

Q3 2007 Life Science Sector Review

*"In [the stock market], the rearview mirror is always clearer than the windshield."
- Warren Buffett*

Last quarter we concluded our remarks believing that the prevailing winds for the life science sector look favorable. We continue to believe so. Not surprisingly, the market retraction which accompanied the subprime lending crisis was rather short-lived. Dizzied investors appear to have been looking in the rearview mirror and reflecting on the heights they had reached - the Dow up nearly 13% year-to-date on top of a 16% surge in 2006 - and in such an oxygen-deprived *fight-or-flight* psychology chose flight.

Market unease does appear to have impacted the quarter's financing activity. Forty-one life science venture financings were completed in the third quarter, a 39% drop in activity over the second quarter and the lowest number of financings completed in the past 5 quarters. The slowdown, however, appears largely unrelated to the turmoil in the credit markets, with just as many financings completed after the August 16th market trough as before. Instead, the slowdown seems to be a continuation of a trend which began in June as was noted in our second quarter review.

Given that TTM life science IPO activity has surged more than 50% over previous 12-month period making up nearly up 20% of all IPOs in the second quarter, market saturation may provide a plausible explanation. But the average size of venture financings in the third quarter - \$22.3 mm in our sample - deviated only slightly from the second quarter average when a record number of financings were announced. In other words, while investors are being more calculated as to *when* to invest, *what* they are investing *in* remains unchanged. This is underscored by a consistent investment mix QoQ, biopharma again accounting for half of the deals, medical device a third. So barring unforeseen circumstances, we anticipate a ramp up in financing activity through the fourth quarter and extending into 2008.

Chopiness in the financing markets has had little to no impact on life science M&A activity. While the number of deals announced was down slightly from the second quarter, M&A activity remains at some of the highest levels since we began tracking M&A activity in this sector five years ago. For the quarter we saw several billion-dollar-plus deals announced, including Medco's \$1.5 billion acquisition of PolyMedica, Teleflex's \$2 billion offer for Arrow International, and Medtronic's \$3.9 billion deal for Kyphon. Perhaps most notable was Siemens' \$7 billion bid to acquire Dade-Behring, the crowning achievement to what is now Siemens' \$12.7 billion bet on the diagnostics space after its \$2 billion acquisition of DPC in late 2006 and \$3.7 billion purchase of Bayer Diagnostics in January. And diagnostics was once again the sector with the single most active acquiror - Inverness Medical. (Given the strategic dispositions of these two, could a Siemens/Inverness deal be far off?)

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Through the first 9 months of the year M&A activity is already up 12% over last year's record level of deal activity and as the fourth quarter begins, deal activity continues at a brisk pace. We surmise that while the markets may have some influence, far more significant an impact are the winds of change that are beginning to swirl around the healthcare sector as a whole. Healthcare is once again front and center in the national consciousness - and in the cross hairs of 2008 Presidential politics. As a result, we suspect M&A activity to remain quite strong for the foreseeable future as industry participants try to optimize their market positions in light of what many see as the inevitability of change.

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