bioentrepreneur
Brought to you by nature biotechnology

Business Development

Published online: 21 April 2003, doi:10.1038/bioent727

Giving your spinout the right spin

David McElroy[1]
David McElroy is Vice President of Operation and Business Development at Verdia Inc., 200 Penobscot Drive, Redwood City, CA 94063 (e-mail: david.mcelroy@verdiainc.com). The views expressed here are those of the author and not those of the author's current employer.

Spinning out a new company presents challenges for both the parent company and the new entity, but setting the right boundaries and expectations upfront can prevent later difficulties and maximize the value of the asset to both parties.

We've all heard tales of the plucky young kindergarten dropouts who hole up in their parents' garage for a couple of months only to emerge with some gizmo that they immediately translate into product revenue, venture financing, a wildly successful IPO and an appearance on the cover of *Fortune* magazine all before their first visit to the orthodontist. But, despite what our graduate school recruiters may have told us, this is not how things get going in biotechnology. In biotech, successful new companies are often incubated for some gestation period within a parent entity, such as a university research lab, a government facility or a corporate environment.

Before we go any further, let me tell you that I'm not going to provide anecdotal stories of successful spinouts, some of which I've highlighted in Table 1. Nor will I present a checklist of action items for the typical spinout since both of these topics have been well-covered elsewhere[1, 2, 3]. I'm also not going to discuss spinouts from universities or the creation of publicly traded mid-sized therapeutics companies from big pharma[4]. Instead I am going to limit my advice to a situation I know something about: spinning out a small venture-funded startup from a larger corporate entity.

Table 1: Selected Biotechnology Spinouts

Spinout	Spinout business	Spinout financing date	Spinout initial financing (millions)	Spinout IPO	Spinout market cap on 3/11/03 (millions)	Parent	Parent business
Abgenix	Antibody therapeutics	1996	$14	1998	$555.20	Cell Genesys	Gene therapy
Affymetrix	Gene chips	1993	$21	1996	$1,528	Affymax	Combinatorial chemistry
Biovitrum	Metabolic disease	2001	$130	Private	N/A	Pharmacia	Pharmaceuticals
Guilford	Neurology products	1993	$2.50	1994	$109.60	Scios	Cardiovascular & inflammatory diseases
InterMune Pharmaceuticals	Infectious disease	1999	$6	2000	$567.20	Connetics	Dermatology
Perlegen Sciences	Genome scanning	2000	$100	Private	N/A	Affymetrix	Gene chips
ZymoGenetics	Therapeutic proteins	2000	$150	2002	$367.30	Novo Nordisk	Disease indications

Where do spinouts come from?

Spinouts usually arise for a combination of strategic and economic reasons—the parent company is faced with deciding between maintaining a hidden asset whose value is not fully recognized in its share price versus obtaining a stake in a potentially successful spinout. Under one spinout scenario a rapidly growing company may one day find itself housing very different businesses, which may need to be split up in order to fully realize their independent value. Very often, new technology assets are developed within the parent company as 'skunk works' by a group of like-minded scientists. Such skunk works projects often lead to the creation of a team struggling to get the internal recognition and funding necessary to move their vision along. However they are created, such spinout candidates may have very different business development, licensing and commercialization strategies from those of their parent. Meanwhile, the cost (in both focus and funding) necessary to sustain such non-core research may be a challenge for the parent. This is especially true if the parent is just starting to generate positive cash flow, as was the case when Affymetrix spun out Perlegen Sciences (see Table 1).

With merger and acquisition activity in the biotech industry expected to rise in the near-term and with big pharma looking to reduce costs, some business units may have no choice but to participate in a spinout. Furthermore, with large corporations tightening their belts, a number of alliance-funded (third-party) non-core business units that are protected 'cash cows' as long as funding is secure, might be given the opportunity to 'realize their true potential' as their revenue prospects disappear from beneath their parent's feet.

Pros and cons in the spinout decision

Spinning out non-core assets should allow the parent to better focus on their continuing activities. Any savings on R&D expenses previously invested in the spinout can be redirected toward retained R&D efforts. A spinout can also reduce the technical and commercial risk exposure of the parent by isolating high-risk activities within the new entity.

A spinout creates a new entity that is able to seek its own financial support without having to struggle for attention from the parent. This allows the spinout to focus on developing its own technology and business independent of the parent's strategic constraints. Having an industry-savvy venture capital (VC) partner guiding the investment should drive the spinout to market faster than the benign management of a parent company, especially where the new entity's business proposal may not be well understood by the parent. Any product or alliance revenue generated by the new entity will now go directly to the spinout for it to use as it sees fit. Since spin-off discoveries are often transforming and generate intellectual property in areas outside the parent company's core interests, a spinout may be better positioned to work with best partners, to expand its licensing business and to leverage that new business in ways that might not have been possible as a neglected business unit of the parent.

Spinning out a new company and allowing it to raise its own finances should generate a liberating sense of independence for the newfound entrepreneurs as they take control of their own destiny. The new spinout will likely have a relatively simpler organization, allowing its staff to take ownership of the decision-making process, and a reward system that is closer to the technology. The creation of a spinout also provides an opportunity to use pre-IPO stock options to retain and motivate key founding staff, attract new employees and retain independent board members.

But all is not rosy in Spinoutsville. In return for these potential benefits, the spinout will be giving up a substantial 'safety net' previously afforded to them by the parent company. In establishing the new entity the spinout may have to forgo the established brand equity associated with the parent company. The spinout could also lose access to key infrastructure such as a broad base of scientific colleagues, complementary technologies, future core technology improvements made by the parent, product development capabilities, manufacturing capacity and distribution channels or market access. The spinout may start off as a research shop with little internal manufacturing capability or development expertise. In order to fill these gaps the new entity may need to maintain an ongoing relationship with the parent, cultivate new partners to fulfill its immediate infrastructure and capability needs, or use its own funds to build development and commercialization capabilities as it goes forward. Finally if the new entity is the latest child of a long pedigree of successful spinouts then it may have to deal with a 'legacy challenge' of either resting on its predecessor's historical laurels or garnering valuation expectations which it cannot fulfill.

Maintaining an ongoing relationship

Spinning out a new company doesn't have to be as traumatic as a contentious divorce, since both parties may want to retain some sort of amicable ongoing relationship. As in any cordial breakup the key is to determine upfront the ongoing boundaries between the new entity and its parent.

The parent is most likely going to retain an equity position in the spinout. However, in order for the new entity to fully exploit its independence and attract suitable VC financing, the parent must be persuaded that it needs to give up control. Given that the parent may harbor a lingering fear of losing too much of the value in the spinout, it may seek an option on technology, product rights or manufacturing and supply rights from the spinout. The parent may look to trigger these options at different phases of product development, with predetermined licensing, milestone and royalty provisions. Upon exercising its options the parent may be obliged to make retrospective and/or ongoing R&D payments to the spinout. In order to maximize independence, the spinout should negotiate a finite time period, restrict the field or scope of the agreement and make the parent forfeit its options if it does not exercise them early on in product development.

The spinout should seek to retain a license option on technology improvements developed by the parent for application in the spinout's field. Between the establishment of the independent entity as a wholly owned subsidiary of the parent and the 'separation event' (such as the parent giving up their majority equity position), the spinout may be obliged to obtain core services from the parent under a service agreement. This arrangement might prove expensive for the spinout since it will not be in a position to control the parent's cost structure or margin. So rather than negotiating these services on a prorated *per capita* or space utilization basis, the spinout should negotiate a below-cost service agreement that would be appropriate for a startup business. In doing so, the spinout can use the argument that rather than treating the spinout as a profit center, the shareholder parents should position the spinout to succeed in the long-term.

As a shareholder in the spinout, the parent will likely want to retain board representation. However, overbearing governance on the part of the parent may compromise the spinout's entrepreneurial spirit and its ability to attract quality independent board members or VC financing. Like any parent, employing overly excessive control of your progeny can be a frustrating endeavor for both parties.

Preparing the people for the spinout

Preparing staff for the spinout event and educating them throughout the process should limit post-spinout trauma and allow for the further development of a separate culture before actually leaving the mothership. The groundwork for this should already have been laid in developing the spinout's technology, organization, goals and strategies as a business unit under the parent. Meanwhile the parent needs to establish appropriate and equitably distributed financial incentives for the spinout's management team. In short, both parties strategic interests should be aligned at least until a separation event.

While there are lots of examples of successful spinouts, there must be an even greater number of candidates that never made it past the starting post simply because they failed to convince their parent that they were capable of standing on their own two feet. So, when approaching a parent company with a spinout proposition, make sure the business proposal seems viable enough to garner the parent's backing but is not so attractive that the parent is loathe to relinquish the new-found asset—otherwise, the spinout's advocates may find themselves exiting the parent in a fit of frustration.

Can we talk?

The management of the proposed spinout will most likely already work for the parent company. Since the parent will always be able to say 'no' to any of its child's demands, the only real leverage in the spinout negotiation is to convince the parent that its position may compromise the future success and shareholder value of the spinout.

Should the spinout retain independent counsel to negotiate the legal aspects of the spinout or rely on in-house counsel of the parent? The parent may suggest that in-house counsel is capable of 'wearing two hats' or uniquely positioned to negotiate a 'win-win' deal. However, there is a potential conflict of interest in this arrangement. Therefore, the spinout should retain independent counsel to review any intercompany agreements. This is not to say that the negotiation process needs to be confrontational. For the separation to work the spinout needs to consider the interests of all parties. Also, bear in mind when negotiating with the parent that strategies and relationships will change. Consequently, any agreements negotiated at the time of the spinout may have to be renegotiated at some point in the future.

Finally, just like expediting an agreement with a potential alliance partner, sufficient time needs to be set aside for the negotiations to be completed. At the same time, the negotiations should be expedited promptly to prevent second-thoughts on the part of the parent (are we selling too cheap?) and to evade the unwelcome attention of other interested parties if the spinout is to avoid having a new corporate parent controlling its destiny.

Attracting VC financing for the spinout

In addition to the parent doing everything reasonable to make the spinout attractive to potential backers, the spinout's management may want to informally contact VC investors to see if the proposed spinout is fundable. This early sounding out of the VC community may also mitigate any 'jilted lover' syndrome associated with the spinout—if the parent does not want the spinout or its product then why should anyone else?

The spinout may face a number of challenges in attracting venture financing. Most spinouts are not really startups, given that they may have grown for some time within the parent before emerging onto the market, so they may be looking to attract a larger first round of financing than the average bootstrapped startup. The parent may hold unreasonable valuation expectations for the spinout especially if the parent is unfamiliar with the spinout's business area or unaware of prevailing market conditions. On the other hand too much interest from VCs may cause concern for the parent. The parent's management might be worried that if they are seen to be selling cheaply they may have to face an embarrassing confrontation with the parent company's shareholders. Appraisal of the spinout may be a challenge since it may not have positive cash flow, and might be unique and lack suitable peers. Finally, the exit strategy for th spinout's investors will need to be considered since several rounds of financing may be needed to support the spinout.

Conclusions

Why go to all the trouble to spin out instead of remaining under a parent's umbrella? Many of you may have to struggle hard to convince your parent that it's worthwhile letting you go and the rest of you may be reluctant spinners. But however you get there, in the end it really is more fun being in charge of your own destiny. So pack up that suitcase, stock up on those tinned goods and get ready for life without your parents!

References

- Van Brunt, J. Biotech spin-offs seek new orbits. *Signals Magazine* (1999). http://www.signalsmag.com/signalsmag.nsf/657b06742b5748e888256570005cba01/cf05408f18adda9d8825679b0052d533?OpenDocument
- Ledbetter, A. & Zipkin, I. Achieving venture returns through corporate spinouts. *J. Comm. Biotechnol.* **8**, 339-347 (2002).
- Dewdney, J. & Phillips, A. Spin-outs on the menu? *J. Comm. Biotechnol.* **6**, 3-11 (1999).
- Van Brunt, J. The big spin (off). *Signals Magazine* (2002). http://www.signalsmag.com/signalsmag.nsf/657b06742b5748e888256570005cba01/f9dcf38f09570c4788256c3d007ce963?OpenDocument