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German Biotechs Embrace Reverse Mergers

New Transaction Model Attractive to Companies that Are Seeking to Go Public in the United States

Henning Mennenoeh, Peter Kohl, and Wolfgang Kircher

Henning Mennenoeh

Peter Kohl

Wolfgang Kircher

Many private German biotech companies are facing difficulties raising capital. In Germany, venture capital is increasingly only available to a small number of companies that receive relatively large funding. An IPO is an option to few German late-stage companies. Many difficulties and uncertainties are none-the-less associated with such IPOs in Germany where low valuations and lack of oversubscription have been common problems. Follow-on financings also prove more difficult in Germany than in countries with further developed capital markets like the U.S. or the U.K.

As a result, German biotechs are finding public listings in more established markets increasingly attractive. **GPC Biotech** (www.gpc-biotech.com), for instance, is not only listed in Germany but also on NASDAQ. Other German biotech companies have explored creative transaction structures, like the reverse merger into a publicly held U.S. company, as a way to access U.S. capital markets. Over the last year, this transaction model has presented itself as an attractive model for German biotechs seeking to go public in the U.S.

In May, private German biotech company Micromet was formally taken over by publicly held U.S. biotech company CancerVax by way of a reverse merger, creating a new transatlantic, NASDAQ-listed biotech company that was renamed **Micromet** (www.micromet-inc.com) and will be led by Micromet's CEO. The new company's drug development pipeline focuses on oncology and autoimmune and inflammatory diseases. Although Micromet was legally taken over by CancerVax, its shareholders actually control the new combined company, having received 67.5% of the shares.

Advantages

There are several potential advantages of a reverse merger for a German biotech company.

Access to U.S. capital markets facilitates raising capital. As a U.S.-listed company, the German biotech will gain access to the U.S. public capital markets for follow-on financings.

In the current climate, large market capitalization companies in Europe typically have sufficient liquidity on their home-country stock exchanges, such as the Deutsche Borse, to satisfy their needs. In contrast, growth companies, such as in the biotech sector, rely more heavily on liquid markets (i.e., stocks with high average daily trading volumes), a strong technology-focused investor base, and a well-established legal and regulatory framework to support their growth and permit smooth exits for their investors.

Unfortunately, the German stock market currently lacks the critical mass to meet these needs of a growing biotech company. Therefore, the regulatory burdens that often result from a U.S. listing are unlikely to act as a deterrent for a German biotech seeking to raise capital.

U.S. listing enhances share liquidity and creates potentially higher valuation. Although a German biotech company may list its shares as a foreign private issuer in the U.S., many financial advisors believe the public flotation of a U.S. entity as opposed to a straight flotation of shares of the non-U.S. entity will enhance valuation and U.S. investor acceptance.

Furthermore, some large U.S. institutional investors are prohibited by their organizational documents or regulatory restrictions from investing in non-U.S. companies. Allowing access to these investors may result in greatly improved demand for the company's shares and potentially enhanced valuation.

Cash balance may add fresh capital to the company. A reverse merger is particularly attractive for a German biotech company interested in a U.S. public listing if the U.S. partner brings a considerable amount of fresh capital to the combined com-

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pany. In the Micromet/CancerVax case, for example, CancerVax had a cash balance of approximately $40–50 million, which the company can now use to accelerate the development of its drug candidates and to expand its drug pipeline.

It is true that there are potential risks of unwarranted dilution as a result of paying a significant premium to the cash value of the target or purchasing unrelated assets of limited value. But these risks will more often than not be outweighed by the biotech's access to fresh capital.

Product Portfolios

Additional product candidates may expand existing portfolio. Similarly, the attractiveness of reverse mergers for German biotechs may further be increased if the U.S. partner brings in additional product candidates that broaden the product portfolio. In the case of the Micromet/ CancerVax merger, CancerVax provided the combined company with an additional preclinical antibody program that strengthened Micromet's existing pipeline of drug candidates.

Exit opportunity is created for old investors. For shareholders in German biotech companies, particularly venture capital houses, the reverse merger is a new way to reach an exit. This aspect should not be underestimated, as other exit routes like IPOs and trade sales have become increasingly difficult in the German market.

It is not surprising that discussions about a possible reverse merger are often initiated by venture capital firms with shareholdings in German biotech companies. They are particularly attracted by the prospect of getting the valuation of their portfolio companies to a level that rewards them for their investments and opens the way to a profitable exit.

A trade sale of an entire business or merger under, for example, Delaware law is attractive as it allows for an approval by a simple majority vote of stockholders, while German law requires a 75% majority of the votes cast. The ability under Delaware law to easily squeeze out minority investors not desiring to sell is another significant selling point to any potential acquirer.

Furthermore, familiarity of the buyer with the legal issues, documentation, and due diligence of a U.S. target company will certainly enhance the likelihood of concluding a successful exit with a would-be U.S. purchaser.

A U.S. listing is particularly attractive to German biotech companies because it can offer several options for obtaining follow-on financings that would, in most cases, not be as readily available on the German market.

Avoiding pre-emption rights and shareholder approvals. The board of directors of a German company generally can issue new shares, either in a follow-on public offering or in a private placement, only after having first obtained shareholder approval and waivers of shareholder pre-emption rights. This is significantly more burdensome and time-consuming than in the U.S., where the management can complete a follow-on equity fundraising quickly to take advantage of favorable market opportunities.

Private investments in public equity (PIPEs). While U.S. PIPE offerings can often be executed quickly and privately (without advance publicity), and the purchase price payable by the investor is often significantly below the market price of the biotech company's shares, German law is less flexible.

It does not provide comparable special rules on the issuance of shares to institutional investors, and a share issuance at a discount of more than 3–5% below the market price is not possible, due to the requirement under German law that the issue price must not be substantially below the stock's fair market value.

Better-developed market for convertible bonds. Although convertible bonds are available both under U.S. and German law, Germany has a less well-developed market for them, while U.S. investors typically have a deep understanding of these instruments. In addition, complicated German legal procedures, such as creating contingent share capital, have restricted the market and therefore, the attractiveness of convertible bonds in Germany. GEN

Henning Mennenoeh is a partner at Hogan & Hartson in Munich, Peter Kohl is a partner at Hogan & Hartson in London, and Wolfgang Kircher is an associate at Hogan & Hartson in Munich. Web: www.hhlaw.com. E-mail: hmennenoeh@hhlaw.com.

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