

# Biotech IPOs—flop or pop?

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Newer biotech companies anxiously measure stock market sentiment to find the best time to first offer their shares to the public in an initial public offering (IPO). The past year has smiled on many of them. According to research firm Frost & Sullivan (New York, NY, USA), the current biotech IPO window opened again in September 2003, with 20 companies raising over \$1.17 billion through April 2004.

Today's IPO market may be stronger than it has been in years, but nothing like the 1999–2000 frenzy, when shares of newly public companies zoomed on their first day of trading far beyond their offering price. Of the two dozen biotech IPOs in the past year, only one, that of Eyetech Pharmaceuticals (New York, NY, USA; Nasdaq:EYET) saw a first-day closing price with a large premium, or 'pop,' over the offering price.

Contrary to conventional wisdom, little or no pop is actually a good thing. I know that's heresy. The popular measure of IPO success—how high the price catapults from the offering price during the early days of trading—persists. But it's just plain wrong.

## Company versus underwriter

In the most common type of IPO, an investment bank buys all the shares the company will offer and accepts the financial responsibility for selling them. The bank typically acts as the lead underwriter among several other banks and allocates shares to members of this syndicate at a discount, commonly 7%–8%.

The lead underwriter tries to promote the deal, taking the company executives and story on the road to meet institutional investors, money managers and stock analysts. The goal is to promote demand, secure conditional offers to buy shares and come up with as high

an offering price as possible. This is crucial for a young biotech. With years before products hit the market, it needs every last ducat from the IPO to survive.

Enter the conflict between the company and underwriter. To entice customers to this or any future deal, the underwriter needs to deliver a return. This presents an incentive to price the shares under what they might bring once available on the open market. Imagine how happy the underwriter's clients are if they buy shares at a \$20 offering price, only to watch them pop to \$30 when they open for trading.

Of course, it isn't that easy. Neither the underwriter nor anyone else really knows what price the new company will command on opening day, let alone the next day, week or month. Supply and demand change from moment to moment. But at the extremes—where there is a Grand Canyon between offering price and opening day price—you have to scratch your head. In the example in which a stock is offered at \$20 and opens at \$30, the company could presumably have offered the shares at much more than \$20, adding tens of millions to its bank account. The first day pop means the company lost money.

## Did the eyes have it?

Consider Eyetech, which has filed a new drug application for its Macugen (pegaptanib sodium) oligonucleotide aptamer treatment for macular degeneration. In its January 2004 IPO, the company sold 7.96 million shares at \$21 a share, raising \$167.2 million, before deducting investment banking fees. Public demand pushed the stock to open at \$30 and closed the first day at \$32.40, for a gain of 45%. Media coverage glowed.

But why? The company transferred \$76.6 million to the underwriter's clients. Anyone could misprice a deal by a few percentage points and hear no complaints, but 45%? Sure, on the one hand, the company achieved the impossible. Its work gained currency in the marketplace, validating years of sacrifice. IPO money brought a better shot at developing

more drugs, benefiting patients and rewarding shareholders. At any price, the IPO certainly beat the alternatives, such as scaling down or even withdrawing the offering due to lackluster demand. Yet, wouldn't the company be even better off with another \$77 million or part thereof?

## Perspective

I'm not blaming investment bank underwriters. They want to provide their client investors with a reasonable gain but almost certainly aren't looking to attract attention with a huge first day pop. They know that encourages those buyers to sell the stock quickly and depress the share price, despite strong underwriter pressure against such flipping.

And if its share price rises significantly and stays there, a company can always offer more stock later. Many biotech companies that went public before the 1999–2000 boom took advantage of the exploding market sentiment to do so. The problem is that poor IPO pricing can deprive a company of the extra cash it may need to survive until then.

## Ideal world

In Bio-topia, IPOs would be priced accurately to reflect opening day and subsequent demand. The price in the early days and months would barely move—up or down—without significant business developments affecting future potential profits. Over many months and years, the price would slowly increase as the company made good decisions about which drug candidates to advance, enjoyed trials that produced excellent data of safety and efficacy and secured US Food and Drug Administration (Rockville, MD, USA) approvals. This rarely happens, because capitalism is a messy business, stock markets behave irrationally in the shorter term, and of course, not every new company succeeds.

But through it all, one truth will not change. A big first day pop isn't a sign of success for a biotech company. It's a red flag that it didn't receive its true worth. 

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