Is consolidation the only option for UK biotech?

Yes, if it is to have the resources needed to develop products of interest to large pharmaceutical partners.

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As stated elsewhere in this issue, there are currently too many small biotechnology companies for the available capital, and this is as true in the UK as it is in the US. The question is how to help these small companies grow. Natural growth can be slow and is a poor choice for rapidly evolving fields such as biotechnology. The alternative, restructuring through mergers and acquisitions—although potentially more disruptive to the ongoing business—is comparatively quicker.

Bigger is not always better, but in this case bigger also means better able to raise money. If UK biotech companies are to take their products through clinical trials, they need to attract funds. However, there is a view that biotechs should concentrate on drug discovery and leave drug development to big pharmaceutical companies. But whatever the solution, consolidation is essential in order to reach critical mass; only then can UK biotech companies compete with US biotech companies, negotiate more attractive commercial arrangements with larger pharmaceutical partners, and secure favorable funding terms from investors.

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The minimum market cap in which institutional funds are prepared to invest has also been increasing. One driver has been the recent consolidation seen among the financial institutions. This has resulted in investors focusing on "less risky" higher market cap levels. One billion dollars is increasingly being recognized as small-cap and $250 million as micro-cap. The majority of biotech companies in the UK are far below the micro-cap level, with most being below $100 million. Many financial institutions also consider biotech companies to have insufficient risk diversification, inadequate capitalization, and insufficient liquidity.

Risk diversification and increased offerings

One of the prime reasons to encourage consolidation among small biotech companies is that it will reduce financial risk for investors through product (and hence risk) diversification. If we look in more detail at risk diversification, not even big pharmaceutical companies can consistently pick the winners. In fact, 75–90% of novel products in clinical trials fail. Product diversification would reduce the risk inherent in drug discovery and development, and it reminds pharmaceutical companies of the need to maintain a product pipeline. Biotech companies have the opposite problem of having potentially "long product tails." Although smart science does not inevitably mean shorter drug development timetables, it would seem sensible to allow consolidated biotech companies to manage, and indeed generate, the product tail that can then be licensed to big pharmaceutical companies for development.

A recent report by the Boston Consulting Group on the pharmaceutical industry explained that patent expirations will result in the average top company losing roughly 30% of its 1997 sales to generics over the next five years. According to the report, "Already, drugs licensed from biotechs and other external sources represent roughly 35% of the existing pipeline in the average top pharmaceutical company. There is potential, however, for even more in-licensing."

Another report, *Pharma 2005*, from PricewaterhouseCoopers, has forecast that pharmaceutical industry revenues will grow by 7% per annum over the next seven years. To meet this consensus forecast, the top companies will need, on average, to generate an extra $28.9 billion in sales from new products between now and 2005. This requires each company to launch between 24 and 34 new products earning $1–1.5 billion per product in the same time frame. Under current business models, these targets are not achievable—they represent four times the current number of new products reaching the market.

The consolidation experience

Only a handful of relevant UK stock market companies appear to be close to the small-cap definition of $1 billion—Shire Pharmaceuticals (Andover), Celltech (Slough), Chiroscience (Cambridge), PowderJect Pharmaceuticals (Oxford), and SkyePharma (London) are examples. The majority of the remainder have witnessed their market values slide below $100 million, in part as a reaction to unfavorable news from companies including British Biotech (Oxford) and Cortecs (London).

This is not to say that micro-cap firms do not have a role in the industry. Gillian Francis, CEO of PolyMASC Pharmaceuticals (London), which is listed on AIM, commented, "A novel solution needs to evolve for biotech fledgling companies who are well

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below micro-cap size since they are often responsible for product innovation and brand-new technology. The dynamics and narrow focus of the research boutique, at least in some fields, facilitate product discovery, whereas product development needs micro-cap or, preferably, small cap resources in order to flourish. Thus, there are two problems: first, creating a structure in which fledgling biotechs can flourish (conventional incubators fail to do this at present) and second, creating a consolidation route that facilitates the M&A process so that companies do not remain micro-cap once there are products to be developed."

Accessing capital seems to have been the main driver behind Elan's (Dublin, Ireland) recent acquisition of Athena Neurosciences (S. San Francisco, CA). At the time of the acquisition, Athena's then-president and CEO, John Groom, noted, "While Athena could have remained independent, this [transaction] gives us access to the $400 million in Elan cash, which provides the flexibility and opportunity to move more quickly to think about product acquisitions, and to become a major force in licensing technology."

The same can be said of Warner-Lambert's (Morris Plains, NJ) $2 billion takeover of Agouron (La Jolla, CA), announced in January 1999. Peter Johnson, president and CEO of Agouron, has said that "Agouron's decision to be acquired by Warner-Lambert was a not a question of survival, but of how to realize our full potential." The company was lacking the resources to address all the opportunities in its pipeline and technology, and a bigger company with the adequate resources acquired it.

Consolidation as a strategy, however, has yet to take a firm hold in the European markets. Among UK companies, SkyePharma, the drug delivery specialist, recently paid $55 million to acquire DepoTech (San Diego, CA), a US company specializing in slow-release drug injections. Peptide Therapeutics (Cambridge, UK) has announced the acquisition of OraVax (Cambridge, MA), an American rival. Cantab Pharmaceuticals (Cambridge, UK) has also publicly stated a strategy of merging with the right partner. Robert Mansfield, CEO of Vanguard Medica (Guildford, UK) has, however, emphasized the point that consolidation only makes sense if there is real synergy.

If we turn to the experience of the big pharmaceutical houses, the failure of the proposed mergers of American Home Products (Madison, NJ) and Monsanto (St. Louis, MO), and Glaxo Wellcome (London) and SmithKline Beecham (London) at the start of 1998 emphasizes the fact that there has to be a meeting of minds at management level, or the partnership will collapse. Indeed, particularly in the biotech sector where the core assets are people, the so-called soft issues are paramount.

The way forward

Lack of support by the capital markets has been illustrated most starkly by the lack of positive reaction to positive news flow. Such anti-biotech sentiment is a long way from the industry's heyday in the 1980s. The initial public offering by Genentech (S. San Francisco, CA) in 1980 sparked a feeding frenzy reminiscent of today's Internet IPO mania. Half an hour after the stock was floated at $35 per share, the price shot up to $88.

Another often-quoted example is that of one of the founders of Amgen, whose initial investment of $10,000 became hundreds of millions of dollars. Today it seems that the market is looking more closely at the company as a whole. To maximize financial rewards for investor risk, the market is increasingly looking for cash generative success rather than promises. Consolidation could be a means of achieving this by creating organizations able to deliver that which is demanded of them. ///