

Challenges of funding in life sciences industry

The life sciences industry in India has attracted \$ 1.0 billion in investments from global Private Equity (PE) funds over the last five years. The absolute number by itself is not small, yet this represents only 2.6 per cent of overall investments made by PE funds in the country over the same time period. Is the life sciences industry relatively unattractive from a risk return perspective or are there regulatory bottlenecks that restrict the flow of funds into this sector or this is a matter of the past and future investments in this sector will be at a much larger scale. Before we hypothesize more, let us step back a little and see what are the factors that determine the funding needs of any industry and then evaluate the life sciences industry on each of those factors to get more insight on this topic.

The funding requirement of any industry is a function of two factors – the growth outlook for the industry and average return on capital that businesses in that industry can sustain over the growth period. For an industry where growth is lower than the sustainable return on capital, it can fund its growth need entirely through internal accruals without require external funding. Over a period of time such industries will build huge cash piles on their balance sheets as the capital they need for growth is much lower than the internal cash accrual and the cash surplus keeps growing every year.

A case in point is the IT / software services industry in India with growth outlook of 12 per cent and return on capital on an average of 25 per cent. On the other hand if the situation is reverse i.e. the outlook on growth rates is much higher than the return on capital demonstrated by the business there will always be a need for external funding. Infrastructure industry falls into this category. The huge demand supply gap for almost all forms of infrastructure in this country will drive growth in excess of 25 per cent for a sustainable period. The return on capital in most infrastructure industries is however around 15 per cent i.e. with the existing capital base these companies can only growth of 15 per cent and if they need to grow faster they need to infuse fresh capital. Where does the life sciences industry in India stack up in this framework.

The life sciences industry is easy to evaluate from a growth outlook perspective but is far more complicated when it comes to determining what could be the sustainable return on capital for the industry. The life sciences industry encompasses of two main segments - pharmaceuticals and medical devices / diagnostics with each segment having several different business models which companies in those segment follow and each of those business models have their own distinctive return on capital profile.

A word then first on the growth outlook of the life sciences industry in India which is better understood and acknowledged. The domestic demand for the life sciences industry is expected to grow at 15 per cent over the next 20 years (not 5 years, not 10 years but 20 years) on the back of

increasing incomes in both urban and rural areas of the country, improving access to healthcare and a demographic profile where for the next 30 years at least 500 million people will be either in the age group of less than 15 years or more than 55 years, both are age groups which have higher need for healthcare. The growth outlook is further enhanced to a 20 per cent level based on a vibrant export demand for generic pharmaceuticals from India given the low cost advantage that the country offers. With this general growth outlook in the back drop let's look at the return on capital profile for the various segments.

The pharmaceuticals segment of the industry comprises companies with multiple business models – ranging from pure research based companies to manufacturing focused companies to companies with their own sales & distribution or a combination of two or more of these models. The aggregate return on capital across all these models is estimated to be 16 – 18 per cent on an average. Every 100 rupees invested in the business generates sales of 125 if not more and a operating profit of 13-14 per cent on this sales totals up to a return of 17 per cent on the investment. With a 20 per cent growth outlook there is clearly a need for funding in this segment of the industry going by the framework described earlier. Rough estimations indicate a funding gap of \$ 1.0 billion over the next year which will have to be met through fresh equity infusion.

The key challenge here is the strong interest of global pharmaceutical companies in acquiring Indian firms which has stretched valuation expectations keeping many financial investors at bay and the situation appears unlikely to change in the near future. This segment holds lot of promise and is second to the IT sector in having put India on the global map in terms of industry leadership. It would be disappointing if the sector misses out on the window of opportunity in the next five years for lack of funding as China is fast catching up to India and will be a strong competitor in years to come. This is an imperfect industry in terms of the solutions it offers to its customers (no drugs available which cure chronic conditions today and acute problems are addressed through symptomatic relief) and potential to build a truly outstanding business here is immense if the right alignment of interest between entrepreneurs and investors can be achieved with focus less on entry valuations and more on future value creation and sharing of upside therein.

Big companies in the sector who have strong balance sheet and can continue to grow without external funding support will keep on getting bigger while smaller companies might just miss the bus. The other segment of this industry is the diagnostics and medical devices segment which in India is dominated by multinational companies with most Indian companies present in this segment operating as distribution platforms for the products of the global companies. Funding interest of technology led investors in this segment is therefore more on smaller innovative start – ups who are developing their own medical device / diagnostic solutions.

The multi-disciplinary skill set needed in such companies (electro/mechanical/material science/biology etc.) is still nascent in this sector and it will take a while before the eco system develops to attract financial capital in a meaningful way. It is not difficult then to see why funding in life sciences industry has historically been behind what has been in other sectors. The future could

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definitely be better if the right alignment model can be worked out between the industry and the financing community.