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Pharma M&A and Financial Trends: The Frenzy and Risks Escalate

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Every day the newspapers are filled with stories about the pharma industry. Many are very positive, with reports of breakthroughs and novel approaches to solving difficult health issues, the commitment of the industry to attack some of the most difficult diseases and break through a myriad of structural roadblocks and escalating development costs. Others are more critical with complaints about drug pricing, the seemingly endless stream of take-overs, and the rush towards orphan drugs.

Yet some are just confusing to all but the most knowledgeable, whether it is the bitter sweet circumstances of the generic drug manufacturers; the developments in emerging markets with regard to selling practices, patent treatment and pricing; the tax inversion wars; and the industry structural changes that are moving every which way around the world.

But the overall impression is that the pharma industry is making progress and going through a frenzy of activity on the strategic, business, M&A and financial fronts.

Introduction

One of the more interesting aspects of the pharma industry today is how diverse the strategies that are being followed are. Strategies range from diversification, moving to be a pure play pharma company, focusing on leadership businesses and exiting weaker businesses, executing large scale mergers, exiting the pharma industry altogether, expanding geographically, consolidating regionally, pursuing biologics, expanding generics, moving into vaccines, pursuing orphan and niche drugs, moving away from primary care indications to specialized areas, implementing cost reduction programs, restructuring R&D efforts, and pursuing biotech acquisitions and partnering/alliances.

In many cases, the pharma companies are pursuing a combination of these strategies. Although there is clearly more than one strategy that will lead to success, it is hard to fathom that all of these incredibly diverse strategies will work. To make matters even more confusing, a number of prominent companies have shifted strategies a number of times in the last five years.

It is clear that the role of M&A, licensing and partnering is even more prominent than it was ten or more years ago. Very few of the larger pharma companies are relying primarily on their own internal R&D developments to replace revenues from drugs whose patents are expiring and to drive growth.

The result is the huge flow of M&A and related deals that we witnessed last year and even more prevalent this year. There has been a virtual eruption of M&A activity and at hefty valuations.

With regard to financing, on the equity market side the picture has been positive but modest as pharma companies have gone to the equity markets because their earnings, cash flows and access to debt financing have been strong. Even IPOs are sparse compared to other industries.

On the other hand, debt issuance by the pharma industry has been very robust, driven heavily by acquisition financing and a love affair between the debt markets and pharma.

These are some of the highlights from the "Pharma Strategic, M&A, and Financial Trends Report" recently completed by Young & Partners that covers through the first quarter of 2015 and the outlook for the future.

Pharma Stock Market

In the first quarter of 2015, the S&P 500 was relatively flat, increasing by a mere 0.4%. In contrast, the STOXX Europe 600 increased by 16%.

The pharma industry did well in the first quarter and outperformed the S&P 500, but not the STOXX Europe 600.

During the first quarter, the Y&P U.S. Pharma index increased by about 2.2%, the Y&P European Pharma index by 9.5%, and the Y&P Generic index by almost 12.2%.

As a result, the valuations of all three groups have been very strong.

From a valuation perspective, the Y&P U.S. Pharma index P/E ratio increased from 25.6x at the end of 2013 to 31.6x at the end of the first quarter of 2015 and the Y&P European Pharma index increased from 23.4x to 36.2x over that same time period.

The Y&P Generic index valuation surged increasing from 27.9x at the end of 2013 to 32.6x at the end of 2014, heavily driven by M&A speculation, but fell back to 26.0x by the end of the first quarter of 2015.

Although these multiples are a real improvement over just a few years ago, they are still well below where they were ten years ago as the pharma industry faces issues of growth, stability, and structural challenges.

Surge in Pharma M&A Deal Activity

In the first quarter of 2015, 15 deals were completed worth $117.6 billion versus 51 deals completed worth $80.4 billion during all of 2014. From an annualized point of view, this represents a dramatic increase in the dollar activity and a significant increase in the numbers of deals completed.

The $68 billion acquisition of Allergan by Actavis contributed significantly to the total.

Activity has been particularly high in the U.S. and Europe.

Drug makers are acting as both buyers and sellers, forming strategic alliances, swapping businesses, exiting non-core units, and using or seeking tax inversion advantages.

What does the M&A pipeline look like? As of March 31, 2015, the value of the deals announced but not closed was $55.5 billion (14 deals), so there are still many deals in the pipeline.

Notable announced transactions include Valeant's acquisition of Salix Pharmaceuticals for $11.1 billion, AbbVie's acquisition of Pharmacyclics for $19.9 billion, and Pfizer's acquisition of Hospira for $15.4 billion.

In addition, there have been a number of large unsolicited offers in April, including Mylan's offer for Perrigo and Teva's offer for Mylan.

Pharma Debt and Equity Financing – Limited, But Readily Available

Pharma companies have generally been perceived as strong cash flow generators, so investors have, thus far, felt comfortable lending to the industry. Borrowing volume has been driven less by investor demand and mostly by the issuers' need for debt financing.

Debt issuance continued to be strong in the pharma industry. In the first quarter of 2015, non-bank debt issuance was $30.4 billion compared to $63.4 billion for all of 2014, a significant increase in activity on an annualized basis.

Equity issuance in the first quarter of 2015 was also very strong with $15.8 billion of equity issued versus $9 billion for all of last year. A significant portion of these equity offerings have been to fund acquisition transactions. Equity issuance activity has been modest because Pharma's need for public equity capital has generally been limited.

There were no pharmaceutical IPOs in the first quarter of 2015.

What Will the Future Bring?

The business outlook for pharma companies will continue to be mixed, as pharma companies struggle to realign themselves strategically. Big Pharma has taken to more radical structural changes in recent years in order to shift the nature and quality of their business portfolios, but specialty pharma and generic pharmaceutical companies are also facing the need to radically change their strategies. Pharma companies are facing a myriad of business and financial decisions about what strategies to follow and the trade-offs they have to make with regard to dividends and stock repurchases versus acquisitions and internal investments.

The stock market prices and valuations of the ethical pharma industry will continue to be bolstered by the rising stock market and, more importantly, the progress that the industry has made in addressing the industry structural changes. The stock market has partially forgiven the ethical pharma industry for its past sins. But further increases in valuations will require a continuation of positive structural changes that create investor confidence.

M&A activity this year will be exceptionally high given the frenzy of deal making that is being pursued. We expect this year's M&A volume to be far above last year's dollar amount and also higher in terms of the number of deals.

Equity issuance will continue to be modest primarily because pharma companies generally do not need equity. So even though the IPO and general equity issuance markets have been strong, pharma issuance of public equity will remain limited.

New debt issuance will depend on the number and size of M&A transactions that will have to be financed. Given the expectation of a high level of M&A this year, it is our expectation that debt issuance will also be high.

What does this all mean for pharma companies? First and foremost, you must choose your strategy wisely as the margin for error has narrowed and determining the right strategy for your company has become more difficult to determine amongst the myriad of paths that are available. Second, in an environment of high prices for everything, sell what you don't need to own and either find inefficiencies in the M&A market as a buyer or emphasize your own development efforts and the partnering/licensing markets instead. Third, if you are facing industry consolidation in your industry sector, make your move early when you have the most choices rather than wait to the end when much of the game has been played out. Lastly, debt and equity funding is readily available for pharma companies, so the task is determining what to fund, not how to fund it.

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