

## Federal money up for grabs

### Proposed changes to a federal grant program would allow more companies to compete for R&D money.

Annie Johnson | BRBJ



*David Hungate / Dominion Images | Steve Poland, CEO of Prime Photonics in Blacksburg, knows that proposed changes to a federal research grant program could make it harder for his small, self-funded company to get money.*



*David Hungate / Dominion Images | Chris Westcott, an electrical engineer at Prime Photonics, adjusts a piece of test equipment. The company develops sensors and instrumentation.*

Like many CEOs of high-tech startups, Steve Poland of Prime Photonics values research money that he's not obligated to pay back.

Poland's Blacksburg-based company has been the recipient of grants set aside by the federal government for research and development activities.

But under pending legislation that would reauthorize the Small Business Innovation Research and Small Business Technology Transfer grant programs, smaller companies could face more competition for this integral pool of money.

That's because one of two major reauthorization proposals would allow companies that are majority-owned by venture capital firms to be eligible for the grants, thus widening the spectrum of qualified recipients.

The government projects a \$2.6 billion budget for the program in 2011. Currently, Virginia is the third largest state recipient of SBIR money. And roughly 50 active SBIR grants have been awarded in Southwest Virginia, according to the office of economic development at Virginia Tech.

Some in the region believe that allowing venture capital-backed companies to benefit from the federal dollars could put smaller, self-funded companies at risk of being left out. Others maintain that venture capital provides a much needed investment boost, and that companies able to secure such funding have a greater potential to commercialize their product, which is a primary goal of the federal funding programs.

Ann Eskesen, who runs a Massachusetts-based consulting firm for large companies looking to partner with SBIR recipients, said that massive changes in the venture capital community have brought the issue to the forefront. Small, early-stage firms are being divided among more and more investors, and venture



*David Hungate / Dominion Images | A miniature wind tunnel sits in front of a board filled with engineering notes at Prime Photonics.*



*David Hungate/Dominion Images | John Coggin, chief engineer at Prime Photonics, adjusts a high-temperature vacuum chamber at the company's Blacksburg headquarters*

capitalists who want to make larger investments are forced to look at more established companies. A startup that can get SBIR dollars -- and that thus needs fewer early-stage investors -- could become more attractive to venture firms at later stages.

"The venture capital community was having to invest more money in the company they were investing in, and for a longer time period," Eskesen said. "What's very important to them about the SBIR money is that it's free money -- there is no dilution of their ownership of that company when a firm is getting SBIR dollars."

In the Roanoke and New River valleys, where scores of small companies are backed by various forms of capital, some entrepreneurs believe allowing VC-backed firms to get in on the program isn't such a bad idea.

"As a small business that isn't VC-backed, competing with well-funded VC-backed small businesses makes things difficult on us," Poland said of his self-funded company, which develops sensors and instrumentation. But, he added, if a business has already gotten capital through VC participation, "that can increase the probability of that small business being successful in commercialization."

Perhaps, then, it comes down to a conversation about the purpose of the program: to launch new technology, or to support small business research efforts.

Or, potentially, both.

## Early funding

The SBIR program was created in 1983 to funnel more federal research and development money to small businesses.

Every federal department with an R&D budget of \$100 million or more must have an SBIR program, which usually dedicates about 2.5 percent of the total budget to SBIR activity.

Agency SBIR efforts involve three phases. In the first phase, awards of up to \$100,000 for six months help pay for merit and feasibility studies.

Projects that show potential after the first phase are eligible for awards of up to \$750,000 for one to two years to perform more research and development.

The final portion of funding, which is typically directed at commercialization, is expected to be generated in the private sector. Federal dollars, but not SBIR funds, can be used if the government thinks the new technology will benefit society. The expectation is that by this point, a smaller SBIR firm has partnered with a larger company to bring the product to market.

At least one reauthorization of the SBIR program has directed agencies to weigh commercial potential as a factor in considering proposals.

Even so, some firms have been able to survive solely on phase I and II grants, Poland said. That is not recommended, and some believe it flies in the face of the one of the program's purposes: to bring new technology to market.

"There is an expectation that a company that derives its revenues from government-sponsored R&D will transition over time into a company that derives significant revenues from products," said Victor Iannello, president and CEO of Roanoke-based Synchrony, which in January received \$10 million in funding from New River Management VI, a venture fund managed by Radford-based Third Security.

He doesn't think a company that successfully raises venture capital should be penalized in the SBIR process.

"Indeed, the infusion of venture capital into a technology company is a strong testament to its commitment to bring products to market," he said.

Jim Flowers, who heads VT KnowledgeWorks, an arm of the Virginia Tech Foundation that focuses on incubating technology businesses, echoed that sentiment.

"If they're good enough to get venture money, they're good, and that means that they have a higher probability of succeeding with the SBIR's objective," he said.

Doug Juanarena, whose Blacksburg consulting firm helps early-stage firms find capital, said virtually all of the companies he works with receive STTR or SBIR funds. He doesn't see why a VC-backed firm shouldn't be eligible for the grants. In fact, when Juanarena came to the area to start a Luna Innovations spinoff, Luna was among the largest recipients of SBIR money in the country, he said.

But, he added, the process could be handled differently.

For example, companies already earning enormous profits have an advantage over small startups that might be in dire need of early-stage capital. He thinks those less capitalized firms should take priority.

"That would be a better way of adjudicating it, I think," he said.

### **Changes afoot?**

It's a question that has had Congress stalled for some time. SBIR is currently running on its ninth continuing resolution, which provides short-term funding to keep the program running. After a Sept. 28 vote to extend the program as-is, it's now set to expire Jan. 31.

The House and Senate both have passed legislation that would reauthorize the program.

Currently, small businesses that are majority-owned by venture capital firms can't participate. The law mandates that small businesses must be 51 percent owned by an individual or individuals. Venture capital was permitted and encouraged but limited to 40 percent of the ownership interest, according to the Congressional Research Service.

In 2001, the Small Business Administration decided that "individuals invested in the business" referred only to actual people, not corporations. Two years later, the SBA determined that venture capital firms could not be considered individuals for the purpose of deciding ownership.

The House version of the bill, however, would allow participation of such corporations, as long as the company meets a series of tests -- for example, VC representatives could not constitute a majority of a board of directors.

The Senate measure would direct federal agencies to award no more than 8 percent of SBIR funds to majority venture capital-owned small businesses as long as no single VC company owns more than 49 percent of the small business. It would allow the National Institutes of Health to award no more than 18 percent of SBIR funds with the same stipulation.

Both bills were passed in 2009, but House and Senate representatives have not yet reached a compromise.

Nydia Velázquez, a Democrat from New York who heads the House Small Business Committee, supported participation by venture firms, arguing that it provides a much-needed investment boost.

In the Senate, Mary Landrieu, a Democrat who heads the Small Business and Entrepreneurship Committee, maintained that allowing too much participation by venture capital-backed companies takes away opportunities from many of the small businesses the program was designed to help.

The National Small Business Association agrees.

"The House position will dramatically change the program from a small-business program with a level playing field for the smallest companies to one that favors larger, well-funded companies with lobbyists and large marketing departments," the association wrote in an April newsletter.

Third Security has a different way of looking at it.

Yes, said Rob Patzig, its chief information officer -- it would be nice to have access to the SBIR money. But it's not a huge deal for this local company.

Patzig said that his firm has put millions of dollars into companies, and a Phase I grant of \$750,000, for example, wouldn't do anything substantial.

"We spend that much in a day," he said.

Patzig also said there shouldn't be a difference between a group of individuals who pool their money and those who choose to invest on their own, as with angel investing.

Sunder Malkani, president of OcuCure Therapeutics in Roanoke, is funded by angel investors. He thinks the SBIR money should be used to help get companies to a stage that is attractive to venture firms as those firms invest money in later-stage companies.

"Allow the smaller companies to advance the science," he said.

The National Association of Venture Capital draws a clear line on its position: Its members would love to get in on the SBIR money.

In June, Jack Biddle, founding partner at Novak Biddle Venture Partners, a venture capital firm in Bethesda, Md., testified on behalf of the NAVC.

Biddle pointed to a 2009 report from the National Academies of Sciences on venture funding that found, among other things, "there is no indication that 'venture-controlled' firms crowded out non-venture-controlled firms; and restricting access to SBIR funding for companies that benefit from venture capital investments would disproportionately risk affecting some of the smallest innovative businesses."