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SPIN-OUTS CREATED FROM THE LEITAT TECHNOLOGY PARK: A MECHANISM TO UNLOCK HIDDEN VALUE

PLENARY SESSION 1

Technology and business: balance and priorities in STPs and AIs

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Spin-outs created from the LEITAT Technology Park: A mechanism to unlock hidden value

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EXECUTIVE SUMMARY

The Leitat Technology Park is the leading STP in the Barcelona area. It serves the needs of hundreeds of SMEs (Small Medium Enterprises). Besides this main role as technology provider, the Park also encourages the creation of spin-out companies originated from technology that has been developed within its walls. In this article a step-by-step procedure for the creation of spin-out companies will be described. This procedure has been used with success in the case of the Leitat Technology Park, and it could be potentially extrapolated to other STPs. Three case examples of life science companies that have originated at the Leitat STP will be discussed.

INTRODUCTION

Spin-outs are independent businesses that emerge from an existing organisation. This could be a department, a business unit, or a project or product team for example. After their segregation from the parent company, spin-outs operate as independent firms. Usually the parent entity, in this case an STP, retains an equity stake in the spin-out. The new company – we will refer to it as "Newco" during this article – might (or might not) have ties with the STP it originated from. Spin-outs can originate in academia, and there are many successful examples of biotechnology companies that were created as a spin-out of research conducted in a university setting. Alternatively, they can also originate in technology centers as well as in established corporations.

Some of the reasons for spin-out creation will be initially discussed. Most of the article will address the operational issues that must be managed during the lifecycle of a successful spin-out company, namely:

- The investment stage. This is the planning stage. It ends on day one of the new company.
- The operational stage. The company executes its business plan.
- The divestment stage. Usually a listing in an organised market or a sale of the company.

In 1906, a group of industrialists in the Barcelona area concerned about quality, certification and research in the wool textile sector decided to create a technology park for the support of their companies. Hence LEITAT was created. During the last 100 years the park has grown and matured. It recently expanded into the life sciences sector. Today LEITAT is a full provider of services to many pharmaceuticals and biotechnology companies. Besides being a service provider, the LEITAT STP also fosters the creation of spin-out companies that are created for the commercial exploitation of its technological developments.

REASONS FOR SPIN OUT CREATION

There are many reasons why STPs might decide to spin-out certain parts of their businesses. Some of the reasons are:

- The activities to be spun-out are no longer central to the future strategy of the STP. For example, a Science and Technology Park might have developed diagnostic kits for the biotechnology and pharmaceutical industry. At some point management might make the decision that further growing this business is not within the scope of the STP.

- The STP believes that turning a specific activity into an independent company will unlock the creativity and entrepreneurial spirit of the scientists involved, thus leading to higher productivity and value creation.

- There might also be a purely financial reason. As spin-outs are creatred, it is likely that the STP retains equity stakes in them. These equity stakes could potentially be worth large amounts of money. If monetised, the new funds could be channeled into the operations of the STP.

COMPANY CREATION AND INVESTMENT STAGE

The Newco will be created by contributions from:

- The STP will make an in kind contribution in the form of assets, physical facilities and the transfer of highly skilled personnel.

- Financial investors will contribute cash in order to fund the operations of the new company

The first task that the execution team should understand is what exactly is being spun-out. Many times this is less obvious than originally thought. For example, the CEO of an STP might make the statement that “we are going to spin-out our fermentation capabilities”. But, where is the perimeter of the transaction? Usually the creation of a spin-out will involve the transfer to the Newco of:

• **Assets.** The R&D programmes and products to be transferred should be listed. With respect to the intellectual property rights (usually in the form of a patent or patent application), a decision has to be made as to what is transferred. This can either be an exclusive licence or an assignment (preferred). Additionally the R&D assets to be transferred might have contractual obligations to third parties. These contracts with third parties also need to be assigned to the Newco. In some cases permission from the third party might be required. In others a notification will suffice.

• **Personnel.** Qualified personnel from the parent company will be transferred to the Newco. This will be done respecting all labour laws, so professional advice is particularly relevant. In many countries this transfer obliges the Newco to commit and respect all rights that an employee has accumulated through his or her professional life in the parent company: salary, benefits, termination compensation, etc. Contractual obligations should be renegotiated at the time of the transfer, in order to make the relationship between the Newco and its employees more aligned to the new situation. For example, it is quite standard to create a stock option plan for the employees of the Newco, something that they probably had no access to in the parent STP.

• **Physical facilities.** Certain facilities (laboratories, physical equipment, etc) will be transferred to the new company, usually at book value. In general real estate assets are not transferred. If the Newco is established in a building belonging to the STP, it is standard to have a rental agreement in place. In any event, it is imperative that only those assets / personnel / facilities that are required for the execution of the Newco´s Business Plan are transferred. In some cases STPs with large overhead costs will try to “unload” excess overheads that they have accumulated over time into the spin-out company. This must be rejected by the Newco´s future managers. In general the Newco will contract out certain services to the STP (legal, IT, tax advice, human resources, etc). This is customary in the early days of the life of the Newco. As the new company grows it is likely that some of these functions are internalised. In parallel to the above, a business plan should then be drafted. The spin-out will have to attract external capital. This, as we will see later, will require an extensive road show and presentation to potential investors. The business plan will be the most important document, together with management presentations, that will be presented to potential investors. A checklist of items that a business plan should address is listed in Box 1.

Key issues that need to be addressed in the business plan include:

- What will be the unique value proposition that this new company will offer to potential investors?

- Why should anyone risk their money in funding this Newco?

- How many resources will the company need in order to fund its operations for at least a reasonable amount of time (e.g. at least in order to reach the next value inflexion point)?

- Who will run the company?

- Is there a management team in place, or will certain positions require the recruitment of additional personnel?

- How will be company value be monetised?

Once the business plan has been drafted a "road show" will take place, in order to convince potential investors of the merits of an investment in Newco. In addition to business plan creation, the execution team must come up with a monetary value for all the contributions that the parent company will make to the Newco, specifically the value of:

- All infrastructure (facilities, equipment, etc) transferred to Newco

- The assets to be transferred, e.g. the value of the products and R&D pipeline (including patents, patent applications, trade secrets, know-how, etc)

- The team of scientists, e.g. the value attached to a highly skilled group of persons that has the know-how to develop, on a repeated basis, drug candidates.

The sum of the value of these three components makes what is refered to as the "pre-money" valuation of Newco. There are sophisticated methods to calculate these financial parameters. A discussion of these methods is beyond the scope of this article. For illustrative purposes let us assume that the execution team has arrived at a value of €4 million for these contributions. Let us also assume that it has been calculated that €6 million will be requested from financial investors in order to fund the operations of the company for a set amount of time (usually the next inflexion point in value creation). In this example, the "pre-money" valuation of Newco will be €4 million. After the required capital (€6 million) has been injected into the company, the "post-money" valuation will be €10 million. In this example the parent STP will own 40% of Newco and the financial investors 60%.

The negotiations on company valuation are one of the most critical aspects in spin-out creation. The parent company will want the highest possible valuation for its in-kind contribution. The investors (and future shareholders) will try to minimize the value of these contributions. From the point of view of the business development team at the parent STP, it is advisable that an external, independent valuation of its contribution is made. There are several specialised firms that can conduct this exercise. When the time comes to sit at the negotiating table with investors, the "pre-money" valuation that is desired will be easier to defend if it is backed by a report from an external firm that validates the figures. Finally, a shareholders' agreement will have to be drafted. This very important document will regulate the relationship amongst the different shareholders in the new company. Box 2 contains a checklist of matters to be addressed during spin-out creation.

OPERATIONAL STAGE

Once the spin-out company has been created and it is up and running, it will face the same operational challenges as any other company. Two scenarios are possible:

- Newco is completely independent from the Science and Technology Park it originated from.

- Newco maintains certain ties and obligations with the parent STP. These ties can be voluntary (Newco has the right to discontinue them at will) or could be mandatory (Newco is obliged to maintain these ties). The more mandatory ties that Newco has with its parent STP the more complex certain future events might be (e.g. licensing agreements or the sale of the company). Typical ties with the STP might include:

    - Rental of physical facilities. The laboratories and offices of Newco are located in the premises of the STP. This is in fact quite standard, at least in the early life of the new company. It is usually in the interest of both parties that the new company remains physically within the premises of the STP. As companies grow there will be many reasons for Newco to decide to move to alternative facilities.

    - Subcontracting of certain tasks to the STP. Examples of these are the sourcing to th STP of non-scientific functions (human resources, IT, legal, etc.). Additionally, there could be scientific tasks that are outsourced to the STP.

    - Licensing agreements. It is likely that the business model of Newco contemplates the partnering of its research assets with third parties. The licensing discussions with third parties might be conditioned by agreements that Newco established with the STP at the time of company creation. Those that will manage the new spinout company should be very cautious when negotiating any ties with the STP. This is especially relevant with respect to any potential future rights that the parent STP might want to keep with respect to the spun-out assets. Future partnering or licensing discussions with third parties might be put at risk. In any event, all transactions between the parties should be at market prices.

DIVESTMENT STAGE

Most investors that have committed funds to a new venture will require, at some point in the more or less distant future, an "exit". This is defined as a transaction whether the company's value can be monetised, so that the investors can sell their shares, with or without a return on their investment. This monetization event is usually in the form of:

- An Initial Public Offering (IPO) in an organised market

- A sale of the company. In this article, the operational aspects of divestments will not be discussed. Nonetheless, it must be noted that most spin-out companies are eventually sold or merged with another company. The preferred exit strategy must be clear from the beginning.

The divestment stage is also of high relevance to the STP. It is likely that the STP will retain a relevant equity stake in the spun-out company. As such, at the time of divestment it will be able to monetize this equity stake and convert its shares in Newco into cash. These funds can then be recycled to create new spin-out companies. In fact, in some STPs with a large tradition of going through the investment and divestment cycle of spin-out companies it is customary to place the profits from divestments in funds that have, as their mandate, the creation of yet new companies.

CONCLUSION

The creation of company spin-outs has been a popular mechanism to unlock hidden value within STPs. The establishment of such companies is a complex process that requires the input of many departments within the parent STP. It is usually the Business Development team that coordinates such efforts. Once up and running, spin-outs can be very successful businesses and bring value to all stakeholders. For the STP they can eventually also bring new financial resources that can then be used to fund the creation of new companies.

CASE STUDIES

The Leitat Technology Park has used the above-mentioned methodology for the creation of several spin-outs. The method and procedures established in this paper have proven very valuable in order to standardize the process of spin-out creation and also learn from each case what was satisfactory and what was not. Three cases from the life-sciences sector are described below.

CASE STUDY 1: DRACONIS PHARMA

For many years the Leitat Technology Park has been a service provider to biotechnology and pharmaceutical companies. These sevices have included medicinal chemistry, biology, pharmacology, pharmacokinetics and clinical trials. There is a high demand from many SMEs (small medium enterprises) that need to have access to pharmaceutical development expertise, yet they can not afford the high costs of internal R&D departments.

In 2011 it was decided by the management of Leitat that these activities would be spun-out into a new company. To be called "Draconis Pharma". The business model of this company is therefore to offer the biotechnology and pharmaceutical industries the possibility of outsourcing their scientific activities. Draconis Pharma works with these companies on either a "fee for service" basis, or alternatively also on a "risk sharing basis":

- **"Fee for service" partnerships.** Under these arrangements Draconis Pharma will conduct a scientific program in behalf of a third party. For example, in the past Draconis Pharma has been entrusted with medicinal chemistry programs, pharmacology studies, etc.

- **"Risk sharing partnerships".** In these trype of collaborations Draconis Pharma only charges its clients companies its costs. No profit margins are therefore charged. On the other hand, the contracts specify certain monetary compensations to Draconis Pharma if the projects are successful.

CASE STUDY 2: LYKERA BIOMED

Certain high skilled scientists joined Leitat some years ago in order to create and operate the new cell culture facilities and laboratories within the STP. These employees had the idea of using their cell culture skills in order to develop new monoclonal antibodies for the treatment of cancer.

Leitat therefore decided to create a new company, called "Lykera Biomed" to exploit these results commercially. The projects for the development of monoclonal cancer therapeutics were transferred from Leitat to Lykera Biomed, and external funding was obtained for their development. As of today several product are in late preclinical development for the treatment of different types of cancer.

The company is currently in advanced discussions with several international venture capital firms in order to execute a large capital increase. The new funds will permit Lykera Biomed the clinical development of its assets and eventually the licensing-out of the new molecules to some of the largest pharmaceutical companies in the world.

CASE STUDY 3: READYCELL

ReadyCell is a biotechnological company focused on providing sophisticated in vitro tools and R+D services in the field of toxicology. The company tools are innovative cell-based and ready-to-use kits for efficacy and safety testing of active molecules as an alternative to animal testing. The company was also created as a spin-out of the Leitat R&D contract service capabilities. In this case a group of seasoned scientists proposed this concept to the STP. It was accepted by upper management.

ReadyCell has clients in many countries and is constantly innovating in order to supply the pharmaceutical, biotechnology and cosmetics industry with the most advanced in-vitro toxicology testing kits.

Box 1: Basic contents of a spin-out's business plan

- **The business model of the new company, its shareholders and governance**
- **The market, including therapeutic area of focus (the unmet medical need that the new company will serve) - the opportunity**
- **Company strategy and unique value proposition to potential investors. Critical success factors, risks and financing strategy**
- **Implementation plan: costs and timelines. Value creation**
- **Human resources: the team. Employees from the parent company. Profile of new recruits**
- **Physical facilities. Subcontracting strategy**
- **Intellectual Property strategy**
- **Exit strategy. What is the path to monetisation of company value?**

Box 2: Checklist of matters to be addressed during spin-out creation

- **Legal structure of the new company**
- **Governance: Board of Directors, observers, Scientific Advisory Board**
- **Transfer of research programmes from parent company**
- **Transfer of employees from parent company**
- **Transfer of physical facilities / equipment from parent company**
- **Relationship between parent company and spin-out**
- **Valuation**
- **Shareholders' Agreements**