The Harbour Group

Alternative Capital Sources: Cause-Related Venture Funding

From Research to Revenue II

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RBC Dominion Securities

Our View

Never has the social and political environment been so positive for funding cause-related organizations and efforts.

- Canadian citizens have generated an amazing amount of wealth from the ‘boom’ in commodities such as energy and minerals/metals.
- The federal budget eliminated capital gains tax on securities donated to registered charities and public foundations.
- There has been a shift to giving in one’s lifetime rather than giving as a legacy – Warren Buffet, Bill and Melinda Gates, etc.
- Canada has seen charitable giving emerge as a key societal value – for example, arts in Toronto have seen over $1 billion in funds injected over the past year.
- Biomedical research has been a major benefactor of increased philanthropy – The Bill and Melinda Gates Foundation, William J. Clinton Foundation, etc.

Our View

In other words, philanthropy and giving have reached unprecedented levels.

So what does this mean for funding biotech and pharma?

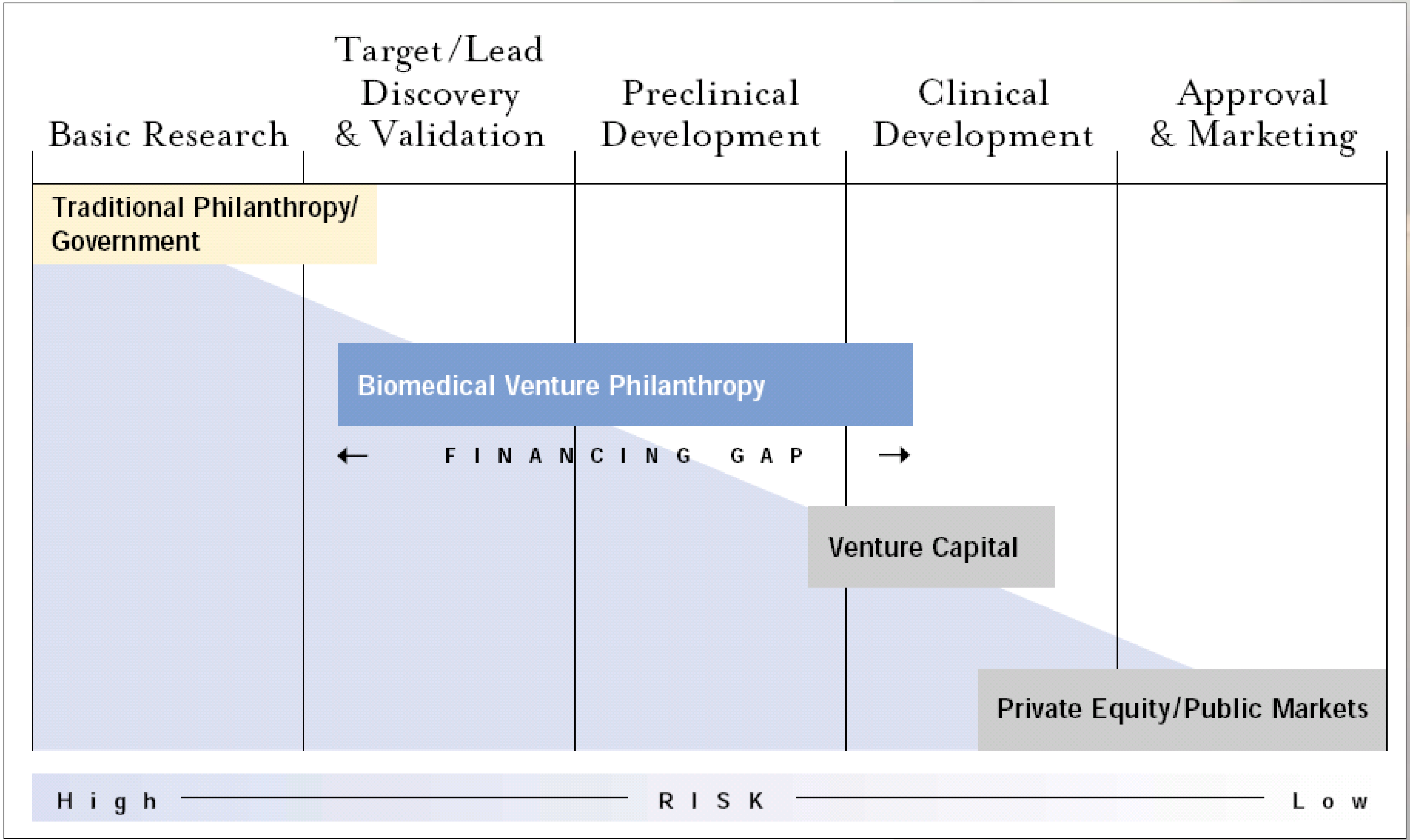
Our View

At the same time as philanthropy has reached unprecedented levels, spending on life sciences research has also reached record levels:

- Last year, research and development spending in Canada reached $1 billion.
- Creation of a knowledge-based workforce in the life-sciences industry is at an all time high, contributing more to Canada’s economy than ever before.
- The political climate has encouraged a migration of researchers north to Canada from the U.S. Many world-class research scientists call Canada home.

The convergence of wealth creation, philanthropy and life science advancement place scientific research in a strong position for funding.

But Gaps Exist in Funding Biotechnology *



* *Howard Fillit, MD, Executive Director, The Institute for the Study of Aging, Inc.*

Funding Biotechnology Research

Funding sources shift over the life cycle of biotechnology development.

- Small biotech companies pursuing high risk, early stage drug discovery, have more difficulty attracting capital
- Funding in early stages relies on grants from governments, scientific research organizations, foundations and endowments.
- As the commercial value is realized, funding sources mature from venture capital to private equity to organized capital markets or sales to mature companies.
- The validation and pre-clinical phases represent the gap between **philanthropy** and **venture capital** which requires alternative sources of financing – failures are huge in this phase.

One source of capital to fund this gap is ‘venture philanthropy’.

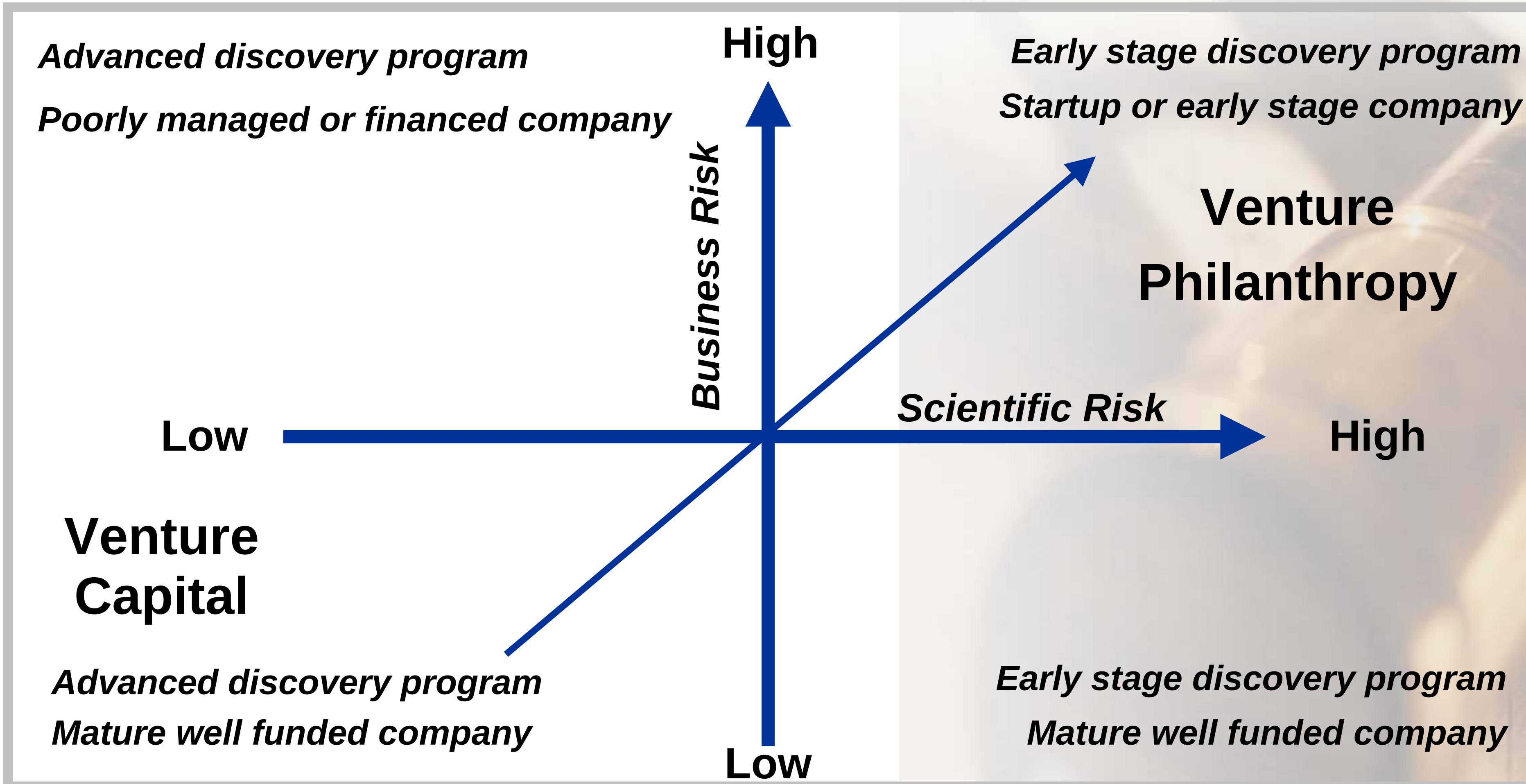
Biomedical Venture Philanthropy

'Venture Philanthropy' is a hybrid merging the principles of philanthropy with venture capital investing.

- Operating model that provides funding to bridge the gap between basic science research and pharmaceutical drug development.
- Invests in drug discovery and clinical development programs in biotechnology companies, research institutes and educational facilities.
- A number of disease-specific charities have adopted variations of the biomedical 'venture philanthropy' model in order to advance their charitable missions of finding a solution to a disease-specific need.
- Various 'venture philanthropy' models have been successfully used by various organizations as a funding source to assist during critical phase in development – there is not one specific right way.

The primary driver of 'venture philanthropy' is to advance research related to the cause - *not profit / return on investment.*

Venture Capital vs. Venture Philanthropy *



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Sources of ‘Venture Philanthropy’

There are several potential sources of venture philanthropy.

- High net-worth individuals (Angel Investors) emotionally involved in the cause they are funding. They have passionate commitment to the cause they are funding.
- Private foundations led by individuals / families with an emotional involvement in the cause being funded. Similar to Angel Investors.
- Pharma and bio-tech firms that stand to benefit from the commercialization of the research being conducted.
- Venture capital firms who are unwilling to fund ventures in very early statges – but who would like the opportunity to provide and exit should a marketable result occur.
- Public foundations / cause-related charitable organizations with mission / mandate to advance research in the particular issue being funded.
- Universities / Hospitals focused on the medical issue being addressed by the research.
- Governments and their agencies with mandate / motivation for economic growth and/or public health.

Of these sources, Angel Investors present a unique opportunity.

Biomedical Venture Philanthropy

'Venture Philanthropy' from angel investors has the vital ingredients required for successfully raising capital.

- A real potential return, albeit extremely speculative, for investors.
- A tie to the emotional cause or mission for the investor that the underlying research is supporting.
- A pool of potential investors that grows constantly – as entrepreneurs and executives grow their wealth, the potential pool of investors also grows.
- A professional, organized effort focused on the cause with infrastructure in place.

Angel Investing and 'Venture Philanthropy'

Angel investors kick-start innovation through an unofficial and informal capital market.

- Angel investors have traditionally been individuals with strong commitment to cause that is being addressed through the research and development effort.
- They are out of necessity high net worth individuals who can take on significant risk in their investment portfolio. They often have more patience and time than venture capital firms.
- Many have an entrepreneurial back ground or have been senior executives in the corporate world.
- Typically work within a network of other like-minded people and firms. They can often refer you to other angel investors, as well as negotiate an exit to a venture capital firm.
- They are often valued sources of business insight and recruiting of critical personnel.
- Angels invest on average $600,000 per venture, versus $6,000,000 for venture capital. However, angels invest as little as $25,000 in many cases.
- Part of their return is a 'psychic benefit' of advancing their cause. It is not just about money and rate of return.

Challenges for 'Venture Philanthropy'

- Set your expectations appropriately. A more mature market exists in the U.S. and U.K., and it has the potential to emerge in Canada – but it does not yet exist.
- Venture must have professional business plan, success criteria and metrics, exit strategy and credible management team – investment is more likely if this is in place.
- Requires credible infrastructure in place to support research and development activities during this phase…it cannot be a black hole without accountability for results.
- Management team must include research personnel as well as business managers that can credibly lead venture.
- Must have a set goal for development – single, or more attractively, a portfolio of technologies with a set exit strategy.
- The investment must have real potential, albeit highly speculative.
- Must be 'marketed' with an understanding of high potential for loss and LITTLE liquidity.
- Must insure not taking money from the charitable cause that is instead flowing to the 'venture philanthropy' vehicle.
- You must know and understand your investors – it is like a marriage without the possibility of divorce.

Structure of Investment Vehicle

- Limited partnership, limited liability company, notes / bonds.
- High-risk vehicle – at best, a high-return speculative investment. At worst, a tax write off for the high net worth investor.
- Has to be marketed just like any other security issue – road show, business plan, etc.
- Meet security regulations - offering memorandum, prospectus – for qualified investors only.
- Need to define practical questions around distribution of vehicle, term, rights. Who will be your partners?
- As an example, one major US-based organization structures funding vehicles as Convertible Notes:
  - Five Year Term
  - Interest – one-half of the “prime” rate, reset annually
  - Conversion rate – negotiated on a case by case basis
  - Customary anti-dilution protection
  - Board Observer Rights
  - Preemptive Rights

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