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Mad about medtech

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Life science investors are once again smitten with medical device startups. But, biotech entrepreneurs and investors should keep things in perspective.

European and North American investors and entrepreneurs are increasingly touting the time and money advantages of medical device startups over biotech upstarts. With so many biotech investors suffering from liquidity and low-return fatigue, there has in recent years been a quiet reassessment of medtech versus biotech. Today, however, this reassessment has gained volume and has become one of the more intriguing debates within the life sciences investment community.


Highland Capital Partners

The healing power of medtech: Bijan Salehizadeh of Highland Capital Partners

The debate was on full view last month at the DowJones/VentureWire conference in Silicon Valley, which featured a lengthy panel discussion on the perception and reality of drugs versus devices as an investment strategy.

There is a growing perception today that medtech, which encompasses everything from stents to neurostimulators, is where the smart money is going. The conventional wisdom is that medtech is more in step with investors' desire to shorten exit time frames, increase liquidity and reduce risk by investing in companies with a product that can be developed faster and cheaper.

But is this growing perception in step with reality? Certainly there is some evidence that medtech, at the very least, is rewarding investors nicely by getting to an initial public offering (IPO) faster and then staying afloat in public markets.

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According to San Francisco-based investment bank Think Equity Partners, the median rate of return on 38 biotech companies going public since the start of 2004 is 1.2%, with just over half of the companies in negative territory as of October 7. But the 29 medical device companies going public in the US, for example, during the same period now have a median rate of return of 12% with only 38% showing negative returns.

"For the first time I'm seeing that [medical device companies] are out with their first product doing $20 million or $30 million in revenue, which makes them really attractive as new issues," says Thomas Dietz, co-CEO of San Francisco-based investment bank Pacific Growth Equities. Of the 44 healthcare companies going public between July 21, 2004, and September 29, 2005, 28 were either medical device or medical service companies, with 16 being biotech or pharmaceutical companies, according to Pacific Growth Equities.

Life science investors are also quick to point out that unlike biotechs, medtech does not need to rely exclusively upon an IPO to reward its investors. They point out that because medtech firms reach proof of concept faster, can move through clinical trials faster and cheaper, they can capture the attention of suitors faster. These investors point out that companies like Johnson & Johnson, Medtronic, St. Jude Medical and Baxter Healthcare are only too eager to snap up promising early-stage medtechs to fuel their growth.

Venture capitalist Bijan Salehizadeh of Highland Capital Partners in Lexington, Massachusetts points to Palo Alto, California-based Conor MedSystems. Conor has developed a next-generation drug-eluting coronary artery stent that also might have other applications beyond cardiovascular indications. Highland invested in Conor in May 2002; Conor's public offering was floated December 2004. As of mid-October, Conor shares were up more than 70% from the IPO listing. Just over three-years old, the upstart now has a $750-million market value.

As ever, one needs to be careful about generalizing about medtech versus biotech. It is impossible to say, for example, that across-the-board R&D costs will be lower at a medtech and that the path to commercial product and investor exit are shorter and wider. This was, at least, the prevailing view among the panelists at the DowJones conference.

Take Mountain View, California-based NeuroPace. The firm's CEO Frank Fischer served on the DowJones panel "Drugs versus devices." NeuroPace is set to begin pivotal trials of an implantable device that monitors the brain activity of epilepsy patients and stimulates targeted areas that will, it is hoped, stop seizures before they start. "[Our development approach] is different from drug development," says Fischer, "but it's still a huge investment and a long time period."

> “But, I don't think we should be surprised if five years from now we're back into a more classic cycle.”

This sentiment was echoed time and again by the other panelists, too, which included a venture capitalist, a serial entrepreneur and an executive with Johnson & Johnson who helps make decisions about which startups to back and eye for acquisition.

Another point that often gets lost in the conventional wisdom about medtech is the fact that investors might be talking more about medtech, but they are still investing the lion's share of their funds in biotech. According to Ernst & Young/VentureOne, the percentage of healthcare venture capital going into medical devices during the first half of 2005 was at a peak of 29.7% (versus 55.9% for biopharma). That's not much different from 2003 when 29.4% went into devices (versus 60.3% in biopharma), and the numbers were similar in 2002, 2001 and 1999 (see Table 1).

"We're all captive to whatever the trends are," says Eugene Chen, a former venture capitalist with San Francisco-based Alta Partners, among others, and now CEO of USGI Medical in San Clemente, California. Chen founded his company in 2001, and he is getting set to market a new endoscopic device that will allow "incision-less" bowel surgery, as well as access to the small bowel where traditional colonoscopy doesn't reach. "We're riding a wave of positive feelings about medical devices now. But, I don't think we should be surprised if five years from now we're back into a more classic cycle."

In other words, it pays to keep things in perspective.

Web links

Websites referenced:

- VentureOne Statistics page
- Burrill & Company Quarterly reports
- NeuroPace
- USGI Medical

Table 1: Keeping things in perspective

Amount invested ($ millions) and industry segment (percentage)							
	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
							Through 2Q
Biopharmaceuticals	1,923.79 37.7%	4,368.99 46.4%	3,600.74 54.3%	3,316.19 56.5%	3,626.58 60.3%	4,527.08 65.6%	1,397.37 55.9%
Healthcare services	549.68	531.72	365.83	405.22	293.88	392.82	172.4
Medical devices	1,492.35 29.3%	2,185.03 23.2%	1,885.32 28.4%	1,694.66 28.9%	1,769.54 29.4%	1,650.63 23.9%	742.33 29.7%
Medical IS	1,118.72	2,333.30	781.23	453.1	323.32	329.29	186.84
Other medical	4				3		
Total	5,088.55	9,419.03	6,633.11	5,869.17	6,016.32	6,899.83	2,498.93

Source: 2Q 2005 Ernst & Young/VentureOne Venture Capital Report
Equity financings include cash investments by professional venture capital firms, corporations, other private equity firms and individuals into companies that have received at least one round of venture funding.