

LIFE SCIENCES
ROUNDTABLE

BUOYED BY BIOTECH

A panel of VCs gathered together in San Francisco to discuss what's vital for growth in life sciences

Life science VCs are famous for being, well, not so famous, at least in comparison to their tech counterparts. It's the tech VCs, after all, who get newsmagazine cover stories when they take a Google public or they launch a new Internet/consumer trend. But it's the folks in life sciences who are backing startups that are developing life-saving drugs and creating innovative medical devices.

And, the sector is no slouch when it comes time to exit. Although the market for VC-backed IPOs was weak last year, with only 56 venture-backed companies going public in 2005, compared to 93 the

year before, nearly half, or 26 of the VC-backed IPOs last year, were in life sciences.

"We are not the lead singers in the band, but we are like the guy that plays bass that does well," says Gil Kliman, general partner of InterWest Partners.

So, to give the bass players their due, *Venture Capital Journal* brought together a life sciences panel to discuss exit opportunities, fund-raising, regulations and other topics that keep them awake at night. Sponsored by the law firm Orrick, the panel was moderated by VCJ Managing Editor **Alastair Goldfisher**.

The panel participants consisted of **Brent Ahrens**, general partner of Canaan Partners; **Lou Bock**, managing director of BA Venture Partners; **Steve Graham**, partner of Orrick; **Dan Janney**, director of Alta Partners; **Gil Kliman**, general partner of InterWest Partners; **Chip Linehan**, general partner of New Enterprise Associates; **Jaime Topper**, general partner of Frazier Healthcare Ventures; and **Chad Waite**, general partner of OVP Venture Partners.

The following is a sample of what the panel discussed.

LIFE SCIENCES ROUNDTABLE



Tech vs. Life Sciences

VCJ: Is it hard to be a life sciences VC when it's your tech counterparts who are getting all the attention?

Ahrens: We certainly get more ribbing at the partners' meetings on Monday mornings when we mention what we're working on. But then, everyone recognizes they may one day need the innovations we're working on, and they all pay better attention.

Linehan: I have a life sciences buddy. He says all the IT guys stand around putting \$5 million in a company and just wait for Google and hope.

Kliman: There's a lot of talk about how the multiples are lower in life sciences, which is probably true, but the hit rate is much higher in life sciences. True, we are not ever going to get a 50X return on a deal, but we are not going to have periods when 80% of our investments are out of business, like in IT.

Bock: We are diversified fund with about 30% to 40% in health care and devices and services and biotech. It seems like our investments take a long time to realize. There are times when you see a technology company in a matter of three or four years produce returns of 20X or 30X on say \$30 million. You kind of wish that there were ways of shortening down life science returns and reducing the dollars so you could have higher multiples.

Linehan: It just depends because everything is cyclical. I have spent 13 years in a diversified fund. We have had as high as 60% in health care and as low as 8 percent. I have been a hero and I've been a goat about four different times over. The key is to have a long-term view.

One of my partners says, "You are never

as good as you think you are on your best day, and you are never as bad as you think you are on your worst day."

Kliman: We looked back at distributions to our investors every year going back to 1981. And what we saw there is that every year there was some liquidity. Years when the IT liquidity was zero were filled in with life science liquidity.

Probably the biggest mistake we made was in our '99 fund when we decided that since IT was super hot, we cut back on life sciences to 25%. You know if it can't be a billion dollar IT company, we were not interested. Well, that 25% in life sciences is our best hope of generating a return on that fund.

VCJ: Is that a decision you look at regularly to change the mix of life sciences and IT?

Ahrens: We closed a \$450 million fund last year and we let the market dictate what would happen as opposed to saying let's cut back in one area and amp up the other. Typically, though, about one-third of the fund is going into health care.

LIFE SCIENCES ROUNDTABLE

Exits

VCJ: So how do exits look this year? Acquisitions seem to be the exit of choice lately. I assume that trend will continue in '06 for venture-backed companies.

Waite: They will be as hot as they were in '05.

Topper: M&A is a much more viable option. Large pharmaceutical companies have figured out that spending \$30 billion on research isn't working for them, so they buy biotech companies instead. And we are starting to put together companies with that in mind. We are working on a couple of companies now where we are building them with an eye for an M&A. We are not putting a lot of infrastructure into these companies, since they are not going to go public and we won't have to sustain them for a decade or something. But they will be interesting and attractive for acquisition.

Graham: IPOs are sexy, and they get all the attention. But the fact of the matter is that M&A has been the exit strategy forever. It just doesn't get the same press. Most companies that are successful will get bought before they ever go public.

Kliman: Yes, for venture exits, the majority are M&A. But the majority of the good deals are IPOs.

The bad news about the IPO market is that you never know when it is coming or going. It could be a great IPO market in '06. Looking back at the IPO windows that we have gone through and it's sort of random. You just don't know when it will occur, and you don't know how long they are going to last. It could be led by either an IT window or a biotech window. So you got to get while the getting is good.

Regulatory Headaches

VCJ: So what's affecting the IPO market. Is it regulations?

Graham: I'm not sure if it is or not. In many ways, Sarbanes-Oxley is as a whipping boy. Clearly, SOX has made the cost of doing business a lot more expensive. SOX, in many ways was an over reaction to all the financial fraud that was going on, but there's been an over reaction to that over reaction.

A lot of things that companies are doing now, such as paying more attention to accounting procedures, quite frankly they should have been paying attention to it before SOX ever came down the pike.

So, yes, it is more expensive to be a public company. But it's also more expensive to be a private company these days. People are just going to have to figure that out and it will become part of the equation of doing business.

Linehan: I don't see it that way. I really don't. The question is whether the law is right and has it done do what it intended to do.

For example, a company with \$500 million in revenue and offices worldwide has to do a lot of work to attract outside directors. But that's a lot more challenging now. I do see a direct impact from SOX, a meaningful impact. I see a lot more companies exiting through an M&A today because of SOX than what I saw five or 10 years ago.

Graham: Absolutely. It is clearly a big impact. The whole idea of trying to recruit people to serve on your board let alone serve in your audit committee is a big concern. But that's the new reality, and people are going to deal with it.

VCJ: What about Section 409A, the IRS code for regulating stock options. How is that affecting the VC industry and startup companies?

Graham: I don't think it is going to have a dramatic effect. Clearly it is going to have

a lot of companies scrambling to come up with their evaluations to find the appropriate exercise price for their stock options. And for a smallish company, having to spend another \$10,000 or \$30,000 in evaluation is significant. But I'm not sure to what extent it is going to really affect private companies.

Historically I don't think companies have been as careful as they needed to be in coming up with a fair market value determination for exercise price for stock options.

Waite: It's a three second discussion. And the worst thing about 409A is, obviously, there is going to be more disclosure. But there's no methodology.

Linehan: And here's another \$15,000 you will have to pay every year just to do business.

Waite: Just to create three different spreadsheets that say the same thing and you come up with the number you want it to be anyway.

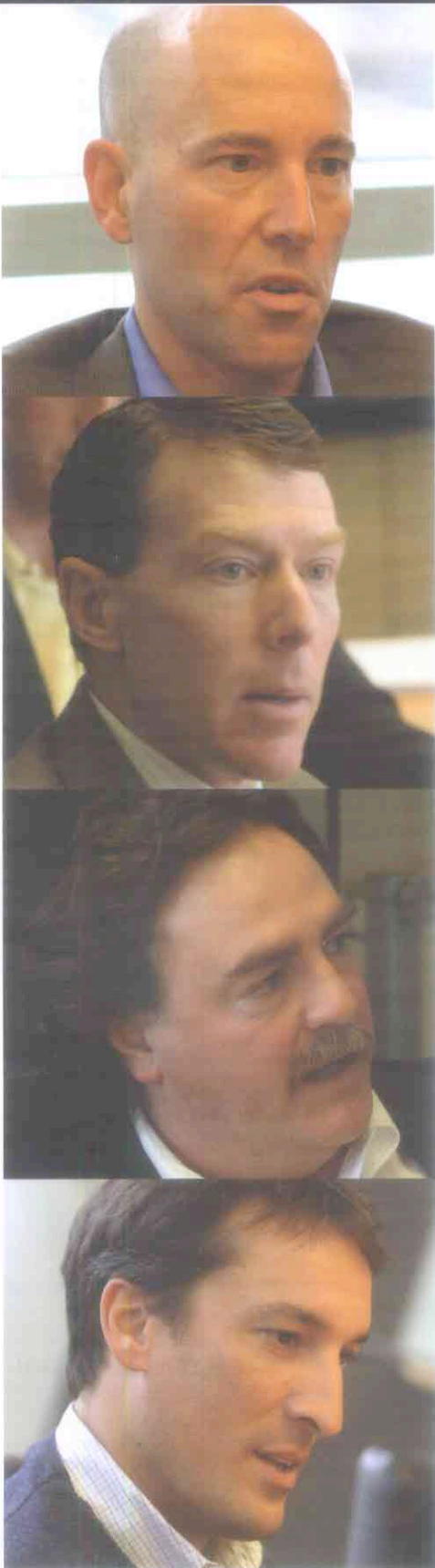
Ahrens: It drives a would-be entrepreneur to say, "You know what, life is too short. I'm tired of dealing with all the overhead of having various regulatory bodies." And to avoid dealing with all this stuff, they go back to working for a big company somewhere.

Waite: At the NVCA board meeting (in December), the issue of 409A came up, and it's a big concern. Regulators are creating an environment in which we just can't do business the way we have been doing business.

Linehan: My concern is about this will get enforced. We're talking about the fundamental lifeblood of what we do. I don't worry so much about a regulatory headache or a \$50,000 tax. I worry about all of a sudden the veil is up and you have an elephant that is knocking around and has no idea what they are going to knock over.

Waite: It is becoming a vortex of unintended consequences. These things are aimed at multi-billion dollar transparency in companies, and the venture community gets sucked into it.

LIFE SCIENCES ROUNDTABLE



Kliman: A lot of our business is non-linear value creation that you can't put a number on. It just happens. We can't explain it, and having to try to smooth that out artificially with doesn't really fit with the early stage business.

VCJ: What about other regulatory concerns, such as working with the FDA?

Topper: It is a little schizophrenic right now. The Vioxx thing has had a real tangible effect. There are people in the FDA who just don't want to do this again, who'd rather just say "No" to everything.

On the other hand, the process is becoming clearer. Early stage companies can go to the FDA and have a very, very productive dialogue with them about what they are going to do and how to get research approved. Ten years ago that was completely unheard of.

Janney: I get a little concerned. There is staff at the FDA who are more thoughtful. They're user-friendly and they do have an open dialogue and are more constructive.

But, post-Vioxx, they are also getting more and more conservative and evolving toward the delay of trials. The FDA may in fact be entering into another period of time in which everything is going to slow down for the next few years.

Ahrens: And we are seeing the drug requirements spilling over to stricter requirements for devices.

Innovations

VCJ: So what innovations are out there that you all are investing in?

Waite: We don't invest in drug discovery or target-related companies anymore because our fund is too small. \$250 million doesn't allow us to play there.

Our focus is on enabling technologies for clinical management, discovery as well as research.

Janney: We're looking at new classes of therapeutics, such as better delivery systems. Alta and Frazier Healthcare are

involved in a vascular information company, developing an application of new technology, leading a new class of potential therapeutics.

What you are going to see over the next couple of years is refinements in understanding core diseases, which are going to lead to new therapeutics and bigger deals with pharma and biotech.

Linehan: For us, it is more of the same. Honestly, I don't see anything revolutionary that is going to change our practice.

There's nothing that we are gearing up for that is a whole lot different than what we've seen in last three or four years. We continue to see really promising opportunities across the four areas we invest in: health care IT, health care services, devices and biopharma.

But we continue to be bullish on the general biopharma area, particularly the development stage pharma companies. On the device side, it's the spine and cardiovascular.

Ahrens: We are looking at something that goes back 15 years. We're looking at general thoracic and OB-GYN procedures. We're seeing some new technologies that could advance the things that have been fairly staid for the better part of a decade.

Bock: What we're looking at is how to finance these companies. This is not necessarily hot technology, but it's an angle that we're trying to explore, such as with the concept of refurbishing drugs that are already out there in one form or another. We have a handful of companies that are taking an existing or a known compound and redirecting it.

One such company, Somaxon, just went public. They took a generic drug that for 20 to 30 years has been dosed at very high levels. At low doses, they found it is an effective insomnia agent. Developing a company like this from scratch could have taken \$100 million, \$150 million or \$200 million in capital.

VCJ: What about personalized medicine?

Topper: It is a great catch phrase, and it is absolutely coming. It has been for a long time.

LIFE SCIENCES ROUNDTABLE

VCJ: What about geographic differences? Any difference in investments there?

Kliman: San Diego, San Francisco and Boston are focused areas for drug development. But there are a lot of these different hot spots all over.

Janney: We funded a company in late 2005 down in Australia that is working with new amino therapy for HIV. And a lot of clinics that are doing work are up in Southeast Asia and further north. It is hard to ignore the facts on the consumer side. There's an evolving market in China that is going to be buying drugs.

Waite: Think about how China and India and all of Asia have changed other industries. It has potential to change life sciences, as well. When sequencing becomes a reasonable price, people are going to ask why they are sequencing in the United States when they can do it in China?

You can see certain types of business where there is a high labor component with some fairly significant engineering talent needed that it is going to be done overseas.

Bock: We've got companies in our portfolios doing the same because it is cheaper. We got companies moving to Shanghai and finding that it is high quality and obviously less expensive.

Hatching in Incubators

VCJ: Where are your deals coming from? Universities? Corporate spinouts?

Bock: The universities, historically, have the new cutting-edge technology. But there's a question as to whether the technology is ready to be pulled out of the academics. I think things were pulled out of academics a little too early back in the 1980s.

Janney: We are pulling a lot of academics deals together. But that's because we do a lot of early biopharma development. It

helps, too, that the National Institute of Health has had a really robust budget in the last five to seven years. That has allowed us to look at a lot of new technologies.

Kliman: Where deals come from depends on the investment area. In biotech drug development, a lot of things come out of academics. Medical devices might come from a variety of different places, such as private practitioners. A model that seems to be working out is incubators. There are several incubators that have been successful in turning out a series of good deals. You should see more of that.

Ahrens: We're trying to tap into the incubators also across the country. Certainly there are substantial ones and well-organized ones here in places like Silicon Valley. And they are all across the country.

Topper: The device incubator seems to work. But you still need people, you need the best people in the world for it to work. It's unusual for them to be in one location at a time. So you have to pull the experts from different locations.

Graham: Yes, certainly, for an incubator to work, you have to have the experts there. You've got to have the people there that can create the management infrastructure that really kind of know what they're doing.

Waite: We are involved in an incubator project in Seattle called Accelerator. We are the second largest partner, but it's an unusual setup in that there were four venture funds and Amgen who were initial partners in the deal.

But with it, we can take some interesting very early-stage risk in what are truly academic technologies and give them 18 to 24 months of runway and put some commercial oriented people around those projects. And then we can develop these companies. With all these partners involved, you have a built-in financing vehicle to make sure these companies hit their milestones and have the capital around the table to actually build a business.

Graham: We are involved as well. We represent all the companies that have come

out of Accelerator, and it certainly is, well, an obviously exciting concept.

But I don't know whether this is the kind of model that can be replicated elsewhere or perhaps even should be replicated.

For this or any incubator to have a chance of working, a lot has to come together in the right way, and I think the situation in Seattle might be somewhat unique.

Janney: We funded a company recently where it was a guy-and 20 years of his work. It would be hard in an incubator to do that with a biotech company.

But maybe there's a technology that can be separated into a lot of different opportunities, such diagnostic or therapeutic. Perhaps those could then be separated in an incubator.

Topper: The problem is that it takes a lot of money to make a little money in biotech.

If you're committing to raising \$100 million, then you're going public at \$200 million, at best, if everything goes perfectly. Linehan: If you take a long-term view and you have the cash and you wait it out, you've got good company, good management team, the ultimate good products, then you're going to make a lot of money.

Challenges

VCJ: So what are some big challenges you're facing?

Topper: It would be great to have some high quality companies go public.

Waite: And get valued well.

Topper: Yeah, get reasonable valuation and get investors interested again.

Janney: We need some really nice clinical results, just you know, kick-ass terrific results that people look and say this is a multi-billion dollar company. A string of those will change the dynamics.

Linehan: And it will start a new cycle right over again.

LIFE SCIENCES ROUNDTABLE

BIOGRAPHIES



Brent Ahrens
General Partner
Canaan Partners

Notable: An early stage health care investor, Ahrens focuses mostly on medical supply companies. He joined the firm in 1999 through the Kauffman Fellows Program.



Lou Bock
Managing Director
BA Venture Partners

Notable: BA Venture Partners is the VC arm of Bank of America, and currently investing from a \$400 million diversified fund. Bock has been the firm's biotech partner for eight years. In December, portfolio company Somaxon Pharmaceuticals went public in a \$55 million offering.



Steve Graham
Partner
Orrick

Notable: Graham heads up the law firm's corporate practice worldwide and has been working in the life sciences space for more than 20 years.



Dan Janney
Director
Alta Partners

Notable: Focuses on life sciences-medical devices and biotech-with biotech comprising a majority of deals. The firm operates an early stage fund and does late-stage investing through another fund, which includes some public investing.



Gil Kliman
General Partner
InterWest Partners

Notable: The firm manages a diversified fund and recently began investing from its ninth fund, a \$600 million vehicle. Before he became a life sciences VC, Kliman was a practicing physician, a startup founder and a technology VC.



Chip Linehan
General Partner
New Enterprise Associates

Notable: Linehan joined the firm 13 years ago and heads its West Coast health care investment practice. He participated in the founding and incubation of ElderHealth.



Jaime Topper
General Partner
Frazier Healthcare Ventures

Notable: Topper joined the firm in 2003 as a venture partner and became a GP last year. He focuses on biotech investing and has served on the faculties of Stanford and Harvard medical schools.



Chad Waite
General Partner
OVP Venture Partners

Notable: Has been involved in emerging growth companies for two-dozen years. About 30% of the firm's investments are in life sciences, which Waite leads.