Why private equity is investing in biopharma

Following a record-breaking five years of global investment returns, private equity firms are sitting on an unprecedented $2 trillion of uncalled capital.[1] Under fierce competition, good deals in traditional industrial and service sectors have become scarce. As a consequence, investment in previously overlooked subsectors of the healthcare market, in particular biopharma companies, appears increasingly attractive. This article describes how private equity firms are now entering this sector, and how pharmaceutical companies can seize the opportunity of abundant new capital through careful strategies as buyers, sellers, and competitors to the private equity funds.

Private equity firms have been under pressure this year to find attractive deals. These investors typically seek to make returns within five years, something that has been difficult to do in the biopharma sector given this industry's high failure rate, long clinical development times, and expensive late stage studies. Now however, returns from the sale of private US/ European biopharma companies have climbed to four to five times upfront transaction values[2] and many more potential deals are available. Big pharma has become more willing to divest aging or non-core assets and emerging biopharma companies are delaying initial public offerings (IPOs) in order to grow organically and scale first via private investment.

Biopharma companies are still expensive to acquire; the average premium paid for public US/European biopharma companies was 64% in 2014-2018.[2] But now more than ever, private equity firms have the uncalled capital and debt facilities to fund larger deals and amplify returns through leverage. More than two thirds of this capital is held by the industry's largest funds, each worth more than $1.5 billion[1] Highly leveraged buyouts are increasingly common with leverage levels now around the pre-financial crisis levels. This suggests that private equity firms will continue to have a major role to play both in growth capital and M&A.

Private equity investment helps plug the funding gap once an emerging biopharma company has outgrown early stage venture capital and is reaching a critical late stage development and growth juncture. In return for a minority stake in the company, the private equity firm injects substantial capital and gives strategic guidance. This type of investment activity has grown substantially over the past six years. For example, since 2013 there has been double-digit annual growth in the number of private equity firms participating in biopharma late stage equity funding rounds.[3]

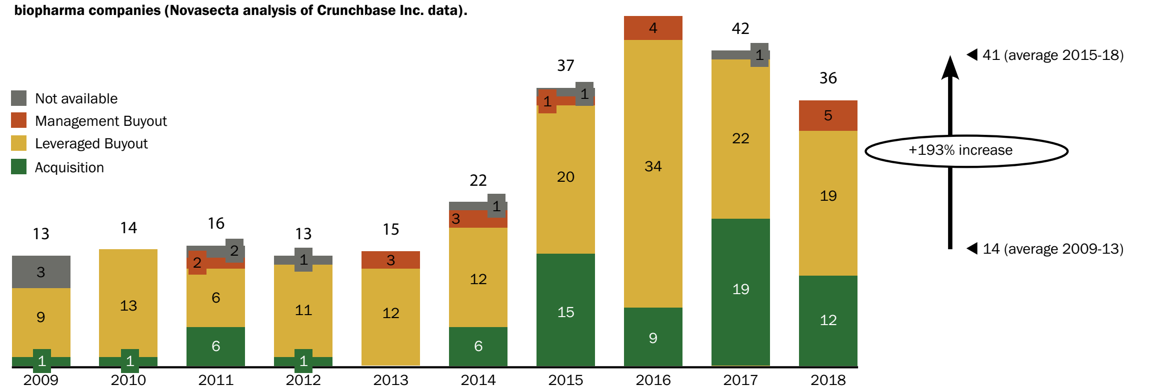
In recent years private equity firms looking to acquire minority stakes in biopharma companies have targeted commercial stage enterprises with promising platforms. An example is Novo Holdings A/S's announcement in May of plans to buy a 10.1% stake in Oxford Biomedica Plc for £53.5 million. Such minority stakes in rapidly growing biopharma companies can yield impressive returns for private equity investors. For example, ChrysCapital earned 10 times its original investment following the sale of a 10% stake in Intas Pharmaceuticals Ltd in 2017. Intas is an India-based pharmaceutical manufacturer.

By contrast, when considering M&A, private equity has typically prioritised healthcare subsectors where returns are easier and faster to capture via balance sheet optimisation or inorganic growth. In these cases the target companies are hospital providers, equipment manufacturers, and pharma support services. Private equity firms have also demonstrated a strong interest in innovative technology, riding the wave of investment into machine learning, big data, and digital medicine with increased bidding for healthcare IT companies. On top of this traditional activity, the annual number of biopharma company acquisitions and buyouts by private equity firms has undergone a step-change, roughly doubling the levels seen in 2009 to 2014.[3]

Buyout activity is increasingly targeting five types of opportunity: family controlled companies with growth ambitions; public companies needing transformation; buy and build opportunities; generics and OTC players; and carve-outs from big and mid-sized corporations.

Family controlled biopharma companies needing exit or growth capital will always be attractive to private equity players, even if these companies are hard to acquire. For example, CVC Fund VII bought a controlling stake in Recordati SpA from its founding family for €3 billion in 2019 through a leveraged buyout. CVC aims to expand the Italian company's very attractive rare disease business to build a global leader in orphan and specialty care. Andrea Recordati will remain the chief executive which is a benefit for the seller compared with the options it might have had in an acquisition by a bigger pharma company. Recordati can maintain continuity of management and staff. In addition,

Fig 2. Step change in the number of private equity acquisitions and buyouts of biopharma companies (Novasecta analysis of Crunchbase Inc. data).



it can look forward to the private equity firm's efficient management of capital.

Publicly traded biopharma companies with successful late stage data and operational challenges represent a second attractive category for private equity investors. Delisting enables the management team to focus on transformation and implementation. For example, this year Waypoint Capital acquired Stallergenes Greer for €730 million, representing an approximately 43% premium on the share price. Stallergenes Greer had started a financial and operational transformation and also has a novel allergy immunotherapy poised for regulatory submission following successful Phase 3 trials.

Buy and build opportunities in niche specialty pharma enable private equity firms to build successful leading platforms via strategic inorganic growth and in-licensing. For example Essex Woodlands Healthcare Partners (EW) was the founding investor of EUSA Pharma Inc, a specialty pharma company in critical care. In 2006 it built the company's sales and marketing infrastructure in the US and Europe, supporting it through four acquisitions. EW sold EUSA Pharma to Jazz Pharmaceuticals Plc for £700 million in 2012. Following EUSA's spin-out from Jazz in 2015, it is once again being backed by EW.

Generics and OTC players with strong brands and reliable, high quality manufacturing represent an opportunity for private equity firms to drive margin growth. Despite the price erosion caused by customer consolidation in the US, the volume and penetration of generics is continuing to rise. Private equity firms' due diligence and global operational guidance enables generics businesses to grow their manufacturing footprint, optimise supply chains, and capture economies of scale. Consequently, private equity firms are willing to pay high prices for such opportunities. For example, Bain Capital and Cinven paid an earnings before interest, tax, depreciation and amortisation (EBITDA) multiple of about 13x when they acquired Stada for €5.3 billion in 2018. The potential for sustained growth means that one generics business can have a series of private equity owners. For example CVC acquired DOC Generici in 2016, a leading Italian generics manufacturer, from Charthouse and is negotiating to sell it this year to ICG for an estimated €1.1 billion. Private equity capital can also enable generics manufacturers to overcome barriers to entry and expand into the more profitable, comparatively less competitive adjacencies, or make the leap into the fast-growing biosimilar market. In 2018, Bain Capital acquired DSM Sinochem Pharmaceuticals (DSP) for $700 million and aims to make DSP the global leader in generic pharmaceuticals, expanding from API manufacturing into finished dosage form.

Carve-outs from mid and big biopharma represent a fifth category of opportunity for private equity firms. Several larger biopharma companies have set a strategic focus on innovation, particularly in immuno-oncology, and are consequently more willing to divest aging assets with declining sales, non-core assets in development, and entire generics / OTC portfolios. This year, Esteve engaged Lazard bank to sell Pensa, its generics business. Novartis has also been rumoured to be considering selling its generics business Sandoz. Private equity firms are likely to be keen buyers for generics and OTC spin-outs; only last year Advent International bought Zentiva from Sanofi SA for $2.3 billion and CVC acquired Theramex from Teva Pharmaceutical Industries Ltd. This year a consortium led by the private funds EQT and ADIA offered to purchase Nestlé Skin Health, a subsidiary of Nestlé that has OTC, aesthetics, and prescription dermatology brands. On the face of it, these carve-outs may not seem attractive: it can be complicated to disentangle operations from the parent company and put in place new manufacturing and sales arrangements. However, carve-outs also play to private equity firms' strengths in optimising balance sheets and working capital.

Private equity funds are therefore becoming increasingly active in biopharma through both minority interests and M&A. Biopharma companies can benefit from the flood of money if they are strategic about it, as a seller or buyer, or simply a differentiated competitor.

As a ***seller***, biopharma can spin off or out-license non-core assets to enable greater strategic focus. For success, these companies should first make the opportunity more attractive to private equity firms and other buyers by making the parts of the company that are non-core both sustainably valuable and easy to buy. For example, implement a business unit structure with separate management and systems, clear accountability, and visibility of cost and profit.

As a ***buyer*** of assets and capabilities, biopharma companies can see private equity firms as a rich source of assets to support their growing portfolios. Assets may become available when pipelines and portfolios are rationalised, and private equity firms may provide early visibility into exit timelines and in-licensing/partnership opportunities. Previous private equity ownership generates a reassuring track record and reduces risk.

When ***competing***, biopharma companies can differentiate themselves clearly from private equity firms for attractive M&A opportunities. For this, a clear M&A strategy and compelling positioning can emphasise the greater strategic value, infrastructural benefits, and better integration capabilities that biopharma companies can offer compared with private equity. In addition, corporate buyers tend to demonstrate strengths in managing the people and cultural issues caused by integration – such as retaining talent or navigating management conflicts. Biopharma companies may be better 'adoptive homes' for assets than the private equity firms which typically focus on cutting costs and paying down debt.

In conclusion, the influx of private equity capital into the biopharma sector provides new opportunities for strategically minded companies to be either buyers or sellers of assets. It also puts pressure on biopharma companies to sharpen their focus and improve execution. One thing is clear: private equity is in the biopharma sector and it is here to stay.

References:

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2. HBM Pharma/Biotech M&A Report 2018

3 Crunchbase Inc. database and Novasecta analysis

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