Breaking Waves:

Turbulent Times for the Biopharma Business

The M&A environment for Big Pharma and biotech is dominated by economic uncertainty, contrasting returns, and the transition to a new business model marked by a much more competitive customer base. This is the principal conclusion of the "Pharma and Biotech Strategic, M&A, and Financial Trends Report" recently completed by Young & Partners that covers the first three quarters of 2012 and the outlook for the year ahead.

By Peter Young, Young & Partners

Pharma merger and acquisition volume in 2011 was quite strong in terms of the number of deals and the dollar volume. The drive to fill pipelines and replace revenues lost to patent expirations, changes in overall business portfolios, and intensifying therapeutic class competition fueled strong deal activity. All that changed in 2012 as political, regulatory, and economic uncertainty has created hesitancy and tainted the profile of the pharma and overall M&A markets.

Pharma share prices have performed very differently by sector. The Young & Partners (Y&P) Generic Pharma stock price index improved modestly, but the Y&P Ethical Pharma indices in the United States and Europe did much better. Nonetheless, P/E multiples are still languishing far below their levels in the 1990s and earlier.

Debt issuance by the pharma industry increased significantly during the first three quarters of 2012 as investors sought yield from sectors perceived not to be vulnerable to the threat of an economic downturn. Equity issuance also picked up modestly.

On the biotech side, the story has been quite the opposite. Biotech M&A volume has been very weak and was at low levels from 2007 to 2011. Acquirers were selective; alternatives, such as partnering and licensing, played a prominent role. That changed in the first three quarters of 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. The key question: is this trend sustainable or just a temporary spurt?

Perhaps more than any other business sector, financial results in the biopharma business are influenced by regulatory decisions that in turn reflect trends shaping the external political and economic environment. These trends include a global economy struggling to achieve growth and financial stability; continuing government efforts to prevent a Euro zone economic and financial meltdown; ongoing structural challenges in the relationships with patients, providers, and a transforming customer base; changes in patent laws and regulation; and reductions in government spending that will have a dramatic impact on pricing, reimbursement, and volume sales, especially in the short term.

In addition, there are political uncertainties such as the US fiscal cliff and presidential elections, the potential for changes in US healthcare laws post election, the wrangling in Europe over what to do to solve the Euro zone crisis, and the slowdown of the Chinese and other emerging market economies.

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

Top 10 Pharma Deals First Three Quarters 2012

There were five deals over $1 billion in value in the first three quarters of 2012.

Close Date	Acquiror Name	Target	Equity Value	Enterprise Value
08/09/12	Bristol-Myers Squibb Co	Amylin Pharmaceuticals Inc	$5,125	$6,638
08/03/12	GlaxoSmithKline PLC	Human Genome Sciences Inc	$2,853	$3,212
09/28/12	TPG Capital, L.P.	Par Pharmaceutical Companies Inc.	$1,855	$1,978
07/23/12	Sandoz, Inc.	Fougera Pharmaceuticals Inc.	$1,525	$1,525
02/03/12	Couckinvest NV	Omega Pharma NV [Beluga NV]	$1,065	$1,519
06/04/12	Takeda Pharmaceuticals U.S.A.	URL Pharma, Inc. [Elliot Management]	$800	$800
01/05/12	Harbin Pharmaceutical Group	Group Sanjing Pharmaceutical	$691	$671
09/03/12	Cinven Limited	Mercury Pharma Group Limited [HgCapital]	$683	$730
06/12/12	Amgen, Inc.	Mustafa Nevzat Ilat Sanayii AS	$650	$650
02/07/12	Alexion Pharmaceuticals, Inc.	Enobia Pharma, Inc.	$610	$1,081

$ values in millions

In the stock market, our large, medium, and small capitalization biotech company indices did well through the third quarter of 2012. However, the sector continues to suffer from volatility as investor sentiment swings easily from highs to lows.

In terms of biotech financing, debt issuance and equity offering volumes improved in the first three quarters of this year relative to last year's modest volumes, in spite of the choppy and difficult overall IPO market. It remains to be seen if the market will let this modest level of biotech IPOs continue in an environment when investors are trying to achieve returns while avoiding risk.

Pharma stocks—strong on price, but still out of favor

During the first three quarters of 2012, the S&P 500 index did well, increasing by 13 percent, but the FTSE Europe Top 100 only increased by 4 percent, a decidedly mixed picture.

The pharma industry stock market performance varied significantly by pharma sector. The generic industry shares improved modestly while the ethical pharma companies gained significantly with increased interest from investors. The Y&P Generic index increased by 7 percent, the Y&P US Pharma index increased by 12 percent, and the Y&P European Pharma index increased by 10 percent. An increasingly competitive generic industry and pressure on profits contributed to less favorable generic pharma investor sentiment on a relative basis.

A comparison of the third quarter ending trailing P/E multiples to those at year end 2011 for our three pharma indices is less mixed as all three pharma indices increased by similar amounts. The Y&P US Pharma index increased to 19.1x from 16.7x, the Y&P Generic index increased to 26.5x from 23.1x, and the Y&P European Pharma index increased to 18.7x from 16.5x.

These multiples are dramatically down from where they were just a number of years ago when the pharma industry was viewed favorably relative to other industries and traded at a significant premium to the overall stock market.

Unfortunately, the pharma industry was once viewed as a very stable, profitable, high-growth industry. The industry is now viewed as far less sta-

Top 10 Biotech Deals First Three Quarters 2012

There were five deals over $1 billion completed in the first three quarters of 2012

Close Date	Acquirer	Target	Equity Value	Enterprise Value
01/17/12	Gilead Sciences, Inc.	Pharmasset, Inc.	$10,378	$10,845
04/25/12	Dainippon Sumitomo Pharma	Boston Biomedical Inc.	$2,630	$2,630
02/13/12	Bristol-Myers Squibb Co.	Inhibitex, Inc.	$2,090	$2,526
06/19/12	AstraZeneca PLC	Ardea Biosciences, Inc.	$1,180	$1,176
03/07/12	Amgen, Inc.	Micromet, Inc.	$1,016	$857
03/08/12	Celgene Corp.	Avila Therapeutics, Inc.	$350	$925
07/05/12	Amgen Inc.	KAI Pharmaceuticals, Inc.	$315	$315
08/14/12	Upsher Smith Laboratories	Proximagen Group plc	$315	$399
01/04/12	Harbin Pharmaceutical Group	Harbin Pharmaceutical Group Bioengineering	$253	$253
04/19/12	Shire PLC	Pervasis Therapeutics, Inc.	$175	$175

ble with structural uncertainties everywhere and stable, profitable growth a distant memory. This will only change for the better when the market has confidence in the industry's ability to respond and compete in an era of value conscious payers and patients.

No mega deals

In the first three quarters of 2012, 26 pharma deals were completed worth $19.2 billion versus 49 deals completed worth $65.6 billion during all of 2011. This represents a major slowdown in activity.

There were no mega deals and the largest deal was only worth $5.1 billion. The five deals valued at over $1 billion (equity value) were 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.

Although there were no mega deals last year either, there were more deals completed and the average dollar deal value was much higher. For example, last year, Sanofi acquired Genzyme Pharmaceutical for $19.6 billion and Takeda Pharmaceuticals acquired Nycomed for $13.7 billion. In addition, there were seven deals above $1 billion in value last year versus only five thus far in 2012.

As of September 30, 2012, the value of the deals announced but not closed was a modest $12.6 billion (12 deals), the largest of which is Watson's pending acquisition of Actavis. This means that the market is still quite active, just not as active as last year.

Pharma debt and equity financing

Debt financing for pharma companies was fairly flat in 2011 and equity financing was decidedly depressed. Thus far in 2012 through the first three quarters, we are seeing much stronger financing activity across both the debt and equity markets.

In the first three quarters of 2012, non-bank debt issuance was $31.4 billion compared to $20.7 billion in the first three quarters of 2011, a major increase in activity. Pharma companies are perceived as strong cash flow generators, so investors, for the moment, feel comfortable lending to the industry in their pursuit of better returns.

Equity issuance in the first three quarters of 2012 was modestly more active with $2.7 billion of equity issued versus $1.5 billion for the first three quarters of 2011 and $1.8 billion for all of 2011.

There were no IPOs in the first three quarters of 2012. This compares to three IPOs in 2011: Pacira Pharmaceutical, Corporacion Farmaceutica, and Sagent Pharmaceuticals Inc.

Although the equity issuance activity has been modest, it has only been partly due to the weak overall equity issuance market. Pharma's need for public equity capital has generally been limited.

Strong biotech market performance

Against the benchmark of the performance of the overall market, the Y&P Large Cap Biotech, Y&P Mid Cap Biotech, and Y&P Small Cap Biotech Indices all did exceptionally well, increasing by 35 percent, 78 percent, and 35 percent, respectively during the first three quarters of this year.

For some time now the market sentiment towards the biotech industry has been decidedly mixed, except for established biotech companies and companies with positive late stage data. But the sentiment this year materially improved. Although P/E ratios only have meaning for the larger biotech firms with earnings, their P/E ratios improved relative to the market.

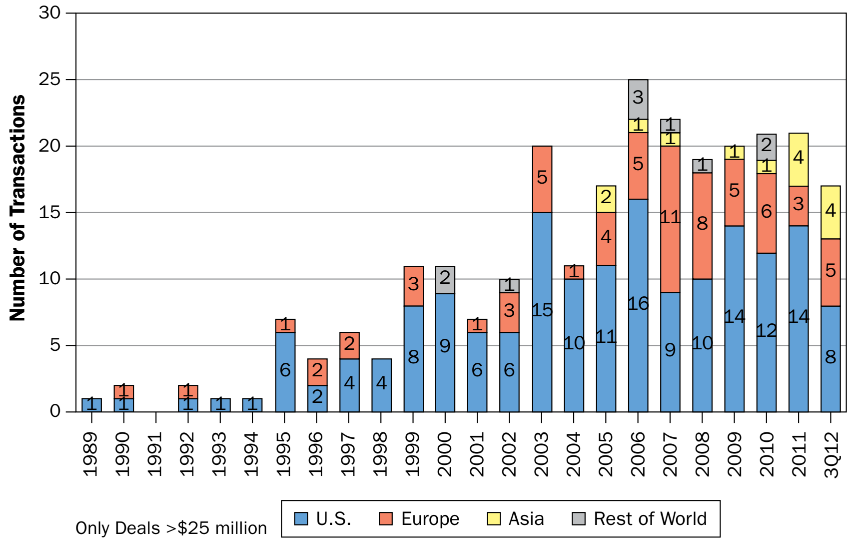
Biotech mergers and acquisitions

Given the perception that Big Pharma needs to fill its product pipeline, Biotech M&A activity has been surprisingly modest. However, there has been a surge recently in dollar volume and, very modestly, in the number of deals completed.

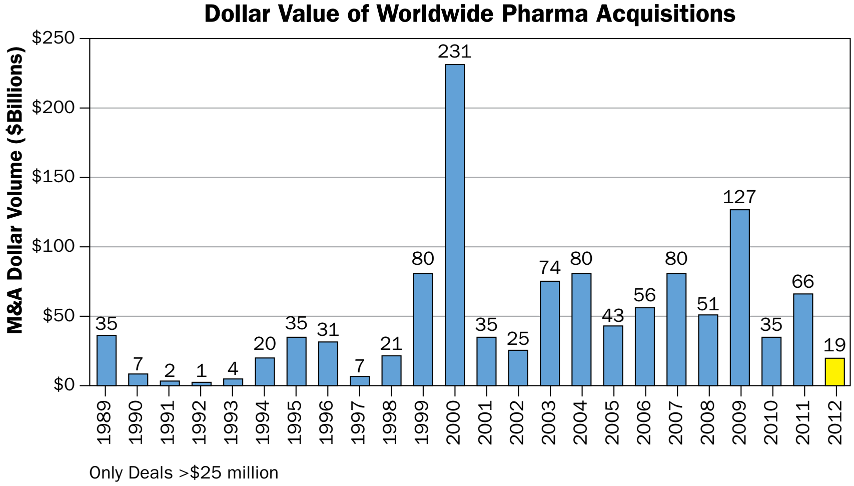
In the first three quarters of 2012, there were 17 biotech M&A deals completed worth $19.2 billion. This compares to 21 deals worth $5.9 billion in all of 2011.

The dollar volume increase was largely due to Gilead's acquisition of Pharmasset for $10.4 billion, In addition, Dainippon Sumitomo acquired Boston Biomedical for $2.6 billion and

Number of Worldwide Biotechnology Acquisitions — Buyer Location



Dollar Value of Worldwide Pharma Acquisitions



Bristol-Myers Squibb acquired Inhibitex for $2.1 billion.

Earnout deals or "structured acquisitions" involving contingent payments became common in biotechnology M&A deals, peaking in 2011. The payouts on these deals have looked more like partnering/licensing transactions with milestones for approval or the achievement of specific sales levels.

These structures have allowed acquirers to mitigate their risk and allow sellers to potentially realize significantly higher valuations upon success. They grew to a larger share of biotechnology M&A activity in recent years, growing from 27 percent of deals in 2007 to 67 percent in 2012. Since then, the percentage has dropped, first to 52 percent in 2011 and now to only 29 percent in the first three quarters of 2012. The primary reason has been the increased negotiating position of sellers.

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

Interestingly, there were no deals announced but not closed as of the end of the third quarter, a worrisome sign for future M&A activity.

Modest boost in biotech debt and equity financing

Seven hundred ninety four million dollars of non-bank debt was issued in the first three quarters of 2012. Although this exceeds the $675 million of non-bank debt issued for all last year, the amounts are still quite small.

Equity issuance volume in the first three quarters of 2012 was 61 offerings worth $4.0 billion compared to 53 offerings worth $3.2 billion over the first three quarters of 2011, indicating a stronger equity market.

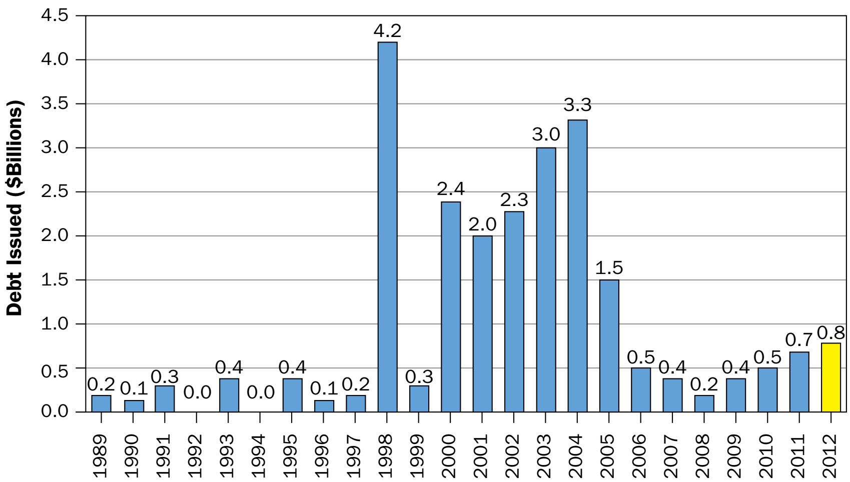
This increase included 10 IPOs: Verastem, ChemoCentryx, Adocia SAS, Merrimack Pharmaceuticals, Cempra Holdings, Tesaro, Supernus Pharmaceuticals, Puma Biotechnology, Hyperion Therapeutics, and Durata Therapeutics.

There were only six IPOs in 2011: AcelRx, Endocyte, Tranzyme, Horizon Pharmaceuticals, NewLink Genetics Corp, and Clovis Oncology. We are clearly seeing a modestly improved IPO market this year.

Pharma's future

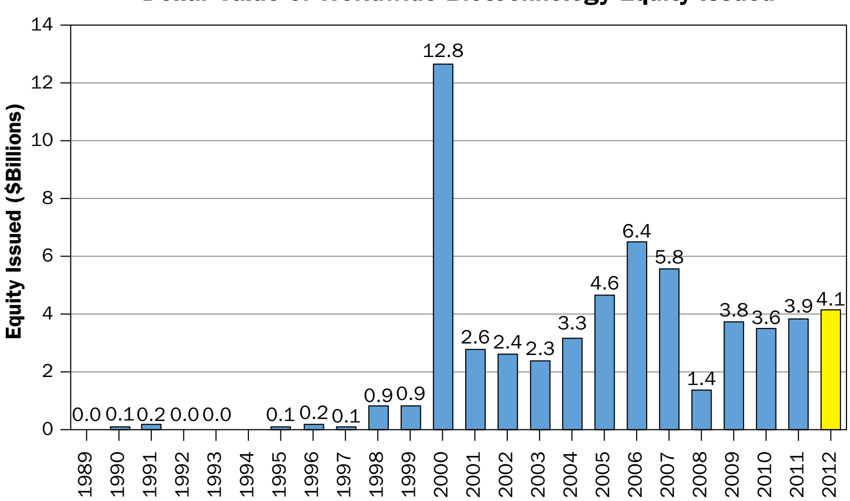
The business outlook for the Big Pharma companies is mixed, as pharma companies struggle to realign themselves to a new business model that will work. The solution will be different for each company. Although the biggest pharmaceutical companies have been able to ride out the adverse global economic conditions better than other sectors, going forward the impact will be more prominent as governments attempt to control healthcare costs as part of their deficit reduction efforts. The revenue

Worldwide Biotechnology Non-Bank Debt Financing



Only Deals >$25 million

Dollar Value of Worldwide Biotechnology Equity Issued



Only Deals >$25 million

challenges will be tied more to the difficulties in getting drugs approved, reimbursement challenges, intensifying therapeutic class competition, patent expirations, weak product pipelines, and failing business models rather than global economic conditions alone.

The stock market will continue to penalize the ethical pharma industry as long as the structural changes are working their way through the industry and solutions are being implemented and tested in the field.

The major debt refinancings were completed quite awhile 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 as the IPO and general equity issuance markets continue to be difficult.

Better prospects for—biotech?

The development capabilities of biotech companies are positive overall. 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.

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 those milestones.

Although the funding of biotech companies became very difficult with the global financial crisis, there has been a modest recovery over the last two years as the biotech shares have performed well and investors have partially warmed up to the industry.

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. However, we witnessed a meaningful increase in M&A activity during the first three quarters of the year, generally strategic transactions for late stage and mature biotech companies, but the increase in the external uncertainties will dampen biotech M&A for a period of time.

Equity issuance will hopefully continue to show signs of life in the future, but a key will be if there is a recovery in the general IPO market. Debt issuance has been low and will continue to be very anemic. PE

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