Investment Opportunities Continue in Biotech and Medical Devices

October 11, 2007

The stock market may be on a roller coaster of late, but for investors looking for quality venture capital opportunities in life sciences or medical device development, the ride still looks good, say biotechnology and venture lawyers at Miller Canfield.

According to the National Venture Capital Association, 68 venture capital firms raised $7.2 billion in the second quarter of 2007. "While that figure represents a decline in the number of funds, the dollar amount is up—a sign that the venture capital industry is healthy," said Philip D. Torrence, venture and technology lawyer at Miller Canfield.

Here are a few trends the lawyers at Miller Canfield have observed, along with highlights of 22 venture capital transactions the firm was engaged in during the last quarter of 2006 and the first half of this year.

• SERIES A FINANCINGS
Of the 22 transactions, more than half were Series A Preferred financings and five were convertible debt financings. The median pre-money valuation was $2.5 million; and the average size was $1 million.

• MILESTONE FUNDING
Increasingly, venture capital investors are funding portfolio companies in increments, based on reaching operational or developmental milestones. The approach enables investors to confirm a portfolio company's predictions for future success.

• LIQUIDATION PREFERENCES
The vast majority of transactions contained a 1x liquidation preference. Over half the transactions Miller Canfield was involved in provided investors with participating preferred stock that was not subject to a cap. So, in addition to the liquidation preference, investors are able to participate in any remaining proceeds on an "as-if converted to common" basis above the amounts designated as the liquidation preference.

• MANDATORY CUMULATIVE DIVIDENDS
In nearly half of the firm's financings, portfolio companies agreed to annual dividend rates of 6-8%. Dividends typically were to be paid in cash or stock, and would accumulate if not declared and paid.

• ANTI-DILUTION
Almost 90% of the transactions provided for broad-based, anti-dilution protection.

• CONVERTIBLE DEBT FINANCING
This type of financing typically converts to preferred stock, or common stock if the portfolio company is sold prior to the next financing round. It's a very good vehicle for early-stage investments, and can serve as a bridge between financing rounds. We've seen warrant coverage for the next issued series of preferred stock in the range of 15-30% of the principal amount of the convertible notes purchased in the convertible debt financing. In nearly three-quarters of the convertible debt financings we handled, convertible promissory notes were secured by a lien on the portfolio company's assets.

• CRAM-DOWN ROUNDS & PREFERRED STOCK OPTION GRANTS
These two innovative tools can help overcome the challenge of retaining management whose stock may be behind numerous rounds of liquidation preferences. In the cram-down, new investors may require all previous investors to participate in a new financing round or convert into common stock. If carried out successfully, this will benefit management and new investors by reducing the amount of liquidation preferences outstanding, and giving the remaining preferred stockholders greater control over the company. Likewise, the preferred stock option grant gives stock options to executives, allowing them to receive the same economic benefits available to the venture capital investors.

• INCREASING OPTION POOLS BEFORE VALUATION
Venture capital investors are now requiring that the option pool be increased to handle up to three years of option grants. This approach shifts all dilution associated with the option pool to the founders and original investors, reducing the per-share price of the preferred stock for new investors.

• MANDATORY REDEMPTION
The long path to liquidity—particularly in pharmaceutical companies—has led some venture capital investors to guarantee a liquidity event by requiring a portfolio company to repurchase a venture capital investor's stock after a stated period of time (usually three to seven years). That mandatory redemption may raise financing issues, since banks view the obligation as a company debt. Furthermore, the ability of a portfolio company to redeem can be limited by state law, or the practical reality of generating sufficient funds to repurchase shares.

The law firm of Miller Canfield was established in Detroit in 1852 and employs more than 800 in offices in Michigan, Illinois, Massachusetts, Florida, New York, Canada and Poland.