BIOBUSINESS BRIEFS

DEAL WATCH

The rise of option agreements

Option agreements to postpone critical partnering decisions have long been used by smaller companies in the pharmaceutical industry that have limited resources to license technologies requiring substantial financial commitments. However, as our analysis presented here shows, such agreements are also increasingly being used by large pharmaceutical companies, with a surge of such deals in 2009 (FIG. 1).

Analysis of the PharmaDeals database reveals 550 collaborative deals between 2005 and 2009 in which an option agreement was a significant component of the deal. In this context, an option is an opportunity, but not the obligation, to make a business decision (also called a real option) and is not tradable, in contrast to option securities on the financial markets. A range of option types were included, including the opportunity to license a specific technology, to license additional intellectual property, to extend the R&D programme, to supply or co-promote a product, or to acquire equity. Overall, just over 75% of these deals were between small to mid-sized companies, with the remaining 24% involving the top 20 pharmaceutical companies (assessed by annual revenue). Notably, the number of deals involving the top 20 companies has grown rapidly recently, increasing 65% from 26 in 2008 to 43 in 2009.

Although this growth began earlier, the recent cash-flow crisis in the biotechnology sector is a key factor underlying the dramatic rise in option deals involving the top 20 companies, which have seen a unique opportunity to minimize their financial risks while securing immature but potentially attractive intellectual property and locking out competitors. Given their size, these companies are prepared to pay a higher price for such options, and payments of US$10–20 million are not uncommon.

From the perspective of the smaller partner, in the era of the biotechnology boom of 2003–2007, when investments were easier to obtain, the then low option fees created an aversion among investors towards this type of transaction, as it gave little upfront cash to their companies and capped the future value of the intellectual property in a predetermined licensing deal. However, in the current economic situation and with the aggressive entry by large pharmaceutical companies, these perceptions are changing. A high-value option deal can now be a viable alternative to a licensing deal and may even pay after successes of development milestones, although without the security of a future commercial partnership commitment.

Further analysis of deal-making activities by the top 20 companies reveals that only ~12% of options in the 129 deals involving these companies have been exercised since 2005. As most of the original deals were done at candidate lead or preclinical stages, considering the attrition of candidates at these stages, this rate is not unexpected. Additionally, most successful options are exercised within 2 years of their signing, which is not surprising given that the generation of more research data can rapidly increase the confidence of a partner to initiate a license or to walk away from the deal.

Overall, in our view, option-based deals are exceptional instruments for licensees to limit their financial exposure while locking in potentially critical intellectual property. Despite criticism of such deals, they have gained significant ground in the pharmaceutical industry and will probably become increasingly popular among potential partners, given the high level of risk associated with pharmaceutical R&D.

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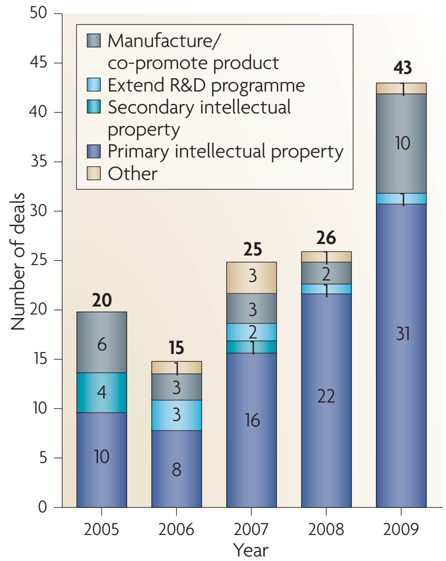

Figure 1 | **Trends in option deals by the top 20 pharmaceutical companies.** Option-based deals have become increasingly popular for top companies. Owing to increasing option fees, such deals are now a viable alternative to a licensing deal for immature assets requiring more time and resources to complete the necessary studies. Source: PharmaVentures analysis; PharmaDeals.