

Investing in Animal Health? Value Real Value

In early 2013, Pfizer, one of the largest US drug makers, sold its animal health division, Zoetis (ZTS) shares in an initial public offering that raised \$2.2 billion dollars. Since then there has been an increase in the general interest of investors in the animal health sector. Also since then, several early-stage animal health companies opted for the IPO approach to raise money for their operations. The followers included Aratana Therapeutics (PETX), Kindred Biosciences (KIN), Parnell Pharmaceuticals Holdings (PARN) and Freshpet, Inc. (FRPT). There is certainly a lot to attract smart investors. Although not nearly as big as the human health equivalent, the animal health market is a steady growth market with certain segments thereof showing very strong growth rates year on year. However, investors beware, the animal health market has very different drivers from those of the human health market, and it is worth potential investors' time and money to understand those differences before jumping in head-first.

The publicly traded animal health companies could be stacked in three major categories: The first is the general animal health and diagnostics category, including veterinary clinical services, centralised diagnostic service labs and manufacturers of in-clinic tests and clinical lab equipment as well as clinic management software. Companies in this category include IDEXX Laboratories (IDXX), Abaxis, Inc. (ABAX), Heska Corporation (HSKA) and VCA Inc. (WOOF). This category is the most established in the animal health field. The second category is the animal health pharmaceuticals and biotech category, including ZTS, PETX, KIN and PARN. The third category includes animal feed and veterinary distribution companies, including Freshpet Inc. (FRPT), Phibro Animal Health Corporation (PAHC) and MWI Veterinary Supply Inc. (MWIV).

The companies listed above are only the tip of the animal health iceberg, where the majority of companies are still privately held.

When it comes to financial analyses, in most cases animal health companies are lumped in the same general categories by financial analysts as their human counterparts. However, the animal health market is distinctively different from the equivalent human market, with a different market size, different market drivers, different limitations and different sensitivities. These are all pivotal considerations that analysts need to take into account when performing their valuations to avoid the creation of an animal health bubble that will affect this nascent market negatively for years to come.

I can provide any number of calculations to give an estimate of what I think the animal health market is worth today, but instead of going down that road, let's just take a look at a public example that we can all see and understand to make this point. To put this in perspective, Zoetis, for

example, already had an established market as the animal health arm of Pfizer, and unlike many early-stage companies in the animal health market it did not have to work at establishing itself or securing market share. Even with those considerations in place, Zoetis is only about one-tenth of the size of its former parent company. As of the date of writing this article, Pfizer Inc. was showing a market cap of 205.12 billion dollars; Zoetis, on the other hand, was showing a market cap of 22.20 billion dollars. For early-stage animal health companies with no products and no revenues, the disparity compared to an equivalent company in the human space can easily exceed the 10-fold difference shown above for the Zoetis case.

One also has to realise that some of the drivers of the animal health market are significantly different from those of the human market. First, the animal health market has two major divisions: production animals and companion animals. While our pets tug at the heartstrings, our cows don't usually aspire to the same treatment, and harsh economic realities and thin margins on the production animal side put up a significant barrier to the ability to penetrate that market with a new technology unless it's leaps and bounds better than current technologies or existing management practices. Furthermore, even if we examine the companion animal side of the market, we will learn in short order that although our pets are viewed by many (not all) as family, there are significant limitations there too. First, regardless of how much we love our pets, there are major differences to how we view them compared to how we treat our human family members. We still feed our pets food that is made with ingredients that we will not feed our families, and we choose what to feed them based on mainly price considerations. Furthermore, when it comes to veterinary visits, significant portions of the dog and cat populations in the United States, for example, never see the vet unless it's an emergency. The absence of cost reimbursement by insurance also influences to a large extent the making of go/no-go decisions with regard to different therapy options for pet owners and vets alike. These influences make such decisions much more economically grounded than what all the talk that we hear about pets being considered family members might lead us to believe.

Another major influencer that may not apply in the equivalent human market is what we call the "churn-rate". This represents the number of owners that, for whatever reason, would buy a veterinary health product once or maybe twice and never buy it again. The churn-rate for many products can exceed the 75% mark, especially when there is no "observable" difference in the pet's behaviour or, more importantly, its quality of life in the eyes of the pet parent.

Another limiting factor to keep in mind is that vets are allowed by the FDA to practise the "art of veterinary medicine" and use existing human medications that are



labelled for use in humans to treat their animal patients. This practice is prevalent and will continue to take a chunk out of the available market share of any equivalent veterinary-dedicated drug.

If we look at the recent IPOs – and to be fair, there aren't nearly as many examples in the animal health field as there are in the human health field – the few that we have in the animal health field clearly show that it is exuberance rather than the fundamentals that is driving those deals. Unfortunately, in many cases exuberance ends up in bubbles, and bubbles, no matter how far they make it, will eventually burst.

If we also examine the level of R&D investment in animal health we find several issues to consider. First, the pipeline. There is no National Institutes of Health (NIH) equivalent funding agency for the animal world. This severely limits the animal health pipeline in general. We therefore see that most animal health drug candidates are copied from the equivalent human drugs. This is also why we see that the animal biotech companies have channelled most of their resources towards clinical studies and approvals for a very small number of candidates with no R&D infrastructure to keep the pipeline filled while still facing the same rate of failure that any human biotech company would encounter. This is a particularly curious situation because we all know that within the human biotech field, companies have tested many thousands of potential drug candidates over the years with very few making it through the FDA drug approval process. Even when we take into consideration that the drug approval process for veterinary drugs is shorter, and has fewer hurdles to jump over, that fact does not somehow translate into more animal drugs being approved compared to their human counterparts, at least not ten times more. This is mainly because the same technical and manufacturing hurdles still exist for pharmaceuticals regardless of the species that they are intended for.

Additionally, in most cases the clinical trials performed in dogs use beagles to represent the “average” dog. But dogs as a species (and to a certain extent cats) underwent significant “artificial” selection pressure over the last 120 years or so, creating breeds that vary considerably in shapes and sizes. This is problematic and adds significant risks that should be considered. While one can say that a dog is a dog, and by and large biochemically all dogs are the same, the differences from breed to breed have to have an impact on the pharmacokinetics and pharmacodynamics of a drug.

These effects will end up adding a certain level of difficulty in determining the “safe dose” for all dogs. While this in no way affects the speed to approval because the FDA, at least according to my knowledge, does not have any requirements for breed-specific testing, in the end what is important is if issues are encountered in the field with people's pets, the results could lead to drugs that will never reach their potential peak market as advertised to investors because pet owners do not see any added value in using them. These “technical” issues are only further complicated by things like palatability (if you don't like pilling your dog or cat) which can affect compliance by the owner (and indeed the dog or cat) and therefore, indirectly, the efficacy of a drug.

The above-mentioned issues are only some of the myriad drivers and limitations that make the animal health market significantly different from the human counterpart. This calls for a different approach to the valuation processes employed in order to value the animal health investment opportunities accurately and avoid the practices that will eventually create a bubble in the market that will end up having a negative effect overall on how the market develops.

The fact that there are currently only a few publically traded animal health companies, most with no revenues to speak of, makes valuations based on “existing” market comparisons of limited use and using traditional quantitative methods like the discounted cash flow method useless in accurately reflecting what these companies are actually worth. It is accepted that valuations for life science-based early-stage companies is not a straightforward exercise; this difficulty is only compounded if the early-stage company is an animal health company.

I have to emphasise at this stage that the thrust of this editorial is not to scare potential investors and put people off investing in animal health companies. On the contrary, I think that the animal health market is a perpetual growth market that people should invest in. However, I do see the makings of a big bubble brewing with the recent explosion of IPOs in the field and I would rather that the field of animal health not pay the price. We encourage all investors and analysts to spend some time understanding how the animal health market is different from the human health market and not to simply apply the same standards to opportunities that may appear to be similar on the surface. We want our market to have strong growth based on the fundamentals that support it and be “bubble-free” for as long as we can keep it bubble-free. For investors, I say invest within animal health, but whatever you do – value real value.



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