FUNDING RESEARCH WITHOUT RED INK

UNIT OFFERINGS RAISE $343 MILLION

NEW YORK—Earlier this year Cytogen (Princeton, NJ), a maker of immunoconjugates to diagnose and treat cancer, faced a problem familiar to many biotechnology companies struggling to turn profits. Poised to introduce its first products, Cytogen hoped to break even in 1993 and make money in 1994. Yet it wanted to fund two new research projects involving immunoconjugates for bladder cancer and prostate cancer.

Cytogen needed to pay for the projects without chalking up red ink that would delay profitability. Selling stock wouldn't work, since using the money raised to fund the projects would show up as an expense on its balance sheet. Cutting a contract-research deal with an established drug company wasn't the answer either, since having the company pay for the projects wasn't worth giving it key marketing rights to future products. And setting up a research-and-development limited partnership to fund the projects wasn't likely, since such partnerships have largely lost their appeal after a 1986 tax law curtailed their deductibility.

Complicated stock offerings

So Cytogen did what a number of biotech companies have done lately. It set up an affiliate company, CytoRad, through a complicated stock offering called a unit offering. CytoRad will use the $35 million raised in its February offering to finance Cytogen's bladder cancer and prostate cancer projects and, in return, CytoRad will own exclusive rights to the technologies. If the projects are successful, though, Cytogen can buy back CytoRad, thus reacquiring the technologies. "Since Cytogen doesn't directly own CytoRad, CytoRad doesn't tarnish its balance sheet," says Martin Cleary, CytoRad's president and chief executive officer.

Cytogen isn't alone in the use of unit offerings. Over the past three years six biotech companies have raised $343 million through seven such offerings (table). Along with Cytogen, the companies include Centocor (Malvern, PA), Genzyme (Cambridge, MA), Immunex (Seattle, WA), Genetics Institute (Cambridge, MA), and Gensia Pharmaceuticals (San Diego, CA).

Unit offerings pay for research without chalking up red ink that would delay profitability.

Unit offerings are indeed complicated. Each unit an affiliate company like CytoRad sells to investors is made up of two pieces. One piece is a share of affiliate-company stock that a sponsoring company like Cytogen can call in at a set price that increases over time. The other piece is a warrant to buy a share of sponsoring-company stock.

Biotech Unit Offerings

Company	Affiliate	Date	Money Raised ($ Millions)
Centocor	Tocor I	7/89	$34.5
Centocor	Tocor II	1/92	103.5
Cytogen	CytoRad	2/92	35.0
Genetics Institute	SciGenics	5/91	40.0
Gensia Pharmaceuticals	Aramed	11/91	50.0
Genzyme	Neozyme I	10/90	52.9
Genzyme	Neozyme II	NA*	NA
Immunex	Receptech	11/89	27.0
Total			**342.9**

*NA means not available. Source: *Bio/Technology*

The offerings are expensive for sponsoring companies. They're designed to pay investors 30 percent annual returns for funding early-stage research, if the research is successful. Take, for instance, an affiliate-company offering that raises $10 million by selling 1 million units at $10 a unit. Of the $10 unit, say the affiliate-company share of stock is worth $8 and the warrant to buy a sponsoring-company share of stock is worth $2. Three years later, the $8 share of affiliate-company stock is worth $17.60, to achieve a 30 percent annual return. If the sponsoring company buys the affiliate company at that time, an investor more than doubles his investment, making $9.60 per share of affiliate-company stock. The $2 warrant, for its part, is valuable if the sponsoring-company stock has increased in price since the unit offering. The sponsoring company, however, doesn't have to buy the affiliate company if its research fails. Therein lies the risk to the investor.

Centocor buys in Tocor I

So far Centocor is the only sponsor to buy back an affiliate company. It purchased Tocor I on July 1, 1991, two years after Tocor I raised $34.5 million by selling 2.9 million units at $12 a unit. Centocor purchased each unit for $24 of Centocor stock, so investors doubled their money, at least at the time. Investors, though, couldn't exercise the warrant portion of their units until January 1, 1992, at an exercise price of $11.25 a Centocor share.

Genzyme plans to buy back a portion of its affiliate Neozyme I. Made up of six drug and diagnostic projects, Neozyme I raised $52.9 million in an October 1990 unit offering. Genzyme is currently trying to raise $73.5 million in a unit offering for Neozyme II. If the offering is successful, Genzyme will pay $23 million in cash and Genzyme stock to Neozyme I for its cystic fibrosis program. Neozyme II will then pursue protein replacement and gene therapy treatments for cystic fibrosis. "The buyback is controversial because the $23 million won't be passed on to Neozyme I investors to begin recovering their investment," says a biotech financial executive.

Whether unit offerings will continue at their current pace is uncertain. "They'll continue as long as affiliate-company research is successful. But they'll lose steam the first time a sponsoring company fails to buy back an affiliate," says David McLachlan, Genzyme's senior vice president of finance. **—B.J. Spalding**