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What will it take to get institutional investors interested in life sciences again?

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Date received (in revised form): 11th July, 2003

Abstract

With the European biotechnology market nearing a crisis state, companies must try to attract and maintain interest from institutional investors. In this article, a brief outline of who companies should be trying to appeal to and how these investors view the sector is followed by an assessment of the areas that management must focus on to attract investors. The problems that they must avoid to prevent disappointing investors are outlined.

Keywords: *financial, investment, market, biotechnology*

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INTRODUCTION

While the fundamental criterion that any investor has is that they need a positive return on their investment, the biotechnology sector has some specific fundamentals, such as cash-burning non-profit companies, that make investing in this area a challenge to fund managers. Investors will be focusing upon companies making money, with positive news flow and with no need to return to the capital market for further funds.

In this paper the areas of concern that institutional investors have and must consider, before any potential investment in the European biotechnology industry is made, are outlined, and the steps that management may address to make their company, and thus the sector, more attractive to institutional investors are discussed.

To begin with, the larger picture must be taken into consideration. The world stock markets have been going through the largest bear market since biotechnology has been developed as a unique sector. Therefore, a lot of the downward price pressures are not inherent to the industry. Add to that concerns about the world economy, possible military conflicts, etc and it is natural for investors to retreat to what may be regarded as more secure sectors to place their dwindling cash.

Many non-specialist investors see the biotechnology sector as a high-risk, high-reward investment, and as such no place to be when the markets are in such decline. This is particularly of concern since the period from 1998 to 2000 was a time of phenomenal growth in the value of biotechnology stocks, although not in fundamental value (Figure 1). The 1998–2000 bubble damaged specialist and non-specialist alike, and created a climate of uncertainty and distrust from which the biotechnology sector must still try to recover.

This leads to another point. Institutional investors should not be regarded as a single unified mass, but rather as a collection of different fund structures with a variety of investment goals. Most large generalist investors do not really understand biotechnology (except the possible return) and are easily scared out of the sector by falling markets and volatility. Traditionally, they take large stakes, and so low liquidity is perceived as a problem. They are strong supporters of the biotechnology sector in bull markets, and provide much-needed stability to stock prices. As non-specialists they will have a preference of less risky

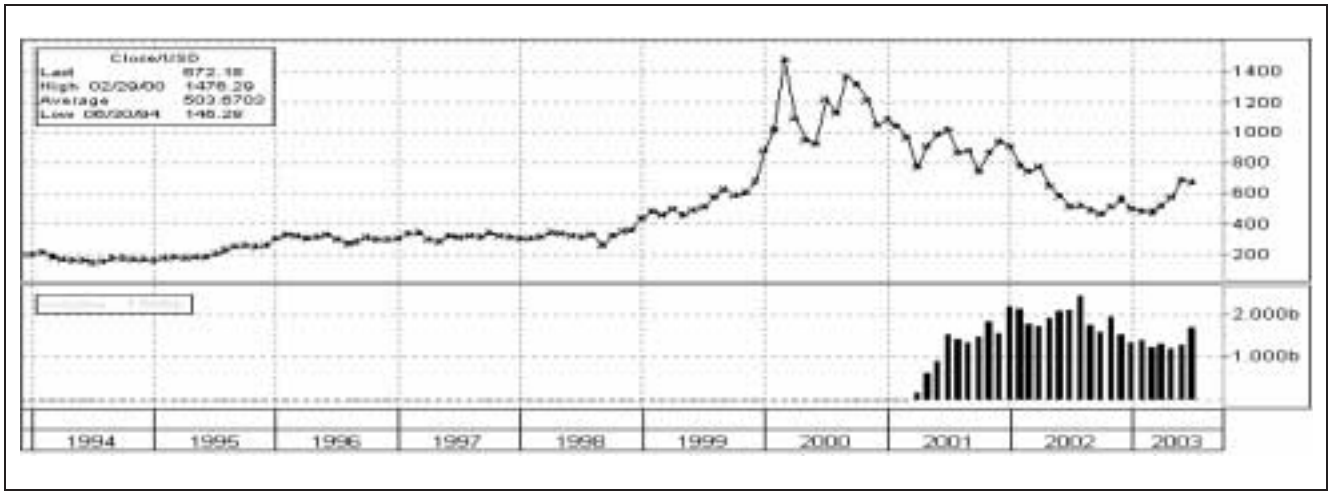

Figure 1: Value of biotechnology stocks
Source: Bloomberg

Many institutions have restrictions with regard to the minimum size of investment (€50m) and maximum holding in one company (10 per cent)

investments and may focus upon the financial strengths of possible investments rather than technology. Many institutions have restrictions with regard to the minimum size of investment (£50m) and maximum holding in one company (10 per cent). This restricts institutional investors to companies with market caps greater than £500m. These investors may be the last to return to the sector, but are usually the first to sell out.

Technology funds in general have a greater understanding of the perceived value in biotechnology companies, and have a requirement or investment goal of placing a percentage of the total fund into healthcare/biotechnology. They are able to assess the technology, management and business strategy of a company and arrive at a valuation judgment on these grounds. Therefore, they may be willing to invest in more speculative stocks or stocks with lower liquidity or even to operate as crossover funds covering private and public equity. Technology funds have a tendency to hold stocks longer and weather short-term volatility in prices, if they believe the underlying story. However, they often have an investment focus that covers several sectors and are therefore inclined to change their weighting from sector to sector as they see the markets changing. The decision to move in or out of biotechnology can depend upon the strength of their other sector focus rather than any underlying weakness in biotechnology.

Specialist healthcare or biotechnology funds are dedicated to a specific market and can be either short or long term in investment outlook. Although these funds have sector expertise, they are not many in total and are unlikely to be able to support the sector if the investors outlined above decide to leave.

There does not seem to be any significant desire for the US funds to take substantial positions in small to mid-cap European biotechnology companies

The categories outlined above are intended to be European in structure. While there is substantially more cash available from US institutional investors, there does not seem to be any significant desire for these US funds to take substantial positions in small to mid-cap European biotechnology companies, especially with the current relative strength of the euro to dollar. Additionally, there are also substantially more crossover funds and hedge funds willing to operate in the biotechnology market in the USA.

Having outlined the investment audience that biotechnology companies most approach, the next question should be, what do the companies have to do to attract, and more importantly to maintain, the interest of these investors? Four areas are important in this regard:

- market-related factors both public and private;
- development success;
- financial stability;
- critical mass.

These areas are not mutually exclusive and will be analysed in more detail. The attractiveness to institutional investors lies in a mixture of different conditions depending upon the particular company's status.

MARKET-RELATED FACTORS

The current bear market and increased financial regulations have resulted in investment banks reducing their analyst support and coverage of the biotech sector

Some of the market-related investment concerns have been outlined above; however, the current status of the European biotechnology markets has a real and direct bearing on the willingness of investors to invest. Furthermore, the current bear market and increased financial regulations have resulted in investment banks reducing their analyst support and coverage of the biotechnology sector, making it harder for public companies to attract attention.

The current low levels of trading in the majority of biotechnology stocks will deter all but the most specialist or long-term funds. An important question is why is the liquidity so low? In principle, in bear markets investors will shy away from cash-burning companies that are not in a near cash neutral/profitable situation. This covers the majority of European biotechnology stocks (see Table 1).

Europe still has a very parochial market structure for technology companies

Additionally, Europe still has a very parochial market structure for technology companies (see Table 2). The presence of several national markets for technology stocks leads to the total sum available for investment to be split across national boundaries. Each country will have local funds to invest in local companies, which allows a degree of protection to companies that may have weaker business plans or management but are listed on stronger markets. The rise and fall of regional technology markets such as Easdaq (Nasdaq Europe) and Neuer Markt has left companies that used to be big fish in small ponds and able to attract market-specific investment struggling to compete in full markets. A continual suggestion to ease these problems is for the creation of one European-wide technology market to rival the US Nasdaq. Currently, this remains a pipedream and management should be creating business plans to work with in the current markets. Switching to the US Nasdaq, although superficially attractive, has yet to be shown to work – the large US biotechnology funds are still keeping a primarily US investment portfolio, and therefore most European companies are usually significantly underperforming their US peers.

During the bubble market of 1998–2000, a great many companies were able to take advantage of the desire of investment funds to participate in what was seen as an exciting time in the biotechnology sector. Private companies achieved fund raisings at (with hindsight)

Table 1: Profitable European biotechnology companies

Company	Country
Acambis	UK
Celltech	UK
Galen	UK
PowderJect	UK
Shire	UK
SkyePharma	UK
Qiagen	Germany
Serono	Switzerland

Table 2: Market structure

USA	NASDAQ, NYSE
Europe	London: FTSE, AIM
	Benelux: Euronext, National Bourse
	Germany: Dax, previously Neuer Markt
	Italy: Milan
	France: Paris, Neuvo Marche
	Other national exchanges, eg Swiss, Swedish

Discounted cash-raising may place the company in the pole position for an IPO when the window reopens

Many companies are now trading at below their cash value, this means that some companies have an apparent negative technology value

grossly inflated valuations for their particular stage of development or to raise substantial cash via a very high-priced offering on public markets (LSE, Neuer Markt, Easdaq/Nasdaq Europe). The underperformance of those biotechnology companies, which went public in 2000, has damaged demand for new issues. This has created several knock-on problems with the current market and helped to create the current initial public offering (IPO) blockage.

Many companies are now trading at below their cash value (Table 3). This means that some companies have an apparent negative technology value, and while this may be justified in some cases, it is clearly unwarranted in others.

The consequences of the previous inflated market is that there are many companies in the small to mid-cap range that may have the cash to drive their business, but not to take the business to profitability. These companies are now sitting below their IPO price, often with an overhang of venture capital (VC) funds as shareholders. Investors will know that these shareholders will be looking for an exit and this further depresses the valuation and liquidity. Furthermore, these quoted companies are now trading at values lower than the last financing rounds of several of the leading private companies who cannot go to the public markets at their current valuations. Until there is a major rise in quoted biotechnology valuations, these companies will remain private and burning cash. The crunch is already being felt; private companies that are delivering performance and controlling costs will still have to return to the private markets to raise cash at discounts to their last rounds. This should not be seen as a sign of failure but of management and shareholder realism. Discounted cash-raising may place the company in the pole position for an IPO when the window reopens, as well as attracting new later-stage investors, such as crossover funds and investment banks.

Table 3: European biotechnology companies with cash greater than market cap

	Country	Market Cap	Estimated Net Cash
British Biotech	UK	43M GBP	48M GBP
Crucell	Netherlands	Euro 100 m	Euro 110 M
GPC Biotech	Germany	Euro 105 m	Euro 108 m

DEVELOPMENT SUCCESS

Although it seems an obvious statement – that the more successful the company, the more attractive it will be to investors – there is more to it than that. Late stage drug failure has been a recurrent burden on investor expectations for the last two years, and while companies cannot anticipate clinical problems, more transparency and better investor relations could help reassure investors.

Transparency in the amount of information that can be revealed in terms of the trial design, end and interim trial reporting points, recruitment, release of clinical results and peer reviewed reporting, ie in meetings and journals, would help investors and analysts create a more balanced and realistic view of the company's development. If investors and analysts can get a better judgment on the inherent risk in the trial, then any unexpected news could be managed better and the possible volatility of the stock price better controlled. The Astra Zeneca and NiCox trial of the AZD3582 Phase II trial and the recent Xenova and Gemab problems are good examples, and the subsequent fall in stock price reflects the market assessment. Of course, this cannot prevent the disappointment and subsequent stock price reaction that any clinical failure will generate.

Clinical delay or failure is a natural risk in the pharmaceutical industry; therefore, companies should try to offset this risk by having a broad pipeline in development. This must be achieved by good management practice and within the company's burn rate. Unfortunately, too many companies are led by their

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management into the two main business development mistakes: either having only one product or having too broad an early stage pipeline.

One product means that management is investing too much of the company's value in a product with a reasonable failure rate. Good risk management would suggest that to balance the clinical failure risk, having three products in clinical trials would be more protective. Naturally, development companies cannot have all their projects running at the same speed and status of development, but one late Phase II compound and several preclinical compounds is not an ideal balance. Management should try to ensure that the lag between the primary compound in development and the next is not too wide.

The other management weakness, especially in a scientist-managed company, is to focus too much on the platform or lead compound's utility. The result of this is often that while the science is outstanding, investors see a company that seems to be continually using its cash to widen the early stage pipeline and not create late stage value. Additionally, most companies do not have the resources to take eight or ten leads into the clinic, so management should not invest time and investors' cash in doing this.

Companies that are cash neutral or profitable can be valued using a different set of valuation tools from companies in the development stage and cash burning

Although these may seem like opposite arguments, good management should be able to develop a business plan that allows the company to create the best mix of the two, bearing in mind the cash needs for the projects.

One way to balance this risk and cash burn is to license the compound. Very few development companies will be taking, or should be planning to take, a product to market alone. By licensing, the company manages to spread the risk, offset the costs and reassure investors that a third party supports the potential of the drug in development. While it is true that the later the drug is licensed, the better the value and return to the company and shareholder may be, earlier licensing may allow the company to free cash to enable them to develop a stronger and broader clinical pipeline.

Finally, once a product is licensed or on the market, the risk does not disappear. Competition and patent expiry may also be risks to the franchise and therefore the company's valuation. This can also affect products in clinical development, hindering licensing or, more worryingly, removing market protection in the case of orphan drug candidates. As already mentioned, proper management structures should be put in place well in advance of any such threat and investor relations should be proactive in making the financial community aware of all the possible threats as soon as possible.

Proper awareness of the above will allow the company to better manage shareholder and market expectations of the company's potential.

FINANCIAL STABILITY

In a normal market environment, the cash that a company has will be reflected in the market capitalisation. Although in the current three-year bear market this has not been true (eg Oxford GlycoSciences, Table 3), it is still a sound principle.

Companies that are cash neutral or profitable can be valued using a different set of valuation tools from companies in the development stage and cash burning. The market therefore sees reaching and sustaining profitability as a positive indicator for the company's value. Few companies have reached this stage in the European biotechnology universe (Table 2); most will still be using their cash to fund the current and future business.

Non-profit-making companies have to show to the investment community that they are able to husband and utilise their cash in the most efficient manner. Companies with large cash reserves are perceived as potentially more sound investments. A cash resource allows management to use several different strategies to help drive commercial growth. This can be used to in-license products or to help drive a merger or

acquisition, both of which help critical mass and pipeline. As long as such activities make sound strategic business sense, the investment community will support use of the cash reservoir to this end. However, if the company seems not to be fulfilling their business plan, the investment community will have the view that, regardless of the cash available, the company will not use it in a way to enhance the business. If this happens, the company may trade at a discount to cash, or come under pressure from investors to review the current management.

Investors are looking for viable business models and critical mass, both individually and for the sector in general

Another option open to investors or management may be to take a listed company with cash back to the private sector, where they would again be able to tap into the venture capital market for funding. This is not a common course, although the recent plan to take Reneuron from the UK AIM market to the private sector may see the start of this as an accepted course of action.

The worst-case scenario is a company (public or private) with low cash reserves and very high burn rates. Such companies will be under a great deal of pressure to relieve this cash situation by:

- early licensing;
- discounted financing or possibly UK Private Investment in Public Equities (PIPEs);
- debt;
- selling of royalty streams.

Early licensing or raising cash by selling future royalty streams may relieve near-term cash concerns but may be seen by investors as selling the family silver at too low a value

Early licensing or raising cash by selling future royalty streams may relieve near-term cash concerns but may be seen by investors as selling the family silver at too low a value. This will have consequences in future calculations of company value. Debt may be difficult to obtain, and discounted financing may be unattractive to existing shareholders and, with the current pre-exemption rights structures in the UK PIPEs, deals are not workable. Shareholders and management will have to be pragmatic in the current market and either accept the pain and changes in valuation involved in raising cash or realise that perhaps the company is not therefore a fully viable entity. Corporate failure is still seen as a large negative for management in Europe, whereas it is seen as a necessary part of the learning curve for successful biotechnology entrepreneurs in the USA.

CRITICAL MASS

The bottom line is that investors are looking for viable business models and critical mass, both individually and for the sector in general. Management has to be able to assess and have the skill to be able to drive an increase in critical mass. For long-term stability, organic growth may be the best way to build a company and retain investor support, but organic growth needs management to have a business plan able to manage most of the risks and expectations outlined above.

The fastest way to build critical mass may be through a merger or an acquisition of another company (or companies). There are problems with this in Europe. Mergers are best performed between two synergistic companies that will yield a strong single entity. Europe has very few companies that are in this situation, so the more likely mergers will be between cash-rich–pipeline-poor and cash-poor–pipeline-rich companies. The majority of mergers will be distress mergers between two low-cash companies, which will be trying to fund the merger by an equity placing. These will be difficult to finance and achieve, since the sum of the parts must create better (not initially more) valued companies.

Acquisitions will also be less common than market conditions might expect. Normally, an acquisition is from large to small, but in Europe there is a structural gap in the biotechnology market. The biotechnology sector in the USA has a range of companies, from the multi-billion dollars level down to US$100m in market capitalisation; acquisitions are

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from companies wanting to go over the significant US$500m, US$750m and US$1bn valuations. In Europe, there is a valuation gap with very few companies in the £200–750m range. Therefore, the numbers of potential acquirers is very limited and so the number of good commercially sound acquisitions will be few. With the exception of Celltech in the UK, growth by acquisition has yet to be a prominent business strategy.

SUMMARY

There are currently 59 per cent more private biotechnology companies in Europe than the USA. This would be healthy if there was some degree of natural selection of the most viable businesses, although a loss of 50 per cent or more of companies would be very damaging. Venture capitalists and universities should try to keep technology within the academic structure for longer periods; fewer but more viable spin-outs will help the industry in the long run.

In the meantime, companies and management teams will fail and valuations will drop. The companies that survive should be better placed to manage investors' expectations. As the markets recover, investors will return to the market to find companies with strong, diverse and achievable business plans. However, companies cannot rely on equity markets alone to generate working capital. Companies must commercialise their products and technology earlier. In the longer term, investors will find that this bear market has made biotechnology management more realistic on their companies' expectations and value, and also better skilled to maximise this to build strong companies and a strong European biotechnology sector.