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Small drug companies exist to get gobbled up

It's profitable to be little fish in food chain

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Esprit Pharma doesn't have drug-discovery labs.

It doesn't own DNA microarrays to examine disease-causing genes, fermentation reactors to grow monoclonal antibodies or powerful computers running chemistry software.

Esprit, a privately held company in East Brunswick, is basically a 150-member sales and marketing organization spread across the country. It was founded last year to sell four medicines for urinary-tract disorders acquired from another drugmaker.

So, why would private-equity groups be willing to sink more than \$90 million in Esprit, as they did this month, just a year after venture capitalists put up more than \$60 million to launch the specialty drug company?

Deep-pocketed investors are betting Esprit becomes a lucrative takeover target for a big foreign drugmaker or for a growing roster of small biopharmaceutical companies in need of a sales force and income-producing products.

Esprit reflects a change in investment strategy in the pharmaceutical industry. The end game, private-equity players say, is no longer to take a company public. They now see hefty returns and fast turn-arounds in small biotechs or specialty drug companies that likely will be acquired by other drugmakers.

Underlying this trend is a desperate hunt among multinational drugmakers such as Pfizer, Johnson & Johnson, Novartis and Merck for biopharmaceutical products and technologies to bolster their anemic product pipelines.

"There is an opening that private equity sees," said Diane Frenier, a partner in the Princeton office of ReedSmith, an international law firm that matches life science companies with private investors. "They can come in a little early and offer financing that these companies need to get to the next stage or defer the need of a biotech company to go public. The private-investment community's willing to take the risk for the big returns."

The rules of the pharmaceutical game are changing fast. Only four biotechs made initial public offerings last year, according to PricewaterhouseCoopers, compared with a dozen in 2004.

Instead, private-equity players, including several cash-flush newcomers to the life sciences, have been investing heavily in small to midsized specialty drug companies to take advantage of Big Pharma's appetite for more products.

Large equity investors -- including Apollo Management, Fortress Investment Group and Bain Capital, whose portfolios span everything from real estate to leveraged buyouts -- are now actively shopping for specialty pharmaceutical investments, Frenier said. Many of the private-equity groups, she added, are looking for a home to invest huge profits from the stock market.

This niche market caught fire when Big Pharma began paying huge sums to acquire biotechnology companies, such as Pfizer's \$1.9 billion acquisition last year of Vicuron Pharmaceuticals and Novartis' \$5.1 billion purchase of vaccine maker Chiron. More recently, J&J, Merck and other big-league drugmakers have paid hundreds of millions for biotechs.

And more acquisitions are on the horizon. Schering-Plough has been open about its interest in a company with products to complement its hot-selling cholesterol fighter Vytorin. Pfizer, flush with cash from the sale of

its consumer products business to J&J, has said it is shopping for additional biotechs priced in the \$1 billion range.

Esprit has a potential blockbuster in Sanctura, a tablet to treat overactive bladders, whose U.S. marketing rights were acquired through a merger with Saturn Pharmaceutica. But, so far, sales of the drug have floundered, as Esprit goes head-to-head with Pfizer, J&J and Novartis, all of which have products in the \$1.1 billion overactive bladder market.

Still, Esprit's investors and the company's chief executive, John Spitznagel, remain supremely confident sales of Sanctura and the company's other products will take off.

They are working off the same playbook Spitznagel used at his previous company, ESP Pharma, a sales and marketing specialist founded in 2002 with \$26 million in venture capital and four products purchased from Wyeth. ESP was sold last year for an eye-popping \$500 million to Protein Design Labs, a biotech attracted by ESP's marketing operation and \$6 million in annual sales.

"Big pharma gets bigger and bigger and acquires more things. As a result, their interest in products below a certain sales threshold wanes," said Brian Halak, a partner at Princeton-based Domain Associates, an investor in Esprit. "So, there becomes available a threshold of products, let's say below \$500,000 in annual sales, that are not that large but very viable."

Anthony Rascio, Esprit's senior vice president, said the company was founded with the expressed purpose of being sold at a premium. The wish list of suitors includes names such as Biogen Idec and Celgene, he said.

"If we could build a successful company with a good product line with a good sales force," Rascio said, "a foreign investor and biotech would have a turnkey operation and a great opportunity to get into the biggest pharmaceutical market in the world."

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