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working world

Does your integration playbook tackle tomorrow's M&A challenges?

Life sciences



The better the question. The better the answer.
The better the world works.

Adding scientific innovation in a high-risk, high-reward industry

Life sciences is a high-risk, high-reward sector. Big pharma and medtech companies are facing several barriers to growth, including a lack of research and development results, pricing and reimbursement pressures, and medications in traditional therapeutic areas that are largely available as generics. The success of technological innovation is the key to growth, and regulatory approval is a gateway to markets.

The emergence of technology companies in the life sciences space and changing customer expectations are also adding to the pressure. Big pharma and medtech companies have the right commercial and clinical development capabilities in place, but are looking to acquisitions to gain access to new treatments and platforms of care to leverage that go-to-market infrastructure.

Among the assets life sciences companies are looking for are treatments in areas such as immuno-oncology. They are also seeking out neurology treatments and niche markets, like Celgene, Pfizer and Novartis investing in cell and gene therapy. Treatments for rare diseases that affect fewer than 200,000 people are also of interest, since these disease categories have a passionate patient advocacy supporting their high price and reimbursement.

In order to create shareholder value, life sciences companies need to maintain a clear, realistic view of what they hope to achieve throughout the transaction life cycle. Are they trying to incubate or grow a smaller business? Are they trying to add to their existing platform to expand into adjacent products or new geographies? Or are they trying to accumulate large-scale assets in deals where they can focus on cost synergies?

About this report

This report is part of the EY *Buy & Integrate* series of sector-specific reports that encourage CFOs, CDOs and transaction leaders to take a fresh look at how they identify and capture synergies during M&A. In the reports we suggest leading strategies to improve your M&A and integration playbook.

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- ▶ Advanced manufacturing
- ▶ Consumer products and retail
- ▶ Health care
- ▶ Technology, media and entertainment, and telecommunications

Higher valuations underline need to boost growth

Competition for viable, at-scale targets has been driving up EV/EBITDA multiples. Additionally, Chinese venture capital has been seeking US biotechnology assets. And US companies have more available capital to make acquisitions, thanks to provisions in the new US tax law. We have seen deals where the bidders have increased the offering price by 10% to 20% at a time, rather than the typical 2% to 5% increments.

In addition to benefiting top-line growth, life sciences companies are also exploring cost synergies. An EY analysis of 75 life sciences deals from 2010 through 2017 showed a wide variance in cost synergies achieved. Pharma companies averaged realized cost synergies of 24.4% of target revenue, driven by large deals that yielded big cost synergies. Synergies in pharma deals were among the highest in all the sectors studied.

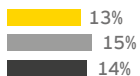
At the other end, cost synergies achieved in medtech deals were the lowest in the life sciences sector, with average realized cost synergies of 7.6% of target revenues, due in part to a focus on growth, rather than cost cutting.

The time frame for how long it will take for an acquisition to deliver shareholder returns depends on the scale and complexity of the transaction. EY conducted a separate study of nearly 300 life sciences transactions that took place from 2010 to 2017. In the study, both transformative deals and bolt-on transactions created shareholder value. However, the bolt-on deals did so faster, averaging a compound annual growth rate of 12% in the first three years, compared with 8% for transformative deals. By five years out, the gap had narrowed, with the CAGR for bolt-on deals at 19% and transformative deals at 17%. Incidentally, deals predicated on geographic expansion reached a CAGR of only 5% over the first five years.

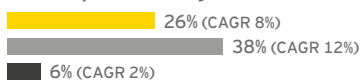
Average normalized total shareholder return (TSR)

■ Transformative
 ■ Bolt-on
 ■ Geographic expansion

One-year average TSR



Three-year average TSR



Five-year average TSR



Key learnings for creating sustainable value

The different paces and paths to value creation emphasize the need to have a clear plan. In our work with life sciences companies, we have discerned several lessons that companies can learn from in order to realize the greatest shareholder value:

Address cultural differences and associated risks. Big pharma companies tend to be much more risk averse than smaller companies in abiding by commercial regulations in order to avoid regulatory and legal actions. The smaller companies they are acquiring may be more flexible, with people taking on more than one function where a larger company would be able to make sure the functions are separated. Once the asset becomes part of a big pharma company, these practices could become fodder for regulatory and quality action, and the acquired business could move higher up on regulators' radar, therefore:

- ▶ Deal executives need to understand the target's degree of risk tolerance and work to align it with how much risk the board is willing to assume, which could well be lower.
- ▶ Executives need to make sure functions are properly separated, the medical affairs and commercial functions in particular. There may be some crossover in smaller companies that can lead to possible regulatory issues.
- ▶ The buyer needs to carefully communicate its views on risk tolerance to the acquired company's employees. Align incentives to take into account the more restrictive risk parameters.
- ▶ Decisions need to be based on science. The incentives for whether a product moves to the next phase of clinical trials can change after the deal. Key personnel at the acquired company could now have financial incentives that are hit when a product moves to the next trial stage. A typical step in the industry is to create a scientific advisory board to conduct external due diligence validating assumptions around standard-of-care pricing and size of the population that could use it.

Decide what talent must be retained. Depending on the asset, the culture of the acquirer and the target can be quite different. Salesforce incentives, tolerance for bureaucracy and a host of other cultural variables may be different at a big pharma company than at a smaller biotech or medtech company that is being acquired. When does culture matter?

- ▶ In the case of a capability acquisition, such as a pure oncology company, every scientist and engineer is a human capital asset that the company may want to keep. In that case, it behooves the buyer to look for the things those employees value most. In many deals, knowing the acquisition rationale lets employees understand where they will fit in the new organization. It could be a matter of emphasizing the greater R&D capabilities at the buyer that can help scientists at the target develop new

treatments. It could be a matter of showing the target's employees the opportunities in a larger business. Or it could be letting them know that they will be able to operate as independently as possible.

- ▶ Conversely, if the goal is buying an existing drug or technology, the cultural issues may not matter as much. It may be more important to get a drug into the acquirer's salesforce and distribution system as quickly as possible or to use the acquirer's "at scale" network to enroll patients in clinical trials more quickly. Making it clear that the target will need to adapt to the buyer's culture can be the right message and could even help speed up necessary headcount adjustment as some employees of the target seek other opportunities.

Anticipate potential integration issues and react quickly to unexpected ones. One of the questions we regularly get from CEOs, CFOs, and heads of corporate development and heads of the integration management office is how to accelerate synergies. This becomes even more pressing when multiples for acquisitions are historically high. Below are some steps that can help the integration process go more smoothly, leading to quicker synergy recognition.

- ▶ HR is one of the most important areas where cost synergies are captured in the first year. Early on, determine the company's future state and a clear Day One operating model. Then, screen employees quickly through that lens.
- ▶ Examine the target's supply chain and pipeline for potential quality issues. In many cases, a smaller target may use third-party manufacturers and quality control could be less rigorous. One big pharma company looked at the products in the commercial pipeline of the company it just bought and realized that they could not be sold under its standards. The products had to be pulled from the shelves for 18 months while they were reformulated, at great cost to the buyer. While the seller is not going to reveal its formulations until after the deal is closed, pharma companies need to ask incisive questions to gather as much information as possible before closing.
- ▶ Establish a regulatory affairs transition strategy early. Get a registration listing of the seller's products during the diligence period and understand where regulated facilities, manufacturing plants, product registrations and other assets are located and who owns them. In addition, understanding the country-specific health authority submission requirements and approval timelines can help the buyer gain several months in the integration.

Assign long-term deal responsibility. Many transformative acquisitions in big pharma can take three to five years to integrate in order to realize synergies. In that time, the CFO and executives in the integration management office may have moved on to new positions and responsibilities and the initial

cost reductions and revenue growth that were accomplished in the first two years become the de facto baseline. In order to maximize synergies:

- ▶ Make sure the integration plan clearly lays out synergy benchmarks that go beyond the first two years. In one case we worked with, the CFO actually laminated the original synergy plan and reviewed it regularly to track progress.

Case study: adding new capabilities in an accelerated integration process

Challenge

Global life sciences company LabCorp acquired Chiltern, a diagnostics and drug development business, in order to expand the clinical testing business of LabCorp's Covance unit. The deal enhanced Covance's strength in oncology clinical testing and added biotech expertise, while also bringing in new testing expertise in medical devices, women's health and ophthalmology. It also added to Covance's functional service provider offerings in biometric areas. The goal during integration in this strategic growth acquisition was to preserve Chiltern's existing value while executing quickly.

Complicating matters, the deal closed one month after signing, rather than the typical three to six months one would see in a deal of this size. This meant that the integration planning that would usually occur pre-close needed to be conducted at a much more accelerated pace in order to not only realize value quickly but mitigate any major risks (e.g., talent retention, customer attrition).

Approach

An integration management office was created on Day One to empower team leads to make decisions on their own, which helped streamline decision-making, such as allowing Chiltern's oncology group to operate separately, for a time, rather than be integrated fully. Otherwise, the best elements of both companies were integrated into future-state models for core operations, operations support functions, commercial and infrastructure (HR, IT, procurement, legal, facilities, finance and accounting), in part to capture cost synergies and in part to spur growth. For example, Chiltern had medical experts involved very early in the process of meeting with potential new clients, a practice that was adopted in the combined organization. Covance, meanwhile, had already established centers of excellence that pulled program managers into one pool of resources to staff clinical studies, a process that maximizes utilization that was expanded to Chiltern.

Result

The disciplined and structured synergy program allowed Covance to reap total cost synergies above the announced target, by enabling deeper integration of back-office functions, such as accounting, IT and human resources. Revenue synergies were identified through deeper customer penetration in the biotech segment and cross-selling for the combined business. With our help, Covance was also able to develop an integration playbook for similar deals in the future.

- ▶ Make sure that somebody in the organization who can stick with the deal long-term is responsible for continuing the integration and accountability. In at least one integration we have been involved with, a senior person who was nearing retirement was given this responsibility and made sure the company continued to maximize synergies for several years. This can be an ideal job as a bridge to retirement, giving the executive an engaging role toward the end of his or her career to leave a lasting legacy with the company, while making sure that somebody who has built up standing in the corporate culture is seeing the deal through.

Establish an integration scorecard and utilize

collaboration tools. An integration scorecard should be an easily digestible picture of deal success as measured against its rationale and planned value sources. This provides an easy way to communicate with operating leaders who were not part of the deal team, but need to be aware of and track the synergy expectations.

- ▶ Scorecard leading practices include the following:
 - ▶ Identify metrics that are consistent with the deal's original value thesis.
 - ▶ Select operational (not just financial) metrics.
 - ▶ Use benchmarks for similar transactions to determine key metrics.
 - ▶ Maintain some metrics consistently across deals in addition to deal-specific metrics to develop an institutional knowledge for future transactions.
 - ▶ Track metrics for an extended period of time, when necessary. For bolt-on acquisitions, synergy tracking may not be needed or only needed for a short period. For deals with complex synergy targets, tracking should usually last three to five years.

Conclusion

Successfully integrating an acquisition requires thorough planning, a mind toward regulatory concerns, corner-office attention to cultural integration, well-defined synergy expectations, and the attention of operational leaders to make sure synergies are being achieved.

Higher multiples driven by increased competition for assets mean that companies need to have a clear view of why they are making an acquisition, a plan for integrating the asset and achieving synergies, and a view of how long integration will take.

The higher multiples in today's life sciences market also mean achieving both the cost synergies and the growth plan are essential.

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