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Survival strategies for start-ups

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Abstract
Following recent difficult private and public equity markets, many biotech start-ups are now under considerable pressure. In this environment, start-ups are struggling to secure financing and their valuations are being trimmed by investors. In order to survive, firms are being compelled to adjust their business models to satisfy investors, enter alliances to decrease their cash burn and consolidate with external assets to build critical mass internally.

INTRODUCTION
The last four years have been mostly characterised by appalling conditions for biotech companies and investors alike. The global biotech industry showed signs of recovery in late 2003 and early 2004 with 40 biotech firms going public and raising over US$2.1bn.[1] 2003 was a near record year for private equity investing in the sector in the USA. The recent decrease in valuations and number of initial public offerings (IPOs) is, however, pointing to a reversion of the global industry to harsher conditions yet again. If we focus on Europe, the market enjoyed a number of public offerings such as Epigenomics and Basilea Pharmaceutica, indicating an improved financial environment. The market, however, can hardly claim to have been bullish, with only five IPOs taking place during 2003 and 2004. Price performance of this group has been overall on a downwards trend. With a tightening public market, private investors are again becoming increasingly risk averse and price sensitive, with start-up companies suffering growing pressure as a result.

BUSINESS MODEL SHIFT
The environment for early stage companies has clearly changed over the past decade and this has brought significant challenges. Survival of start-ups is fundamentally reliant upon three building blocks: management, technology and financing, and these are interrelated. The key for many start-ups today is securing financing. For this, many companies have felt compelled to move their technology away from a service model to focus on a product-based strategy. Furthermore, companies have shifted away from platform technologies to clinical development businesses. Both of these adjustments have been largely triggered by investors who understand their exits are driven by late stage clinical products.

However, changing a business model can create a number of issues. Drug discovery and development is a long and expensive process and, as companies reposition their business, the need for capital is considerably increased. In particular, companies seeking to license - in products to broaden a clinical pipeline will probably require cash to support the costs of acquisition and development. As companies consume more cash, the overall allocation of venture capital becomes concentrated in fewer businesses rather than being placed more broadly across the industry. Finally, it is unclear how team skills initially optimised for early stage discovery can migrate into later stage drug development and often recruitment is required. In short, there are significant risks involved, but many management teams see it as the only option in the current climate to create a more sustainable long-term business.

Start-ups also benefit from a business model shift towards drug discovery and development

Despite the risks involved, start-ups evidently also benefit from a business model shift towards drug discovery and development. Firms have the opportunity to build pipelines of products with diversified risk profiles. Management can closely control product development by directly adding value to the development of their products and attempting to lower clinical risks. Companies that implement the business model successfully will capture a larger and more sustainable upside in principle than would a company with a service business model.

PARTNERING

With nearly US$3.5bn of partnering income generated in the first five months of 2004, biotech partnering activity continues to demonstrate the important strategic and financial role it plays in the global industry.[2] As biotech companies mature and move into drug development, there is an ever-increasing strategic need to build clinical expertise, business development and commercial capabilities to drive greater returns on their products and technologies. As a result, we are seeing an increasing number of partnering deals in particular for later stage companies with clinical products.

Consolidation can create value with cost savings, diversification of pipelines and optimasation of management

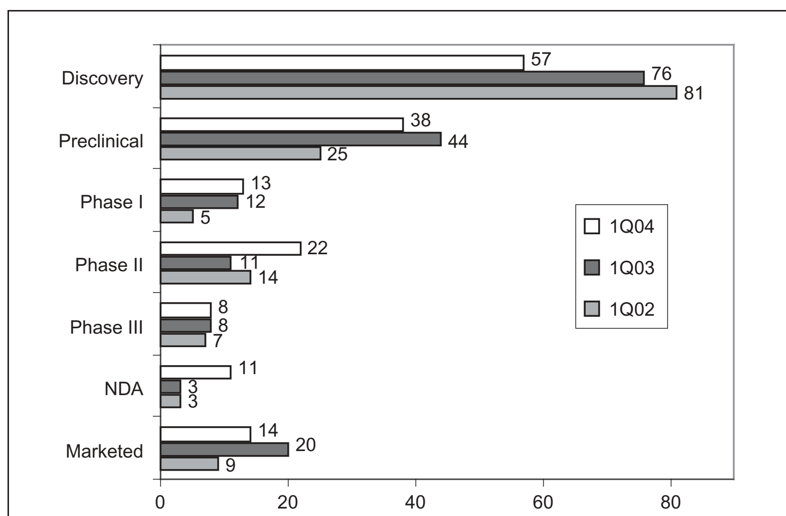

Figure 1: Number of biotech produce alliances by stage of development (1Q04 means the first quarter of 2004)
Source: Burrill & Company

A review of biotech product alliances during the first quarter of 2004 illustrates a growing number of alliances for clinical and marketed products, from 38 in 2002 to 54 in 2003 and 68 in 2004 (Figure 1). Hence it seems pharmaceutical companies are increasingly viewing biotech start-ups as a source of clinical compounds to sustain their thinning pipelines. In the first quarter of 2004 however, there was also a significant drop in the number of discovery deals as compared to the equivalent period in 2003. It is true nevertheless that we continue to see sizeable discovery deals such as Roche's US$178m deal with Syrrx and US$67m deal with 4SC, as well as GSK's second deal with Theravance for US$129m. This observation argues that strong and distinctive platform technologies still have the ability to secure large deals. So overall, biotech start-ups are benefiting from a growing interest from pharmaceutical companies and firms at the discovery stage, if lucky to be selected, can benefit from significant collaborations.

M&A – CONSOLIDATION

As smaller companies adapt to this new business environment, mergers and acquisitions (M&A) are also likely to increase in number. Consolidation can create value with cost savings, diversification of pipelines and optimisation of management. It can also help start-up companies achieve the critical mass that is important in justifying a sustainable business. Total deal volume continues to soar, with nearly US$15bn generated so far in 2004 globally (excluding the US$62bn Sanofi Synthelabo–Aventis deal).[1] Leading this activity are deals that demonstrate some sizeable consolidation of companies outside the USA, including the UCB–Celltech deal for US$2.7bn (Table 1).

Smaller start-up companies should be driving consolidation considering the benefits, but in practice, however, investor and management agendas can hinder the process. Managers coming out of biotech/pharma/academia may be

Table 1: Selected M&A in the second quarter of 2004

Acquirer	Acquiree	Value (US$m)
UCB	Celltech	2,700
BioMarin Pharmaceutical	Medicis Pharmaceutical	175
Pharmaceutical Resources	Kali Laboratories	145
ID Biomedical	Shire Pharmaceuticals	120

Source: Burrill & Company.

unaccustomed to the different challenges involved with M&A. Understandably the integrative process itself can be challenging and management will often perceive the integration of teams as threatening as there will be redundancies at the executive level.

Another major current challenge to M&A is of valuation and the perspective of shareholders. Investors might have become shareholders at different times or financing rounds, at different price points and with different rights associated with a liquidation event such as M&A. Consequently expectations may be different. In particular, they might be holding their investments at dissimilar values and will hence have different tolerance for shareholding dilution caused by combining assets. As a consequence it is often hard to align investors to agree to an M&A process even if it creates value in the longer term. In practice, venture capital investors' interest may become more aligned only when the company is failing and M&A is perceived as a last resort.

Capital is available but investors are uncertain about the numbers of exit opportunities feasible in Europe

Once M&A is finally agreed upon by managements and investors, the implementation of consolidation can also have challenging implications. In particular, integration of unfamiliar assets, teams and locations can be difficult and take considerable time. In addition, the assets might cause the company to lose a clear focus and the vision for the merged entity will need to be redefined. Overall the benefits of M&A can be lost in implementation issues and in order to benefit of M&A activities, the deal needs to be thought through early and the synergies strong enough to overcome the challenges.

FINANCING TRENDS

Over the past decade, venture capital investment in Europe has progressively increased to reach a peak in the bull market of 2000 with US$1.4bn invested (Figure 2). Since then, investment has been declining, reaching a low of US$850m in 2003. This decline does not reflect the general availability of VC funds, as most European venture funds are still sitting on significant cash to be invested.

So while the capital for biotech start-ups is available, investors are uncertain about the number of exit opportunities that are feasible in Europe. This is clear if you look at the number of IPOs seen in Europe over the past two years, which lag the USA by a factor of ten. As a result of this concern, venture investors are concentrating their investments into a small number of later stage companies and broadly shunning those start-ups seeking capital. Deal statistics reflect this, with 48 companies raising funds this year in Europe, of which 58 per cent of the funds are concentrated into only 11 companies (Table 2). It is getting harder for smaller companies to survive and hence consolidation becomes increasingly

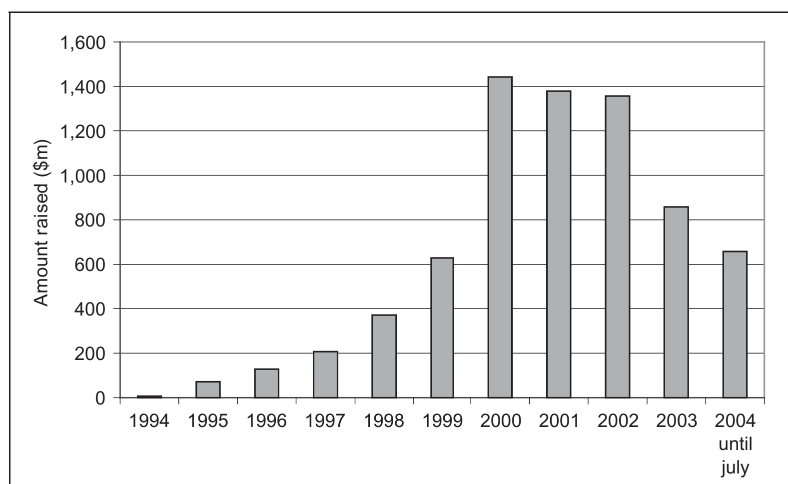

Figure 2: Total venture financing in Europe from 1994 to 2004
Source: Biocentury

Table 2: Largest VC fundraising rounds in Europe in 2003 and 2004

Company	Amount raised (US$)	Country	Year
Speedel Group	57,600,000	Switzerland	2003
Intercell AG	50,000,000	Austria	2003
Ardana Bioscience Ltd	48,512,000	UK	2003
Lorantis Ltd	42,212,500	UK	2003
Arpida Ltd	39,400,000	Switzerland	2004
Addex Pharmaceuticals SA	39,000,000	Switzerland	2004
Cyclacel Ltd	39,000,000	UK	2004
Jerini AG	38,100,000	Germany	2004
PowderMed Ltd	35,200,000	UK	2004
Arrow Therapeutics Ltd	34,860,000	UK	2003
igeneon AG	33,400,000	Austria	2004

Source: BioCentury.

inevitable. Venture investors who are driving this process believe the stronger companies although few will be better positioned for a European IPO or other liquidity event.

CONCLUSION

The emerging European biotech sector is currently undergoing significant structural change

In summary, the emerging European biotech sector is currently undergoing significant structural change in response to the issues of economics and sustainability. As European investors are concentrating their investment in few larger, later stage companies, the years immediately ahead will continue to be difficult for the majority of smaller biotech start-ups. If we accept the cyclical nature of the global industry, however, and the comparative immaturity of the European public markets still, then public markets could regain interest in private biotech companies within three years. Companies as well as investors need to prepare for that opportunity. Companies will need to adjust their business model and their cash burn, and consolidate their assets, while investors will need to diversify their risks in earlier stage companies through participating with larger investments in later stage businesses.

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