Biotech Start-Ups Increasingly Opt For a Sale to Drug Firms Over an IPO

By David P. Hamilton

BIOTECHNOLOGY START-UPS long have followed a simple playbook: Go public at an early stage, keep raising money for a decade or more and eventually produce novel medicines that could make the company the next Amgen Inc. or Genentech Inc.

Increasingly, however, many start-ups are laying aside those plans. Instead, they are considering the once-unthinkable alternative of holding out until a larger pharmaceutical or biotech company decides to acquire them.

"It is a sea change in our industry that's really radically important," says Brian Atwood, a co-founder of venture-capital firm Versant Ventures in Menlo Park, Calif. "We've always thought about IPOs, about making the next Genentech. This has caught a lot of us by surprise."

Since 2003, acquisitions of biotech start-ups have significantly outpaced the initial public offerings that were traditionally a major milestone for maturing biotech companies. Since October 2003, when the current IPO-financing "window" opened for biotechs—investor enthusiasm for offerings in the sector is traditionally cyclical—67 private biotechs have made initial offerings, according to an analysis by consultants at Bain & Co.

Almost six times as many, however, chose to accept acquisition bids, Bain says. That analysis includes acquisitions of both public and private biotechs, although Bain says roughly 80% of these transactions involve private start-ups.

What's more, larger biotech and pharmaceutical companies are starting to pony up significant sums in these deals. The median value of biotech acquisitions last year nearly tripled to $170 million compared with the previous year, Bain calculates. Among the major deals: **Pfizer** Inc.'s acquisition of closely held Idun Pharmaceuticals for $280 million; the purchase of San Diego-based Syrrx Inc. by Japan's **Takeda Pharmaceutical** Co. for $270 million; **Johnson & Johnson**'s takeover of Peninsula Pharmaceuticals for $245 million; and **Merck** & Co.'s acquisition of GlycoFi Inc. for $400 million.

As a result, acquisitions appear to be more lucrative than IPOs. From 2003 to 2005, Bain calculates, buyers of private biotechs paid an average of 3.5 times the target's accumulated capital investment. Initial offerings over that period, meanwhile, valued start-ups at just twice the level of their pre-IPO investment.

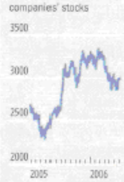
The surge in biotech acquisitions largely reflects a newfound hunger on the part of major pharmaceutical companies for drug candidates to fill their depleted pipelines. As blockbuster drugs like Merck's cholesterol-lowering Zocor lose patent protection and face generic competition, drug makers have largely turned to the biotech industry for fresh ideas. To a lesser extent, established biotech companies also are trolling for the next big idea.

At the same time, the market for biotech IPOs has grown markedly risk-averse. As recently as 2000, investors frequently snapped up initial offerings from cash-hungry biotechs with little prospect of a marketable product for 10 or 15 years. These days, however, few investors will even look at a biotech IPO unless the start-up has a drug candidate in late-stage testing, meaning that it might be only a few years away from possible regulatory approval.

DEALS

DEAL MAKERS

The Dow Jones Wilshire U.S. index of biotechnology companies' stocks



Source: Dow Jones Indexes

Even many of those IPOs have performed poorly. Since 2004, most biotech IPOs have priced well below their original asking range, one by roughly 50%. Of 13 biotechs that have gone public in the past year, shares of only four have appreciated significantly since the offering.

The rapid shift in financial dynamics has been disorienting for some biotech executives. In 2004, **Salmedix** Inc., a San Diego maker of cancer treatments, registered an initial offering in which it hoped to raise $86 million. As other biotech offerings foundered, Chief Executive David Kabakoff

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and his team decided against pushing forward with the offering, although they never withdrew the filing.

By the end of that year, Salmedix had presented promising early data from a clinical trial of its lead drug for non-Hodgkin's lymphoma, and several larger companies expressed interest in striking a partnership to take the drug through further testing and commercialization. Although Dr. Kabakoff initially hoped to strike a deal that would allow Salmedix to co-market and share profits from the drug in the U.S., the established biotech **Cephalon** Inc. stepped forward with a $160 million offer to buy the entire company.

Facing a lackluster reception in the IPO market and uncertainty about the prospects for the company's second-line drug candidate, Salmedix took the deal, which may bring an additional $40 million from Cephalon if the drug meets development milestones.

"There was some angst about it," says Dr. Kabakoff, who nevertheless expresses satisfaction that the deal paid off for company employees and its investors. "I and others in the management team would have liked to take the company forward and at least get the product into Phase III," or late-stage human tests, he says.

Many venture capitalists welcome the spate of acquisitions as a convenient way to "exit" from early-stage investments. In fact, private investors often can reap greater benefits from an acquisition than from an exit in the public markets, because preferred shareholders receive favorable treatment. In an IPO, by contrast, preferred shares are generally converted to common shares so as not to disadvantage new public shareholders.

Many venture-capital firms have hired pharmaceutical or big-biotech executives with deal-making experience. Two years ago, for instance, Versant hired Bradley Bolzon, a former business-development executive at Roche Holding AG. "He's a transaction guy," Versant's Mr. Atwood says. "We're using that skill set pretty aggressively."

In some cases, venture capitalists are starting to reshape their investment strategy as a result of the growing likelihood that their start-ups might be acquired. At New Enterprise Associates, another Menlo Park, Calif., venture-capital firm, partner Jim Barrett says he now makes investment decisions based in part on whether a start-up's drug candidates will ultimately be attractive to major drug makers.

For instance, venture financiers often traditionally favored companies whose drugs treat niche medical conditions, in part because a start-up could realistically market a new drug to a small group of physicians and patients with a specialized sales force.

Now, Dr. Barrett says, he is more open to experimental drugs that address broad markets, because big drug companies like them. The biochemist points to the firm's investment in **Targacept** Inc., a Winston-Salem, N.C., spinoff from R.J. Reynolds Tobacco Co., that is exploring the use of drugs that mimic nicotine as memory boosters, as the sort of thing he once would have shunned.

In other cases, to reduce the capital needed to get a firm to the IPO stage, venture-capital firms are pushing biotech start-ups to "virtualize"—often by licensing drug candidates from other firms, outsourcing important infrastructure and conducting clinical trials in low-cost overseas locations.

The big question haunting many in the biotech industry is whether the move toward an acquisition model—one in which biotechs could end up resembling medical-device start-ups, which rarely grow into independent companies and instead are frequently acquired by major device makers such as **Boston Scientific** Corp. or **Medtronic** Inc.—is a aberration or a permanent feature of the landscape.

"Without a sustainable IPO market, it becomes much more difficult to build the next Amgens," says Ivor Royston, co-founder of San Diego-based Forward Ventures, a venture-capital firm, and a former biotech entrepreneur. "I have a company here in my portfolio with the potential to be the next Amgen—if it doesn't get bought out."