Navigating the Complex Terrain: Healthcare and Biotech Markets in Q3 2023

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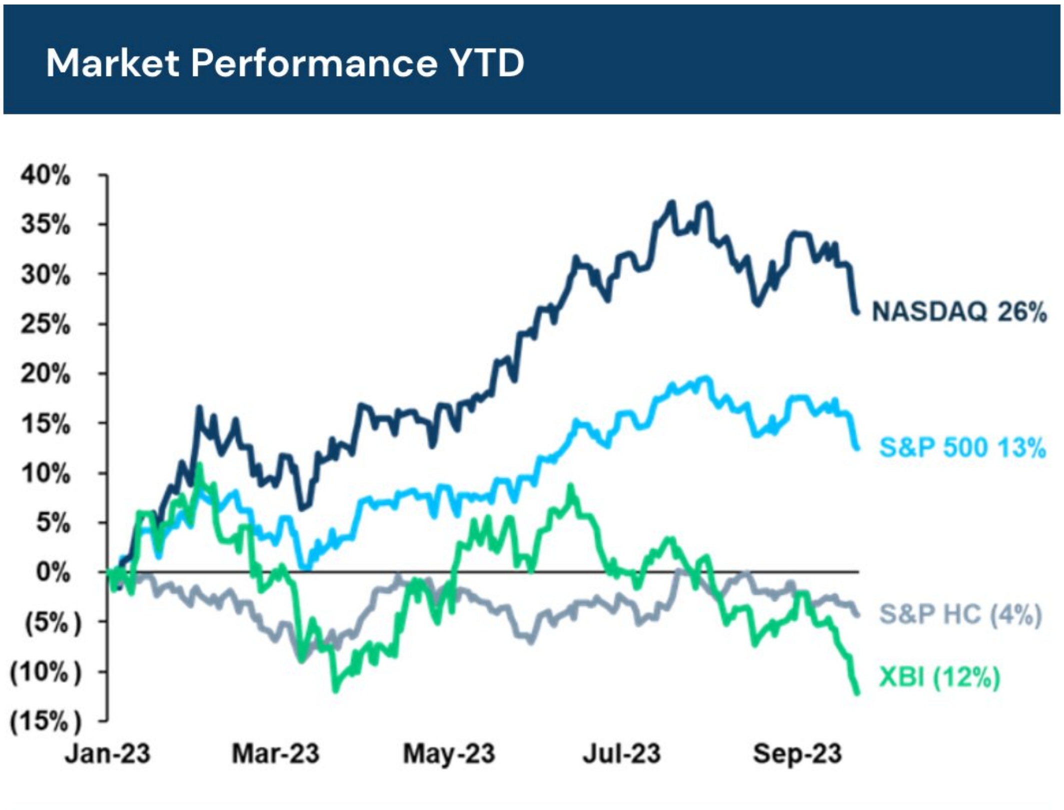
The State of the Markets

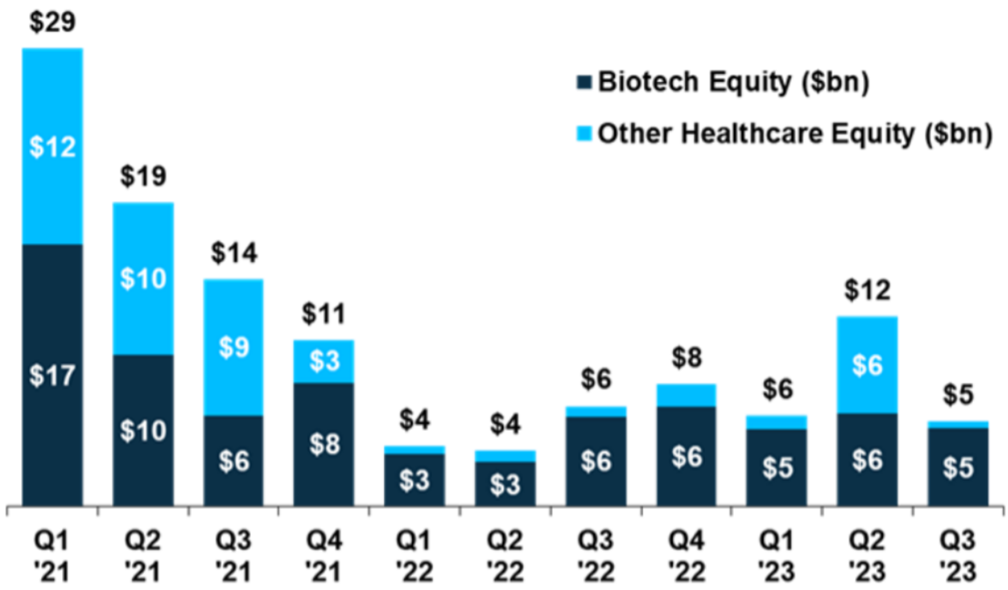
As the third quarter comes to a close, it's easy to be optimistic about what the next several months may hold for the equity markets. With inflation moderating and Fed rate hikes nearing an end, major macro headwinds may be a challenge of the past, and investors can once again lean into exciting growth stories (and stocks).



Source: FactSet as of 9/22/2023

Unfortunately, such optimism has not yet found its way into the healthcare sector. While the S&P 500 is up 13% YTD, the healthcare components are down 4%, underperforming the S&P by the widest margin since 1999. The pain has been particularly acute in the biotech space lately, with the XBI down 12% YTD and set to fall for the 3rd straight year.

Healthcare Equity Issuance By Quarter



Source: Dealogic. Includes registered healthcare equity offerings >$30mm.

Naturally, the capital markets have been similarly impacted, with biotech IPOs scarce and non-biotech equity almost non-existent. Public biotech companies can still find financing, with a steady cadence of $5-6bn of biotech equity each quarter for the past year. Investors regularly point to value opportunities (relative to other sectors) and fundamental data or regulatory wins are rewarded with material share price outperformance. But we're not yet out of the woods when it comes to capital raising.

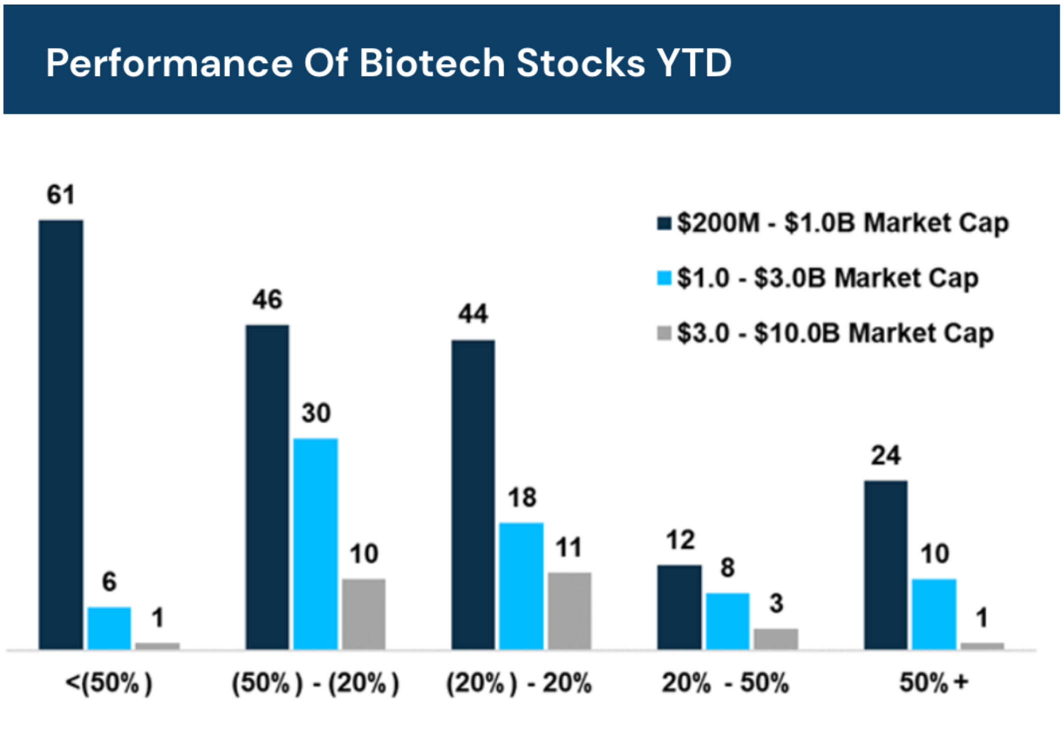
Let's dig into both the biotech and non-biotech areas of healthcare in more detail, and perhaps find places for optimism even in our underperforming sector.

Biotech Stocks Remain Under Pressure

It's been another difficult year for biotech stocks, with the XBI near 2023 lows and a historically high percentage of companies trading at or below their cash value. The XBI is hardly a perfect measure for the health of the sector, given only ~75% of its components could even be considered SMID-cap biotech. But even when we look at a broader set of true biotech companies (market caps

$200mm-$10bn), it is apparent just how broad the pain has been.

If we divide the SMID-cap biotech world by market cap ranges, both the largest ($3bn+) and smallest ($200mm-$1bn) companies to start the year have lost value. Expectedly, the sub-$1bn names have had the most opportunity for outsized success, but also the highest risk of failure. Returns for the larger cap names are lower in variance, albeit skewed to the downside with limited opportunities for “homeruns.” The sweet spot has been the $1-3bn market cap range, which has seen a disproportionate number of wins and is the only market cap range that has seen net value creation this year.



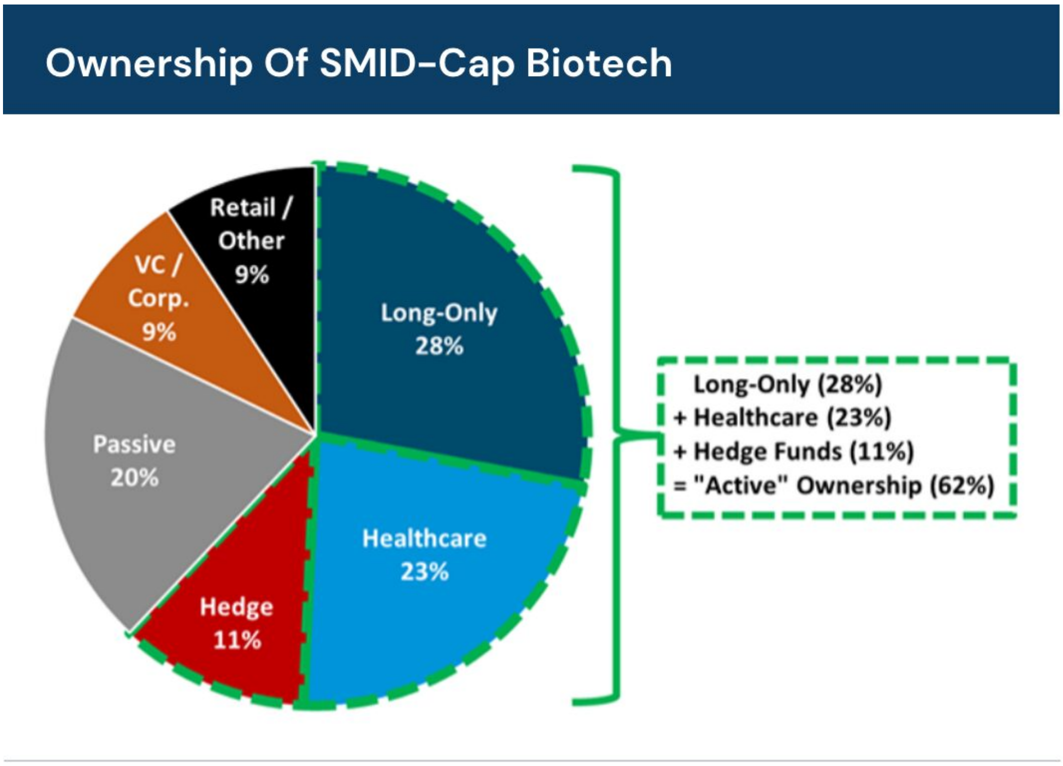
Source: FactSet as of 9/22/2023. Market caps as of 1/1/2023, to reflect YTD performance trends.

While overall performance has been challenged, there have clearly been plenty of big wins for investors. 35 different SMID-cap biotechs are up over 50% this year, through a combination of M&A, clinical, and regulatory successes. When the average healthcare specialist fund only owns ~30-40 stocks, you can imagine the outsized impact of a few correct picks, and recognize how certain funds have been able to differentiate themselves from their peers. Perhaps the best spin on biotech lately is that it’s a stock picker’s market – plenty of opportunity for funds to outperform, but plenty of pitfalls along the way.

For those funds that have struggled YTD, we may see an increased focus on ways to make up ground, including outsized bets on situations with Q4 catalysts, or increased activity in the capital markets.

Surveying the Biotech Investor Universe

We've covered a lot in terms of the performance of biotech, but it raises a natural question – who actually owns these stocks?



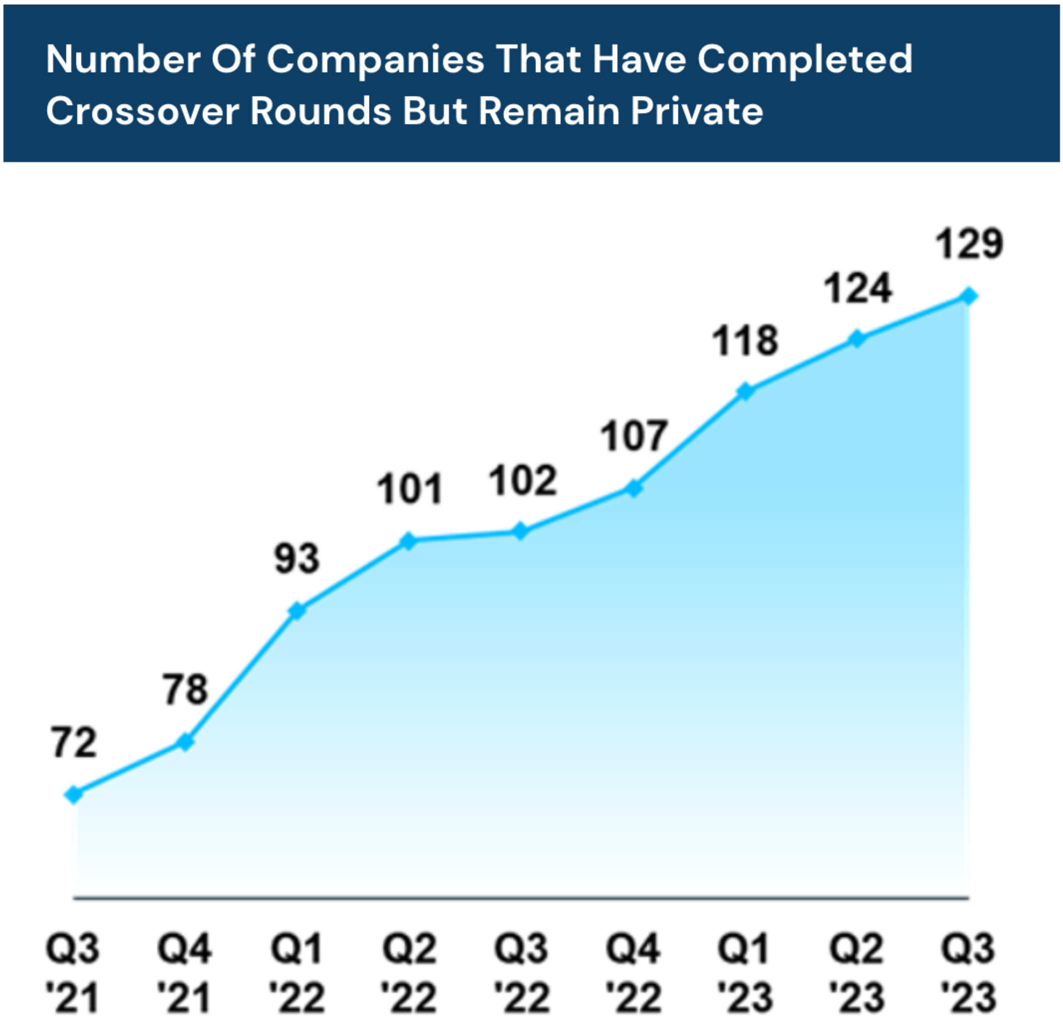
Source: FactSet. SMID-cap biotech includes biotech companies with mkt cap $200mm-$10bn.

Roughly 62% of SMID-cap biotech is owned by "active" institutional funds. These investors make buying and selling decisions every day based on the fundamentals (generally) and make up 99% of the investor dialogue for corporates (and bankers). The long-only funds still make up the largest piece of the pie (Fidelity, T. Rowe, etc.), but the healthcare-dedicated community is almost as large now, and these funds are the ones most often driving capital markets activity (RA Capital, BVF, etc.).

Anecdotally, a number of the major mutual fund complexes have commented lately that the generalist PMs are turning an eye toward biotech. If we are looking for a path for biotech to outperform in the coming months, any incremental dollars flowing in from these sector-agnostic funds would be a great start.

Private Biotech Fundraising and the IPO Backlog

Turning now to the private financing markets, the dearth of biotech IPOs has definitely put a wrench in many later-stage private deals. Excluding seed + Series A rounds, private financings are down 9% vs. 2022 (on a $ basis), though we have still seen 10 “crossover” rounds priced this quarter (crossover defined as a round with at least 3 traditionally public-side investors participating). The backlog keeps building of companies who have completed a crossover round but remain private.



Source: PrivateRaise, press releases.

A return of the IPO market (or more reverse merger activity) will help relieve this backlog – but also likely spur more later-stage private financings, as investors can once again see a path to liquidity in those investments.

So, what types of biotech companies are most likely to take the plunge into the public markets over the next few months? Top-tier situations with clinical data in hand, great management teams, and a deep roster of supportive investors naturally come to mind. So too do companies in “hot” therapeutic areas or modalities – think next-gen gene editing, obesity-related drug companies, or anything in the I&I space. Speaking of …

Hot Topics – I&I Leading the Way

Notable I&I Wins

Date	Company	1 day % Change	Δ Mkt Cap ($bn)	Event
Clinical / Regulatory				
09/26/23	Immunovant	97%	$2.6	Phase 1 data (Autoimmune Disease)
07/17/23	Argenx	28%	5.9	Topline Data from CIDP Study
06/26/23	Moonlake	78%	1.1	Phase 2 data (HS)
M&A				
06/20/23	Dice	37%	0.6	Sale to Eli Lilly for $2.4bn
05/22/23	Vectivbio	36%	0.3	Sale to Ironwood for $1.2bn
04/17/23	Prometheus	70%	3.8	Sale to Merck for $10.8bn
03/13/23	Provention	260%	1.5	Sale to Sanofi for $2.9bn
IPOs				
07/13/23	Apogee	24%	1.2	$300mm IPO
05/04/23	Acelyrin	13%	1.3	$621mm IPO
Total			**$18.3**	

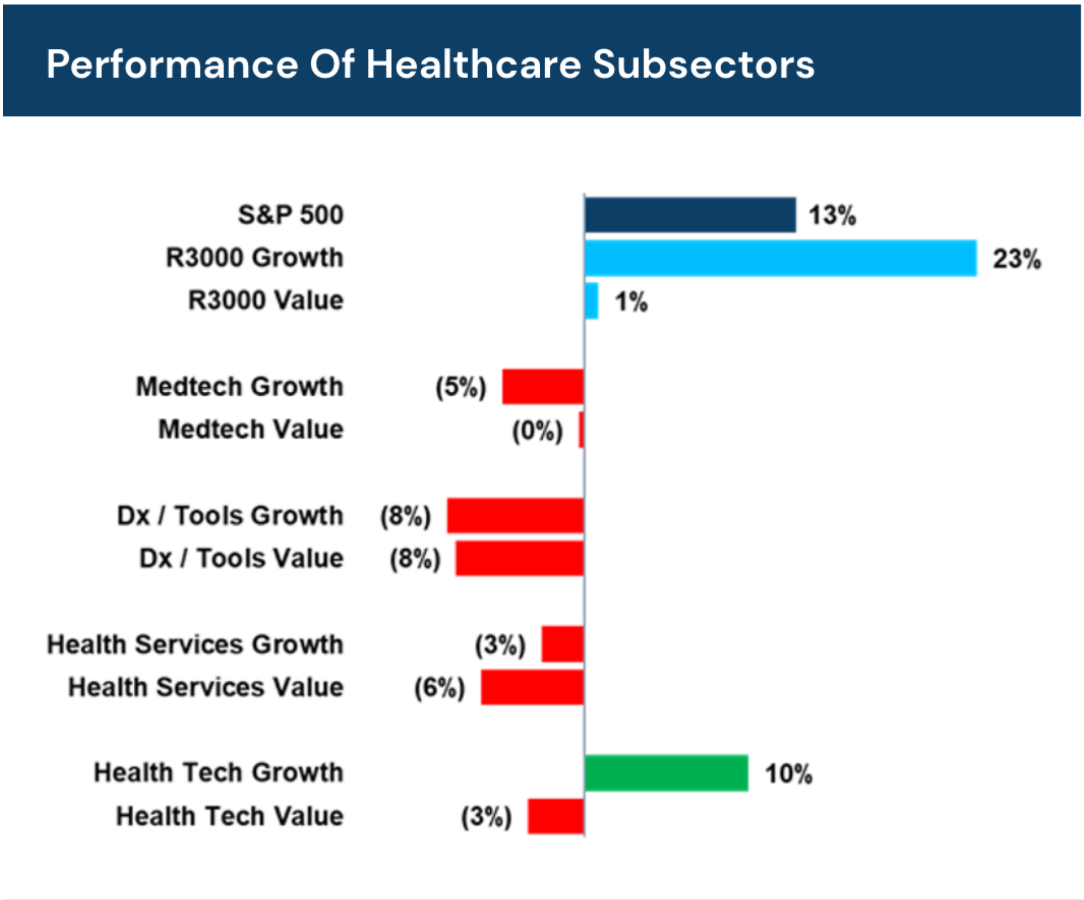
Source: FactSet, Dealogic, press releases.

One of the best-performing therapeutic areas of 2023 has been inflammation and immunology ("I&I"). A composite of SMID-cap I&I stocks has outperformed the XBI by over 20% this year. While there have certainly been a few misses, it's hard to find a space with more outsized investor wins than I&I. This includes major M&A trades (Prometheus, DICE ...), big data wins (Moonlake, Argenx ...) and two of the largest healthcare IPOs of the year.

Multiple I&I catalysts remain in 2023, and additional I&I IPOs are in the queue – we'll see if this momentum can continue into year-end.

Broader Healthcare Sectors Similarly Struggling

Pivoting now away from the world of biotech, unfortunately the picture does not look much different elsewhere in healthcare. All sub-sectors within healthcare are lagging YTD, with slow-growth cash-flow machines feeling just as much pain as hyper-growth dx/tools or health tech businesses. Consider the relative performance versus the S&P 500 (up 13% YTD) or the small-cap Russell 3000 indices (growth up 23%, value up 1%) – almost all healthcare components are under pressure.



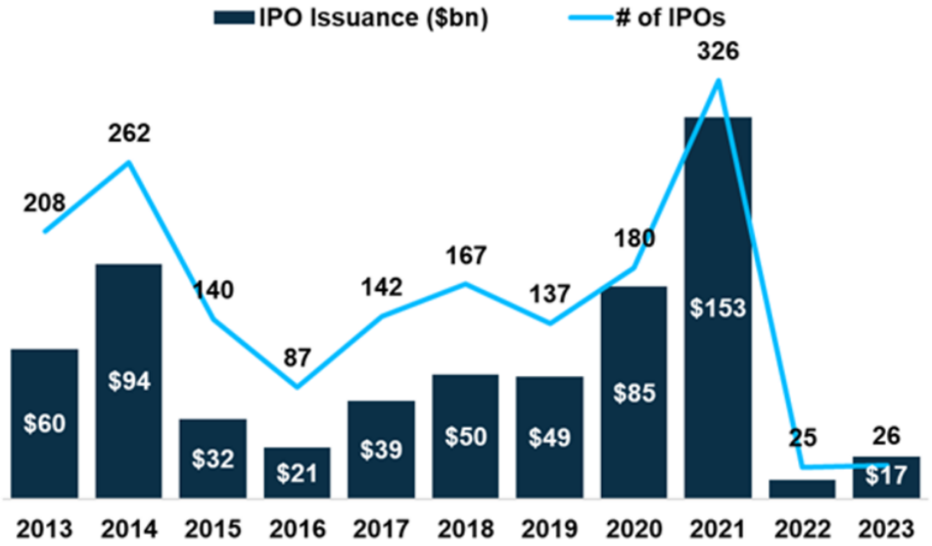
Source: FactSet as of 9/22/2023.

From a macro standpoint, while the Fed hikes may be largely behind us, it won't be long before the Presidential election cycle kicks into high gear. What this means for healthcare performance over the next 13 months is anyone's guess, but safe to assume the rhetoric across multiple areas of our sector will drive volatility.

Signs of IPO Life?

Away from healthcare, it's somewhat surprising how quiet the IPO market has been across all sectors, given strong market performance and falling volatility. After a historically slow 2022 for IPOs, 2023 has seen only 26 IPOs price for a total of $17bn, well below what's typical in the US markets.

IPO Issuance Across Sectors



Source: Dealogic. Includes US-listed equity offerings >$30mm since 2013.

That said, we have seen greenshoots in the IPO market over the past month. Large deals for companies like ARM, Instacart (Maplebear), and Klaviyo have successfully gotten to market, even if aftermarket performance has been mixed. Investors have the appetite – we just need to see more conviction and follow-through.

Might we see healthcare companies start to test the waters over the next few months? We can confidently say that investors are clamoring for high quality, high growth, profitable businesses to reinvigorate their portfolios. Areas with strong secular tailwinds may be set to open the healthcare IPO market over the next few months, including companies in behavioral health, those with liquid biopsy technologies, or those benefitting from value-based care themes. Speaking of …

Hot Topics – Still Value in Value-Based Care?

Recent Value-Based Care Transactions

	Company	Round	Amount Raised
Private Capital Raises	Aledade	Series F, Jun-23	$260M
	strive HEALTH	Series C, May-23	$166M
	Vytalize	Series B, Feb-23	$53M
	pearl	Series B, Jan-23	$75M
	UpStream	Series B, Nov-22	$140M

	Acquiror	Target(s)	Date / Value
M&A	CVS Health	Oak St Health	Feb-23 / $10.6B
	VillageMD	Summit Health	Nov-22 / $8.9B
	CVS Health	signifyhealth	Aug-22 / $7.9B

Source: Pitchbook, CapIQ, press releases.

As the investor community has pivoted away from ultra-high-growth businesses that are still finding their way to profitability (or even a sustainable business model), many funds are wondering where best to spend their time. One diverse group that continues to draw attention are the value-based care platforms, providers and enablers, which may finally have enough "value" to make for an interesting investment. A basket of these peers is down ~20% YTD, and while capital markets activity has been slow, broader newsflow (private capital raises and M&A) has kept the hope alive.

We'll be on the lookout for a turnaround in this space, and expect to see fresh go-public activity in 2024.

Looking Ahead

Here at Leerink Partners, we like to be optimists. But we are also realists. For all the reasons to be excited about the next several months, there are landmines out there that could derail even the best macro theses on the healthcare sector.

Regardless of the direction of the market, Leerink Partners will be here to help!

Contributors:

Leerink Partners ECM Team

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