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Upward trend in financing continues, but fewer feel flush

For biotech finance, 2006 may wind up being a banner year. Fundraising by public and private biotech companies totaled about $27 billion by early December—that's almost one-third more than in 2005. But the picture may not be quite as rosy as it seems, as almost all of this increase came from a handful of exceptionally large debt deals.

Amgen, in Thousand Oaks, California, accounted for roughly one-sixth of the biotech financing for the year with a $5 billion debt offering. But this deal, the largest debt offering ever floated by any biotech company, wasn't the only such transaction. Three of the five largest recorded biotech debt offerings occurred in 2006, according to data from *BioCentury*. Follow-on financing also continued apace at $4.6 billion by early December, but may end down slightly from $4.8 billion in 2005.

For smaller biotech companies, venture capital (VC) investment and initial public offerings (IPOs) flowed steadily, although those financings came at a high price, as valuations dropped off precipitously from last year. The difficult IPO market could continue to make merger-and-acquisition (M&A) and substantial partnership deals, both of which flourished in 2006, increasingly attractive company alternatives.

Biotech financing bottomed out five years ago but has been rebounding steadily as it climbs towards the record levels of 2000 (**Figure 1**). In late 2003, a biotech IPO window opened that continues to remain active. But there is little of the rampant public and private investor enthusiasm that has characterized previous strong periods of investment.

"2006 is not hugely different from '04 or '05," asserts Stelios Papadopoulos, recently retired vice chairman of investment bank Cowen & Company. He argues that biotech investment is becoming more rational, driven increasingly by evaluations of company merit rather than broad swings in investor favor, which historically have moved in a roughly three- to five-year cycle.

"Prior IPO markets lasted anywhere from a few months to a year and a half; this market has been going on for three years," notes Papadopoulos. "It is driven more by the quality of the company being offered than any type of market event or transient enthusiasm. The boom and bust cycle for biotech IPO markets is no longer in effect and is unlikely to come back."

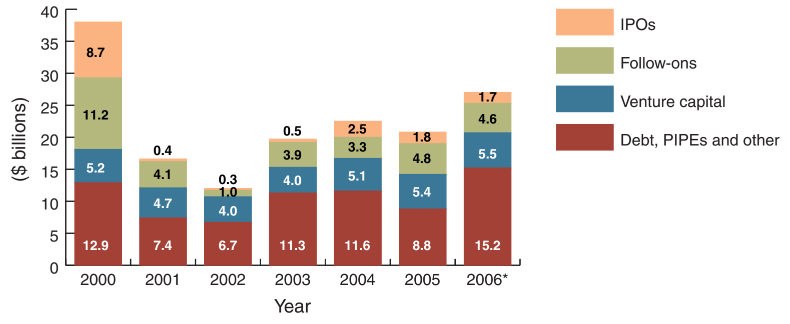

Figure 1 Biotech financing has been rebounding steadily, if slowly, as it climbs towards the record levels of 2000. *Data as of Dec. 7. Source: BioCentury

But with this increasingly rational approach, biotech is now failing to attract the broader range of institutional investors that flooded into IPOs during flush times. This, in turn, is helping to squeeze valuations. "In past windows you had a buy-side market that was willing to pay more than they are willing to pay now," says Barbara Kosacz, partner and head of the life sciences practice at law firm Cooley Godward Kronish.

"There are not that many buyers and they have more power than they've ever had before to set the price that they want," she argues.

As a result, in 2006, "you have a few deals going out that are big raises, but the rest are pretty crappy," asserts Kosacz. "Most of them got cut in terms of the price range and number of shares." Biotech IPOs rebounded a bit toward the end of the year to hit $1.7 billion with 43 offerings by early December, *BioCentury* data show. Still, the amount raised through IPOs has been steadily eroding since the last peak in 2004.

Median pre-money valuations for biopharmaceutical companies at IPO also fell to $110 million in the first three quarters of 2006, according to research firm Dow Jones VentureOne. That's down from $165 million in 2005; median valuations haven't been this low since 1998.

Younger companies are also feeling the effects of this increased conservatism in valuation. After holding steady for the last several years at around $19 million, pre-money valuations for VC-backed private biopharmaceutical companies nose-dived during the first three quarters of 2006 to just $15 million.

Still, in the aggregate, 2006 turned out to be the biggest year yet for biotech VC investment with $5.5 billion by early December, up slightly over 2005, which had edged out 2000 as the largest year for biotech VC investment.

The biggest change, however, may be that VC investors looking toward an exit in the face of relatively unattractive IPO options continue to eye an increasingly active and lucrative M&A market. IPO time frames have simply become too long for many VC investors, pushed out to at least five to ten years, as public company investors often insist on positive phase 2 data.

The number of M&A deals involving a biotech company continued to climb to new heights. According to data from research firm Recombinant Capital, there were more than 300 biotech M&A deals by early December 2006, fully one-quarter more than in the prior year.

This shift from IPO to M&A as an exit strategy will metaphorically weed out the men from the boys among VC investors, says Papadopoulos. "It's somewhat more challenging to anticipate the needs of pharma than it is to simply wait for the next IPO window."

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