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Biotech M&A: What Happened in 2017 and the Year Ahead

By JIM COFFEY

Looking across the entire M&A spectrum, overall deal values were generally on the decline in 2017. PricewaterhouseCoopers reports that “M&A values decreased by over 60% in Q3 2017 as compared to Q2 2017, and the \$30.0 billion total deal value was roughly half of the average quarterly value witnessed over the prior two years. This decrease is driven by declines across all subsectors, *except Biotech* [emphasis added].”

Mergers and acquisitions in the biotech sector have generally kept up the pace in 2017 compared to last year. According to PricewaterhouseCoopers LLC, “after a series of declining values, quarter-over-quarter throughout 2016, deal values have increased in both Q1 2017 and Q2 2017. While deal value is near a 2-year high, deal volume is the lowest it has been in the recent past. Megadeals have driven several of the recent quarterly deal values, including the acquisition of C.R. Bard in Q2 2017 for \$25.7 billion, which comprised approximately one-third of the total deal value for the current quarter.”

Biotech, therefore, unlike other markets, continues to display a certain kind of immunity against these broader market declines, and fertile ground for M&A activity. The evidence and collective wisdom of the markets also seems to indicate that this pace will likely continue into 2018.

The Biotech Anomaly

What explains then the notable exception for biotech in 2017? What were the drivers in biotech and life sciences that sustained M&A activity in 2017 that other industries simply lacked? Available cash surpluses, both domestically and internationally, and low interest rates are frequently drivers of growth in all business sectors, but in biotech and life sciences, inorganic methods of supplementing growth and the need to diversify existing business models may better explain the industry’s sustained growth.

Large pharmaceutical companies need to continually supplement their existing drug offerings. They also

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must maintain a finger on the pulse of the latest in innovative drug development in order to be competitive amongst their peers. Doing everything in-house, especially when considering the high cost of research and development, can be impractical and take up too much time. And when failure occurs, big pharma owns it. As a result, large pharmaceutical companies regularly search for and monitor innovative technologies by not only “hanging out with the startups” but oftentimes by acquiring their early stage products and technologies. Startups, therefore, literally serve as the “petri dishes” for big pharma. Those that show promise in research and development in innovative technologies, many times, get funded by or acquired by big pharma. Those companies whose results are not as promising or who ultimately fail in clinical trials fail as the startup—and not as part of a bigger and more accountable enterprise. Therefore, deal values in biotech in 2017, both large and small, reflect these transactions and account for some of the activity in the space

Other Factors Driving Biotech Industry Growth

According to Baker Tilly, a full-service accounting and advisory firm, “[i]n the pharmaceuticals sector, favorable market fundamentals and healthy valuations have contributed to M&A activity in 2017. Companies continue to look to acquire new drugs, technology and intellectual property to expand and stabilize their pipelines. New companies, drugs and products frequently entering the pharma market makes for a highly competitive industry landscape. Furthermore, the chance of any given new drug, process or technology achieving widespread success and profitability remains very low. Therefore, the majority of companies with excess cash and healthy balance sheets are looking for acquisitions to expand product offerings and improve long-term growth prospects.”

In its Life Sciences M&A update: H1-2017, Baker Tilly states, “[t]he outsourcing of research and development (R&D) and manufacturing processes in the pharmaceutical industry has become increasingly prevalent over the past two decades. In particular, contract research organizations conduct clinical trials and research, manage data results and develop and formulate new products to help their clients reach regulation standards. These organizations help pharmaceutical companies boost efficiency by allowing them to channel

their resources toward core operations, such as drug innovation. The industry experienced a period of aggressive growth over the past five years, benefiting from an aging U.S. population and an expansion in private health-related R&D expenditures. IBISWorld forecasts that industry revenue will increase at an annualized rate of 5.4 percent to \$22.2 billion over the next five years to 2021.”

The continued growth and expansion of life science incubators and accelerators, entities that provide shared lab space, resources, and opportunities for collaboration, many of which are backed by universities and private industries, also played a critical role in the sustained growth of biotech in 2017. Innovation centers located across the U.S. in cities such as Berkeley, Calif., Boston; Cambridge, Mass.; Chicago; New York; Seattle; and San Francisco, to name only a few, gave scientific founders bases from which to operate, access to expensive equipment that might not otherwise have been available to them, and perhaps most importantly, opportunities to succeed.

A Beneficial Side-effect

The symbiotic relationships and working partnerships that are oftentimes formed between big pharma, startups, clinical research organizations, and incubators can serve to benefit everyone by creating ecosystems for sustained development and growth. This was no doubt the case in Cambridge, Mass., in 2017. LabCentral is a 70,000 square-foot facility in the heart of the Kendall Square, Cambridge, biotech innovation hub. LabCentral is a first-of-its-kind shared laboratory space designed as a launchpad for high-potential life-sciences and biotech startups. It offers fully permitted laboratory and office space for as many as 60 startups comprising approximately 200 scientists and entrepreneurs. LabCentral provides first-class facility and administrative support, skilled laboratory personnel, and a domain-relevant expert speaker series, as well as the other critical services and support that early-stage companies need to begin laboratory operations on day one. A private, nonprofit institution, LabCentral was funded in part by two \$5 million grants from the Massachusetts Life Sciences Center, with support from its real-estate partner, MIT. Founding sponsors include Triumvirate Environmental and Johnson & Johnson Innovation. The first startups joined in early November, with lab operations launching officially Nov. 15, 2013.

To accommodate for increased demand for its growing startups, LabCentral, with support from Pfizer, Inc., expanded in 2017. With the addition of a 33,000 square-foot facility, capable of supporting up to six early- to mid-stage companies, by 2018, LabCentral now has the capacity to serve a total of about 450 scientists and entrepreneurs in about 66 companies across its two-building campus.

Innovative working partnerships like the ones described above foster beneficial deal making and merger and acquisition activity. Whether in the form of a simple M&A transaction, a strategic partnership, a licensing or collaboration agreement, industry growth occurs and enterprise value is created when all players in the life science food chain are open to collaboration. In fact, some of the deal activity recorded for 2017 no doubt began with mutually beneficial collaborations such as the ones described above.

Long-term Planning, M&A, and the Life Sciences Industry

Large pharma companies, when planning for growth and expansion, must look ahead at least five to 10 years. This is a necessary evil considering the extenuated drug development timeline and the regulatory constraints that can significantly affect the timeline for bringing a new drug onto the market. Planning ahead in an uncertain regulatory market, and building a robust pipeline of drugs while trying to realize a cost savings (in the face of pricing pressures from payers) makes big pharma’s forecasting task far more challenging than in other industries. Strategically collaborating with a startup or better yet bolting on an innovative technology to an existing business plan through an acquisition hedges against big pharma’s risk and provides a real upside if the drug development goes according to plan.

Thus, life science dealmakers and their counsel must be accustomed to taking the long-term view. Collaboration agreements between big pharma companies and innovative startups can sometimes lead to large investments and/or lucrative buyouts. Therefore, care in signing the initial agreement must be taken in order to insure that the nascent relationship gets off on the right footing. Life science companies and their attorneys who are negotiating in this space are wise therefore when taking an approach that facilitates long-term collaboration. Creativity, a word that most people don’t usually associate with the legal profession, becomes incredibly important when drafting these incipient agreements. Creativity in addressing royalty streams, milestone payments, the preservation of rights for future collaborations, and the protection of proprietary rights to operate in the future, plays a significant role in successful life science deal negotiations. In the absence of this careful planning and foresight, opportunities may be lost and advantages previously gained subsequently squandered.

It is also vitally important to factor in the incredibly high risk associated with these deals. People forget about the high rate of failure in this industry. Most drugs in development ultimately will fail when it comes time for approval, even after huge investments. Therefore, deal structures need to be negotiated to address the high risk/high reward nature of the industry.

The Year Ahead

Research breakthroughs, low cost outsourced research and development, the implementation of artificial intelligence (AI), an abundance of cash on corporate balance sheets, low interest rates, and possible drug pricing negotiations in 2018 may make next year a big one for pharma. There’s no way to tell for sure, but given all the innovation taking place in the space and the less than certain regulatory scheme under the new administration, 2018 will surely be interesting.

According to an industry analysis report issued by Q1 Productions, “[l]ooking ahead . . . the industry may be seeing a positive push toward growth, innovation, and streamlined legislation.” In fact, “Accenture finds that 74% of life sciences executives believe that AI alone will result in significant change and even completely transform their industry within three years. Using AI for key clinical health applications could potentially create

\$150 billion in annual savings for the US economy by 2026.”

In sum, given conditions in the rising stock market throughout the life sciences industry and the heavy in-

vestment being made in disease treatment research and development, it's a good bet that the pharmaceutical industry will continue to expand through 2018.