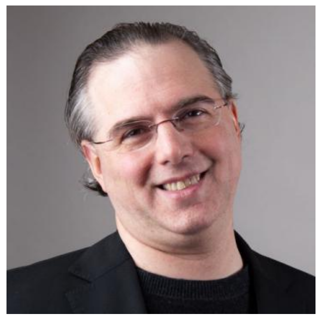
Biotech VCs, Stung by Startup Returns, Elbow into Royalty Financing

Steve Dickman | 8/16/13



The new landscape for venture capital investing does not seem to leave much room for classic company formation. Investor after investor has **shut down or moved beyond startups** into what seem like greener pastures.

So it should come as no surprise that at least a few VC firms are now expanding into the royalty space, as shown by a deal **announced** this week. Aisling Capital and Clarus Ventures, two top-tier VC firms, acquired 20 percent of the royalty stream created by sales of **ibrutinib**, a novel tyrosine kinase inhibitor developed by Pharmacyclics (NASDAQ: **PCYC**) and partnered with Johnson & Johnson (NYSE: **JNJ**) for use in B-cell malignancies such as chronic lymphocytic leukemia (CLL).

According to the **press release**, Aisling and Clarus each invested $48.5 million for matching 10 percent shares of a $485 million royalty-financing deal that Royalty Pharma struck last month with Quest Diagnostics Inc. (NASDAQ: **DGX**). Ibrutinib recently was **designated by FDA** as a “breakthrough” therapy. Analysts cited by FierceBiotech expect the drug to hit $5 billion in revenues in a short time, making the royalty stream very valuable. Under a deal structured like this, Aisling and Clarus are essentially wagering that the drug will be a blockbuster, and will provide them much more than $48.5 million in steady royalties over the lifetime of the product’s patent – if they or their limited partners do not choose to take profits first. It would not surprise me to see some of the royalties later bought back at higher prices by Royalty Pharma or acquired by third parties.

There is no doubt in my mind that the choice to invest in royalties had to be explicitly approved by the funds’ limited partners (LPs), either in the fund charter or, more likely, in an ad hoc fashion before this deal was done. I can’t imagine there was much resistance when the Aisling and Clarus general partners described the risk-reward in the ibrutinib deal. The LPs probably asked them to do more of this type of investing, given the product's high-reward/low-risk profile.

The announcement answered two questions in my mind: first, what will VC funds do now that the returns make it harder to justify raising more money to support traditional models? Second, what will royalty funds do to make money now that they are facing a more efficient (read: barbarously competitive) market for the royalties of approved drugs?

Royalty deals as likely winners

In some ways this deal looks like a one-off: maturing VC funds that need to deploy large amounts of capital setting themselves up for near-term (if more modest) returns in lieu of typical home-run, long-term bets on early-stage biotech. Once they get a few of these out of their system, the VCs will swing back to their true nature as swashbuckling, entrepreneurial investors, right?

I am not so sure. In fact, I would argue that actually the royalty play illustrates the "new normal" in life sciences VC investing: a search for investments with short time horizons; a lack of faith in preclinical or even phase I molecules and the teams developing them; and an irresistible pull to "sure-fire" deals of a more financial nature.

These are the same trends that have led to the rise of the asset-based strategies deployed by life science VC funds like Atlas Venture and Index Ventures. Those strategies build portfolios of assets, rather than management teams, and flexibly deploy those teams in ways that can be changed ... **NEXT PAGE »**

Steve Dickman is a former venture capitalist and the CEO of boutique consulting firm CBT Advisors as well as the author of the blog Boston Biotech Watch. Follow @

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