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BIOTECH AND PHARMA | Q&A

The Biotech Industry Is Healthier Than Investors Think. These Are the Stocks to Watch.

RA Capital Management's Peter Kolchinsky says the companies that survived the industry's 2021 rout are thriving—and looking to make deals.

By Josh Nathan-Kazis Follow

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Key Points

About This Summary

- Investors have largely steered clear of the biotech sector since its early-2021 collapse. Beneath the surface, the recovery is well under way.
- RA Capital Management's Peter Kolchinsky says the big pharmaceutical companies have plenty of cash to continue snapping up smaller biotechs.
- Kolchinsky is especially optimistic about the prospects for drugmakers Ascendis, Vaxcyte, and Rhythm Pharmaceuticals.

If you look at a stock chart mapping the performance of the State Street SPDR S&P Biotech exchange-traded fund since early 2021, it seems to tell a simple story: The biotech sector has been a disaster for investors.

The ETF, which trades under the ticker XBI, collapsed in February 2021 as the early-pandemic-era enthusiasm for biotech dissipated like air from a popping balloon. It was more or less moribund until this past summer, when biotech stocks began to rebound, apparently driven by an easing of investor worries over the Trump administration's efforts to reduce drug prices and a marketwide shift toward riskier sectors.

While the latest surge has brought the sector back into the spotlight, Peter Kolchinsky, a managing partner at RA Capital Management, has been there all

along. What's more, he says that from his perspective, the biotech downturn has been over for several years. "Just because the world has decided that biotech is back doesn't mean that it's only just back now," he says. "To those of us who have been living this, it has been functioning for a while."

RA Capital, which Kolchinsky co-founded in 2004, started as a biotech-focused hedge fund. It has since expanded its focus and now invests in private biotechs and even forms start-ups of its own. It calls itself a multistage investment manager and says it had $13.3 billion under management as of the end of October.

The firm doesn't disclose its performance but has racked up some recent wins: It was a major shareholder of Cidara Therapeutics, a biotech company testing a novel influenza prophylaxis that Merck ↓ MRK -1.16% agreed to buy for $9.2 billion in mid-November. RA Capital says it expects to receive over $2.4 billion for its stake in Cidara.

In late November, Kolchinsky spoke with *Barron's* about how value is created in the biotech industry, and why biotech fund managers are like gardeners. An edited version of the conversation follows.

***Barron's*: Biotech stocks are just emerging from a prolonged period of underperformance. What have the past few years been like for your fund?**

Peter Kolchinsky: I'm going to alter the way that you framed that. I would say that the sector really collapsed from the fourth quarter of 2021 to about May of 2022. And from there, it has been recovering.

In retrospect—and these things are clearer in retrospect, but we felt it ourselves along the way—the air got squeezed out of the sector in May 2022. People were uncertain about the future. We were telling people that there are great companies able to raise money, even under those conditions. Yes, there are also a bunch of companies that probably aren't going to make it. But there were a whole bunch that were doing well.

Some were getting acquired, and some were launching their own drugs. Specialists could feel like value was being created along the way. The indexes didn't necessarily show it. Even with great portfolios, we got dragged down. October of 2023 was brutal, but briefly. And then the sector rebounded.

Our eyes see a pattern: The sector is flat, but I don't look at the market as a whole. I look at specific companies, and I see progress.

Have things improved, in part, because some of the chaff, or lower-quality companies, have been stripped away?

Yes, at times there were a couple of hundred companies trading below cash [i.e., with market values that were less than their cash on hand]. But very few biotech investors had any exposure to those companies.

If you poll all the biotech CEOs about how they feel, the number of companies trading below cash means that sentiment would be overwhelmingly negative. However, value is created by the few companies that are succeeding.

The whole portfolio approach to biotech means that at any one time, a lot of companies are in the process of failing. If you market-cap-weight biotech CEOs and allow their voices to be proportional to the amount of money invested in their companies, the negative sentiment quiets down. You barely hear it.

From the third quarter of 2021 to May 2022 was when every company that no longer could exceed the new cost of capital got squashed. A higher cost of capital means investors are more selective, demanding lower valuations relative to before, and focusing on the best programs. We took a hit in our portfolio, and focused our portfolio on the strongest, best companies. The market was brutal and remains tough. The companies that survived this culling were strong enough to thrive.

Are you saying that for the biotech specialists, the biotech downturn was never as bad as it looked?

No, we all took our hits. But from May of 2022 onward, there was a period of recovering performance. With all the excess squeezed out of the sector by May 2022, many of the companies that survived were solid. They kept doing the work that unlocked the value in their science.

We have been active, deploying money and betting on companies that we are excited about, like Cidara.

Biotech M&A activity has been getting a lot of attention. But your recent letter to investors suggests that despite a perception that 2024 was very slow for biotech deals, they never really stopped.

There were some monster deals at the end of 2023, and some significant deals at the beginning of 2025. M&A drives liquidity and returns. The nature of our ecosystem is such that even when generalist investors seem to leave and the market for initial public offerings shuts down, there is still a lot of life in the business. There's a lot of turnover.

Is there really enough demand from the big pharmaceutical firms for all the hundreds of biotechs out there?

We do an analysis looking at how many years of strategics' [large drug companies'] free cash flow it would take to acquire all the sub-$10 billion [in market value] development-stage public biotechs. How big is the buying power of the strategics that are constantly buying? And it is massive. At this point, it would take only 3.5 years of strategics' free cash flow to acquire every single sub-$10 billion development-stage biotech company for a 100% premium.

We aren't suggesting that they acquire all of them. But you can appreciate how small this pool [of would-be sellers] is.

Think of this as a garden that has all kinds of produce growing in it. The big pharmas are like restaurateurs that are always trying to figure out the tastes of the public. They come in and buy certain types of produce. Maybe corn is valuable to them, or eggplant. We are tending to the garden. We are mindful of

what the restaurateurs are likely to be buying. This garden has to be somewhat proportional. It stays in a certain zone.

Every once in a while, a biotech company goes commercial on its own. It's like becoming a farm-to-table farm. Ascendis Pharma has gone commercial with several drugs

Ascendis sells drugs that treat hypoparathyroidism and growth hormone deficiency. You're the largest shareholder, and the company is the largest single position in your portfolio. Why are you enthusiastic about Ascendis?

The CEO is remarkable in that he refuses to talk to any strategics, and we can understand why. Look at the market capitalization of biotech companies that achieved $4 billion in annualized revenue. When they were at a $1 billion [in revenue] run rate, they had market capitalizations in the mid-to-high-teens billions. But as they approached $2 billion in revenue, they rocketed up, and their market capitalization reached a much higher range, around $30 billion to $40 billion.

Ascendis is at about a $1 billion run rate, and its valuation is $13 billion. Nobody who owns Ascendis, in my view, thinks its revenue is staying here. They think revenue will grow to several billion dollars. The jump in valuation could come as revenue approaches that level, sometime in the next 12 to 15 months. As revenue climbs to $2 billion, this is the kind of company that would get recognized by the market as deserving to be in a valuation zone of $30 billion or so.

You tend to make a lot of money when your portfolio companies are acquired. Is Ascendis' CEO's reluctance to sell a problem?

A company can be wildly profitable in its own right. Think about what it's like for a fund of our size. When you have a position in a company like Ascendis, you can get a quick hit if it is acquired. Then you have to redeploy all that

capital productively. Or, you take a page out of Berkshire Hathaway's playbook: Let your companies grow.

We would have been confident continuing to hold Cidara, even if it wasn't acquired. You can imagine holding a company and saying, "I don't feel confident about their ability to launch this drug, I hope they get acquired." But that is a risky bet, because pharma might call your bluff and might not acquire the company. Then what will you do? Sell when the drug is approved?

The whole notion of shorting the launch [i.e., betting against a biotech when it gets a drug approves] is an old-school theme in biotech. People would do that because we had so little experience with biotech companies launching their own drugs. Our sector is only 49 years old. That is how old I am. You learn stuff every decade. Biotech has learned stuff in its 40s. What it learned is how to launch your own drugs.

I'm looking forward to more of our companies launching drugs, like Ascendis did. That puts some competitive pressure on the big pharmas, because they need that growth. They can't afford to let too many of the companies with novel medicines achieve escape velocity and get into orbit on their own. They have to pluck them while they are still relatively low to the ground.

What other public biotechs are you enthusiastic about right now?

We are excited about Vaxcyte's work on what we think could be the best vaccine against pneumococcal infections. Rhythm Pharmaceuticals excels at treating many forms of genetic obesity that GLP-1s barely impact, with a drug that is already approved for some types of genetic obesity that we think will work in many other kinds.

You're deeply involved in the private markets. What's your most intriguing investment there right now?

The company I'm most excited about is into what I call concierge science to deliver true healthspan benefits. It's called Radence, and it is focused on using

all known medicinal technology, from imaging to blood tests to medicines, to maximize disease prevention without being constrained by what insurance will cover. Yes, it's expensive, and probably only a million people in the world can afford the $50,000 to $100,000 per year that this kind of advanced medicine costs. But that's a $50 billion to $100 billion market, so we can create a very valuable company.

Thanks, Peter.

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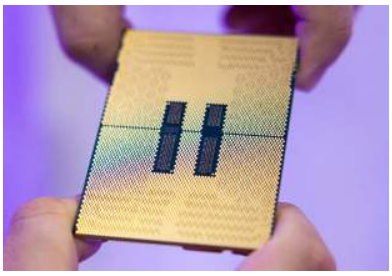

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