No off-day for healthcare M&A

The healthcare industry can be dizzying to keep up with when considering the amount of innovation, drug trials and corporate-deal making taking place on any given day. Here’s a rundown of the latest trends in the sector and how they are playing out in the US equity space.

In any sector undergoing powerful forces of disruption, it is not always clear which companies will survive and which will not. As advancements in technology play out their influence, in-depth analysis and a differentiated perspective are essential to see through the myriad of distractions.

Gene therapy—at the forefront of drug innovation—holds the potential to shred the fabric of traditional healthcare, as it reshapes the ways pharmaceutical companies contemplate what products they bring to market. Over the past few years, the healthcare industry has experienced a boom in new ways to treat diseases and other ailments. Investigational new drug submissions, or drugs filed to test in clinical trials, were up nearly two-fold from 2017 to 2018 for new gene therapy products.¹

For spinal muscular atrophy, there may soon be three gene therapy products on the market—up from the current two, according to Amanda Birdsey Benson, lead biotechnology analyst at Mellon.

There is an existing gene modulating technique approved by the FDA in December 2016, which is administered every few months intrathecally, or under the middle membrane that surrounds the spinal cord; another therapy approved by the FDA in May, administered just once intravenously; and a third expected to come to market next year, which is an oral agent.

“It’s possible that the intrathecal therapy gets replaced with the oral agent but it’s also possible that they all get used in combination,” Benson says. “It’s something we’re expecting to see in real time over the next 12 months.”

As with any other sector, innovation often breeds survival methods from incumbents as an attempt to avoid being left behind. In the healthcare sector, legacy players are trying to evolve by acquiring their newer, more cutting-edge counterparts. During the first half of 2019, over $200bn in acquisitions within the pharmaceutical industry had already taken place, surpassing 2017 and 2018 numbers.² This year’s deals included Bristol Myers Squibb’s monster $74bn acquisition of biopharma company Celgene as well as the smaller $11bn Pfizer acquisition of Array BioPharma, both of which helped bolster the sector as fourth in regards to highest volume of M&A during the first half of 2019 (see chart).

¹ US Food and Drug Administration: April 16, 2019
² Axios: With cash to burn, pharma deals are all the rage: June 26, 2019
Survival of the fittest

John Porter, senior portfolio manager of the BNY Mellon Small/Mid Cap Growth Fund, says:

“Anytime you have this kind of innovation and disruption in the marketplace, by definition the established players have more to lose, however, they also tend to have the scale and resources to participate in the new innovation.”

“Sometimes it’s through their own R&D and sometimes it’s by way of M&A. They’ll see a gap with a drug that’s going off patent or new technology so they acquire the competing solution, continue the development and distribute it themselves.”

Porter, who primarily invests in small and mid-size companies, says some of the smaller companies coming out with new drugs will undoubtedly remain independent and become large successful companies but there will also be established large players that use their size to participate in new innovations coming to market.

“Hypothetically, if you’re a $2bn market cap company working on a solution for a disease and you think there’s a multi-billion dollar revenue opportunity if you solve this problem—that might be worth $10bn or $15bn if you’re right, versus $2bn today—and you’re playing for a big return,” Porter says.

Despite future revenue potential in going solo, it can also be advantageous for innovators to align with already established players in the space. This can help through access to additional resources, which can help drive R&D at the initial drug developer or it can be through leveraging the marketing support and brand recognition of the established player to reach their client base when the drug finally goes to market.
Taking the leap

While a deal may seem clearly advantageous for the acquiring companies, they are still taking a leap to capture the edge of innovation through M&A. In fact, there is so much uncertainty that regulators tend to be more permissive of acquisitions in light of the level of risk that larger acquiring companies take in evaluating both the efficiency and marketability of a new drug, according to Porter. As bright as new innovators are—they often lack true foresight into the probability of a successful drug launch.

“Even if you’re an insider at one of these newer pharma companies, there’s still an element of uncertainty no matter how amazing the data is. Until your drug is on the market and in broad use, you don’t really know how it’s going to perform,” Porter says.

“There are many instances where companies sell for billions of dollars to large pharmaceutical companies and the drug ends up being a total dud but there are just as many stories where the drug was a wild success and the acquisition was a home run for the larger pharmaceutical company.”

Legacy pharmaceutical companies tend to take this risk because it can allow them to diversify their product set, therefore diversifying their business model and revenue streams. Still, using M&A as a survival method is not a decision taken lightly as there are number a factors at play. This can include how confident the acquiring company is in data from the new innovator, their risk tolerance and who the shareholders are, according to Porter.

For Porter, knowing the business strategy of a new drug developer is a key component of uncovering opportunities in the space:

“That’s why we spend a lot of time talking to these executive teams. Most of our pharma-analysis is focused on the science but some of it is from a strategic perspective where we try and evaluate what their motivations and priorities are.”

“We even look at executive compensation to gauge how they are being paid as well as what they are incentivized to put their efforts towards. All of those things can factor into whether the companies we watch end up being willing sellers or not.”
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