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Early upfront share deals have become the go-to exit strategy for biotechnology companies

Early upfront share deals represent an attractive exit strategy for venture-backed biotech companies and their institutional investors. This M&A transaction usually involves an initial upfront purchase price payment upon signing combined with future milestone payments.

Founders and institutional investors in the field of drug development find themselves in an increasingly competitive environment. Today's equity financing rounds involve very large funding volumes even in early stage companies and biotechnology companies are often financed by international syndicates in order to safeguard both, the quality and the speed of drug development. This makes exit strategies increasingly important. Driven by the profitability targets of their investment funds, successful VC investors are looking for an early cash event in the portfolio of their investee companies. The early upfront share deal represents the go-to exit strategy.

What exactly is an early upfront share deal?

The idea is to sell biotechnology companies to Big Pharma already after the completion of the clinical phase-I-study. The shareholders receive a significant part of the purchase price in the form of an upfront payment upon signing followed by further payment tranches that are linked to reaching specified development milestones. Nevertheless, the purchaser is obliged and undertakes to successfully complete the development of the drug in order to obtain a marketing authorization and to commercialize the drug.

What benefits does this type of M&A transaction offer to the different stakeholders?

In contrast to a license deal or the sale at a later stage, this deal structure offers attractive benefits to all stakeholders of venture-backed biotechnology companies in a very early stage.
The shareholders are able to monetize the drug or the product pipeline based on the current development status immediately, as the initial purchase price is paid upfront against the simultaneous transfer of shares. At the same time, the completion of the clinical development, regulatory authorization and commercialization of the drug are outsourced to a suitable pharma partner while retaining a certain measure of control. Although decisive influence in the company ends with the share sale and transfer, the purchaser is bound by legally enforceable provisions set forth in a detailed development plan in order to work on and obtain a marketing authorization for the drug and to market the drug. If these

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development covenants are breached, the purchaser may even be obliged to return the program by way of a re-transfer and the IP rights pertaining thereto.

A clear upside for the VC funds is the fact that the shareholding no longer appears in the books after the deal has been closed, so that they can present their LPs an exit with a cash event early on in the process. Possible future milestone payments supplementing the purchase price represent further significant upside potential.
An extra plus in comparison to a license deal is the fact that the purchaser also gains control and governance over the acquired company, including all internal and external resources pertaining to the program. Even though a takeover always triggers a certain amount of integration costs, the advantages for strategic buyers still outweigh this downside. Synergy effects are increased and the development process is be continued without time-consuming interruptions.

A crucial advantage for the acquired biotechnology company is the fact that its long-term financing is secured and the search for further VC investors can be abandoned. In addition, the transaction creates immediate clarity in governance issues. Unlike in a license deal scenario, key employees benefit from the exit by means of a direct or virtual stake in the upfront payment.

Why are early upfront share deals so popular or useful especially in the life sciences sector?

The development of drugs and therapies is both costly and time consuming. It dictates a fairly linear strategy for the biotech company: Drug design, preclinical research followed by clinical trials and marketing authorization. VC-financed biotech companies are able to act much faster than corporate R&D in the early development stages. If the clinical data are promising, the innovative contribution to drug development often ends with the phase-I-study. This is also the point in time when the accelerating effect of venture backed equity financing and the ad-value contributed by VC life sciences investment funds start to fade. If the biotechnology company is disposed to a large pharmaceutical group in this early stage already, the chances of rapid success in obtaining a marketing authorization and actually selling the drug increase. This is equally attractive for Big Pharma, of course. For these reasons, an upfront share deal is often expedient for all players.

What are the specific legal issues and pitfalls in early upfront M&A transactions?

In particular the drafting of the covenants for the milestone payments requires a deep understanding of the life sciences sector and the legal parameter: Extensive legal expertise in the fields of intellectual property right, and medicinal law as well as international contract standards is required to properly address the relevant range of topics extending from the regulatory approval procedures of the FDA and EMA, the usual practices of commercialization and structuring of royalty payments to the effects on the purchase price of so-called combination preparations and therapies. The content, time table and scope of the covenants requiring the purchaser to continue the drug's development are extremely important. In many cases, purchasers are U.S. pharmaceutical groups, which additionally calls for expertise in Anglo-Saxon contract law. Moreover, the liability regime under the guarantees can be negotiated in a different manner in the case of early upfront share deals than in customary M&A transactions, because a significant part of the purchase price only becomes payable in tranches at later stages, which triggers a particular need of protection.

Do you see a trend in favor of early upfront share deals in the biotech sector?

The first deals of this type occurred in the USA more than 15 years ago. Two recent early exits transacted in Germany were the Merck & Co.'s takeover of the Munich-based company Rigontec and the sale of Breath Therapeutics to Zamboni. We do not see a broad trend, however. Nevertheless, the early upfront share deal could be an attractive structuring option if the following requirements are met. The ideal candidates for an early upfront share deal are VC-backed single-compound biotech companies acting in an interesting indication area that yield promising clinical data in the phase-I-study. Ultimately, however, early upfront share deals always depend on the willingness of large pharmaceutical companies to take the risk of acquiring programs in an early development stage. Even after subjecting the science and the company to a due diligence, the deal remains a bet on good clinical data in phases II and III and the ability to obtain a marketing authorization for the drug. The biotech industry remains a buyer's market driven by the BD and M&A departments of pharmaceutical companies.

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