



# Evolving paradigms in biotech IPO valuations

Going public with a valuation higher than \$300 million may now be necessary to attract interest from institutional investors, says Stelios Papadopoulos.



A few times over the past two decades, a confluence of forces has conspired to redefine the landscape of biotechnology and helped to propel the industry to a new level of size and complexity. Perhaps the most important trend in the year 2000 was not the arrival of dozens of genomics and genomics-related companies onto the public markets, but the abrupt increase in proceeds and valuations stemming from initial public offerings across the biotech sector. In the aftermath of the 2000 market, investment professionals and corporate executives alike are debating the forces that brought about the new metrics in the IPO market, and whether such metrics are historical aberrations or the signs of a new order in biotech.

## The first 20 years

Biotechnology's first entry into the capital markets—generally considered to be Genentech's (S. San Francisco, CA) IPO in October 1980—was a \$35 million offering. During the first 20 minutes of trading, the stock soared from an offer price of \$35 per share to \$88 and closed the day at \$56, giving the company a valuation of \$400 million. Next came Cetus; in March 1981, its IPO grossed \$120 million—at the time the biggest industrial IPO in US corporate history—and gave the company a valuation of approximately \$500 million.

Neither this growth trend nor the Genentech and Cetus IPO metrics continued. For much of the 1980s, most notably the market windows of 1983, 1986, and 1987, the average IPO raised \$20–30 million and left company valuations at around \$100 million. Later, as the markets opened up again and more biotechnology companies went public, there was a pronounced increase in total capital raised, but not necessarily in proceeds and IPO valuations.

For instance, in 1991, although a record 35 IPOs were completed, the average of \$30 million per company was consistent with the experience of the 1980s.

Notwithstanding traditional market cycles, the biotechnology sector retained this new dynamic through the 1990s. In fact, even during 1994, the worst year for financing in that decade, the US biotechnology industry raised more capital (\$1 billion) than in 1986 (\$900 million), the best year in the 1980s. In the best of times during the 1990s, the aggregate capital raised per year in the United States was several billion dollars, almost an order of magnitude greater than the best years during the 1980s.

## Tularik steps up

As the 1990s came to a close, a remarkable thing happened: Tularik, long considered a premier biotech company, filed for an IPO. It was remarkable because since its inception, the company had embarked on an aggressive capital-raising campaign with venture and institutional investors that brought its valuation to slightly above \$400 million, essentially precluding itself from a traditional IPO in the minds of industry observers. This value, coupled with the historical level of IPO valuations (the only IPO that would have represented a step-up in valuation was the Cetus one in 1981), created the interesting challenge of how to obtain liquidity for Tularik's investors.

There was also the element of timing. In an industry where capital is a strategic asset that becomes generously available only during so-called market windows, the ability to time financing attempts accurately represents a competitive advantage. Given that over the past 20 years, such market windows have amounted to about 10% of the total time and that they often arrive unannounced, choosing them carefully requires a combination of luck and insight.

*Stelios Papadopoulos is managing director of investment banking, health care at SG Cowen, New York.*



Thinking of a biotechnology IPO in the fall of 1999 was neither reckless nor naively hopeful. There were signs that suggested that a financing window would soon open: the high-tech sector was growing tired, smart investors were beginning to lock in profits, and the increasing noise level surrounding the human genome sequencing initiatives was beginning to make biotechnology look exciting. Biotechnology, after a few years of lackluster stock performance, could be the next Internet—or so many investors started to think.

After evaluating a variety of exotic structures, Tularik's management chose the most straightforward solution, namely, to file for an IPO at a valuation mildly above that of the last private round. And within that simplicity there was elegance. The timing was perfect as the IPO was met with investors emerging from hibernation and willing to consider once again biotech ideas. This time the ideas were coming with the added patina of genomics, the biotech version of Internet investment nirvana. That Tularik was not a genomics company did not matter much. It was a high-quality biotech company and that sufficed. And as far as the valuation was concerned, it turned out to be much less of a problem than anyone had anticipated. Timing again was just right, as the market was about to make a dramatic reevaluation of biotech IPO metrics.

The deal was filed in mid-October 1999 with an indicated price range of \$11–13, giving the company a valuation of approximately \$500 million. When the deal was priced in mid-December to raise approximately \$100 million, the offering price was \$14, and it closed at \$20.125 after the first day of trading. By year's end, the stock was at \$32.375, and it continued to rise to the all-time high of \$89.625 on February 18, 2000. A mere two months after the IPO, the company's value had soared to \$4 billion. The company managed to raise another \$110 million selling 2,875,000 shares at \$38.84 on March 22, 2000 and the venture investors had ample opportunity to lock in profits through secondary stock sales and distributions.

### The class of 2000

Investment bankers may have a lot of shortcomings, but they clearly have a unique attribute. Namely, they can read market trends and capitalize on them faster and better than professionals in most other sectors. Hot on the heels of Tularik, companies began filing for IPOs. The market frenzy reached its peak during the first quarter of 2000, and notwithstanding a slowdown in

IPO activity later on, 2000 was a record year for biotechnology financing. In all, 63 IPOs were completed in the US, raising \$5.4 billion. The average IPO proceeds soared to \$85 million, after moving within the \$20–30 million range for most of the market windows during the preceding 20 years.

Just as rapidly as the market changed, so did the behavior of investment bankers. The typical biotech IPO was universally considered to be a \$100 million, three-handed transaction. Deals below \$100 million were looked upon with a blend of pity and indifference. And, as investment banking old-timers often reminisce with mild amazement, the fees earned in some IPOs in 2000 were greater than the total proceeds of some of the tougher, smaller deals that were completed under duress in the 1980s and 1990s.

It is interesting to analyze the forces and circumstances that brought about this change in valuation metrics. Certainly, the companies that had IPOs in 2000 were not demonstrably better than their counterparts during the previous 20 years. One conclusion could be that either the current valuations are too high or the previous ones were too low. The answer is not quite that simple.

Even though much of what happens in the context of the relationship between biotechnology and the capital markets is cyclical in nature, there have been certain secular trends. Perhaps the most important is the continuing growth in the size of funds and the average amount of money available to each fund manager. For example, whereas a typical biotechnology-specialized fund in the 1980s was measured in the tens of millions of dollars, an equivalent fund today is 10–20 times larger. The obvious consequence of this is that the size of the average stock position has grown by the same amount; it is not uncommon to see single positions today that rival the size of whole funds of the 1980s.

By the end of 1999, this shift in fund sizes has rendered most biotechnology stocks essentially illiquid. Given that most funds prefer not to own more than 5% of the outstanding shares of a company, a \$25 million investment position would call for a minimum valuation of \$500 million. And that \$25 million could easily be one of 40 or so such positions in a \$1 billion portfolio.

The new order has basically determined that no matter what the investment merits may be of a biotechnology company with a market cap of \$100–200 million, the broad institutional investor market cannot consider it. Consequently, whenever such investors decide to purchase shares in biotech IPOs, they can only choose among those with

market capitalization satisfying their liquidity needs and potential upside consistent with the fund's performance objectives. This all sounds reasonable, except that common sense dictates that the higher IPO valuations take away from the ultimate returns. That is true on average, but investors over the years have come to appreciate that in biotechnology, it is far more important to pick the right stocks than the cheapest ones. For instance, holding Amgen shares offered at a split-adjusted price of \$0.75 per share in the June 1983 IPO has generated an investment rate of return (IRR) of 28% through mid-2001. If the valuation of Amgen at the time of IPO were \$500 million instead of the actual value of \$190 million (in itself a high value for that time), the IRR would be reduced to 22%. Even though the decline is significant, it is preferred to the complete losses associated with a number of biotech investments.

### The way forward

It is hard to imagine fund levels shrinking back to 1980s levels. Therefore, it is reasonable to assume that for the foreseeable future, we will either have IPOs in the \$300–500 million range or we won't have them at all. A low valuation (e.g., in the \$100–200 million range) will not necessarily attract more investors, but will clearly undermine the stock's liquidity. IPOs completed at such a valuation range—and some will indeed get done—will look more like private placements rather than registered public offerings. What may happen is that companies filing for IPOs will be more mature and better capitalized. This could be consistent with the excess capital now available within the venture ranks and the need for venture capitalists to commit more capital per company.

On the other hand, IPOs almost always get done in an environment in which investors believe that new issues in a particular sector are likely to trade up in the immediate post-IPO market. That perception more than anything else drives the deal market and, in a sector in which valuation analysis based on fundamentals remains a daunting challenge, it will continue to do so. The simple conclusion is that IPOs will happen as always in the cyclical fashion typical of biotech, but when they happen their valuations will be at valuations at the multi-hundred million-dollar level established in 2000. One would hope that all of us would exercise greater discrimination in identifying and backing those companies likely to make a significant difference and evolve into industry leaders. **15**