

VCs hope to capitalize on a reversal of grant rules

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After six years of being frozen out of grant money allocated to small business innovation and research, venture investors hope the startups they back will finally be eligible again for federal funding.

The potential prize is a piece of more than \$2 billion in Small Business Innovation Research funds from 11 federal agencies that has been blocked from companies that are majority owned by venture capitalists.

Though venture-backed companies in a broad range of industries would become qualified, life sciences insiders and investors say companies they have backed that have nascent discovery and development programs could be the biggest beneficiaries.

“Every one of these companies pretty much has 80 percent of their value locked up in one program and the other 20 percent spread out among one to three other programs,” said Srin Akkaraju, managing director at New Leaf Venture partners, a firm that invests in health care technology. “That’s just a limitation of resources.”

Getting a return on a health care venture investment usually takes a notoriously long time. The SBIR grant program is the perfect way to make sure embryonic ideas get to fulfill their promise for investors and for patients, Akkaraju said.

Nondilutive financing to help get those companies further along or to supplement venture capital is vital to the process, said Dr. Stephen Bloch, general partner in Canaan Partners' health care investment arm and a practicing physician. The SBIR program is more important for early stage venture capital than later stage venture capital, he added.

“Without grants, venture capital won’t play if it costs so much to play early or the costs aren’t defrayed in some fashion,” he said.

The bill would reverse an administrative law judge’s reinterpretation in 2003 of the program’s eligibility requirements. At the time, some feared that startups with multiple millions in venture dollars would dominate the SBIR process.

Bob Molinari, a member of Life Science Angels and a “heavy user” of the SBIR grants as an executive and board member of several life science companies, hopes the SBIR funds will go to early stage companies that aren’t already well-funded.

“This was meant for the founding struggling entrepreneur that needed to generate early stage data to provide a proof of concept that was totally new,” he said. “Well-funded venture groups (before the ruling) weren’t using it for that purpose. They were using it to complement equity investment.”

The unintended consequence of the 2003 ruling was that companies that did demonstrate the merit of matching public dollars with “a meritorious proof of concept by virtue of venture investment” were suddenly excluded from competing, said Matt Gardner, CEO of **BayBio**, Northern California’s life science trade association.

The funding environment for life science companies after the ruling has been daunting, he said.

Even before the economic downturn, the amount of capital available to early stage life sciences companies was shrinking. Venture funding statistics compiled by PricewaterhouseCoopers show that in the five years leading up to the recession the amount has been halved, forcing life science companies to focus on costs, prioritize research and quite often shelve projects for lack of funding.

“The pressure in the VC world has been on late stage assets,” Akkaraju said, “but at the same time, the overall pressure for funding later and later stage assets has been detrimental to investing in early stage innovation. The lack of SBIR grants just added to that.”

The ability to apply for SBIR grant dollars could change that for some enterprises. An approved bill could increase the size limits on SBIR grants up to \$250,000 in phase one, and up to \$2 million in phase two. It does not, however, increase the amount of research dollars distributed.