Schools' Rights Are Investment Grade At Osage University Partners

By Alex Lash / Email the Author / March 2013

Executive Summary
The $100 million venture fund is the first to use the rights universities hold – but rarely exercise – to make venture bets. So far, with a share of Osage's profits as incentive, dozens of schools have been happy to share.

Universities and other research institutions can strike gold from royalties when products based on their inventions become best-sellers. But another source of potential income usually remains beyond their reach: the rights to invest in the companies that their technology transfer offices spin out. They rarely have the cash or the expertise to exercise those rights, and that's where Osage University Partners comes in.

The Philadelphia-area investment group, a sister fund of the longer-in-the-tooth Osage Venture Partners, has invested about half of its inaugural $100 million fund by striking deals with tech transfer offices, or TTOs. The TTOs give Osage their rights, known as participation or preemptive rights, and Osage sends back a cut of the returns if the fund becomes profitable.

It seems to be the only venture fund giving the idea a go, and so far, with 23 portfolio companies – 14 of them in the life sciences – and a target of 30 to 35, tech transfer officials like what they see.

"It's innovative not just for the sake of doing something different," says Scott Forrest, PhD, director of business and technology development at the Scripps Research Institute in La Jolla, CA. "It's also a way for groups like ours to monetize a wasted asset." Scripps is an associate partner of the fund, which means it can sign over its participation rights to Osage on a case-by-case basis. There are 42 associate partners to complement eight core partners, which have signed blanket agreements with the university fund. The core eight include Columbia University, the University of California, Berkeley, and the University of Pennsylvania, where Osage founding partner Lou Berneman once ran tech transfer. Its 50 partners have licensed technology to about 2,000 working companies, of which roughly 225 are what Osage managing partner Bill Harrington, MD, says are "investable" life science companies.

No money changes hands up front, but every core and associate university partner becomes, in effect, a general partner in the fund. As with all venture funds, limited partners are paid back first; once they are whole, the general partners start to reap carried interest. The TTOs share Osage's carry based on a formula that Osage officials declined to share. But the schools whose spin-outs attract Osage's investment and eventually contribute returns to the fund will enjoy a larger cut. "We're confident that the way the economics are allocated, it's mostly tied to productivity," says Harrington.

“The universities know that. Otherwise it would be difficult to reward the schools that are prolific.”

“It’s a brilliant strategy,” says Todd Sherer, PhD, the head of tech transfer at Emory University in Atlanta and the current president of the Association of University Technology Managers (AUTM), a national tech-transfer organization. (Emory is one of Osage’s partners.)

Brilliant strategy is one thing, successful returns another. The first fund probably won’t prove its worth in dollars before the partners set out to raise a second fund, says Harrington. But to give itself a chance for nearer-term exits, the group looks for late-stage deals, too, as it did with its only exit so far: Avid Radiopharmaceuticals Inc., whose molecular imaging technology can detect in living patients the beta-amyloid plaques associated with Alzheimer’s, which previously could only be confirmed post-mortem. Eli Lilly & Co. Inc. bought Avid for $300 million up front in 2010. [See Deal] Avid was based on work that spun out of the University of Pennsylvania, where Avid CEO and founder Daniel M. Skovronsky, MD, PhD, was at the Center for Neurodegenerative Disease Research.

Osage has even joined recapitalizations, as it did in late 2012 in a Series B round for Applied Genetic Technologies Corp., which was founded more than a decade ago. [See Deal] Harrington estimates the fund’s portfolio companies have been on average three years old upon Osage’s initial investment.

The fund cannot invest in companies without ties to its 50 university partners. However, there is flexibility in case Osage likes a company with no preemptive rights attached. (Once in a while a TTO doesn’t negotiate for them.) This was the case with Receptos Inc., a spin-out from the Scripps labs of two researchers who teased out the structures of G-protein coupled receptors, one of the pharma business’ most widely targeted protein families. (See"Receptos Inc." — START-UP, February 2011.) Receptos reeled in a $25 million Series A round in 2009 [See Deal], and Osage joined the Polaris Venture Partners-led Series B round in 2012. [See Deal] Even without preemptive rights, Osage is honoring the Scripps partnership by applying the profit-share agreement to its investment. Not doing so – going behind its partner’s back, so to speak – would be a breach of trust that Osage says would harm its reputation.

Such cases will be rare; all Osage’s TTO partners now negotiate participation rights as part of their boilerplate, says Harrington. “Without the rights, there would be no underlying basis for a relationship with the TTOs and no basis to drive investment in the university spin-outs.”

Osage also tries to play early-stage matchmaker between its partner TTOs, industry, and other VCs, even where it’s not directly involved in deals. With lines into its 50 partners and a proprietary database that tracks academic projects, it’s using this social capital to

build goodwill. After all, it needs its associate partners to sign over their rights, and it also needs VCs who have already built syndicates to put out the welcome mat. Without a friendly syndicate, Osage could play the preemptive rights card to force its way into a deal, but it doesn't want to.

And Harrington says the group hasn't had to yet. It helps that as a passive investor – no board seats, please – the fund doesn't make waves. And their relatively small contributions don't threaten other investors with dilution, especially in the new biotech financing climate. With a shrinking pool of syndicate partners, VCs are shying away from the old model, which bumped along from Series A to B to C with everyone's fingers crossed that the same core group could sustain the long journey. Instead we're starting to see massive Series A rounds with a small group of investors who map out a start-up's first several years. The extra room has allowed the university fund to invest a bit more than officials first expected, if syndicates let them go beyond the pro rata amount that their rights allow (another reason to build up goodwill). Participation rights can vary wildly, but they generally give TTOs an average of mid-single-digit ownership in a post-Series A capitalization table, says Scripps' Forrest.

Osage first aimed to make initial investments of half a million to $1.5 million, but they've bumped that range to $2 million — $2.5 million, with perhaps twice that in reserve. "To go from one to two million dollars in a $40 million financing isn't going to crowd anyone out," says Harrington. "If we're in for 1.5 [million] and want to go to 2.5, it generally doesn't meet a lot of resistance."

Even though Osage's investments have ties back to academic research, the fund shouldn't feel an effect from the sequester cuts to the National Institutes of Health. The impact of those cuts on research aren't likely to "trickle up" to the for-profit sector for years, if at all. However, a nearer-term problem is what AUTM's Sherer describes as a tech-transfer bottleneck, with understaffed offices lacking resources to sort through their researchers' projects and move the best ones forward. "Through the global financial crisis, universities haven't increased patent budgets or [added staff], so we've had more inventions coming our way but no increase in staff or budget to handle them, and with fewer outlets [among VCs or pharmas to license them]," says Sherer.
That's actually a selling point for Osage, which offers itself as another set of eyes to help sort through research and get the word out to other investors. In the next couple years, it will be the goodwill those relationships build, as much as any exits the first fund provides, that determines if the team can raise a second fund in 2014 or 2015, and if any copycats emerge. "Frankly I'm a little surprised," says Scripps' Forrest, "that no one else has tried this."