Picking your VC

Venture capitalists can make or break a startup. Here are some ways you can sort the gems from the pebbles.

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In biotechnology, the journey from scientific discoveries and entrepreneurial ambitions to commercial success is virtually impossible to navigate without guides who have been there before. How can you find mentors to help you create the company of your dreams? My experience has been that if you are careful in your choice, one of the best places to find help in building your business is from venture capitalists.

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will be judged by your ability to negotiate cash-generating deals through either additional financings or corporate partners. Most of the time these will be complex negotiations involving a number of partners and contingencies. This deal-making ability is an essential component of all biotechnology business plans. VCs are in the flow of making deals because of the number of biotechnology companies they finance. They have a sense of who and how to negotiate your specific deal and can help craft and market novel deal structures. To give another Tom Perkins example: When Eli Lilly (Indianapolis, IN) approached Hybritech about acquisition, Tom insisted we aim for \$40 per share, even though we were trading well below \$20 at the start of negotiations; his boldness paid off, because when we filed our income tax returns following the acquisition, the official sale price was \$40.25.

This deal-making skill will continue to be essential throughout the life of your company. But perhaps the biggest deal you will face during the initial stages of your company's development is taking your company public. What makes it so important is that it is based on an amazing economic phenomenon developed in late 20th century capitalism. Companies that have never made a profit are valued at hundreds of millions of dollars once they are publicly traded.

How can this be? Public investors are now focused on future value rather than on current income. Dividends have almost disappeared from stock valuations, and investors are pursuing big ideas that could result in enormous future profits and valuations. Since biotechnology's specialty is exactly this, virtually all biotechnology companies must go public before reaching profitability. Therefore, the skill exhibited in these negotiations will determine whether your company winds up with sufficient cash to make good on this promise.

Because your VC shareholders will most likely use the initial public offering as their way of recouping their initial investment in your company, they will be aggressive nego-

The second issue VCs can help you with is recruiting top people. No matter how sexy the science, attracting top people is what will make or break your company. Good ideas need to be executed by capable people. Respected VCs can be invaluable in recruiting top-notch employees. Before you even make your first hire, VCs can use their contacts to help you recruit an exceptional board of directors. The board of directors will be crucial to the success of your company during its early years, and the VC's perspective on who will really assist you is a critical factor to jump starting this process. For example, during the early years of Hybritech, when I had a particularly difficult recruiting challenge, I always sent the individual to see one of our board members, Tom Perkins. Tom's reputation as one of the most successful venture capitalists in history—as well as his incredible persuasiveness—made it very difficult for prospective employees to turn down our offer.

Now here is the kicker that many startups miss until it is too late: You cannot buy VC experience. Certainly, there are consultants you can hire to advise you and, depending on their experience, this is sometimes a valuable asset to a startup. But the only way to access the range of experience that a VC brings to the table is to accept VC money. Since you need money anyhow, this is the value added that is often missed when initially discussing equity for money relationships.

The art of the deal

Once your company is up and running, you

Experience you can't buy

Unlike computer and software businesses, drug companies are not started in garages. There is a simple reason for this. You have to spend big bucks developing your product over years of work before you even have a glimpse of whether it will work. When one considers that biotechnology management must handle everything from discovery to manufacturing to clinical trials—each step further complicated by regulatory intervention—the task is daunting. What is worse, the penalties for management inexperience are severe.

So where do you turn? A great relationship with your VC can provide a safe haven when confronting a host of issues along the road to developing a product. The first and most obvious assistance your VC can give you is deep pockets: In twenty years, I have never seen a biotechnology business plan come in on schedule and within budget. Good VCs maintain “dry powder” in the form of additional cash to help you win the battle when you are running low on ammunition. For example, it took three tries before Neurex (Menlo Park, CA) succeeded in going public. Without continuing cash infusions by the company's venture capital investors, Neurex would have expired; instead, it was eventually acquired for upward of \$900 million.

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tiators in ensuring that the company structure, finances, and documentation passes muster with top-tier investment banks and leads to the best deal possible. I remember that during the early 1980s one of the rising stars in the biotech field was a young company that everybody thought would rival Genentech, Biogen, and Cetus as a leader in gene-splicing. Unfortunately, because no venture capitalists had been involved from the beginning, the company's legal and financial structure was a rat's nest; the company could not go public, and it faded away.

Firm recognition

Since VC firms come in all shapes and sizes, you will want to pick the type of VC that will do the most for your business. On the other hand, the VC firm will review hundreds, if not thousands, of business plans each year and will opt to finance perhaps 1%. Therefore, it is critical that both sides do not waste time and money initiating negotiations that lead nowhere. As a bioentrepreneur, your best strategy is to familiarize yourself with the firms that finance biotechnology and pick one you think will be the ideal lead investor in your company. If you can convince them to assume that role, they will convince other firms in the industry to invest in you as well.

There are at least four different types of VC firms relevant to your search. The first are the "megafirms." These are large, well-known partnerships with many employees, multiple locations, and diversified investment goals. They have lots of money, neat offices, great PR programs, and are able to hire recent graduates from prestigious business schools. These firms provide deep pockets and great letterhead credibility to a young company, but sometimes they send board representation that, while smart and dedicated, is still a little wet behind the ears.

The second type of firm you might investigate is the "boutique VC." These companies are small, focused partnerships that specialize in certain kinds of ventures. They tend to aim for higher returns on smaller portfolios, eschew institutional amenities such as plush offices in multiple locations, and recruit industry-tested, accomplished executives or entrepreneurs as partners. These firms usually provide the best hands-on assistance in building and managing a successful company, but they may not have the same resources as larger firms when cash flow becomes a serious problem.

Next, you might turn your attention toward the "pilot fish." These are not usually stand-alone firms but rather network-oriented partnerships that aim to be invited into deals. They rarely serve as lead investors, preferring instead to let bigger or

more specialized firms undertake most of the due diligence, business planning, and deal structuring. They make their investments by riding deal flows. These firms provide good money and great networking resources; however, they do not usually provide much management insight at the board level.

Finally, you should familiarize yourself with "corporate VCs." These are actually departments in large companies vested with the task of watching new technologies for opportunities. They usually are more interested in accessing product rights for their company than in achieving high returns from their investments. Corporate investors can provide credibility, because many other investors will rely on the due diligence they presume a Merck, Glaxo, or Pfizer has performed; however, stock in the hands of a large company may be dumped on the market to solve a temporary earnings shortfall, and the timing of these sales may damage the stock's market value.

The ideal biotechnology funding would include representatives from each of these categories. This would bring prestige, expertise, deal-flow visibility, and customer potential to the equation.

Finding the lead investor

True leadership in any endeavor is provided by an individual, not by groups of people. In my experience, one of the most important personnel decisions new ventures make is their choice of lead investor—the person who will serve as captain of the investment team. When the going gets tough—as it certainly will—this person will determine whether the venture continues to receive the ammunition it needs to survive.

How should new companies select their lead investor? This is more of an art than a science, but I can suggest four important criteria for screening out the potential losers. The first is understanding the individual's track record. Does this person have career accomplishments that are relevant to your venture's success? Has he worked in the industry, demonstrated leadership, earned the respect of colleagues, taken the kinds of risks the company will take, helped build successful companies? Remember, the lead investor will be an integral part of your management team, not just a source of money.

One way to access this track record is by looking at the VC's commitment to other companies in the past. Does he have a reputation for sticking with the ship through the storms that seem certain to sink it, or is he known as someone who will quickly cut his losses and bail out? Most importantly, has he ever helped turn around a company when most people thought it was already

"road-kill?" Just as the captain of the ship must be willing to go down with it, the lead investors must be willing to do everything in their power to prevent the company's demise. The last thing you want is someone known for scurrying away like a rat in the night.

Another way is to assess whether the individual's investments are based on a shared vision of the opportunities your company will exploit. Does the individual share your scientific excitement about the company's ability to change the way medicine is practiced? Does he or she want to help create a value in your company through a sincere interest in capitalizing on the company's people and strategy? If you find someone who is preoccupied with deal structure and continually talks about the quick upside of the business, he is probably the wrong person for you. Lead investors must share the bioentrepreneurial dream, not just the financial greed.

Once you have familiarized yourself with these aspects of the individual's history, you will probably have a fairly good idea of how well respected they are within their industry. But it will serve you well to inquire in this respect from as many people as you can. Because the lead investor must ride herd on an expanding portfolio of shareholders, this person must command respect among existing and future VC participants. Often this respect rests on the lead firm's deep pockets and deal flow access; however, the more relevant source of respect is his track record for making money for other investors.

Conclusions

The United States' vibrant and aggressive venture capital industry is one reason it leads the world in technical innovation and wealth creation. To my knowledge, every top-tier biotechnology company has succeeded with the help of good VCs. This is not a statistical fluke but an indication of how difficult it is to succeed without their help. Some of the most exciting and productive people I know happen to be VCs. Their talent and expertise has been crucial in creating new companies *de novo*.

In biotechnology, the journey from scientific discoveries and entrepreneurial ambitions to commercial success is virtually impossible to navigate without these guides who have been there before. But, as in any industry, VC quality varies widely, and the jewels lie scattered among piles of lesser stones. My advice to any would-be bioentrepreneur is to learn how to recognize the real gems before you embark on your journey: Both gems and pebbles may initially weigh the same, but when things get tough, who wants to lug around a pile of rocks? ///