Professional Perspective

Navigating a Resilient but Uncertain Venture Capital Fundraising Environment

Marc Rubenstein & Rajarshi Banerjee, Ropes & Gray

Bloomberg Law

Read Professional Perspectives | Become a Contributor

Reproduced with permission. Published December 2022. Copyright © 2022 The Bureau of National Affairs, Inc.
800.372.1033. For further use, please visit: bna.com/copyright-permission-request

Navigating a Resilient but Uncertain Venture Capital Fundraising Environment

Contributed by Marc Rubenstein & Rajarshi Banerjee, Ropes & Gray

After a nearly two-year Covid-19-fueled surge in financing opportunities, 2022 has been a difficult year for the life sciences industry. The SPDR S&P Biotech ETF, a closely watched biotechnology index, is currently down by over 20% year to date and is roughly 50% below its February 2021 peak. In May 2022 over one hundred small public biotech companies were trading at market caps that were lower than the cash they had on hand. It's no surprise then that the industry has endured headlines about "bloodbaths," "infernos," and, most devastating of all, in the words of one *Bloomberg* article: "bad vibes."

What is less obvious is that, although this market downturn has been disastrous for development-stage public biotech companies, it has not had nearly the same impact on private venture-backed startups. While VC investments in the U.S. biotech sector have been steadily declining since Q1 2021, 2022 is on track to be the third-highest fundraising year on record for private VC-backed biotech companies, falling only behind the heady years of 2020 and 2021.

There is good reason to expect investment levels in private biotech companies to remain buoyant. According to the National Venture Capital Association, U.S. VC funds across all sectors raised a record-breaking $131 billion from their limited partners in 2021, surpassing $100 billion for the first time ever. Even amidst this year's cratering biotech market, some of the largest biotech VCs announced major new funds: Atlas Venture announced a $450 million fund in March, Third Rock Ventures followed by announcing a $1.1 billion fund in June, and ARCH Venture Partners closed a nearly $3 billion fund shortly after. Absent a significant new market shock, we expect investors to deploy much of this dry powder over the next three to four years.

Despite this good news, the private biotech ecosystem has not been immune to the anxiety in the public markets. Investors, board members and management teams have been observed to fret that the high valuations at which private biotech companies raised capital during the Covid-19 years are difficult to justify in the current environment. They worry that companies should anticipate that their next round of funding may be a 'flat' or 'down' round. This means that the share price offered to the next round of investors will be the same or lower than that offered in the company's last financing.

The prospect of a down round would have been unthinkable for successful private biotech companies in 2020 or 2021. Even in this environment, it is difficult for companies pushing the frontiers of medical science to come to terms with the possibility that they may be worth less next year than they were at an earlier stage in their life cycle.

Amidst this gloom, CEOs of private biotech companies that are looking to fundraise in 2023 face a difficult choice: approach investors now and accept a flat or down round, or wait for market sentiment to improve before potentially raising funds at a higher valuation.

The Case for Waiting

Private biotech companies that raised large rounds during the Covid-19 years have the luxury of waiting several months or even years before returning to investors, especially if they tighten their belts or are able to access so-called non-dilutive financing through business development transactions or other means. These companies can make a bet that, over the coming quarters, market sentiment will improve, and biotech VCs will look to put the billions of dollars that they have raised in recent years to work, leading to a more attractive fundraising environment for companies.

If this bet works out, then companies that wait out the current gloom may be able to avoid a down round, with its dilutive effect on existing stockholders, particularly employees and, potentially, early investors who may not have any contractual 'anti-dilution' protections. However, if it does not work out, companies will find themselves going out to investors closer to the end of their cash runway, at which point they may be more inclined to accept less favorable economic terms from investors than they would now.

©2022 The Bureau of National Affairs, Inc.

The Case for Accepting a Down Round Now

A down round can be demoralizing for a private company. However, there are certain benefits to raising funds at a lower valuation in the current environment instead of waiting to see how things shake out.

The obvious benefit is that locking in funds now, even in a down round, gives companies the certainty that they will have the capital they need to reach their next value inflection point. This may be demonstrating proof of concept of a platform technology, meeting an endpoint in a clinical trial for a lead product, or having an approved therapeutic on the market. At this point a company can return to investors in a stronger position. For companies looking to go public in a year or two, accepting a down round now also allows them to show a healthier step up in valuation when they approach the public markets.

Moreover, as jittery as the current environment seems for companies, it is entirely plausible that investors may have greater negotiating leverage a few months from now than they currently have. This could be due to worsening macroeconomic conditions – there is a looming specter of a global recession in 2023. Also, private biotech companies that need to raise funds at some point over the next year and are biding their time now might have no choice but to rush to investors in a quarter or two, at which point these companies may have to compete with each other for the attention of VCs by accepting less favorable terms.

Structuring Deals to Avoid a Down Round

Companies that are looking to fundraise in the current environment and are concerned about the impact or optics of a down round can explore creative ways to structure deals to avoid a down round, or at least avoid the impression of one.

One approach is to incentivize investors to accept a flat or up round by offering them warrants to purchase additional equity at a low pre-determined exercise price. This can avoid creating the impression of a down round today and give investors the opportunity for more upside in the future if a company does well. However, a sophisticated future investor or analyst should be able to spot that a flat or up round with warrants is a financing that may have otherwise been a down round.

Companies can also explore a deal structure where investors agree to a flat or up round now but have access to a mechanism that will in effect adjust the pre-money valuation of the round if the company fails to achieve pre-determined milestones within certain timelines. These valuation adjustment mechanisms might help companies avoid a down round, but they have their downsides. For one, these mechanisms add negotiation complexity – even if investors agree to pursue this deal structure, companies might find themselves spending time going back and forth with investors on the specifics of the mechanism or on the definitions of the milestones.

These mechanisms can also hinder a company's freedom to operate – a biotech may be less inclined to pivot from its current course of action if it means missing a milestone and triggering a dilutive adjustment to outstanding equity. Finally, any kind of after-the-fact valuation adjustment creates uncertainty for both companies and investors. Companies should therefore determine whether the benefits of valuation adjustment mechanisms outweigh their potential drawbacks.

Exploring Pharma Collaborations to Bring in Non-Dilutive Funds

For private biotech companies that are looking to sit out the current fundraising environment, licensing and collaboration deals with pharmaceutical companies offer the prospect of large upfront fees and milestone payments that can postpone the biotech company's cash out date by several months or years. These payments are also 'non-dilutive' funds – they do not dilute existing shareholders or otherwise affect companies' capitalization tables – which makes them especially attractive for biotech companies that are worried about going through a down round. However, VC-designated board members are increasingly recognizing that, while these deals do not cause a direct equity dilution, they may dilute a company's asset portfolio in a way that is potentially no less meaningful than a dilutive equity raise.

2022 began with a spate of major collaboration deals between biotech companies and big pharma. At January's J.P. Morgan Healthcare conference, one of the industry's biggest events, Pfizer and genetic medicines company Beam Therapeutics announced a collaboration. This involved a $300 million upfront to Beam, with the potential for Beam to receive up to $1.05 billion in additional contingent payments or, in industry parlance, biobucks.

 ©2022 The Bureau of National Affairs, Inc.

At the same event, Pfizer's pandemic partner BioNTech announced a $750 million immunotherapy collaboration with Crescendo Biologics with a $40 million upfront to Crescendo. Pfizer's vaccine rival, Moderna, announced an oncology collaboration with Carisma Therapeutics with a $45 million upfront payment to Carisma. Dealmaking activity has continued throughout the year, giving promising private biotech companies an eye-catching fundraising alternative to VC-led equity financings.

However, licensing and collaboration deals can take significantly longer to negotiate than VC-led equity financings. It is not unheard of for a year to go by between initial meetings with potential pharma partners and a signed agreement. It is also not unheard of for potential pharma partners to pull out of a negotiation after months of diligence and discussions for reasons that are difficult to foresee, such as a change in internal business strategy.

Pharma partners can delay large collaboration payments to biotech companies by asking for lengthy technology evaluation periods before entering into collaboration agreements. They may also structure option deals with low upfront payments and larger discretionary option exercise payments that might not be paid until the parties achieve a certain R&D milestone. For these reasons, a license and collaboration deal is unlikely to be a viable alternative to an equity financing for biotech companies that need to raise funds in 2023 and are only starting to think about doing a deal.

Conclusion

Despite this year's sharp downturn in the public markets, the private biotech ecosystem has proved to be remarkably resilient. Nevertheless, venture-backed biotech companies face difficult decisions when it comes to fundraising. Companies that think strategically about the timing and terms of their next fundraise and thoughtfully explore alternatives to equity financings will emerge from this current period of uncertainty poised to take advantage of improved market conditions.

©2022 The Bureau of National Affairs, Inc.