Strategic Implications of Alternative Sources of Capital for Private Biotechnology Companies

Presented by:

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Today I will describe the sources of capital available for private biotechnology companies, with emphasis on how the climate has changed in the past several years. I will then give suggestions on how a biotechnology company can respond to the new environment.

It is widely accepted that capital in the range of $50-$100 million is required to take a new pharmaceutical entity to the market. Therefore, one can assume that it takes at least $50-$100 million to build a therapeutic biotechnology company. This is the minimum total financing that a biotechnology company should plan to raise to develop and test a product for market launch.

Sources for Startups

With this in mind, let's review the sources of capital that have been available to start-up companies in the past and see if they are viable sources of capital today.

First, the public market. It is nearly impossible to take a biotechnology company public today, unless either the company has products in the market and is generating sales and earnings, or the company has completed clinical trials which demonstrated very positive outcomes and the company is awaiting approval of an NDA or PLA. This is quite different from the situation five years ago when a number of companies went public in the absence of sales or earnings. So the first source of capital, the public market via an initial public offering, is no longer available for most young biotechnology companies.

Second, during the past ten years a number of biotechnology companies have raised significant amounts of capital through R&D limited partnerships. Tax law changes that were enacted in 1987 have changed the tax deductibility of investments in R&D limited partnerships. In order for a partnership to be of interest to investors today, the cash-on-cash return must be high enough to entice investors. As a result, R&D limited partnerships are not a viable means of raising money for most biotechnology companies.

The third historical source of capital for biotechnology companies has been venture capital. This source remains available today, but the maximum amount that the venture company firms in aggregate will invest in any one company is approximately $15 million. At this level, venture capital firms typically become tapped-out because the financial risk to any one partnership becomes too great.

The fourth source of cash for a private biotechnology company is a corporate partner, usually an established pharmaceutical company, which provides capital for the biotech company in return for marketing rights, patent rights, or equity. Corporate partnerships have been used successfully by biotechnology companies in the past and will provide capital in the future. A large number of private biotechnology companies are now looking for corporate partners to save them. We are in an over supplied market. A biotech company may have difficulty getting the attention of pharmaceutical companies today.

I'd like to make two points about dealing with corporate partners. First, make sure that you raise enough capital from your partners to accomplish both their objectives and your objectives. From the corporate partner's perspective the objective may be the development of a product or the initiation or completion of clinical trials. From the biotechnology company's perspective, sufficient capital from several corporate partners to take the biotechnology company to profitability may be the objective.

The second point is that raising capital from corporate partners does not address the issue of investor liquidity. There are several ways the investors can gain liquidity when their biotechnology company has corporate partners. First, the biotech company can sell product rights to the corporate partner. Second, the shareholders can sell the biotech company to the corporate partner, maybe under a put option. Third, in the absence of the above two, the biotech company must at least keep open the option to sell to other companies in the future, or to take the company public.

Sources for Private Companies

Realizing that we are in a capital constrained environment, here are some suggestions for private biotechnology companies.

First, keep your research and development focused on a few tightly defined projects, rather than dissipating your resources across too many. Try to add value in a few areas.

> "Today's business environment requires that biotechnology companies take a closer look at how they manage their resources."

Second, keep your spending rate low. If you assume it will take at least seven years to get a product to market, you can multiply eighty-four months times an average monthly spending rate and calculate the amount of capital you will need. Until the technology has been proved, both in vitro and in animals, it is wise to spend at a conservative rate.

Third, be reasonable on valuations so that your company's value does not get ahead of your company's progress. If your valuation gets too high, you'll have a difficult time raising money, and you'll also have dissatisfied investors when you do a financing at a lower-than-last-round valuation.

Fourth, develop financing and liquidity strategies early in the life of your company. Large amounts of capital will be consumed over 7 to 10 years. The sources of this capital and the expected route to liquidity that gives investors a satisfactory rate of return should be planned. Biotechnology companies should have integrated business, financing and liquidity strategies.

In summary, the range of financing options available to private biotechnology companies has constricted during the last two years. The new environment requires that biotechnology companies be more frugal, remain tightly focused, be reasonably valued and have a strategy for getting liquidity for their investors.

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De Novo Ventures is a lead venture capital investor focusing on the early stage financings (the seed, start-up and first round) of medical companies in the western U.S., particularly in California.

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