

# Finding value

How biotech companies can have successful valuations **Interviewed by Troy Sympson**

**F**or biotech companies, the valuation process can sometimes be a long and difficult one. According to Carl S. Saba, senior manager, consulting, for Burr Pilger Mayer in San Francisco, valuation services is one of the biggest issues biotech companies are currently facing.

“The Financial Accounting Standards Board (FASB) increasingly requires fair value measurements in accounting, so valuations are needed in order to comply with financial reporting requirements,” he says.

Saba notes that, in general, valuations are done for financial reporting and tax purposes, along with a merger or acquisition, or during litigation. He notes that while most of the time, biotechs will fall under the first two categories, the exposure risk makes it imperative to get one — no matter what stage of development the company is in.

*Smart Business* spoke with Saba about valuations and how biotech companies can use them to their advantage.

## What are some of the tax and accounting requirements that drive valuations for biotech companies?

A lot of biotech companies issue stock options to employees in order to conserve cash resources, since the biotech business model generally takes a long time to mature. When a biotech does this, there are both tax and accounting implications.

On the accounting side, Financial Accounting Standard 123 (FAS 123) was recently revised, becoming FAS 123(R), which, in part, says that companies have to expense the fair value of their stock option awards on their income statements. In the past, stock options didn't have to be expensed on financial statements; they were generally shown as a footnote disclosure. So, in order to expense options under FAS 123(R), biotechs need to know what grants are worth on the grant date and, in order to value that option, you need to know what the underlying stock is worth. So, the main reason biotechs need to have a valuation done is so it can be used as a basis for valuing options and, subsequently, expensing them. If they don't, they may



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have issues clearing an audit or possible restatement risk if the company becomes public and subject to SEC review.

On the tax side, IRS Section 409A deals with deferred compensation and part of that covers stock options. Basically it says that if you issue stock options to employees, make sure you don't set the exercise price on the option below the fair value of the underlying stock. In other words, don't inadvertently issue a stock option that's 'in the money.' If you do, it becomes subject to 409A, and both you and the employee can face adverse tax implications.

## What risk factors do biotechs face in valuations?

You've got significant tax exposure to your employees in the issuance of options, so if you don't get regular valuations, you could be in trouble. Also, unlike in the past, you can't have your board 'decide' what your stock is worth without a proper valuation analysis to support that conclusion. The Silicon Valley rule of thumb establishing a 10-1 or 8-1 ratio between common stock and preferred stock will likely not hold up to an IRS audit under 409A. On the financial reporting side, there's a risk of either not clearing your audit or the risk of

restatement if you become public, and there is a large gap between a recently determined stock value and the IPO price.

## What are some of the challenges that come up in valuations of biotech companies?

The biggest challenge has to do with the fact that biotechs' business models take time to mature. Typically, a biotech will spend 10 to 15 years incurring heavy research and development expenditures, while trying to generate compounds that might have marketability, and then trying to get them through all the stages of pre-clinical and clinical trials. Thus, a lot of conventional valuation procedures — the cost approach, income approach and market approach — don't work. So, a biotech has to try to determine what might be of value tomorrow by evaluating possible future outcomes for the company and the relationship between current expenditures and future results.

## What makes biotech valuations unique?

Since biotechs have to keep raising capital for a while, they often end up with complicated capital structures. There isn't just one type of ownership, such as common stock. You've got a layered capital structure, with common stock, preferred stock and, possibly, convertible debt, options and warrants. So, when you value a biotech, you have to do a valuation of the total equity, and then figure out how to split that equity among the layers of ownership. But, you can't split it evenly since they're all different.

So, there are three ways to do this: with a probability-weighted approach based on future outcomes, with an option model, or by looking at what the company is worth on the valuation date and allocating based on that. The last option, while easier, is not really acceptable anymore other than in very limited circumstances.

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