LIFE SCIENCES SNAPSHOT

A Quarterly Report on Financing Trends

A CONVERSATION ON SPINOUTS — UNLOCKING MARKET VALUE AND CREATING BUSINESS OPPORTUNITIES Q3 2021

orrick

Data provided by

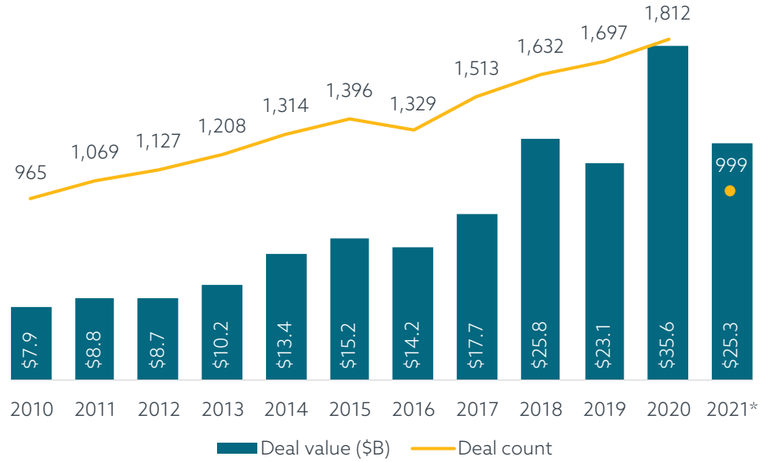
PitchBook

Key Takeaways

This edition of Orrick's life sciences publication series reviews the key drivers of venture investment in the life sciences industry, which is proceeding at a record pace thus far in 2021. Key findings include:

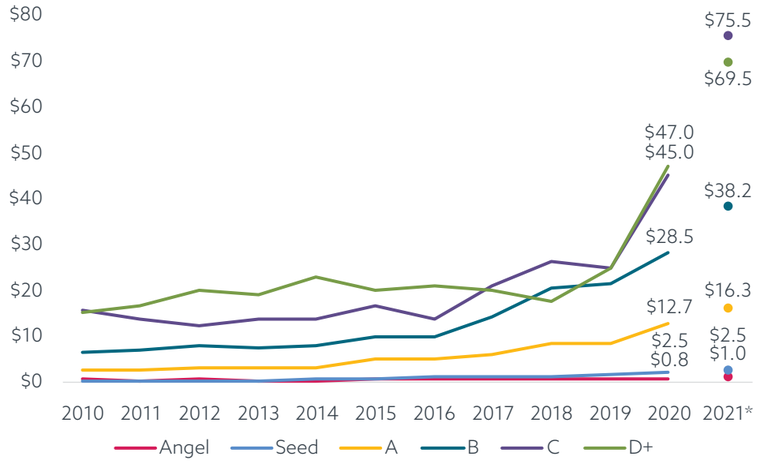
- Investment continues at a record pace. By midyear 2021, $25.3 billion of venture capital has been invested into US-based life sciences companies—a sum already higher than eight other years' annual tallies since 2010.
- The rising influx of capital has boosted deal metrics across all financing series.
- Liquidity trends provide a favorable backdrop for investors, with initial public offering (IPO) sizes in particular surging to new records—$36.4 billion in aggregate exit value by midyear.
- In any heady environment, there will be rightful calls for caution and rigor in investment processes. However, the rate of technical innovation and size of market opportunities can also justify significant investment.

Life sciences VC deal activity



Source: PitchBook | Geography: US
*As of June 30, 2021

Median life sciences VC deal size ($M) by series



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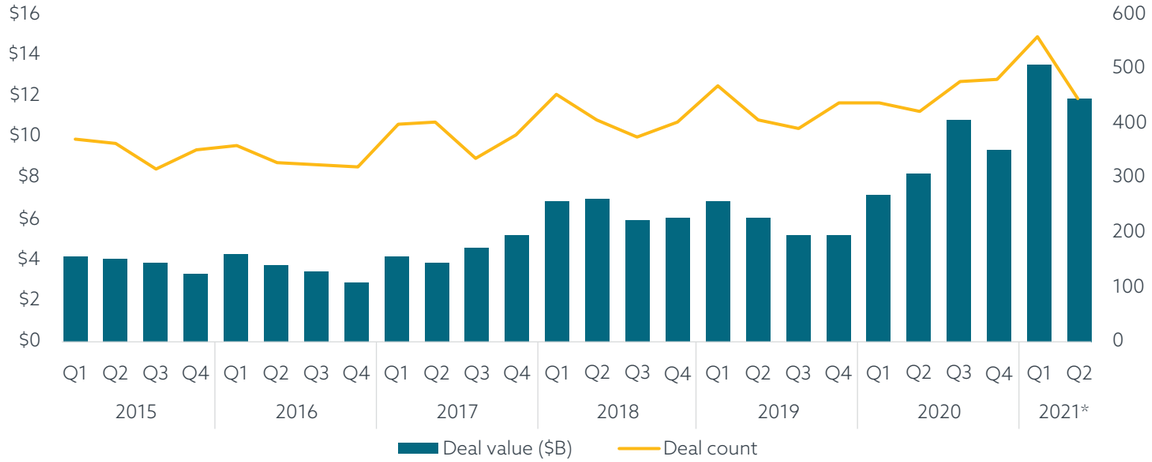
Market Analysis

Life sciences VC deal activity by quarter



Source: PitchBook | Geography: US
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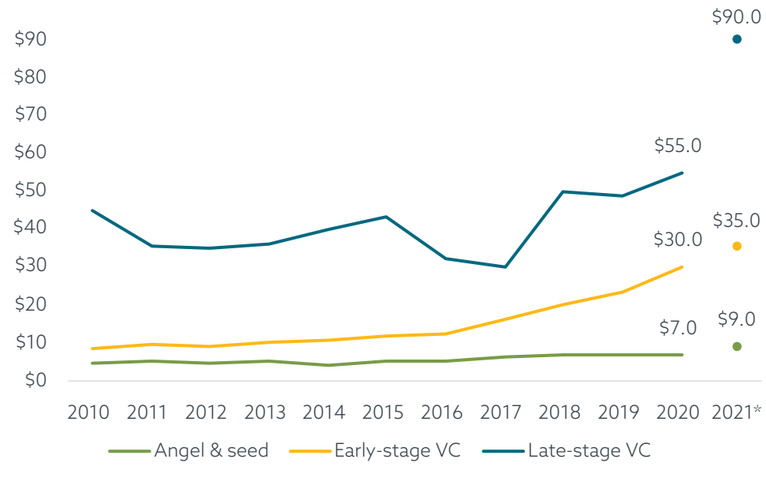
At $25.3 billion invested by midyear, the US life sciences sector is experiencing an unprecedented rate of venture investment in terms of aggregate capital. Just shy of 1,000 financings have been completed; at this pace, 2021 could set a new high in deal volume. These dual trends indicate broad, sweeping enthusiasm for multiple business plays and technologies across the sector, as outlier transactions in terms of size fail to explain the fast pace of dealmaking. From analytic platforms employing machine learning and other techniques and tools on mass datasets to expedite drug discovery, to increasingly bespoke gene editing techniques brought to bear on specific diseases, to novel antibodies designed for difficult-to-treat cancers, the array of technologies proves vast.

Median life sciences pre-money valuations ($M) by stage



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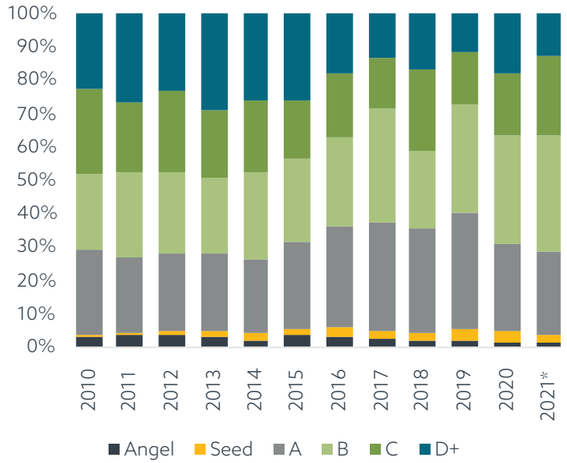
Life sciences VC deals ($) by series



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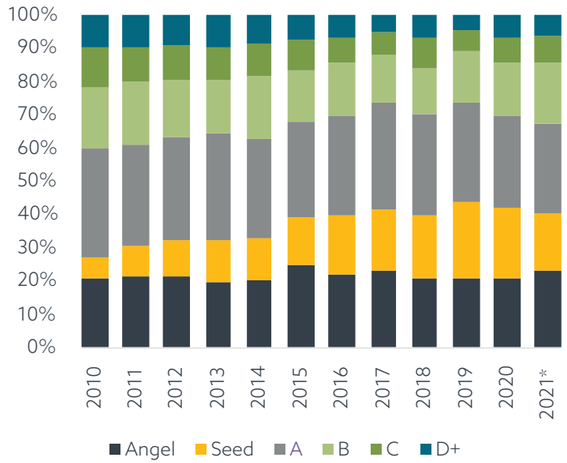
Life sciences VC deals (#) by series



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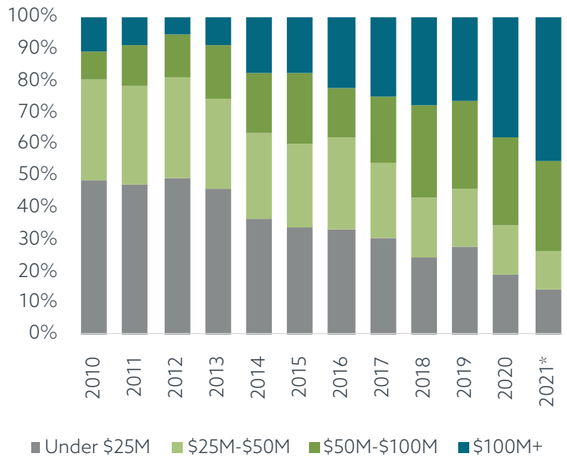
Life sciences VC deals ($) by size



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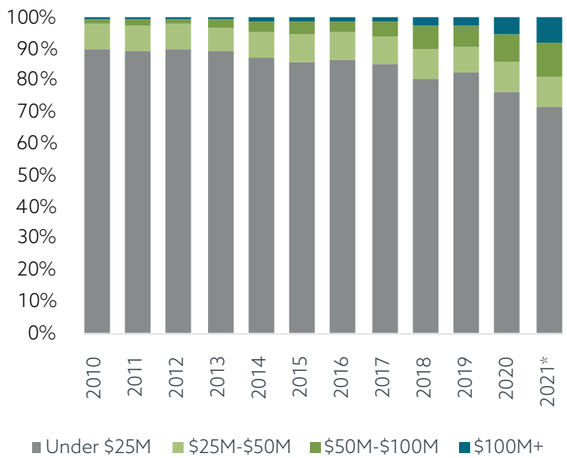
Life sciences VC deals (#) by size



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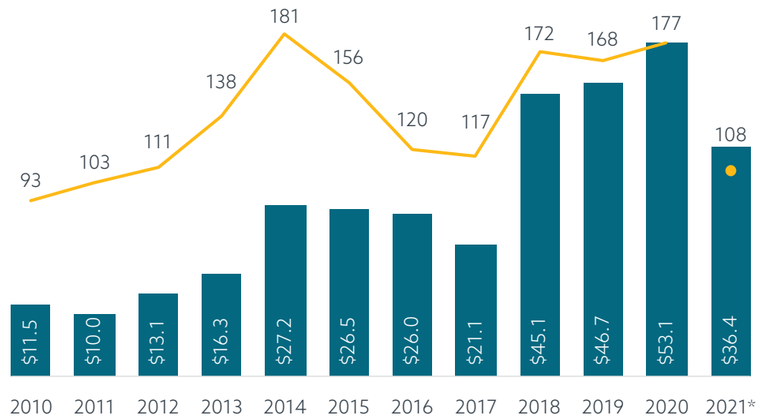
Market Analysis

Flush with capital as commitments to venture funds continue to flow, fund managers are subsequently competing for opportunities that lead to new highs. Every stock series has either held or set record highs, with the latest stage seeing the largest leaps—including Series C increasing from a $45.0 million median deal size to $75.5 million in 2021 to date. The late-stage venture pre-money valuation median is nearly doubling year over year, from $55.0 million in 2020 to $90.0 million in H1 2021. These trends may raise concerns about irrational exuberance. However, even if competition has induced records across the board, that does not imply that all investor discipline has disappeared. Instead, fund managers are adapting to the current market realities as the life sciences sector enjoys the fruits of two decades of innovation that continues to unlock potentially groundbreaking, lucrative treatments and platforms. Liquidity trends in H1 2021 are also encouraging, with $36.4 billion in aggregate exit value across 100+ transactions. Thus, the sheer amount of capital in the market makes for cautious—if not conservative—due diligence practices. But thus far, as the sector thrives with much-needed, promising innovation, the life sciences venture funding environment is more robust than ever.

Life sciences VC exit activity



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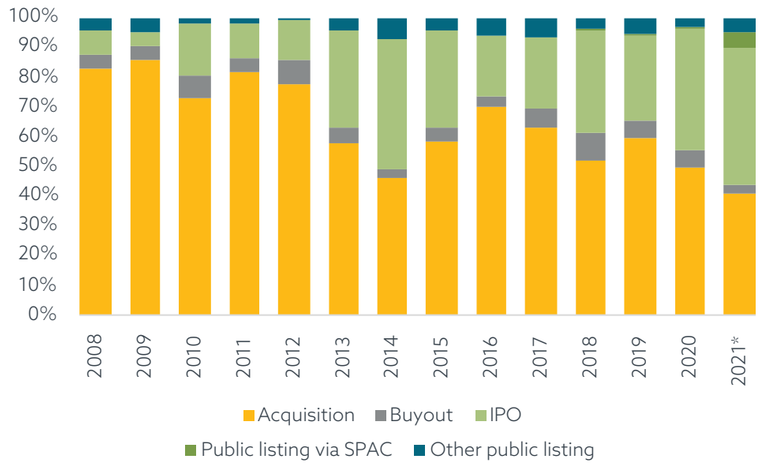
Life sciences VC exits (#) by type



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Roundtable

Panel

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Neel: Thank you to our panelists for joining us. How do life science companies think about unlocking value by spinning out assets? Any examples to share?

Andy: I think that the question really depends on the parent and its corporate stage of development because there are multiple ways to think about a spinout. For example, you have large pharma companies like Pfizer and Merck who spun out whole business units into standalone entities. That unlocks value by not having conflicting businesses under one roof and allowing each to independently stand on its own with its own investor base. A smaller company example is Agios when they divested their oncology business to focus on genetic disorders. You also have earlier-stage biotech platform companies where the spinout is driven by having a broad platform with lots of programs that can be developed, but not all of them can fit within the current capacity, capabilities or focus of the parent. So essentially, making the same decision that Agios made but much sooner in the company's lifecycle. We [Locust Walk] have spent a lot of time looking into situations where you have a company with a handful of early to mid-stage clinical programs and a deep well of future programs. Their value as public companies are driven by those clinical assets and little credit is given to the earlier programs. While the companies also need to maintain a pipeline to support themselves as a public company in case something goes wrong with one of those lead assets, the value of these pipelines are often only reflected as essentially an "insurance policy". Thinking through spinouts or additional partnerships is about unlocking the value of the earlier-stage pipeline, including by financing and developing programs that the parent would otherwise not have pursued for whatever reason. We [Locust Walk] are actively involved in the formation, financing and business development of some of these spinouts and it's because we've seen others that have been successful.

Jean: From the pharmaceutical company perspective, another area where I see value being created by pharmas is when they are very clear why they're divesting something, perhaps not because it failed or didn't deliver as expected, but because it's a strategic focus like with Novo Nordisk and some other companies. Many of those spinouts have gone on to create tremendous value, both for the new investors, as well as for the divesting company, so when it's clear that it's a strategic focus move, that's another way to unlock value for both sides.

Gregg: Jean, are you seeing that where the pharmaceutical company may be either moving away from an indication entirely or where it's a class of compounds they no longer feel they should devote resources to? Again, not necessarily that it's a failed program, but they simply have higher priorities.

Jean: Both. Where the bigger value tends to be unlocked is when they make a strategic determination because they need to narrow the focus. You also see it where they have decided there are higher values elsewhere.

David: Recently, we have worked on two very different types of spinouts. One was a geographic territory spinout: the privately held biotech, at the time of its crossover round, agreed with its new investors that funding of the oncology platform clinical trials was better left for a spinout company. Ultimately, the biotech had a very successful IPO and, because the crossover investors were unwilling to fund the oncology platform in Asia, the original biotech investors preserved value in the Asia opportunity. The other spinout is a separate field indication opportunity: the biotech investors were, as in the first example, unwilling to fund clinical studies for the "non-core" field. Both examples have their own versions of tax and IP issues, but the central point is that both spinouts are driven by the need for management teams and financing capabilities for the geographic and field specificities.

Gregg: I've seen with some of my clients that these programs may simply need a new home, one where they can be the focus of attention and where the science or the program can be advanced by a different development team.

Neel: Are there milestones that might trigger a company to think about spinning out an asset into a separate entity or to simply sell it off?

Andy: At the biotech level, which is a different set of questions than pharmaceuticals, the key questions are about whether the spun-out company can survive on its own. Is there a management team? What are the capital requirements? Is the technology or assets partnerable now or do you finance it first? Is there a pullback right, or put another way, if the company is going to be spun out, is the parent really going to "let go"? Really, it's the cascade of questions that are asked as you build out the business plan and think through the corporate development strategy. There are multiple ways of pursuing the spinout but fundamentally it all comes down to whether the company is viable to investors and partners, and we've seen examples where this has been very successful and examples where it has not.

Jean: The primary consideration is whether they have the resources and funding to develop it or are they better off monetizing it and creating another company. Large pharma has multiple reasons—it can be anywhere from a product at the end of its life that somebody else, perhaps with more focus, could create better to something they didn't want to prioritize.

Gregg: I've been on the buy side of several of these where the pharmaceutical companies have decided to make a move away from a certain area or they've lost interest in a particular product. They haven't put the marketing resources behind it to generate the kind of sales that they thought they could. And it's often a smaller company that's found an asset missing an internal champion at the larger company that purchases it and applies the appropriate level of resources against it.

Andy: There's a lot of examples of where technology platforms or assets can be spun out and put into the hands of groups with the right capitalization, management, risk tolerance and structure and that can really exploit it and do well independently. It's part of the reason why the larger pharmaceutical companies maintain active relationships with the key biotech start-up investors. But it also makes it imperative for groups seeking assets from larger companies to make clear how they will be successful and why it is in the company's best interest to divest the asset to them.

Gregg: If you set up the entity from day one using something like the Nimbus structure, so you're going into it knowing that you'll be creating several related but separate entities, each with its own program, and you're developing them independently with their own employees and development teams, where the end game is to spin them off, it's just a lot easier. And by structuring it that way from the outset, you know you've got these nicely packaged subsidiaries that don't have to be disentangled from the company.

Andy: Gregg is right. The Nimbus model has proven to be successful. You also see other variations of it such as what ElevateBio and BridgeBio are doing. In some ways, Roivant was doing the same thing.

Jean: I would add that if there's a management team that has a key understanding of the technology, that helps tremendously.

Neel: How would you describe market appetite for acquiring spun-out assets?

Andy: I think it's no different than any other acquisition that someone may be looking at. If the data is there, if there is some synergy that's really important, the acquisition will happen whether it's a spun-out asset or direct buy. One of the questions in biotech will always be "what have you done to create value since you spun it out?" A key question is what are the rights the parent is maintaining in the spun-out company. If there is some sort of buyback then that could reduce the willingness of another party to try to acquire the spun-out company and needs to be considered. But again, these are the sorts of questions that need to be addressed at the time of the spinout when each company (the parent and the spinout) are defining their goals for the transaction.

Gregg: Jean, from the pharmaceutical executive or development team point of view, do you have a sense, one way or the other, if it's better to make a clean break and sell it all, letting the acquirer do with it as they please, develop it and/or market it on their own, or are companies having a tough time letting go and preferring to retain some rights beyond royalties, maybe even an option to repurchase?

Jean: From the acquirer's perspective, a clean break is preferred because retained rights limit who can buy it, the value, the potential for management and new investors. On the other hand, if there is an opportunity for fair pricing, then it can work.

Andy: As an example, we [Locust Walk] were working on a spinout for some IP out of a Big Pharma, and a necessary condition of the deal included a buyback at a pre-determined price at a pre-determined point in the asset's development. We tried hard not to have it included, but it remained in the deal and that term actually prevented us from being able to successfully finance the company because of how it capped the prospective investors' upside. It prevented the spinout from happening.

Neel: What impact does the climate for exits, specifically the proliferation of SPACS in the life sciences sector, have on spinout strategies?

Andy: As far as using a SPAC, it should be viewed as a financing mechanism and as a way to go public as compared to the crossover/IPO path. There are a lot of reasons to pursue a SPAC versus a crossover and those considerations are independent of whether the SPAC target is a spinout or not. But to do a SPAC combination, the spun-out company has to be public ready. It has to have the basics of the financials and the governance and fundamentally the company needs to be able to stand on its own two feet as a public company. Most spun-out companies that are coming out of biotechs or smaller-sized pharmas can't do that. We [Locust Walk] are approached often with companies asking us if they can spinout a company directly into a SPAC. I would say it is an unlikely path at first, but certainly an option as the spun-out company progresses. The clear example of this is Cerevel, which was a very successful spinout and then SPAC transaction.

David: We were recently asked to pitch on a biotech that was debating whether to proceed with an IPO or, alternatively, pursue a SPAC combination as securing an upfront funding commitment was seen as viable. Do we see this as a general trend?

Andy: Well, I think the right way to think about SPACs is that you aren't skipping the IPO process, you're replacing both the crossover and the IPO process. If you've already done a crossover, doing a de-SPAC doesn't make much sense in most cases. It's a bad deal for investors because of the dilution. The SPAC does have some important timing advantages. A crossover/IPO takes about nine months so there is a speed advantage to a SPAC. But the de-SPAC transaction at its core is like any other reverse merger, it's just with a clean shell.

Neel: As a forward-looking trend, do you anticipate an increase in spinout activity?

Jean: I think the trend will be consistent. Biotechs and pharma have always been motivated to unlock value in things they're sitting on.

Andy: I agree regarding big pharma because they're always making a determination as to whether or not something makes sense for the bottom line. For biotechs, the trend is in many ways, tied to the financing markets. I think we're going to see spinouts occur more frequently, especially for companies that have gone public in the last three to five years and have a pipeline of clinical programs. There's some subsection of those assets of that platform, whether it's a different therapeutic area or it's a different strategic thesis that doesn't match the parent company's core mission but is still valuable. That's something they are going to pursue as a way of unlocking value where they don't currently get it.

Gregg: I'm seeing a lot of that, where a company may have too many assets and they just don't have the time, attention or the resources to fully develop and pursue them, so those assets are prime for a spinout.

Andy: This is a timely topic and something we're [Locust Walk] dealing with actively on multiple fronts. Spinouts are a real strategic option for the right types of companies and something Boards should be seriously considering if it makes sense. Now, there are a lot of details that need to be figured out to ensure it is done in a way that maximizes the likelihood of success of the spun-out company and delivers all the benefits the parent is seeking. We don't know how long the current financing environment will continue to support these spun-out NewCos so it is something companies should be thinking about while the opportunity exists.

David: I'd like to add that the world's gotten a little bit easier from a tax-free spinout perspective. In the last five years, the IRS has broadened the tax-free rules specifically to apply to biotechs and other technology companies that are not yet revenue-generating. The IRS has changed the rules and tax lawyers have gotten more comfortable about achieving spinouts. For life sciences companies seeking to qualify under these tax-free rules, there are still other challenges, including how the original company and the spinout share IP, but the tax regulatory environment has certainly improved.

**This transcript has been edited and condensed for clarity. The thoughts and opinions expressed belong to the panelists and not their respective organizations.*