

VentureWire

Along With Silver Linings, Some Dark Clouds For Health Care VCs In 2010

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Health-care venture capitalists are mixing the optimism of a new year with a splash of realism.

The final weeks of 2009 offered rays of hope, as acquirers snared several drug and medical-device makers, and some biotechs filed to go public. Meanwhile, entrepreneurs, sensing that some firms were ready to consider new deals again, returned with promising ideas.

"For the year or two years before July, most of the deals we saw were recapitalizations, and they weren't fresh and new," said Dennis Dougherty, general partner of Intersouth Partners. "We've been more active in the last six months than the prior year and a half."

But surviving firms still have reason to worry. The meltdown that's weeding out rivals is also eliminating potential co-investors. And this challenge comes atop the uncertainty surrounding health-care reform and the perennial problems of regulatory and reimbursement risk.

"I'm not a conspiracy theorist or a doomsdayer, but I do think things are going to get tougher and tighter than we've ever seen in our business," said James Garvey, chairman of SV Life Sciences.

Venture firms, for instance, don't expect fund-raising to get easier anytime soon, which means building big rounds for maturing medical companies will be tough for some time. Deep-pocketed firms may be tempted to take more of a round than normal to get a financing done, but the smaller the syndicate, the greater their risk. And neither the public markets nor crossover investors seem poised to fill the void.

Solutions are sparse for existing companies, but firms do aim to cut their financing risk with new ventures. This means working with trusted investors capable of carrying a start-up a great distance, if needed, and building syndicates of firms at similar stages in their funds.

Its also means courting corporate investors. Strategics are not timid about innovative, high-risk companies, and the resources and validation they provide are valuable to start-ups. "The most aggressive and stable source of capital is the corporate funds," said Andrew J. Schwab, managing partner of 5AM Ventures.

Schwab's firm, which invested with Takeda Research Investment and Roche Venture Fund late last year in new drugmaker Envoy Therapeutics Inc., expects to bring Big Pharma into the bulk of its biotech deals. "That's definitely something we're doing more of as there's less private venture capital available," he said.

Navigating The Regulatory Hurdles

Financing is hardly VCs' only concern this year, of course. Many contend that caution at the Food and Drug Administration is making it increasingly difficult to drive new drugs and devices to market, as regulators request longer and more complex studies. But the FDA appreciates the need for new treatments for dire diseases, so companies targeting these conditions are particularly attractive in today's regulatory climate, investors say.

"You focus [on] diseases where benefit will be appreciated in a way that some degree of risk will be tolerated," said James E. Thomas, partner at Thomas McNerney & Partners.

Thomas McNerney, for example, is among the investors in Cebix Inc., a start-up developing a C-peptide replacement therapy for neuropathy, retinopathy and other long-term complications of Type 1 diabetes that are not well-treated today.

One way medical-device investors seek to mitigate U.S. regulatory risk is by going to Europe,

where the hurdles for securing marketing clearance for new devices are lower. Gaining initial approval there – and even launching overseas – can also help prove the viability of the business opportunity, said Ross A. Jaffe, managing director of Versant Ventures. A number of companies have pursued this strategy successfully, including Versant-backed Ablation Frontiers Inc., acquired by Medtronic Inc. last year.

"I don't think it shortens the regulatory path in the U.S., but it certainly gives us as investors confidence," Jaffe said. "We're continuing [that] strategy with a number of our companies, particularly ones [that] have a long regulatory path in the U.S."

Focus On Lowering Health Care Costs

Vcs in recent years have found that regulatory approval is only half the challenge for medtech companies. Getting paid adequately is the other, and at a time when the use of medical technology could soar with the extension of health-insurance coverage, therapies that cut overall costs of health care are most likely to win over insurers, some said.

"We have a very specific philosophy: improve clinical value, and reduce cost to the system," said Lisa M. Suennen, managing member of Psilos Group.

Lowering costs is part of the thesis of Psilos's September investment in imaging company Gamma-Medica Ideas Inc. GMI's LumaGEM product is designed to improve cancer diagnosis in women with dense breast tissue, a population for whom mammography and other screening techniques are either insufficient or very expensive, according to the company.

Challenging as the new year promises to be, however, it's also one that could to spawn new opportunity. The prospect of millions of people gaining access to health insurance has investors considering new business models in health-care services, for example.

One such opportunity may be to help the medical system deal with the shortage of primary-care doctors as demand for these physicians climbs, said Gregory M. Weinhoff, a partner of CHL Medical Partners.

"We think there's clearly going to be a need to address the shortage of access points to care," he said.

While a healthier fourth quarter for acquisitions and IPOs brightened the mood, life sciences investors say the downsizing of the industry could hurt syndicates and bring added risk to surviving firms. Regulatory issues and uncertainty around health-care reform also contribute to caution heading into 2010.

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