

The Venture Capital Analyst

TRACKING INNOVATION AND THE MONEY BEHIND IT » JULY 2002 | VOLUME V | ISSUE 7

In This Issue

» **Motorola Ventures**, following its parent's lead, is pulling out of life sciences investing. *Corporate Venturing News* >p.19

» **Merrill Lynch & Co.** cancels its health care fund, despite already having raised \$325 million from outside investors. *Private Equity News* >p.20

» **Vertical Group** invests in device companies using a range of deal structures, including PIPEs and LBOs. *Venture Profile* >p.8

Also Inside

News: Devices draw IT backers >p.3

Exits & Endings: InterWest adds on >p.7

Investment Roundup: >p.10

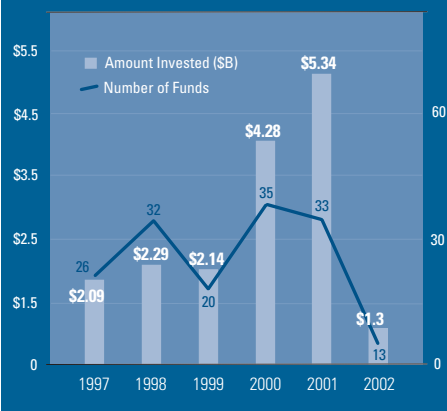
From the Lab: Battling Alzheimer's >p.16

Corporate Venturing: Boston Scientific's investment spree >p.18

The List: Law firms & start-ups >p.21

A Sharp Decline

Fund closings are off markedly from last year's pace. *More data on pages 5 and 6.*



Source: VentureOne

Specialty Pharmaceutical Ventures, Popular Again, Face Fresh Obstacles

COMPETITION ON RISE; DRUG MAKERS GETTING WISER TO GAME

Venture capitalists once again are investing heavily in specialty pharmaceutical companies, which aim to acquire drug companies' unwanted products and sell them. Since last September, five such ventures have drawn a total of roughly \$265 million.

But the task of building the companies may be more challenging this time around. For one thing, many of the best opportunities in the specialty pharmaceutical field already have been exploited. And the increasing competition is making it difficult to acquire drugs at attractive prices. Meanwhile, corporations that once spun out drugs with little concern for what they got in return have become savvier about out-licensing.

Despite these drawbacks, health care investors have good reason for their renewed interest.

Many are seeking to launch companies that can quickly gain all the assets they need to become fully integrated biopharmaceutical companies. This is partly because swelling fund sizes have put pressure on firms to deploy larger sums of capital, but it is also a sign of interest in drug companies that can produce a return sooner than the typical drug discovery start-up. Because specialty pharmaceutical companies are built by acquiring products that are either

>continued on p. 22

Real Estate Groups Seeking Partnerships With Backers of Life Sciences Companies

One of the busiest venture investors in the life sciences these days is a real estate company.

Alexandria Real Estate Equities Inc., the massive Pasadena, Calif.-based REIT that owns and manages 83 buildings filled with biotechnology and pharmaceutical companies, has invested in five of those companies this year alone, according to VentureOne.

Alexandria's willingness to put its money where its laboratory space is speaks to the increasing interest real estate developers and brokers are paying to life sciences investors. While few other real estate groups are taking venture stakes in their tenants, many see the relationship between their business and venture capital as a natural one.

The developers, creating millions of square feet in expensive laboratory

>continued on p. 25

FROM THE FRONT

Specialty Pharmaceutical Ventures

>continued from p.1

FDA-approved or in the later stages of development, companies are in position to become profitable quickly—sometimes right away.

Also driving the appetite of VCs are the entrepreneurs from the first wave of specialty pharmaceutical companies—formed in the period from the early 1980s to the mid-'90s—who are once again looking to form companies. In the specialty pharmaceutical field, a company's success hinges almost entirely on the management team's ability to execute—both in terms of making the right decisions in acquiring compounds and in marketing them.

Thus, John T. Spitznagel—the former CEO of Roberts Pharmaceutical, a company sold to specialty pharmaceuticals giant Shire Pharmaceuticals Group plc in 1999 for \$1.2 billion—was able to draw \$28 million from **Apax Partners**, London, and **Domain Associates**, Princeton, N.J., and **New Enterprise Associates**. Mr. Spitznagel has used his new venture, **ESP Pharma Inc.**, to acquire four FDA-approved cardiovascular drugs from Wyeth.

While ESP Pharma intends to acquire both approved and clinical-stage products, other new specialty pharmaceutical companies focus on one or the other. **Barrier Therapeutics Inc.**, Princeton, N.J., is looking to purchase clinical-stage dermatological products. **Ovation Pharmaceuticals Inc.**, Lincolnshire, Ill., plans to concentrate on approved products, particularly cancer therapies. (For a list of these companies' venture backers, see table on this page.)

A common problem for all these companies is procuring high-quality products. While there are many products whose only fault may be falling short of the \$500 million sales potential that pharmaceutical companies demand, many more drugs have far more serious drawbacks.

“The good opportunities are much more picked over than they used to be” four to five years ago, said Scott S. Halsted, a general partner with **Morgan Stanley Venture Partners**, New York. Morgan Stanley was among the backers of The Medicines Co., a specialty pharmaceutical business that was formed in 1996 and went public four years later.

The dearth of opportunities requires patience on the part of management teams that may be eager to realize success right away. VCs caution that finding the right drugs to acquire may take a year or more.

‘The Word Is Out on Specialty Pharma’

And once the drugs are found, extracting them from the pharmaceutical companies may prove more difficult than in the past.

The traditional challenges VCs have faced is pharmaceutical companies' inability to out-license drugs efficiently. Frequently, it has been difficult to obtain all the data needed to evaluate a product that the drug company no longer deems a priority. Firms also encounter seller's remorse: Behind every drug, investors say, is a champion who is loath to let his or her invention go.

While these challenges remain, specialty pharmaceuticals companies also find that drug companies are taking a more sophisti-

Companies Recently Raising Capital

» **Avera Pharmaceuticals Inc.** *San Diego*

Focus: Acquire clinical-stage drugs targeting central nervous system disorders. Licensed one compound from GlaxoSmithKline plc and Cornell University Medical College

Amount raised: \$16 million

Investors: Bay City Capital LLC, BTG International, Frazier & Co., GlaxoSmithKline plc, InterWest Partners, St. Paul Venture Capital Inc., Windamere Venture Partners LLC

» **Barrier Therapeutics Inc.** *Princeton, N.J.*

Focus: Licensed nine dermatological drug candidates from three Johnson & Johnson divisions

Amount raised: \$46 million

Investors: J.P. Morgan Partners, TL Ventures, KBC Bank and Insurance Holding Co. NV, and Baker/Tisch Investment Partners and Perseus-Soros BioPharmaceutical Fund, L.P.

» **ESP Pharma Inc.** *Edison, N.J.*

Focus: Bought four cardiovascular products from Wyeth; intends to acquire additional approved and clinical-stage products

Amount raised: \$28 million

Investors: Apax Partners, Domain Associates, New Enterprise Associates

» **Ovation Pharmaceuticals Inc.** *Lincolnshire, Ill.*

Focus: Acquire under-promoted branded pharmaceuticals. Initial focus is on cancer

Amount raised: \$2 million in seed financing; \$150 million committed from GTCR Golder Rauner LLC, Chicago

» **Vela Pharmaceuticals Inc.** *Lawrenceville, N.J.*

Focus: Acquire late-stage clinical drug candidates designed to treat psychiatric, neurologic and behavioral disorders. Also reformulates products to improve their effectiveness and develops new indications for drugs

Amount raised: \$44 million

Investors: J.P. Morgan Partners, Johnston Associates Inc., MBF Capital Corp., New Enterprise Associates, Venrock Associates

Source: VentureOne

cated approach to discarding unwanted assets. GlaxoSmithKline plc last year created a unit that trades drug compounds, databases, research technologies and patents in exchange for equity in the company (usually less than 20 percent). The unit, called the Genetics & Discovery Ventures Group, puts GlaxoSmithKline in position to reap far greater profits than it could by simply selling rights to drugs for cash or royalties.

Meanwhile, Berlin-based Schering AG has formed a unit to identify potential acquirers of its unwanted drugs, said spokeswoman Jeanine O'Kane. A global licensing unit of the research and development arm of Pharmacia Corp., meanwhile, is dedicated to in- and out-licensing drugs. Spokesman Mark V. Krajnak described out-licensing as a "prime focus" of the company.

Similarly, Eli Lilly & Co. has teams that work to in-license products and to sell assets, said spokeswoman Terra L. Fox.

These units also are finding more potential buyers. This means today's start-ups must be even more aggressive than their predecessors—sometimes pursuing drugs that have not been put up for sale—while simultaneously maintaining the discipline to procure products wisely.

"Certainly, one of the challenges is [that] the word is out on specialty pharma," said NEA Partner Ryan D. Drant. "It's become a fairly competitive marketplace for buying these products."

Acquiring the Drugs May Not Be Enough

The cost of acquiring an approved drug typically has run from two times sales revenue, for a product about to come off patent, to five times sales revenue for a drug with growth potential, said Timothy Coan, specialty pharmaceuticals analyst with U.S. Bancorp Piper Jaffray.

But VCs say prices today are higher than ever. (Companies generally do not disclose the terms of their acquisitions, so specific figures are hard to come by.)

"Unfortunately, I think people are paying much too high prices for products these days," said James L. Currie, a managing director with **Essex Woodlands Health Ventures**, Chicago, which has three specialty pharmaceutical portfolio companies. "It's getting to be a bit of a horse race."

Mr. Currie said he doubts that simply acquiring products is enough for today's specialty pharmaceutical companies. The companies, he said, must also have development capabilities that allow them to improve the value of their acquisitions, such as by identifying new delivery methods or additional conditions for which the drugs might have use.

Mr. Currie, whose firm has three specialty pharmaceutical companies—**Xandoyne Pharmacal Inc.**, Florence, Ky., **PediaMed Pharmaceuticals Inc.**, Exton, Pa., and **Integrity Pharmaceuticals Corp.**, Fishers, Ind.—said he could not back a company that did not plan to incorporate development capability. "I don't think you can buy a bunch of 'me-

Make your mark

at the private equity industry's premier event with the 2002 Private Equity Analyst Conference Visibility-Plus Marketing Program.

2002 private equity analyst conference



visibility-plus marketing program

The Private Equity Analyst Conference is the must-attend event for leading institutional investors, venture capitalists, and buyout specialists. Visibility-Plus offers numerous opportunities to further your relationships with these select industry professionals through a powerful combination of advertising and on-site event marketing. Benefits include:

- » Custom 2-page advertorial in the Visibility-Plus supplement
- » Two complimentary conference passes (a \$4,390 value)
- » On-site signage and literature distribution
- » A one-time mailing to conference attendees after the event
- » And more!

Make The Private Equity Analyst Conference a marketing event for your firm.



Visit www.assetnews.com or contact us today for more information

Ken Camello | Advertising Manager » 415-538-2627 | kcamello@ventureone.com

www.assetnews.com



FROM THE FRONT

Specialty Pharmaceutical Ventures

>continued from p.23

too' products and make a ton of money on it," he added.

Still, many VCs—including ones who are quick to cite the challenges that new companies face—say they are interested in forming additional specialty pharmaceutical companies.

J.P. Morgan Partners is considering five potential opportunities in this space, said Dr. Srinivas Akkaraju, a principal with the New York firm. J. P. Morgan already has backed Barrier Therapeutics and **Vela Pharmaceuticals Inc.**, Lawrenceville, N.J., which in-licenses drugs and drug candidates for central nervous system disorders.

Meanwhile, James E. Thomas, who backed The Medicines Co. as a managing director with **Warburg Pincus LLC**, New York, said he is evaluating an opportunity to create a company that would acquire clinical-stage products, based roughly on The Medicines Co. model. Mr. Thomas is now managing partner with **Lumina Ventures LLC**, a new health care firm with offices in New York, Minneapolis and San Bruno, Calif.

With the right management teams, these firms contend, they can still build companies and quickly put themselves

in a position to realize returns. **Xcel Pharmaceuticals Inc.**, a San Diego company launched last year with \$70 million from Domain, NEA and **Elan International Services Ltd.**, Bermuda, already is in registration to go public.

The company is led by Michael T. Borer, who headed specialty pharmaceutical company Dura Pharmaceuticals Inc. Dura, formed in 1981, went public in 1992, and eventually was acquired by Elan Corp.

Will Wall Street Raise the Bar?

But given that the field is growing ever more crowded, it may be difficult for new companies to achieve similar success, said Brian G. Atwood, a managing director with **Versant Ventures**, Menlo Park.

"The [financial] performance of these companies is something Wall Street really appreciates," Mr. Atwood said. But, "As you see more and more of these companies become public, there will be a supply [and] demand issue where price [to] earnings multiples even out."

If Mr. Atwood is correct, today's start-ups will have to grow up more quickly than their predecessors to succeed as public players.

*By Brian Gormley
brian.gormley@assetnews.com*