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Exit strategies in Europe

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As well as overcoming legal, cultural and linguistic barriers, European biotech companies must focus on building investor visibility, pharma collaborations and consolidation to boost their chances of successful exits.

Bringing a biotech product to market is a long and gruelling process, taking years and sometimes decades. Managing the expectations of investors, who often have commitments to return capital to limited partners on time scales much shorter than those for biotech product development, is thus a critical goal of any biotech venture. But, for several reasons, providing investors with viable exit options has proven particularly difficult in Europe over the past few years.

Here, two German biotech company executives, a French venture capital fund manager and a Swiss valuation expert explore the investment climate in Europe for biotech companies seeking exits. They go on to discuss the critical issues influencing exit strategy and the factors contributing to success or failure. This article is excerpted from a *Nature Biotechnology Bioentrepreneur* roundtable discussion convened at BioSquare, in Geneva on March 8, 2006. The transcript has been edited to address the major themes of that discussion.

How does the European investment climate differ from that in the United States?

Jean-Yves Nothias: To understand this you have to look at what has happened in Europe over the past five or six years. Many of the prominent biotech companies, such as Genset in France or Transgene or LION Bioscience of Germany, that were around a decade or so ago when I started as a financial analyst, haven't really succeeded. As yet, compared with the United States, there is not a real critical mass of successful biotech companies in Europe to foster investor confidence, and we have suffered a lot during the past few years from a financing drought that has hamstrung European entrepreneurs wishing to get good valuations for their companies.

Jean-Yves Nothias: managing director of the investment arm of Société Generale Asset Management Alternative Investments (SGAM) based in Paris, where he leads the biotech team.

Another problem is that in Europe we don't have a NASDAQ-like stock market. That's a major issue. At the moment we only have disparate markets such as LSE-AIM (London), Euronext-Alternext (paris, Brussels, Amsterdam, Lisbon) or Deutsche Börse (Frankfurt). We should be aiming to have a common, global market in Europe.

On the other hand, if you look at the US today, it's also very difficult for biotech companies to get listed on the public markets. A lot of my US investor colleagues are complaining about valuations on the market; right now they have to accept valuations given by the market that are lower than their own valuation as venture capitalists. So I would say, it has been difficult in Europe, but it's not that much easier in the US, and the playing field is leveling. In the future we should see more higher quality companies in Europe being built on the basis of products and even technology platforms.

The other point I would make is that the European market is quite inefficient compared with the US: the US market is a one-unit market with the same rules for everybody. When you talk about merging companies from the UK with companies from France or Germany, you run into complexities due to the different legal aspects of the companies from different national jurisdictions. Even if you look at, for example, attracting investors from different parts of Europe, for them it is difficult to really understand, every time, the legal differences between countries.

For example, a German company we invested in some time ago also had a sizeable number of US-based investors, who preferred to have that company become a US legal entity. US investors considered that German laws and bureaucracy were too complicated, especially when you have to deal with social issues and when you have almost to shut down a company a year before it runs out of cash. US people who work in a commercial environment where there are a lot fewer business constraints tend to be afraid of these kinds of things. Thus, in terms of legal aspects, it is much more complex to do mergers and acquisitions (M&As) in Europe than in the US. One unfortunate consequence of this is that at some point, some people thought, "Okay, in Germany and in France, we don't know what to do, so we're going to turn to US investors and turn our companies into US entities." I personally think that is a mistake.

Patrik Frei: We did a study for the European Investment Bank last year to see what kind of debt-financing possibilities there are for European biotech companies, and the idea was to identify companies that could benefit. At the end, we found that there really aren't that many companies around that have this possibility because the European market is just not mature enough to be able to take such financing options compared with the US. In some ways, it's not necessarily a lack of available capital but it's the stage of the industry that we are at in Europe.


Patrik Frei: CEO of valuation consultancy Venture Valuation, based in Zürich.

I'd agree with most of what Jean-Yves said, although I'm not convinced about a common stock market. In Europe, there are different countries, cultures and languages. All of this makes it much more difficult in any business transaction. Many said that having a NASDAQ in Europe would solve all our problems. But we had EASDAQ and that failed; I'm not so sure if that is the Holy Grail for Europe. And even if you did have something like that again, the different nationalities, languages and cultures are a disincentive for Europe-wide investors. People like to invest in what they know and feel comfortable with; they invest in their local area. So I'm not so sure if a European-wide market would really solve all the problems we are facing right now.

What factors influence the choice of exit route taken by a private company?

Peter Buckel: I can talk about my experience at Atugen, an siRNA technology platform company based in Berlin, Germany, where I was CEO until September 2005. In the previous year, the firm had reached a stage where it needed further financing, but the existing investors (venture capital firms MPM Capital and Apax Partners) had already been vested for six or seven years, their funds were nearly finished and they wanted to exit. We looked both at mergers and at the possibility of doing [a] further private financing round. But at the time it was virtually impossible to get private money for a pure-play technology platform, so we ended up looking at other opportunities.


Peter Buckel: CEO of SuppreMol, a startup company based in Martinsried, Germany focused on autoimmune therapies.

Over the next year, we explored a series of merger possibilities: a US-listed company, a Canadian-listed company, an Australian company—which wanted to reverse merge into a NASDAQ-listed shell company—and also a German private company. We quickly dropped the option with the German company because it would have required additional private financing. This did not appear realistic, given that both firms had businesses based around technology platforms. In the end, a completely different opportunity came along in the form of SR Pharma, a company listed on the AiM. SR Pharma's original internal projects had failed, but it still had money and was looking for a new story. So we came together, and in June 2005 Atugen reverse-merged into SR Pharma. SR Pharma now is a London-based holding listed on AiM, and Atugen is a technology subsidiary based in Berlin.

Ulrich Dauer: At my company 4SC, a fully integrated drug discovery company based in Martinsreid, Germany, the business constraints were different. Although we could have merged or stayed private, we chose instead to approach the public market. But instead of doing an initial public offering (IPO), in December 2005, we took, if you will, a 'silent' approach, with a pure listing of our shares on the prime standard of the Frankfurt Stock Exchange. Before that, we had structured a private placement in two closings—in the first closing, we invited existing investors, and in the second closing, we raised money from investors who typically invest in IPOs or public companies. All in all, we raised a bit more than €10 million. With this money, on top of our cash reserves, we were able to pursue our goals for the following 24 months.


Ulrich Dauer: CEO of 4SC, a company focused on drug screening for anti-inflammatory and anticancer compounds located in Martinsried, Germany.

Why did we go that way, rather than merely staying private? First, we had a rather complex shareholder structure with five preferential share series and all sorts of preferential rights, such as liquidation preferences, anti-dilution, etc. We also had two so-called silent partnerships or long-term loans from governmental organizations. Because it was necessary to convert all the shares into common shares to fulfill the criteria for listing on the exchange, this process represented an opportunity to clean up the firm's whole shareholder structure.

We decided against a classic IPO because there are so many associated challenges, especially in the German market. 4SC has quite a moderate cash burn rate, so we decided that an IPO, which typically raises €40 or even €60 million, was not tailor made to our financing needs. Instead, the public listing option provided us with the advantages of going public without the hassles of a flotation.

The strategy has had several advantages. We have been able to increase our investor visibility. And we have provided our shareholders with the chance to directly benefit from the growth potential of our business. Existing investors have been locked in for 18 months; they can sell 20% of their shares six months after the listing, 50% after 12 months and the rest after 18 months. We allowed them to sell 3% of their shares because we had to offer them something to make them waive their preferential rights. Of course, the other advantage of the listing was it enabled us to generate funds that give us much more flexibility in pursuing our strategic goals.

What factors can influence your chances of achieving a successful exit?

PB: In the case of Atugen, we were in quite advanced negotiations with three potential partners, but in the end nothing came to fruition. In two of the cases, it did not happen because the partner company's investors ended up firing their CEO; they had irreconcilable differences about the desirability of the merger and/or the new CEO did not agree with the merger strategy. This shows how many things can fail in such a discussion, even if you have already proceeded a long way in your discussions and negotiations. For Atugen, the whole process, from finding merger prospects to actually achieving a reverse merger with SR Pharma, was a bit like a dance, the ultimate outcome of which could not have been anticipated or predicted at the outset.

UD: Our experience of M&As at 4SC is similar to Peter's. The thing with M&A, compared with other exits, is that most of the critical success factors are beyond the control of the management team. And it is even worse if you want to be the takeover candidate because, other than being good at your business, it is not clear what you should do as a management team to make your company more interesting to acquirers as a potential trade sale. So our conclusion was that you can't define M&A as a company strategy—it's more of an opportunistic thing.

J-YN: The truth is that at the end of the day, you are trying to sell products to the pharma companies, wherever you are, and whether you are a private or a listed company. That's where you succeed. That's one of the criteria, basically, for US companies to get listed—if they have a strong relationship with a big pharma that has taken a license on one of their products.

For example, one of our US portfolio companies was publicly listed in 2004, achieving a valuation that was much lower than the price we could have expected. But a year after, Novartis bought one of the company's products for a lot of money and the valuation of the company suddenly jumped from €100 million to €400 million. So it's always a question of how you foresee the potential of a product in one particular company to be bought by a big pharma. And if you are able to foster some competition between pharma companies for your product, then you get even better multiples on your valuation.

Right now, our fund is contemplating some of our first exits on the market with European-based companies. The first one is now in the public domain so I can comment on it: it's Cyclacel, a Scottish company. They originally tried to go public in 2004, but were not successful. They had a prestigious investment bank, Morgan Stanley, with teams in both London and New York, and they were trying to do a dual listing. The dual listing didn't go well, however, because basically the bank's two different teams in the US and in London had two different visions for the company, two different valuations, and two different client pools. So the transaction failed because the preferred route was to do a US-only listing, but the company had insufficient visibility in the US, where it's very important for investors to have company management in proximity. So we worked on that, and now Cyclacel has a subsidiary in the US, and what the management has chosen is to reverse merge into an empty shell, Xcyte—actually, it was not completely empty, it had €20 million in cash. And all involved are pretty happy about it because we see it as a liquidity event. It has been very difficult for Cyclacel to get to European banks or to get a good valuation for a European-based listing, so that was part of the issue.

Another part of all this is the importance of raising your profile with investors. Having banks producing reports on your company really helps you get liquidity. Maybe Ulrich can comment on that?

UD: Yes, of course it's important. At the moment, 4SC is not at this point because we are a small-cap company—our market cap is around €47 million—which does not generate tremendous interest from analysts at international banks. Clearly, though, our goal is to get them interested, and we know that this would have a positive impact on the liquidity of our stock. One thing we do have in Germany are small analyst boutiques or companies that you can ask to cover your company. And that is certainly one way to help small-cap investors get a kind of expert view on the potential of your business.

PF: This emphasizes an important problem for European companies: their small size. Even though we've been talking about it for five years, most companies are still too small, and there needs to be consolidation. An important point of most M&As, therefore, is to raise your size and profile through acquisition; to build a bigger company that then becomes more interesting to investors.

PB: I would add that the success factors in M&As, or in being taken over or in raising private money or IPO are kind of the same. You need to show some growth potential that is interesting for any partner. I'm not saying M&A is wrong, but you should focus on being good in your business, and then you will have those kinds of options.

When and how should company investors and founders discuss exit strategy?

UD: I've heard it said that some company founders don't like to talk about the exit. But talking about the exit is critical. Entrepreneurs, founders and investors all need to be on the same page about exit strategy because it's a game. Entrepreneurs need investor capital, but to attract investors into their business, they have to provide investors with attractive exit options. So if we are not in the same game, we cannot play. Basically, investors need exits because they need to raise funds and the funds are raised best on the basis of a good track record of exits.

It's important to remember that a financing event like an IPO is not just an exit event. If all the original investors ended up selling their holdings in the company during a flotation, the firm would lose credibility on the public market. So most companies have staggered lock-out periods for their private investors or things that at least show public investors there is some commitment to the company from the existing investors.

J-YN: European investors historically have had different time lines for exits from entrepreneurs. Every time an entrepreneur went to a private investor, the investor tried to lower the valuation and looked for an early exit; in other words, investors have been transforming business models in a manner that is often incompatible with the time lines for maturation of a company's science and technology. I think it's changing now. I see more venture capitalists backing companies, even technology platform companies. The difference now is that investors are injecting more money, both because they appreciate that more time is needed for companies to mature to the point where they have real products to sell and because with nothing to sell, it's very difficult to attract new investors to a company.

PF: As part of the valuation process, my company gets involved in the whole exit strategy discussion with a client. I meet the management team and have a workshop with them to really understand the basics behind the company and establish the right assumptions. I just came back from just such a discussion with an Italian firm, and it was interesting to see how they still didn't really understand the investment cycles of venture capital. And I think the constraints that venture capitalists are working under need to be better understood by entrepreneurs and management. Investors need to be able to exit at some point and they have a certain time frame. By talking to your investors, you can understand the lifespan/lifecycle of their fund and the time frame they have in which to exit. So I think it's critical that companies discuss exits with their investors, and as early as possible, so as not to have surprises at a later stage.

The discussion about exits also needs to take into account the different perspectives. What's the optimal exit for an investor? But also what's the exit possibility for the founders. A founder may regard an M&A exit very differently from an investor because an acquisition often makes it difficult for the founder to stay on board; in contrast, with an IPO, he/she can often retain their position and involvement in the company. Thus, I think this is a critically important topic for the management team and investors of a startup company to resolve.