

DIABETES CLOSE UP

Diabetes Close Up
December supplement, 2005, No. 53
J&J To Buy Animas in Sublime Strategic Play

T h e S h o r t e r V e r s i o n

From the Editor:

J&J's LifeScan announced December 16 that it intends to buy Animas Corporation for \$518 million in cash, or \$24.50/share, a 35% premium over Animas' closing price the 15th. We think this acquisition makes very good strategic sense – essentially, it's the #1 glucose monitoring company buying the #2 pump player. In many respects, this was a classic J&J deal – Animas is newly profitable this year, the deal is immediately accretive, and it offers J&J an excellent leg up as it enters the pump market. Too, J&J had owned ~10% of Animas for some time. Now, while Animas is #2, it is still far behind leader Medtronic MiniMed, whose new(ish) leader, successful cardiac surgery veteran Bob Guezuraga has really impressed the diabetes community. Smart, ambitious, and seemingly hyper-focused, he appears very serious about taking the business to the next level and leaving success in diabetes as his legacy. What could be better for patients than significant focus industry-wide on better physiologic delivery? As competition heightens, we expect innovation to move faster – all good, from a patient perspective. Details on the acquisition are below – what J&J gets, what Animas gets, and what's next. What a way to end what's been a very dynamic year in diabetes ...

--Kelly L. Close

The Longer Version

What J&J gets:

- ***A valuable new technology platform in Animas' insulin pump franchise.*** *We believe J&J's entrance into this market has obvious benefits, as LifeScan is the top strip manufacturer for intensively and hyper-intensively managed¹ patients. In some ways, J&J is just catching up, as its competitors already have pump partners – Abbott, the fastest-growing glucose manufacturer (and #3 player, gaining on the top two), has two pump partnerships, one with Deltec, one with disposable pump newcomer Insulet, while Roche owns Disetronic; and Medtronic has a partnership with BD².*
- ***Next-generation pump technology with Animas' Debiotech micropump.*** *Starting with Insulet, we believe next-generation insulin pump technology will be game changing, particularly as we near the advent of real-time continuous glucose monitoring, which offers far more physiologic delivery.³ We anticipate a new bolus demand for pumps as soon as continuous monitoring is widely reimbursed. While it's true that "low(est) hanging fruit" was picked awhile back in terms of obvious pumpers, we think next generation pump technology could result in an expanded pump market – the entire new generation of next-gen devices appear more discreet, more user-friendly, and easier to teach and learn. We believe the success of Animas' micropump, slated for commercialization in 2007, will be key to the success of the J&J/Animas deal.*
- ***Top-notch infrastructure.*** *Okay, this part is big. Animas has built fantastic infrastructure all around, from a superb sales force - 55 top-notch reps supported by 70 so-together CDEs - to stellar reimbursement (major, especially if J&J acquires a continuous player) and smooth fulfillment. In particular, Animas is well known for remarkably good customer service - we applaud the company for never cutting costs on this front. It's received a high ROI for that strategy, which was always popular with patients but not always with Wall Street.*
- ***Strong relationships with patients and professionals.*** *Animas has built extremely strong relationships with many of the previously-mentioned coveted group of patients, the intensively/hyper-intensively managed. Pump company reps have close ties with patients and families based on frequent contacts. While J&J has been very successful with this segment historically (another reason we think the fit between the two companies should be strong), J&J was at risk at losing some of these patients. Now, if J&J can help Animas innovate more quickly, less is at risk. Notably, on the relationship front, both companies have professional relationships valuable to the other side.*
- ***Potentially key intellectual property in the general area of continuous glucose monitoring, specifically fully implantable infrared sensor and fourth-generation Cygnus technology.*** *While we believe the pump platform is by far the primary driver for this deal, we can't*

¹ We define this group as patients who test their glucose 4-8 times a day or more; post-prandial testing is increasingly common in this group. Note that some hyper-intensively managed patients (pregnant type 1s, as one example) users test as much as 14 times a day.

² While it's true that the latter two combinations wouldn't necessarily be characterized as absolutely ideal since Disetronic has been off the US market since just after its mid-2003 \$900 million acquisition by Roche closed (of late, we assume that the embargo will be lifted sometime in 2006 – perhaps new Roche leadership can make this happen) and since not all Medtronic users have wed themselves to the BD strip, it was still notable for J&J to be the *only* of the top strip companies without a pump partner. Is Bayer next up?

³ My experience with continuous has underscored the importance of having a pump when one has lots of data – the ability to easily “correct” too-high readings is much easier with a pump and correspondingly, it is much easier to refine basal rates with continuous.

imagine that J&J LifeScan hasn't been working intensively (though quietly) on continuous – we look for public movement on this strategy in the next year to two. From our perspective, the faster J&J acquires the right continuous partner, the better. Dex Com is the obvious choice and from our perspective, the current market cap of ~\$390 million would be a bargain for J&J, given the size of the market, the quality of the product, and the likelihood of high demand. Think of the infrastructure synergies alone...

- **Growth and immediate accretion!** *While this purchase is clearly a strategic play, Animas' expected revenue of ~\$105+ million in 2006 adds about 5 percentage points of growth to LifeScan's expected 2006 base of \$2.2+ billion – although margins may be lower for pumps than for strips, pump margins are increasing and will undoubtedly prompt more strip sales: a nice circular groove, yes? How excellent will it be to have 300+ LifeScan reps humming about the benefits of pump therapy? The deal should be immediately accretive, which matters to large-cap investors.*
- **And of course, some challenges.** *The main challenges in the business relate in our view to competition and manufacturing. From a competitive perspective, we expect the bar to continue to be raised all around and we think that the market will see expansion, as noted, so that's a positive for all. On the flip side, manufacturing challenges can be expensive – literally all the players have had voluntary (some less voluntary than others) recalls and this can do serious damage, both from patient loyalty and margin perspectives. Similar manufacturing challenges have been seen in 2005, of course, in blood glucose monitoring with all three of the top players experiencing problems prompting some distraction. Stay tuned on this front – commitment to attention and investment in this area will be critical.*

What Animas gets:

- **Significantly deeper R&D pockets.** *This year ('05), we look for LifeScan to achieve a landmark \$2 billion in sales – say at least 5% - 10% of that, or \$100-\$200 million, is put into R&D. This gives J&J and Animas substantial resources for next-generation pumps. The \$2 billion is probably a stretch goal as it would represent significant annual glucose monitoring growth, on the order of 18%. J&J/Lifescan shouldn't be expected to reach that lofty level – but we think there's a good chance it will. Our \$2.2 billion projection for '06 for LifeScan's base business assumes lower growth of closer to 10%; it should be over \$2.3 billion with Animas, assuming a first quarter close to the acquisition.)*
- **Sales and marketing prowess.** *As noted we believe LifeScan has about 300 sales reps globally – some amazing professionals with very influential relationships – quite a footprint, overall, that could be leveraged on Animas' behalf. As we understand it, the companies will operate separately at least at the start, but synergies will undoubtedly quickly emerge, particularly in the sales and marketing. While every sales rep will not be detailing every product, ultimately an Animas brochure could be in every LifeScan system distributed. On the marketing side, we have seen outstanding LifeScan campaigns over the years that could tie very well to Animas products (e.g., Live Life Without Limits), especially as direct-to-consumer continues to increase in importance. Over time, a successful integration would, of course, result in more optimization as sales grow and expenses are reduced.*
- **Strong international presence.** *Once the acquisition closes, Animas becomes part of a global company, with access to millions of LifeScan users worldwide.*

- **Outstanding clinical research team.** *The clinical resources have become legion at LifeScan in recent years, and this should help the clinical/regulatory strategy for Animas going forward. We hope the combined entity can crack the integration between insulin and glucose data, in particular.*
- **Exciting product integration.** *Since J&J has long had an investment in Animas, patients have long wanted the products to be integrated – we look for that to finally happen. How? We understand J&J's new Ultra, due out soon, should have significant advantages over the original model, and the next step would seem to be to integrate the two – this has likely been in the works. How long it takes to integrate the product with Animas' pump is anyone's guess, but when it happens, it'll be a long-awaited selling point. We think LifeScan has among the best data management (we love standard deviation by meal), and this'll be appreciated by Animas pump users, who are as demanding (maybe more so) as any other pump users.*
- **Less scrutiny** – *J&J offers the benefits of a public company absent the scrutiny - it's very hard to be a one-product company with Wall Street's eyes on you all the while. Animas has avoided Wall Street distraction admirably to date and will likely welcome less intrusiveness so it can just focus on the work in this increasingly competitive field.*

Why is this good for patients? *For patients, we think this combination bodes well. As competition heighten, we look innovation to increase industrywide – and move at a faster pace. J&J/Lifescan will come up to speed quickly on pumps and will offer very welcome resources.*

Why is this good for investors? *For investors, Animas shareholders did quite well in terms of premium – 35% above the ~\$18 close on December 15 and 63% above its \$15 IPO debut in May, 2004. It's tough to beat that. From a multiple perspective, J&J paid on a trailing revenues basis about 7.6x trailing sales – more than Abbott paid for TheraSense (5.7x) in 2004 or Roche paid for Disetronic (5.1x) in 2003 but a lower multiple than Medtronic paid for Minimed (11.2x) or J&J paid for Inverness (11.2x), both in 2001. We frankly wouldn't want to be across the table from either team in a tough negotiation – CEO Kathy Crothall once again did an admirable job for her shareholders, in selling a third company to J&J. Total losses before turning profitable were under \$100 million and purchase price was over \$500 million – significant value to have created in a relatively short period of time.*

What's next? *We think continuous will be the next step for J&J and as noted, suspect plenty of work has been ongoing. Clearly, J&J/LifeScan with valuable pump and continuous platforms will make it a formidable competitor to both Medtronic and Abbott. It will have infrastructure, it will have the pump platform, and it will have the management.*

What else? *While we're reluctant to talk about the artificial pancreas – so much has been promised, so little has been delivered – we believe this purchase signals that J&J is very serious about developing it. Certainly we know Animas has been serious about it from the get-go. While we appreciate that most companies aren't over-promising on this front, we view improvement on continuous monitoring as one of the most critical areas of progress in 2005, and we think that open-loop artificial pancreas technology is in the mix in the next five years.*

*On that front – a key meeting will take place in Washington this Monday, December 19, “Obstacles and Opportunities on the Road to an Artificial Pancreas: Closing the Loop” – (<http://www.niddk.nih.gov/fund/other/closingtheloop/>). Following this, we’ll publish our full December issue of *Diabetes Close Up*, which will highlight some terrific talks at this meeting, including a session chaired by Dr. Francine Kaufman on glycemic targets (with talks by Drs. Robert Sherwin, Michael Brownlee, and Christopher Saudek), by Dr. Irl Hirsch on where the closed loop system stands (with talks by Drs. Richard Bergman, Bill Tamborlane, Jeffrey Joseph, and Guido Freckmann), and by Dr. Bruce Buckingham on technical challenges (with talks by Drs. Ken Ward, Francis Moussy, Wayne Bequette, and William Clarke). An industry perspective will follow with Drs. Kerstin Rebrin of Abbott, Garry Steil of Medtronic, Jim Brauker of DexCom, and Matthias Essenpreis of Roche – this should be a fascinating discussion given all the leaders in the continuous field. Following that, we’ll hear about regulatory considerations from the FDA. We hope to see you there ... if you are going, send us a line. If not, we’ll hope to talk to you along the way in 2006. In the meantime, see below for all our recent blogs, and if there’s something we’re missing that you’d like to hear about, drop us a line at info@closeconcerns.com!*

Blogwatch - See below for blogs since our last newsletter – you can see any update online at <http://www.closeconcerns.com/>

- **December 15: J&J buys Animas – win/win**
- **December 15: Merck – Analyst meeting diabetes and obesity details**
- **December 15: NYC to monitor patients with diabetes**
- **December 14: Arena announces positive results of Phase 2b trial for APD356**
- **December 12: Lilly and BMS – Analyst meetings diabetes and obesity details**
- **December 8: Medtronic SHAPE = Lopsided**
- **December 7: Orloff departure from FDA bodes badly for drugs at agency**
- **November 29: Dex Com Continues Momentum**
- **November 29: Consumer demand for obesity drugs real**
- **November 28: GLP-1 competition looks like it may finally emerge, in 2009**
- **November 23: Banning Surgery Below BMIs of (gasp ...) 30 in where else, England**
- **November 15: Addition of Amylin's Byetta lowers A1c in poorly-controlled TZD pts**
- **November 14: AHA Musings - Drugs and More Drugs and More on FIELD**
- **November 14: Another Complications Drug – SPP301 for Diabetic Nephropathy reports positive Phase IIb data and enters Phase 3**
- **November 14: FIELD results negative ... no home run for Fournier**
- **November 13: FIELD trial results out tomorrow ~**
- **November 12: Novo Moves Ahead of Lilly ~ What, Six Months Only!?**
- **November 12: DT&T Day 3 - Panels, panels, panels...**
- **November 11: DT&T Days 1 and 2 ~ Continuous Update and Much More ...**
- **November 9: Sanofi 3Q05 - Mixed Quarter for Diabetes - Lantus Wins, Acomplia?**
- **November 8: Pharmacogenetics promises to predict individual drug reactions**
- **November 8: New study finds high rates of kidney disease**
- **November 8: Waist-to-Hip ratio: A new definition of obesity?**
- **November 6: CMS and Bariatric Surgery - Key Decision Coming Nov 24**
- **November 2: WSJ and Symlin - please!**
- **November 2: DXCM 3Q05 - Focused, calm, and fine-tuned**

Note: This newsletter was updated after its original publish date of December 16, 2005 to reflect additional acquisition details and commentary.

Diabetes Close Up is a newsletter highlighting notable information and events in the diabetes industry. This newsletter is put forth as an unbiased commentary on the industry and is not meant to serve as a recommendation to buy or sell (or hold!) any stocks. Companies in which Close Concerns writers have stock and/or that are current or past clients of Close Concerns include Abbott, Animas, Amylin, DiObex, Johnson & Johnson, Medtronic, Metrika, Roche, and Sanofi-Aventis. If you have any suggestions or comments regarding content, please contact info@closeconcerns.com. If you would like to subscribe to DCU, please contact subscribe@closeconcerns.com. If you would like to offer any suggestions or comments regarding content, please contact info@closeconcerns.com. More information and disclosures found on our website www.closeconcerns.com.