



EXIT STRATEGIES FOR SME LIFE SCIENCE COMPANIES IN THE EU

IMPORTANCE OF EXITS

Exits are of paramount importance for shareholders who have invested capital in the earlier stages of the company and want to make a good return on their investment to compensate for the risk that has been undertaken. They also serve to recycle capital into the market, where it may eventually be deployed again by individual investors and larger investment vehicles to promote further growth in the industry. The availability of a variety of exit options in the EU is crucial to ensure that innovation continues to prosper, and capital continues to circulate. Coordinated processes that can overcome regional differences are important to ensure that the EU remains a competitive bloc in the global life sciences industry by virtue of fostering the development of SMEs.

ACCESS TO FINANCE

The funding path for any particular life science SME differs from that of another, but there is an archetypal pathway that is adopted by many companies. Early-stage pre-clinical companies typically deploy low value instruments such as grants and angel / seed financing, but as lead candidates progress further down the pipeline, venture capital / private equity funding is more prominent. After this, SMEs have multiple options available for growth, such as public listings, M&A, joint ventures, and partnerships with larger pharmaceutical companies.^[1]

OPTIONS FOR EXIT

Exits require significant forethought and thorough planning. Particularly in the life sciences, where returns typically outperform all other sectors in the public market, there is very large upside for SMEs. Choosing a particular exit plan can be a daunting decision to make but has a significant impact on business development choices and should be delineated well in advance. In the life sciences space, M&A, licensing deals, and IPOs are the key exit strategies to be considered.

M&A

M&A can be a favourable option for life science companies who own an entire technology platform or a defined development project and have a defined market.

Strategic fit with potential acquirer portfolios can ascertain which companies the business can be pitched to, and small life science companies with teams that are highly specialised in niche areas can boast knowledge that larger companies may be attracted to. Inertia due to size has caused a shift from organic to inorganic growth in large pharmaceutical and biotech companies, as desired revenue growth cannot typically be achieved by inhouse R&D alone. This entails that large players in the space are permanently on the lookout for strategic opportunities^[2].

In some cases, the sell-side may have an advantage if their unique technology has very promising data that are unmatched by competitors, if these exist. This can give the company leverage in negotiations to achieve a substantial premium in an acquisition, which can indeed be very lucrative^[3]. However, in the face of a dearth of data or at the hands of an inexperienced management team, the company may find itself facing a highly-skilled internal business development team which may drive down the acquisition price and include terms that may not be desirable for the company. Although an acquisition has the advantage of offering liquidity to shareholders as their stakes are bought out, the downside is that one may lose operational control of the company if the contrary is not delineated in the SPA.

LICENSING

Structured exits in the form of licensing are becoming increasingly popular as they provide ventures with a source of funding, and mitigate risk for investors whilst maintaining the possibility of large upside. Payments based on milestones of development are favourable in that they factor in the financial needs of the company at different stages of its lifecycle and give access to otherwise unavailable capital, as large-cap pharma is typically reticent to outright acquire early-stage ventures with a high risk profile^[4].

Licensing agreements can also be tailored to give the investee right of first refusal for an acquisition, or options to individually purchase pipeline assets should trials be successful. Depending on the terms of the agreement, one can arrange for dilution to be such that the original management team retains control of the company throughout, and instead receives royalties contingent on third-party sales. This can be an attractive option for ventures that do not wish to lose operational control.

Furthermore, licensing agreements can provide further validation of the potential of the company's technology, which can be used to draw in further investment in the form of bridge loans, non-dilutive grants, and strategic equity investments. However, strategic investors will be on the lookout for returns, and will recognise that the total amount of the announced licensing deal may never be realised as typically only 10-20% is paid upfront, the rest being contingent on milestones^[5] (see blue box on "Biobucks"). One must be careful to avoid the process becoming a tug-of-war between the venture who wants to increase the upfront payment, and the investor who wants to push payment to the back-end to minimise risk. Another factor to keep in mind is that licensing deals may reduce the attractiveness of the venture for an outright acquisition by a third-party as the original investor will be deemed to have access to more clinical data from the venture than the rest of the market, thus giving it an advantage in knowing whether the venture is worth acquiring or not.

IPO

IPOs in the life sciences can command very large valuations due to the potential upside of assets in the trial stage. However, this also entails that due to this binary nature of success vs. failure, these IPOs are amongst the riskiest^[6]. Notwithstanding, floating on public markets can grant access to large pools of capital that would otherwise be unavailable, but stocks can be very volatile up until regulatory approval.

There are many considerations to factor in when deciding to go public, including what market to list on, acceptance and disclosure requirements, listing costs, liquidity, and target investor base.

Whilst many life science companies decide to list on NASDAQ, European exchanges such as LSE AIM, Euronext Alternext, and Deutsche Börse Entry Standard can be better suited. Acceptance requirements for NASDAQ listings are typically more stringent and have minimal annual pre-tax income, public float, and stockholders' equity requirements. Alternatively, the aforementioned European alternative markets have more lax acceptance requirements which facilitate a smooth listing and prompt access to capital. Disclosure requirements on NASDAQ such as quarterly filing of reports and compliance with SOX also constitute administrative burdens which result in high yearly listing costs due to the necessary internal and external infrastructure needed to comply with such regulations.

Whilst liquidity on NASDAQ is around 12% for companies with market caps under \$500m compared to about 4% per month on AIM (as measured by spread, turnover, and order depth), the absolute number of companies listed on NASDAQ means that a large proportion of small-cap companies have no assigned analyst, which may in itself impact liquidity and share price due to news coverage. Furthermore, NASDAQ, originally a junior market, has now matured and is dominated by more established and very large players.

REFERENCES

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- [2] Forbes - Are M&A Replacing R&D In Pharma?
- [3] EY – Biotech deals – Biotech deal market soars
- [4] Oliver Wyman – Licensing to Win
- [5] STATnews – What's behind those billion-dollar biotech deals?
- [6] NASDAQ – Pushing preclinical: Wave of early-stage biotech IPOs tests investor risk appetite
- [7] EY – IPO insights – Comparing global stock exchanges
- [8] PwC – Which market? An overview of London, New York, Hong Kong and Singapore stock exchanges
- [9] The Bradshaw Law Group – Reverse Mergers: A Basic Primer

"Biobucks" is a term commonly used in business transactions between large pharmaceutical and smaller biotechnology companies to describe the total possible value of the transaction, excluding royalty payments. While public announcements of these deals often state a single lump-sum figure as a representation of the entire deal-value, often only a small fraction of the amount is certain, while the remaining amount is highly uncertain.^{[1][2]}

[1] Morrisson, Chris (23 June 2009). "When Is A Billion Dollars Not a Billion Dollars?". In Vivo Blog.

[2] Garde, Damian (28 November 2016). "Why billion-dollar biotech deals are often just a mirage". STAT.

As junior markets, AIM, Alternext, and DB ES are arguably more adept at fundraising for SMEs, and have more scope to raise capital if companies operate a hybrid business model as opposed to the all-or-nothing biotech plays often favoured by NASDAQ^[7,8].

A reverse IPO (more commonly known as a reverse merger) can be a more attractive option for private companies who do not have the necessary cash on hand to allocate to the IPO process or want a faster process. A reverse merger, whereby a public dormant company is taken over by an active private one, is typically shorter in timeframe and does not necessitate an investment bank to underwrite shares in exchange for a fee. Reverse mergers can also warrant that ownership of the company remains in the hands of the private company owners, and is not dependent on raising additional capital, hence minimising risk^[9].

CHOOSING A STRATEGY

The choice of exit strategy will ultimately be determined by the goals of the management team and shareholders, which can range from raising capital for operations to increasing personal liquidity and exiting the business to pursue alternative goals. No single strategy is adequate for every company, and each requires a shift in corporate behaviour and transparency with the market. Ventures are started for different reasons, which will inevitably impact what exit strategy is carried out. Companies should also keep in mind that the EU is intended to act as a trade bloc and should avoid compartmentalising themselves and restricting their strategy to a purely domestic focus. Investment can and should be sought from countries throughout the EU, and exit plans should consider variations between different member countries that could ultimately lead to a competitive edge or more successful implementation.

ACRONYMS – DEFINITIONS

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| AIM | see LSE AIM |
| DB ES | Deutsche Börse Entry Standard, a transparency standard for SMEs. |
| EU | European Union |
| Euronext | Euronext is the largest stock exchange in Europe and sixth largest in the world. |
| Alternext | Alternext is Euronext's market for small and mid-sized firms. |
| IPO | Initial Public Offering – when a private company or corporation raises money by offering its stock to the public for the first time. |
| LSE AIM | The Alternative Investment Market (AIM) is London Stock Exchange's global market for smaller and growing companies. |
| M&A | Mergers and Acquisition |
| NASDAQ | The Nasdaq Stock Market is an American stock exchange, the second-largest in the world. "Nasdaq" was initially an acronym for the National Association of Securities Dealers Automated Quotations. |
| R&D | Research and Development |
| Reverse IPO | Acquisition of a public company by a private company so that the private company can bypass the lengthy, complex process of going public. |
| SME(s) | Small & Medium-sized Enterprises |
| SOX | The Sarbanes-Oxley Act of 2002 passed by the U.S. Congress to protect investors from the possibility of fraudulent corporate accounting activities. |
| SPA | Sales and Purchase agreement |