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Late-stage investors see opportunity in the bear market

Crossover rounds may be less attractive, but undervalued small-caps, early-stage deals offer prime hunting ground

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As biotech's bear market bites down on crossover rounds, late-stage investors are redeploying their capital in two different directions: undervalued small-cap public equities in need of cash and early-stage venture.

Growth VCs and crossover investors see the stark draw down in the public markets as a rare chance to buy into high-quality companies they perceive as undervalued.

"You need to seize this opportunity because these opportunities don't come along that often," Sofinnova Partners' Joe Anderson told BioCentury.

For some firms, this will largely come through structured deals such as PIPEs that will allow them to take a large position and provide working capital in an environment where follow-ons have been few and far between. Others see the undervaluation of small-caps as an opportunity that requires immediate action via building a position on the open market, if their mandate allows.

As late-stage deals slow down, some crossover investors that have found themselves overexposed to the public markets in the past year may reallocate capital to early-stage deals. In that scenario, crossovers could find themselves competing with more traditional VCs, which are continuing to deploy capital from recently raised funds. The competition could see early-stage private valuations climb, even as public market valuations fall.

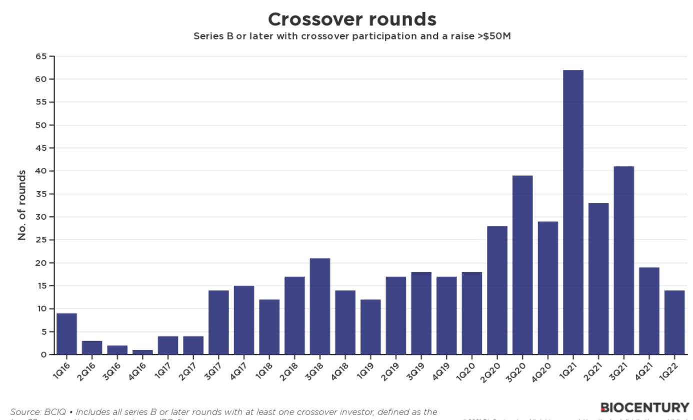
Crossed out crossovers

The falloff in public equity financings, particularly initial public offerings, has translated into a decrease in the number of private crossover rounds intended to position a biotech to go public via an IPO.

Crossover financings are typically series B or C rounds in which one or more new investors take large stakes in the company and offer to invest in a planned IPO. In some cases, these investors serve as long-term anchor shareholders once the company becomes a publicly traded entity.

Although crossover rounds began as a way for public equity investors to get larger allocations in hot offerings as an insider, as IPO performance waned in 2021, so did the prospect of making any returns on most crossover deals.

Investors and bankers told BioCentury for its 2022 Financial Markets Preview that the step-up in valuation had been decreasing through 2021, going from somewhere around 1.6-1.8x down to as low as 1.2x in 2H21. Combined with a median IPO performance of -23% at YE21, crossover investors weren't making any money, at least on paper.



It's not surprising then that an analysis of financing data from BioCentury's BCIQ database shows the number of crossover rounds completed has fallen dramatically since its peak in 1Q21. Crossover financings numbered 19 in 4Q21, down nearly 70% from 1Q21.

Fewer deals in which to put capital to work has late-stage growth and crossover investors either looking later — for example, at listed small-cap biotechs — or earlier — to series A deals, which require more time to mature and offer valuations that are usually less volatile.

Seizing the small-caps

The bear market has not only stymied crossover deal flow, but has also created an undiscerning market in which companies across the board, high-quality or not, have seen their valuations slashed in the past year.

Since Feb. 8, 2021, the S&P Biotech ETF (XBI) is down about 65% relative to the Standard & Poor's 500 index, an underperformance that has left many biotechs trading at very attractive valuations.

For growth investors looking to redeploy their capital, many see the small caps as their best chance to generate outsized returns.

"We are super active now on the public undervalued names," RTW Investments' Stephanie Sirota told BioCentury. "This is just one of those rare opportunities."

She said that by one metric, the price-to-sales ratio of the NASDAQ Biotechnology Index (NBI), valuations are not far off their all-time low.

"The NBI price-to-sales troughed at 4.5x. The absolute peak was before the genomics bubble burst in 2000, and it was about 23x price-to-sales with limited innovation compared to today," she said. The current weighted price-to-sales ratio for the IBB ETF, which tracks the NBI, is 6x.

She said RTW is primarily looking to build positions in the open market because the sector could hit bottom and start to reverse at any moment.

"If you look at historic selloffs like the one we are in right now, look at how quickly the recovery happens," Sirota said. "Those recoveries can be really fast. Generally, you want to be able to seize the opportunity."

Other firms with growth funds that have mandates that enable them to be active in public markets would prefer to take positions in companies via structured investments such as PIPEs, rather than buying on the open market.

"This is just one of those rare opportunities."
Stephanie Sirota, RTW Investments

Forbion Capital's Sander Slootweg told BioCentury that Forbion's growth fund, like others that are structured with a 10-year horizon, has a built-in hedge to cover nearly all market scenarios.

Forbion Growth Opportunities I fund, which had its final close in April 2021 at €360 million ($430 million), hasn't had much opportunity to pursue one of its main strategies of investing in crossover rounds. But he said the fund's other two strategies are still going strong in the down market environment: structured financings for public equities and investments in larger private rounds where the company has no near-term intention of going public.

"It is all about timing," Slootweg said.

What may differentiate this bear market from others is how well-financed the sector was entering the downturn, with nearly half of all biotechs having more than two years of cash at the end of last year. That still means, however, that more than half will likely be looking to raise capital this year or early next.

Anderson said that while experienced management teams will slim down their operations to focus on their core business, they would also be smart to take on new capital if they need it to reach their next major milestone — even if that capital comes at lower-than-hoped-for valuation.

He pointed to the 2008-09 financial crisis as an example of companies with successful drugs making money for themselves and their investors even if the companies financed at low valuations.

"If they were at $10 per share premarket correction, but had to finance at $3, and then their drug worked, the stock recovers and over time they go on to exit at $30, they make money anyway," he said. "Where you're expecting a big win, the stock valuation at the point of financing should not be allowed to get in the way."

The late-stage VCs won't be alone in chasing undervalued public equities, which will also be prime hunting ground for most of the specialist public equity portfolio managers that have cash to deploy.

Early-stage competition

A slowdown in late-stage crossover deals may create a dynamic where falling public equity valuations result in an increase in early-stage venture valuations.

The argument is that many of the most active crossover investors raised new funds in the past few years and won't simply be able to sit on the cash — they will need to deploy it. Those that already have heavy exposure to the public markets may not want to double-down via a PIPE or small-cap strategy and may instead look to invest earlier in seed or series A financings.

At the same time, the more traditional early-stage VCs are also continuing to create and fund new companies. The result could be greater competition for early-stage deals that leads to a rise in valuations.

"Everyone wants to have a series A round."
Karin Kleinhans, LSP

LSP's Karin Kleinhans told BioCentury that early-stage rounds for biotechs are now being populated by a wide swath of investor categories beyond traditional VCs, including sovereign wealth funds, incubator or accelerator funds, crossover investors, private equity and family offices.

"Everybody wants to have a series A round," said Kleinhans. "It is really competitive and prices are also driven by competition, not just by public market comparators."

Catalio Capital's George Petrocheilos told BioCentury that his firm has both moved earlier and added a venture debt fund to aid companies that might need additional capital, without the heavy dilution.

"In 2020 and 1Q21 we invested in 11 crossover rounds ahead of an IPO. From 2Q21 to today, we have invested in one crossover round. We expected what is happening, we repositioned a year ago and we just go earlier at this point," he said. "So more A rounds, more B rounds, less C rounds, and really no crossovers for now."

SPACs to the rescue?

Investors said that, given current market conditions, companies may choose to stay private longer, but SPACs could offer a brighter alternative.

Sirota said private companies that need capital could consider a top-up or bridge financing, adding on to their previous financing round, but the risk is whether the raise would be sufficient to extend the company's runway long enough for the markets to be more receptive.

A SPAC merger could offer an attractive alternative because SPACs typically have larger amounts of capital available through their IPO and PIPE.

"A well-timed SPAC can be an incredibly useful counter-cyclical tool for a company to go public," she said. "I love a good SPAC in a bad market."

At least 40 SPACs targeting life sciences companies have yet to find an acquisition target, including two targeting European biotechs: LSP's European Biotech Acquisition Corp. (NASDAQ:EBACU) and Forbion's Forbion European Acquisition Corp. (NASDAQ:FRBNU).