

MAGAZINE: MONEY MATTERS

FROM: APRIL 2007 ISSUE | POSTED BY: ANDREA SIEDSMA

Hammering Away posted on APRIL 5, 2007

Local venture capitalists assert that their industry isn't broken- it's just taking a refocused approach to funding

Last fall, notable national venture capital firm Sevin Rosen announced it would kill its latest fund, citing a saturated venture capital market and a “weak” exit environment for companies. This, of course, sounded an alarm in the industry, causing some to question: “Is the VC model broken?”

Absolutely not, says Kleanthis Xanthopoulos, managing director of San Diego-based Enterprise Partners Venture Capital (EPVC). What has happened is that VC and company strategies have switched to survival mode over the last couple of years. And today it takes more time and money to grow a venture-backed company than it did even seven years ago.

“In the old venture model days, VC firms would put \$30 million to \$40 million into a company and have an exit within three to four years,” Xanthopoulos says. *“Today companies are taking longer to mature and they absorb more money. For example, a VC will put in \$17 million today instead of \$30 million into a life science company.”*

In order for companies to be attractive to most VC firms in 2007 and beyond, they need to control the amount of money they spend, work on a proof-of-concept and have a product that works.

“People now are trying to be very careful about how they deploy their capital,” says Xanthopoulos, who joined EPVC in 2006 after being CEO of San Diego-based biotech Anadys Corp. “For example, five years ago you couldn’t outsource manufacturing for pharmaceutical companies. Today, companies don’t have to build infrastructure. That’s how they manage their capital more efficiently.”

The life science market, in particular, has seen some significant returns recently because companies have become smarter with their capital. Many VC



firms are also moving more toward later-stage deals.

EPVC, which focuses on the life science and technology sectors, has historically focused on early-stage deals. The 21-year-old firm's last fund, Fund 6, which was \$350 million, focused on the health care and information technology fields. EPVC is currently raising money for its seventh fund, which will focus on medical devices, pharma and other emerging technologies in health care. One thing that hasn't changed? EPVC is looking for companies and industries that will provide the greatest returns. Go figure.

Early-Stage Pulse

Truth be told, there is a handful of local VC firms that write checks to startups. One of them is San Diego-based Hamilton BioVentures, which focuses on the life science market. Hamilton's current fund is \$100 million.

"We really like the fact that there are important sustainable markets for life sciences," says Elliot Parks, managing director of Hamilton BioVentures. "We all know about the Human Genome, stem cell research and gene cell therapies. I think that life science companies have a bright future."

There was a time when it was typical to grow a company and drive it toward an IPO. And while that sort of exit is less attractive and available these days, the shift in the market has created a niche for Hamilton BioVentures.

"**Somebody has to do it,**" Parks says of his company, which generally does deals from \$1 million to \$3 million. "If nobody invested in early-stage companies, there would be no later-stage companies. If you can pick the right and most promising opportunities and work hard to grow those opportunities, you can have a fair number of successes."

As in the past, the real financial reward in the life sciences comes with solid clinical trial results. And though Parks adds that he's seen companies with clinical success stumble, his firm feels that what it is doing is ultimately good for society.

Another San Diego-based VC firm that has chosen to invest in early-stage life science companies is Avalon Ventures. The firm also invests in wireless firms. But know this: Many of the companies Avalon funds are ones the firm starts itself.

Walter Tender, Avalon's chief financial officer, says when he and his Avalon partners make an investment, they try to be very sure that they understand what exit is likely before they make the investment. Today, that exit will most likely be a merger or acquisition.

"In the late 1990s, companies with little or no revenue had valuations in the hundreds of millions of dollars based on potential," Tender admits. "You always want to build a lasting company that is going to grow, but the reality today is that very few companies are going to make it to the IPO market."

There is no question that M&A activity in the life science and tech sectors is up over the last couple of years. It's an exit strategy that most VCs now expect and plan for. This strategy has placed pressure on small biotechs to find ways of building value so that large pharma will come in and save the day. Biotechs can't even touch the public markets without having a drug in clinical trials.

"Big pharma has the money and expertise to get a drug through clinical trials, and they are willing to take the risk, which most VCs aren't," Tender says. "Early-stage VCs like us aren't willing to take much clinical trial risk—it's too expensive. But there have been a number of larger \$400 million-plus VC funds that are much more willing to finance clinical trials and take that risk."

Since many biotechs are running out of money, they also opt to merge with another biotech.

"**We have one company right now that is looking to merge with another biotech that has money. It's not the best outcome, but it's better than closing the doors,**" Tender says. "If we end up with shares in a combined entity, it gives us a chance at an upside."

The Era of Longer Engagements

Much like real estate, venture investing is primarily a localized business because it requires local knowledge of the market.

“It’s like saying buying land in Des Moines, Iowa, is vastly different than buying beachfront property in San Diego,” Tender says, who goes on to describe why he’s hot on the San Diego region in particular. “There is a tremendous amount of research, a corporate presence, and a whole bunch of startups already in this region,” he says. “This is fertile ground for ideas, and you have the infrastructure to handle it.”

Nevertheless, no matter how good the ideas, people, science and technology are, investing has been and always will be a high-risk business. Overall, the VC model may not be broken, but the business of funding certainly is not shatterproof.

“If you look at the big picture, the most money ever raised in venture was during 1998 to 2000,” Tender says. “In order for all that money to come back and have a positive return, you’re going to still need a few more Googles. I don’t think that’s going to happen. That was a time when too much money was in the tech area. Now there is going to be a clearing out, and there will be some money lost. But we think there are some really good opportunities out there. You just have to be a little more thoughtful in terms of the stages of the companies you invest in and at what point you’re likely to exit.”

According to angel investor Bill Payne, a member of the San Diego Tech Coast Angels, this is an era where size does matter. Since most venture capitalists have more money to invest, they are investing larger amounts in later-stage, less risky deals, expecting huge returns on their investments.

“Venture capitalists are engaged for 10 years in a single fund. It’s hard work, and really smart and experienced people are not willing to do it for less than a huge upside opportunity,” says Payne. The focus on bigger returns is not only great for investors but also for executives of the companies they fund.

“The change in the market is the press to be large, which is driven by investors who want to make a lot of money,” he says. “There is a rush toward quality VC firms. Limited partners strive to invest only in VC firms with top quality performance.”

Since many VCs have shifted their focus more toward later-stage deals, smaller startups have to be a little more patient with their growth and their funding expectations, Payne says. He pointed out that successful high-tech companies like Skype and Google began their fund raising with modest amounts of angel money to demonstrate that they could get some traction in the marketplace. What has also changed is the gap between angel financings and venture capital rounds.

“There are a lot of angels investing in \$300,000 to \$1 million rounds, and VCs who are investing in \$7 million to \$50 million deals,” he says.

So, one way angel groups are trying to bridge this growing funding gap is by banding together on larger deals. Payne, who also launched the Vegas Valley Angels in Las Vegas and the Frontier Angel Fund in Whitefish, Mont., is not opposed to banding with other angels to create a small consortium.

Entrepreneurs are the most affected by the change-up in the VC model. Bottom line: Large VC firms and angel groups don’t want to throw money into a startup valued at \$20 million today. So, it’s critical that entrepreneurs understand the capital food chain so they can structure their funding strategy and milestone objectives accordingly.

“Maybe we did in stupidity in 1999, but no logically right-minded investor will put money into an overvalued early-stage deal,” explains Payne, who recently wrote an e-book called *Definitive Guide to Raising Money from Angels*. ***“We all want to see these companies go through several iterations of fund raising, meet milestones and prove how good they are before we write bigger and bigger checks.”***

Refocusing on Later-Stage Deals

You won’t see many \$100-million technology initial public offerings this year (ah, the good old days), but that doesn’t mean that the industry, including investment firms, is having dismal thoughts about the future. Here are some newsworthy trends.

- **M&A Is Hot.** Venture capital firms are now looking for alternative exit strategies. Mergers and acquisitions, in particular, provide VCs and the companies they invest in a “safer” and often more rewarding outcome.

- **Money, Money, Money.** On a national scale, VCs predict they will invest about \$27.6 billion in American companies this year, according to the National Venture Capital Association.
- **Late-Stage Advantages.** Many investors are beginning to invest in later-stage deals, though a few local companies still believe in backing young entrepreneurs. Among these VC companies are Enterprise Partners, Hamilton BioVentures and Avalon Ventures.
- **Winged Financing.** Angel firms are now banding together to provide larger financing to small companies, thus filling the gap between later-stage and early-stage deals.