

## HEALTHY OPPORTUNITY

### Reform May Be Plus for Health Care PIPES

by Joe Gose

The passage of health care reform could foster a bullish sentiment among PIPE funds that invest in promising health care companies – at least for the next three to five years.

Despite concerns about costs and new regulations, the law is expected to give some 32 million people access to health insurance for the first time, greatly expanding the customer base for drugs, treatments and devices that small companies are working to develop today.

Moreover, the government could place emphasis on those emerging protocols if they prove to be cost-saving alternatives to hospitalization or other treatments.

Additionally, the law known as the Patient Protection and Affordable Care Act has established a pool of \$1 billion that is being made available to small biotech and pharmaceutical companies. The incentive could help these companies to better leverage PIPE dollars in these particularly volatile times.

Lastly, the act's passage provided investors with some certainty as to the direction of reform, for many months an unsettling unknown variable that hung over the market.

"You could definitely see biotech companies and medical device companies being beneficiaries of reform," said **John Chambers, managing director and head of health care investment banking for Roth Capital Partners**, which has facilitated 12 private placements to secure \$155.3 million for health care companies so far this year.

"When you look at the volume of PIPES, registered directs and financings that have been done in the life sciences, getting some certainty has clearly been a net positive," said Chambers, who is in Roth Capital's New York office.

#### Hale and Hearty Deal Flow

Indeed, companies in the health care industry have been the busiest private placement issuers in 2010, as of midway through last week. They had executed at least 137 transactions to raise \$1.6 billion, or an average of \$11.4 million per deal.

That's well in excess of the 95 placements health care companies completed in the comparable period last year during the PIPE market's depression, and it even outshines the 110 deals done in the same period in 2008 before the financial crash. The companies raised a total of \$1.2 billion and \$1.6 billion, in 2009 and 2008, respectively.

What's more, biotech and pharmaceutical issuers are outpacing all other sectors in terms of activity, according to PrivateRaise, DealFlow Media's data service.

Biotech companies have issued at least 50 private deals to raise \$808.7 million for an average placement of \$16.2 million, while pharmaceutical firms have completed 50 placements to raise \$487 million for an average of about \$10 million per deal. Meanwhile, medical equipment makers have issued at least 31 deals to raise \$245 million, or an average of \$7.9 million a transaction.

For much of the year, the brisk deal making coincided with a run-up in health care company stock prices. The Burrill Biotech Select Index, which tracks a portfolio of biotech companies with wide ranging market capitalizations, posted an 8% jump in the first quarter of 2010 before succumbing to the bears of the broad market in May.

Health care legislation gave life science companies a boost in the first quarter, according to Steven Burrill, CEO of **Burrill & Co.**, a San Francisco-based

merchant bank focused on biotech, pharmaceuticals and other health care sectors.

"While investors initially gravitated to investing in Medicaid insurers and HMOs in the wake of the passage of the health care reform bill, the prospect of adding millions of new paying patients certainly is a plus for pharma and biotech companies," Burrill wrote in a monthly commentary.

#### Bill Benefits

Issuers and investors will soon look to leverage some of the \$1 billion available in tax credits and grants available to pharmaceutical and biotech companies under the new law, Chambers said.

Under the plan, the government will pay for 50% of costs associated with qualifying therapeutic discovery projects in 2009 and 2010, although the benefit will max out at \$5 million per company to ensure that it is spread among a broad number of firms.

The incentive, which will be rewarded on a competitive basis, is only open to companies with 250 or fewer workers and may not go toward salaries for highly paid employees, interest expenses or facility rental, among other restrictions.

Profitable companies will use the benefit as a tax credit while unprofitable firms will be able to accept the incentive as a grant. The Internal Revenue Service is expected to release the application for the tax credit by June 21 and applications will be due on July 21. Industry observers anticipate that there will be more demand than funding.

Investors could also benefit by provisions in the new law that will give biotech firms 12 years of market exclusivity for biologics after approval by the U.S. Food and Drug Administration. That should

provide comfort that investors will enjoy the fruits of their risk-taking. It generally takes about 12 years and \$1.2 billion to bring a product from the bench to commercialization, Chambers said. Along the way, 90% of the efforts fail.

“You can’t attract investors if you have a five-year [exclusivity] life,” he said. “They’ll come in for a short time, but you won’t get the long-term fundamental investors.”

### Balancing Pros and Cons

Ultimately, the health care industry largely views the number of the newly insured as an overall expansion of the market. But companies also face many unknowns as to exactly how the law will be implemented and how its costs will affect their top and bottom lines.

In particular, medical device makers will pay a 2.3% tax on sales, starting in 2013. The Medical Device Manufacturers Association has said that companies could end up owing more in taxes than they generate in profits, which could lead to layoffs and budget cuts in research and development.

Yet, while device makers are wary of the tax and expect some financial challenges, they’re hopeful that the increased customer base will more than offset the new levy.

Speaking at the Bank of America

Merrill Lynch Healthcare Conference in May, executives with diagnostic test maker **Gen-Probe** acknowledged that they would be hit with the tax but were somewhat uncertain about whether certain products would be subject to it.

On the other hand, the law will bring more people into the health care system, mandate preventative health care, require coverage for certain screenings and other measures that could benefit the company, said Michael Watts, senior director of investor relations for San Diego-based Gen-Probe.

“To what extent they help offset the tax is anybody’s guess at this point,” Watts said at the conference, which was held in New York. “Obviously, we’ll wait and see what happens there and do what we can to offset the effects of the tax in other ways.”

Other potential drawbacks include new costs such as a requirement for drug makers to provide Medicaid with a rebate of 23.1% – up from 15.1% – in order to remain in the program.

Price pressures such as those in the public sector could ultimately have a \$200 million negative impact on sales at Forest City, Calif.-based **Gilead Sciences** this year, said John Milligan, president of Gilead, at the Bank of America Merrill Lynch conference.

In fact, after the health care bill passed, the biopharmaceutical firm revised its

2010 sales projection downward to a range \$7.4 billion to \$7.5 billion from the \$7.6 billion to \$7.7 billion it had projected early in the year.

“Much of health care reform is completely uncertain at the moment,” Milligan said. But he added that some 45% of the company’s U.S. sales were through Medicaid or other public sector programs that were likely to be affected by pricing changes later this year.

Roth Capital’s Chambers suggested that in a few years, the landscape could look much different than it does today. Over that time, he anticipates that the government will begin to look at the profit margins of drug and device makers to gauge whether the companies are benefiting too richly.

If so, companies could see an additional squeeze on pricing or new taxes, Chambers said.

“But investors really aren’t focused on that right now,” he said. “They’re looking at the near-term with some certainty that there will be incremental access for more people and a focus on alternatives to keep people out of hospitals. The benefits should overwhelm anything on the negative side for the next three to five years.”

*Joe Gose may be reached at [joe@deal-flow.com](mailto:joe@deal-flow.com).*