Deals an evolving art

New focus on accounting standards may lead companies to revisit deal-making structures

Dealmaking in the life sciences business is accelerating and continues to evolve into new forms. The old pattern of patient, round-by-round investment in startup companies and slow development over years has not disappeared, but now shares the landscape with new ways of buying, selling, developing and financing companies, products and technologies. At the same time, new challenges have arisen that will spur further innovation in dealmaking.

In M&A, three major trends are driving Big Pharma: consolidation and acquisitions as blockbuster drugs come off patent; divestiture of non-core business products and potential products, and the boom in M&A in general and private equity in particular.

On the buy side, venture capital investment is moving up the chain and teaming with the overflow of private equity money to do bigger acquisitions, whole-company acquisitions (and not just minority investments), and to acquire the development stage molecules and technologies that bigger companies are divesting. Also, to spread risk and make bigger deals possible, private equity firms are increasingly teaming in consortiums of other private equity buyers and strategic buyers.

On the sell side, Big Pharma is increasingly divesting products and businesses that are not in core therapeutic areas. That trend, which appears to be accelerating in the United States and Europe, has created some attractive acquisition and licensing opportunities for strategic and financial investors. Through such acquisitions, smaller companies have expanded their own late-stage drug development pipelines and added additional marketed products to their portfolios. Financial investors have found these products to have potential upside with lower development risk as compared to earlier stage investing. For example, Merck KGaA has announced that it is accepting bids for the sale of its generics business, which is estimated to be worth nearly $4 billion, spurring intense interest from Big Pharma, generics companies and private equity firms alike.

As in other industries, stock option woes and increased accounting scrutiny have affected some publicly-traded life sciences companies, breeding new challenges — but also opportunities — for dealmakers.

In M&A, with creativity and careful deal structuring, companies have continued to buy, sell and merge, in some cases, even with unresolved stock option investigations and restatements.

The new focus on accounting issues may lead companies to revisit some traditional deal-making structures in life sciences collaborations as well. For example, the use of steering committees has been a standard feature of collaborations aimed at identifying, developing and commercializing new drugs. However, absent thoughtful and vigilant deal-making, the indefinite term of such steering committees may lead to unanticipated and unwanted accounting issues.

Structured finance has allowed companies to extract immediate value from future license revenues, as investors have emerged to acquire, package and re-sell royalty spreads to financial investors. In these deals, companies sell, securitize or pledge their rights in future royalties under licenses granted to third parties in exchange for cash and funding up front, thereby generating a financing alternative to venture capital, IPOs, traditional debt or licensing deals.

For 2007, all of these trends appear to be continuing, but as always, one thing is sure: more change is expected.

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