Turbulent Waters

The latest numbers in pharma and biotech deals reveal a sector in transition, where market volatility has sharply degraded the appetite for risk—even as the potential of biotech science suggests a bright future for investors who make the right bets on therapies able to prove value to a restive new class of payers.

By | Peter Young

Pharma merger and acquisition volume in the first half of 2011 was stronger than 2010 in terms of the number of deals and dollar volume. The same pattern is evident on an annualized basis. The drive to fill pipelines and replace revenues lost to patent expirations and intensifying therapeutic class competition continues to fuel the high level of deal activity.

Pharma share prices showed some improvement in the first half, but all Young & Partners' pharma indices lost considerable ground in the third quarter as the overall stock market was battered. Debt issuance increased modestly in the first half, but equity issuance was anemic, as investor appetite for taking on equity stakes disappeared.

On the biotech side, the story has been a bit different. After a surge in 2006, M&A collapsed in the 2007 to 2010 period and slowed further in the first half of 2011. Acquirers have become selective and other alternatives, such as partnering and licensing, are playing a prominent role. Risk calculations loom large.

In the stock market, our large and medium capitalization biotech company stock price indices staged a moderate recovery in the first half, but the small capitalization biotech company index suffered from a very poor performance. The third quarter was painful for all biotech companies with 11 percent, 11 percent, and 20 percent decreases in the three indices. Debt and equity offerings continued to be weak as market sentiment veered decidedly away from risk.

These are the highlights from the first half "Strategic, M&A, and Financial Trends Report" prepared by Young & Partners. The report looks at both the biotech and pharma industries and tracks:

» 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

This year's findings document the critical importance of external business factors as a driver of M&A and financing performance. These factors include the backdrop of a global economy struggling to achieve growth and avoid a new recession; the threat of a Eurozone economic and financial meltdown; the ongoing business structural challenges facing pharma and biotech relationships with patients, providers, and a transforming

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customer base; changes in patent laws and regulation; and reductions in global government spending that will have an effect on industry pricing, reimbursement, and volume sales.

The Big Picture

It is clear that the global economy is suffering from stagnant growth in the developed countries. Unfortunately, even the emerging markets are showing some signs of slowing growth. The developed economies are facing high unemployment, weak housing markets, rising government deficits, and high sovereign debts. The difficulties in the Eurozone are particularly severe and, absent a revision of the overall approach to European monetary union, will almost certainly have a negative economic and financial impact on Europe and, indirectly, the rest of the world.

The pharmaceutical industry was relatively untouched from a demand point of view by the previous post-Lehman Bros. economic and financial crisis, as pharma and biotech companies saw unabated demand for their drugs and drug candidates. The revenue challenges have been tied more to the difficulties in getting drugs approved, reimbursement challenges, patent expirations, weak product pipelines, and failing business models.

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. In addition, biotech companies have been hurt by the contraction in the availability of equity funding due to the market's flight from risk.

The drug industry scored some modest gains under the 2010 US Health Care Reform bill. By coming to an early agreement with the Obama Administration to contribute billions of dollars in cost savings in government health programs, the pharmaceutical industry was promised higher prescription volumes and an exemption from price negotiation and controls under the Medicare Part D drug benefit for seniors. It is not so clear whether the drug industry will fare as well when long-term deficit reduction negotiations get under way and interest groups with opposing agendas take direct aim at the pharmaceutical industry. Its ongoing image problems with regulators and the public make companies vulnerable to these additional "contributions."

On the financial side, established pharmaceutical companies are in a position to weather the fiscal debt crisis due to their strong cash flows and their high credit ratings. On the other hand, biotech companies have been severely punished by the financing markets and have little or no access to capital. Until the market's appetite for risk returns, many good biotech companies will be starved for equity capital. The severe disruptions in the financial markets that started in early August have only served to make a difficult situation worse for biotech companies with a frozen IPO market and hesitant venture capital investing.

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Pharma Stock Market – Out of Favor

During the first half of 2011 the overall stock market performance was modest. By June 30, the S&P 500 index had increased by 3.8 percent and the FTSE Europe Top 100 fell by 1.8 percent.

The pharma industry performance was mixed relative to the market. The Y&P US pharma index increased by 8.1 percent, the Y&P European pharma index increased by 11.3 percent, and the Y&P generic index increased by 1.3 percent.

Trailing P/E ratios also changed. The Y&P US pharma index increased to 15.6x from 14.4x at year-end 2010, the Y&P European pharma index decreased to 16.6x from 17.7x at year-end 2010, and the Y&P generic index increased to 28.4x from 22.3x at year-end 2010.

These multiples are dramatically down from where they were just a few years ago when the pharma industry was viewed favorably relative to other industries. Part of this trend is due to the fact that pharma companies are no longer the darlings of the stock market that they once were. Although industry multiples have been relatively stable since 2008, the multiples are quite low. Future uncertainties have increased and investors have come to realize that there are major structural problems that the industry will have to overcome. Getting better control of expenses—the general sales and administrative ratio to revenues number—is critical to Wall Street perceptions of future success.

The third quarter was a disaster for global equity markets. With the S&P 500 down by 14 percent and the *Financial Times* European Top 100 down by 16 percent, the pharma industry could not avoid the debacle with US pharma shares down 6 percent, European pharma down 11 percent, and generics down 20 percent.

Stronger Deal Activity

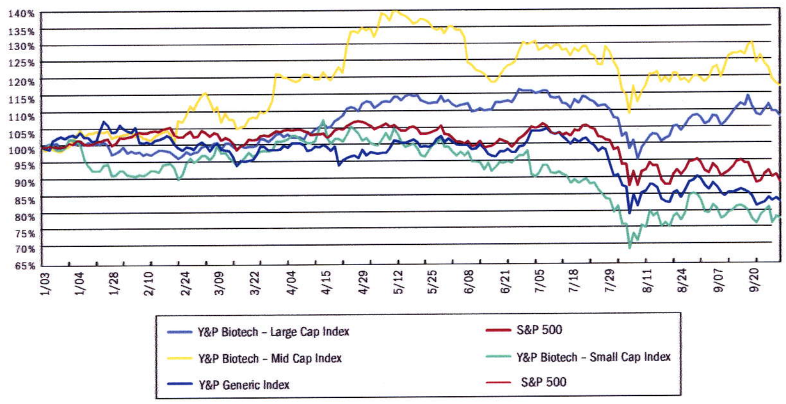
For the first half of 2011, 25 deals were completed worth $37.7 billion versus 14 deals worth $15.4 billion completed in the first half of last year and 40 deals worth $34.8 billion for the entire year of 2010. This increase in activity reflects the pharma industry's ongoing pursuit of products, consolidation, and revenues. However, there are no megadeals thus far this year and there were none last year. Big Pharma has been more cautious about the benefits of megamergers.

There were six deals over $1 billion in equity value in the first half of this year, the largest of which was Sanofi's acquisition of Genzyme for $19.6 billion in enterprise value. Perhaps a clear indication of the deal pipeline was the fact that as of June 30, the value of the deals announced but not closed was $26.1 billion (18 deals), a clear sign of a very active level of merger activity.

Stock Market Trends

Y&P Biotechnology Indices – Three Quarters 2011

In the first three quarters, the Y&P Mid Cap Biotech and the Y&P Large Cap Biotech Indices outperformed the market.



Source: Young & Partners

Debt and Equity Financing: Weak Issuer Demand

The debt and equity financing activities of pharmaceutical companies slowed considerably in 2010 after a major surge in 2009 from the financing of two megamergers involving Pfizer and Merck. The slower but active pace continued through the first half of 2011, with non-bank debt issuance totaling $19.7 billion, compared to $34.8 billion for all of 2010. This active but slower pace was mostly driven by lower issuer demand rather than lack of investor interest. The market demand has continued to be strong for investment grade debt.

Equity issuance in the first half was only $1.5 billion versus $5.2 billion for all of 2010 as the market continued to be only modestly active. The number of offerings was 11 versus 29 for all of 2010. Although the issuance activity has been modest, it has only been partly due to a weak equity issuance market. Pharma's need for public equity capital has generally been limited.

Moving Away From Risk

The Y&P Small Cap index has done poorly for all of this year. Although the Y&P Large and Mid Cap biotech indices did well in the first half of 2011, increasing 16.0 percent and 29.7 percent, respectively, they followed with very poor performances in the third quarter.

As the overall stock market fell in the third quarter, the biotech companies did worse. The Y&P Biotech Large Cap index fell by 15.5 percent, the Y&P Biotech Mid Cap index by 18.5 percent, and the Y&P Biotech Small Cap index by 10.6 percent.

This is understandable since the stock market has been running away from risk and the biotech industry is perceived to be a higher risk sector.

Biotech M&A: Where Did the Volume Go?

Given the perception that Big Pharma needs to fill its product pipeline, biotech M&A activity continues to be surprisingly modest. In the first half, only 11 biotech M&A deals worth $4.3 billion in equity value were completed. This is a continuation of the very subdued biotech M&A activity over the last two years. Only 21 deals worth $5.3 billion were completed in 2010, compared to 20 deals worth $6.1 billion in 2009, and 19 deals worth $4.8 billion in 2008.

Why the modest number and dollar volume? Acquisitions of biotech companies by Big Pharma and big biotech companies have continued, but the size of deals have become much smaller. Part of the reason is that the supply of decent-sized biotech companies has been depleted. In addition, there has been a heavy use of partnerships, in-licensing, and earn-outs. Earn-out deals, for example, have dramatically increased their share of biotechnology M&A activity, growing from 27 percent of deals in 2007 to 67 percent of deals in 2010 by number of deals. In the first half of 2011, 70 percent of biotech M&A transactions were earn-out deals. These deals are attractive as they lower investor risk through specific progress and performance milestones.

As of June 30 there were only two deals worth a combined $299 million that had been announced but not closed. This very modest biotech deal pipeline is a further indication that the biotech M&A market is in a slump.

Biotech Debt and Equity Financing – Ultra Depressed

There was only $540 million of biotech non-bank debt offerings completed in the first half of 2011 compared to $475 million issued in all of 2010. The lack of biotech creditworthiness coupled with a weaker debt market for non-investment-grade credits have been major factors.

Equity issuance in the first half of this year came to 45 offerings worth $2.7

Top 10 Deals First Half of 2011 by Equity Value
(Figures in $US Billions)

Close Date	Acquirer	Target	Equity Value	Enterprise Value
03/04/11	Amgen	BioVex Group	$1,000	$1,000
04/11/11	Amgen	Clinical Data	931	933
04/04/11	Forest Laboratories	Plexxikon	805	935
01/31/11	Daiichi Sankyo	Taligen Therapeutics	478	478
04/01/11	Alexion Pharmaceuticals	Calistoga Pharmaceuticals	375	600
04/30/11	Gilead Sciences	Gemin X Pharmaceuticals	225	525
06/14/11	Cephalon	ChemGenex Pharmaceuticals	204	195
02/02/11	Cephalon	Synosia Therapeutics	119	119
01/26/11	Biotie Therapies Oyj Ligand Pharmaceuticals	CyDex Pharma	89	89
05/16/11	Astellas Pharma	Perseid Therapeutics (Maxygen)	76	91

Source: Young & Partners

billion. This compares to 65 offerings worth $3.6 billion for all of 2010. This represents a small uptick in equity issuance volume that started in the fourth quarter of 2009. In total in the first half there were three IPOs: AcelRx, Endocyte, and Tranzyme.

With the third quarter collapse in the equity issuance market and a flight to quality, equity issuance has almost disappeared for the biotech industry. Smaller startups are now very heavily dependent on attracting partners and acquirers rather than remaining independent through organic growth.

What Lies Ahead?

The business outlook for pharma companies is mixed, as many struggle to realign themselves to a new business model that will work. The solution will be different for each company. There have been some major changes in strategy, with a prominent divide emerging between companies that retain large in-house R&D capabilities and those who favor outsourcing through academic partnerships and biotech stakeholding.

Unfortunately, the move to trim government deficits will result in government policies that will have a negative impact on the industry.

The stock market will continue to penalize the pharma industry as long as the structural changes work their way through the industry and solutions are being implemented. Generics will continue to do well as long as they achieve growth, but with high volatility and low margins, as we have seen recently.

Pharma industry multiples are below market multiples now and will continue to suffer until the industry outlook improves and regulatory risk uncertainty is resolved. Nevertheless, pharma M&A activity will continue to be high, as pharma companies use acquisitions to enhance their product pipelines. The need to fill the shrinking drug pipeline will continue to fuel mergers and acquisitions, in-licensing arrangements, and the formation of partnerships and joint ventures. However, companies have been rethinking the role of megamergers, so dollar volume will likely stay in the $40 billion to $60 billion range.

On the bright side, the scientific and development capabilities of biotech companies have clearly been validated. Although there will be successes and failures by individual companies, biotech companies are demonstrating their ability to develop new drugs at a faster pace than the larger pharma companies. Careful vetting of commercial potential, particularly with regard to presenting a viable "value proposition" to the all-important payer, is critical to success for both sides.

The severe negative has been on the funding equation. Historically, the biotech industry's relationship with the financing markets has been volatile. The distressed equity financing market, since the start of the third quarter, will make biotech funding even more challenging. But the funding of biotech companies will continue to be difficult, even if there is a recovery in the overall IPO market.

For the time being, shareholder liquidity must come from the pharma and big biotech companies through partnering, licensing, and M&A deals. The interdependence of pharma and biotech is greater than ever. Such are the ties that bind.

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