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De Novo's Device Strategy

Pays Off, Others May Follow

INVESTORS DREAM OF ZIGGING WHEN THE REST OF THE MARKET IS ZAGGING in order to turn a profit in an area just when others are jumping on-board. De Novo Ventures, having successfully closed on its second fund and built a promising portfolio of device companies, appears to be making this kind of contrarian bet.

Four years ago, most venture capital (VC) funds were more interested in jettisoning their life science portfolios in favor of Internet and telecom start-ups, whose bubbles had not yet burst. Most of the money remaining for health care ended up in the biotech sector, which was also undergoing a financing boomlet. Medical device start-ups struggled.

Several veteran life science venture capitalists, some of who ran and others who were pushed from firms vacating this space, decided to start funds focused exclusively on health care. One that successfully made this transition and decided to include medical device investing as an important part of its strategy is De Novo Ventures. (Another is Versant Ventures, formed by former partners from Brentwood Ventures, Institutional Venture Partners, and Crosspoint Ventures.)

Recent activity suggests, however, that these health care venture firms won't be alone here for long. With the bursting of the high tech bubble, venture funds like Kleiner Perkins Caufield & Byers and New Enterprise Associates, which shut down their once-significant life science practices, are now looking to re-enter this space. Meanwhile, De Novo and Versant share a key strength: their partners' varied health care investment and operational experience, which, they suggest, enables them to identify promising start-ups in areas others had abandoned.

De Novo, in focusing more heavily on medical devices, is in a field its partners know well: they've been presidents/CEOs of a total of 14 device companies, most located in the San Francisco Bay area. The four founders—Fred Dotzler, Richard Ferrari, David Mauney, MD, and John Simpson, PhD, MD—have been a part of many success stories in this sector, as entrepreneurs, chief executives, or investors. Thus, in addition to experience with life science investing *per se*, an important part of De Novo's message to prospective portfolio companies is the extensive operational experience that the firm can offer to them.

"We came together because, based on our prior collective experience, we believed there was a specific kind of insight missing from partnerships between VCs and device firms," Rich Ferrari explains. “While VCs always talk about adding value through their experience, in addition to simply investing money, we knew that this was rarely the case.”

De Novo’s original strategy was to take that base of experience, overlay a set of principles for identifying investment opportunities, then utilize the partners’ skills to help the portfolio companies with strategic, operational, or product development issues. “No matter what problem our portfolio companies were going through,” says Rich Ferrari, “the odds are that one of our partners had previously faced it and solved it.”

Since its founding in March 2000, De Novo has organized its first fund, for which it collected a portfolio of 17 companies, primarily early stage (A and B rounds, proof of concept and product development phases) and divided roughly 60/40 between devices and biotechs. Seven of these generate revenue, including **MicroVention Inc.** (coils to treat cerebral aneurysms), **Fox Hollow Technologies Inc.** (next-generation atherectomy), **LuMend Inc.** (a device for crossing chronic total occlusions), and **CryoVascular Systems Inc.** (using cryotherapy for treating vascular disease). **TriVascular Inc.** (abdominal aortic aneurysm stent-grafts), another De Novo company, while not yet selling product, already has a distribution and merger deal with a large cap company, **Boston Scientific Corp.**

Buoyed by its initial successes, De Novo this March closed its second fund, De Novo Ventures II, also aiming to raise $250 million. It was promptly oversubscribed, exceeding the target by $50 million. In the past 18 months, the firm added two partners, both former industry senior executives who bring strong operating experience, Joe Mandato and Jay Watkins. Mandato has led six device companies and been entrepreneur-in-residence at Mayfield Fund. Watkins was co-founder of Origin Medsystems, which was acquired by **Eli Lilly & Co.**, and when Lilly spun-off its device businesses to form **Guidant Corp.**, he headed Guidant’s minimally invasive surgery group. Watkins also served as president of Compass, Guidant’s corporate business development and venture arm. De Novo also added Rajiv Doshi, MD, and Aimee Angel to focus on future investment opportunities. Doshi has spent the last three years teaching medical device design courses at **Stanford School of Medicine** and Department of Mechanical Engineering, after also having worked at Compass. Angel joined the firm after completing her Fellowship with the Biodesign Innovation Program at **Stanford University**, where she was developing novel devices in cardiovascular medicine.

De Novo’s optimism about life sciences is slowly spreading to other investor groups.

Fueling the firm’s expansion is the size of De Novo II, which at $250 million, is 2.5 times larger than the group’s first fund. “It’s very difficult to provide the added value of experience to a start-up if a VC is sitting on eight or ten boards.” Joe Mandato claims. “To obviate that limited capacity problem, we know that we need to have the people necessary to staff our fund accordingly so we can deliver the level of service on which we pride ourselves.”

The De Novo partners will continue to combine efforts when aiding portfolio companies, tapping individual partners’ particular strengths. Rather than have a single partner work exclusively with a start-up, Ferrari explains, “We’re going to spread ourselves more broadly over our companies to bring our collective resources to bear.”

De Novo I and II differ in more ways than just size. The second fund will tilt even more heavily towards medical devices, an allocation which Rich Ferrari says better reflects the partners’ experience. Also, 80% of De Novo I investors were individuals, while 20% were institutional. That split is reversed for De Novo II.

De Novo II, like De Novo I, will focus on early-stage companies “because that’s where our skill sets are and that’s also where the value gets created in a company,” Ferrari says. De Novo isn’t discouraged from early-stage investing by the lack of current exit options—particularly the continuing absence of a significant device IPO market—requiring investors to stay longer with start-up companies. “Staying in longer results in many VCs standing on unfamiliar ground because historically they would be gone by this stage through an IPO, but smart investors can still make money if they’re in tune with what it takes to move a company through its various stages, knowing they’ll probably hit a wall or two along the way but that they can work through those problems,” Ferrari contends, “and we believe that plays to our strengths.”

“We’re very conscious that these financing relationships are going to be longer than in the past several years,” Joe Mandato agrees. “In other words, is this a viable company or a

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science project?" he says, pointing to the firm's track record of revenue-producing portfolio companies as evidence of the accuracy of De Novo's assessments so far.

"We're not likely to invest in a company without a clear clinical value to the patient or path to commercialization," Ferrari adds. He's interested in "clinical impact plays" that can change medical procedures because in those cases, he notes, "the path to sales and the path to an M&A transaction or an IPO becomes almost obvious." He adds, "Investors run into problems when they're facing a gray zone when they have an interesting technology but are not sure of its clinical value."

De Novo is looking at therapeutic medical devices addressing cardiology, neurology, ophthalmology, orthopedics, plastics, gastroenterology, and pulmonology, and biotechnology companies that have drugs in at least early clinical development. So far, De Novo II's initial investments are in orthopedics, hearing, and atrial fibrillation.

In addition, De Novo also is on the look-out for companies seeking to apply existing technologies to new therapeutic areas. High on this list, Raj Doshi says, are minimally-invasive approaches, which offer "potentially compelling opportunities beyond cardiology, including in pulmonology and thoracic surgery, gastroenterology and general surgery, and dermatology and plastic surgery.

De Novo's optimism about life sciences is slowly spreading to other investor groups. Is there enough investment opportunity to support the additional interest? De Novo partners agree that the firm benefited initially from the increased deal-flow that resulted from the fact that a significant chunk of investment capacity had just vacated life sciences when they launched their first fund...they believe there's more than enough deals to go around. "Even now when people are trying to get back into this business," Joe Mandato observes, "the capacity is relatively modest considering the opportunity we are finding that exists in the market." ●

Comments?

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