
Private equity's growing role in the generics industry

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Abstract Private equity plays an increasingly important role in a number of industries. Early-stage ('venture capital') investors have been active in the biotech industry for a long time. Most late-stage ('buyout') investors, however, have steered clear of pharmaceutical R&D and generics companies. But the reasons, a comparatively high regulatory environment and the resulting complexities, are losing their threat. In the future, one is likely to see financial investors taking a closer look at the pharmaceutical industry — and at generics opportunities in particular.

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GROWING IMPORTANCE OF THE PRIVATE EQUITY INDUSTRY

Private equity financing plays an increasingly important role in the restructuring of a number of industry sectors. US\$73bn was invested in buyout transactions globally in 2003, an increase of 61 per cent on 2002.¹ Such impressive figures are possible because in recent years, record amounts of capital have been raised globally by early-stage and late-stage private equity firms: almost US\$400bn during the last 48 months. The large majority of this capital is provided by institutional investors, mostly pension funds, insurance companies and asset management firms. Given the long lifetime of funds, typically 10–12 years, this capital is waiting to be invested and funds are tightly competing for attractive investment opportunities. Obviously, private equity plays a very different role in financing than debt and mezzanine capital: equity investors are drivers of merger and acquisition (M&A) activity and are directly

competing with strategic investors for opportunities. Private equity firms accounted for as much as 25 per cent of the European M&A market in 2004² — ten years ago, this figure was well below 5 per cent.

There are a number of myths about the private equity industry, especially in the less mature markets outside the USA. The truth is:

- Private equity investing requires a long-term horizon. Historically, the major part of a successful fund manager's total compensation results from successful exits during the last few years of the fund's lifetime (so-called 'carried interest' or 'carry').
- Investors in private equity funds are not keen on capital gains created from making and exiting investments within short timeframes as the free capital needs to be invested in other attractive opportunities. Investors in private equity funds also realise that high returns over short investment periods

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will have been achieved by exposing the capital to meaningful risk: as private equity firms are keen on raising additional funds they will try to avoid any doubt that they are not diligently pursuing their fiduciary duty.

- Late-stage private equity investors tend to be especially risk-averse. From their perspective, a business acquisition and the development of the sector carry enough risk given overall return expectations of investors that exceed 15–20 per cent annually, depending on the investment focus and geography. Consequently, they are not prepared to invest in unproven business models, management teams without a very powerful track record or non-validated products in development.

Private equity investors not only acquire participations in companies, but also play an active role in developing them, usually through board positions. While some private equity investors certainly oversell their capabilities to grow small companies into large ones, experienced investors can add substantial value. Their equity ownership allows them to take crucial strategic decisions in portfolio companies such as acquiring businesses or ownership decisions such as floating the company or selling all or parts of it.

BUYOUT FIRMS' CAUTIOUS ATTITUDE TOWARDS PHARMA

Criteria for private equity investments concern the upside potential and the downside risk of an investment. Put simply, typical factors indicating upside potential are a generally favourable macro-trend that will ensure demand for the company's goods or services, a proven management team and some unique offering or market niche that protects a company's profitability from

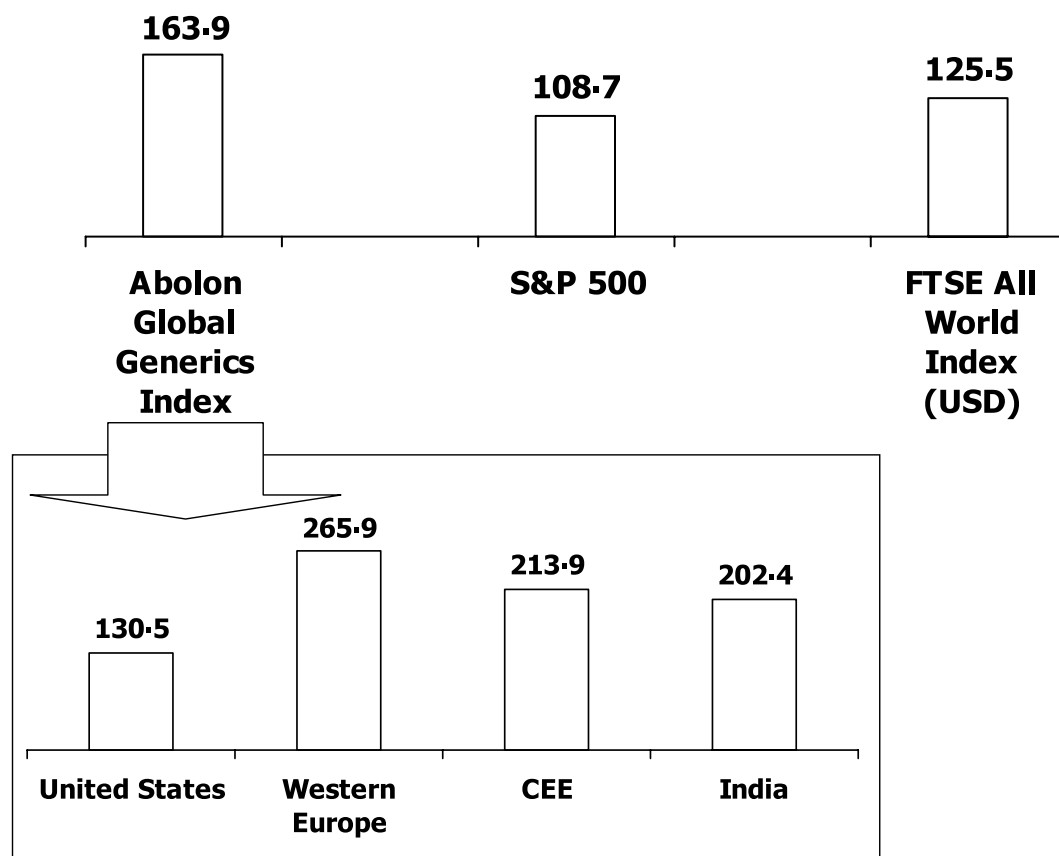
excessive competition. Downside risks heatedly discussed at private equity firms are geographies with unstable political situations; temporarily high, though unsustainable, profitability; and excessive dependence on the goodwill of external parties, eg regulatory authorities.

For most buyout firms, the downside risk of the pharmaceutical industry historically seemed to outweigh the upside potential: buyout investors are extremely wary that pharmaceutical products may be forced off the market by regulatory bodies and that reimbursement levels may be arbitrarily reduced during the next round of healthcare reforms. Merck's and Pfizer's recent withdrawals of their COX-2 inhibitors and reference pricing schemes negatively impacting prices even for patent-protected drugs in Europe seem to prove the point. As a consequence, comparatively few buyout investors, though intrigued by the prospect of years of patent protection for approved products, have dared to invest in pharma businesses. Recent examples are the acquisitions of Nycomed by CSFB and Blackstone and of Warner Chilcott by a syndicate including JP Morgan and Bain Capital. Also, prices that have been paid for pharma businesses by strategic buyers, which have been steadily increasing, seem to make it difficult for private equity firms to achieve the returns their institutional investors expect.

As a consequence, private equity investment in R&D-based pharma and generics businesses has been underrepresented by comparison with other sectors.

INCREASING ATTRACTIVENESS OF GENERICS ASSETS

The first question for a late-stage investor is whether equity investors in generics companies have achieved superior returns



Source: Bloomberg, Abolon

Figure 1: Three-year performance of equity indices as of 17th February, 2005 (17th February, 2002 = 100 per cent)

Source: Bloomberg, Abolon

CEE, Central and Eastern Europe

before. The Abolon Global Generics Index³ has, on average, outperformed the FTSE All World Index by 10.1 per cent and the S&P 500 by 15.1 per cent annually during the last three years in spite of recent declines in the US generics stocks (Figure 1). Share price appreciation (outside the USA) is extraordinary and has been driven by governments' increasing support for cheaper solutions in healthcare (Western Europe), strongly growing economies and companies' efficiency improvements (Central and Eastern Europe [CEE]) and the potential to play a potentially dominating role in the global generics industry going forward based on extraordinary cost advantages (India).

There are few examples of publicly known returns from investments of private equity funds in generics companies. Examples of extraordinary returns are Zentiva and Sabex, two cases that will be examined in more detail. Another example is the growth investment made by two US family investment offices in UK Generics, which was sold to Merck KGaA in 1994 and constitutes a major part of Merck's generics operations today.

Besides past returns, private equity investors are also intrigued by the generics industry's limited R&D exposure; but, historically, most of them felt that this limited R&D risk did not compensate for the lack of intellectual property (IP)

protection, the difficulty of differentiating international non-proprietary name (INN) and branded generics from competition in comparison to innovative drugs and the uncertainty from cost containment measures imposed by public authorities.

Little has changed around the lack of IP protection and the difficulty differentiating generics products. The investment community has been surprised by the ability of generics players to sustain high margins and market share, however, eg in most of Western and Eastern Europe, proving that their business model actually works. Investors are also taking note of the rapidly increasing consolidation currently taking place — investing in the resulting entities would allow the increasingly large buyout funds to ‘put meaningful money to work’. Many hope that future valuations for pharma businesses will provide more reasonable price levels to justify investments.

Most importantly, the private equity market has dramatically changed: the funds raised during the past years hardly find enough attractive opportunities to invest in. As a consequence, valuations across sectors are competed upwards. Supported by historically low interest rates, banks are prepared to provide debt financing at record (high) EBITDA (earnings before interest, tax, depreciation and amortisation) multiples for lucrative private equity mandates. Private equity firms strategies for coping with the limited supply of deals are few as, in the end, they compete based on capital: ‘A dollar from Fund A looks very much the same as a dollar from Fund B’, as a fund manager admits behind closed doors. The most common strategy is to emphasise to potential portfolio companies the fund managers’ sector expertise and to prove their superior capabilities in supporting management and building leading companies by referring to previous investments. As a second strategy, funds have been seen re-disbursing capital to their institutional investors or combining

forces to do mega-deals that encounter little competition from individual funds or strategic buyers.

A third strategy is to broaden the scope of the fund’s investment strategy into sectors or deal types with less competition — and healthcare falls into this group due to its comparably high degree of regulation. During the past years, a number of buyout groups have made their first healthcare investments ever, often in the hospital or nursing home sector. In Europe, for example, BC Partners acquired General Healthcare Group and Hirslanden Klinken in 2000 and 2002, respectively; Alchemy sold its first hospital investment, UK-based Four Seasons group, to another first-time healthcare investor, Allianz Capital Partners, in 2004; Blackstone acquired Southern Cross, its first wholly owned healthcare investment in Europe, in 2004.⁴ More recently, Cinven acquired specialist mental healthcare provider Partnerships in Care. Other private equity firms entered the healthcare space in areas promising shorter product development times than R&D pharma: Triton and PPM Ventures acquired Pharmacia Diagnostics in Sweden in 2003.

Those transactions and several attractive exit valuations increase the comfort level of buyout investors with the healthcare sector and may well serve as a first step towards pharmaceuticals investments; it is not surprising that more and more funds are taking an active look at pharma opportunities coming to market. Roche’s over-the-counter (OTC) business received strong interest from numerous buyout investors that had no previous exposure to the OTC market and were negatively surprised when they were outbid by strategic acquirer Bayer.

The generics industry has seen limited involvement from private equity investors to date (Table 1): interesting investments in Europe were Warburg Pincus’s investment in Zentiva (previously Leciva),

Table 1: Private equity firm's majority investments in generics companies

Private equity investor	Investment	Country	Year of investment	Year of exit	Form of exit
GTCR	GeneraMedix	USA	2004	–	NA
3i	betapharm	Germany	2004	–	NA
Advent International	Terapia	Romania	2003	–	NA
RoundTable Healthcare Partners	Sabex	Canada	2002	2004	Sale to Novartis/Sandoz
Advent International	Fada Pharma	Argentina	2001	–	NA
Advent International	Alcalá Farma	Spain	1999	2003	Sale of generics division to Pliva and of branded products division to Chiesi
Warburg Pincus	Zentiva (formerly Leciva)	Czech Republic	1998	2004 (partial)	IPO

Advent International's investment in Terapia and 3i's recent acquisition of betapharm. In North America, RoundTable Healthcare Partners' investment in Sabex has been in the headlines because of its remarkable exit valuation. This paper will look more closely at two of these investments in the European and North American generics industry both have been enormously successful and exemplify the full cycle from investment to exit. They provide some insight into how private equity investors help portfolio companies grow and create meaningful value.

CASE 1: ZENTIVA (CZECH REPUBLIC)

Warburg Pincus acquired a 66.6 per cent participation of Czech-branded generics company Leciva held by the Czech government's privatisation authority⁵ in a management buy-out in 1998, a time when the CEE region was regarded as risky by most investors owing to potential political and economic instability. Leciva was the leading pharmaceutical company in the Czech Republic, with a strong position in the Slovakian market that was dominated by local competitor Slovakofarma at that time.

The management team, comprising Czech nationals at that time, had approached a number of Western private

equity firms to help complete the privatisation. In spite of good manufacturing practice (GMP)-approved manufacturing facilities and reasonable margins as a result of the company's competitive cost structure, potential investors were hesitant — it was unclear how far the basic conditions for a successful private equity investment were fulfilled in this case: was the CEE region sufficiently stable to allow pharmaceutical companies to generate sustainable profits? How could market share declines of this previously quasi-monopolist business be stopped and could margins be sustained or even increased to Western pharma levels? Did the past activities of Leciva's talented and ambitious management team live up to the private equity industry's requirements for an 'impressive track record'? The so-called 'golden share' — through which the privatisation authority retained a veto right on important decisions — was certainly deeply worrying for Western investors.

Warburg Pincus won the auction process as the firm was prepared to comply with the government's and management's preference for an unleveraged equity investment and invested a total of \$125m of equity including subsequent tender offers.⁶ In addition to their existing shareholdings, management received a generous option package in order to align

interest with investors and to make sure they were not hesitant once attractive exit opportunities arose.

In retrospect, none of the original concerns came true: the Czech government proved one of the most reliable in the CEE region, keeping reimbursement rates high and not complicating the company's strategic initiatives through the rights of the golden share. Under the leadership of Jiri Michal, the company's banker-type CEO with his origins in production, management was very open to the investors' input which was based on long years of working with pharmaceutical companies internationally. More than anything else, the board members focused management attention on products when discussing financials, processes and capabilities, having seen insufficient product focus in many emerging market pharma businesses. Additional and more effective products were developed internally rather than licensed in and distributed as had been Leciva's business focus in the past. As a consequence, the company's gross margin increased substantially from 39.3 per cent in 1999 to 59.8 per cent in 2003. At the same time, management made the business grow at impressive double-digit rates. By selectively introducing international management candidates, the financial investors were also instrumental in supporting Michal's ambitions to build a highly performing management team. In 2003, Leciva managed to regain market share in the Czech Republic for certain product classes although its market share had still been above 50 per cent of prescriptions at that time.⁷ Competitors admitted that Leciva had become the local benchmark for marketing effectiveness in its core countries.⁸

Opportunistic participation in the consolidation expected in the fragmented CEE pharmaceutical industry ('buy-and-build' strategy) had been part of the

investment thesis shared by Leciva management and the Warburg Pincus board members. Four years after Warburg Pincus's investment in the company, Jiri Michal and Ondrej Gattnar, Slovakofarma's CEO, agreed that a combination of both companies would be beneficial to all owners. In extensive negotiations with Slovakofarma's management-owners, Michal and the Warburg Pincus board members negotiated the acquisition of a 69.3 per cent interest in Slovakofarma. Following a public offering to Slovakofarma's minority shareholders, Leciva's holding in Slovakofarma increased to 85 per cent. The combined operations were renamed Zentiva to highlight the new company's ambition to play a meaningful role in the CEE pharmaceutical market. Exploiting scale effects and applying Leciva's proven marketing effectiveness makes Zentiva the most profitable public generics company in Europe.⁹ After achieving pro-forma sales of \$369m in 2003,¹⁰ Zentiva went public on the Prague stock exchange on 28th June, 2004. Investors were intrigued by the growth potential of the CEE region and Zentiva's profitability: the offering was five times oversubscribed.

After \$125m pre-initial public offering (IPO) dividends, Warburg Pincus received \$85m of proceeds on the Zentiva IPO. After a 2004 dividend payment and the 86 per cent appreciation of the Zentiva share price by the first anniversary of the IPO, Warburg Pincus's investment is worth more than \$950m, implying a multiple of almost eight times the firm's original investment in the company.

Warburg Pincus' investment in Zentiva differs substantially from the following case, Sabex, in that the original investment was a financially unleveraged privatisation of a generics business with a locally dominant position in what was perceived as a risky geography at the time of the investment and in that a major acquisition

played an important role in growing the company and its value ('buy-and-build strategy') before the exit.

CASE 2: SABEX (CANADA)

RoundTable Healthcare Partners' investment in Canadian generic injectables company Sabex is an example of how investor turned industry executives have helped create superior value in portfolio companies. RoundTable had held the final closing of their first fund in March 2002, one month before the Sabex investment. RoundTable was founded by a group of individuals who had previously worked together at Baxter. For Baxter, they had negotiated distribution agreements with specialty pharma businesses and selectively considered acquiring them. One of these was Sabex in Boucherville, Quebec.

Michel Saucier, who had been CEO of Sabex for 20 years, finally felt the time had come to change the ownership of the business. An auction process was initiated and Saucier invited the RoundTable investors, who had stayed in touch with him, to submit a bid. They won against offers implying higher valuations because RoundTable enabled Saucier to retain a minority stake and to implement his long-term vision of expanding Sabex into the lucrative US market.

Saucier made sure the investors understood he wanted to step down as CEO as soon as a capable successor was found. Before signing the transaction, RoundTable partner and chairman-to-be Jack McGinley introduced to Saucier Pierre Fréchette, one of his former reports at Baxter, who was subsequently hired as Sabex's new CEO contingent on the successful closure of the transaction.

In a leveraged buyout transaction, RoundTable acquired a majority stake in Sabex, buying shares from Sabex's founder and increasing the company's capital to finance its growth. A stock option

programme was set up for management, putting as much as 10 per cent of the company's value in management's hands.

The core of the investment thesis was to expand manufacturing capacity for liquid dosage forms and to ensure growing demand for the company's high-quality products was met, to acquire additional products that were difficult to manufacture and to build a strong presence in the large and lucrative US market. Fréchette remembers: 'At Baxter, I had presented budgets to the individuals on Sabex's board before and I always ended cutting the capital investment budget in those days. During the first budget meeting, the discussion turned out differently. The debate was about how much more manufacturing capacity was needed than I had planned as everybody was convinced that we should increase capacity massively.'

Fréchette felt the investors offered broad experience without overmanaging. Chairman McGinley himself re-negotiated the distribution agreement with Baxter and helped acquire new injectable products. RoundTable was also instrumental in identifying and selecting the individuals for newly-incorporated Sabex US who turned out to be a brilliant team. As a result, the company grew rapidly month by month. Sooner than planned, the acquisition debt was paid down from operating cash flow and the board started to consider refinancing the company to take out part of the original investment as a dividend. McGinley remembers the board never discussed any corporate acquisitions as the strategy seemed so clear and straight that they did not want to distract management attention.

A few months after RoundTable's investment, Fréchette was charged with approaching a number of generics companies with a presence in the USA on potential supply and licensing deals. His focus was on companies that had limited manufacturing capacity for liquid dosage forms and a potential interest in

distributing Sabex's high-margin products. He also made sure to leave the message that Sabex was not for sale now, but might be after a couple of years.

Sabex had remained on the short list as a potential target for a number of strategic partners. One of these was Novartis's generics division Sandoz. Its US team had secured backing from Novartis for entering negotiations with RoundTable on the acquisition of the company. They were intrigued by Sabex's very profitable and rapidly growing injectables business with its high barriers to entry and substantial capacity reserves for liquid dosage form production that would otherwise have taken a long time to install and get approved by US, European and Canadian authorities. Sandoz realised that these capacity reserves and the broad range of products in Sabex's pipeline justified a very meaningful sales multiple.

Ultimately, Sabex was sold for \$565m or six times sales of almost \$90m in fiscal year 2003/2004, resulting in a multiple of 8.2 times RoundTable's original investment after an investment period of only 26 months. Unsurprisingly, such results trigger internal discussions at other private equity funds about taking a closer look at the generics industry going forward.

OUTLOOK

Private equity investors will continue to shy away from situations where valuations are perceived as excessive: owing to synergy effects, strategic buyers will be able to outbid financial investors, especially as long as their own valuations provide them with strong 'currencies' that make acquisitions earnings-accretive even at high profitability multiples. But spectacular cases like Zentiva and Sabex provide the precedent buyout investors need before considering investments in a sector. CEE, India, China, Latin America and — though at a highly fragmented industry structure — Europe

offer a wealth of potential opportunities. The most mature market, the USA, may also see public companies go private because of ongoing earnings volatility that should make generics less attractive to potential public shareholders.

Given the desperate need for less competitive deal situations, more and more private equity investors include the generics industry — and, increasingly, the pharmaceutical industry as a whole — in their areas of strategic interest (or 'sweet spots' as the industry calls them). Sabex and Zentiva may not long be the only spectacular investment cases in the generics industry.

References and notes

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