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Pharma and Biotech Financial Trends: A Frenzy of Activity

Examining the fast-moving growth drivers for the two segments and what their 2014 numbers mean for respective M&A and other strategies going forward

By Peter Young

The pharmaceutical and biotechnology industries, like all industries, are facing industry-specific changes coupled with disruptive events in the external global environment. The industry business factors include the productivity and cost of R&D; the changing relationships with patients and providers; shifts in patent laws and regulation; and reductions in global government spending and behavior with regard to pricing and intellectual property. The overall picture conveys a number of positive signs as growth has returned to the industry, driven by new innovative products and pricing, and the arrival of notable new blockbuster drugs onto the market scene.

The external factors for the pharma and biotech industries include a global economy struggling to achieve growth; the financial and economic woes of many of the emerging market countries such as India and Brazil; a deterioration in the Euro Zone business and economic conditions; a solid economic recovery in the US; an outbreak of geopolitical tensions around the world; and a positive surge in global stock market valuations. These external factors have had an incremental effect on the pharma and biotech industries, although far less than for industrial and consumer companies, and will continue to have an impact going forward.

Highlighted in this article are these and other details from the "Pharma and Biotech Strategic, M&A, and Financial Trends Report," recently completed by Young & Partners, that covers the first three quarters of 2014 and the outlook for the future.

Pharma trends

Pharmaceutical companies of all sizes have been revamping their strategies to survive in this new business environment. The diversity of strategies being followed is remarkable. Strategies range from the following:

- Diversification
- Moving to be a pure play pharma company
- Focusing on leadership businesses and exiting weaker businesses
- Large-scale mergers
- Exiting the pharma industry altogether
- Geographic expansions
- Regional consolidation
- Pursuit of biologics
- Expansion of generics
- Movement into vaccines
- Pursuit of orphan and niche drugs
- Movement away from primary care indications to specialized areas
- Cost reduction programs
- Restructured R&D efforts (making research more nimble and collaborative; prudently stopping research projects earlier than in the past; and pursuit of singles and doubles rather than just home runs)
- Pursuit of biotech acquisitions and partnering/alliances

In most cases, company strategies are a combination of the above.

Although no clear picture has emerged with regard to who the winners and losers will be, these changes in the environment and the diverse strategies of pharma companies are driving the pharma M&A market to a frenzied pace.

Looking back, pharma merger and acquisition volume in 2012 and 2013 was fairly soft in terms of the number of deals and the dollar volume.

That slower pace was driven by a number of factors. In those years, pharma companies were tentative with regard to attempting larger acquisitions given a host of uncertainties they were facing. In addition, the valuations of public pharma companies had gone up considerably, making public company acquisitions more expensive.

That has changed in 2014 as companies are more aggressively pursuing a variety of strategic changes that require a high level of M&A and related activities.

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With regard to financing, the equity market side of the picture has been positive but modest, as pharma companies have not had to go to the equity markets because their earnings, cash flows, and access to debt financing have carried the day. Even IPOs are sparse compared to other industries.

Debt issuance by the pharma industry has been very strong, driven heavily by acquisition financing and a love affair between the debt markets and pharma.

Biotech trends

On the biotech side, M&A volume has historically been very modest, and that has continued in 2014. Acquirers have balked at the price tags and have relied extensively on alternatives such as partnering and licensing. A combination of high stock market valuations and the bidding up of prices for late-stage biotech companies has dampened the pharma company pursuit of certain biotech companies.

In the stock market, biotech companies are now clearly in favor and the share prices of biotech companies have benefited. Investors are excited about the new products and technologies and are strong believers that the biotech business model is working.

In terms of biotech financing, debt issuance continues to be at a virtual standstill as the debt markets have shunned the biotech sector. However, the situation has been quite the opposite in terms of equity offerings since early 2013. The strong overall IPO market, coupled with the stock market's love affair with biotech, has resulted in a high level of equity issuance, including IPOs.

Pharma stock market: Strong price performance

In the first three quarters of 2014, the S&P 500 increased by 6.7%, while the STOXX Europe 600 increased by 4.5%. However, the pharma industry did even better, outperforming the market indices by a substantial margin. During the same time period, the Y&P US Pharma index increased by 10.9%, the Y&P European Pharma index by 13%, and the Y&P Generic index by almost 35%.

As a result, the valuations of all three groups have gone up on an absolute and relative basis, with the greatest increase happening in the generics sector fueled by a high level of M&A activity and speculation.

From a valuation perspective, the Y&P US Pharma index P/E ratio increased from 25.6x at the end of 2013 to 27.1x at the end of the third quarter of 2014, and the Y&P European Pharma index increased from 23.5 to 29.0x over that same time period.

The Y&P Generic index valuation increase was even more impressive, increasing from 27.9x to 35.8x over the same time period, heavily driven by M&A speculation.

Although these multiples are a real improvement over just a few years ago, they are still well below where they were 10 years ago when the pharma industry was viewed as a very stable, profitable, high-growth industry and valuations were sky high. The industry has recovered some of its growth and appeal, but it is still less stable and subject to more uncertainties than in the golden years.

We will see even more positive changes if the industry continues to regain its footing and if and when the market has confidence in the industry's structural stability.

Surge in pharma M&A deal activity

Forty three deals worth $73.6 billion were completed in the first three quarters of 2014, versus 42 deals worth $39.9 billion completed during all of 2013. This represents a significant increase in both the number of deals and dollar activity from an annualized point of view. The $27 billion acquisition of Forest Laboratories by Actavis contributed heavily to the total. Activity has been particularly high in the US versus Europe and the rest of the world.

Pharma companies have become more aggressive with regard to acquisitions, with companies looking to replenish their pipelines, strengthen their leading businesses, either push their borderline businesses into leadership or an exit, and, in some cases, to redomicile in more favorable tax jurisdictions via tax inversion transactions.

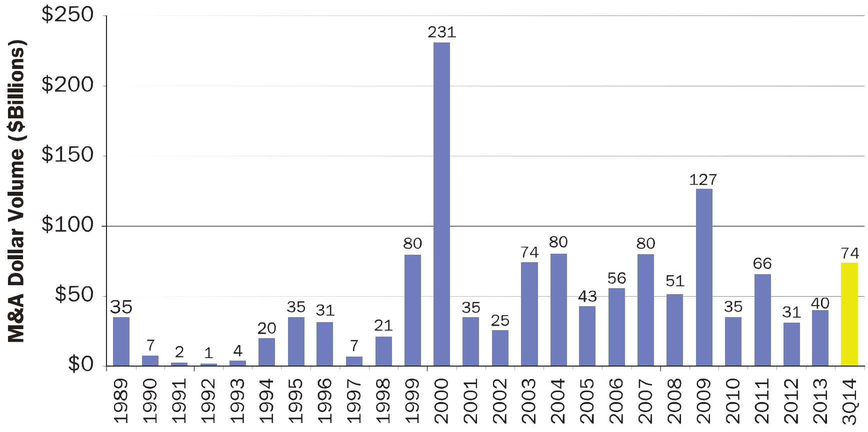
In some cases, drugmakers are acting as both buyers and sellers, forming strategic alliances and swapping to shore up their core businesses. For example, in a $19-billion swap, Novartis sold GlaxoSmithKline its vaccine unit while GSK sold its oncology business to Novartis. The two companies also formed a joint venture to develop a consumer healthcare business.

What does the M&A pipeline look like? There were a large number of deals announced but not closed as of the end of the third quarter. As of Sept. 30, 2014, the value of deals announced but not closed was $86.6 billion (14 deals), a hefty dollar amount.

A few of the announced but not closed deals, however, are tax inversion transactions that may be in jeopardy. AbbVie's proposed acquisition of Shire for $54.2 billion was recently terminated due to new Treasury regulations that remove some of the financial benefits of tax inversions. A number of the other tax inversion deals may fail, but some will still go through.

Dollar Value of Worldwide Pharma Acquisitions

The value of deals was low for most of the 90's, but escalated to a higher, but volatile level since 2000. The volatility has been driven by the periodic mega deals. There has been heavy activity in the first three quarters of 2014.

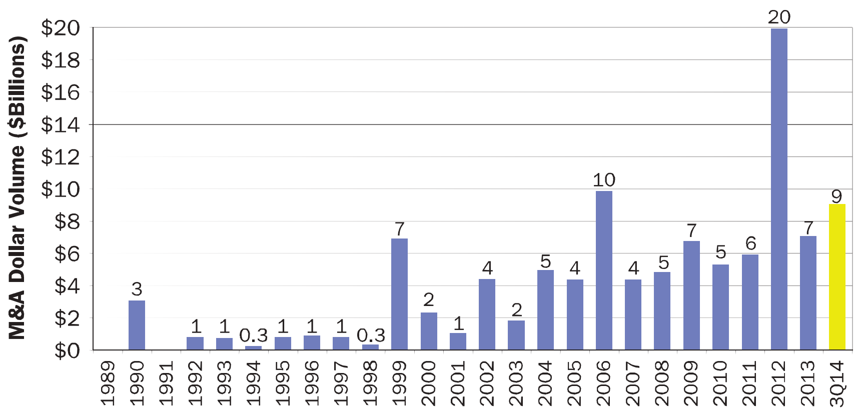


Only Deals > $25 million

Source: Young & Partners

Dollar Value of Worldwide Biotechnology Acquisitions

Since 1999, M&A activity has been relatively modest. Dollar volume in 2012 was high due to the $10.4 billion Pharmasset deal, but plunged in 2013. It has rebounded through the first three quarters of 2014.



Only Deals > $25 million

Source: Young & Partners

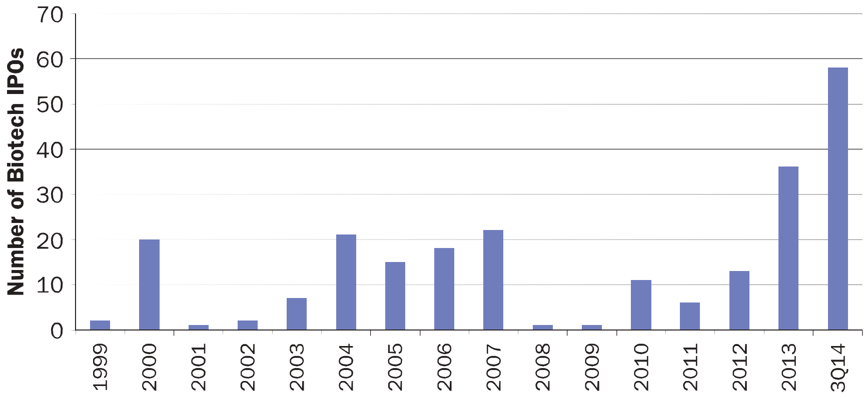
Pharma debt and equity financing: Limited, but readily available

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.

In the first three quarters of 2014, non-bank debt issuance was $44.2 billion compared to $41.2 billion for all of 2013, a significant increase in activity on an annualized basis.

Worldwide Biotechnology: Number of IPOs

After becoming non-existent in 2008 and 2009 during the financial crisis, IPOs recovered and the number reached an all time high in 2013. We are now at record levels in 2013 and the first three quarters of 2014.



Only Deals > $25 million

Source: Young & Partners

Equity issuance in the first three quarters of 2014 was also strong, with $6.2 billion of equity issued versus $6 billion for all of last year, an increase on an annualized basis. Although this was an increase, it was an increase from a very small base. There were only five IPOs in the first three quarters of 2014.

Equity issuance activity has been modest because pharma's need for public equity capital has generally been limited.

Biotech stock market: Strong performance

Against the backdrop of the 4% to 6% overall stock market price increases through the first three quarters, two of the three Y&P Biotech indices did exceptionally well and one did poorly.

The Y&P Large Cap Biotech and Y&P Small Cap Biotech indices increased by 27.4% and 19.7%, respectively, but the Y&P Mid Cap Biotech index decreased by 6%. Valuations are generally very strong as investors continue to feel the industry is attractive.

For a long time, the market sentiment towards the biotech industry was decidedly mixed, except for established biotech companies and companies with positive late-stage data. But the sentiment changed in early 2013 and investors have fallen in love with the industry again. There are some who are voicing concerns that valuations are too high, including the Federal Reserve Chairman in public statements. Regardless of one's view of valuation, the volatility has the potential to be high. With many biotech companies suffering from relatively low market float, modest movements of capital into or out of the biotech sector can cause very significant increases and decreases in the price of shares.

Biotech mergers and acquisitions: Consistently modest

Biotech M&A activity has been modest historically, with spurts of activity from time to time.

In the first three quarters of 2014, there were 19 biotech M&A deals completed worth $9.1 billion, of which $3.7 billion came from the acquisition of Idenix by Merck & Co. This compares to 27 deals worth $7.1 billion in all of 2013.

Overall deal activity has been driven by the need of pharma companies to expand their pipelines. However, high stock market valuations and the bidding up of prices for late-stage biotech companies have acted as a partial constraint. Also, biotech companies exercised the IPO alternative for much of 2013 and through the first three quarters of 2014 as both a funding and liquidity alternative, which gave many of them a healthy alternative to a sale of the company.

In addition, earn-out deals or "structured acquisitions" involving contingent payments continue to be heavily used in biotechnology M&A deals. The payouts on these deals look more like partnering/licensing transactions with milestones for approval or the achievement of specific sales levels, which has helped to bridge the gap between buyers and sellers.

With regard to deals announced but not closed as of the end of the third quarter, there were $2.7 billion involving four deals, a modest pipeline.

Although pharma and biotech executives believe that there should be a great deal of M&A activity, pharma and biotech companies are accomplishing many of their strategic and financial goals using other alternatives to M&A, such as licensing, partnering, etc. Although the number of licensing deals has fallen somewhat over the last couple of years, the total value of licensing deals rebounded recently to $30 billion last year. This is a reflection of intense competition among large pharma and large biotech for products addressing the most attractive targets and indications. It is notable how much larger the licensing number is compared to the M&A dollar volume for biotechs.

Biotech Debt and Equity Financing: Surge in IPOs

With regard to debt issuance, only $597 million of non-bank debt was issued in the first three quarters of 2014 compared to $592 million of non-bank debt issued for all of 2013. Debt issuance, essentially, has been almost non-existent.

Equity issuance, however, was massive in the first three quarters of 2014, with 129 offerings worth $10.1 billion completed compared to 114 offerings worth $8.2 billion for all of 2013. Activity was very high in the first half of this year, slowed in the third quarter, and is showing signs of a rebound in a volatile fourth quarter.

The IPO portion of biotech equity issuance in the first three quarters included 58 IPOs that totaled $4.2 billion, a very strong showing and ahead of last year's 36 IPOs totaling $2.6 billion. The contrast with the mere five IPOs in pharma in the first three quarters is notable.

Although there have always been long periods of dormancy between periodic and short biotech IPO peaks, it is not clear how long the current peak period lasts since there are some driving factors that are different this time around. At least in the past, the peak periods have usually not lasted more than a year or so and we have been at peak for almost two years now.

Pharma: What will the future bring?

The business outlook for pharma companies is mixed, as they struggle to realign themselves to a new business model that will work. The solution will be different for each company. However, there are very positive signs for the health of the industry as growth has resumed, innovative products are arriving, and interesting strategies are bearing fruit.

Big and specialty 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.

Until recent US Treasury department actions were taken, many companies were aggressively pursuing tax inversion deals as a way to reduce taxes and use cash from overseas earnings, but that route has lost much of its appeal.

Generics did well as long as they achieved growth, but with high volatility. However, the clear slowdown in patent expirations and the ethical drug company expansions of their generic efforts have forced generic companies to consolidate, acquire, and push into non-generic businesses.

M&A activity through the first three quarters of 2014, on an annualized basis, was far above last year's dollar pace and also higher in terms of the number of deals.

We believe there will be strong volume ahead of us driven by the strategic initiatives of pharma companies. This view is supported by a surge in announced but not closed deals as of the end of the last quarter. This surge will drive an increase in the fourth quarter and spill over into the first part of 2015.

Biotech M&A will continue to be active, with the primary theme being pharma and big biotech acquisitions of biotech companies for pipeline enhancement.

The stock market prices and valuations of the ethical pharma industry have improved with the rising stock market and progress that the industry has made in addressing the industry structural changes. The stock market has partially forgiven the ethical pharma industry in an overall rising equity market. But further increases in valuations will require a continuation of positive structural changes that create investor confidence. Generic pharma companies are being treated well by investors, but they, too, will have to successfully navigate their current business pivot to keep investor confidence.

The major debt refinancings were completed quite a while ago and new debt issuance will depend on the number and size of M&A transactions that will have to be financed.

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.

Biotech: What will the future bring?

The development capabilities of biotech companies have been and will continue to be positive overall. Although there will be successes and failures by individual companies, biotech companies are demonstrating and will continue to demonstrate their ability to successfully develop new drugs.

Biotech M&A will continue to be active, with the primary theme being pharma and big biotech acquisitions of biotech companies for pipeline enhancement. However, M&A dollar volume will continue to be modest, mainly because pharma and big biotech companies are heavily using non-M&A methods to achieve their pipeline goals, such as licensing and partnering.

M&A valuations will continue to be high, with the most promising biotech companies at all stages attracting the greatest interest and relatively high prices.

Historically, the biotech industry's relationship with the debt and equity markets has been volatile. The structural challenge has been the misalignment of when the funding sources or industry acquirers are available versus the time and costs to get to milestones.

However, that has not been the case in the equity market for biotech for the last two years. Venture funding has returned and there has been a dramatic surge in volume of IPOs since the beginning of 2013. Barring a major disruption in the global equity markets, we expect the positive environment for equity funding to continue. Equity issuance was very strong in the first three quarters of 2014. It remains to be seen, however, whether the biotech IPO window will remain open going forward with the volatility of the equity markets. PE

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