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A Healthcare Spending Spree

Looking to build their pipeline, companies are ready to buy - at almost any price

A HEALTHCARE

SPENDING

SPREE

Looking to build their pipeline, companies are ready to buy - at almost any price

A glimpse of the future was offered in the healthcare sector last week when Swiss pharmaceutical giant **Roche Holding Ltd** said it would pay \$3 billion in a hostile bid for **Ventana Medical Systems**, a whopping 44% premium for a medical device maker that specializes in cancer diagnostics.

Roche had been sniffing around Ventana for some time but was getting nowhere with its suggestion to have mutual strategic discussions with Ventana management. At last, Roche's patience wore thin. "As Ventana has so far declined to enter transaction discussions, Roche has decided to commence a tender offer," Roche officials said, announcing their hostile bid. Roche's generous offer is one of several huge M&A deals that could come to define healthcare finance over the next few years. British drug maker **AstraZeneca**, looking to bolster its drug pipeline and to add a number of new vaccines to its arsenal, just purchased biotech firm **MedImmune** for \$15.2 billion (a 53% premium over MedImmune's pre-announcement stock price), while the Netherlands' **Qiagen** last month agreed to buy molecular diagnostics company **Digene** for \$1.6 billion.

By Christopher O'Leary



M&A activity is up in most sectors of the healthcare market, ranging from medical technology to hospitals. “Certainly there’s been consolidation in the market, especially among the specialists,” says **Bill DeFalco**, a first vice president at **Fox Chase Bank**, referring to the hospital and surgical-center market. But it is the global pharmaceutical companies that appear most primed to spend serious money. Faced with generic manufacturers that are gnawing away at their market share and pipelines that are drying up, pharmaceutical companies are bracing for another presidential election in which they’ll likely be cast again as greedy villains. Many top pharmaceutical makers are considering the purchase of key players in biotech or they are trying to secure claims in the rapidly expanding diagnostics sector.

The prospect of a continued wave of blockbuster deals has Wall Street elated, bankers note, and deal activity shows no signs of cooling down for the rest of the year. Global M&A in the sector was up to \$147.3 billion as of June 27, compared with \$132.8 billion in the same period last year. Meanwhile, initial public offerings are also spiking upward — \$6 billion raised by 60 global IPOs as of June 27, compared with \$2.9 billion by 49 deals in the same 2006 period, according to **Thomson Financial**. Some analysts and bankers expect that acquisitions of \$1 billion or more will likely be routine.

One factor behind the burst of new deals is a growing belief among biotech firms and pharmaceutical companies that much of healthcare’s next transformative wave rests not in the standard blockbuster drug rollout model, but rather in the advent of a sort of personalized, tailor-made healthcare industry, using sophisticated biological-linked technology, such as vaccines specifically designed for an individual. Diagnostics, the laboratory of much of this new healthcare model, is currently the realm of a host of small startup companies financed by venture capital, and it’s an area where private equity so far has been a minor presence. So large pharmaceuticals are rushing to fill the void. For example, Roche’s drive to increase its role in tissue-based diagnostics (histopathology) led it to seek to purchase Ventana, a leader in that sector.

“The deals going forward will be about expanding the breadth and depth of biological technology capabilities, in addition to expanding the biological capacity of larger pharmaceutical players — that is the wave of the future,” says **Michael Zbinovec**, a healthcare analyst at **Fitch Ratings**. “We’ve heard about personalized medicine since the human genome was sequenced, and that’s the way medicine will be presented — not necessarily in the next five years, but certainly in the next couple of decades. You will see the diagnostic tied to the therapeutic in one package.”

Change in tactics

In the past, large pharmaceuticals would center their business strategies on a handful of top-tier drugs — think of **Pfizer** with Viagra. It was a strategy that paid off in major revenue during the heyday of the drugs’ popularity, but it had pitfalls. Competition from generic makers, once the patent expired, tended to gut a manufacturer’s profits. Pfizer, for example, is facing the expiration of its patent on Lipitor in 2010, which analysts predict could cut annual sales by \$10 billion or more once generic versions hit the market. Also, any forced withdrawal of a major drug from the marketplace, such as **Merck’s** Vioxx, tends to wreak havoc on a company’s bottom line.

As a result, the pharmaceutical market “has become more cyclical; typically, it was considered to be recession-proof, but when intellectual property lapses, it lapses in a big way, especially since you’re tied to the blockbuster model,” says **Les Funtleyder**, a healthcare strategist at **Miller Tabak**. “Most of the industry sees the writing on the wall — they see that medicine is going to become more specialized and more targeted. They know that they can’t rely on the blockbuster model completely in the future.”

While the traditional route for startup diagnostics and biotech firms has been to build strategic partnerships and eventually go public, that formula may soon be overshadowed

A Healthy Market

US M&A	No. Deals	\$Million
1/1/06-6/26/06	508	84,342.7
1/1/07-6/26/07	465	85,911.2
US IPO	No. Deals	\$Million
1/1/06-6/26/06	17	1,355.8
1/1/07-6/26/07	25	2,553.6
Global M&A	No. Deals	\$Million
1/1/06-6/26/06	1161	132,837.4
1/1/07-6/26/07	1084	147,352.8
Global IPO	No. Deals	\$Million
1/1/06-6/26/06	49	2,973.6
1/1/07-6/26/07	60	6,084.5

owed by the development of a sort of “farm team” strategy, in which a startup diagnostics company, for instance, receives funding early on from a larger-cap pharmaceutical company. That pharmaceutical company could then purchase the startup when, or if, their products come to fruition. “We’ve reached the point where pharmaceutical firms would rather have total control of the development pathway and take the balance-sheet and income-statement risk of an acquisition, rather than have it be a strategic relationship which was in effect off-balance-sheet financing of product development,” says **Kenneth Moch**, a managing director of healthcare investment banking for **ThinkEquity Partners**.

Acquisitions “are becoming a more favored alternative, as a liquidity event, to taking a company public,” he adds. “In fact, there is a strong argument that going public is no longer a liquidity event, but one more stage in the financing pathway until a higher-value liquidity event can be achieved.”

Even more alluring for startup diagnostic players, acquirers seem ready to pay heavily for their purchases, with premiums often averaging about 20% over the target’s previous stock price, with biotech firms nabbing the highest average premiums, in the 30% to 35% range. “Premiums vary wildly depending on how many bidders are in the process, and on the strategic nature of the acquisition,” Moch says.

Call it the marriage of the quick-footed and the deep-pocketed — one healthcare industry banker says “there are a bunch of companies out there that are not on the investor’s radar screen, or even ours, but they’re clearly on the screens of larger pharmaceutical companies.” For this banker, “that’s the next generation of deals.”

The next generation

The major growth areas in healthcare over the next few years are, to little surprise, the most innovative of sectors — biotech and its subset arena, diagnostics, analysts say.

Indeed, biotech’s day in the sun seems to have arrived. Publicly traded biotech firms generated \$70 billion in revenues last year, according to **Ernst & Young’s** annual industry study, which predicts \$100 billion in annual revenues by decade’s end. And of special interest to pharmaceutical firms, biotech drugs are more and more entering the ranks of blockbuster status, such as Amgen’s anemia drug **Aranesp**, which had more than \$4 billion in sales last year, a 26% year-over-year increase.

Diagnostics-specific companies tend to be further back on the evolutionary scale, with the sector remaining fragment-

ed with hordes of tiny VC-funded startups. That could change as more startups are purchased at an earlier stage in their development. “As assets get acquired, the scarcity value of the existing companies goes up, and people who want to be a part of that sector may feel they have to make a purchase. Otherwise it might not be there,” Funtleyder says.

The growing potential to be acquired is starting to dissuade a number of diagnostics startups from considering IPOs. Management at these startups may feel that going public is not worth the time or expense, bankers say. Company “valuations are so high now that you’re often better off going on the partnering route than the IPO route,” Fitch’s Zbinovec says. “We’ve seen some of these biotech companies getting more and more leverage, and extracting more out of these deals for earlier-stage compounds.”

Bristol-Myers Squibb, for one, is said to be intent on carving out a large area of control in diagnostics. It just signed a research services contract with diagnostic and life-science



Miller Tabak’s Funtleyder:

The pharmaceutical market

‘has become more cyclical.’

company **Immunicon**. **Schering Plough** is said to be planning to take on substantial debt -- a fairly rare move among healthcare leaders -- in order to fund a number of purchases, including its recently-announced \$14.4 billion acquisition of

Organon BioSciences, a biotech outfit owned by Dutch chemical company **Azko Nobel**.

Pipeline issues

One factor that could determine just how widespread M&A activity will get is what the major drug makers have in their pipelines. Some promising newcomers in the next six months include **Johnson & Johnson’s** two anti-infective products, doripenem and ceftobiprole, which it hopes the FDA will approve by year end. Also, **GlaxoSmithKline** plans to introduce four new drugs later this year, including **Cervarix**, which is designed to prevent the spread of cervical cancer and may rival Merck’s **Gardasil** as the only vaccine available for the prevention of human papilloma virus.

In light of the **Vioxx** and **Baycol** withdrawals, however, the FDA has begun pushing for additional data from manufacturers. And this, at times, greatly slows the approval

COVER STORY

process, which in turn could cause product rollouts to be postponed. Enough delays of new products may then prompt radical actions. For example, analysts said that Pfizer, faced with Lipitor going generic in a few years and with delays in its pipeline, could look to acquire a competitor to beef up its pipeline and kick up revenues.

Still, bankers admit that what drug makers have brewing at lower levels of the pipeline remains a well-guarded secret and that a cornucopia of new products could be in the works. “The Street doesn’t know what [manufacturers] have got in the early stages,” Funtleyder says. “Some companies likely don’t have as much as they’d like, and you can never have enough pipeline, just because it has a such high attrition rate. But to assume these companies are all going to go on a buying spree is a big assumption.”

A run of notable product failures could in turn kill any acquisition momentum, especially purchases of fledging biotech or diagnostic companies. “The key factor that could slow

M&A down could be surprising product failures,” Moch says. “Especially if pharmaceutical firms realize the risks they’re taking are no longer worth it, or if investors no longer value that risk.”

Another salient question is what role private equity firms could play in developing sectors of healthcare. Typically, private equity managers have not been that comfortable with product-oriented companies, such as drug makers, while biotech and diagnostic companies often do not have any revenue streams to leverage. “The fundamental economics of this business do not widely support private equity investors,” one healthcare banker says. However, there are signs this may change. **Biomet** agreed in early June to be acquired by a group of private equity funds for \$11.4 billion, and **Lexicon Pharmaceuticals** just got \$300 million in new funding from two private equity firms. Private equity players have also been busy in the area of product royalties; the firms will back manufacturers for a stake of future drug royalties. **IDD**