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CAPITAL MATTERS

RCT Eyes New Device Strategy

Looking for less capital-intensive deals, RCT BioVentures is planning to go where few device VCs have gone before: investing in LLCs.

Medical device venture capitalists don't take to change easily, at least not when they're asked to alter how they invest. The model for starting and funding a new medical device company hasn't evolved much in decades. The simplicity of the formula – back a company that's developing a single device – doesn't lend itself to many changes. But the BioVentures arm of **Research Corporation Technologies**, a Tucson, AZ-based investor, is exploring a new avenue for early-stage device investing: asset financing.

It's an approach similar to one being adopted by a handful of biopharmaceutical investors: invest in single products and build simpler tax structures around them to make sales and distribution of cash back to shareholders less complicated. The device industry doesn't present the same opportunities for asset-based financing as biopharma. Large medical device manufacturers don't have shelves filled with early-stage projects starved for attention. Corporate research and development focuses more on new iterations of existing products. Truly innovative approaches come largely from engineers and surgeons with experience and connections to VCs. Instead of looking to the shelves of big companies for product candidates, as biopharma VCs often do, RCT is looking toward individual entrepreneurs for its investment ideas. In backing these entrepreneurs, RCT prefers creating limited liability corporations over standard corporations, although the firm will still invested in traditional companies if they have a plan to keep capital needs low.

The strategy continues a long history of funding innovation. For a century, Research Corporation, the parent organization of RCT, has supplied grants to scientists like Robert Goddard, PhD, the father of rocketry in the US. Many of those scientists in turn signed over their patents to the corporation, which earned fees by licensing them out to industry. RCT spun out of Research Corporation in 1987 when the IRS determined a nonprofit 501(c)(3) like Research Corporation couldn't draw revenues from licensing and royalty fees. Research Corporation remains, still issuing grants to scientists. RCT manages the fees and operates the BioVentures group. Today, RCT has $250 million to invest, according to managing director Paul Grand.

RCT BioVentures' overarching theme is capital preservation, a familiar theme for many VCs these days. The group eschews early-stage technologies that will require follow-on rounds to reach an exit. Instead, RCT is looking for opportunities to invest, or co-invest, in a single round that provides enough capital to develop the product to a point where it could be commercialized, distributed or sold.

RCT executives say the LLC structure can house a new product until it reaches a point where it's either valuable enough to sell to a strategic buyer or useful enough to commercialize through distributors. Each product will require minimal FDA review – 510(k) notification at the most – and already will serve an established device market. Grand says RCT expects to invest between $3 million and $8 million in each effort. RCT has funded two LLCs so far: **Option 3 LLC**, a partnership with entrepreneur James Dreher, and **Axiom Technology Partners LLC**. Axiom is developing a fascial closure device. Option 3 has a broader charge; RCT hopes Dreher can produce multiple products that can obtain FDA approval with little time and capital. Each product will be developed under its own LLC.

RCT's current 10-company portfolio consists of six biopharmaceutical companies and four device ventures. Looking forward, the company expects to invest more heavily – or perhaps almost exclusively – in medical device companies, as the capital costs for those products tend to be lower than for drugs.

Christopher P. Martin, SVP and chief financial officer, says the LLC structure benefits both entrepreneurs and buyers. Management is less likely to get diluted in follow-on financings, although those shouldn't be necessary under RCT's thesis. Martin says the LLC structures are easier to acquire, making the path to liquidity that much easier to follow. To acquire a product, a strategic acquirer doesn't have to execute the same merger agreements necessary to buy a corporation. In acquiring a company, the payment goes into the company and then out to investor, creating a "taxable event" that can skew the valuations. Acquiring an LLC just involves a straight payment to investors. RCT is a corporation, so it can handle the required annual reports of gains and losses from LLCs. Venture capital firms, with limited partnerships, aren't structured to manage the annual financial losses and gains reported by LLCs. One VC says the workarounds are difficult so it's easier to avoid investing in LLCs.

The new asset-financing strategy remains consistent with RCT's insistence that executives must execute. According to two sources, RCT already has a reputation for firmly holding executives to their financial and operational goals. Martin agrees the reputation has some validity and isn't afraid of sharing his disappointment when a plan doesn't come together. Last year, **Teleflex Inc.** acquired **VasoNova Inc.**, developer of a central venous catheter navigation technology that allowed for better placement of catheters inserted in the superior vena cava. Teleflex paid $55 million, producing a solid return for investors. But Martin says, "To this day, I believe we could have and should have been able to do it in the capital-efficient plan originally developed. We all had to put more money into it than everyone anticipated, mainly due to some technology development and execution issues."

Grand acknowledges that early-stage investing comes with risks and uncertainties. But, in the minds of RCT, the LLC model will help management avoid dilution of ownerships that can come with follow-on rounds. "You can't predict everything that can happen," he says. "But we do expect management to deliver on value added milestones that investors and management agree to at the outset. Our new model is very founder-friendly and strongly aligns founders and management with the investors." Founders and managers who are capable of keeping capital needs in check have a better chance of avoiding dilution that can come with sequential venture round financings. If RCT can deliver on its capital-efficient, founder-friendly approach, it may provide a valuable alternative for other device investors to follow.

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