Business Week Online

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MARCH 7, 2005

FINANCE

Where VCs Fear To Tread

Angel investors are filling a critical gap by providing early backing for biotechs

William H. Edwards isn't your typical biotech magnate. A few years ago, the 54-year-old Raleigh (N.C.) Realtor started to dabble in angel investing, doling out his own money to bankroll a handful of non-biotech startups. But when a friend went to work for Voyager Pharmaceutical Corp., a Raleigh company working on a drug to combat Alzheimer's, Edwards busted open his wallet -- investing not just in its first financing round but in five subsequent ones that raised $40 million total. Edwards is convinced Voyager has a good shot at producing a potential $10-billion-a-year blockbuster. "It takes a small company sometimes to find a cure," he says.

Angels -- rich private investors like Edwards -- are flocking to biotech. And they're filling a critical financing gap. Venture capitalists are steering clear of startups, preferring to fund companies with drugs nearly ready for market. Stock investors are equally wary, since one biotech initial public offering after another has nosedived this year. So angels are stepping up, betting that biotech is poised to deliver major drugs for everything from cancer to brain disorders. They poured $1.98 billion into biotech last year, up 10% from 2003 and 52% from 2002, estimates Jeffrey Sohl, director of the Center for Venture Research at the University of New Hampshire.

While individuals have always played a key role in funding biotech startups, today's angels represent a new breed -- one that bears striking similarities to venture capitalists. Angels increasingly are investing in later rounds of funding, even though they have to shell out more money for fewer shares than they got in earlier rounds. Many angels have organized clubs, a handful of which are dedicated solely to funding biotechs and other life-science companies. That helps them spread their risk and pool bigger sums of money. They're making their picks by scrutinizing clinical trial data and grilling entrepreneurs, just as VCs do. "Angels are getting much more sophisticated," says Michael K. Barron, a partner in the Boston office of law firm Nixon Peabody LLP.

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Biotech execs like the shift. Unlike VCs, angels don't try to take control. While VCs often demand perks -- such as dividends when a company is sold -- angel shares come with fewer strings and don't reduce the value of the founders' shares as much. "When the VCs come in, early investors take a haircut," says Michael J. Giannini, Voyager's vice-president for business operations.

Life Science Angels Inc. is one of the latest examples of the new trend. The group, composed of 80 big Silicon Valley investors, formed in January and will hold its first meeting on Mar. 2. So far it has been inundated with 60 business plans from entrepreneurs seeking funding. Co-founder Allan W. May, chief executive of Vascular Architects Inc., a maker of medical devices based in San Jose, Calif., says many of the group's members are biotech industry vets, well aware of the risks in trying to find the next magic cure.

Those risks are compounded by the current dearth of strong IPOs, the traditional way early investors harvest their profits. Three of the four biotech IPOs so far this year have raised far less than anticipated. Last April, Favrille Inc. (FVRL), a San Diego company working on several cancer drugs, said it hoped to raise $86 million. By the time it hit the market on Feb. 2, it had halved its share price to $7 and raised a little more than $40 million. The stock has hovered around the offering price ever since. Meantime, several biotech IPOs have been postponed recently.

Instead of being scared off, angels have simply modified their tactics. Many are now looking for acquisition bids for their companies as a potentially more lucrative exit strategy. Although IPOs have faltered, there are still plenty of eager private buyers for early stage biotech companies. On Feb. 10, Peninsula Pharmaceuticals Inc., based in Alameda, Calif., suspended its planned IPO, saying it was in discussions to be acquired by another company.

The muted public market for biotech IPOs may actually be fueling the angel trend. When IPO markets are chilly, many biotechs go back to private investors to get the money they need to move their drugs along. With more biotechs competing for private funding, valuations in later rounds may be more affordable than before, making it easier for angels to stay in the game longer.

Necessity has become a virtue for both angels and biotechs. And it could be the start of a lengthy relationship. The deep pockets -- and strong stomachs -- of angels will be important lifelines for biotech for some time.

By Arlene Weintraub in New York