Pharma and Biotech Financial Trends: Every Which Way

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Introduction

Financial results and trends for any industry are partly driven by industry business factors, but external factors can be significant at times. The industry business factors include the ongoing business structural challenges facing pharma and biotech companies, including a very different R&D/commercialization dynamic; 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 IP. The external factors for the pharma and biotech industries include a global economy struggling to achieve growth and financial stability; continuing government efforts to prevent a Euro zone economic and financial meltdown; political uncertainties in the U.S.; the economic problems that are now affecting emerging market economies such as India and Brazil; and a positive surge in Western stock market valuations.

These external factors have had an enormous incremental effect on the financial trends in pharma and biotech thus far this year and will continue to have an impact going forward.

Looking back, pharma merger and acquisition volume in 2012 was fairly soft in terms of the number of deals and the dollar volume. The slowdown was partly a function of a reduced number of larger deals across all industries as the uncertainties around the European economic crisis, the U.S. presidential elections and fiscal cliff negotiations, and concerns about a slowdown in China created a cloud of concern. However, the strategic needs of Big Pharma were sufficiently strong to cause important, but smaller deals to go forward.

Through the first three quarters of 2013, there was a further slowdown in dollar activity, but a similar pace in terms of the numbers of deals completed, bolstered by a surge in Asia. As of September 30, 2013, only one deal above $1 billion in value has been completed which was the acquisition of Bausch & Lomb by Valeant and three large deals above $1 billion had been announced, but not closed. This slower pace has been driven by a number of factors. As was the case in 2012, Pharma companies have been tentative with regard to larger acquisitions given the host of uncertainties they are facing. In addition, the valuations of public pharma companies have gone up considerably, making public company acquisitions more expensive.

Pharma share prices performed well in almost every sector. The Young & Partners ("Y&P") Generic index and the Y&P Ethical Pharma indices in the US and Europe all did well, buoyed by a very strong overall stock market. This has resulted in very strong P/E multiple increases from what were previously anemic levels that were languishing far below their very high levels in the 1990s and earlier.

Debt issuance by the Pharma industry fell significantly during the first three quarters of 2013 with the drop in M&A activity. Much of the debt issuance in pharma for a number of years has been tied heavily to larger M&A transactions. Equity issuance was also relatively modest, including IPO activity.

On the biotech side, M&A volume has historically been very weak and was at low levels from 2007 to 2011. Acquirers were selective and alternatives to M&A, such as partnering and licensing, played a prominent role. That changed in 2012 as biotech M&A picked up to 2006 levels and higher with the $10.3 billion Pharmasset deal and four other $1 billion plus transactions completed. This proved not to be sustainable. In the first three quarters of 2013, the number of deals has been healthy, but the dollar volume was very weak. 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, the equity markets have fallen in love with the biotech industry again. With relatively low market float, modest to moderate movements of capital into the biotech sector have caused very significant increases in the price of shares as investors have searched for places to invest in growth areas.

In terms of biotech financing, debt issuance has been 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. The strong IPO market generally, coupled with the new love affair that the markets have with biotech resulted in a high level of equity issuance, including IPOs.

These are the highlights from the "Pharma and Biotech Strategic, M&A, and Financial Trends Report" recently completed by Young & Partners that covers the first three quarters of 2013 and the outlook for the future. The report looks at both the biotech and pharma industries and tracks:

- The strategic and business environment for both industries
- Stock prices and P/E ratios within proprietary index groups of pharmaceutical and biotech companies

- Completed M&A deals of $25 million and up
- Issuance of non-bank debt and equity

Pharma Stock Market – Strong Price Performance

In the first three quarters of 2013, the S&P 500 did well, increasing by 15%, while the FTSE Euro Top 100 increased by 7%. The pharma industry also did well. During that same time period, the Y&P U.S. Pharma index increased by 18.9%, the Y&P European Pharma index by 12.4%, and the Y&P Generic index by 30.1%.

Valuations have also increased significantly, with the most dramatic increases occurring in the ethical pharma sector. The Y&P U.S. Pharma index P/E ratio increased from 18.6x at the end of 2012 to 23.5x at the end of the third quarter of 2013. The Y&P European Pharma index increased similarly from 15.1x to 21.4 x over that same time period.

The Y&P Generic index increase was less impressive, increasing by a small amount from 22.9x to 23.6x over the same time period, but this was partly driven by earnings increases.

These multiples have improved, but they are still dramatically down from where they were just a number of years ago when the pharma industry was viewed very differently. The pharma industry was once viewed as a very stable, profitable, high growth industry. The industry is now viewed as far less stable with industry uncertainties everywhere and stable, profitable growth a distant memory.

The significant turnaround this year has been welcomed by investors and the industry.
We will see even more positive changes when the industry regains its footing and if and when the market has confidence in the industry's structural stability.

Modest Pharma Deal Activity – Still No Mega Deals

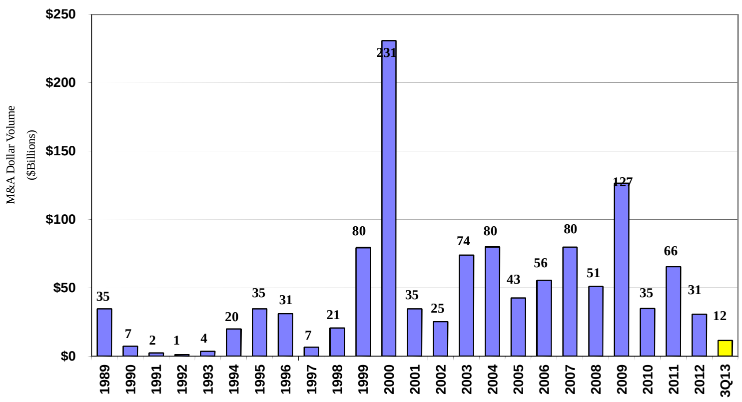
In the first three quarters of 2013, 29 deals were completed worth $11.6 billion versus 38 deals completed worth $30.9 billion during all of 2012.

This represents a significant slowdown in dollar activity, but a similar pace in terms of the numbers of deals completed, bolstered by a surge in Asia. The one deal above $1 billion in value was the acquisition of Bausch & Lomb by Valeant for $4.6 billion. The next largest deal was only $879 million, the acquisition of Guangzhou Baiyunshan Pharma by Guangzhou Pharma.

In comparison, there were five deals valued at over $1 billion (equity value) in 2012, primarily strategic deals: Couckinvest NV's acquisition of Omega Pharma NV for $1 billion, Sandoz's acquisition of Fougera for $1.5 billion, TPG Capital's acquisition of Par Pharmaceutical for $1.9 billion, GlaxoSmithKline's acquisition of Human Genome Sciences for $2.8 billion and Bristol Myers Squibb's acquisition of Amylin Pharmaceutical for $5.1 billion.

However, there are signs that the pace is picking up. As of September 30, 2013, the value of the deals announced but not closed was $29.9 billion (17 deals), the largest of which is Amgen's acquisition of Onyx.

Global Pharma M&A in Dollars
(1989 through Third Quarter 2013)



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 in their pursuit of yield. Borrowing levels have been more a function of the issuers' needs.

In the first three quarters of 2013, non-bank debt issuance was $25.4 billion compared to $50.9 billion for all of 2012, a significant decrease in activity. This is directly related to a slowdown in M&A activity and the related financing that would have been required.

Equity issuance in the first three quarters of 2013 showed a meaningful increase on a very small base, with $4.6 billion of equity issued compared to just $3.5 billion for all of last year. There were 3 IPOs in the first three quarters of 2013.

Although the equity issuance activity has been modest, it has not been due to a weak overall IPO market since the IPO market for life sciences has been strong this year. Instead, it is because Pharma's need for public equity capital has generally been limited.

Biotech Stock Market – Strong Performance

Against a strong general market performance backdrop, the Y&P Large Cap Biotech, Y&P Mid Cap Biotech, and Y&P Small Cap Biotech Indices did exceptionally well in the first three quarters of this year, increasing by 58%, 68% and 161%, respectively. This is a continuation of their strong performance last year.

The equity markets have fallen in love with the biotech industry again. With relatively low market float, modest to moderate movements of capital into the biotech sector have caused very significant increases in the price of shares as investors have searched for places to invest in growth areas.

For some 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 last year and continues this year.

Biotech Mergers and Acquisitions – Consistently Modest

Given the perception that Big Pharma needs to fill its product pipeline, Biotech M&A activity has been chronically modest for the last couple of years, with just a few exceptions.

In the first three quarters of 2013 there were 21 biotech M&A deals completed worth $6 billion. This compares to 19 deals worth $19.7 billion for all of 2012. Dollar volume has fallen, but the number of deals has increased. The dollar volume decrease was largely due to Gilead's acquisition of Pharmasset in 2012 for $10.4 billion. But it was not the only large deal last year. Dainippon Sumitomo acquired Boston Biomedical for $2.6 billion and BMS acquired Inhibitex for $2.1 billion.

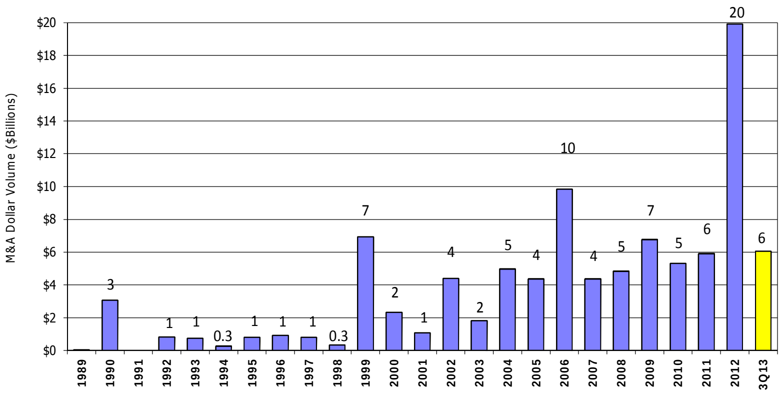
The reduced number of large deals is partly due to the very high stock market valuations and the bidding up of prices for late stage biotech companies which has dampened the pharma company pursuit of certain biotech companies. Also, biotech companies have had an attractive IPO alternative to a sale available for much of 2013.

Although pharma and biotech executives believe that there should be a great deal of M&A activity, pharma companies are accomplishing many of their strategic goals using other alternatives to M&A such as licensing, partnering, etc.

Interestingly, earn-outs have become a major portion of transactions this year with 13 of the 21 deals completed. Although earn-outs or "structured acquisitions" involving contingent payments have been common in biotechnology M&A deals, they peaked in 2011 and fell to 32% of biotech deals completed. This has changed dramatically thus far in 2013, surging to 62%. The primary reason has been an increased need to bridge the value gap between buyer and seller.

Interestingly, as of September 30, 2013, the value of deals announced but not closed was only $500 million (1 deal). This suggests continued weakness looking forward in biotech M&A volume.

Global Biotech M&A in Dollars
(1989 through Third Quarter 2013)



Biotech Debt and Equity Financing – Modest Improvement

Debt financing has been close to a standstill. Only $492 million of non-bank debt was issued in the first three quarters of 2013 compared to $794 million for all of 2012. This is a continuation of an almost non-existent debt financing market for a number of years.

Equity issuance volume in the first three quarters of 2013 was much stronger, with 78 offerings worth $5.9 billion compared to 85 offerings worth $5.6 billion for all of 2012. This puts the industry ahead of last year's pace in terms of both number of deals and dollar volume.

The IPO market has become exceptionally strong recently with a surging stock market and very positive biotech stock price performance. First three quarters 2013 issuance includes 29 IPOs totaling $2 billion. This is a huge increase over the 13 IPOs in 2012 and the 6 in 2011.

Although there have always been long periods between the periodic biotech IPO frenzy that happens from time to time, this time around the inactive period was particularly long. The real question will be how long this peak period lasts. At least in the past, the peak periods have been relatively short.

What will the future bring? – Pharma

The business outlook for pharma companies is mixed, as pharma companies struggle to realign themselves to a new business model that will work. The solution will be different for each company.

Although the pharmaceutical industry has been less affected by global economic conditions compared to most industries, going forward the impact will be more prominent as governments attempt to control healthcare costs as part of their deficit reduction efforts. The revenue challenges will be tied more to the difficulties in getting drugs approved, reimbursement challenges, patent expirations, weak product pipelines, and failing business models rather than global economic trends.

The stock market has partially forgiven the ethical pharma industry in an overall rising equity market. But any real turnaround in valuations will require structural changes investors have confidence are effective. Generic pharma companies, however, are being treated well by investors, but with caution as the revenue cliffs that once were just the terrain of the ethical pharmaceutical companies are now migrating to the generic companies.

Pharma M&A will continue to be active, but modest in terms of the size of deals and very strategically focused. Although there have been a few announced large deals recently, such as Perrigo/Elan, Amgen/Onyx and Actavis/Warner Chilcott, these are not mega deals. We do not see many mega deals happening in the next couple of years. We do expect companies to continue to divest non-core assets and established product lines.

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. Non-investment grade debt will be issued more sporadically.

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 revived, pharma issuance of public equity will remain limited.

What will the future bring? - Biotech

Biotech companies are continuing to demonstrate their ability as a group to be effective at developing new drugs and methods, but the challenges that face drug development generally will challenge biotech companies as well.

Historically, the biotech industry’s relationship with the debt and equity markets has been volatile. The good news is that the current love affair that the equity markets have with biotech companies shows no sign of slowing down on both the stock market and the equity issuance fronts.

The primary biotech M&A theme will continue to be pharma and big biotech acquisitions of biotech companies for pipeline enhancement. Historic M&A volume has been modest as, pharma and big biotech continued to use non-M&A methods to achieve their pipeline goals, much to the detriment of biotech companies seeking an exit. M&A volume will likely continue to be modest, particularly with the existence of numerous external uncertainties that will tend to dampen biotech M&A for a period of time. The heavy activity will be in the form of partnering, licensing and shedding of non-core assets.

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