EDITORIAL

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# Exiting this year and into the next

There once was a time when the initial public offering (IPO) was without rival in the hearts and minds of biotech investors and entrepreneurs. The thought of a champagne cork-popping event like Genentech's fabulously successful IPO in 1980, which saw shares of the S. San Francisco firm leap from $35 to $88 in less than an hour, was enough to set the heart of any investor racing. But times are changing. Today, it is not the IPO, but the trade sale that is on everybody's lips. And the action is not in late-stage, but early-stage deals, with big biotech, not big pharma, making most of the transactions.

According to Recombinant Capital, from January to November this year, there have already been 190 biotech mergers and acquisitions (M&As), with a total value of $48.8 billion (cash is not disclosed for all M&A deals). For the same period in 2004, there were 141 deals bringing in $26.9 billion; whereas in 2001, there were only 155 deals amounting to $15.8 billion. Not all of these M&As were trade sales (i.e., where a private biotech receives cash for its assets), of course, but the 'stock' of the trade sale is clearly on the up.

Digging deeper into the data reveals that big biotech, not pharma, accounts for most M&A activity, although the deals tend to be much smaller. Big pharma accounted for only 5%, 7% and 7% of M&A biotech deals in 2001, 2004 and 2005, respectively. Yet the few pharmaceutical companies shopping are spending more: they contributed over a third of the M&A cash spent on biotech in 2001, a fifth of that spent last year and more than a half of this year's money. It seems that in recent months, a one-time US federal tax break under the American Jobs Creation Act 2004 has prompted cash-flush pharma to go on an extraordinary shopping spree for US biotechs.

From a small biotech's point of view, perhaps the major reason that a trade sale is becoming increasingly popular is that the likelihood of a favorable public offering is becoming increasingly remote. Unlike the boom times in bygone years, public offerings no longer raise significantly more funds than trade sales. Today, the number of biotech companies capable of receiving on the public markets a favorable price that provides a good return on investment has dwindled to a trickle: so far this year, just 35 biotech companies went public compared with 100 in the 'bubble' of 2000.

The other reality is that small biotech companies with a promising product or technology no longer have to wait as long for a prospective buyer. Big pharma and big biotech are now not waiting until late-stage data are available to do deals, when a product's commercial prospects can be neatly plugged into net present value calculations to divine market worth.

This is demonstrated clearly by licensing data. Eight of the ten largest discovery stage deals ever announced in biotech were completed this year. What's more, both the average and median value of these deals increased dramatically from 2004–2005 over 2002–2003 relative to the vaunted late-stage deals that have been cast as the be-all and end-all ever since the market crash in 2001. The average value of (reported) phase 1 deals, for example—and keep in mind that not all deals are made public—increased just 15% from 2003 to 2005, from $86.9 million to $100.1 million. Meanwhile, the average value of discovery stage deals during this time frame climbed 37%, from $55.6 million to $76.2 million and the preclinical deal average soared 136% from $53.1 million to $125.4 million.

One of the main reasons pharma and biotech anglers are looking farther upstream is that the flow of valuable late-stage biotech products is diminishing. As venture capitalist Mike Ross, a partner in San Francisco-based Silicon Valley Life Sciences, puts it: "They've picked over the later-stage opportunities so thoroughly, now they're grazing farther up the food chain. If you have a target that the pharma companies believe in, you can get terms that are almost equivalent to a phase 2 deal."

What's new is that all of this deal-making has tilted the balance of power for in-licensing terms once again toward smallish biotechs that are making the innovative products. As a result, in many cases, it is now cheaper to buy a biotech than to in-license its products. The best, but far from the only, example is Pfizer's acquisition last January of fledgling La Jolla, California-based Angiosyn for $527 million plus a cut of royalties on the company's only drug, a preclinical-stage biologic (T2TrpRS, a fragment of a tRNA synthetase) for age-related macular degeneration. It would only be rational to assume that this was a freak display of M&A, but we suspect that like the growing intensity of hurricanes, trade sales in 2006 involving smallish biotechs with hot early prospects will continue and produce even larger numbers. After all, the incentives driving big pharma and big biotech to cut early-stage deals with biotechs will only increase with time.

Deals like those between Pfizer and Angiosyn, or Novartis and Chiron last month, might make more headlines. But it is cash-rich, big biotech—not only established firms like Shire Pharmaceuticals, Cephalon and Genzyme, but also relative newcomers like Valeant Pharmaceuticals or Guilford Pharmaceuticals—that is doing the lion's share of deals. And it is big biotech that is offering the greatest exit opportunities to investors and entrepreneurs of small biotech companies.

So although the IPO is likely to remain the Holy Grail for aspiring entrepreneurs and pioneers of biotech ventures, the trade sale has clearly gained new stature as arguably the more realistic option for those seeking a positive return on their investment. And if the public markets continue to give biotechs disappointing valuations, looking for a potential buyer might prove an easier and more fruitful goal than looking for the Grail.