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East Bay drug maker soars 700 percent on Wall Street with plan to NOT make drugs

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Xoma CEO Jim Neal (left), with CFO Tom Burns: "There's an unbelievable amount of value sitting in this portfolio."

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Long considered one of biotech's walking dead, drug developer Xoma Corp. is coming alive – but not by making drugs.

Xoma essentially is transforming itself from a drug-development company to a financing company, leveraging its scientific hits, cutting its costs and shedding its strategic missteps. In the end, company leaders believe, the new Xoma will leave costly and time-consuming drug development to its partners, sit back and reap the financial rewards.

That, of course, assumes that Xoma's partners can achieve development milestones that trigger payments to the East Bay company (NASDAQ: XOMA), and that they can win Food and Drug Administration approval of those drugs, the sales of which could generate millions of dollars in royalties for Xoma.

From there, Xoma wants to plow that milestone and royalty income into making bets on other companies' drugs, providing cash for early-stage programs and, potentially, scoring royalties on those drugs as they garner regulatory approvals.

The strategy is a flip for Xoma, which had developed and licensed out platform technologies and experimental drugs that other companies turned into windfalls, but it was never able to convert those into approved drugs of its own. But the move also highlights how drug-development companies sometimes must get creative to translate their innovations into long-term payoffs.

Wall Street has embraced Xoma's strategy. The company's stock, which opened 2017 at $4.20 per share, closed the year at $35.51 – a jaw-dropping 745 percent increase. Xoma closed Wednesday at $32.63.

If only that wait was less painful for investors who watched Xoma burn through $1.2 billion since its founding in 1981. Shareholders grew increasingly frustrated as the company never made a drug of its own, never turned an annual operating profit, built up $40 million in debt on its balance sheet and seemed to wander zombie-like from drug programs in diabetes, cancer and hepatitis to programs in hypertension, eye diseases, acne and a condition that causes leg ulcers.

The wide-ranging nature of Xoma's programs, however, could prove to be its salvation. Licensing its experimental drugs cedes the heavy lifting and risk to partners that must take the drugs through the three-phase FDA trial-and-approval process, which generally takes six to 10 years and often requires $1 billion or more.

Xoma estimates that its partnered programs could generate $60 million in milestone payments over the next three years.

"We'd been chasing these shiny baubles," said Neal, who in late 2016 was named Xoma's fourth CEO in a 10-year period. "We hadn't talked about what we'd licensed to others – to people who can do later-stage development."

So as Neal and Chief Financial Officer Tom Burns, who had served in other finance

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and accounting positions with the company since 2006, settled into their new roles in early 2017, they opted to look at "the good part" of Xoma's legacy. "Let's think about this differently," Neal said.

The strategy they helped shape with the help of the company's now-largest shareholder, BVF L.P., changes Xoma to its core.

"(Xoma's now) really more of a finance company than a biotech company," said BVF President Matthew Perry, now a member of Xoma's board.

The 30 drug programs on which Xoma has the potential to receive royalties or milestones caught the attention of BVF, a San Francisco-based private investment firm that focuses on long-term investments in small-cap biotech companies. BVF had been an investor in San Diego's Ligand Pharmaceuticals Inc. (NASDAQ: LGND), which has harvested milestone and royalty revenue from its portfolio to invest in the promise of royalties from other companies' potential products.

"There was very little, if any, value ascribed to (Xoma's) collection of technologies and the royalties they were getting from partners," BVF's Perry said. "They were valued as a company going out of business."

BVF made its initial investment in Xoma in November 2016 – about a month after Xoma declared a one-for-20 reverse stock split to regain compliance with NASDAQ's $1 minimum bid requirement – and a larger, $25 million direct investment last February at $4.03 per share. It now has common and preferred stock totaling 6.2 million shares – about half of the company – and 19.9 percent of the voting shares.

The investment plays off Xoma's history of some scientific wins. Its bacterial cell expression technology, for example, was licensed to South San Francisco-based biotech powerhouse Genentech Inc., which used it to make the eye drug Lucentis. Belgium's UCB S.A. tapped the same technology for the Crohn's disease and rheumatoid arthritis drug Cimzia.

More recently, in August, Xoma licensed to drug giant Novartis AG the commercial rights to gevokizumab, a monoclonal antibody targeting inflammation.

Those deals bring in licensing revenue and, potentially, royalties, if drugs hit the market.

"There's an unbelievable amount of value sitting in this portfolio," said Xoma CEO Jim Neal. "Cynically, you could say all you have to do is be around long enough."

The deal for gevokizumab – tested unsuccessfully by Xoma in human trials against diabetes, a blinding eye disease known as Behcet's uveitis, erosive osteoarthritis in the hand and pyoderma gangrenosum, which causes ulcers on the leg – brought in a $31 million upfront payment from Novartis, including a $5 million equity investment.

It was one of nine Xoma licensing deals last year alone. The company is actively promoting other programs for licensing, including a preclinical cancer immunotherapy focused on the white blood cell-regulating protein interleukin-2.

In the past, Xoma sunk cash generated from licensing deals into the black hole of its own programs, including its ill-fated drug-development work.

"You couldn't really keep doing the research on your nickel," said Steve Engle, Xoma's president and CEO from 2007 to 2011.

Exiting drug development has allowed Xoma to cut millions of dollars in expenses, a process started three years ago. It has cut its workforce to less than 20 from about 180 in 2015, eventually shedding the 80-person group that built antibody libraries that propelled deals with Pfizer Inc. (NYE: PFE) and Takeda Pharmaceutical Co. Ltd.

"The core of the company had always been R&D – that was the last thing anyone wanted to let go," Neal said. "But we couldn't afford that 'luxury.'"

Xoma, which a decade ago employed more than 300 people full time, also moved from labs and offices in Berkeley to office space in Emeryville.

The company also turned to face its debt. In March, after BVF's investment, Xoma paid off a $17 million debt to Palo Alto-based Hercules Technology Growth Capital Inc. (NYSE: HTGC). It also negotiated a deal with onetime partner Les Laboratoires de Servier to delay repayment of $14.3 million in debt from last January to July; Novartis settled that debt for Xoma and agreed to extend the maturity of its own Xoma debt two years to September 2022.

Meanwhile, licensing fees and royalties continue to flow into Xoma, accounting for nearly all of its $47 million in revenue through the first nine months of last year.

That is a scant amount of money for a typical biotech company to cover a year's worth of research and development. But Xoma's cost cutting, coupled with the stream of incoming payments it expects from partners, means the company has four years of operating capital– more than enough to start scouting other company's drug assets and building out its basket of potential royalty deals.

Xoma could shell out $5 million to $20 million per deal for drugs in early or mid-stage studies, Neal said, in exchange for the promise of royalties years later that could payout over a decade.

That is risky, given that some estimates say that six of every 10 drugs entering clinical studies fail in Phase I or Phase II. But companies struggling financially to push their drugs closer to the finish line, Neal said, are intrigued with the idea of getting nondilutive cash now and paying out a percentage on royalties later.

"The sources of capital are limited (for early-stage drug developers)," Neal said. "And if they're tapped out on equity opportunities, there's only debt – we've done that a few times – or partnering deals where you're monetizing royalty streams."

Xoma's strategy has precedent with Ligand, whose average royalty rate the revenue of other companies' products is expected to be in excess of 4 percent in 2017 the company said in November, and above 5 percent this year on underlying product revenue of more than $2 billion.

Those are numbers that Xoma can only project at this point, Neal said. But without the legacy science of Xoma, the next-generation company would have little hope of a new life.

"There's a history here that at some level you need to own and embrace," Neal said. "Without it, we wouldn't have those assets."