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STARTUPS

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Understanding the funding options for life sciences

INSIDER VIEW

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Venture capitalists are shaking the doldrums of recent years, while life sciences companies are dusting off capital spending and development plans. Because the investor affects long-term success, medical device companies seeking capital for product and business development must consider the benefits and detriments of available funding sources.

• Valuation variance. Cash-strapped startups strained by tight resources and extended sales cycles may view trading equity for capital as a "cheap" alternative. However, with valuations currently low, equity financing is a more painful process for management. The price an investor is willing to pay for equity — the all-important valuation — varies by type of investor.

Corporate investors tend to be less valuation-sensitive than venture capitalists, whose concern is return-on-investment. A decision made solely on valuation, though, can be short-sighted: No founder is happy owning a larger piece of a failed company. Often a more expensive source of financing, venture capitalists make their reputations on building successful companies. A less mature company — one that needs a hands-on partner with broad experience and extensive contacts — may need to give a little on valuation to ultimately gain success.

• Commercial strings attached. Investments by strategic partners are often attached to a parallel commercial relationship. Bundling a financing arrangement with rights to distribute a new product has advantages, among them limiting downside business risk.

However, a startup beholden to its strategic ally is less attractive to other potential partners, especially those directly competitive with the corporate backer. If presented with financing and commercial rights as a package deal, a startup company bargaining with a major life sciences partner should focus on the terms of the commercial deal. For cross-border markets or multiple product lines, a young company should consider the relationship's geographic parameters and its extension to other products. It is crucial for the startup to do its due diligence: A strategic partner may sometimes invest in a company as an anti-competitive tactic.

• Milestone pitfalls. Milestone financing is a preferred investment method for strategic partners and VCs alike. For the venture capitalist, it allows a staged infusion of funds at low valuation and protects against a large cash investment into a highly risky venture.

The approach can focus a young company on achieving incremental goals, but may also rivet management's attention to the wrong goals. Milestones, then, need to be objective and achievable, and should not leave an easy "out" for the investor. Goals should be business- or market-driven, rather than merely product-oriented.

Even with the return of new VC dollars, strategic financing may be appropriate for a young company. By carefully considering the dynamics of valuation and competition, the distractions of inappropriate funding milestones and the complications of intellectual property protection, a company can position itself for ultimate success.

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