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Settling into the New Normal

Venture Crunch, More Virtual Firms: The 2011 Biotech Reality

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After the economy collapsed in the fall of 2008, biotech – and nearly every other global industry – battened down the hatches. Firms raised money when they could, cut programs and staff when they had to and settled in to wait out the storm, hoping for sunny skies in a year or two.

But during 2010, it started to become clear that economic recovery was not going to be just around the corner.

"It was a year in transition," investment banker Jack Florio, of Brinson Patrick Securities, said to sum up 2010. "In 2009, folks were scrambling to survive and just waiting for everything to get back to normal, but this is the new normal."

Overall, the industry managed to raise a healthy chunk of capital. *BioWorld Insight* reported public and private financings totaling $19.3 billion for the year, up from the $17.6 billion in 2009 though still a far cry from the $24.8 billion raised back in 2007.

"2010 wasn't a horrible year, in terms of aggregate dollars," said Glen Giovannetti, global biotechnology leader and Ernst & Young LLP. "But the trend continues of investors being very selective."

The Venture Club: Is it Members Only?

That might be painfully true for venture capital, especially if the venture investment community continues its contraction, as many are predicting.

According to *BioWorld Insight*, private company financings were up slightly in 2010 – $4.5 billion vs. 4.3 billion in 2009 – and "VC money has been OK in an overall down market," Giovannetti told *BioWorld Insight*.

The largest venture rounds in 2010 included Reata Pharmaceuticals Inc., which added $78 million in a Series G round aimed at giving the Irving, Texas-based company enough runway to get its chronic kidney disease drug bardoxolone to the FDA. Redwood City, Calif.-based Pearl Therapeutics Inc. also had success reaching out to new investor Vatera Healthcare Partners, which led a $69 million Series C round in October. (See *BioWorld Today*, July 12, 2010, and Oct. 19, 2010.)

And Giovannetti believes VC investments will continue in 2011, though the trend likely will continue toward virtual models and single-asset plays that can offer quick exits.

But Stan Fleming, managing member at Forward Ventures, said he thinks the venture community is in for a tough 2011. "The overall macroenvironment is showing signs of improvement, but biotech is still locked in the depths of the great recession. And, for the bio venture community, it's more like the great depression," he said.

There's less new money in the private market these days, leaving many syndicates to rely on inside rounds. And most of the venture money remains in the hands of a few. "It's a pretty inefficient market in the first place," Fleming told *BioWorld Insight*. "But with so few buyers, it's not really a market at all; it's more of a club."

For years, industry observers have been saying that the biotech venture model is broken. But as many biotech funds are reaching their decade mark, the question may be whether trying to measure venture investing in life sciences by the same yardstick as other industries like technology is a fool's errand. After all, drug development takes years and millions – and both of those figures seem to be expanding every year.

"I think it's time for the bio venture community to explore some new business models, because the old one has just not worked," Fleming said.

In the year ahead, it will come down to whether the venture community can gain access to new money. Fleming isn't optimistic, but the industry has seen a few funds close in the past few years, most recently new firm Longwood Founders Management LLC, which managed to raise $85 million in inaugural fund, with the aim of backing early stage innovation. (See *BioWorld Today*, Dec. 29, 2010.)

And now that big pharmas have finished digesting their mega-mergers, they should be looking even more at biotech assets, though partnering likely will be the preferred deal type. (See *BioWorld Insight*, Jan. 3, 2011.)

A Light in the IPO Window?

Probably the best news of the year was the opening of the initial public offering (IPO) window. After a nearly two-year IPO drought, the market was buoyed in 2010, with *BioWorld Insight* reporting that 19 biotechs had priced on global markets. Altogether, those offerings brought in a total of $1.2 billion and averaged about $64 million per offering.

The downside was that nearly every company priced below its anticipated range and most traded down after hitting the market. A handful also ended up having to return to public or private investors later in the year for additional capital, such as AVEO Pharmaceuticals Inc., of Cambridge, Mass., which raised a $61 million PIPE less than seven months after pricing an IPO at about a 35 percent discount to its target price. (See *BioWorld Today*, April 2, 2010, and Nov. 1, 2010.)

Fourth quarter IPOs seemed particularly harsh. Palo Alto, Calif.-based Anacor Pharmaceuticals Inc. slashed its offering price to $5 (from the hoped-for $16 to $18 range) and raised the number of shares from 4.7 million to 12 million. And San Diego-based specialty pharma firm Zogenix Inc. had hoped to sell 6 million shares priced between $12 and $14 each, but had to settle for pricing 14 million shares at a mere $4 each. (See *BioWorld Today*, Nov. 29, 2010.)

"Zogenix priced horrendously below range," Fleming said, though he noted that the stock did trade up later, "so that was one bright spot."

But the rash of steeply discounted IPOs that ended 2010 left Fleming to believe that the window is closing. "And as the window closes, strong companies step back. They can afford to wait," he said. "It's the weaker companies that have no choice and end up being very vulnerable to the monopolistic pricing."

Others were more optimistic.

"I think we'll see a similar number of companies [price IPOs in 2011], but stronger companies," said Brinson Patrick's Florio.

E&Y's Giovannetti agreed. "It's not going to be a bull rush," he noted, but for companies in Phase II- or Phase III-stage development, with validating partnerships and a solid R&D plan, the IPO will remain a possible exit.

As of Dec. 30, *BioWorld Snapshots* showed 18 firms with pending S-1s. Whether all or any of those will succeed in pricing is anyone's guess.

"The IPO window now is not the way we used to think about or describe it in the past 25 years of the industry," Giovannetti said.

For companies already established on the public markets, most have been able to go to investors when they needed in 2010, with 72 follow-on offerings last year vs. 54 offerings in 2009. But the amounts have gotten more conservative. In 2010, follow-ons raised $5.6 billion and averaged $78.1 million each, while fewer offering in 2009 brought in $6.5 billion and averaged $120.5 million each.

Biotech also began embracing some of the financing vehicles that have been used for years in other industries, Florio said. His firm recorded 25 at-the-market financings in 2010 compared to only nine the year before. And equity credit lines continued to be a popular flexible financing tool, with about a dozen of those in 2010.

Surviving Biotech's Brave New World

As in 2009, last year saw more than its share of dramatic restructurings, and those cuts left firms leaner and forced many to cut programs that either weren't producing or were too long term.

Biogen Idec Inc., of Cambridge, Mass., for instance said in November that it was moving out of the cardiovascular and oncology arenas, and South San Francisco-based Exelixis Inc. dropped work on all of its internal programs except for XL184, a dual MET/VEGFR inhibitor that yielded stellar Phase II data. (See *BioWorld Today*, Nov. 5, 2010, and Dec. 6, 2010.)

Companies could continue to make cutbacks in 2011, but don't expect the wave of restructurings that plagued the industry over the past two years.

"In general, folks should focus on de-risking assets they have, engage with partners early and continue to stay as lean as possible," Florio said.

And don't expect big pharma to come to the rescue.

"Certainly 2011 will be stronger than 2010" in terms of M&A activity," Giovannetti said, predicting that maybe 30 to 40 private companies might succeed in attracting buyers. "But it's not going to be an exit for everybody."

Besides, even if an acquisition does happen, investors still might not see all their money up front. The current buyer's market has made earn-out arrangements the deal structure du jour, with most of the big dollars coming on the back end, contingent on drug development and sales milestones. Indianapolis-based Eli Lilly and Co. only paid $180 million up front for Alnara Pharmaceuticals Inc. and its late-stage enzyme therapy liprotamase, with another $200 million due in regulatory and commercial milestones. And Onyx Pharmaceuticals Inc., of Emeryville, Calif., picked up promising late-stage cancer drug carfilzomib in a potential $850 million deal that called for only $276 million up front. (See *BioWorld Today*, Oct. 13, 2009, and July 6, 2010.)

The earn-out trend has been a boon to mid-size biotechs, like Onyx, which don't want to blow all their cash on a single deal. But for the sellers, it can be "brutal," Forward's Fleming said. "If all the quote-unquote exit does is entitle you to share risk [in further development], then the model doesn't begin to" pan out.

Still, it might be better for a firm to take an earn-out M&A deal rather than test its luck with the shrinking venture community or lukewarm public markets.

After all, Giovannette pointed out, the M&A "dynamics really haven't changed" and going into to 2011, "the pharma patent cliff is that much more acute." ■