How to Survive in a Down Market

A Survival Guide for Biotech CEOs

BY MICHAEL VARABIOFF

You're the CEO of a promising biotech start-up. You've got a blockbuster drug candidate and you're on the cusp of commencing your Phase I clinical trials. You've been hiring like crazy. You completed your Series A financing six months ago and have enough money to last another six months, at which time you will need to raise at least $5 million to hit your next valuation milestone. And then the bomb drops. The NASDAQ Biotech Index falls like a rock, followed closely by the TSE biotech stocks. The country is verging on recession and the prospects for financing a biotech start-up are bleak.

Sound familiar? Financing technology start-ups is subject to the ebb and flow of the financial markets, which act in an unpredictable fashion and change very quickly. Every seasoned CEO has faced this scenario at one time or another. Here is a survival guide to help you make it through to the next bull market.

Cut your Burn Rate Look for ways to immediately reduce (or defer) your costs. For most organizations, the biggest single cost item is people. You should only keep those people who are absolutely critical to the success of your venture. You may think that losing those key employees will be disastrous, but chances are if you're laying off staff, so are your competitors. Your next biggest cost is probably your space. Consider moving, renegotiating your lease, subletting a portion of your space, or if you own your facilities, selling all or a portion of them. With the rest of your costs, you need to go through each expense item and determine whether it is absolutely necessary. You'll be surprised at how much you can live without. Once you've shaved the expenses, try deferring payment as long as possible (without adversely affecting your credit rating). If you're going to be late on a payment, advise the receiving party as soon as possible to mitigate any drastic action by creditors. Most people will work with you through difficult times if you communicate with them.

Don't Buy It, Rent It Do you really need to own your building, your lab and your people to be a successful biotech company? When times are tough, don't buy it, rent it. Buying is very expensive. In the case of your space, the concept is easy: Rent your space rather than buying it. Historically, many drug and device companies bought space because there were significant leasehold improvements that had to be made to buildings to meet business objectives. Companies didn't want to spend the money on these improvements only to find that the lease wouldn't be renewed. Nowadays, landlords are addressing the need for specialized space by constructing buildings designed specifically for the needs of biotech companies. In the case of your people, rather than hiring a large number of employees, contract out as much work as possible. There are a significant number of contract research organizations (CROs) handling everything from preclinical studies and clinical trials to regulatory affairs. The beauty of renting is that you don't have assets sitting idle during down times, and you can usually terminate these arrangements on very short notice.

Trade Cash for Upside Potential

In most early stage ventures, cash is scarce; therefore, you must find other ways to compensate your staff and pay your outside advisors and suppliers. Usually this is done with equity in the form of shares or stock options. When cash starts to run out, you should consider offering your employees a revised compensation package that is weighted more heavily towards equity and less heavily towards cash. While everyone needs a minimum level of cash to survive, in difficult times employees understand that they may have to accept less cash in exchange for more upside potential. As with all dealings with your employees, it is essential to get competent legal and tax advice when restructuring employment terms. You should also consider offering your external advisors and suppliers equity in lieu of cash.

Incentify Your Key People Your people are your greatest asset. Now, more than ever, you need that core group of people to be dedicated and focused on seeing the company through some rough waters, and not looking for other opportunities. A good way to do this is by increasing their option position, either by granting more options, repricing their existing options to a price more in line with the market, or accelerating the vesting schedule.

Focus on Your Core Product You've got two or three potential drug candidates. This is probably a good strategy since if one product fails, you've got others to fall back on. Unfortunately, at this point you don't have the luxury of being able to pursue all of your candidates. You need to pick your best drug candidate and focus on it, and put the others on the shelf for the short term or license them out.

Define Your Milestones and Hit Them In the drug development game, where it could take hundreds of millions of dollars to bring a drug to market, the key to a successful long-term financing plan is to precisely define your milestones, and then be absolutely sure you hit them. By demonstrating your ability to set and achieve goals, you gain the confidence of the financial community and each successive round of financing should become easier. Conversely, if you miss your milestone, investor confidence rapidly erodes. When money is tight, you must revisit your milestones and make sure that they are accurately defined, but more importantly that you will be able to hit them. This may require you to be a little less ambitious with your current milestone, or break it down into more manageable steps to ensure that you reach each one. In this environment, it's better to hit the first two of three small milestones than to shoot for one big milestone and fall short.

Lower Your Expectations (Be Realistic) You may think your drug is worth billions. And maybe yesterday it was. But today it's worth a lot less. Take a good, hard look at the current market conditions and reassess what a realistic valuation is for your company. Valuations will be dropping all over your sector. When you have that crucial meeting with a potential financier, you want to be talking in today's dollars, not yesterday's.

Rely on Strategic Partners Successful drug development programs by biotechs often result in a licensing deal with big pharma, pursuant to which big pharma will complete development of the drug and handle its manufacture and sale in exchange for milestone payments and an ongoing royalty. From the biotech's perspective, it is better to do this deal

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Contract Out Your Services You've got some very highly skilled people in your organization, as well as some sophisticated lab equipment. You may also have more space than you need. Consider ways in which you can use these assets to generate some cash flow. For example, you may be able to contract out some of those skilled people to other firms for the short term, or you might be able to rent out some of your extra space to a biotech start-up. This is obviously not a long-term strategy, as the big win will likely come from the success of your drug, not from the contract revenues. However, it may be a strategy for generating badly needed cash in the short term.

Leverage Your Assets One of my clients was living hand-to-mouth. They needed cash to meet the next payroll. They had SR and ED tax credits approved, but would not be receiving the cash for another two months. This company was able to go to the bank and obtain a loan secured by the proceeds from the tax credit. In this way, they were able to solve their short-term cash problem.

Above All Else, Act Quickly and Decisively You are in a period of uncertainty and significant change. Time is not on your side. This is not a comfortable place to be for you or those in your organization, and as a result there will be a tendency to delay making the hard decisions. Don't do it. Make your plan and implement it quickly. If you don't, first you will run out of cash. The sooner you get your burn rate under control, the better your chances of survival. Every week or month of delay burns up cash that you will need to survive. Second, your employees will sue you and your directors. Upon termination, your employees are legally entitled to a period of notice or a severance payment. The usual result is that you will pay terminated employees a severance payment. The directors of your company can be personally liable for unpaid wages, vacation pay, unpaid taxes and other obligations, so you must be sure to maintain enough cash to satisfy these obligations. Third, you won't have enough time to raise money and the closer you come to running out of money, the lower your valuation will become. It will take a lot longer to arrange new financing than you think, particularly in a down market. The sooner you start, the better your chances of raising those additional funds.

Surviving in a down market is a challenge. It is also an excellent opportunity to fix anything that's wrong with your company. The good news is, if you do survive, you will likely have a stronger, leaner, more successful company when the market turns.

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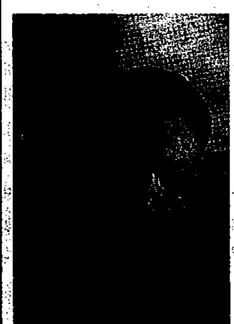

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From: Michael Varabioff

Sent: Tuesday, October 19, 2004 10:24 AM

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