Impact of COVID-19 on Pre- and Early-Commercial Biopharmas

- BRIAN LANE AND BLAINE MARTIN

This Viewpoint is one in a series of ongoing articles Pay Governance will be publishing regarding the impact of COVID-19 on compensation programs. All of our Viewpoints can be found on our website at www.paygovernance.com.

While the impact of the COVID-19 pandemic has varied across industries, most companies have had their performance impacted in one way or another. With respect to compensation programs, the fundamental balance of maintaining employee motivation and engagement while dealing with the fallout, economic disruption, and — in some cases — newfound cash and liquidity concerns are universal. The response, however, may differ significantly by company and across industries.

Our Viewpoint series has addressed many of the executive compensation considerations associated with COVID-19. The focus of this Viewpoint is on companies in the pre- and early-commercial biotech and pharmaceutical ("pre-commercial biopharma") space as well as how these companies are dealing with the pandemic and its impact on compensation programs.

The pre-commercial biopharma business model operates with its own unique compensation and governance practices driven by two fundamental differences from other businesses:

1. Valuation based on product pipeline, clinical progress, and future expectations of scientific success more so than financial performance.

2. An inherent reliance on external financing to maintain sufficient cash flow for operations.

For example, a recent Glass Lewis paper[1] suggests that 40% of biopharmas utilize an annual incentive design categorized as ***non-formulaic***, compared to just 7% across the full sample of small- to mid-cap companies Glass Lewis reviewed. We find that pre-commercial biopharmas' incentive designs tend to differ from broader industry practices in the following ways:

- Heaviest weighting given to strategic milestone measures vs. financials
- Financial metrics focused on the balance sheet versus the income statement
- External fund raising as an ongoing corporate objective
- Increased use of human resources and talent attraction/retention as core metrics
- Less reliance on strictly formulaic results driven by an explicit pay/performance scale
- Greater emphasis on qualitative evaluations of performance achievement to determine bonus payouts.

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What We Have Seen Year-to-Date in the Biopharma Industry

The biopharma industry overall has outperformed others through the pandemic's economic disruption, resulting in fewer observed compensation cost-cutting actions. There is, however, bifurcation among biopharma companies: some have performed quite well year-to-date, while performance has slowed for others.

Those that may have recently closed an updated round of external funding have not experienced a slowdown in their clinical trials, or were able to shift to telemedecine appointments for patient follow-up are still operating largely business-as-usual, having been able to weather the storm to some extent. Further, a select few companies were able to shift focus directly to COVID-related therapies and have seen significant shareholder value creation and/or increased hiring plans.

<table>
<tr><th>What We Have Seen</th><th colspan="2">Observations</th></tr>
<tr><td>Strong Market Performance Overall Relative to Other Sectors</td><td colspan="2">• Year to date (through May 15):
— Russell 3000 is down 12%, including being down nearly 32% at its lowest level in late March
— NASDAQ'S Biotechnology Index (IBB) is up 10% over the same period.</td></tr>
<tr><td>Continued Positive Performance from Recent Initial Public Offerings (IPOs)</td><td colspan="2">• Several successful 2020 biopharma IPOs
• There have been 13 total IPOs in the sector since the start of the year compared to 15 for the same time period (Jan 1 to May 15) in 2019
• All 13 2020 IPOs have produced positive returns to shareholders from their offering prices — including the 5 that went public after April 1 (amid COVID-19 disruptions).</td></tr>
<tr><td rowspan="3">Bifurcation within the Industry</td><td colspan="2">• Of the 210 active companies in the NASDAQ IBB index, about half have positive year-to-date total shareholder return (TSR)
• 75th percentile TSR = +19%; 25th percentile TSR = -24%
• The index's overall return is driven largely by more heavily weighted larger companies:
— Median return of companies with $2.5B market cap or greater is +1%
— Median return of companies with less than $500M market cap is -10%</td></tr>
<tr><td>Above Median Performers</td><td>Below Median Performers</td></tr>
<tr><td>• There has been significant shareholder value creation among top performers, many of which are the larger constituent companies
• This has kept the value of equity holdings positive, including recent grants — this is a good</td><td>• Depressed valuations bring several concerns, including:
— Diminished incentive / motivational impact of outstanding equity
— Reduced retentive value of outstanding equity</td></tr>
</table>

What We Have Seen	Observations	
	indicator for companies that typically rely heavily on equity compensation across all employee levels • Some, including those that were able to shift focus to COVID-19-related products/research, have announced increased hiring plans.	— Additional retention pressure from better-performing competitors — Increased probability of becoming an acquisition target at lower-than-historic valuations • For private companies, the potential for the next financing to be a "down round" has similar implications for employee equity, particularly if there are anti-dilution protection provisions, and may also push back an expected IPO/liquidity event.
Executive/Director Pay Reductions	• Minimal actions to date among pre-commercial biopharmas — possibly due to less direct and immediate impact on cash position than other industries • Executive Pay Reductions: — 484 observed across all industries — Four (<1% of all reductions) among Pharmaceutical, Biotechnology, and Life Sciences companies • Director Pay Reductions: — 302 observed across all industries — Two (also <1%) among Pharmaceutical, Biotechnology, and Life Sciences companies.	
2020 Proxy Disclosures Related to COVID	• In addition to descriptions of any executive or director pay reductions, several biopharmas included COVID-related disclosures within their 2020 filed proxies, categorized into two broad categories: — Reminders that 2019 performance was final and associated payouts were determined before the pandemic — Forward-looking suggestions that the Compensation Committee will consider the pandemic's impact on 2020 performance and pay decisions.	

Compensation Impact for the Balance of 2020 Remains Uncertain

As companies in all industries consider the fact that many of their 2020 performance objectives have little chance of achievement, questions are surfacing about the possibility of resetting performance goals or replacement bonus plans, using discretion in determining payouts or adjusting performance, and/or focusing more on non-financial metrics in the absence of threshold levels of financial performance. For pre-commercial biopharmas, in an environment where cash bonus payouts are not funded by financial performance, it can be informative to assess the expected impact of COVID on common categories of incentive plan performance metrics.

Types of Incentive Metrics	COVID Impact	Pay Governance Commentary
Pre-Clinical Pipeline	**Mixed**	• Stay-at-home mandates and/or worries about employee safety present challenges to pre-clinical lab work • However, many have adopted lab-workers only in their facilities to continue research efforts.
Clinical Trial Progress	**Moderate**	• Challenges in enrolling patients and the inability to conduct in-person physician visits has slowed clinical progress • Supply chain disruptions and delays have impacted manufacturing capabilities and thus the ability to have timely product/doses • Some have outright postponed trial initiation to later in 2020.
Submissions of New Drug Applications or Biologics License Applications	**Minor**	• Little impact to the extent clinical trials were completed and submission is entirely in management's control.
Food and Drug Administration (FDA) Approvals	**Mixed**	• Some worry that the FDA's shift in focus to addressing the pandemic could delay new product approvals in other categories.
Balance Sheet / Cash Burn	**Mixed**	• The impact depends on the timing of the last raise, current cash position, and projected burn • There is limited impact for those with relatively healthy cash positions or recently closed financings • There is more conservatism or concern for those approaching a raise who may now need to preserve cash to extend their runway if facing uncertainty on the timing of the next round.
Fund Raising	**Mixed**	• There appears to still be private and public investments available — e.g., the aforementioned 2020 IPOs and several well-known biotech venture capital firms closed significant funds toward the end of Q1 • Valuations and company-specific funding decisions, however, may be impacted by how potential partners view slowed clinical progress or delayed regulatory approvals.

Other potential considerations and compensation program implications include:

- **Increased Merger and Acquisition Potential**
  — It might be an opportune time to review current employment agreements as well as company-wide severance and change-control policies to ensure post-termination benefits are competitive and consistent with current governance norms
- **Continued Stock Market Volatility**
  — An additional layer of caution with respect to equity awards and the impact of changing stock prices might be warranted; for example, equity awards calibrated based on desired value delivery could put pressure on equity pools without adjustment
  — Further, companies considering a shift away from an all-options approach might accelerate their thinking in order to deliver a small portion of equity as full-value shares
- **Increased Need to Conserve Cash**
  — While being mindful of dilution and share usage concerns, consider the potential to deliver equity in lieu of cash — e.g., bonuses delivered in restricted shares.

Year-End Considerations

As we approach mid-year, those that adopted a wait-and-see approach and delayed setting 2020 goals may now be in a better position to decide where to focus the team. Others have started to discuss frameworks for 2020 performance and bonus determinations.

Come year-end, during Compensation Committee review of annual performance vs. objectives in determining bonus payouts, we expect robust discussion around the key principle of rewarding for performance results within management's control. The scorecard approach used by many pre-commercial biopharmas for bonus payouts should help mitigate the potential for a down year in any one area to result in overall zero bonuses. Any adjustments to performance or discretionary judgments on the level of performance achievement should be considered carefully.

To the extent the discussion turns to it, areas that could support the application of discretion to adjust performance/payouts could be:

- Broader resiliency of operations including continuity of the supply chain, ability to ensure production of trial doses, etc.
- Management's ability to adapt — e.g., adoption of telehealth / virtual follow-ups for clinical trials and prioritization of trials that can be completed over others
- Understanding the root cause of delays in deciding whether to relax any time-based performance objectives
- Prudent cash management — e.g., making the difficult decision to stop or delay trial starts if appropriate
- Any shift to COVID-related operations that have repositioned the company favorably in the short- and longer-term
- Long-term vs. short-term decisions — e.g., where objectives/strategy shifted, did Management favor long-term strategy at the expense of short-term performance objectives?
- Relative performance in comparison to direct peers

Of course, any such discussions should incorporate the broader context of the overarching economic and societal impact that the pandemic has had on all company stakeholders.

General questions about this Viewpoint can be directed to Brian Lane at brian.lane@paygovernance.com or Blaine Martin at blaine.martin@paygovernance.com.

[1] Brianna Castro et al."2020 Meeting Notes, Under the Microscope, Talking with Biopharma Companies About Their Unique Governance and Compensation Challenges." Glass Lewis. 2020.