The Deal

THE NEW NORMAL

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DEALMAKING IN PHARMACEUTICAL AND BIOTECHNOLOGIES HAS SURGED, IN PART BECAUSE OF CHRONIC WEAKNESSES IN NEW- PRODUCT PIPELINES

If the first six months are any indication, 2010 may prove one of the most active years on record for pharma and biotech strategic activity.

Forty M&A deals totaling $80.5 billion and 30 $100 million-plus partnerships totaling $10.9 billion were announced through June. Biotech venture deals also reached a 10-year peak during the second quarter, with 139 deals totaling $1.29 billion, based on National Venture Capital Association data. What distinguishes 2010 is the visible evolution of the pharma business model as pharma and biotech companies recognize the need to consolidate, partner and raise capital to survive, and there is no sign of this trend abating.

For pharmaceutical companies the drivers are both clear and familiar, as failing pipelines and patent expirations continue to dampen sales growth.

IMS Health Inc. estimates that more than $80 billion of branded dollar volume has been exposed to generic competition since 2002, with a further $74 billion expected to face generic competition from 2009 to 2012. The peak of U.S. patent expiries will be in 2011 and 2012, when generic versions of six of today's 10 largest products are expected. At the same time, pipeline productivity has languished. Between 1999 and 2009, the industry filed a relatively constant 35 to 40 novel drugs with the Food and Drug Administration each year while more than doubling R&D spending from less than $25 billion to more than $50 billion. As a result, pharma companies have outsourced R&D by using M&A and in-licensing to access new products.

This year's deals also demonstrate the noteworthy shift to niche therapeutic categories where there is significant unmet clinical need. Therapeutic niches have become much more attractive to pharma companies, as they offer better odds of regulatory approval and reimbursement. Neurologic conditions such as multiple sclerosis and Parkinson's disease and numerous orphan indications are typical of the categories that may stimulate more deal activity.

Sanofi-Aventis SA's potential matchup with Genzyme Corp. is a prime example. The company has been pursuing new products as generic versions of its blood thinners, Lovenox and Plavix, have impacted sales, with an additional 20% of revenue also facing

competition by 2013. Genzyme offers Sanofi-Aventis orphan drugs including Gaucher treatment Cerezyme and Fabry drug Fabrazyme. These therapies have added regulatory protection and treat diseases where no other treatment options exist.

For smaller, development-stage biotechs, growing development costs and scarce capital threaten the progress of their innovative new therapies. The estimated cost to bring a drug all the way to market exceeds $1 billion, but to advance a drug candidate to Phase 2 still requires access to substantial investment. Many such companies lack sufficient capital to advance even one program to this point. Inaccessible public equity markets, coupled with the reluctance or inability of venture capitalists to fund follow-on rounds, have forced earlier partnering and exits through sale. Despite last quarter's surge in VC biotech deals, we anticipate more M&A activity.

Also deserving attention are the small and midsized commercial-stage specialty biopharma companies. Many of the more than 650 companies today need growth capital to acquire or launch commercial products. While consolidation among these commercial companies will continue, we also anticipate an uptick in financing activity, especially using alternative sources of capital such as royalty financing.

Many of these specialty companies have valuable product assets to which Wall Street attributes little or no value. By monetizing these assets, companies are able to secure nondilutive capital at attractive costs. An average of $1.5 billion has been invested in this space annually over the past four years, with companies such as Dyax Corp., NeurogesX Inc. and NPS Pharmaceuticals Inc. realizing the benefits of such financing in recent months. The two broad trends already identified -- increased licensing activity between pharma and biotech, and the insatiable appetite for capital -- will continue to drive this financing venue forward, particularly when traditional capital markets are unavailable.

The first half of 2010 has demonstrated that dealmaking has become critical for survival. While it is hard to predict how long this active deal environment will last, today's real challenges will force the industry to continue the evolution and adaptation of its business model. Further consolidation in the sector is inevitable. But we also see continued growth in partnerships and financing activity -- especially in alternative financings -- as trends that are indispensable to tomorrow's pharmaceutical and biotechnology sectors. This may be the new normal.

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