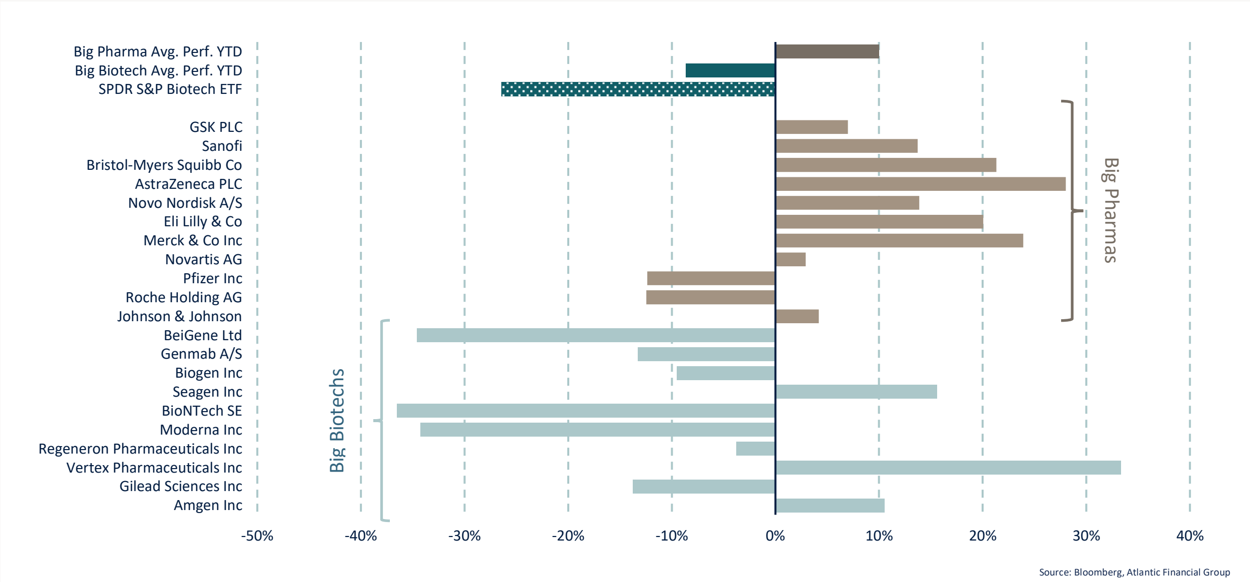
Weekly Investment Focus

18 July 2022

"BIOTECHS FOR SALE ?"

- Biotechs seem to be oversold...
- And are struggling to find new funding
- A new M&A cycle could help them to regain ground
- If the regulator allows the sector to become more concentrated

CHART OF THE WEEK: "Big Pharma vs. Biotechnology"



FINANCIAL MARKET ANALYSIS

Biotech companies depend on capital markets to finance long and risky development cycles. They are among the companies most affected by the monetary tightening initiated by the FED and **the biotech index is down -26% since the beginning of the year,** -52% since the top in August 2021 (see Chart of the week). One might wonder whether the correction has gone too far, as nearly 200 listed biotech companies are trading below the value of their cash reserves.

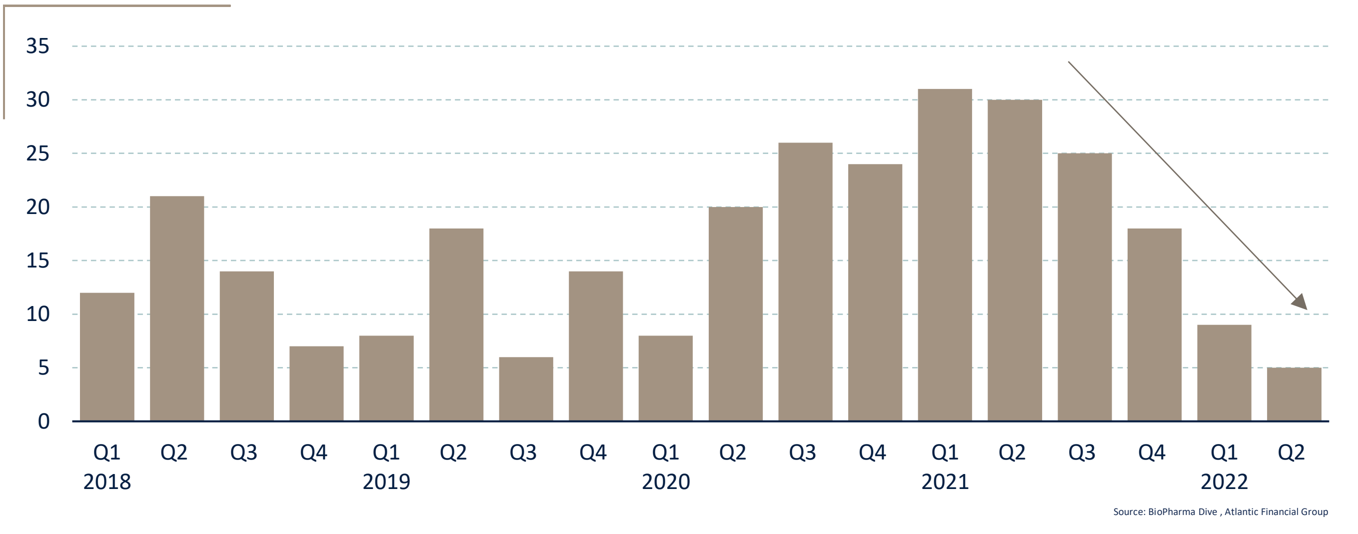
♦ Biotechs struggle to find new funding

In recent years, **biotechs have been raising new funding without too much difficulty, thanks in particular to good returns on past investments and exceptionally low interest rates.** The sector was even enjoying a certain craze due to positive underlying trends over the mid- and longer term, including:

- The growing need for treatments and therapies from **an ageing world population**;
- The increase **in innovation and technological advances** in biotechnology;
- The accelerated search for **vaccines and treatments to counter the Covid-19 pandemic**.

Since the fourth quarter of 2021, **biotechs have been facing increasing difficulties in raising financing. IPOs and secondary market capital increases are rare.** For the first half of 2022, only 14 biotech companies were listed on the US stock exchange, for a total of $4.2 billion, compared to nearly 61 companies in the same period last year, for $9.3 billion. (see Fig. 2)

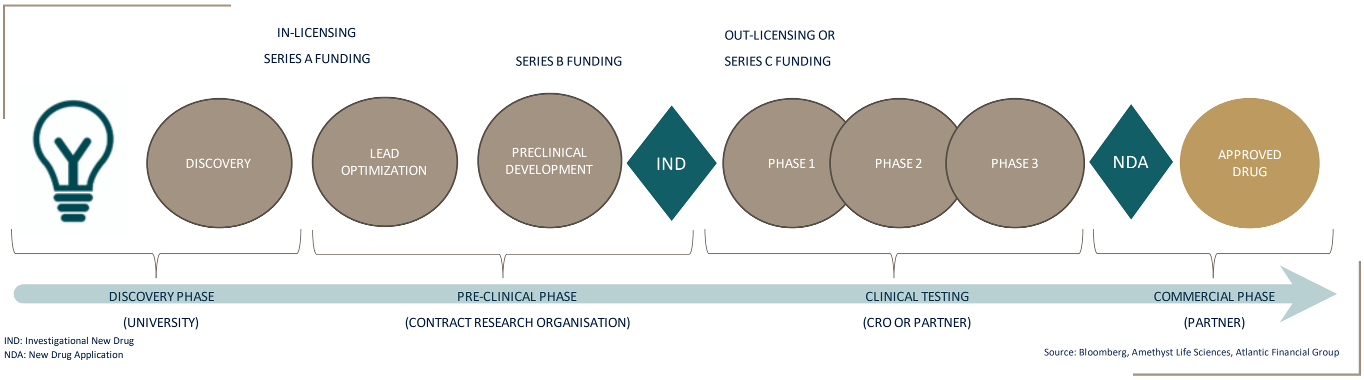
Fig. 2 - Evolution of the number of biotech companies listed since 2018



Many biotech companies have to accept much more onerous financing conditions in order to continue their R&D activities. **They often have no choice but to take out high-interest loans** or seek to **monetise future royalty fees with large pharmaceutical companies** earlier in the development process.

Of course, not all companies are in the same boat. For example, **financing is easier for companies that have good quality assets, that can generate regular news flows or that are sufficiently capitalised to reach the next de-risking event**, such as the success of a phase II study (see Fig. 3).

Fig. 3 - Drug development process

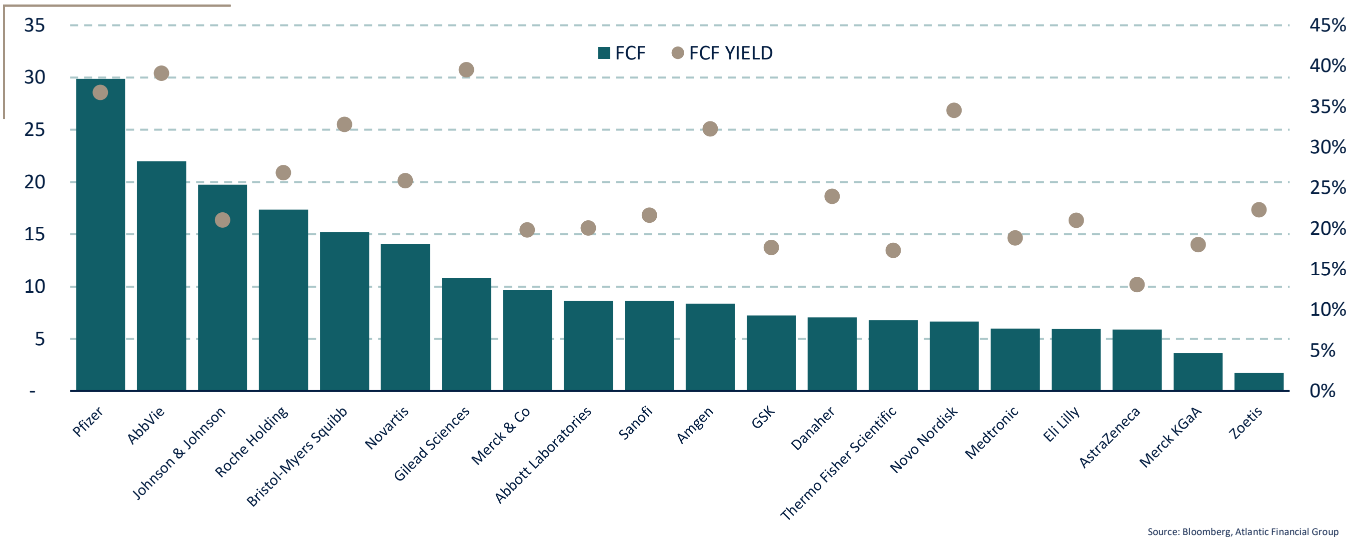


♦ A new M&A cycle could help them to regain ground

Historically, **big pharma companies make acquisitions to achieve their growth plans.** The last major announcements came in 2019 with Bristol-Myers Squibb (BMY) buying Celgene for $74bn and Abbvie (ABBV) buying Allergan for $63bn. It is very likely that future M&A deals will be smaller in size to slip through the regulatory net.

The top 20 pharma have a combined cash flow of more than $210 billion available to invest in mergers and acquisitions, thanks in part to the windfall from the coronavirus pandemic (see Fig. 4).

Fig. 4 - Free cash flow of large pharmaceutical companies



The sharp decline in biotech company valuations will not be the only criterion capable of reviving M&A activity in a sector where the number of deals in 2021 has reached its lowest level in a decade (see Fig. 5). **Most of the deals that are currently taking place are related more to promising drug pipelines,** such as those based **on messenger RNA (mRNA) or gene therapies,** rather than to rescuing cash-strapped biotech companies.

Fig. 5 - M&A transactions in the biotechnology sector

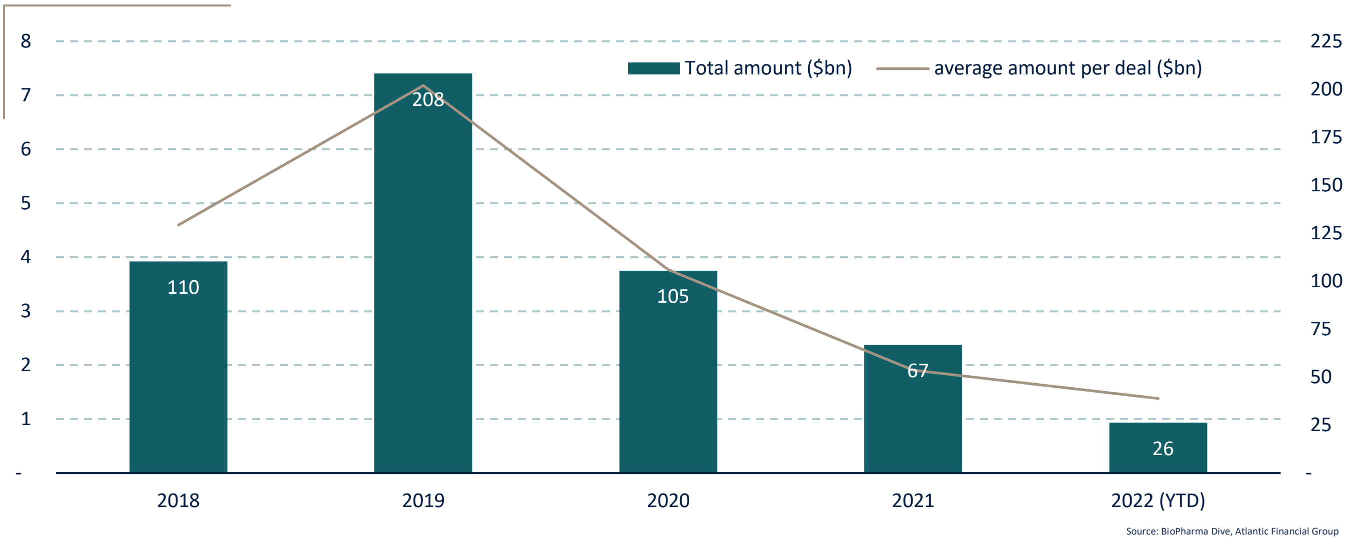
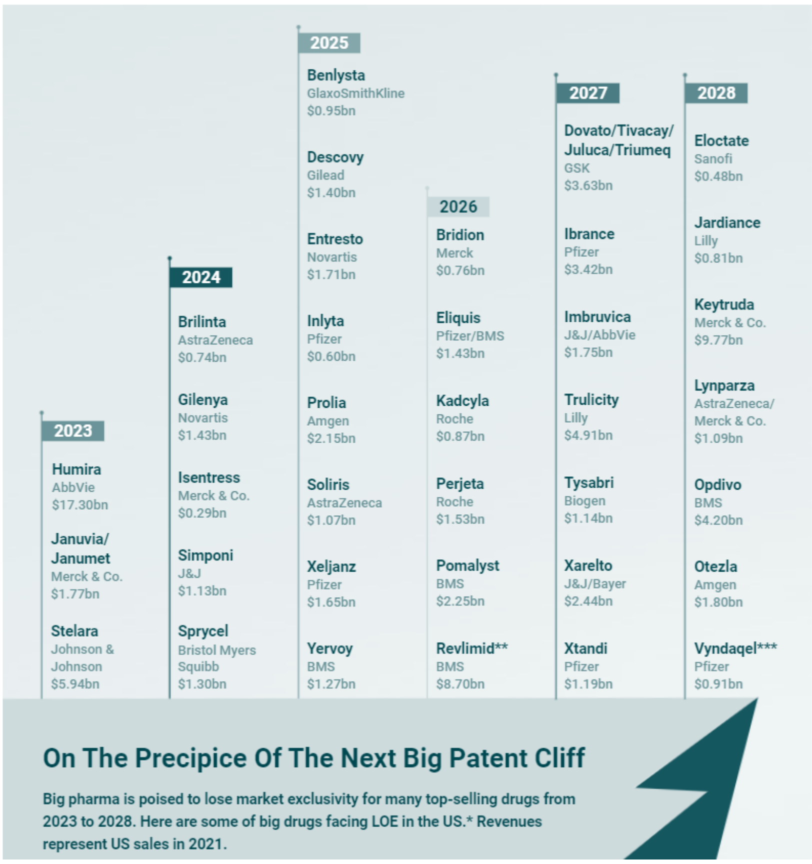


Fig. 6 - Drugs whose patents are expiring



Source: Company financial filings, patent settlement agreements, Scrip & Biomedtracker

Deals focused on new technologies are proving attractive to both large companies and investment funds. The use of mRNAs is not limited to the covid-19 vaccine and could one day help fight other viruses such as influenza, chikungunya, Ebola or HIV or diseases such as cancer.

Many of the big pharma companies, including Merck, Bristol Myers Squibb, Amgen and AbbVie, are likely to lose patent exclusivity in the coming years on top-selling drugs such as Keytruda, Opdivo, Enbrel and Humira, respectively. It is therefore the patent gap that will drive more buying as executives look for ways to compensate for expected revenue declines (see Fig. 6).

Between 2023 and 2030, pharmaceutical companies could lose more than $200 billion in revenue due to patent expiry on some of their drugs. The top ten pharmaceutical companies stand to lose more than 46% of their revenues over this period. Pfizer, Novartis, Merck, Eli Lilly and Bristol Myers Squibb will be the most affected by the loss of their patents. Roche, which has already faced biosimilar competition in 2020 for three blockbuster drugs, now looks better positioned with the launch of Lucentis (ranibizumab) biosimilars in the US later this year. Sanofi is also largely protected from losses, with its key growth driver Dupixent (dupilumab) protected in the US until 2031, with a possible patent term extension.

♦ Will the regulator allow the sector to become more concentrated?

In recent mega-transactions, regulators have been mainly concerned with overlapping products between buyers and acquisition targets, their concern being to protect innovation. The regulator's decision has been to force the acquirer to divest certain products. For example, Celgene had to sell its psoriasis drug Otezla to Amgen in order for the Federal Trade Commission (FTC) to allow its acquisition by Bristol Myers Squibb, because of a competing treatment that Bristol Myers Squibb was developing. Allergan, on the other hand, sold a digestive disorder drug, Brazikumab, in order to obtain regulatory approval for its acquisition by AbbVie. Even Roche's takeover of gene therapy biotech Spark Therapeutics was slowed by FTC concerns about overlap between the Swiss drugmaker's haemophilia drug Hemlibra and an experimental gene therapy being tested by Spark.

Antitrust scrutiny by regulators, particularly in the US, UK, Europe and Canada, has made mega-deals more difficult to achieve. Companies will have to undertake a greater number of smaller deals to achieve the same results. Otherwise, the regulator may force them to divest some profitable assets that could compete with the target assets, or vice versa.

Conclusion:

The biotech universe is vast and very diverse. The quality of the drug development portfolios and the research focus are not equally attractive. However, the performance of small caps in the sector is relatively similar, and the slightest return of investors to risky assets would bring them back to the fore.

For their part, the big pharmaceutical companies have cash to deploy and could come to market to complete their product range and face the patent cliff that threatens them from 2023. For the time being, negotiating power remains on the side of the buyers and big pharma could thus maintain its growth rate, despite the economic uncertainties, and thus strengthen its defensive attributes.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2022 Year-to-Date (%)	2021 (%)	2020 (%)
Equities							
World (MSCI)	598.7	44.94	-1.6%	-0.1%	-19.6%	19.0%	16.9%
USA (S&P 500)	3 863	49.16	-0.9%	2.0%	-18.3%	28.7%	18.4%
USA (Dow Jones)	31 288	50.36	-0.2%	2.1%	-13.0%	20.9%	9.7%
USA (Nasdaq)	11 452	50.94	-1.6%	3.2%	-26.5%	22.2%	45.0%
Euro Area (DJ EuroStoxx)	385.2	46.13	-1.1%	-2.1%	-17.3%	23.5%	0.8%
UK (FTSE 100)	7 159	47.14	-0.5%	-1.4%	-1.1%	18.4%	-11.4%
Switzerland (SMI)	10 982	51.02	-0.3%	1.8%	-12.4%	23.7%	4.3%
Japan (Nikkei)	26 788	52.75	1.0%	1.9%	-5.9%	6.7%	18.3%
Emerging (MSCI)	962	34.09	-3.7%	-4.9%	-20.4%	-2.3%	18.8%
Brasil (IBOVESPA)	96 551	32.75	-3.7%	-6.1%	-7.9%	-11.9%	2.9%
Russia (MOEX)	2 110	33.39	-4.8%	-8.4%	-43.1%	21.9%	14.8%
India (SENSEX)	54 281	51.54	-1.3%	2.4%	-6.9%	23.2%	17.2%
China (CSI)	4 285	42.32	-3.6%	0.4%	-12.6%	-3.5%	29.9%
Communication Serv. (MSCI Worl	80.72	44.43	-3.3%	-0.3%	-26.3%	10.9%	24.2%
Consumer Discret. (MSCI World)	295.4	49.32	-2.1%	1.6%	-27.5%	9.2%	37.0%
Consumer Staples (MSCI World)	261.8	51.96	-0.1%	4.8%	-8.9%	11.7%	8.8%
Energy (MSCI World)	200.8	36.70	-3.3%	-14.1%	9.1%	37.5%	-27.7%
Financials (MSCI World)	121.6	38.54	-2.7%	-2.9%	-17.5%	25.1%	-3.1%
Health Care (MSCI World)	332.3	55.55	-0.3%	7.2%	-9.1%	18.0%	15.4%
Industrials (MSCI World)	257.9	43.14	-1.4%	-1.7%	-21.3%	16.6%	11.8%
Info. Tech. (MSCI World)	415.3	51.03	-0.6%	1.7%	-27.3%	27.6%	46.2%
Materials (MSCI World)	280.0	29.00	-4.0%	-11.3%	-21.6%	15.4%	21.6%
Real Estate (MSCI World)	186.3	41.21	-1.6%	1.7%	-19.2%	23.6%	-5.7%
Utilities (MSCI World)	150.0	44.64	-0.5%	2.2%	-6.0%	11.1%	4.8%
Bonds (FTSE)							
USA (7-10 Yr)	2.92%	56.54	1.5%	4.0%	-9.3%	-2.4%	9.3%
Euro Area (7-10 Yr)	1.85%	56.23	1.1%	4.7%	-10.9%	-2.9%	4.5%
Germany (7-10 Yr)	1.15%	59.57	1.5%	4.2%	-9.2%	-2.7%	3.0%
UK (7-10 Yr)	2.09%	55.71	1.0%	2.8%	-7.3%	-4.9%	5.4%
Switzerland (7-10 Yr)	0.76%	58.72	1.0%	4.1%	-7.7%	-2.3%	0.4%
Japan (5-10 Yr)	0.24%	56.04	0.0%	0.7%	-1.1%	0.0%	-0.1%
Emerging (5-10 Yr)	8.15%	22.59	-1.8%	-3.0%	-21.8%	-2.3%	5.2%
USA (IG Corp.)	4.63%	55.01	0.5%	1.7%	-13.4%	-1.0%	9.9%
Euro Area (IG Corp.)	2.87%	56.79	0.2%	3.0%	-10.0%	-1.0%	2.8%
Emerging (IG Corp.)	8.02%	15.86	-0.9%	-2.4%	-17.6%	-3.0%	8.1%
USA (HY Corp.)	8.56%	46.82	0.1%	0.5%	-12.7%	5.3%	7.1%
Euro Area (HY Corp.)	7.68%	37.29	0.0%	-1.1%	-13.2%	3.4%	2.3%
Emerging (HY Corp.)	12.40%	12.92	-2.8%	-6.4%	-21.4%	-3.2%	4.3%
World (Convertibles)	351.3	41.89	-1.2%	-0.9%	-19.8%	2.4%	38.8%
USA (Convertibles)	471.4	45.53	-1.1%	0.3%	-20.5%	3.1%	54.5%
Euro Area (Convertibles)	3 397	44.40	0.6%	-1.9%	-17.3%	-0.3%	6.1%
Switzerland (Convertibles)	174.0	50.44	0.2%	0.9%	-6.4%	-0.5%	0.5%
Japan (Convertibles)	194.3	46.26	0.1%	-0.3%	-3.2%	3.3%	2.8%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	745	54.33	n.a.	-2.1%	n.a.	8.2%	6.4%
Distressed	966	51.71	n.a.	-2.4%	n.a.	12.5%	3.8%
Event Driven	788	49.99	n.a.	-3.6%	n.a.	12.9%	7.0%
Fixed Income	388	44.90	n.a.	-1.9%	n.a.	5.2%	3.6%
Global Macro	1443	70.41	n.a.	-3.1%	n.a.	9.6%	6.5%
Long/Short	880	45.76	n.a.	-2.8%	n.a.	8.3%	7.9%
CTA's	401	51.65	n.a.	1.1%	n.a.	8.2%	1.9%
Market Neutral	287	59.78	n.a.	-1.1%	n.a.	6.2%	1.7%
Multi-Strategy	728	56.97	n.a.	-1.8%	n.a.	7.0%	5.6%
Volatility							
VIX	24.23	40.04	-1.7%	-18.2%	40.7%	-24.3%	65.1%
VSTOXX	28.82	49.84	4.6%	-4.2%	49.6%	-17.6%	67.5%
Commodities							
Commodities (CRB)	574.4	n.a.	-1.8%	-8.1%	-0.7%	30.3%	10.5%
Gold (Troy Ounce)	1 715	27.95	-1.1%	-6.8%	-6.2%	-3.6%	25.1%
Oil (WTI, Barrel)	97.59	37.92	-6.2%	-15.4%	26.8%	58.7%	-20.5%
Oil (Brent, Barrel)	107.66	42.61	-3.4%	-11.5%	40.8%	51.4%	-23.0%
Currencies (vs USD)							
USD (Dollar Index)	107.94	67.97	-0.1%	3.1%	12.8%	6.4%	-6.7%
EUR	1.0090	32.97	0.5%	-4.0%	-11.3%	-7.5%	9.7%
JPY	138.26	34.08	-0.6%	-2.3%	-16.8%	-10.2%	5.1%
GBP	1.1886	36.15	-0.1%	-3.0%	-12.2%	-1.0%	3.1%
AUD	0.6798	42.41	1.0%	-2.2%	-6.4%	-5.6%	9.6%
CAD	1.2993	45.86	0.1%	-0.1%	-2.7%	0.7%	2.1%
CHF	0.9757	46.48	0.8%	-0.8%	-6.4%	-3.0%	9.4%
CNY	6.7469	39.06	-0.4%	-0.8%	-5.8%	2.7%	6.7%
MXN	20.464	46.86	1.3%	-1.0%	0.3%	-3.0%	-5.0%
EM (Emerging Index)	1 645.2	28.13	-0.9%	-1.5%	-5.1%	0.9%	3.3%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)

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