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Biotechs: Recent VC Exit Trends

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Venture capital exits generally come in the form of initial public offerings or merger/acquisition transactions of portfolio companies. According to Ernst & Young's annual report on the state of the venture capital industry (*Transition: Global Venture Capital Insights Report 2006*), the US and Israel have seen increasing M&A activity in recent years, while Europe has experienced an increase in IPOs. This trend has not, however, been seen to apply to biotechnology companies of late. Although IPOs have historically funded late stage trials and product launches, there appears to have been a recent decline in the number of VC-backed biotechs achieving an IPO exit both in the US and Europe. (Interestingly, Israeli biotech firms have been an exception to this trend with a spate of offerings taking place on the Tel Aviv Stock Exchange 'TASE' in the past two years (See *Life science firms trek to the TASE, IVCJ*, March, 2007).

Recent Trends in the US

Some commentators believe that the increased M&A activity in the biotech sector in the US during 2005 and 2006 will not diminish in 2007, and that there will be at least 30 biotech IPOs this year – a level last seen in 2004. This is despite the fact that there were only 18 IPOs in 2006 and 17 in 2005 – almost all of which were priced at or below the bottom end of their pricing range. Although Sirtris Pharmaceuticals successfully went public in March this year, other recently planned biotech IPOs, such as BioVex's \$45 million offering, have been shelved. Most recently, both Prestwick Pharmaceuticals and Voyager Pharmaceutical Corp. cancelled planned offerings, citing poor market conditions. The increase in the minimum size requirement for an offering, compared to the late 1990s, and the increased cost and burden arising from Sarbanes-Oxley may be contributing factors to this depressed IPO trend. Nevertheless, it is anticipated that recent revisions to Sarbanes-Oxley relating to small companies may help reverse this trend.

Recent Trends in the UK

Despite the recent success of the AIM market generally, AIM cannot be considered a mature market for biotech. As of the end of April, 2007, there were only 43 biotechs from a total of 1,639 companies listed on AIM. Of these, 11 listed in 2005, 15 in 2006 and only 2 so far this year. European biotech portfolios may suffer more than their US-based counterparts given that Europe has fewer large biotechs. In the current climate, it is only relatively mature companies – those with promising Phase II results or those in Phase III – that are likely to succeed in the public market.

On the other hand, there appears to be a current trend toward a greater number of trade sales in the UK biotech market. Larger biotechs are increasingly looking to acquire smaller entities for new products to boost their development activities and global research infrastructure, while such transactions offer target companies access to wider distribution channels. Since December, 2005, there have been a number of biotechs that have taken the M&A rather than the IPO route, including KuDOS Pharmaceuticals and Arrow Therapeutics, which were acquired by AstraZeneca; Domantis Ltd., acquired by GlaxoSmithKline; Oxxon Therapeutics, acquired by Oxford BioMedica; and

Paradigm Therapeutics, acquired by Takeda Pharmaceutical. The Domantis acquisition for £230 million in cash was one of the largest acquisitions in terms of size for a private biotech.

The majority of small to mid-size biotechs are typically engaged in on-going R&D with one or more licensing agreements in place with larger pharma companies. This structure makes pre-IPO valuation difficult, with financial advisers typically implementing valuation metrics below the level that the VC investor anticipates or desires. Accordingly, public markets are increasingly perceived as a strategic financing source rather than an exit event – a potential alternative to a series C or D financing round – enabling the VC investor to keep the company progressing, while providing the potential to achieve a cash exit at a later date.

The fact that biotech business imperatives are influencing the form of exit is borne out in Ernst & Young's 2006 Report, which highlighted the increase in the median time from initial investment to exit – three years in the mid-1990s to five years in 2006. In biotech investments, this period is now usually seven years or more. The impact of this longer investment period to exit creates a greater emphasis on capital efficiency, staged portfolio financings, milestones and the mitigation of risk. Such a changing exit timetable may also create a need for turnaround strategies and distressed exits.

Why the Trend Away from IPO Exits?

The move away from IPO exits appears to be driven by general conditions in the markets in which the entities operate. Traditionally, biotechs are perceived as struggling. Costs associated with R&D and compliance with drug regulations and safety protocols are rising, while margins are shrinking. As drug patents expire, competition from generic manufacturers is growing.

Many factors in the current environment make IPOs an unlikely exit strategy, including:

- market fashion and sentiment, which traditionally influence IPO markets and cannot be relied upon for an objective view of a firm's potential
- the lengthy timetable involved in taking a company to market
- high legal and regulatory approval costs in IPO preparation
- the relatively substantial size and scale of a business needed before it becomes attractive to the market
- the ongoing costs and regulatory requirements, particularly in the US, associated with operating a public company
- the necessity for continued growth and 'good news' that public markets require to avoid stock illiquidity
- the necessity for VC shareholders to enter into lock-up periods (typically 6-12 months) leaving them vulnerable to adverse price movements and less control over the business during this period of potential volatility.

It is unsurprising, therefore, that commentators have started to query whether public equity markets and biotechs are currently suited to one another. However, with the increasing globalization of the industry through licensing and M&A arrangements, it would seem that exit opportunities in global markets may increase.

Outlook for 2007 and Beyond

The biotech industry is currently engaged in a healthy M&A cycle, with many companies being able to achieve far better valuations from larger pharmaceutical companies seeking to bolster thin pipelines than from public investors via IPOs. It is likely that M&A transactions in the UK, as with the US, will continue to drive the general exit strategy for VC investors in small biotech companies, not because IPO exit strategies are failing, but because consolidation in the industry is a necessary part of growth. With such consolidation, the European public markets in particular may support biotech in the future more than they do at present. This, in turn, may heighten the financial viability of an IPO exit.