ITEM 64

OFFICE OF THE CITY MANAGER
DES MOINES, IOWA

CITY COUNCIL COMMUNICATION 97-415
AUGUST 4, 1997 AGENDA

SUBJECT:	TYPE:	SUBMITTED BY:
RESOLUTION TO APPROVE SUBMISSION FOR CEBA FUNDS AND GIVE PRELIMINARY CITY FUNDING APPROVAL	◆ RESOLUTION ORDINANCE RECEIVE/FILE	JAMES GRANT COMMUNITY DEVELOPMENT DIRECTOR

SYNOPSIS —

City Economic Development staff has been working with Diamond Animal Health (Diamond), a subsidiary of Heska Corporation, to help craft a financing package to fund a critical expansion project planned by the company to be phased from 1997 to 1999. To this end we have also been working with our community partners, the Chamber of Commerce, MidAmerican Energy Company, the Mid-Iowa Development Fund, and the State of Iowa.

Diamond is entering a period of facility expansion, renovation, and growth. In the next three years Diamond and it's parent, Heska Corporation, will need to spend approximately $13 million to upgrade the plant facility, to purchase equipment, and for increased working capital. This expansion project will allow Diamond to increase its current contract manufacturing base, develop new contract manufacturing relationships, move into areas of new technology, and export worldwide. The financing plan for these improvements will include State CEBA, City, Mid-Iowa Development Fund, and private sources.

The project will retain 38 jobs and create 82 new jobs over a five-year period. Manufacturing wages will average $14.42, and administrative wages will average $9.61. Engineering, scientific, and managerial positions will average at somewhat higher levels than the manufacturing wage. In addition, the company provides benefits that approximate 25 percent of these base wages.

Heska, Diamond and private lenders will provide approximately $12.2 million toward the expansion project. The direct community incentives total $800,000: City and State at $300,000 each, and Mid-Iowa Development Fund at $200,000. MidAmerican Energy is working with the company to reduce utility costs.

Preliminary approval is requested at this time. Loan agreements and related documents will be prepared for Council review and approval at a later date.

FISCAL IMPACT —

This project is within the boundaries of the proposed agribusiness, Urban Renewal and TIF District. The City's $300,000 contribution will be funded from tax increment revenues generated by this project. The agreement between the City and Diamond will include the company's agreement not to seek tax abatement.

City and County staff have discussed the use of County funds as an interim loan to the City to be repaid by the tax increment revenues. This will need to be reviewed by the Board of Supervisors, although the arrangement would be similar to the Kemin project financing. An alternative interim source of funds could be UDAG repayments or direct City debt to be repaid from TIF. At the time that loan agreements are presented for Council approval, the interim financing arrangement will also be designated for Council approval.

RECOMMENDATION —

Approve the roll call authorizing the submission of a CEBA application in the amount of $300,000, and giving preliminary approval to a $300,000 City contribution.

BACKGROUND —

Diamond Animal Health was created in December 1993 when the management team of Diamond Scientific, a wholly-owned subsidiary of Miles, Inc. (now Bayer Animal Health), acquired the company from Miles in a management buy-out financed by $250,000 of equity investments from members of the management team; $2,350,000 of senior mortgage notes; $1,500,000 of subordinated notes; and $450,000 of state and municipal grants and low interest loans. In the buy-out, management negotiated a three-year contract to manufacture Miles' cattle and pig vaccines; acquired ownership to the cattle vaccine line; and acquired or leased all physical assets of the business, including both a USDA and FDA licensed manufacturing facility and a 180-acre research farm.

Since the buy-out, Diamond's management has followed a three-stage strategy:

1. Reorganize manufacturing operations, to improve profitability;
2. Expand the contract manufacturing business to achieve a stable revenue and profit base; and
3. Differentiate the proprietary bovine biological product line to provide future growth and value.

Current Business

For the first three years since the buy-out, Diamond has operated principally as a contract manufacturing operation. As part of the buy-out, Diamond negotiated a three-year "take or pay" contract to manufacture all of Miles (now Bayer) Animal Health's cattle and pig vaccines, initially representing 90 percent of Diamond's business. Since then, the Bayer contract has been renegotiated and extended by two and one-half years, through June 1999. Additionally, new customers have been added, increasing Diamond's sales to customers other than Bayer from 10 percent of revenues to 40 percent. Goals for this business include further increasing the customer base to reduce dependence on a single customer, stabilization of revenues at or above $12,000,000 with steady future growth from there, and long-term reliance on this and the Heska contract business as a firm base of support for corporate growth.

Heska's Strategy

Heska's goal is to become a leader in companion animal health. The Company's strategy to achieve this goal includes the following elements:

- *Promote strong relationships with veterinarians.* Heska plans to become the companion animal health care company of choice for veterinarians, who are the primary distribution channel for companion animal diagnostics, vaccines and therapeutics. Heska intends to accomplish this goal by providing novel products that advance companion animal medicine, by selling its products exclusively to veterinarians, and by supporting the general practitioner through high quality diagnostic services and through access to a staff of medical specialists. The Company believes that support of veterinarians is critical to enhancing Heska brand loyalty.

- *Develop a broad line of innovative products for comprehensive case management.* Heska's strategy is to offer and develop a broad line of products and services for comprehensive management of companion animal diseases, such as allergy, heartworm infection and flea-associated conditions. For several companion animal diseases, Heska is developing products and services for each step of veterinary care, from diagnosis to treatment and prevention. The Company currently has six products on the market and over 25 products in research and development, and it also provides veterinary diagnostic laboratory services. The Company expects that its business will not be substantially dependent on one product or technology.

- *Commercialize products from its large, sophisticated research effort.* Heska scientists have developed a large body of knowledge, from the organism to the molecular genetic level, about the physiology of parasites, such as fleas and heartworms, and the basic immunology of dogs and cats. The Company believes that this body of knowledge is unmatched in the industry. The Company's strategy is to use this knowledge and the skills of its researchers to create innovative, proprietary products. Heska's current employees hold more than 20 D.V.M.s and over 45 Ph.D.s. Most of these employees have been affiliated with prestigious academic research institutions and/or leading biotechnology or animal health companies.

- *Leverage resources through strong strategic relationships.* Heska has entered into agreements with three major pharmaceutical companies (Novartis, Bayer and Eisai) to provide funding for its research and development programs. These partners have rights to market certain resulting Heska products. Heska believes that the size and experience of these partners will enable the Company to penetrate markets more quickly and extensively. Additionally, to broaden its portfolio of products and technologies, the Company is aggressively pursuing licenses to promising technologies from leading biotechnology companies and research institutions.

- *Pursue complementary acquisitions.* The Company intends to build its business in part through the acquisition of complementary technologies, products and business. In 1996, the Company acquired its present canine allergy product line and the licensed Diamond manufacturing facility, and in 1997 it purchased one of the largest veterinary diagnostic laboratories in the United Kingdom. The Company believes that significant acquisition opportunities exist in the companion animal health industry and plans to actively pursue such opportunities.

The proposed expansion project is critical to implementing the broad marketing strategy of Heska, as well as implementing and increasing the Diamond strategic plan for contract manufacturing. For the three year period 1997-1999, Diamond proposes approximately $7,000,000 in facility upgrade which will allow the plant to meet European Union standards and function more efficiently for its contract customers. In addition, the company will spend approximately $6,000,000 for equipment and increased working capital needs.

Presently, the community incentive component is $800,000 of the $13,000,000 project. Lenders will provide the $6 million of equipment and working capital financing, and Heska Corporation will pledge to fund the rest of the project.

Heska has indicated a preference to limit their participation in the facility upgrade portion of the project to 50 percent with community sources (including private lenders) providing the remaining 50 percent. To date, the local lending community has not committed to participate in the expansion project. Reasons given include the recent cash flow of the company as well as the fact that the expansion is for leasehold improvements since Heska/Diamond does not presently own the real estate.

It is Heska's intention to continue to try to obtain bank financing in the project, but it will commit to provide the financing shown above. A proposal to take title to the real estate is pending with the real estate owner, and the company's cash flow situation is projected to improve as Diamond expands its contract manufacturing and as Heska brings its companion animal products to market. However, it may be several months before another proposal is sought from lenders.

Since Heska has been primarily involved in research and development, and since Diamond has not achieved profitability, City staff felt that it needed a third party analysis of the proposal to help with risk assessment.

A copy of a letter from Professor Roth of Iowa State University is attached. He makes it clear that he does not have the background for judging the financial components of the project. However, he does view the Heska products as innovative and comments favorably on Heska's research efforts. He views the investment of Novartis, a multi-national pharmaceutical and biologicals company, as a positive indicator of Heska's market potential. He also agrees that contract manufacturing is a growing part of the pharmaceuticals and biologics business. Additionally, he indicates that upgrading the facility provides a competitive edge to Diamond, and will make the facility a valuable community resource.

Professor Roth's analysis has been valuable as part of City staff's due diligence. Staff recommends the $300,000 City contribution to the project, as well as the pursuit of State funding and funding from Mid-Iowa Development Fund. City staff will continue to work with Heska to seek bank financing as part of the project so that Heska funds can be freed for research and development needs.

This project will create/retain 120 quality jobs, with high wages and good benefits. Diamond's credit history with its current City loan has been good and the company has been and is current on its loan payments to the City.

Urban Renewal Area And Tax Incremental Financing District

An urban renewal area and a tax increment finance district are proposed to be established in southeast Des Moines generally bounded by Dean Avenue to the north, the Des Moines River to the south, SE 43rd Street (City limits) to the east, and SE 14th Street to the west. This area includes Diamond and several other agribusinesses as well as being eligible for designation as a State of Iowa Enterprise Zone.

The Council is requested to authorize the City Manager to prepare the necessary documents relating to the designation of an urban renewal area and tax increment financing district. As part of those actions, the draft documents shall be reviewed by the appropriate City Boards and Commissions, and their recommendations shall be forwarded to the Council on the establishment of the urban renewal area and tax increment district.

With the establishment of the urban renewal area and tax increment district, funding can then be made available from the tax increment district to assist investments within the TIF District and to repay the proposed $300,000 City loan to Diamond.

Attachment

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Dear Mr. Ryan and Mr. Stricker:

I have reviewed the information that you provided me regarding Diamond Animal Health. The purpose of this letter is to provide my assessment of the business information which they provided. I want to emphasize that my expertise is in the scientific basis for animal vaccines and I am familiar with the animal vaccine industry. However, I do not have extensive business management experience.

Diamond Animal Health has projected dramatic increases in revenue from 1997 through the year 2001. This increase in revenue depends heavily on contract manufacturing for Heska, Micrel/BI and Aviron. I have no basis for judging whether these revenue projections are realistic.

Heska has a current contract with Diamond for production of products, but their projects are nearly all still in the development phase. Micrel/BI and Aviron are listed as pending contracts for products that are apparently not yet approved for marketing. The crucial element for Diamond's long term success will be for Heska to get several products approved by the USDA, put into production, and successfully marketed. Sufficient information was not provided for me to judge the time line or liklihood of success for Heska products. A full analysis of this would require someone to extensively study each of Heska's Rand D projects in detail. It is very encouraging that Novartis AG is reported to have made "a large equity investment in the company" in April 1996. Novartis is a very large company with extensive experience in animal health. They would certainly have studied Heska's research portfolio in detail and they have the expertise to assess its potential. The fact that Novartis is willing to invest heavily in Heska is a good indication that Heska's investment in basic research is likely to pay off in terms of marketable products. Since Heska is the parent company for Diamond, these products would undoubtedly be produced at the Diamond facility.

Diamond's plan to upgrade their facilities to achieve full European Union (EU) certification is very sound. This will give them a significant competitive advantage with certain products and certain customers. In addition, it makes their facilities a valuable resource. If it should become necessary to sell the facilities I would anticipate that several vaccine companies which do not have EU certification would be interested in purchasing an EU certified facility. It seems to me that investing in upgrading the facilities would ensure that the facilities would continue to be utilized and the employment base would remain in the Des Moines area. Currently only a small minority of the veterinary biologics companies in the U.S. have facilities that have been certified for producing products for sale on the European market.

I agree with the analysis and rationale presented in the "market overview" section of the documentation. It seems likely that outsourcing and contract manufacturing will continue to be an option exercised by many large and small biologics and pharmaceutical companies. This should help to maintain the revenue flow for Diamond while they are waiting for the Heska products to be approved for manufacture.

In summary, I believe that Heska and Diamond combined are well positioned to be successful in the current animal health products environment in the U.S. Heska has a solid reputation for high quality and innovative research which should begin to generate novel animal health products. Diamond has established a modest base for contract manufacturing which should expand significantly when Heska's products are approved for production. Upgrading of the Diamond manufacturing capabilities should ensure that these facilities continue to be used and remain as an important employer in the Des Moines community.

If you have any questions or if I can be of further assistance please do not hesitate to contact me.

Sincerely,

James A. Roth

James A. Roth, DVM, PhD
Distinguished Professor

cc: David Roederer