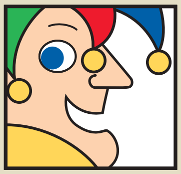
Biotech IPOs: handle with care



Tom Jacobs, of the Internet site Motley Fool (http://www.fool.com/), provides his angle on biotechnology investments. Read on and become "Foolishly" informed*.He can be contacted about biotechnology and investing at TomJ@Fool.com. Jacobs cannot give individual investment advice but welcomes any.

It's that time again. Warm and fuzzy public markets are briefly thawing the biotech sector, which you may have noticed has been languishing in the midst of a protracted financial winter—maybe even a mini Ice Age (see p. 1413).

Although a raft of public floatations may herald much popping of champagne corks for managers and employees at lucky firms, the swelling of biotech company treasuries, increased job satisfaction at venture capital firms and pinging jackpot sounds at investment banks, the news is not necessarily good for individual investors. Why? Because initial public offerings (IPOs) are financing events for companies, not tremendous opportunities for investors.

IPOs made easy

The events leading to an IPO generally unfold like this. Entrepreneurs found companies. As it's no fun to burn their own money (presuming they have any left from previous ventures), they next seek investor capital to fund company development and products. They beseech venture capital firms that invest pools of money entrusted to them by risk-tolerant wealthy investors. The venture capitalists (VCs) take the risk and invest their clients' money.

The money is not free. Company founders agree to give up part of their ownership share in exchange for the cash. All parties agree on a valuation for the company and the venture capitalists receive percentage ownership of company stock in proportion to cash invested.

The VCs expect to lose money most of the time, but make windfall profits from the rare home run, which they can only score when their investment conducts a 'liquidity event,' that is, the sale of the company to another company, a buyout of the VCs or (yes, you guessed it) an IPO. Such events provide liquidity for the venture capital investment—cash or the opportunity for cash for venture capital. You can't drink what ain't liquid!

IPO timing

Of course, the company founders are also looking for payback. They've toiled for years, given up nights and weekends, become strangers to their families and usually learned rather too much about their colleagues' personal habits. They earn less and have fewer benefits than if they'd taken that cushy job at Pfizer (New York, NY, USA; NYSE:PFE). Plus, their company's research and development department is a black hole for cash: in biotech, you must feed the hungry beast.

So to maximize company and personal gain, when do they decide to first sell shares to the public? Bingo! When they think that market sentiment will lead large institutions to purchase huge blocks of their shares at the highest price (or close if the bankers underprice to give deals to favored clients), enriching the company treasury and perhaps them as well. Think late 1999, early 2000 for anything 'genomics.'

Of course, because market enthusiasm for unproven biotechs comes and goes and generally affects the industry *en masse*, there is not an orderly progression of biotech IPOs. In practice, what happens is that companies stand in line and when the IPO window opens, they all rush out together, each trying to get the best deal.

Be aware and beware!

As an individual investor, you are thinking: "If the investing market is so favorable that this company has chosen now to secure the best possible return, how likely is it that I'm paying a reasonable price?" The answer is, not likely at all—which is exactly as it should be. The IPO is a financing event, and the company owes its pre-IPO investors the effort to make them the most money. Because you and the rest of the public are not yet investors, the company owes you nothing. Watch out!

On the flip side, not every company has the luxury of choosing whether or when to have an IPO. It may need money now, which may be a lousy market for its shares, when even the investment bankers that can sell ice to Canadian indigenous peoples can't make large institutions buy. Outside of biotech, used golf club retailer Second Swing (Minnetonka, MN, USA) has been trying to get an IPO out the door since 2002, but apparently can't find enough buyers at any price.

So if companies go public in a lousy environment, it screams that they are desperate. They will take any terms from anyone just to get the thing done, and the stock price often falls quickly—as did the Loudcloud (now Opsware; Sunnyvale, CA, USA; Nasdaq:OPSW) venture of Netscape Internet browser inventor, Marc Andreesen, in 2001, plummeting under $1.00 (it's since recovered). This is not a situation that should attract an individual investor.

The moral of the story is simple. Because IPOs are financing events for the company, they occur at times of maximum market enthusiasm or maximum company desperation, both usually a disaster for investors.

Exceptions

Yes, they exist, and you can find them. To start, a great source is the *Investor's Business Daily* newspaper that regularly includes a table of companies contemplating IPOs and stock prices for recent IPOs. You can find who's on deck using the US Securities & Exchange Commission's web interface (http://www.sec.gov/edgar/searchedgar/webusers.htm) to see who's filed a Form S-1 (Registration Statement), which is required for a company planning to issue shares.

Then, if you think a company might be a good investment when it offers shares, read the S-1 yourself to learn about its business and financials and how much of a gamble you might be taking. Remember that although almost every public company today was once private, it's the rare firm that provides big rewards from IPO day on the scale of a Microsoft (Redmond, WA, USA; Nasdaq:MSFT) and eBay (San Jose, CA, USA; Nasdaq:EBAY). And even for those companies, you could have waited to see their perfomance when public and learned more, and still made money if you invested later. Biotech IPOs are events almost always best observed from afar, and certainly not with any money that isn't marked "for high risk only."

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