The Life Science Boom

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Last year was the Year of the Deal in life sciences. There were 43 U.S. healthcare initial public offerings (IPO), triple the number in 2012. There were 60 mergers and acquisitions (M&A), with the average deal size 49 percent larger than the previous year’s. And according to FTI Consulting’s fourth annual Life Sciences Investment Survey, investors expect the party to continue in 2014.

But before you pop the champagne, regulators are scrutinizing many life sciences transactions to sniff out those done solely for the purpose of tax avoidance. Meanwhile, investors are asking more questions, activists are stirring the pot and a consolidating payer base is continuing to bring new challenges to product marketing.

In the wake of the survey, summarized here, FTI Consulting convened a panel of life sciences investment experts to review the prospects and challenges in 2014 for companies and investors in Big Pharma, biotech and specialty pharma. The panelists included:

**Judy Brown,**
Executive Vice President and Chief Financial Officer, Perrigo Company, a leading global healthcare company and the world’s largest manufacturer of over-the-counter pharmaceutical products.

**Tom Crawford,**
Senior Managing Director, Strategic Communications at FTI Consulting. Based in Washington, D.C., he advises boards of directors, executive teams and senior decision makers on public-policy issues.

**Alan Hartman,**
Partner in Centerview Partners, a leading investment banking and advisory firm providing advice on mergers and acquisitions, financial restructurings, valuation and capital structure to companies, institutions and governments.

**Barbara Ryan,**
Managing Director, Strategic Communications at FTI Consulting, and panel moderator. Based in New York, she has more than 30 years of Wall Street experience as a sell-side research analyst covering the biopharmaceutical industry.

Here are their perspectives.
Barbara Ryan: 2013 certainly was the Year of the Deal from the standpoint of collaborations and mergers and acquisitions, as well as initial public offerings. Life sciences investors are expecting even more of these deals this year. Alan, what are your clients saying?

Alan Hartman: Life sciences is split into three subsectors: Big Pharma, Big Biotech and a broad category of specialty pharma/generic companies, which is where most of the deals last year and so far this year have taken place. We’ve seen much less activity in the first two sectors except in their non-life sciences portfolios such as consumer and animal health. Big Pharma companies are less willing to do transactions and have less firepower today due to the hefty dividends they must pay and because much of their cash is offshore.

On the other hand, companies in the specialty pharma area want to diversify their product lines. Many started off making one or two products and now want to handle more, and the market likes that. The fact that these specialty pharma companies have the ability to use cash, have greater risk tolerance and are driven by the need to supplement their small internal R&D [research and development] actually puts them in a better position than Big Pharma to do mergers and acquisitions. So that’s where the vast majority of deals have happened, and they’ve been incredibly well-received. That fuels more activity because the investor base seems to want more and more transactions.

Barbara Ryan: You raised a good point about dividends. The Pfizers of the world have been pushed to pay out more than 70 percent of their free cash to shareholders, who are demanding even more.

One big winner in today’s environment has been Perrigo, which started out at $115 a share last year and currently is about $170. Judy, can you talk about Perrigo and its strategy as a potential future acquirer in this environment?

Judy Brown: In the last several years, Perrigo has been doing many acquisitions. The Perrigo story has been built on a combination of a lot of M&A and strong organic growth — 17 transactions over the last five years. Most of them were small acquisitions of similar businesses or those located in geographic areas where we want to expand. But our most recent one – Elan – is what I call a “super charger.” This deal...
has changed the game for us. It increases our cash flow and puts us in a better situation tax-wise. That means we can think differently about the size and types of transactions we could undertake. Having a footprint in Ireland signals our intention to grow internationally.

Because of the Elan acquisition, we now are an Irish company. That gives us more flexibility in where we deploy cash and how we invest globally. To Alan’s point, we are being proactive in this large cap growth phase in creating the kind of financial balance sheet flexibility that we will need going forward.

**Barbara Ryan:** Tom, I know that you and Judy have worked together on Washington tax policy issues and collaborated on the Perrigo-Elan deal. Because Perrigo essentially relocated its tax headquarters from Michigan to Ireland, let’s talk about how U.S. tax policies are driving inversion and why companies are relocating to another country to avoid our tax structure. It’s a very current and controversial subject.

**Tom Crawford:** Companies around the world are competing for markets in the United States and elsewhere. They’re facing global challenges related to revenues, struggling economies, jobs and the inability to provide services. For companies that want to expand to a specific country, sometimes the easiest strategy is to try to capture an enterprise that’s already there.

Of course, people today are outraged about organizations that invest overseas solely to avoid paying taxes, especially following the economic collapse. However, companies like Perrigo are in a different category. Perrigo was based in the United States for 126 years and enjoyed a mid-80 percent market share in its space. It wanted to grow and had a business proposition — in terms of consumer cost and healthcare — that would provide value around the world. Instead of talking about inversion, the company made a strong business case for relocation. Top executives talked about international growth: having a platform, being able to export homegrown expertise and supporting its activities in the United States. Management has been vocal about how U.S. tax policy causes problems but also showed why the Elan strategy would make Perrigo a stronger company and benefit its U.S. operations and employees. Judy testified in front of the House Ways and Means Committee when very few companies were willing to do so.

Because of this strong narrative, Perrigo has escaped the criticism that frequently comes when companies move the headquarters overseas. Businesses need to be proactive about building relationships and helping the public understand what the company wants to do and why. Organizations spend too much time thinking about the deal and forget to talk about who they are, what they’re about and where they’re going. Policymakers are not looking to crucify companies that explain themselves and have a rationale for what they’re doing, but the government will come down hard on those who try to arbitrage the system for a tax benefit.

**Barbara Ryan:** Alan, if you look at the IPO climate today, companies that want to strengthen their pipeline clearly have more options. (In the past, the only choice was to go to Big Pharma and strike a deal or be acquired.) That must make the M&A landscape for Big Pharma much more expensive and challenging.

**Alan Hartman:** The IPO market is white hot for companies in oncology, rare diseases and other specialty areas. These companies can attract capital without partnering with Big Pharma. In the rare disease area, a lot of people wonder whether Big Pharma is even useful if the peak sales of a product will be $300 million, $200 million or perhaps as low as $50 million in some cases.

This is not what Big Pharma is looking for. More than 90 percent of the deals that have happened over the last five years have been for marketed drugs. So for
Big Pharma, which is struggling to cut its own R&D budget, it doesn’t make sense to take on another R&D-based project. This could force the head of R&D to cut some program he’s just told the CEO [chief executive officer] is critical. That’s a very difficult thing to do and pay a purchase price at the same time.

Such deals face a tough dynamic in today’s environment. It may be easier for Big Biotech to do — the Celgenes of the world that have more R&D space in their budget for external deals than Big Pharma does today. Investors also have changed their attitude about diversification. If I go back almost 10 years, when we put Biogen and Idec together in a merger, many investors said, “Hmm, I don’t really like that. I could have bought Biogen; I could have bought Idec. I would have moved back and forth between them. You don’t need to diversify for me.” But today’s investors want diversification. They understand how all these interrelated factors — different assets coming in, others going off patent, new clinical trials, etc. — bring greater stability to capital markets. For a huge chunk of companies, the market is saying, “We’d like you to be bigger. We’d like you to be diversified. We think there’s real value in that.”

### Taxes: The Elephant in the Room

**Barbara Ryan:** Tom, let’s go back to the elephant in the room: U.S. tax policy. What should we be thinking about?

**Tom Crawford:** We need to think about two aspects of tax policy: R&D incentives and the treatment of intellectual property [IP]. Regarding R&D, there’s a movement around the world to try to capture innovation. The R&D tax credit in the United States has become very cumbersome, with a complex structure and lots of audit issues. Many want to replace it with some form of alternate, simplified credit or a system that makes getting a credit for investments much easier.

Another problem is that many of the leading U.S.-based innovators don’t have any revenues yet. I represent the Biotechnology Industry Organization, and I handle capital formation policy for the group. What we’re trying to do is reintroduce structures like the R&D partnerships from the early ’80s, which yielded a lot of significant developments. Amgen came out of one of those partnerships and was
successful in turning molecules into cures and therapies. The idea is to allow these pre-revenue companies to pass their losses along to their investors so there’s an immediate yield as opposed to having to wait a long time for a return on investment.

We also are competing with other countries that offer incentives for businesses to create intellectual property, which adds good jobs and spurs economic growth. Places like China will pay for infrastructure. In this competitive global landscape, U.S. tax reform has to focus on what our economy will look like in the future.

Even more controversial than inversion is IP migration. This means you develop IP here in the United States and then export it to some low-tax or tax-haven jurisdiction. Sometimes you can structure a scenario in which 100 percent of your revenues are in the United States, but it’s all booked abroad, thus avoiding tax here. That has provoked a very negative response to pharma in particular even though it’s legal.

But it might not be for long. The OECD (Organisation for Economic Co-operation and Development), the European Union and the G20 all are working on new rules. Companies that want to be in a jurisdiction for tax purposes would have to demonstrate that it’s not solely for the purpose of avoiding or minimizing tax. The company must have boots on the ground, or facilities, or some sort of management presence in its declared jurisdiction. The OECD has rules out right now for country-by-country reporting. That’s the first step in gathering the information that you need in order to be able to go out and attack IP in the strategies and structures that companies are using.

The United States recently put out a very aggressive proposal that effectively says if you’re not managed and controlled in a given jurisdiction, you can’t be taxed there. This proposal is not retroactive so it doesn’t affect companies that already have established themselves in a foreign jurisdiction.

The OECD effort that I’m talking about is a direct reaction to Amazon, Apple, Google and Starbucks. The Minister for Finance of Ireland told us, “I’m going to keep our Irish rate — we’re not going to give that up. But I’m going to call the bad guys in and tell them you have to get right or you’re getting out.” This new attitude is spurring change around the world, and deals that appear to be made for tax purposes only are going to have trouble.

The Activist Investor

Barbara Ryan: Let’s talk about activist investors and their impact on capital markets. Even those who were not traditionally activists now are investing more purposefully. How is this changing the conversations and motivations among your clients?

Alan Hartman: Activism in the life sciences space has proved to create exceedingly good investments for the Carl Icahns of the world. Two prime examples are Genzyme and MedImmune. Both companies sold quickly and reinforced the activist view that Big Pharma should own biotech. A lot of activist investors continue to have that opinion, though it hasn’t really panned out — but sometimes they get lucky, as Icahn did. He was in Biogen when, all of a sudden, it discovered BG-12 [an oral multiple sclerosis treatment]. He deserves credit for being in the stock for a better part of five years, but the new management team also merits kudos.
I think it’s hard to overestimate the importance of activists. When they show up, they are incredibly successful at forcing change. It may not be immediate — that’s the surprise. It may take a year or two or three, and it may require one or two or three meetings, depending on the situation. Patient activist investors in healthcare can enjoy returns that, frankly, sometimes are off the charts.

Barbara Ryan: I think the most obvious defense is a good offense: maintaining a high multiple, which means the market thinks you’re doing lots of things right.

Judy Brown: You also must go on the offensive by communicating continually. The conversation doesn’t necessarily have to be about the stock price — which goes up and down. In today’s activist environment, we must strive for transparency: Disclose more, not less; take every phone call. There are no dumb questions from any current or future shareholder. We want them to feel that if they have an issue or a question, they can come to us.

Shaping the Narrative

Barbara Ryan: Companies no longer are the sole source of information. Shareholders will talk with your competitors. They’ll talk with people in Washington, and they’ll talk with regulators — and with anyone and everyone. Alan, are more companies feeling as if their shareholder communications are falling short?

Alan Hartman: Companies today are definitely more sophisticated in their investor communications. They think about it, learn from others’ mistakes and strive to be proactive. But it’s hard for me as an advisor to say to a senior executive, “You need to communicate more,” when that obviously takes away from the attention needed to running the company. Some shareholders expect free access to the CEO and CFO [chief financial officer] and complain if the investor relations guy is the highest level of contact. But as operations become more global, CEOs and CFOs will have many more demands on their time and may not be able to deal directly with shareholders as much as shareholders would like.

Everybody is clamoring to know about a company’s next big deal. They want to know because they are anxious. In essence, a possible transaction presents a lot of unknowns. So the more positive a company sounds about doing a deal, the more positive the stock will be rewarded in the short term. It’s a unique moment in time and doesn’t last very long.

Ultimately, even great-sounding strategies and well-explained transactions can fail to deliver. Maybe the operations become just too diverse and can’t be run especially well. This eventually will happen to some organizations, and then it will be much more important to distinguish why Company X, Y or Z is different. If your strategy depends upon the equity multiple in order to continue to do deals, your cost of debt is important as well so it’s crucial that the market have confidence in your strategy.

Judy Brown: Companies have long-term shareholders, many of whom invest with a three-to-five year horizon and only want to talk about the overall growth rate and what the balance sheet is going
to look like five years from now. Other equally valuable investors are short-term and are in and out of the stock more frequently. For them, an announcement merely implies that you’re willing to do a deal as opposed to the deal itself. It’s hard to satisfy both kinds of investors.

But, as they say, I love all my children equally. You know that they each have different needs and desires, and, therefore, you try to treat everyone fairly and consistently — but don’t change your story. Consistent, constant communication is key.

Other Perspectives

Barbara Ryan: What should we all be thinking about in 2014?

Tom Crawford: I would mention one dynamic that we haven’t touched upon: Buyers seem to be consolidating. Distributors are going global and are combining — at least on the purchasing side — with retailers and others. This may impact revenue growth rates and pricing. It hasn’t yet affected organizations’ financials, but there certainly are a lot of companies looking at the issue.

Barbara Ryan: I’ve recently been on the road talking with life sciences companies that are in the development stage of going public. In every meeting, management and investors alike are discussing not only the science itself and what that means but also the commercial strategy and how that is going to resonate with payers for reimbursement.

Judy Brown: The FDA’s movement toward switching a greater number of prescription drugs to over-the-counter is putting more and more healthcare in the hands of patients and consumers. This trend of proactive personal health and wellness will create opportunities for some players and close doors for others.

Tom Crawford: I would follow very closely the implementation of the Affordable Care Act. The emerging discussion about pharma and biotech is whether or not healthcare reform lowers or increases the cost curve. If costs increase dramatically, people will blame it on the cost of drugs and will put extra pressure on reimbursement and coding practices. There also is a very big trend toward generic. As healthcare costs continue to rise, pharma will be an easy target. This is ancillary to all these other tax policy and business matters, but I think it’s a big issue.

Barbara Ryan: Thank you all for your perspectives.