

# The lengthening handshake

Although mergers and acquisitions (M&As) failed to hit the heights some analysts had predicted in 2009, a new type of tiered transaction rose to prominence—the structured deal. Randy Osborne reports.

The desire to find low-risk ways to generate revenue as patent expirations loom has driven M&A activity in the biotech and pharmaceutical sectors in recent years. But in this respect, 2009 was not a banner year. According to Walnut Creek, California-based consulting firm Deloitte Recap, only 35 pharma-to-biotech mergers worth more than \$20 million took place; and for biotech-to-biotech takeovers, the number was only slightly higher—38.

But more important than the M&A activity level are the reasons companies are buying and the clever ways in which buyers are minimizing risk and sellers are maximizing upside. What has emerged is a new kind of merger—structured deals involving takeovers that take place in stages or buyouts with milestones.

## Big deals

Stealing the drug industry's M&A show in 2009 was a trio of megadeals: Basel, Switzerland-based Roche sealed up its almost \$47 billion buyout of Genentech, of South San Francisco (initiated the previous year); Pfizer, of New York, completed its \$68 billion takeover of Madison, New Jersey-based Wyeth; and Merck of Whitehouse Station, New Jersey, paid \$41 billion for Kenilworth, New Jersey-based Schering-Plough. By early 2010, plans were disclosed to fix overlaps and nail down synergies. Pfizer said it would send hundreds of Wyeth employees packing; Merck did the same with Schering redundancies; and all parties—under pressure from investors to make good on the transactions—were scrutinizing R&D for any overlapping capabilities or unnecessary personnel.

Most pundits forecast at least a moderate rise in M&A activity, as pharma beefs up its flagging R&D capabilities. PricewaterhouseCoopers believes the year will feature strategic deals and “mergers of productivity,” but PwC partner Tracy Lefteroff says he never expected the takeover boom in 2009 that some claimed would be driven by biotechs' cash desperation. “I've seen how difficult it is to kill these small biotechs,” he says. “They've always managed to leverage their assets to get the funding they need, even if it's at a much slower and scaled-back pace.” Chris Dokomajilar, senior consultant at Deloitte Recap, concurs. “The fire sale was back in 2008,” he says. “Companies are either

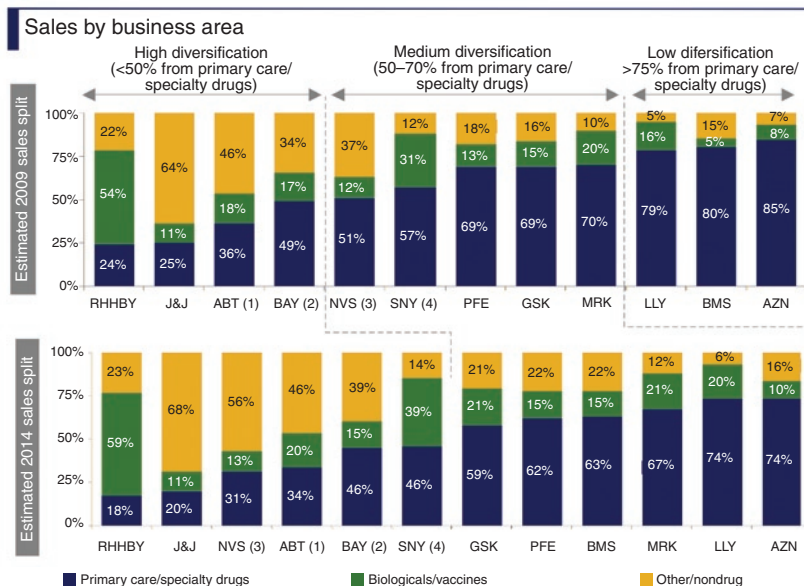
holding off, or looking for other avenues. The M&A route is the last resort.”

Tony Gibney, managing director of Leerink Swann in New York, finds at least one trend from 2009 that is heartening for biotech and will continue. M&A involving middle market-cap firms was “unprecedented,” with clinical development-stage companies snatched up despite the risk, and “you're seeing more than just one party show up” at the table to bid, he says. New Brunswick, New Jersey-based Johnson & Johnson (J&J) bought Cougar Biotechnology, of Los Angeles, for \$970 million. Paris-based Sanofi Aventis took over South San Francisco, California-based BiPar Sciences in a deal worth up to \$500 million. Vertex Pharmaceuticals, of Cambridge, Massachusetts, took over Laval, Quebec-based ViroChem Pharma in a \$377 million cash-and-stock transaction. Gibney says 60–65% of the M&A deals have been of this kind, compared to around 20% previously. Pharma tended to pay impressive one-day premiums to share prices, but still paid prices near or below the 52-week trading prices, though deals above \$400 million showed lower premiums because the mid-caps

had not been trounced as severely as others.

And M&A deals have been more carefully structured, tying the ultimate payout to milestones of clinical and regulatory success (as in the Sanofi-BiPar transaction) so that the risk-reward ratio satisfies both sides (Table 1). Chadds Ford, Pennsylvania-based Endo Pharmaceuticals paid \$370 million in cash for Indevus Pharmaceuticals, of Lexington, Massachusetts, with as much as \$267 million more tied to milestones. Similarly, The Medicines Co., of Parsippany, New Jersey, staged its buyout of Cambridge, Massachusetts-based Targanta Therapeutics from \$42 million to \$138 million. As in many deals, Medicines paid a high premium (72%) to Targanta's stock price, agreeing to a value that the lackadaisical market had not recognized. “You've seen more [milestone-dependent takeovers] historically with private companies, and that continues to be a big part of private deals,” Gibney says, but in the year ahead the trend will pertain more and more to acquisitions of public firms as well.

“Those deals almost mimic M&A,” Gibney says, citing the deal by Basel, Switzerland-based Novartis with Wilmington, Delaware-based Incyte for the latter's phase 3 JAK1/2 inhibitor against myelofibrosis and an earlier-stage compound in the cMET inhibitor class. The collaboration and licensing arrangement drew \$150 million up front, plus \$60 million as an immediate development milestone, with a total of more than \$1 billion in payments possible over time. PTC Therapeutics, of South



**Figure 1** Company strategies focused on diversification. Roche, Novartis and Johnson & Johnson have made a strong case for diversification. RHHBY, Roche; J&J, Johnson & Johnson; ABT, Abbott; BAY, Bayer; NVS, Novartis; SNY, Sanofi-Aventis; PFE, Pfizer; GSK, GlaxoSmithKline; MRK, Merck; LLY, Lilly; BMS, Bristol-Myers Squibb; AZN, AstraZeneca. Source: Bank of America/Merrill Lynch, New York.

**Table 1 Selected structured mergers and acquisitions**

Date	Acquirer	Target	Terms
January 13, 2009	Cephalon (Frazer, Pennsylvania) (Nasdaq: CEPH)	Ception Therapeutics (Malvern, Pennsylvania) (private)	An option, not an outright sale; \$350 million potential deal; \$100 million upfront to Ception for an option to buy the company If option is exercised: • \$250 million to acquire 100% of Ception • Ception stakeholders would receive clinical and regulatory milestone payments
January 5, 2009	Endo Pharmaceuticals (Nasdaq: ENDP)	Indevus Pharmaceuticals (Nasdaq: IDEV)	\$370 million cash (\$4.50 per Indevus share) for Indevus; potential \$267 million cash (\$3.00 per Indevus share) for regulatory and sales milestones
January 12, 2009	The Medicines Co. (Nasdaq: MDCO)	Targanta Therapeutics	Staged buyout from \$42 million to \$138 million
January 13, 2009	Cephalon (Nasdaq: CEPH)	Ception Therapeutics (Malvern, Pennsylvania) (private)	An option, not an outright sale; \$350 million potential deal; \$100 million upfront to Ception for an option to buy the company If option is exercised: • \$250 million to acquire 100% of Ception • Ception stakeholders would receive clinical and regulatory milestone payments
November 25, 2009	Novartis (NYSE: NVS)	Incyte (Nasdaq: INCY)	\$150 million up front; \$60 million immediate development milestone; possible \$1 billion in payments over time

Plainfield, New Jersey, garnered \$100 million up front in a partnership valued as high as \$437 million with Cambridge, Massachusetts-based Genzyme, to co-develop lead program PTC124, a small-molecule drug that targets genetic disorders caused by nonsense mutations, such as some cases of cystic fibrosis and Duchenne's muscular dystrophy.

"Structured deals are here to stay," agrees Sherrill Neff, a partner with Philadelphia-based venture capital (VC) firm Quaker BioVentures. "It's very effective where the large acquiring company doesn't want to destroy the advantages [in top personnel] of the small company," he says. "Sometimes, the last thing they want to do is lose all that management firepower." Although such arrangements seem to favor the acquirer, Stephen Bloch, of the VC company Canaan Partners, says the "staged earn-out" model can work well for both sides. Canaan saw two exits from its portfolio travel that route last year. San Diego-based Calixa Therapeutics was bought for \$92 million by Cubist Pharmaceuticals, of Lexington, Massachusetts, which agreed to pay up to \$310 million more to Calixa shareholders if milestones are met. Canaan also had BiPar, grabbed by Sanofi. "In the old days, you saw a lot of deals with sales milestones, but those take too long. We're seeing tangible, reasonably near-term clinical milestones. The 'bio-dollars' are possible for everybody to reach."

We saw an awful lot more [structured M&A in 2009], including even public-company situations," says Glen Giovanetti, head of global technology for Ernst & Young (E&Y). "From an acquirer's standpoint, it's the way to go, but when there are lots of potential buyers, you're not going to see it." Although venture capitalists may be "increasingly comfortable" with such a setup, "it's not a home run. They still

want some home runs, but this is a 'bird-in-the-hand' environment."

#### 'Pivotal point' reached

Structured or not, M&As will stay near 2009's levels, as pharma continues to be ultra-selective, in Bloch's view. "This is a debate we have all the time at my shop," he says. "A lot of small companies out there are vulnerable without a capital market, but the reality is that the big [pharma] guys can only digest so much. If you're investing [in a biotech], you have to be very careful that the company has enough leverage and white space around it to be attractive to pharma"—in other words, that the biotech's pipeline fits as near to perfectly as possible with the pharma's strategy. "We need to think about it from the science up, but also from the commercial down, and sometimes the 'commercial down' gets forgotten."

"I think we're at a pivotal point' in M&A, Neff says. "What's different is that [pharma is] getting serious about cutting deep in their own organizations to make way for an increased spend on the acquired companies." Previously, scientists in the pharma behemoths "didn't like research that wasn't their own—there was a big uphill battle every time," Neff says, but the senior ranks lately have changed, and are "populated by people who really know what they're doing." He points to Jeremy Levin, senior vice president of strategic transactions at New York-based Bristol-Myers Squibb, who "comes out of our world and knows his way around biotech. He's unafraid of finding good science within the walls of BMS or somewhere else." Bank of America/Merrill Lynch of New York seems to agree, noting that low-diversity BMS, which pulled about 80% of revenues from small molecules—more specifically, primary care and specialty drugs—will reduce that number to 63% by 2014.

Pharma firms are becoming more practical about R&D, Neff says, "cutting deep in advance" of M&A so that they can dedicate money to the acquired firm for new experiments. "If you've got a \$5 billion research budget allocated in the traditional way, and you have a guy [doing research] who knows 'X' billion is his for this year, it's very difficult to convince that guy to give up on his pet projects" after the takeover of an outside company, he says. "Sanofi, BMS, GlaxoSmithKline—they're all very consciously going out there and saying, 'We want to spend a much higher R&D dollar outside of these doors.' And this year, they're scrambling all over the place, looking for something to launch in 2012 or 2013."

Chip Gillooly, global vice president with the capital group at Durham, North Carolina-based consulting firm Quintiles Transnational, is less sanguine about would-be M&A deals overcoming the hurdles cited by Neff. "I haven't seen [the idea of bringing new blood and its research aboard] succeeding phenomenally well," he says. Uppermost management often welcomes newcomers, "and frankly, many of them are in their roles because their predecessors didn't. So the barriers are coming down, but this is like an ocean liner. It takes a long time to turn."

Trying new ways to get R&D done as speedily as possible and with as few ruffled feathers is an ongoing effort, Gillooly says, and will influence the rate of M&A in the coming year. Pharma firms are paying much more heed to "how we can build virtual infrastructures so that we can accelerate and disband research as soon as it's no longer relevant, and build another infrastructure as we need it," he says. As an example of what Gillooly calls "the beautiful insanity of our industry, M&A talks evolve into [a situation where the pharma firm says], 'I don't want infrastructure, I want this core team of brilliant

people, and I want these three or five assets.” Gillooly says three-way and four-way deals, short of M&A, will become more common.

### Diversify or die

Leerink Swan's Gibney finds “absolutely a trend toward diversification. In the early 1990s, pharma wanted to do ‘purification’, with med-tech spinouts and carve-outs of non-core assets,” he says. This push lasted into 2006, when Pfizer, of New York, made “the last of the purification plays” by selling its consumer health division to J&J. PwC's Lefteroff notes that J&J is one of the few pharmas “that stuck with the old model—it's what all of them used to be.” Now, the pendulum has begun to swing back.

On the spectrum of diversity in revenue gainers, Roche sits at the top, with 54% of sales coming from biologics and vaccines (Fig. 1). London-based AstraZeneca is the least, with 88% of its income derived from small molecules. Bank of America/Merrill Lynch project that Roche's biologics and vaccines share will rise to 59% by 2014, and AstraZeneca by then will be gaining 79% of its sales from small molecules, as the firm casts meanwhile for biotech buyouts to ease the imbalance.

That's potentially good news for biotechs, but Gibney says the still weak market in early 2010 also makes pharma lean toward reducing risk, especially given the uncertainty around US healthcare reform. Hence the entry by pharmas into over-the-counter drug sales, with Novartis' exercise of its option to buy the remaining shares in Alcon, of Hünenberg, Switzerland, for \$39 billion. Novartis had purchased 25% of Alcon in 2008, and decided at the start of this year to take the rest. At the end of 2009, Sanofi made known its plan to buy the over-the-counter drug specialist Chattem, of Chattanooga, Tennessee, for \$1.9 billion.

Such deals “don't really impact [M&A chances for] biotechs all that much,” Lefteroff says. “These companies aren't walking away from or defocusing their pharmaceutical pipelines. They're looking for a way to steady their earnings.” Anyway, says E&Y's Greene, the favorable glow that consumer-oriented companies seem to emit “may just be an artifact of the math—you may not be adding shareholder value, although [pharma's purchase of such a firm] reduces exposure to the vagaries of R&D over time,” so their appeal may not persist.

### Reading tea leaves

In general, “an increase, but not monumental” in M&A between pharma and biotech is what Gillooly expects during 2010. “There will be a fair amount of activity around asset acquisi-

tions, where they sort of acquire the company, but not all of it,” he says.

The trend toward such pacts is gathering steam, and “there are more to be done,” Gibney says, although some smaller companies may be reluctant because such deals—by tying up much of the firm with a partner—“take away the [option for a full] M&A outcome for some period of time.” Paratek Pharmaceuticals, of Boston, was able to land such a deal with Novartis valued at up to \$485 million to develop the late-stage antibiotic PTK 0796 for life-threatening infections, after Merck ended a licensing arrangement with Paratek for the candidate. Carmiel, Israel-based Protalix BioTherapeutics entered a profit-sharing deal with Pfizer for the phase 3 Gaucher's disease drug Uplyso (taliglucerase alfa), even though Protalix's stock slid on the news because investors had hoped Pfizer would buy the whole company.

If there's anything to hold down biotech M&A in 2010, it might be the improving capital market. “There's less of a need to do the deals, and there's the perpetual confidence of a smaller company to get to the next milestone,” Gibney says. Interest remains strong in the “sleeper” mid-cap category, too—those companies valued between \$1 billion and \$5 billion, whose worth has stayed level over the past 12 months. It creates some interesting conversations between such firms and would-be partners or acquirers as they try to hash out terms.

More threatening for pharma-to-biotech M&A may be the drift toward an emphasis on patient outcomes. The goal of coming up with a better result with a drug—rather than what appears in the laboratory to be a “better” drug—will skew the way deals are done and with whom, he says. “As the overall healthcare environment or ecosystem shifts toward patient outcomes, all the players need to refocus on what creates value,” Greene says, and the future may find pharma turning its eyes to companies devoted to services, devices, monitoring and information and away from innovative biotechs.

Stephen Kaldor, former executive at Takeda San Diego, led the Japanese firm's \$270 million buyout of Syrrx, of La Jolla, California, in 2005. He has maintained a keen interest in the M&A space ever since. Like others, he forecasts “at least a moderate uptick for privately and publicly held biotechs. If you look at pharma-pharma [deals], there will be some of those as well, but most of that has already occurred.”

For the past year and half or so, M&A has been largely product focused, Kaldor notes, as firms struggle to fill near-term revenue gaps brought about by patent expirations and

flagging sales. “Some of that will continue—it's kind of the baseline of activity,” he says. But Kaldor, now president and CEO of San Diego-based Ambrx, sees “an uptick in gaining access to capabilities, and novelty on top of capabilities.”

“Pharma has finally placed the bet on biologics,” he notes. “A few have been late to come to the table, but they have pretty much all placed a stake in the ground.” Along with the push for access to platforms as well as products, Kaldor says, the twinned movements will continue toward outsourcing early-stage development and toward establishing business units for further research—“autonomous units looking to insert ‘plug and play’ capabilities.” (The latter model was pioneered by J&J, with units such as Centocor, Janssen Pharmaceutica and Ortho-McNeil Pharmaceutical.)

E&Y's Giovanetti doubts the draw of platforms will be that powerful for pharma in M&A, “unless it's such a novel technology that they feel they have to control it” entirely through ownership. Instead, the pharma firms will go for collaborations that give access. Negotiations between pharma and product companies often start as talks about alliance, and end in takeovers, he says, but this is harder for a platform-based firm to pull off.

Smaller, product-based biotech companies may have a harder time getting the usual type of M&A done. “We've got a broken model there,” according to Gillooly. “Still very little capital is available, and the structure, more often than not, that these companies assume is to build a ‘mini-pharma,’ in hopes they can control the levers associated with getting a product to market.” Such industries as finance, aviation and insurance “realized a few decades ago that a successful company cannot be master of all, but has to create networks and partnerships that allow them to be nimble and responsive.”

Kaldor, though, predicts that biotechs in 2010 will have more leverage in conventional M&A, helped by an improving economic climate at the start of the year, and that more M&A will occur. “People are, without being silly, looking at initial public offerings as a preferred track,” he says. In January, ten filed IPOs waited in the queue, and hopes were bolstered by Cambridge, Massachusetts-based Ironwood Pharmaceuticals' decision to raise its price range from \$172.5 million to a level that could go as high as \$267.2 million. Although Ironwood disappointed Wall Street by pricing 16.7 million shares at \$11.25 each for \$188 million, well below the range's top end, the lined-up IPOs bode well for biotech. The industry “was trying to fake things a year ago,” Kaldor says. “Now it's credible again.”

*Randy Osborne, Atlanta*