an attainable revenue model, competitive barriers to entry, and a strong management team. **DESPITE THE DROP IN VENTURE-CAPITAL FUNDING, INVESTORS ARE STILL VERY INTERESTED** in companies that offer them an opportunity to get a great return on their investment.

than 10-fold reduction in valuation, and are giving the previous investors in DirectGene the opportunity to invest in a Series A for Advagen at a greatly reduced valuation. In this way, they can do a bit of dollar cost averaging. More importantly, I established a benchmark of more realistic valuation to put in front of the venture-capital community in the first half of next year. We are trying to proactively dress ourselves in a way that makes us more attractive to the venture-capital community.

RUFFIN. Things have changed in terms of what the VCs are investing in. Everybody is looking for companies with products. The best companies, whether they be early stage or late stage, in terms of the story they are able to tell right now, are those that can show a fairly clear and expeditious way to product revenue with a discovery or development platform behind it. This will allow for follow-on products and other products through the pipeline. Early-stage companies that can show that they have a very strong platform technology and a quick road to products that have the ability to raise money will garner the most attention. The ability to raise money depends on a number of things. One of the things that investors are clearly looking for is a strong management team. If investors see companies with good science and good management they will make the investment. We are pretty upbeat about the prospects for the industry next year.

DENNIS. We've had a number of companies that have done extremely well this year in raising private rounds of funding. There have been more than a half-dozen in the state that have raised $30 million to $40 million in the past nine months, and that's a pretty good track record given the current environment. A lot of this money has been raised off shore, and lot of it out of Asia.

RUDNIC. It's a tough market, but we've found that our story resonates a little bit better than others because we have a very product-focused type of company. We have products that will be on the market in the relatively near term. Our first products will be on the market in 2005 and we will have several products on the market in 2006. We have a clear path to revenue, which tends to resonate better with people who are looking for investments.

VC and alternative sources

WILLIAMSON. Right now I am turning my back on the venture-capital community and seeking funding elsewhere. I've cut back the company tremendously in terms of head count. And, I am only doing very focused product-development work. I'm seeking funding from angels, individuals of high net worth, as opposed to venture capitalists. We are having modest success in this area.

LAVINSKY. Those companies that are unable to raise venture capital from professional venture-capital firms and have already tapped the resources of their friends and families may consider state or federal grants or Small Business Innovation Research (SBIR) awards. More than $10 billion has been awarded by the SBIR program to various small businesses. Often a grant or a SBIR award will enable a company to build itself to a stage that will attract a venture capitalist or other strategic investor.

CAMPBELL. I don't think angels in biotech work. These companies need so much money to be successful, that an angel investor who puts a little bit of money in for an early-stage round will get wiped out at the end of the day — never seeing a dime in return. For example, if an angel invests $500,000 in a company that ultimately is successful and moves forward and needs to raise a couple hundred million dollars, how much equity will that angel investor have in the company at the end of the day? More than likely zero. These investors want to be part of a great technological revolution by throwing a little money in, but a little money doesn't do it.

RUDNIC. I'm on the board of directors of the Tech Council of Maryland so I get a chance to discuss a lot of issues with other CEOs in the area. The companies that are more platform-technology, long-term focused, and biologically based are having to go overseas for money. I know some CEOs are going to Asia for funding because there is a lot of money specifically in Taiwan, Hong Kong, and Singapore. There is a significant amount of capital in those markets. Some of the CEOs who have been successful have fostered relationships with people in the Asian markets so that they can tap into the markets over there.

DENNIS. From a state perspective one of the things that we recognize is that we are very short on VC funds, and always have been, regardless of the current environment. One of the things that we've been doing to correct that is using state funds, under a grant mechanism, to start seed and pre-seed funds. We have recognized there is a real gap in the existence of seed and pre-seed money to get companies started. Within the past year, the state started four pre-seed funds. The state uses a granting mechanism called the technology action fund, which has $10 million to $12 million in it annually, to leverage the raising of additional funds to start seed funds. We are working hard to provide alternative sources during this dry spell.

RUFFIN. A lot of early-stage companies won't necessarily want to partner their lead product at an early stage because they don't get the price for it that they think they could get if they have Phase I or Phase II clinical data. One of the advantages for companies with a discovery platform is that they can do discovery-stage deals to bring in cash and use it to power their products through or invest in their lead products. Survival is important for these companies, and if they have to they will partner their products earlier than before. This is clearly what a lot of the larger pharmaceutical companies are counting on. They want to be able to pay a price for these products, which frankly a lot of the early-stage companies in better economic times would not settle for.

DLESK. We have a significant NIH grant of $4.7 million supporting the development of our cocaine-addiction product Cobrex. We've tapped into some of the NIH money and we have additional grant applications in at this time. We will continue to use this type of funding where we can. The only problem is that the funding is very specific for one product, which doesn't necessarily cover the broad needs of the company.

VC valuations

LAVINSKY. The law of supply and demand gives venture-capital firms an extraordinary edge in times like these when venture capital isn't as plentiful as it has been in the past. Valuations for most companies are down considerably, and it is not uncommon for a company looking for funding to be discouraged or even hostile when asked to give up a much larger piece of the company than expected in return for an investment. Generally speaking, companies now have significantly lower valuations than comparable companies that raised capital in late 1999 and early 2000, but they are undergoing a more thorough evaluation process before raising their first dime of venture capital. What is resulting is a much stronger breed of companies with a greater chance of financial success.

ANDERSEN. In this market a flat valuation is pretty good because the benchmarks are down. If we link valuations to performance in the public market, the public biotech and device sectors are down quite a bit. So to maintain a flat valuation is a pretty good accomplishment at this point. Companies are trying to make sure they have the entire plan and data in hand before they go out to raise the funds, or else they basically will have to give up most of the company to get a round closed. With the valuations of the public market falling too, that has other effects. We saw a number of mergers and acquisitions fall through because the value of the public market stock came down so far between the time the deal was announced and when it was supposed to be closed. That public market effect is now rippling through the private investment market pretty seriously.

RUDNIC. Valuations have really gone down. There are about 200 public biotech companies that are trading for less than their cash value. That has driven the valuations for private companies, such as ours, down. Investors say, if I can buy a publicly traded biotech company and have instant liquidity, why would I want to lock up the money with a privately traded company? It's a difficult question to answer, unless a company offers them extremely good value and the prospect of near-term liquidity through an IPO or profitability with products reaching the market. That seems to be where the focus is in the U.S. The Asian markets tend to be a little more patient, and look a little bit longer term, but I can say it is a very difficult situation virtually across the board.

CAMPBELL. The later-stage companies are at such low valuations right now that VCs can buy a later-stage company that has a lot of risk taken out of it at a valuation similar to what would have been for an early-stage company years ago. There's not a lot of incentive to go into the earlier-stage companies, unless the investor can own a significant percent — 80% plus — of the equity for a very small amount of money. Very, very early-stage company deals are getting done by VCs coming in and doing an 80-20 split with management. The VCs figure if things don't get any better on the valuation side, it's okay because they still have 80% of the company, so at the end of the day they will still have something worthwhile. At the other end, VCs are going to later-stage companies that have Phase II clinical data. Pretty big rounds are getting done by deep-pocketed investors who put together a syndicate that essentially could fund a company for years going forward without having to access the public market. These VCs figure they have enough money to fund the company with this financing, and if the market is still horrible in the next couple of years and the company can't go public or do a secondary offering, then they will throw in their own money again and nobody else can dilute them.

BUCKLEY. Valuations are a real sticky point with everybody. VCs are looking for a bigger percentage so valuations are getting knocked way down. The investor is getting a bigger percentage of the company than it might have been looking for even three years ago. I know of several companies that have turned down offer sheets just because they thought the valuation was so low and what investors were looking for was so much that they didn't want to give it up. When capital is tight, investors are going to take more to give the funding. When all is said and done, the VCs will be fair, but it's not to most companies' liking.

CAMPBELL. If a public company's market valuation is less than the cash on its balance sheet and it is a cash flow negative company — that is it burns cash — it can't raise money. A lousy valuation precludes a company from getting financing. A company can't sell its stock if it's trading for less than cash.

DENNIS. VCs are putting ugly deals on the table. And in many cases, companies are trying their best to hold out until the environment gets better, because the deals are injurious. As is typical in the U.S., if the VCs make the decision to step back, somebody else emerges. That's a good thing — it's not totally dead space.

DE BORD. There are still some very exciting things happening and definitely some very large rounds of financing that continue to be raised. It will be interesting to see what happens to a lot of the private companies that raised money a year or a year and a half ago at

The venture community has a lot of money that it is looking to invest, but with everything that is going on with the economy and the market, **VCS ARE HESITANT AND HAVEN'T BEEN AS QUICK TO COME FORWARD AS THEY MAY HAVE BEEN FIVE YEARS AGO.**

high valuations and that have yet to raise again. We don't yet have a lot of data points as to what happens to those valuations.

VC deals

LAVINSKY. Approximately 40% of the funding raised by companies in the healthcare sector in 2002 went to biotechnology and pharmaceutical ventures. In the medical-device field, there was increased attention in the latter half of the year to various products used to help patients suffering from heart problems. For example, medical-device companies that have recently raised capital include IntraLuminal Therapeutics, which develops products to cross and recanalize totally occluded arteries; CHF Solutions, which manufactures mechanical pump/filter systems to remove excess fluid in congestive heart-failure patients; and MicroMed Technology, which develops products to help patients suffering from congestive heart failure.

LAMONTAGNE. Product deals are getting a lot more traction than platform deals. Specialty pharma is still fairly hot. VCs are investing in late-stage products. Genomics companies are having a terribly hard time raising money. A company can have a really good business plan and great ideas, but right now VCs are holding onto their money. The bottom line is that there are far fewer exit strategies available to companies and investors and as long as there's no IPO market there isn't going to be a light at the end of the tunnel. There are a lot of private companies that would have been funded or gone public in a different market, but instead are stuck in limbo.

RUDNIC. The thing that drives an IPO window and a surge in the market is a lot of money going back into the mutual fund market. As we see people start to have more confidence in the stock market and invest more of their 401K money and IRA funds into their mutual funds, there will be a surge in the buying of these under-valued biotech companies and other companies in the tech sector. That will fuel an opening of the IPO window. I believe biotech will lead the charge coming out of that IPO window. This will be a very fast event. The publicly traded companies will be the first to be bumped up. After awhile these companies will become saturated and there will be a surge for new issues, so an IPO window will open. Whether the window opens at the end of 2003 will depend a lot on the world situation.

LAMONTAGNE. Many of the late-stage deals are almost like bridge rounds, which is not what VCs are traditionally known for. The idea is that venture capitalists support innovation and help young companies, but that's not what VCs are doing right now. They are funding known quantities.

DENNIS. Of the deals that have done best in the past year, most have been for medical-device companies. The reason is that they are close to their end market or they have a shorter regulatory path. Drug-discovery companies also have had a lot of traction, where they represent tool-kit types of technology and have substantial pharma support.

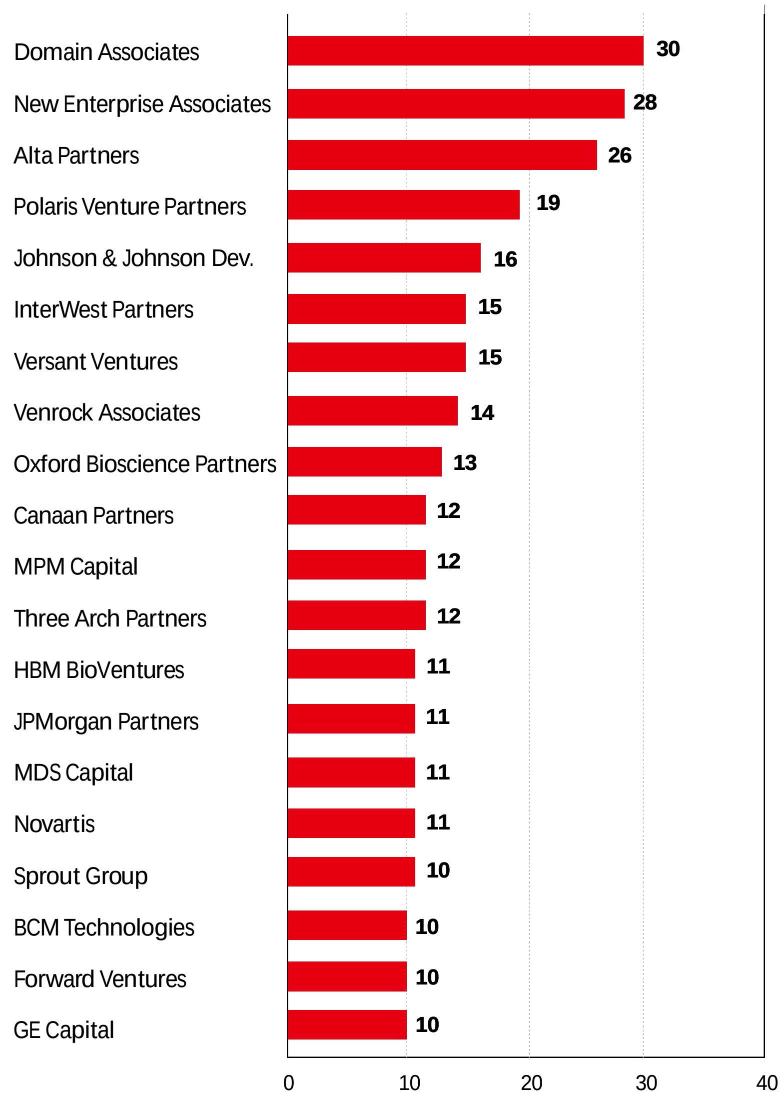
DE BORD. On the product side, companies that have solid clinical data, with late-stage products will continue to be funded at healthy valuations. There's money out there for the right deals. I work on a later-stage mezzanine fund, so my perspective is much different than a start-up venture capitalist. My focus is on later-stage companies that have most of the management team in place and have a product in clinical trials. On the late-stage side, there is so much more to analyze. We can assess the quality of the management team, the market size, and we almost always know the indication for a drug. We have clinical data that will make or break a company sooner. It's not less risky, there's just more to absorb. And these companies need significantly more capital because clinical trials cost so much, although the corporate partnering side of the business still is very important. In our portfolio we've had many corporate partnership agreements announced, which helped to fund the burn rate, of which we are always a big proponent. For example, Eyetech, Kosan, and Cytokinetics all recently have signed corporate partnerships raising hundreds of millions of dollars from pharma should they hit their milestones. Conversely, some of our companies have retained the rights to the technologies and those companies will need a lot of capital to push those through.

WILLS. Palatin has a product under development called LeuTech that is to be used to rapidly image and diagnose sites of infection. Our corporate partner is Tyco Healthcare/Mallinckrodt. We've been through Phase III and the BLA came back from the FDA stating that from a clinical, safety, and efficacy standpoint everything is fine, but there are some CMC issues. We've been addressing those issues and we anticipate getting the BLA amended and back in front of the FDA early first-quarter 2003, hopefully with approval in six months, and selling the product in the second-quarter or third-quarter 2003. This fits the short-term requirements. Mid-term, our second development product closest to market is a sexual dysfunction drug for both male and female. It is different than the Viagra-type drugs. We've gotten a lot of interest from potential partners. Then we have a proprietary drug-discovery system that we have developed called Midas, whereby we are able to synthesize peptides into therapeutic leads. That's the long-term strategy.

DLESK. Being a specialty pharmaceutical company focusing on addiction — there are very few companies that are doing anything

Investment in Life-Science Startups

Number of Deals by Investor



Source: VentureWire, New York
Note: Numbers are for the time period of 1/1/02 through 12/6/02.

in the addiction area — the biggest problem we run into is that we're not part of the herd. The venture capitalists tend to invest in hot spaces where there are other similar investments going on, and that makes sense to reduce their liquidity risk. From a business standpoint, we have a great opportunity, since there's a huge unmet medical need in the addiction field with very little competition. But with the relatively conservative tenor that the VCs are taking lately, doing something that is out of the mainstream doesn't fit with their investment criteria at this point.

VC requirements

LAMONTAGNE. Companies can't go to investors and say give us the money and we'll put together a management team — that's not going to fly. They might have been able to do that in the past. A company can't go to a venture-capital firm with a menu and say fund us and we'll become this, this, and this. Investors need to know that a company is established, has management in place, a management team with a track record. Also, it has never been more important for companies to accurately and realistically position their business models. Every venture capitalist has seen hundreds of "next-generation solutions" and "paradigm shifts" that didn't solve or shift anything.

CAMPBELL. A good story isn't going to get a company anywhere these days. If it's a therapeutic company, it needs to have human data. If it's an early-stage company there has to be a fantastic management team, earth-shattering science, and there has to be a major hook — and not just a story — there has to be compelling data. Companies that had a Series A/B round in 1999 and 2000 are having a very hard time right now. A lot of these companies are just not getting funded. They go away, they get bought, there's a weeding out process. Unless a company has the three things necessary to make a biotech company successful, which are great science, great management, and a solid balance sheet with a lot of money, it's out right now. I've been involved in the industry for more than 16 years, and I've seen three or four cycles, but it's never been this bad for as many companies.

RUFFIN. The importance of good science and quality management is absolutely critical for most of these companies now. Because of the challenges facing the life-sciences industry and the high risk involved, companies need experienced management teams. Especially, when they are wending their way through the clinical process that can take 10 years to 12 years. VCs are looking for companies that have people with clinical experience and people who have taken drugs to the clinic before, people who know what they are doing, not just the scientist out of the university with an idea. Investors want to put the good science that these people have together with folks who have the skill sets from the corporate world and the experience in taking products through commercialization.

RUDNIC. What I am finding in the venture-capital markets is that they have gotten much more involved in the details of the story. They have become much more discriminating in terms of the stories that they are interested in, and they are becoming much more detail focused than they have been in the past. A broad story in a general area in the past was what got investors interested. Now, investors want to know who specifically is on a company's team, what is the technology, what is the patent status, what are the claims in the patent, and what differentiates the company from its competitors.

EHRLICH. The financing environment is so challenging these days, that for the first time in a while, we are advocating that our companies seek all the outside help that they can to improve their chances of raising money. For example, for the first time we are considering hiring presentation coaches for a number of our already seasoned portfolio company CEOs to enhance their presentations to new investors. Many folks would agree that the environment is so shaky these days that companies have to be far better than they ever were in the past to raise money successfully. Even when deals are getting done, they seem to take as long as six to nine months, versus about half that time in previous years.

VC and the future

LAMONTAGNE. This is not the first time this has happened to the market. A lot of companies that are getting by sparingly now are going to end up doing very well down the road. Many companies that have raised the first round will have to live with that and survive. On the other side, there are going to be a lot of great companies that just aren't going to make it.

ANDERSEN. There will be a shakeout of some sort, and the VCs are very cautious right now, but it's a situation where if one jumps in they all want to pile on. A company might have oversubscribed rounds, but there are nine other companies that can't get their foot in the door. Companies are doing everything they can to come in with the best possible presentation, and I think that means stretching things out to the second quarter of 2003 if they can and hoping that by then investors are a little more receptive.

CAMPBELL. The nice thing about this industry, one way or the other, is that it is very volatile. Things can change very quickly. Market caps can double very soon, but there has to be a catalyst. There are a lot of products in the clinic that are very strong and that will get regulatory approval. When investors start looking at the glass being half full as opposed to half empty, then everything will be fine.

WILLIAMSON. I reorganized the company's board, reduced headcount, developed a new business plan, imposed upon the company a down valuation, and acquired new technology all at the same time. We've imposed upon ourselves the discipline necessary to remove as many reasons as possible for VCs to say "No" so that we can ultimately get to "Yes." I have a sales and marketing background, so I listen to the marketplace and accept what it tells me. The marketplace was essentially telling me that the company as it existed in the then current environment was not fundable. I couldn't change the environment, but I could and have changed the company.

CAMPBELL. Right now it's a great time to be an investor. It's a great time to have a checkbook, and be smart about the companies that have good technology and sound management, and make a big bet. A lot of the smart money is going in that direction, and they will make a killing. The industry is not going to go away, there's a lot of very interesting technology out there.

BUCKLEY. The VCs will have to start loosening up. Once a few investments are made, funding should start swinging back again. Some of the funds that have been around for 2 1/2 or 3 years promise returns in five to seven years, so VCs have to start doing some investing or they will be handing the money back, and I don't think they want to do that.

RUDNIC. I think things will improve, and probably improve next year. There are a lot of things that can make that happen. Being the eternal optimist, if we can get through the Iraq situation quickly and if we can turn some things around with the economy, by the end of 2003 we could be looking at a much different situation.

NOW INVESTORS WANT TO KNOW WHO SPECIFICALLY IS ON A COMPANY'S TEAM, what is the technology, what is the patent status, what are the claims in the patent, and what differentiates the company from its competitors.


Edward M. Rudnic, Ph.D.

DLESK. We are preparing to launch our first product, ThiaSure Multivitamin/Multimineral Dietary Supplement, in February, we recently changed the company name from Addiction Therapies Inc. Given the tough nature of getting significant institutional investment, we decided to find a way to generate revenue. Within our space in the addiction field we identified that there was a significant unmet need. Many of the 9 million alcoholics in the U.S. have nutritional deficiencies, which can lead to brain damage and cognitive impairment. There are no products specifically designed to address that need. The addiction text books say alcoholics should take high levels of thiamine along with other vitamins, yet this typically isn't done because patients have to take four or five different pills to do it right. We brought all that together into one product — ThiaSure. Since vitamins don't require Food and Drug Administration approval, this is a product that we quickly can bring to market to generate some revenue and establish the company within the addiction marketplace. And hopefully when the venture market opens up we'll be better positioned in terms of having a product in the market and having established relationships with the treatment providers in the addiction field.

RUDNIC. We were principally funded by Healthcare Ventures out of Princeton, N.J., a top-tier life-science venture-capital firm. From the beginning, they have been very involved in the business plan, how the money is spent, fiscal control, and at our board meetings they are very observant in terms of how we spend our money and where we spend our money. We have good fiscal discipline in this company, and have been within budget virtually every month that we have existed. We have spent money with restraint, but at the same time when we had to spend money we've bought value. The ultimate goal is not to do an IPO, the ultimate goal is to be profitable and be self-sustaining. That way a company has the most control of its destiny and the most independence. ✦

PharmaVoice welcomes comments about this article. E-mail us at feedback@pharmalinx.com.