

Funding the Public Biotech Company: Here Come the VCs!

The credit crisis and shake-out in the financial services industry have dramatically and negatively impacted the ability of publicly held biotechnology companies to raise capital in the public markets. Not only have valuations declined, but investors have exited the market and the mix of those remaining has changed. In particular, hedge funds and mutual funds that are traditional small company investors have migrated up-market, to companies with more than \$100 million in market capitalization, 12-plus months of cash on hand and deeper and more mature product pipelines. This has left a void at the lower end of the market, particularly for smaller companies that had been managing cash in anticipation of a capital raise in 2009.

A new entrant into the market in 2009 is the venture capital industry, which traditionally restricts investments to private sector companies. VCs have become attracted to public company investments in this environment because plummeting stock prices offer attractive valuations in businesses which have already achieved important developmental milestones, thus offering a more favorable risk profile than many private companies. VC-led deals constituted 40% of the Private Investment in Public Equities and Registered Direct Offering transactions for public biotechs and medtechs in the first quarter of 2009.

VCs can be a positive addition to the investor base of a public biotech company because they tend to be long-term investors with a stomach for riding out the risks and uncertainties involved in bringing new products to market. Put another way, they are not stock flippers. In addition, VCs bring deep industry expertise, management skills and networking connections that can be valuable to companies and add credibility in the eyes of the investment community. Because VCs' investing styles reflect the private marketplace, however, successfully completing an investment from a VC involves considerations that are different than deals with traditional public market institutional investors.

Successful execution of a VC investment may involve an extended time period. By nature, VC firms employ rigorous and in-depth due diligence processes that include extensive market research as well as a deep dive into a company's technology, finances, management and third-party relationships. This means that a significant due diligence

What to expect from Venture Capital investors

Public companies seeking investment from VCs should anticipate the following:

- Longer and deeper due diligence phase
- Matching investor strengths with company needs
- Favorable pricing, consistent with a long-term investment horizon
- Requests for board seats and governance rights
- More extensive negotiation of terms and documentation than traditional institutional investors

runway needs to be built into the marketing and execution schedule for the transaction. VCs typically do not sign confidentiality agreements when they investigate investments, yet public securities law considerations would suggest that such agreements be in place. Managing the due diligence process thus becomes a time-consuming effort for the company.

VCs typically invest in public companies through a PIPE structure but may occasionally participate in a RDO (most typically when they are existing investors in a company). Once a VC firm is prepared to invest, pricing the deal is often less of a challenge than with institutional investors, due to the long-term investment horizon of the VC. Warrant coverage is frequently a part of the deal. Reflecting their investment style in the private market, VCs often invest in convertible preferred stock, which is a more complex security and involves more time to negotiate than a common stock investment. VCs also require governance rights from the company, including board seats and protective covenants that other institutional investors do not ask for. The result is a much closer and durable post-deal relationship between the company and the investor than with a traditional institutional investor, although one which is more time-consuming and costly to implement.

VC investors may also raise special legal issues to a PIPE or RDO transaction. Often the VC is already an investor in the company, and sitting on its board of directors, from a pre-IPO financing—in effect, extending its equity ownership in the new transaction. Nasdaq rules may characterize equity securities that are sold to members of the board of directors (including their financial interest in shares sold to their affiliated ventures funds) as “compensation” which requires stockholder approval in the absence of a waiver from Nasdaq. Further, the voting rights or protective provisions afforded to VC investors might be characterized as creating a dual class of voting stock that would require stockholder approval or Nasdaq relief. Finally, if the post-financing equity position of the VC investor is significant, the transaction might trip change-of-control or anti-takeover provisions in governance documents or other material agreements.

The interest by VCs to invest in public biotech companies presents an interesting alternative in the low end of the market. It is unlikely that this alternative will continue once the current unique market conditions revert to historical norms. However, public biotech companies seeking funding in 2009 should vigorously pursue this investor class.

If you wish to discuss any of these matters further, Mr. Asher can be reached by telephone at (617) 248-5087 or by email at washer@choate.com.