Commentary: Jasper Bos

Spotting biotech opportunities in a changing market

With the biotech public markets having lost over 70% of their value from a peak in February 2021, it is clear that the life science sector is in an entirely different position than it was just a year ago[1]. According to the research organisation Bay Bridge Bio, a total of $14 billion was raised by biotech companies from initial public offerings (IPO) in 2021. This was an increase of more than 70% in the amount of capital raised through public offerings compared with the same period in 2020[2].

This market expansion was primarily driven by large public biotech investors and crossover investors who fared tremendously well in the bull market period from 2017 to 2021. However, given the recent market losses, many of these funds are experiencing a shift in fortunes, with valuations significantly down in the first months of this year[3]. We are currently in a situation where the prime financiers of crossover rounds and IPOs are no longer able to invest in new issues. Instead, threatened by potential redemptions, many of these funds are expected to divest riskier, earlier-stage assets, further increasing pressure on the public markets. This is illustrated by the fact that the biggest losses in the biotech sector have been recorded for companies which have assets in early stages of development or preclinical[4].

At the same time, in the past few years we have seen an unprecedented increase in activity by life science venture capital (VC) firms in the private markets. This has created a demand for capital for biotech companies at Phase 2, or a later stage of development. Traditionally, companies have gained access to this capital through crossover rounds and the subsequent entry onto public markets[5]. In the absence of receptive public markets and the withdrawal of crossover and public market investors, there is a big opportunity for VCs to fill the vacuum in the years to come.

The opportunity for VCs

We believe that the current market environment offers enormous opportunities for biotech VC investors – both VCs that invest in innovative companies and the limited partners which support these investments. This applies to both the public and private markets. The prices of assets on the public markets are already low (with many companies trading well below cash), while those on the private markets appear set to decline as well. The dynamics of the private markets are strongly affected by the amount of 'dry powder' or capital, currently controlled by VCs. Most VCs have recently raised new, larger funds and we expect prices to decline as competition for this finance decreases. The current absence of crossover followed by IPO financing is also affecting competition, as companies are forced to stay private longer.

This dynamic is more pronounced in Europe than in the US. As evidence, we have seen large US VC and crossover funds focus less on new European opportunities this year and instead favour more local deals and focus more on refinancing their own portfolios. With reduced competition on deals, we believe unequivocally that this is the best time to double down on European biotech company investment and provide money for later-stage clinical development.

It is against this background that Forbion recently announced the first close of Forbion Growth Opportunities Fund II, its second fund for late-stage biopharma companies mostly located in Europe. The new fund attracted €470 million from investors, exceeding its €450 million target. Several new investors participated, including the PME pension fund. We also saw the return of several limited partners – Pantheon, Wealth Management Partners and Eli Lilly and Company – which had participated in the new fund's predecessor, Forbion Growth Opportunities Fund I. On 15 June, we announced the first investment from Fund II: a subscription and share purchase agreement with VectivBio Holding AG of Switzerland which is developing treatments for rare diseases. A description of this investment is found in Box 2.

As a VC, our primary focus is to invest in privately held European clinical-stage biotech companies. We also selectively invest in public biotech companies with strong clinical or early commercial programmes that come with depressed valuations. The Growth Opportunities Fund II addresses a real need in the market because there are few specialist late-stage investor groups in Europe. Instead, most VCs focus on a blended portfolio of both early-stage and late-stage deals. Historically, this has meant that most European late-stage companies ended up courting US-based VCs or US crossover firms as European VCs have been less experienced in this market segment.

The pendulum has now swung. With many US VCs less active in the European market, together with fresh capital raised by many European VCs, a real opportunity has presented itself for the Europeans to step up their game and increase later-stage investments.

This opportunity is accompanied by a real need on the part of companies for follow-on capital. We estimate that the market for funding private late-stage European life science companies has grown from €2 billion in 2019 to approximately €3 billion today[6]. With exits in the near future relying more on M&A in the pharma space, we believe the European life sciences market specifically offers an attractive risk-reward profile for VCs[7]. The reasons, outlined in Box 1, include the quality of science, valuations and operating costs.

The efficiencies of European biotech, in terms of lower running costs and valuations, will likely result in comfortable returns for investors. This in turn will drive more investment in the sector and lead to more M&A activity. There is no shortage of funds for global M&A with some estimates of the potential capital as high as $1.7 trillion[8].

For the past two years, two trends have depressed the market for pharma M&A. The first is the Covid-19 pandemic which created uncertainty about the security of supply chains and therefore the ability of pharma to manage acquisitions. The second were the recent high valuations of biotech assets. With these two factors largely in abeyance, we expect a revival of M&A. This will also be driven by upcoming patent cliffs for several companies. It is estimated that more than nine of the 20 best-selling drugs will lose patent protection in the coming years, driving a search for new assets.

In such an environment, having the ability to continue to privately finance companies into later stages of development, and potentially into early commercial development, will be a distinct advantage. Cost-efficient, reasonably valued companies with differentiated products, will be the winners.

Conclusion

European biotech companies have a distinct track record for being able to develop novel products while managing cash burn. As investors, we anticipate demand for these companies to emanate from pharma M&A. Simultaneously we will be securing sufficient capital and reserves for these companies to develop their assets to a later stage than they might not be able to do otherwise.

Box 1. The European life science market

The risk-reward profile of European life science currently rests on three pillars:

- The quality of science is on par with the rest of the world, including the US, with strong innovation providing the catalyst for company creation and early-stage investing, ultimately leading to deal flow for late-stage rounds;
- The average valuation of European assets is 30% lower than that in the US for assets at a similar stage of development. We expect that with decreased competition for deals, this differential will become even more pronounced; *and*
- The cost of operating a biotech business in Europe is now 60% of that in the US. Consequently, capital exposure to development risks is lower while the upside potential of an investment can be higher.

Box 2. Investment in Swiss biotech

The Forbion Growth Opportunities Fund II has entered into a subscription and share purchase agreement with VectivBio Holding AG of Switzerland in order to support the company's portfolio of treatments for severe rare diseases. VectivBio's lead product is a synthetic GLP-2 analogue in clinical development for a range of rare gastrointestinal diseases. The company is listed on Nasdaq. Forbion has agreed to purchase 3.5 million shares in a private placement yielding gross proceeds to the company of $20 million. In parallel, VectivBio is conducting a follow-on public offering to raise $30 million.

References:

1. Torreya Capital LLC, Biopharmaceutical Market Update, 16 May 2022.
2. The pending biotech IPO crunch, baybridgebio.com/blog.
3. Healthcare Hedge Funds are in Critical Condition, www.institutionalinvestor.com, 11 May 2022.
4. Torreya Capital LLC, Biopharmaceutical Market Update, 16 May 2022.
5. The 10 Biotech Venture Capital Firms in Europe to Watch in 2018, www.labiotech.eu, 26 March 2018.
6. This opportunity consists of more than €800 million in life science growth capital; €800 million in cross-over funding and more than €1.2 billion from IPO and follow-on financings. The size of the cross-over figure reflects an increase in the average size of these rounds from €45 million to €100 million over the past two years.
7. This calculation is based on data derived from the McKinsey & Co report, Biotech in Europe: A strong foundation for growth and innovation, 23 August 2019.
8. Liu, Angus, Get ready for M&A: Large biopharma companies will have $1.7T in dealmaking firepower next year, analyst says, *Fierce Pharma*, 1 December 2021.

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