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Consolidation challenges in Europe's life science sector – Making it happen

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Abstract

Even though the current market environment is tough on biotechnology companies, the number of consolidation transactions in Europe has fallen. Platform specialists have to turn themselves into product companies in order to be heard by investors. Product companies are crushed between high financing needs and their cost of capital. A full integration strategy can destroy value for founders and early investors. Thorough analysis, good strategic fit, a rigorous integration plan and retaining the talent are predictors of success in a merger situation. Engineering the future value proposition around fundamental drivers of investor return determines mid-term access to capital. Trade sales are becoming a very lucrative exit route, provided the assets meet expectations of the pharmaceutical industry.

The positions put forward in this article are the author's and do not necessarily reflect the positions of JSB Partners.

Keywords: *merger, acquisition, consolidation, value chain, access to capital, trade sale*

INTRODUCTION

In the current market, the European biotechnology industry is undergoing a period of dramatic change. Consolidation might be a solution to many of biotechnology's problems. However, the number of mergers has fallen in 2002 compared with 2001.[1] This indicates that certain challenges have to be met to create value in consolidations.

The dramatic situation has brought down valuations and dried up access to financing, even for successful biotechnology companies. However, for those organisations that still have access to capital, such as large pharmaceutical and biopharmaceutical companies, the ongoing crisis is an opportunity to acquire valuable additions to their own product portfolios and technological base.

At the other end of the spectrum, mergers of have-nots are being contemplated in the ambitious attempt to create new stories; stories that may provide a second lease on life for the companies, teams and investors affected (Table 1).

The factors influencing consolidation and their impact on value creation in biotech will be investigated here.

SPECIALIST *VS* FIBCO: THE LIMITS OF INTEGRATION

The value creation model in the biotech industry has initially been a FIBCO (**F**ully **I**ntegrated **B**iopharmaceutical **CO**mpany) model. Examples for successful implementation include Genentech, Amgen and, to some degree, Biogen. This model was based on three success factors:

- Focus on areas where small companies could compete: the barriers to entry were fairly low in high-value/small (specialist-)-target group-therapeutics. The economies of scale were not highly developed by anyone in the manufacturing of biologics, so the early entrants found the field open for their products.

- Focusing on therapeutics with low risk–fast track to market: the development risk was low in physiological proteins such as interferons, granulocyte colony-

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Table 1: Features and objectives in consolidation transactions

	(Bio)Pharmaceutical–Biotech	Biotech–Biotech
Transaction features	Acquisition Both public and private	Merger Mostly private Often consolidation within venture capital (VC) portfolios
Strategic rationale	— Strengthen product pipeline through acquisition — Strengthen technology platform — Target company features: • products with clinical proof of concept • dominating intellectual property (IP) of capability position • good value for money	— Build critical mass and increase value — Achieve reasonable degree of integration along value chain — Resolve financing issues — Resolve capability issues — Create exit opportunities

FIBCO models depended on low barriers to entry, low risk projects and access to capital

stimulating factor and erythropoietin; this is not necessarily true for other biologicals, as Centocor came to realise.

- Access to capital to finance expansion. For Amgen, creative development partnerships were a tool; all three examples went public early on; all three derived significant cash flow from strategic alliances with established pharmaceutical players.

The European biotechnology industry has been late to start, particularly on the Continent; it is concentrating to a large degree on technology rather than products. In this space it is hard to imagine that companies can carve out for themselves a major piece of the value that is being created by the products resulting from third parties applying these enabling technologies. Looking at the value chain (Figure 1), most value is created in the late stages of pharmaceutical development. Selling shovels to gold diggers has worked well for companies like Qiagen. However, creating value is a very difficult task once the tools become either generic, as is the case in a number

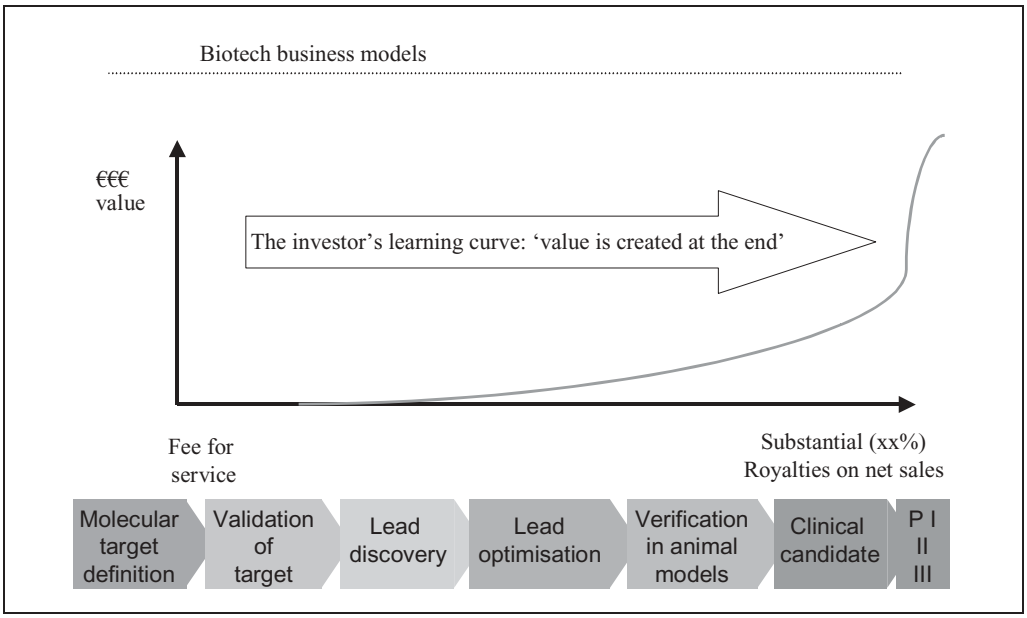

Figure 1: Biotechnology business models. Source: H. Schuhsler TVM (2002)

of the genomics technologies, or the market for these tools is so limited that a small number of users has to finance the entire development.

Unfortunately, it has become increasingly difficult to successfully implement a FIBCO model today, 20 years later. The low-hanging fruit have been picked. Full vertical integration is possible only in cases where the product can be marketed to a small target group and salesforce costs are not prohibitive. But as demands in clinical development continue to increase, the risk of failure threatens even late stage projects and development costs rocket. As a consequence, the enormous financing needs for stand-alone projects have to be satisfied at low valuations, as technology value only increases once milestones are met and risk is reduced. This leads to such significant dilution that driving a project beyond clinical proof of concept (Phase I/IIa) hardly makes sense for founders and early stage investors.

Figure 2 shows the effect on price per share (ie effect of money raised and valuation) of a partnering decision *vs* going it alone in a case study of a company with two projects in clinical development and a discovery platform to feed. Even though technology value in the successful stand-alone scenario was much higher, in this case, it takes three financing rounds and development time up through approval to bring price per share to where it is early in the partnering scenario.

'Stand-alone' may not provide maximum value to shareholders

DO MERGERS CREATE STRONGER COMPANIES?

Biotechnology in Europe is suffering from well-known woes. 'Too small, too much platform, not enough management, not enough money' are some of the arguments put forward. In continental Europe, a large number of companies were created around genomic technologies in the late 1990s, when 'genomics' was a magic word in the market. Today, this situation has changed and many of these once promising start-ups are struggling to find adequate financing. As the market has ceased to give high value to marginally validated targets, investors tell these companies that their business model has fallen apart.

A number of companies, particularly those showing good scientific progress and having top-tier investors, resort to vertical integration in order to capture more value along the value chain. The make-or-buy question is answered more and more by acquiring the capabilities, technologies and even projects that are needed in order to put forward a new, convincing equity story for the combined entity. The move to merge is in part triggered by need, in part by the opportunities offered in a down market. In any case, a clear strategic rationale needs to exist, providing a superior long-

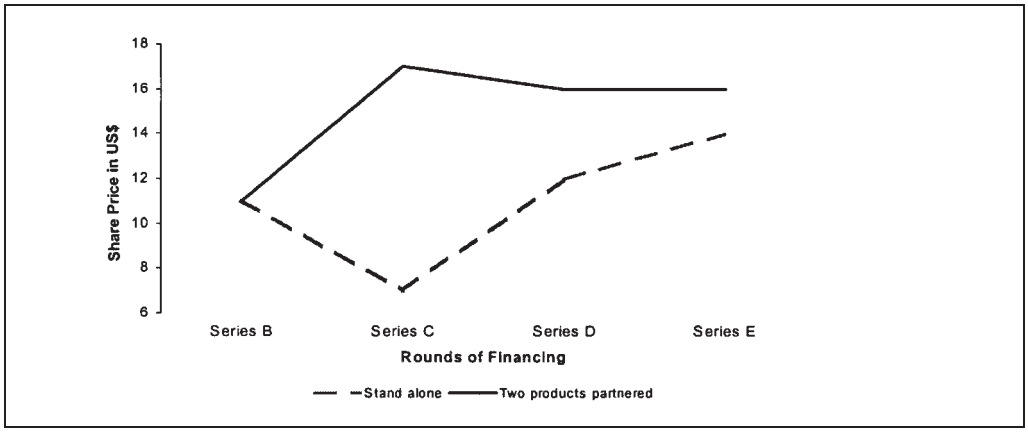

Figure 2: Case study: biotechnology company with drug discovery platform plus two products in clinical development.
Stand-alone scenario: develop both projects alone. No partners.
Two-products-partnered scenario: partner both products.
Source: JSB Partners LP analysis

term perspective, not just a quick fix for today's problem. For example, a number of genomics companies in the German market are thinking about sensible steps to reach higher-value levels in the chain and therefore actively shop for medicinal chemistry expertise and late stage preclinical/early clinical development projects. In that, they follow examples such as GPC Biotech buying Mitotix or MediGene acquiring NeuroVir. Such integration moves may make strategic sense; they will only succeed when a number of conditions are met:

Mergers have a higher chance of being successful with key issues anticipated, vigorous integration, sufficient financing and motivated management

- In preparing for a merger, a number of different scenarios have to be analysed for their impact on the strategic position, the projected valuation of the company, capability and financing needs and the effect on shareholder position. To think about what-ifs not just in qualitative terms, but also in fully developed quantitative analyses is a must. The benefit of this exercise is not so much precise planning; to aim at precisely predicting the future is a futile endeavour. Its key benefit lies in the process itself: to think through value drivers and resource needs in a disciplined way, to see the effect of a certain direction taken on financials, value and shareholder positions in quantitative terms is an efficient way to compare scenarios, anticipate key issues and make better decisions in the process.

- A rigorous integration process needs to be defined that trims the merged company down to what is essential in order to reach these higher-value levels. When done right, this is a painful exercise for both merger partners. Synergies need to translate not only into an improved strategic position, but also into cost savings.

- Financing needs to be assured so that the combined entity has the resources necessary to accomplish the integration and reach the next milestones in its core projects. Ideally, the new equity story is sufficiently strong to attract new outside investors. However, in a number of cases, the immediate post-merger financing is done by investors already engaged in the pre-merger entities in order to give the merged entity enough time to manage the integration and achieve the first new milestone.

- Management is key in turning a concept into reality. Identifying the trusted stewards of the merged shop, retaining them and remotivating them are steps that determine the success of the new entity. This entails creating certainty, ie a firm job offer, for selected people (both management and key contributors) early on in the process, and charging the new management group with the authorities and responsibilities needed to create a united corporate culture and take the steps that make the merger work.

Examples for successful handling of such processes include the merger of ORCA with Epigenomics or the merger of Exilixis and Artemis. Some time has passed since these transactions, so the impact the transactions have had on these companies can be seen. Epigenomics successfully consolidated the team, its IP position around methylation and successfully translated that position into a substantial deal with Roche. Given the common roots, the merger of Exilixis and Artemis institutionalised a pre-existing relationship; the combined entity was very successful in the corporate alliance market. The acquisition of Tibotec-Virco by J&J is a good example of a successful integration in a large organisation. Tibotec-Virco's team and projects gave J&J instant expertise and pipeline in a new therapeutic area; J&J was savvy enough to keep Tibotec-Virco's culture alive.

THE GOAL OF CONSOLIDATION IS TO CREATE VALUE RECOGNISED BY THE MARKET

The current market conditions remind the biotechnology industry that making losses is not a value proposition in and by itself. Investors demand reasonable burn rates, a short- to mid-term perspective for generating profits and ways to mitigate risk. Once a company has reached a level of maturity that allows it to show these elements, it can prosper even in a tough environment. Looking at the European biotechnology industry, relatively few companies are in that kind of position. Some have not succeeded, such as British Biotech in its proposed merger with MorphoSys;[2] some are being created, eg OGS-Celltech. So, for executives and shareholders alike, it is essential to position their assets in a way that meets investor expectations. Three elements may be considered in such moves.

Assets need to be proportioned in a way that meets investor expectations

A thorough analysis of the company

A thorough analysis is needed of what elements in the company meet investor expectations and what other elements are lacking. In a market that puts little value on platform technologies, there may be an incentive to think about steps towards product candidates and the degree of real or virtual integration it takes to be a credible player in a chosen field. In this current market environment, a renaissance of dual business models can be seen. At the peak of the bubble, a number of investors looked at a fee-for-service business as a distraction from creating real value. Today, a more sober attitude prevails: if positive cash flow and some value share can be realised from those businesses, they are regarded as a welcome means to prolong cash reach and build the technology and expertise at somebody else's expense. For example, the analysts covering GPC Biotech see its alliance with Altana as a key value driver.

Exit perspective

Creating an exit perspective within a useful period of time is a key determinant of the success of a financing round. The exit perspective today is no longer solely determined by an initial public offering window, but trade sales are rapidly becoming a very reasonable alternative. Acquisitions such as Tibotec-Virco and Scios by J&J, or just recently Idenix by Novartis, at valuations beyond €300m lead the way. Clinical proof of concept is the value-adding step that reduces risk to a degree that pharmaceutical companies start to think about acquiring an asset.

The problem in the background is that private equity investors in biotechnology are faced with troubles of their own. Asset managers have started cancelling commitments or demanding significantly lower terms for managing a fund. Some large institutional investors claim to be overexposed in biotechnology or to suffer from the lack of cash flowing back as exits do not happen. As a consequence, raising new funds has become difficult.

Building towards a potential trade sale means to understand what the pharmaceutical industry is looking for in an acquisition. The requirements are manyfold and include items such as a clear IP position, possibly restricting other players' freedom to operate, a therapeutic area with limited risk in later stage development, market size and profit expectations, no strings attached such as commercial rights or royalty stacks.

Timelines

Understanding the timelines for getting solid deals done is an important element in successfully implementing a consolidation transaction. Including the appropriate preparation, a reasonable timeline for an M&A transaction is about nine months. Some transactions get done more quickly, particularly when there is a good deal of understanding between the parties beforehand. Common shareholders may facilitate the process, but in just as many cases this creates additional obstacles that need to be taken

care of. In some cases, particularly when a stand-alone strategy is about to fail, executives or shareholders try to find a shortcut to a merger. In some cases it works; typically there is a significant risk that undue haste destroys the negotiation position without necessarily accelerating the process.

Seize the opportunities of today to be of value tomorrow

AN OUTLOOK INTO THE FUTURE

As the peak of the bubble was reached almost three years ago, most unprofitable biotechnology companies have come close to the end of their cash reach. A certain number have been refinanced at significant discounts to former valuations, and some have failed. Yet, a large number of biotechnology companies in Europe are faced with the integration challenge. Their mid-term perspective will depend on decisions they make today; taking advantage of the opportunities the market offers today will determine their value proposition tomorrow.

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