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Eat Or Be Eaten: Controlling Your Fate In The Specialty Pharma M&A Feeding Frenzy

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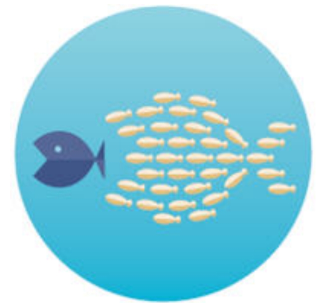
You can't blame specialty pharma companies for looking over their shoulders lately. For the smaller fish in the specialty pharma pond, a shadow circling overhead may turn out to be a Big Pharma at the top of the food chain seeking a rich source of R&D innovations or a growing revenue stream to supplement its business.

While a small company seeking an exit may welcome this prospect, a midsize specialty pharma might be less sanguine, hoping to escape becoming a predator's meal by bulking up with a few acquisitions of its own. As the M&A feeding frenzy intensifies at all levels, it's more important than ever for specialty pharmas to understand the dynamics of the waters they're swimming in. By staying alert to their own prospects as well as the appetites of those around them, these companies can achieve the best outcomes for their organization and its investors — whether as predator or prey.

The increase in specialty pharma M&A is easy to understand. With growth hard to come by in legacy business lines, higher-priced drugs used to treat conditions like cancer, rheumatoid arthritis, multiple sclerosis, and orphan diseases offer new possibilities. While some larger companies venture into their own specialty pharma directions (e.g., Bristol- Myers Squibb (NYSE: BMY) moving into oncology), it's more common for them to look for other companies that already have the important development work well under way — thereby minimizing the risk of clinical failure.

Among specialty pharma companies, we find two general types, each with its own concerns and priorities. On one hand, there are midsize companies such as Mallinckrodt Pharmaceuticals that are small enough to be acquired by a Big Pharma, but large enough to make acquisitions of their own. For these midsize specialty pharmas, active M&A is essential for maintaining their independence. On the other hand, we find smaller specialty pharmas. While being the smallest type of fish in the pond might seem like a precarious position, the reality is that the current seller's market can allow a tremendous range of options for the most appealing targets. These can range from an acquisition by either a midsize or large pharma — indeed, many small biotechs are built to sell from day one — to additional investment, strategic deals, partnerships, and even the opportunity to grow into big fish all on their own.



A SMART DIET FOR MIDSIZE SPECIALTY PHARMAS

The eat-or-be-eaten situation facing midsize specialty pharmas has led them to be particularly active in M&A. According to the HBM Pharma/Biotech M&A Report for 2014, of the $219.4 billion in worldwide biopharma M&A activity last year, midsize pharma companies such as Actavis and Shire accounted for nearly 60 percent of deal value — twice the level of large acquirers. These deals tend to follow an 80-20 rule; a handful of big acquisitions generate the most headlines, but the great majority of deal volume comes from small and midsize companies joining with even smaller ones.

The challenge facing midsize specialty pharma companies is that they want the same thing everyone else does: a post-proof-of-concept asset or revenue-generating company with a product either close to commercial approval or already approved. But there aren't enough of these companies to go around, and those that are available will be costly. Rather than competing head-to-head for the most obvious targets, midsize companies should identify assets that either offer unique strategic value to their own businesses to justify a higher price or fly under the radar of other acquirers, easing competition. Often, smaller biotechs are more focused on science than business development and don't have the resources, expertise, or relationships to promote themselves effectively to potential partners or acquirers. Even the larger specialty pharma companies are bandwidth- constrained, limiting their ability to identify and/or pursue compelling acquisition opportunities.

> *"Agile and focused biotechs are a key source of innovation and expertise to revitalize the pharmaceutical industry."*

While some midsize companies are inclined to wait for deals to come to them, this approach presents two problems. First, any target that makes its approach is doubtless shopping itself elsewhere as well, and this competition will drive its price higher. Second, this passive approach ignores the urgency to grow; while waiting for a suitable target to swim by, the company is all too likely to end up in the jaws of Big Pharma.

Horizon Pharma (NASDAQ: HZNP), a Chicago-based specialty pharma company with a diverse portfolio, illustrates a successful strategy by a midsize pharma to find the right deal for its situation. Horizon acquired Vidara Therapeutics in September 2014 for $660 million, an especially high multiple of 10X net revenue in an industry where 5X to 6X is more typical. While Vidara's products lie outside Horizon's historical areas of focus, Vidara's Actimmune, a treatment for the infections associated with chronic granulomatous disease (CGD), had been designated an orphan drug by the FDA. In addition to entitling its maker to FDA incentives and support, Actimmune's orphan status reflects the rare disease it targets and the lack of competition in its space, allowing breathing room for Horizon to overcome uneven performance and solidify its specialty pharma business. Perhaps equally significant, Dublin-based Vidara offered the opportunity for Horizon to structure the transaction to leave the surviving corporation with an Irish domicile and its much lower corporate tax rates. While the incidence of so-called tax inversions has slowed significantly following rule changes by the U.S. Treasury Department, it is a prime example of how the strategic case for an acquisition includes more than an analysis of a particular drug candidate.

MULTITRACK STRATEGIES FOR THE SELL SIDE

In today's seller's market, specialty pharma companies and their investors have the luxury of pursuing multitrack strategies that keep all their options on the table. Just three years ago, their opportunities might have been limited to either VC or private equity investment or a strategic deal. Today, they also can consider mezzanine funding, follow-on rounds from current venture investors, IPOs, partnerships with global pharma companies, or even regional deals in other parts of the world that allow them to retain R&D and commercialization rights in the U.S. Far from being seen as desperate or indecisive, this approach — now being pursued by some companies beginning at the earliest stages of development — is seen as a position of strength by a smart company that knows how to maximize its value.

For a multitrack strategy to be effective, a potential acquisition must be at least as viable and appealing as any other option. As on the buy side, sell-side suitors must be both active and informed. This begins with the definition of a strong business case even for development-stage assets: What is the size of the opportunity, and how is it supported through rigorous primary research and discussions with industry opinion leaders, in-the trenches prescribers, and payers? In our own multitrack engagements, we typically start with a comprehensive commercial assessment to ensure the company's business case is fully developed before beginning any real partner outreach. Since the size of any deal is directly related to the nature of the opportunity, it is to the smaller company's benefit for the discussion to focus on the size of the pie, not just how it will be divided. This is most easily achieved through a robust commercial assessment.

In addition, when a smaller company is pitching a partnership or acquisition to a larger one, it is critical to demonstrate a credible understanding of the potential partner's market, the gaps in its R&D pipeline, and the mutual benefits of an acquisition and how each is supported by the smaller company's business case. By the smaller company taking on the task of doing much of the groundwork for potential partners, acquirers, or investors, it allows these parties to focus on validating a proposed strategy rather than creating one from scratch — a much less time-consuming endeavor which both eases deal-making and potentially increases the size of the transaction.

As an example, Civitas Therapeutics pursued a successful multitrack strategy in 2014. Spun out of Alkermes (NASDAQ: ALKS), an early developer of drug delivery platforms, Civitas focused on developing an NTE (new therapeutic entity) for advanced Parkinson's disease. While preparing for an IPO seeking to raise $80 million, the company was instead acquired by Acorda Therapeutics (NASDAQ: ACOR) hours before it was scheduled to go public for $525 million in cash.

Whatever path — or paths — specialty pharma companies choose, from a built-to-sell strategy to long-term independence backed by patient investors and willing partners, the current outlook is promising. With most common diseases adequately served by available treatments, agile and focused biotechs are a key source of innovation and expertise to revitalize the pharmaceutical industry as a whole. This gives them unique value to investors, partners, and acquirers alike — and allows greater freedom to control their own destinies. So long as the appropriate value maximizing strategies are used, for once the supposed prey is getting to dictate if, when, and how it is to be eaten.

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