ALTERNATIVES WATCH

Headwinds and opportunities in biopharma

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Although the biopharmaceutical sector is facing major headwinds due to a tough regulatory and political environment, COVID, inflation, rising interest rates, geopolitical stability, overcapitalized innovation, poor managerial execution, and more, I believe the biopharmaceutical sector offers investment opportunities in a select number of private and public companies across all cap sizes in the U.S., EU, and Japan.

At first glance this may sound contrarian, since the sector sacrificed a decade of gains over the period extending from 2/21 through 3/22[1]. However, while the decline has been remarkable, it was not surprising for several reasons. First, we believe that the huge inflows of capital that flooded into late-stage private company crossovers[2], IPOs[3] and public companies of all sizes (as seen by the rapid rise of the XBI from February 2021 to June 2022), dramatically inflated many valuations to inappropriate levels. Second, many of these companies were poorly managed. The impact of inadequate leadership should not be underestimated, for it directly correlates with failures to meet timelines and to navigate through strenuous regulatory pressures and the unique challenges presented by the pandemic.

Since its peak in early 2021, the biopharma sector has given back all its outperformance versus the SPX over the last decade. There are approximately 730 biopharmaceutical companies in the U.S. + EU + Japan with a market cap of $100MM+ and there are an estimated 500-700 private biotec companies U.S., EU and Japan[1]. I believe the biopharma sector is overcapitalized. Of the 189 biotech companies that went public in 2020 and 2021, 74% did not have a first in class target or a novel platform1. Unsurprisingly, companies with a first in class target or novel platform and human data performed the best whereas those without human data or a first in class target/novel platform performed worse. There are several reasons the sector is ripe with opportunity for active investment management:

Innovation is expanding

As scientific knowledge accelerates with AI/ML, investment opportunities abound not only in solutions to new disease targets, but also in the technology to deliver these solutions. Thematically, it is clear that the sector continues to witness unparalleled innovation from both a drug targeting and a drug platform perspective. This is apparent not just from screening private and public companies in the U.S., EU, and Japan, but also from engaging with academic centers and venture capital firms. What is remarkable is that the pace of innovation has accelerated over the last decade with no evidence it is slowing down. However, a note of caution that selective active management is key given many of these innovations will fail, take longer than many realize to materialize, will be leap-frogged, and or turn out to be me-too-s/not disruptive. The Covid-19 pandemic has also been a significant catalyst in the acceleration of innovation. The rapid development of multiple vaccines is encouraging the governments of developed countries to dramatically increase investments.

M&A activity will be a constant

We expect large companies to continue to acquire smaller breakthrough firms generally focused on pharma or biotech solutions, creating a clear economic driver for the next decade. There are concerns that rising interest rates will have a meaningful negative impact on small/mid cap biotech companies. Although interest rates are rising, they are from a level of near zero. Even if interest rates stay in a 2-4% range, rates should not present a meaningful barrier to raising money and/or for large cap companies to generate a robust return on investment from M&A. Of note, while there is some fear that the FTC is increasingly flexing its muscles in an attempt to hinder M&A in the space, based on my due diligence this is not a meaningful headwind. I believe M&A will be vibrant over the next few years.

Drug pricing is inefficient

Globally, drug pricing is unstable, but in an evolutionary phase — creating investment opportunities. Since the U.S. election, drug pricing legislation concerns have been a modest headwind/overhang for the investment community. Consistent with my due diligence, the agreed-to drug pricing legislation as part of the reconciliation package was evolutionary not revolutionary and preserves a return-on-investment for innovation. I am optimistic that this will give the drug industry a much-needed multi-year political reprieve, along with the ongoing COVID pandemic/epidemic. I expect this will help push the industry to continue its free-market evolution around drug pricing.

With the right combination of thoughtful analysis and risk management I believe there are major opportunities to invest in public and private companies with the potential not only to change the standard of care but also to generate outsized returns

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Sources:

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