EXPRESS Pharma

Tapping the credit line

*Just as the Indian pharmaceutical sector looked set to bag its share of fresh funds and promoters got ready to cash out, there are pressures to 'protect' the sector. Are these justified, asks **Viveka Roychowdhury***

The Indian pharma sector seems to be the 'flavour' of the season. Not a week goes by without a buzz about a new deal. Rajeev Dalal, Partner, Life Sciences Practice, Ernst & Young points out that the proportion of private equity (PE) investment in health sciences was approximately eight percent of the total PE investment in the first half of this year (H12010). The key deals in this segment have been AIF Capital's $ 50 million investment in Famy Care and New Silk Route's $55 million investment in Nectar Lifesciences.

In volume terms, the share of PE deals in healthcare and pharma sector increased from a mere 2.9 percent in 2007 to 5.1 percent of the total deals in 2010, according to Datamonitor Indian analysts Prashant Sharma – Lead Analyst, Company Profiles - Company and Market Intelligence, and Naveen Reddy – Lead Analyst, Financial Deals - Company and Market Intelligence. No doubt this amount is still small compared to other sectors but the trend is encouraging for an industry which has had to wait on the sidelines for too long.

Analysing the quantum of fund infusion in the sector, Dr Abhishek Sharma, Vice President and Head, Life Sciences, MAPE Advisory Group says that fund infusion has also picked up so deal-sizes are also bigger. Where one frequently saw deal sizes below Rs 40 crore three years back, it is easy to find deal sizes in the range of Rs 100 crore now. This is because several early stage firms have now grown to critical sizes and also because the investor's appetite has increased. They are willing to pick up increasingly larger stakes to play for the upside, opines Sharma.

From a fund manager's perspective, Darius Pandole, Partner - New Silk Route (NSR) says that when evaluating investment opportunities, NSR would examine various critical parameters which would include the quality of the promoters and management, the sustainability and scalability of the target's business model, overall industry structure and dynamics, risk factors, deal terms providing minority investor protection and most importantly a pathway towards eventual exit. Though NSR's typical investment horizon is three– five years, the firm has an ability to take an even longer term view. "The critical goal, he emphasises, "is to create optimal shareholder value during this investment period." The time horizon is dictated by a variety of factors such as the maturity of the investee company at the time of investment, the ability of the management to achieve scale effectively, general market conditions facilitating an exit, an ability to attract potential strategic investors that may be looking for target acquisitions, etc. NSR has invested $55 million in Nectar Lifesciences. The fund's current exposure to the biopharma sector is less than 10 percent.

The very nature of investing in lifesciences projects entails high risks across all the project related phases, point out the Datamonitor analysts. Funds investing in the lifesciences sector need to have deep domain knowledge to evaluate the fundamentals of potential investment targets. That was one of the main reasons why the sector was ignored by most investors until recently. Pundole says that a deep technical diligence and a R&D capability analysis would need to be undertaken to ascertain parameters like their ability to pass stringent regulatory examination, such as procuring FDA approvals, etc., which require considerable training and preparation, and without which a company cannot sell into the lucrative regulated markets.

Ripe for the picking

"Though NSR's typical investment horizon is three– five years, the firm has an ability to take an even longer term view. The critical goal is to create

Dalal credits the recent heightened interest to the relative resiliency shown by the Indian health sciences sector during the slowdown in 2009. Dr Ajit Dangi, President & CEO, Danssen Consulting also points out that, "R&D pipelines drying up and cost of discovery research ballooning, MNCs with surplus funds are looking at acquisition targets in emerging markets like India very actively. Indian companies with US / EU FDA approved manufacturing facilities , good ANDA / DMF / FTF pipelines and good share in regulated as well as domestic market are

optimal shareholder value during this investment period"

- Darius Pandole
Partner
New Silk Route

"The relative resiliency shown by the Indian health sciences sector during the slowdown in 2009 has increased its attractiveness for strategic as well as PE investors"

- Rajeev Dalal
Partner
Life Sciences Practice,
Ernst & Young

"DIPP`s suggestion of restricting automatic approval of FDI in Pharma Industry is a knee jerk reaction and is ill conceived"

- Dr. Ajit Dangi
President & CEO
Danssen Consulting

"We believe that the new takeover regulations will make M&A tougher and more expensive in Pharmaceuticals. Pharma companies are usually majority or significantly held by promoters. In the current scenario, no other block apart from promoter is likely to hold a block big enough to trigger the open offer. Given that, the promoter becomes key deciding factor in whether to accept or reject the offer. Secondly, the 100 percent compulsory offer clause ensures that only the biggest players will have deep enough pockets to venture into M&A of listed entities"

- Dr Abhishek Sharma
Vice President and Head
Life Sciences, MAPE Advisory Group

likely to be prospective targets. As the healthcare burden of most developed countries is increasing due to increased life expectancy and paucity of funds in a battered economy, the share of generic medicines globally is likely to accelerate where Indian companies have competitive advantage. This is one more reason for increased M& A s, alliances and JVs with Indian companies."

This has increased the visibility of pharma sector as far as M&As are concerned with several blockbuster deals (especially inbound) taking place in this sector recently, like Abbott's acquisition of domestic formulations business of Piramal Healthcare, Hospira's acquisition of generic injectibles business of Orchid Chemicals, says Dalal. Drug sales in India are forecast by several sources to approach $50 billion by 2020, which would put the country among the top five markets globally, says Dr Milind Antani, of Nishith Desai Associates, which is good enough reason for MNCs to flock to India.

More importantly, as Sharma says, besides being firmly entrenched as a key provider for the global need for high quality low cost medicines, new local players in India have come up with differentiated models which distinguish them from competition. As a result, he reasons that the Indian life-sciences sector has shed its image of old-economy family-run businesses with growth in several companies beating their counterparts from other sectors.

Compared to other sectors, Sharma opines that the Indian life-sciences sector provides an investor with defensive characteristics and high growth metrics. It provides a play on domestic consumption which is a favourite with several funds. Interest in several sub-sectors like Domestic Pharmaceuticals, Contract Manufacturing and Diagnostics has also picked up considerably. He points out that there have been successful IPOs in companies across various sectors which provide good exit options for the funds. The share of PE investments has certainly gone up as far more funds and company promoters now looking at the sector. MAPE Advisory Group expects this trend to continue with several interesting high growth companies reaching the stage where they will require PE funding.

Vikram Gupta, COO, IndiaVenture Advisors also points out that a large number of entrepreneurs have entered into this sector because pharma and healthcare are considered as safe and recession proof, especially after the slowdown.

The Datamonitor analysts too agree that this is a good time for Indian companies which are looking to unlock value from their branded generic business. The companies that in the past aggressively pursued outbound acquisitions, and are now facing increased debt obligations and competition on domestic and foreign turfs, may look out for exit options. Sun Pharma, Wockhardt could be such cases. Similarly, the companies with large generic businesses may look at selling them. Lupin, Torrent Pharma, Cadila Healthcare, Aurobindo Pharma, Glenmark Pharma, Divis Laboratories: all of them have substantial generic businesses, they point out.

The early investors in the pharma space, like ICICI Ventures, are already booking profits from their investments in this space. The Datamonitor analysts point out that the fund has made a significant return, almost three times their investment, on the sale of Vetnex Animal Health to Pfizer Animal Health. Sharma too points out that ICICI Ventures had been investing in pharma since 2006 and hence, a lot of their investments are now maturing and its only natural for them to prepare for an exit for some of these investments.

Another PE firm, ChrysCapital, which made its first investment in the pharma sector by acquiring ICICI Ventures' 12.5 percent in Ahmedabad-based Intas Biopharma for $11 million in January 2006, will be selling part of its stakes in an IPO expected around May 2011. So also, Actis Advisors and Sequoia Capital India Advisors, two PE firms which together own 70 percent of OTC and personal healthcare major Paras Pharma, are looking to sell out to book their profits. Sequoia Capital India is also in the process of selling part of its stake in Dr Lal PathLabs, to US-based PE firm TA Associates Inc. inorder to book some profits.

While SEBI aims to put the market on TRAC ...

In the midst of this capital churn, the Securities and Exchange Board of India (SEBI)'s Achuthan Committee on Takeover Regulations has proposed some changes, which according to Gupta, will make the markets more investor friendly and transparent. Dr Milind Antani, of Nishith Desai Associates, which specialises in providing strategic legal and business solutions during M&As, PE & VC investments and fund formation, adds that the Takeover Regulation Advisory Committee (TRAC), has attempted to simplify the Takeover Code and align it with the international best practices.

Gupta says that under the new guidelines, open offers would require 25 percent ownership (instead of 15 percent as per the earlier guidelines) and also need to be issued for the entire 100 percent equity of the target company, instead of the 20 percent required earlier. Creeping acquisitions would now be limited to five percent annually, but only after 25 percent initial ownership. Open offer requirements may include indirect ownership of any kind that could provide de facto control of the target company. His view is that the key intention behind the new regulations is to improve corporate governance in M&A and private investments. The new code will increase market activity and benefit all parties involved, provide a transparent and investor-friendly regulatory structure for acquisitions. This is expected have a positive effect on the overall Healthcare and Life Sciences industry. Pharma and biotechnology sector could witness better norms, pricing and time lines, he predicts.

About its impact on the deal environment, Antani says, "Since major players in the pharma and biotech sectors are large multinationals, the PE investors could get higher headroom to acquire stake in a listed company since the TRAC recommends that a stake up to 24.99 percent could be acquired without triggering an open offer. This could result in more Private Investment in Public Enterprises (PIPE) transactions."

Dalal opines that a 25 percent stake would be an ideal size for PE investors in mid cap companies since PE investors holding upto 25 percent may exercise significant voting rights on account of the multiplier effect caused by absenteeism at general meetings and thereby may exercise "shadow control" on the management by blocking special resolutions.

Sharma of MAPE Advisory Group, focuses on the flip side of the recommendations saying, "The new takeover regulations will make M&A tougher and more expensive in the pharma sector. Pharma companies are usually majority or significantly held by promoters. In the current scenario, no other block apart from the promoter is likely to hold a block big enough to trigger the open offer. Given that, the promoter becomes a key deciding factor in whether to accept or reject the offer. Secondly, the 100 percent compulsory offer clause ensures that only the biggest players will have deep enough pockets to venture into M&A of listed entities."

"While DIPP's concern about the impact on price increase seems to be justified, it cannot be generalised across the entire range of drugs"

- Vikram Gupta
COO
IndiaVenture Advisors

While allowing that the recommendations made by the TRAC on M&A could have far reaching consequences, Dangi points out that "to get the full impact of this reform all other regulators and stake holders such as SEBI, RBI , Banks etc. will have to work in a concerted manner. Since foreign companies have easy access to capital unlike domestic promoters, there is also a possibility of increased de-listing of companies resulting in India Inc`s market cap going down. Overall the recommendations are fairly well balanced from the perspective of all the stakeholders."

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- Dr Milind Antani
Head-Pharma LifeSciences group,
Nishith Desai Associates

But DIPP may pull pharma off track...

In fact, the declining market share of Indian pharma companies thanks to recent takeovers has resulted in the Department of Industrial Policy and Promotion (DIPP) proposing that the pharma industry be taken off the list of sectors where foreign direct investment (FDI) is allowed automatically. This would mean that all M&A proposals involving the sector will have to be vetted by the Foreign Investment Promotion Board (FIPB), which clears foreign investment proposals. The Datamonitor analysts admit this could result in some slow down in foreign PE and VC funds investments in India.

"There could be some slow down in foreign PE and VC funds investments in India, if such investments are brought under the purview of FIPB"

Gupta reasons that there is a fear that such M&As would have a direct or indirect impact on the pricing of drugs in India as foreign companies have

acquired these stakes in domestic companies at very high prices and they would want to recover their investment by increasing the prices of the drugs wherever possible. Secondly, he points out that foreign companies typically have higher costs of R&D and marketing in their respective countries and they may want to recover these costs through increased prices in India. Lastly, in certain cases, foreign companies may end up in a monopolistic situations and that may lead to increased pricing of those drugs.

- Prashant Sharma
Lead Analyst
Company Profiles - Company and Market Intelligence
Datamonitor India

"There could be some slow down in foreign PE and VC funds investments in India, if such investments are brought under the purview of FIPB"

- Naveen Reddy
Lead Analyst
Financial Deals - Company and Market Intelligence
Datamonitor India

Dangi minces no words when he calls DIPP`s suggestion "a knee jerk reaction and ill conceived." According to him, "The fear of medicine prices going up due to foreign takeover of Indian companies is ill founded and is akin to the fear of Indian companies getting wiped out after the product patent regime came into force. No such thing happened and instead Indian companies started investing heavily in R&D and in few years time many new drugs will start trickling from Indian R&D stables igniting the innovative spirit of Indian entrepreneurs.

Countering the DIPP's contention of escalating prices of medicines, Dangi points out, "Most MNCs have now realised that aggressive pricing in emerging markets does not work. It only delays market penetration. More and more MNCs therefore are adopting country specific pricing. With intense competition, regulations like DPCO and pricing authorities like NPPA in place, the fear of medicine prices going up is misplaced." More important that price is "access to medicines which can only be improved by improving health infrastructure, expanding health insurance, reducing transaction costs and enhancing tax incentives etc." advocates Dangi.

While Gupta allows that DIPP's concern about the impact on price increase seems to be justified, he reasons that it cannot be generalised across the entire range of drugs. There are two important aspects to consider. Firstly, the ultimate economics will work on the overall demand supply situation and unless the sellers are able to recover their costs they may not be incentivised to sell the drugs under price control and secondly, while the competition for generic drugs is only increasing, there is a need to bring in more innovation driven therapies that can be brought primarily through globalisation of the pharma industry. As new disease areas are being discovered, innovative and target therapies will be the way to address serious illnesses, says Gupta.

As the Datamonitor analysts comment, under tough fund raising situations, companies are also exploring a greater pie offerings to investors in terms of share in future royalty payments or share in revenues from particular geographic segment. Recently, Glenmark's US subsidiary Glenmark Pharmaceuticals Inc entered into a unique royalty deal with US based Paul Capital Partners' royalty fund, Paul Royalty, an international healthcare investment fund. While one cannot fault the Indian government for sticking to its brief to look at the greater good, it merely means that companies will need to devise innovative means to grab their share of the pie. Balancing profits and serving healthcare needs from the patient perspective and proving this responsibility was never an easy task.

viveka.r@expressindia.com

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