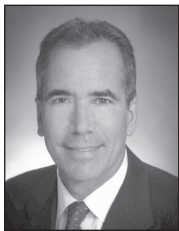




Biotech Valuations and Their Exit Strategy Implications

IPOs Are Down and M&As Are Up: This, Too, Will Change

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Over the last several years, investors in public biomedical IPOs have assigned substantially lower valuations than pharma and medtech companies have assigned to similar acquisition candidates in M&A transactions. This fact is shown

dramatically in Figure 1.

As one might expect, this preferential treatment of M&A transactions is a relatively recent phenomenon. If the time period 2002 to 2004 is examined, just the opposite was occurring. As Figure 2 shows, public investors assigned a much higher valuation to companies, at similar stages in their development, than did acquirers.

Sea Change

So what accounts for this rather dramatic shift in valuations? On the one hand, the institutional market of biotech IPOs is controlled by relatively few investors. Recent valuations of biotech IPOs have been disappointing to say the least. If biotechs have been able to go public at all, it's only after convincing some of these

investors to buy in, and these investors have put downward pressure on prices.

We also know a sea change has occurred within pharma companies in terms of their outlook for developing new products. The Wall Street Journal reported on page one

of a recent issue, "Over the next few years, the pharmaceutical business will hit a wall." Some of the top selling drugs in industry history, including Lipitor, will disappear as patents expire and generic drugs hit the market at a fraction of the price of their patented cousins. Figure 3 shows that \$67 billion of pharma sales will disappear between 2007 and 2012.

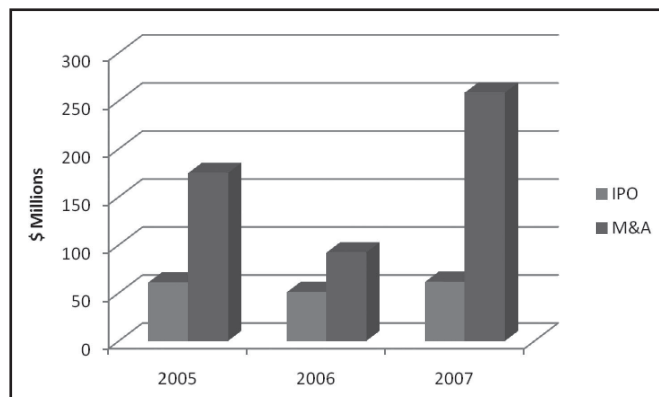


Figure 1: Average Valuations of IPOs vs. M&A Transactions, 2005-2007
Analysis: FairView Advisors; Data Source: Thomson Financial

At the same time as patents are expiring on some of pharma's most successful drugs, their own product development has stalled. The century old approach of finding small molecules (chemicals) to treat diseases is producing fewer and fewer drugs. Some influential industry researchers are questioning how many more chemical combinations there are that are useful against disease. Since all chemicals are derived from different combinations in the periodic table, there are only so many combinations left.



As effective chemical combinations prove harder to come by, chemical research is being superseded by biotechnology. And biotech drugs are particularly appealing because they face little threat of competition from generics. The FDA currently has no regulatory pathway to bring a generic biologic to market, and hence, there is no threat to the high prices drug companies charge for their biologic drugs. The net effect of all this is that big pharma has spent nearly \$76 billion since 2005 to acquire biotech companies.

So, two divergent forces – lower pharma revenues and diminishing prospects for new drugs – are working, and they have led to, and sustained, the valuation gap between private companies that become acquisition targets, and the similar companies that alternatively take the IPO route. But as is the case with all pendulum-like market forces, this gap should start reversing soon – enter crossover investors and funds like Orbimed, MPM Capital, QVT Financial, Wasatch, Hambrecht & Quist, etc.

The crossover fund's goal is to play the valuation gap between the last private round and the IPO, or the IPO and the expected higher eventual stock price, or the last private round and the M&A event. Naturally, the tens of billions of dollars of investible funds represented by these funds put upward pressure on potential IPO stock prices, and will lower the valuation gap between M&A valuations and IPO valuations.

Although recent market turmoil, caused by the roiling credit markets, has temporarily shut the IPO window, 2007 produced a substantial uptick in the number of

IPO filings and average funds raised by biomedical companies, as shown by Figure 4.

Exit Strategy

What does all this have to do with exit strategy? Those of us in the biotech industry know that biotechs are the solution to the pharmaceutical pipeline problem. The number of biotech products in clinical trials and new biotech/big pharma collaborations are soaring.

But it's not easy to bring new biologic drugs to market. Depending on whose numbers you believe, the cost of developing a single drug can be \$1 billion or more. Venture capitalists make investments because they believe they are going to make a significant return for their limited partners.

So, if you are an entrepreneur seeking funding for your biotech company, then you should be thinking of your exit strategy. The days of developing a fully integrated pharmaceutical company with research, development, manufacturing and sales operations are gone. It takes too much money and it simply isn't practical. Venture capital backers don't have infinite patience; they need to see

how they are going to get out of the investment with a handsome return.

The good news is there are now more possible exit strategies than ever before. In addition to the traditional IPO, the list now includes:

- M&A transactions, including licensing and corporate partnering;

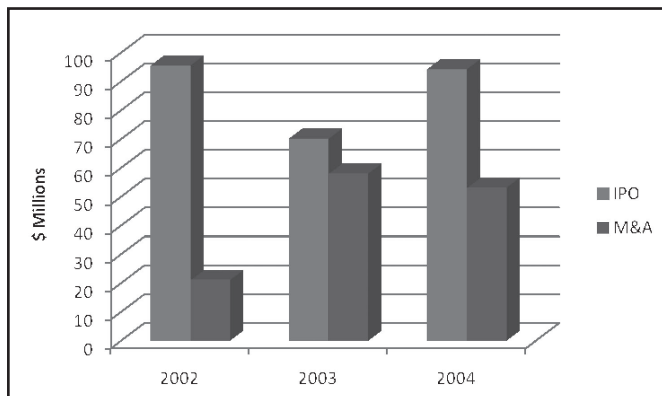


Figure 2: Average Valuations of IPOs vs. M&A Transactions, 2002-2004
Analysis: FairView Advisors; Data Source: Thomson Financial

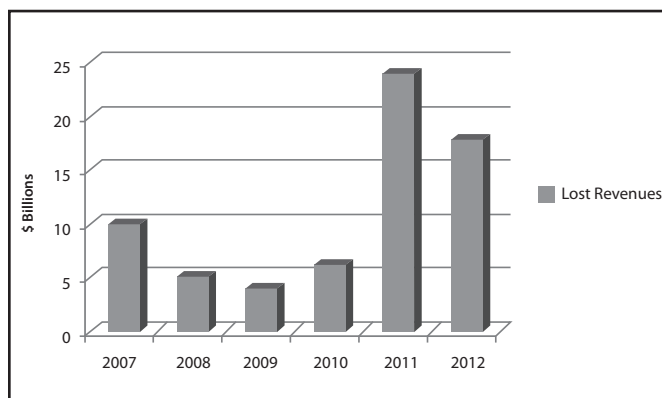


Figure 3: Pharma Revenue Lost to Patent Expiration
Analysis: FairView Advisors; Data Source: Sanford C. Bernstein & Co.



- Crossover funds;
- Biopharmaceutical, clinical development funds;
- Traditional hedge funds; and
- SPACs (special purpose acquisition companies or “blank check” firms).

The point is that there are many exit avenues entrepreneurs must cultivate in order to satisfy their venture backers.

Each one of these potential exits must be developed by communicating your story with compelling materials,

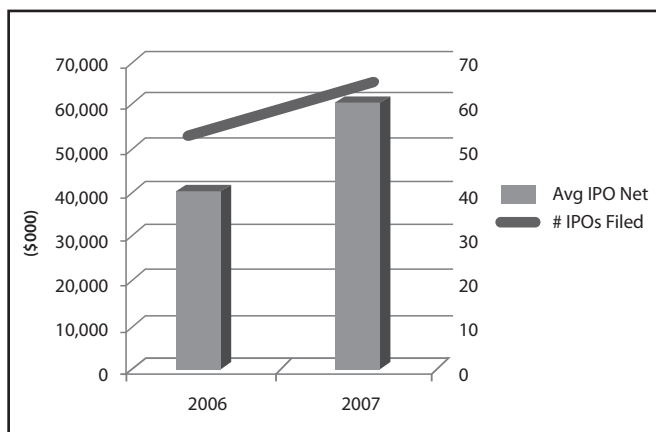


Figure 4: IPOs Filed and Money Raised
 Analysis: FairView Advisors; Data Source: Windover Information Inc.

conference calls, management meetings, solicitation of term sheets and negotiation of documents. This is a very time-consuming process, and it can interfere with successfully running your company and hitting important milestones.

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Seeking help from an outside firm knowledgeable in the variety of potential exit strategies and able to handle much of the day-to-day work involved in managing the exit process can lead to more favorable deal terms for your company and your venture backers. ■

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