Creating capital efficiency and shareholder value through divestment in the life sciences sector

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As the life sciences (LS) industry continues to be challenged by anemic organic revenue growth, the value of divestments as a way of refocusing business portfolios on long-term core assets and long-term growth areas has never been more obvious.

The rise of the NASDAQ Biotech index this summer to near its all-time high of 4,163 set on 13 July 2015, added to the argument for reassessing portfolios, as executives looked to get the most value out of non-core assets. But even as the index has come down in recent weeks, the reasons to consider divestment remain: slow organic growth, aging portfolios, reimbursement headwinds and internal R&D productivity that is insufficient to fuel the pipeline.

The research suggests that significant opportunity exists for life sciences companies to improve performance, free up capital and create shareholder value by optimizing their portfolio on an ongoing basis. While many companies hesitate to divest because they are concerned with distractions to the ongoing business and investor reaction, EY teams see overwhelming benefits to pruning the portfolio and redeploying capital toward higher-growth adjacencies.

Do divestitures improve capital efficiency or create value?

EY teams examined whether life sciences companies are sufficiently leveraging divestitures as a corporate finance tool and whether the divestitures lead to improved operational outcomes by eliminating the potential dilutive effect of a lower net income contributing business within the portfolio.

EY teams explored whether the divestiture decision would be appreciated by the investor community and would create shareholder value for the RemainCo (the seller) post-divestiture.

After eliminating deals below US$100m in revenue, seller revenue of less than US$100m, the sale of isolated manufacturing plants or facilities, individual brands or products and the rights to develop certain assets, we narrowed the research to 68 companies that were responsible for 119 divestitures from 2008–17.

During the screening process, 18 companies were eliminated since they conducted spin-offs, as divestitures and spinoffs cannot be treated similarly for value-creation measurement purposes. (For more information on spin-offs, read the study **published** at CFO.com by EY colleagues who have researched value creation of spin-offs across multiple industries.)[1]

Geographically, the 68 divestors included companies headquartered in the US (35%), Europe (31%), Asia-Pacific (APAC) (32%) and the rest of the world (ROW) (1%).

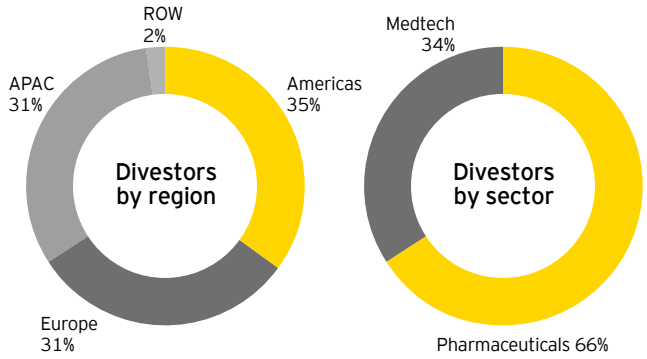
Methodology

EY teams focused on 661 publicly traded life sciences companies that have executed an aggregate number of 1,436 divestitures and spins-offs within the period of 2008–17.

In order to identify meaningful deals with material impact that could financially and operationally influence the capital efficiency and shareholder value, we have excluded deals with the following characteristics:

- Deal value < US$100m
- Seller revenue < US$100m
- Sale of:
  - Isolated manufacturing plants and facilities
  - Individual brand or products
  - Rights to develop medications or medical devices, as it is very hard to predict any operational outcome within the research period
- Spin-offs due to small number to avoid confounding the data set

68 divestors by geography and sub-sector



About 66% of the divestors were pharma and biotech companies, while 34% were medtech companies.

In the absence of any comparative set, we would not be able to derive any meaningful conclusions, so EY teams identified 256 publicly traded comparable companies in the original cohort that have not done any divestitures in the research period. Of those, 112 had revenues higher than US$100m and 17 had a meaningful return on capital employed (ROCE)[2] for comparison purposes. These 17 companies constituted the non-divestor control group.

[1] *Six Key Steps to a Successful Spinoff*, CFO.com, http://ww2.cfo.com/accounting-tax/2018/07/six-key-steps-to-a-successful-spinoff/

[2] ROCE = EBIT (1-tax rate)/average total capital, whereas total capital includes total common equity, total preferred equity, total debt and minority interest

Measuring study outcomes

We measured the impact of divestitures in two dimensions:

a. Internally focused capital efficiency as defined by operational metrics that resulted in ROCE

b. Externally focused as measured by investor reaction and share price appreciation to reward or penalize total shareholder return (TSR)

Return on capital employed

ROCE is a financial ratio that measures a company's profitability and the efficiency with which its capital is employed. For this research, it was identified as an appropriate financial ratio to determine how portfolio optimization decisions improve or erode capital efficiency. The initial analysis showed that the cohort of 68 divestors delivered a median ROCE of 7.2% when compared with a cohort of 17 non-divestors, which only had a median ROCE of 3.7%, a significant difference that amounted to nearly doubling of the ROCE of non-divestors.

When the divestor cohort was further stratified by the frequency of divestitures – rare divestors (only one divestiture in the study period), moderate divestors (two divestitures) and frequent divestors (three or more divestitures) – EY teams found that the median ROCE increased with the number of divestitures, resulting in the frequent divestors (9.1%) outperforming non-divestors by almost three times. The median ROCE measure increased proportionately with the number of divestitures across all sub-cohorts as seen in the below graph.

Total shareholder return

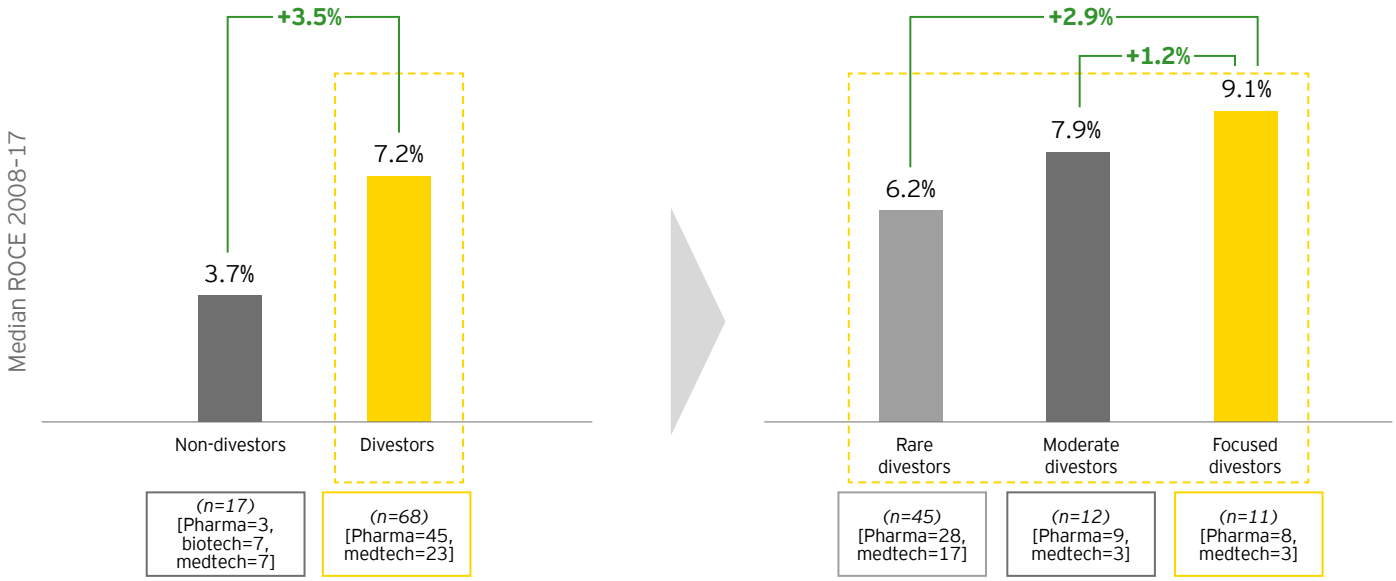
The ultimate measure of value creation for any public company is the appreciation of TSR, a metric to measure how the investors are rewarding or penalizing divestitures within a year after announcement in a normalized fashion.

In this particular study, we identified 61 deals (out of 119) having disclosed DivestCo (divested asset) and seller revenues to allow EY professionals to calculate the size of divested asset and normalized it as a percentage of the corresponding seller's revenue. This allowed the differentiation between small deals as defined by the seller divesting up to 5% of revenues, medium deals with the seller divesting 5.1%–10% of revenues and, finally, big deals with the sold entity's size exceeding more than 10% of the seller's revenues.

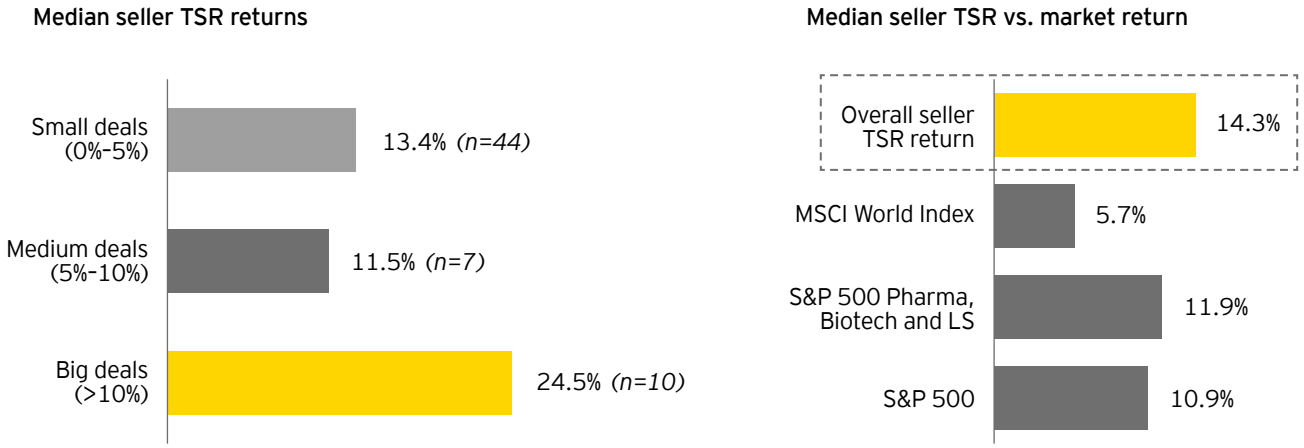
EY teams further analyzed the TSR appreciation for sellers after the announcement of the divestiture for these 61 deals across all sizes to understand the return on sellers' TSR in comparison with market indexes. Most of the emphasis should be given to one year after announcement to allow for the deal to consummate and the DivestCo to operate on a steady-state basis as its own entity separated from the seller.

The analysis suggested that in aggregate one year after the deal's announcement, TSR of life sciences companies with at least one divestiture was 14.3%, eclipsing the aggregate 11.9% increase if the S&P 500 Pharma, Biotech and LS Index and the 10.9% increase for the S&P 500 as well as Morgan Stanley Capital International (MSCI), which rose 5.7%.

ROCE analysis of life sciences companies between 2008–17



Sellers' TSR vs. comparable market indexes one year after divestiture announcement



As to the size of the deal when compared with the size of the seller, there was no particular trend suggesting whether smaller transactions or larger transactions led to a higher shareholder return. This may be a function of cohort sizes being too small and would warrant further analysis.

There is another reason companies should prioritize divestments now. As we explore in both *"Life Sciences 4.0: securing value through data driven platforms"* and the 2019 Firepower report, many life sciences companies will face significant challenges to their business models as the lines between health and technology continue to blur. As companies race to buy or build data-centric capabilities, they need to invest in the digital tools that will have the greatest impact. However, the tools that will be of greatest value will vary depending on the actual business. Companies focused on breakthrough innovations will likely want to prioritize tools that accelerate clinical trial recruitment, for instance, while companies developing interventions for chronic diseases may be more interested in tools that improve the consumer experience. As digital technologies become the status quo, companies that have already made their therapeutic bets will be better positioned to accelerate revenue growth using these new skills. As such, divestitures that allow organizations to focus on fewer therapeutic areas are a crucial step in positioning companies for a data-centric future.

"At Johnson & Johnson we have a disciplined and consistent approach to portfolio optimization. We have a framework and defined set of criteria we use to evaluate our businesses and determine how best to drive capital efficiency, adjust our portfolio, and reinvest in innovation."

Susan E. Morano
Johnson & Johnson Medical Devices

Five key factors to take into account for successful divestitures

To maximize shareholder value from a divestment, the CEO, CFO, head of corporate development and business unit leaders should keep the following factors in mind:

1. Be decisive to take timely action

In the October 2018 EY Capital Confidence Barometer study, 59% of life sciences respondents said they were reviewing their portfolios more often than once a year and 72% said that the main result of their most recent portfolio review was divesting an asset identified as underperforming or at risk of disruption. Once the value case is established with insights from the financial, tax and operational advisors and bankers, the board should quickly make the decision and keep the momentum of the implementation.

In the 2018 EY Global Corporate Divestment study, 48% of life sciences executives said they've held on to assets too long. Executives with a long career in the same company may have a tacit bias to keep an underperforming legacy business, which they may have even run at some point during their careers. Factor in the years and money invested in capex or R&D to turn around the business and executives at life sciences companies can be even more reluctant to let a business go.

At the same time, for a company that has historically grown to be more comfortable in making acquisitions, divestitures pose a different challenge. It's the equivalent to exercising a new set of corporate muscles in a workout.

Expected valuations and time windows will change based on macro-economic conditions or geopolitical risks at the global arena. Speed to value should remain a key success indicator once the divestiture decision is made. If the board and the executive team fail to act within the right time frame, the valuations initially desired will not be within reach (e.g., assets sold at a fraction of their initial valuation, in some cases after a year or two when they were first considered for divestitures, as the executive team did not act timely to exit the asset).

2. Importance of the transferring executive team

In large life sciences companies, executives tend to rotate roles in a two to four-year cycle in order to gain diverse experience, give perspective to the new business unit and train the future generation of executives in different market conditions and portfolios. When the divestment decision is made, one of the critical factors is to determine whether the value of the asset will be maximized with the current leadership team during the sales process or whether some of the members of the existing leadership team should be moved to the "mothership" since they may be better suited for running other portfolio businesses.

This decision should not be made lightly. In the case of a PE buyer, it is important that a knowledgeable management team is in place for day one. If it is a strategic buyer, the know-how that comes with the leadership team is key to keep the business on a successful path. Depending on the buyer profile, at the end of a one to two-year period, upon the completion of the retention bonus period, the management team may exit and be replaced by the buyer-determined team or they may continue to stay in their roles if the business continues to perform and deliver on the transaction's investment hypothesis.

3. Keep the DivestCo performing

Ongoing mediocre performance will erode deal value, but in the 2018 Global Corporate Divestment study, 40% of life sciences executives said that the performance of the business deteriorated during the sale process. Selling a well-performing asset is much easier than an underperforming one as the out-year projections and the typical "hockey stick" turnaround will be hard to justify as the potential buyers will challenge the seller as to why they have not performed that turnaround while they had the asset under their control.

The reason the seller may want to exit the business is that performance is suffering as a normal course of business value erosion potentially due to lack of investment from the RemainCo given its total portfolio prioritization. But underperformance might also be caused by management being distracted by the transaction and not giving full attention to running the business during the transition period. In either scenario, it is essential to meet forecasts for the business, especially if the asset's performance is material for the seller and must be disclosed to the investors. Overall, making short-term, focused and high ROI improvements to support the value story before the sale process begins and clearly demonstrating this to the buyer pool will help make the asset more compelling.

4. Designate a leader to focus on governing the separation

While any decision will require teamwork, it comes down to one lead executive to manage this essential process to create value for RemainCo and DivestCo. The executive will have to make some tough calls, manage employee morale and keep the performance on pace through what can be a tedious process. It is ideal to separate the roles of the business operator from the executive sponsor who will plan and implement the carve-out and separation process. EY teams have seen two types of executive profiles in divestitures. Either a seasoned executive uses this experience as a way to make his or her mark and build a legacy, or an up-and-comer uses this divestiture as a springboard to roles with bigger scale and scope. In either case, the appointed executive should embrace this challenge for one to two years.

Put somebody in charge of running the divested business as a separate business if it isn't operating that way already. Get clarity into what operations will be separated and how assets and employees will be aligned in both the divestiture and the remaining company. Decide who should go with the divested company and who should stay with the parent. This will involve several questions for senior management, including how to retain the management team through the divestment process, how a potential buyer will react to the management team and whether that buyer will instead want to bring in its own team.

But not only leaders will feel the uncertainty. Key talent may also opt to seek new opportunities if they feel the new culture does not align to their personal values. It is critical that the sellers identify key talent and make sure they know what to expect throughout the process. Take steps to retain key employees by explaining "what's in it for you" so that they will still be around to add value when the unit is divested.

5. **It isn't over until TSAs are exited and stranded costs are eliminated**

The signing or even the closing of the transaction does not end the value-creation process for the seller. Numerous transition services agreements (TSAs) put in place during the negotiation process will almost always outlast the close date of the deal by months to years.

The deal management team governing the separation process should not lose sight of managing the TSAs when the buyer exits them. There will be stranded costs across all functions that the seller needs to endure while providing these transitional services over the course of the agreed-upon period. A TSA wind-down process has to be established early on with a clear action plan to pull the proper levers for cost take-out tied to the exit timing. In the EY 2018 Corporate Divestment study, 67% of life sciences executives said they wished they had used analytics in the identification of stranded costs. Starting separation planning earlier and utilizing analytics helps to identify areas of entanglement and understand the magnitude of stranded costs, potentially avoiding delays in closing.

Ultimately, the stranded cost identification and elimination process should be in place once the dust settles and the asset becomes part of the new owner.

Conclusion

The study paints a very clear picture: portfolio optimization combined with divestitures can be a powerful tool in the corporate finance executive's tool box.

When used timely and effectively, it leads to improved operational outcomes and efficient employment of capital as measured in the ROCE.

And the investors in the study took notice by rewarding the sellers with higher shareholder return one year post-announcement.

We strongly recommend a thoughtful and recurring portfolio optimization process that identifies non-core assets that may be a better fit to other portfolios and will raise capital for sellers to innovate in key areas.

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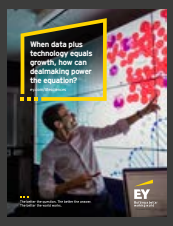
Further insights



2019 M&A Firepower Report: when data plus technology equals growth, how can dealmaking power the equation?
Life sciences companies are using their firepower to create competitive advantages and M&A is essential.

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Life Sciences Capital Confidence Barometer, November 2018
Life sciences executives take a "less is more" attitude toward M&A.

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Life Sciences 4.0: securing value through data-driven platforms
Life sciences companies must consider how and when to participate in emerging platforms of care – something we call Life Sciences 4.0.

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