

Is your capital
allocation strategy
driving or diminishing
shareholder returns?

Spotlight on life sciences industry
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With more cash available, a formal, data-rich capital allocation process is essential

Life sciences companies have been able to access significant amounts of cash from overseas and increase their operating cash flow as a result of lower tax rates because of US tax reform. In addition, many life sciences companies have been successful in reducing their working capital levels. For example, Pfizer decreased year-end working capital as a percentage of revenue from 12.4% to 1.1% over the last five years thanks to a comprehensive optimization program.

46%

of life sciences executives say their companies do not have a formal, systematic approach to capital allocation.

With this abundance of capital and the global economy continuing to expand, life sciences companies must make capital allocation decisions that will drive long-term growth. Long-term thinking should be an area in which life sciences companies have an advantage over other sectors. The very nature of product development, with its rigorous testing regimen, regulatory hurdles and systematic decisions about whether to advance a product to the next phase means that successful life sciences companies need to regularly evaluate long-term investment decisions.

Yet in a recent EY survey of more than 500 CFOs, nearly half (46%) of the 90 life sciences respondents say their companies do not have a formal, systematic approach to capital allocation. Of those life sciences CFOs who do have a formal capital allocation process, only 55% say that their process is directly

55%

with a formal capital allocation process said it was directly linked to their overall strategic plan.

linked to the overall strategic plan (versus 63% for all respondents). Similarly, 31% say their companies can quickly pivot and assess new opportunities or reprioritize planned investments, compared with 40% of all respondents.

Adopting a formal, data-rich approach to capital allocation may enable life sciences companies to rethink the timing and magnitude of their share repurchases and increase investment in focused R&D programs and innovative third-party technologies through acquisitions, joint ventures or partnerships.

7%

say they repurchased shares because their business was undervalued by the market.

Objectively evaluate share repurchases

Life sciences companies are among the highest share repurchasers. An EY analysis of public data shows that from the 2008 financial crisis to the present share repurchases have been accelerating at the 45 largest life sciences companies as valuations have increased significantly. While there was a decrease in 2017 at a time of significant uncertainty related to the outcome of tax reform in the US, once the Tax Cuts and Jobs Act was passed, life sciences companies resumed their high levels of share repurchases, many using cash from overseas.

We believe a company should repurchase shares if it has excess cash and its intrinsic value exceeds its market value. But in 2018, life sciences companies set a record for share repurchases even as life sciences stocks were trading at their all-time highs. Meanwhile, according to the survey, only 7% of life sciences companies indicate they repurchase shares because they feel their stock is undervalued.

A major driver behind share repurchases, and one that almost one-third (32%) of life sciences CFOs acknowledge, is the desire to increase earnings per share, a short-term benefit rather than a long-term strategic goal.

While returning cash to shareholders might be an easy default position, especially as many research and

development (R&D) programs have yielded results below expectations, share repurchases still need to be viewed through the same lens as other investment decisions. We would challenge life sciences companies to evaluate whether the return on buying back their own shares is greater than other potential uses for capital, including R&D, acquisitions, and improving equipment or facilities.

Invest in focused R&D programs

In the EY survey, 31% of life sciences CFOs say they repurchased shares because they had cash in excess of investment opportunities with an acceptable return. One reason may be that returns on R&D across life sciences have been declining for years. As a result, R&D spend as a percentage of revenue has dipped slightly over the past year, even as companies have more cash available from tax reform and working capital efficiencies.

Companies can improve their R&D efficiency and achieve higher returns on investment if they increase the focus of their R&D programs. Smaller, niche biotechnology companies tend to outperform larger pharmaceutical peers when it comes to return on R&D. Some larger firms have shown a trend in recent years toward greater specialization. For example, Takeda Pharmaceutical Company announced in July 2016 that it would focus on just three therapeutic areas: oncology, gastroenterology (GI), and central nervous system. The company's rationale at the time was to improve R&D productivity for long-term, sustainable growth. One of the key strategic considerations for Takeda's recently completed US\$62b acquisition of Shire plc was a deeper focus in GI and neuroscience, as they held complementary positions.

Life sciences companies should focus their R&D programs to increase their return on investment. By doing so, R&D will become a more attractive strategic option.

63%

say that they hold higher-risk investments at the corporate level or in a venture capital arm.

Invest in innovative third-party technologies

To capture the upside of technological disruption, life sciences companies must make the right bets through acquisitions, joint ventures or partnerships.

Bristol-Myers Squibb's recently announced plan to acquire Celgene is an example, with the transaction helping the company to expand its treatments for cancer and its immunotherapy platform. Medtronic's acquisition of Mazor Robotics, meanwhile, allowed Medtronic to enhance its platform of spine surgery technologies.

Johnson & Johnson recently announced a partnership with a leading technology company to study a wearable's ability to detect irregular heart conditions. While it's still in its early stages and the future business model is still to be determined, this is an example of a life sciences company partnering with a leading technology firm.

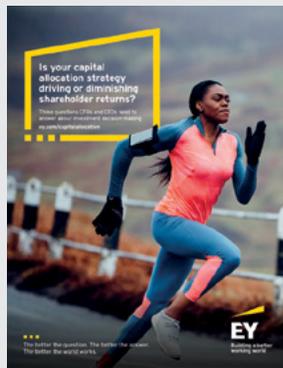
We advocate holding smaller, innovative investments at the corporate level, whether through a corporate venture capital fund or otherwise. In the capital allocation survey, 63% of life sciences CFOs say that they hold higher-risk investments at the corporate level or in a venture capital arm.

A business unit leader may reject investments that will likely not pay off in the near-term, so making them at the corporate level enables organizations to make the investments they need.



Conclusion

Through tax reform and working capital improvements, life sciences companies have significant cash to deploy. Senior executives should ensure that a formal, data-driven process is used to optimize capital allocation. For many life sciences companies, one result from this process will be more capital being allocated to focused R&D programs and M&A.



The recent EY Capital Allocation report, *Is your capital allocation strategy driving or diminishing shareholder returns?*, poses three questions CEOs and CFOs need to be able to answer:

- 1 Can we react quickly enough to opportunities and threats?
- 2 Are we making objective, unbiased decisions?
- 3 Are we returning cash to shareholders at the right time, and in the right way?

This sector spotlight article examines capital allocation challenges and opportunities in the life sciences industry. Other articles examine capital allocation in advanced manufacturing, consumer and technology.

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To learn more and to have a conversation about the life sciences industry, please contact us:

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