



National Venture Capital Association

The Importance of the Biotechnology Industry and Venture Capital Support
in Innovation

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Daniel J. Broderick, Managing Director, Mason Wells

On Behalf of

The National Venture Capital Association

My name is Dan Broderick. I am a founding Managing Director of Mason Wells Biomedical Fund located in Milwaukee, WI. Mason Wells is a small Venture Capital fund focused on seed and early stage investing in the life sciences industry in Mid America. Prior to joining Mason Wells, I spent 18 years at the Mayo Clinic, in Rochester, MN, where I led their medical technology commercialization efforts. I also serve on the Board of the National Venture Capital Association (NVCA). NVCA is a trade organization representing approximately 470 venture capital firms in the United States. Additionally, I am the Founder and President of a non-profit association called the Mid America Healthcare Investors Network which I will explain later in my testimony.

I respectfully submit testimony today on behalf of the NVCA, and those venture-backed companies that are developing innovative technologies that

improve the quality of our lives and raise our standard of living. For the last 20 years, the dual financing sources of the SBIR program and the venture capital community have allowed many of these promising companies to conduct groundbreaking scientific research while simultaneously building viable businesses that will bring these innovative products to the marketplace. However, changes in the interpretation of SBIR grant eligibility have prevented many small companies that receive venture financing from also receiving SBIR grants, effectively cutting off a critical research lifeline. This dynamic has negatively impacted young companies across the country, particularly in the life sciences sector, but in other high tech industries as well.

What is Venture Capital?

Venture capital is the investment of equity to support the creation and development of new, growth-oriented businesses. Venture backed companies are critical to the U.S. economy in terms of creating jobs, generating revenue and fostering innovation. In terms of global competitiveness, the entrepreneurial segment of the economy is the true differentiator for America. U.S. companies originally funded with venture capital now represent 11 percent of annual GDP and employ over ten million Americans. Companies that were originally funded with venture capital dollars include FedEx, Genentech, Intel, Cisco, Amgen, Apple, Starbucks, Amazon, e-Bay and Google.

Understanding the Venture Capital Structure

There appears to be a misunderstanding that venture capital firms are large corporations that control the small start up company by having a majority control over the company's board. It is important to understand the organizational structure of the venture capital firm, its limited partners (LP's) and the relationship between the VC firm and the portfolio company.

Private venture capital funds are organized as limited partnerships and are managed by general partners. The general partners are the individuals staffing the VC firm. They are responsible for, and control all aspects of the fund's operations including making the investment decisions. Venture capital funds are small organizations. In fact, the average number of general partners in a firm is only ten. The investors in these limited partnerships are usually pension plans, foundations, trusts and accredited investors. They are called limited partners because they are exempt from liability because they exert no control in the day-to-day operations of the VC fund, they do not participate in setting the strategic direction of the fund, and they take no role in making the funds investment decisions. This holds true even if one LP is the majority investor in the fund.

The LP investment is not a revenue stream for the VC fund. Rather, the money the LP's invest in a VC fund are to make investments in portfolio companies and as loans to fund the day-to-day operation of the VC fund. The only way that a VC fund makes a profit is by successfully investing in a

company over a five to ten year period, which is later sold for amounts greater than the amount of money invested. Even then, the VC must first repay the LP's entire principle amount including the loan used to support the VC fund operations. Only then do the LP's and the VC fund share profits in a predetermined ratio, usually 80 to 20. Conversely, in most cases management will profit upon a sale of the company from the first dollar. It is important to remember that the dollars associated with a VC firm are investment dollars **not** revenue dollars.

Typically, it is the start up company that seeks out VC funding. Company management and founders who decide to raise venture capital are looking for more than money. They are looking to the VC to add expertise, experience and a network of contacts to the company in order to help shepherd it through the commercialization and growth process. This is often accomplished through the workings of the companies' board of directors.

Based on my experience, the great majority of companies have established a board of three to seven members prior to any VC involvement. Members of these boards usually comprise founders, management, investors (shareholders) and industry experts. Once a venture capital firm is involved, most boards slightly increase in size by two to four members, with the members representing the same group of people. Each vote on the board is equal. For example, the management (i.e. CEO) vote is equal to the investors (i.e. VC) members vote. It is the fiduciary duty of each individual member to act in good faith, and in a manner to be in the best interest of the

corporation. The groups involved generally do not vote as a block, rather each member votes their own conscience.

I would also like to briefly address the relationship between corporate venture capital and traditional VC firms as outlined above. Typically, corporate VCs play a different role than a traditional VC firm. They generally only co-invest with traditional VC firms and usually do not take a board seat. They also generally only own less than 20% of the portfolio company because of corporate reporting rules. Furthermore, corporations only manage 4% of all venture capital under management.

Why do venture capital firms care about SBIR grants?

For the last two years, portfolio firms have continually alerted us to situations in which an SBIR grant has been denied because they have venture investors. As a result, several of these companies have shelved research projects, laid off scientific teams, or scaled back operations. Many of these firms were caught by surprise because this program has been working well for over 20 years.

For example, Kereos is a small St. Louis biopharmaceutical company that is collaborating with an academic lab at Washington University School of Medicine to bring an exciting but early stage technology to patients with cancer or cardiovascular disease. Kereos did not apply for SBIR funding because it intended to accept venture capital funds that would result in over

51% ownership by U.S. venture capital firms which, under current rulings, makes them ineligible for SBIR funding. As a result, they are not able to pursue a number of exciting research opportunities for product extensions that would advance medicine and innovation but which lie outside the venture capitalists' focused initiatives.

It is paramount not to confuse the role of venture capital funding with the role of basic R&D funding. Both are critical to bringing innovation to the marketplace. However, basic research funding is targeted at discovery and invention. It is this type of activity that the SBIR program has historically supported in the past. Venture capital dollars are applied later in the life cycle and used to build a strong and viable businesses so that promising discoveries can be brought to market.

Some would argue that if a company receives venture capital, it has “hit the lottery” and does not need government funding. Nothing could be further from the truth. In the life sciences sector, the cost and time associated with bringing a discovery to market is colossal. Multiple rounds of financings at millions of dollars per round is required. In 2004 alone, the venture capital industry invested more than \$5.7 billion in the sector with the average investment in each biotech company at \$9.8 million.¹ Yet these venture capital investments are aimed at commercializing products and are not sufficient to meet a company's ongoing research needs. With the average

¹ PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association Money Tree Survey (NVCA Yearbook 2004)

cost of bringing a new drug to market at \$800 million², young biotechnology companies cannot divert precious venture capital funds earmarked for business growth to embark upon new research projects. Although these projects may hold the next ground breaking treatment for Alzheimer's, cancer or heart disease, under the current eligibility interpretation, the SBIR program cannot fund these projects if the venture capital firm owns 51 percent of the company. This stalls or permanently shelves additional research, and the SBA has missed a tremendous opportunity to support a promising innovation.

Venture Capital National Impact

Another belief is that venture investment only impacts select regions of the country. To the contrary, venture capital is a national phenomenon. (See Exhibit A.) While California and Massachusetts are the leading regions for venture capital investment, VC dollars have been flowing into all 50 states over the last twenty years and have directly benefited regional economies across the country. More than \$10 billion has been infused into states such as Texas, Pennsylvania, Colorado, New Jersey and Washington, respectively. Other states such as Florida, Connecticut, Illinois, Maryland and Minnesota have received venture investment of more than \$5 billion each. As a result, these states have experienced economic growth in terms of jobs and revenues. A combination of venture capital and SBIR grant distributions in any region would have an incredibly positive impact, as

² Journal of Health Economics, vol 22, p 151

groundbreaking research could be conducted simultaneously with new products being brought to market.

Ironically, the current SBIR eligibility rule hurts the very “low tech regions” it is trying to support. In regions such as these, where venture capital lacks presence, numerous venture firms must frequently join together to fund a promising start up, as a single local firm does not have the resources to meet the company’s need. As each firm takes an equity stake in the company, the total venture ownership stake quickly rises above the 51 percent threshold as defined by the SBIR eligibility. Consequently, companies in regions with a smaller VC presence are unjustly penalized by the current SBIR eligibility rule. Since there is no way to tell in advance which small companies will grow to tomorrow’s large public success stories or important regional employers, nurturing companies in all segments of the country is important.

Mid America is one important example where investing in early-stage technology companies is difficult because of the smaller percentage of venture capital investment. In 2002, I founded the Mid America Healthcare Investors Network to help investors in Mid America to more efficiently work together to invest in companies located in this large geographic area. This region consists of 14 states in the central part of the country. The inability of small businesses, owned 51 percent or more by VC firms, to compete for and receive SBIR funds is of particular concern to venture backed companies located in Mid America. The ruling that disqualified VC financed companies from competing for SBIR grants removed an essential

source of financing to support R&D efforts. Since the ruling, the pace of R&D at many technology companies located in Mid America has slowed, or stopped altogether, which delays commercialization of technology and the resultant products that benefit to the public.

Technological Innovation: SBIR and VC working together

The 2000 Small Business Reauthorization Act sought to expand and improve the SBIR program, stimulate technological innovation, use small businesses to meet Federal research and development needs and strengthen the technological competitiveness of small businesses in the United States. By excluding venture-backed companies from eligibility, the SBIR program is bypassing many of America's most promising and innovative small businesses. After all, these are the companies whose technologies, business plans, financial strategies and management teams have all been vetted by highly skilled professionals with extensive backgrounds in science and business, who earn their living identifying the best and brightest opportunities.

The venture capitalist searches for companies that are poised for success, companies that will be viable for years to come, companies that intend to put a product on the market that will improve lives. Funding these types of companies is also in the best interest of the SBIR program as it prevents government dollars from ending up in grant mills, funding technologies that

will never see the light of day. Funding venture backed companies brings the science to life.

A way to ensure the ongoing success of the SBIR program is to re-open it to the broadest and most qualified base of small businesses as possible. This requires allowing venture-financed companies to compete again. The venture capital industry has been a major player in augmenting the SBIR program since its inception 25 years ago. Venture capital and SBIR funding have been proven to work together to research, commercialize, and distribute innovative products on an accelerated basis. The relationship between the two is symbiotic, with the beneficiary being Americans who are the recipients of life saving innovations, time saving technologies and standard of living enhancements.

Conclusion

Recently, Congressman Graves, R-MO introduced H.R. 2943. This legislation clarifies SBIR eligibility requirements for venture backed start up companies. H.R. 2943 would amend the Small Business Act by adding a definition allowing any business concern that is at least 51 percent owned and controlled by one or more individuals and/or venture capital companies, provided that no affiliated venture capital company shall own or control more than 49 percent of the business concern, nor be controlled by a company which is not a small business to participate in the program. The NVCA applauds this effort and encourages quick action on this legislation.

We look forward to working with the committee to address this spiraling problem.

Thank you for the opportunity to express my views on these vital issues.