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L3C – The Next Generation of Small Biotech?

At least once in their careers, most discovery scientists, chemists and biologists alike, have the thought, “I’ve got a great idea, and if I could just find the money, I would start my own company!” Unfortunately, this dreamy statement also neatly encapsulates the core challenge facing any would-be, first-time, or even serial entrepreneur: how to find money to get the concept and the company off the ground. For while there are many operational questions of how to value a new venture, and what legal form the entity will take – limited liability companies (LLCs) or partnerships (LLPs), S or C corporations, or less-common limited and general partnerships and sole proprietorships - the true first hurdles are from whom, and in return for what, early funding can be obtained.

Ten years after the funding highs of the late nineties, valuations of biotech startups are substantially lower. And in the last several years a second trend has emerged that only worsens the struggles of would-be entrepreneurs to realize their dreams: the so-called equity gap, the dearth of capital to finance the smallest, earliest companies. \$1M investments do still happen, but as venture-capital funds have developed and grown, the size of individual investments needed to provide homes for the large amounts of money raised by venture funds has grown to closer to \$5M for each deal. This has opened a large gap between the scale of money available for the earliest financing, government-sponsored grants such as SBIRs and STTRs if the founders are lucky, and second mortgages, owners’ credit cards, and friends-and-family money if they are not, and the deeper VC pockets needed for a business to flourish. Business “angels” have always existed, and in recent years they have partially filled this gap and provided not only money but experience, networking contacts, and a tolerance for risk. But entrepreneurs seeking to move their companies past the SBIR and friends-and-family stage cannot always find the right match with the interests of angels.

Venture philanthropists and private foundations have pushed to the fore recently, both in this gap and at other stages of corporate development, and brought a willingness not only to invest in smaller endeavors, but also to invest in longer-term efforts. VCs need to make larger investments than before, and additionally now measure their portfolios’ performances by how much money an investment makes relative to how long it takes for their gains to be realized. In San Diego this “need for speed” has resulted in the recent trend towards investing in late-stage NRDOs – no research development only organizations. Thus, discovery-stage biopharma companies facing long lead times to product registration and marketing, or biotechs headed toward small markets or low-margin exits, may no longer represent attractive investment opportunities to VCs even if they manage to reach a scale otherwise worthy of this source of investment. Venture philanthropy, though, is often willing to take different types of risks than traditional VCs, as their mandate can be to make program-related investments. Unfortunately, public-private partnerships (PPPs) and private foundations such as the Cystic Fibrosis Foundation and the Juvenile Diabetes Research Foundation can be stymied in their efforts to provide this capital to for-profit enterprises. Charitable donations by a business or a foundation can be legally complex and thus costly, and actual investment in a for-profit enterprise even more so.

Recently, the State of Vermont passed legislation to permit formation of a so-called low-profit, limited liability company (L3C), and similar legislation is under active consideration in Michigan, North Carolina, Georgia, and Montana. The stated goal of the Vermont legislation was to allow “low-profit” companies with socially responsible goals to access a range of investors, including for-profit companies, private

foundations, governments, and wealthy individuals, by defining a legal entity that complies with existing Internal Revenue Service regulations regarding program-related investments (PRIs). These foundations and other investors may now acquire an ownership stake or lend money to the L3C, using assets that older tax law would otherwise require be given out as grants. This allows not-for-profit sources of capital to hold shares in an L3C, and therefore potentially recover their initial investment and even realize a capital gain that could be applied towards another charitable aim. A biotech investment thus becomes both legally possible and financially attractive to a new class of investor.

The structure of an L3C is designed to create a microenvironment conducive to the simultaneous investment of private and not-for-profit capital. Ownership is layered, and risk and reward is unevenly spread over a number of investors. Investors viewing their ownership as charity or a grant can assume the highest risk in the venture, enabling money intended for prudent investment only, e.g., pension funds, to participate in a safer investment with some potential for market returns. IRS rules currently dictate that 5% of private foundations' assets must be granted to charitable projects with socially responsible aims, such as research on neglected diseases, and currently investment in biotech drug discovery and development efforts, no matter what their aim, does not qualify. So, the L3C could open the door to billions of dollars not currently available to the biopharma and biotechnology industry.

If adopted more widely in the U.S., the L3C structure could be a win-win for both sides of the biotech entrepreneurial struggle, as investor/donors would then have the possibility of sustainability and return through ownership versus pure charity, and scientists and other start-up founders could then have access to a fresh new pool of money willing to invest in deals of a scale, and with a time horizon and expected rate of return, that traditional investors of the last several years have forgone.

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