FINalternatives
HEDGE FUND & PRIVATE EQUITY NEWS
As originally reported on FINalternatives on Tuesday, September 15, 2015 www.finalternatives.com

Q&A: Biotech Investing with Crossover Fund RA Capital

The first word that comes to mind when chatting with the team at Boston-based RA Capital Management is *intriguing*. The company is basically a sophisticated life sciences think-tank wrapped in a fund that finances private, IPO and follow-on financings for a portfolio of early-stage biotech companies. The company's crossover fund, offered to institutional investors, has more than $1 billion in AUM.

FINalternatives recently sat down with the RA Capital team to get a sense of their unique approach in what is a notoriously fickle industry.

Tell us a little bit about your company.

RA Capital is a $1 billion healthcare-focused crossover fund manager. Crossover means that we can invest in companies whether they are public or private. We are deeply science-driven, analyzing considerable scientific and clinical data to identify development stage companies that have compelling technologies. Because the best drug and other technologies at attractive valuations may be in public or private companies, our crossover strategy allows us to invest at any stage of a company's life cycle.

Our investment team is comprised of portfolio managers Peter Kolchinsky and Rajeev Shah, and managing directors Tomas Kiselak and Andrew Levin. Our team is supported by a large and diverse research team of associates and analysts in what we call the TechAtlas division, which is also a farm team for the investment team's growth. Peter started investing in 2002, Raj joined in 2004, and the firm started from there. RA has now grown to almost 50 people, most of whom are scientists and many of whom have earned PhDs.

The team functions like a scientific think tank, mapping out various therapeutic battlegrounds and asking the big questions. How will cancer be cured? What might cause drug prices to come down? How will the latest breakthroughs in gene therapy be applied to curing diseases? Once we have an informed opinion, we ask ourselves what companies are on the right side of history and zero in on them as potential investments. Our team works closely with our portfolio companies to help them expand and refine their business plans, so we're more like a venture or PE fund in that regard.

Our walls are covered with TechAtlas maps of many therapeutic landscapes, such as lung cancer and diabetes, showing every drug and every company trying to treat those diseases in the context of their closest competitors. The TechAtlas system is the core of our operation, allowing us to coordinate how all members of our expansive team are simultaneously tracking innovation in every segment of our industry.

Talk a bit about the crossover fund. How does it work?

In the case of private companies looking to go public, our model as a crossover fund manager is to bridge what has traditionally been considered a discontinuity, a chasm that required a leap of faith by management and existing shareholders that the public markets would be supportive of their company. With our model, investing in a private round and then leading the IPO takes some of the stress and uncertainty out of the process for everyone.

For our LPs, investing in a crossover fund means that they benefit from the discounted valuations in the private markets. Private companies are sometimes acquired before they go public, but in most cases, the private firms in our portfolios have gone through an IPO, and each of those did so at valuations higher than the prior private round.

By getting involved before the IPO, we can help the company optimize its business plan for the public markets and later, assuming they aren't acquired first, receive substantive allocations in the IPO itself. Increasingly, we're exploring the formation of companies from scratch where we see an opportunity to bring the right technologies together with the right people. In those cases, we'll be starting with a much larger ownership stake and then moving those companies towards the public markets.

We don't see an IPO as an exit point. A private company that IPOs simply shifts to the public portion of our portfolio, and if we think it is still undervalued, we remain shareholders. Some companies can be in our portfolio for several years, while others quickly reach a valuation we consider fair, at which point our job is to move that capital.

Walk us through a typical investment – what is your process? Do you approach candidates with a broad view about them and where they may fit in the portfolio already in mind, or are you more opportunistic?

Both. Our TechAtlas team is aware of most of what is going on in our industry, trying to map out every company, drug, and technology in just about every disease area, and we typically reach out to companies that are the best in their space to explore whether we can invest in them. But there are always a few ventures truly in stealth mode at any one time, so you have to be prepared for them when they surface.

Along with investing in the company, we sometimes take board seats, and we can help a company strengthen their business plan. Intellectual capital is arguably more important - and rare - than cash capital, which is abundant these days. For example, sometimes our maps suggest that a company can become more competitive by doing a particular clinical trial, licensing another drug so they can create a combination therapy, or partnering with a particular pharmaceutical company.

We are always making connections between our companies and potential partners. And when our companies need to raise additional capital, we help put together a financing, either leading a deal ourselves or helping to find a new outside lead. Our strategy is to be an active participant in the growth of a company, not just to be a passive investor.

Do you favor public or private companies? Where in the cap structure do you typically operate?

In sheer numbers, a bit more than half of the companies in our portfolio are public. When looking at private companies, we value time to IPO, but we've also invested in startups that will stay private for a few years. Private companies have to have a more attractive risk-reward than a public one due to liquidity differences, but we don't look at them as discrete market segments. We see a single continuum defined by a unified risk-reward-liquidity equation. We've only rarely done debt-based financing and not yet done any royalty-based financing, but otherwise we can be anywhere in the equity cap structure as long as the risk-reward-liquidity equation is attractive.

How much does the science drive the investment thesis for a particular company? What else plays a role - management, technology, potential market, IP, etc.?

All of those elements matter. Biology is challenging and can confound even the most skilled team, so we always start by confirming that a company has a sound scientific premise and compelling data. Then we want to see a good team, one that is both experienced enough to see the project through as well as creative enough to come up with unexpected solutions to unexpected problems. Creativity also allows a company to grasp new and valuable opportunities to apply their technology. Sometimes a drug can do more than one thing. And of course the market has to be adequate and patents in order. Our team is well equipped to conduct such diligence on dozens of investment opportunities at a time.

Biotech and Pharma have been very popular sectors for a long time. Are they overvalued?

It's certainly true that biotech used to be a risky distraction for many professional investors, like a trip to Vegas. However, it is proving itself to be an engine of productivity that investors can't afford to bet against, at least not for the long run, and many are realizing that it deserves a permanent allocation within their portfolio.

Investors who believe we're in a bubble that should revert to historical levels are rooted in the past, not the present. They don't see how the fundamentals have improved. We're in a new era of biotech. A decade ago, we wouldn't have believed that the biotech sector could be this effective or mature. There are bubbles and undervalued opportunities that coexist, frankly, at all times – but you can't paint the whole sector with that 'bubble' brush.

There are many different themes within biotech. Certain areas are seeing continual innovation; more cancers are being cured than ever before and some genetic diseases now look like they might be beaten. The sector may correct, giving back some gains from time to time, but scientific advances like that can never be undone. Now fueled with more capital and talent than ever before, we're seeing breakthroughs with a regularity that would have been previously unimaginable, which is what makes biotech one of the most compelling sectors out there.

So for a manager like us, there is always an area or company that is underappreciated and undervalued; we focus on these opportunities. We are as idea-rich and eager to buy into these companies as ever, partly because our team is more efficient and our level of diligence more sophisticated than ever – so we know how to distinguish between the truly great and the seemingly great players in each space.

What is your executive-in-residence program?

We offer an Executive-in-Residence program for experienced executives who want to join us and see the industry from our perspective - working with us to evaluate hundreds of technologies and companies - and use these insights to inform their next career moves. We want to see how someone we respect with real industry experience, when empowered by our platform, chooses from among all the options to invest their precious time and reputation. That might inform where we invest.

What is one interesting or unusual fact about your firm?

We'll map anything. For example, we made a career map for our website to help potential applicants decide whether they want to apply to join our TechAtlas division; it shows how a scientist might choose among investment banking, consulting, and many other career options, including joining us. We even once tried to map beers for fun, and our lead graphics designer once made a map of all dog breeds, showing how one might decide based on certain needs and preferences.

The needs of our portfolio companies sometimes take us into new territory. For example, one of our portfolio companies has a device for scanning your ear canal, initially intended for custom hearing aids. But it also opens up the world of sensor-laden consumer wearables for the ear, so-called hearables, so we're about to start mapping that area of tech. Healthcare intersects with a lot of other technology sectors, so it's good to keep one's skills sharp. You never know what you may need to map next.

General Disclaimers

The information contained herein (the "Materials") is provided for informational and discussion purposes only and contains statements of opinion and belief. The Materials are not, and may not be relied on in any manner as, legal, tax, or investment advice. The Materials do not constitute an offer to sell, a solicitation to buy, or a recommendation for any security, nor do they constitute an offer to provide investment advisory or other services by RA Capital Management, L.P. and its affiliates and/or any investment products it advises (collectively, "RA Capital" or the "Firm"). Each recipient should make its own investigations and evaluations of RA Capital, and any investment products it advises, and should consult its own attorney, business adviser, and tax adviser as to legal, business, tax, and related matters thereto. The information contained in the Materials is not intended to be, and should not be viewed as, "investment advice" within the meaning of 29 C.F.R. §2510.3-21 or otherwise.

Any views expressed herein, unless otherwise indicated, are those of RA Capital as of the date indicated, are based on information available to RA Capital as of such date, and are subject to change, without notice, based on market and other conditions. No representation is made or assurance given that such views are correct and such views may have become unreliable for various reasons, including changes in market conditions or economic circumstances. Such views may have been formed based upon information, believed to be reliable, that was available at the time the Materials were published. Certain information contained herein concerning economic trends and/or data may be based on or derived from information provided by independent third-party sources. RA Capital believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based. RA Capital has no duty or obligation to update the information contained herein.

The content of the Materials neither constitutes investment advice nor offers any opinion with respect to the suitability of any security. Any references, either general or specific, to securities and/or issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, advice or recommendations to purchase, continue to hold, or sell such securities, or as an endorsement of any security or company. Certain current and prior investments may be highlighted in order to provide additional information regarding RA Capital's investment strategy, the types of investments it pursues, and current or anticipated exit strategies. In addition, due to confidentiality restrictions, the information contained herein might not reference investments in certain companies. Accounts managed by RA Capital may invest in certain companies referenced in the Materials; however, RA Capital makes no guarantees as to accuracy or completeness of views expressed in the Materials. Any strategies and companies referenced in the Materials may not be suitable for all investors.

As stated above, the Materials are not an offer or solicitation for the purchase or sale of any security, including any interest in RA Capital Healthcare Fund, L.P. (the "Master Fund") or RA Capital Healthcare International Fund Ltd. (the "Offshore Fund," and, collectively with the Master Fund, the "Fund"), and should not be construed as such. Such an offer will only be made by means of a confidential Private Placement Memorandum (the "PPM") to be furnished to qualified investors upon request. The information contained herein is qualified in its entirety by reference to the PPM, which contains additional information about the investment objective, terms, and conditions of an investment in the Fund, and also contains certain disclosures that are important to consider when making an investment decision regarding the Fund. In the case of any inconsistency between any information contained herein or in the Materials and the PPM, the terms of the PPM shall control.

The Materials are proprietary and confidential and may include commercially sensitive information. As such, the Materials must be kept strictly confidential and may not be copied or used for an improper purpose, reproduced, republished, or posted in whole or in part, in any form, without the prior written consent of RA Capital. The recipient of the Materials must not make any communication regarding the information contained herein, including disclosing that the Materials have been provided to such recipient, to any person other than its authorized representatives assisting in considering the information contained herein. Each recipient agrees to the foregoing and to return (or destroy upon RA Capital's instructions) the Materials promptly upon request.

Any investment strategies discussed herein are speculative and involve a high degree of risk, including loss of capital. Investments in any products described herein and the Fund's performance can be volatile, and investors should have the financial ability and be willing to accept such risks. An investor could lose all or a substantial amount of his or her investment. The Fund may be leveraged. Interests in the Fund are illiquid, as there is no secondary market for the Fund interests, and none is expected to develop. The Fund interests are subject to restrictions on transfer. Prior to investing in the Fund, investors should read the PPM and pay particular attention to the risk factors contained therein. Fees and expenses charged in connection with an investment in the Fund may be higher than the fees and expenses of other investment alternatives and may offset investment profits of the Fund. RA Capital has total trading authority over the Fund. The use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequentially, higher risk. A portion of the trades executed for the Fund may take place on foreign exchanges. It should not be assumed, and no representation is made, that past investment performance is reflective of future results. Nothing herein should be deemed to be a prediction or projection of future performance. To the extent any prior or existing investments are described, RA Capital makes no representations, and it should not be assumed, that past investment selection is necessarily reflective of future investment selection, that any performance discussed herein will be achieved or that similar investment opportunities will be available in the future or, if made, will achieve similar results.

In particular, to the extent valuation information is provided for any unrealized investments, such valuations are RA Capital's estimates as of the date set forth in the Materials, and there can be no assurance that unrealized investments will be realized at such valuations. While RA Capital believes any valuations presented herein are reasonable, such valuations may be highly subjective, particularly for private investments, and are based on information provided by third parties and/or RA Capital's assumptions, any or all of which might be mistaken or incomplete. Actual realized returns will depend on, among other factors, future operating results, the value of the assets and market conditions at the time of disposition, any related transaction costs, and the timing and manner or sale, all of which may differ from the assumptions on which the valuations contained herein are based. As a result of the foregoing, actual realized returns may differ materially from the valuations contained herein.

Certain information contained in this document constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "target," "project," "estimate," "intend," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events or results or the actual performance of any investment may differ from those reflected or contemplated in such forward-looking statements. Prospective investors should not rely on these forward-looking statements when making an investment decision.

None of the information contained herein has been filed with the U.S. Securities and Exchange Commission, any securities administrator under any securities laws of any U.S. or non-U.S. jurisdiction, or any other U.S. or non-U.S. governmental or self-regulatory authority. No such governmental or self-regulatory authority will pass on the merits of any offering of interests by RA Capital or the adequacy of the information contained herein. Any representation to the contrary is unlawful. The interests in the Fund have not been, and will not be, registered under the U.S. Securities Act of 1933, as amended, or qualified or registered under any applicable state, local, provincial, or other statutes, rules, or regulations. The Fund has not been, and will not be, registered as an investment company under the U.S. Investment Company Act of 1940, as amended.