

Is your growth strategy a big deal?

Bolt-on deals outperform in latest EY life sciences research



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Definitions

Transformative: these acquisitions are large, affecting more than 50% of either company's market capitalization or greater than US\$10b in deal size, and strategically meaningful to "transform" the company into something different. They provide the opportunity to enter new markets, transform the way the company operates and have a cross-border component. They involve multiple business units and therapeutic areas, and they tackle complex issues with HR, IT, supply chain, finance and tax, among many others. Synergies are a meaningful portion of the value generating hypothesis including cost and revenue components.

Bolt-on: this is a small- to medium-size acquisition and most likely less than 25% of the buyer's market capitalization in a new high-growth area, or an area adjacent to the core. It offers a means of diversifying while leveraging part of the same platform, infrastructure or skill set. It also helps expand a market offering, including beyond the pill solutions and platforms of care, while primarily focusing on revenue synergies.

Geographic expansion: this encompasses a collaboration, joint venture, direct investment or acquisition in another life sciences target in a different geography – not to be confused with cross-border transactions that are part of a larger transformative transaction.

Whether M&A contributes to shareholder value creation has been an ongoing debate for decades. EY conducted research based on 278 life sciences transactions that closed between 2010 and 2017 to further evaluate this question. We investigated how transaction type (transformative, bolt-on or geographic expansion) affected total shareholder return (TSR) over several time frames. Our findings suggest that bolt-ons were the winner in getting to incremental value faster – impressively so.

Bolt-ons delivered a higher TSR starting after year one. At year one they delivered 15% TSR; year three, 38% TSR (compound annual growth rate (CAGR) 12%); and year five, 96% TSR (CAGR 19%) with the biggest differential effect at year three when compared with transformative and geographic deals.

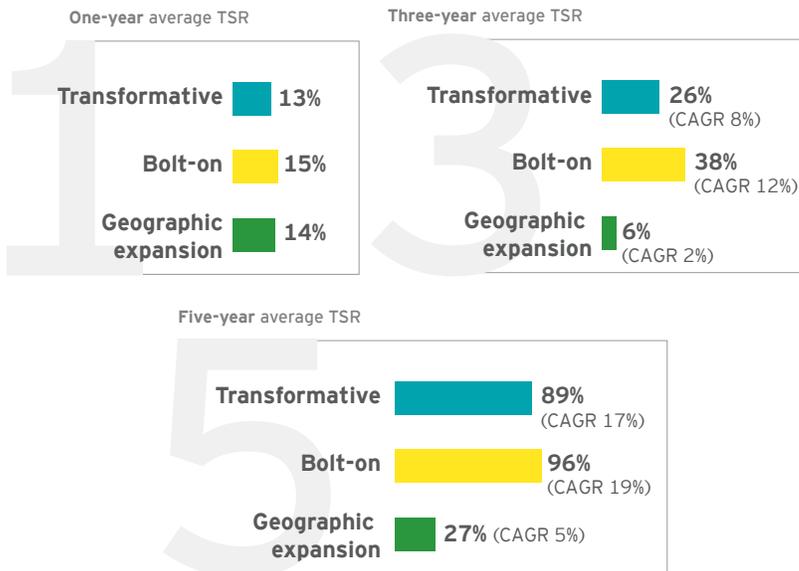


Methodology

The analysis started with a universe of 278 transactions in the life sciences space of more than US\$1b in value that closed during the period of 2010 to 2017. We excluded deals that were done by financial buyers, affected less than 10k employees and sized less than US\$4b. These criteria lowered the number of deals to 58. We then categorized these deals into three types: transformative, bolt-on and geographic expansion, and calculated total comparative shareholder value generation over one, three and five years post-close, normalized by the year of close.

Analysis suggests that bolt-on acquisitions are better poised for value capture while transformative deals take longer time to deliver returns

Average normalized TSR performance



Source: Data compiled from Capital IQ and EY analysis.

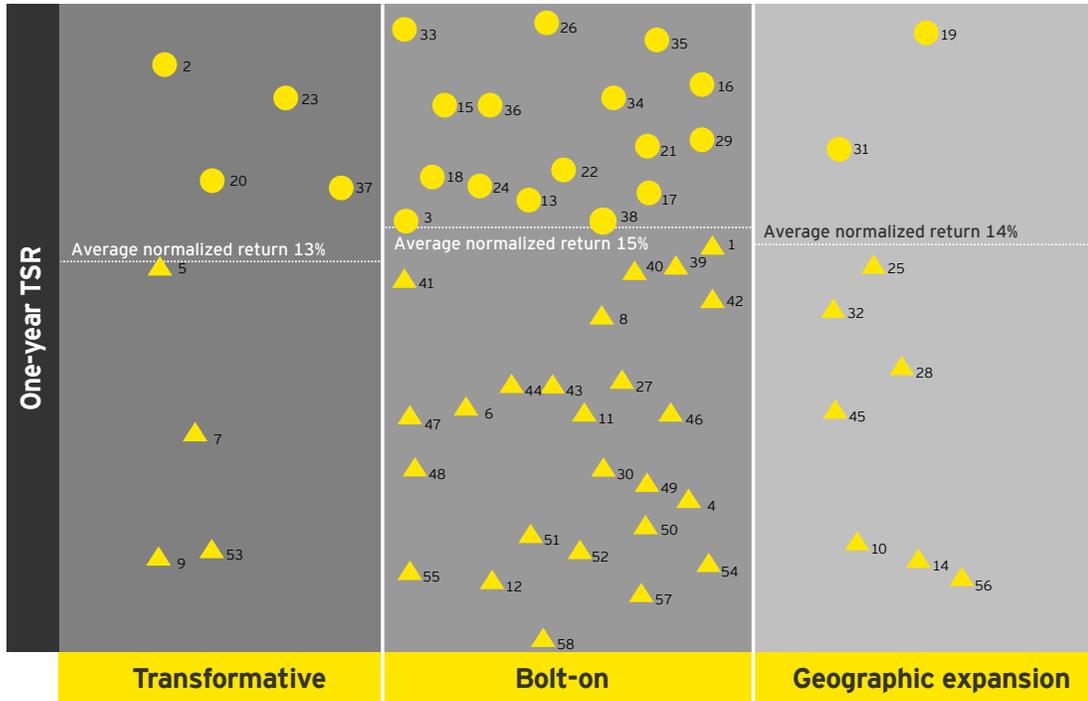
Key learnings

- ▶ Three-year TSR is a better measure of success for M&A as compared with one- or five-year TSR.
- ▶ Avoid acquiring old growth businesses whose best days are over – if the top-line growth is weaker, bottom-line growth from cost cutting won't deliver better TSR.
- ▶ Good M&A may not fix underlying business model challenges.
- ▶ Geographic expansion forays are inherently risky with operational levers that are difficult to control – many moving parts often lead to many missed investor expectations.
- ▶ The most recent Life Sciences Capital Confidence Barometer reports that 18% of executives say moving into new geographies is a strategic driver for M&A showing the continued interest in geographic expansion to generate value.

Observations

- ▶ Overall, life sciences companies engaged in any type of transaction in the period of 2010-17 had similar or higher returns than the S&P 500 in one-, three- and five-year post-deal intervals.
- ▶ Companies that executed a bolt-on transaction benefited from a higher total shareholder return when compared with other deal types.
- ▶ Transformative transactions delivered value; however, it took longer – typically three to five years – to achieve results comparable to bolt-on transactions.
- ▶ Geographic expansions, such as a large multinational life sciences company acquiring a local company in an emerging market, demonstrated some returns but not at the rates observed with bolt-ons or transformative transactions.
- ▶ There were 21 bolt-on transactions that demonstrated meaningful value generation when compared with transformative deals and geographic expansions when measured 3 years post-close.
- ▶ Bolt-on deals, despite the risks of patent expirations, negative clinical outcomes of a pipeline asset and unfavorable reimbursement decisions, showed a slight edge compared with transformative deals over a five-year period.

One-year TSR by deal type

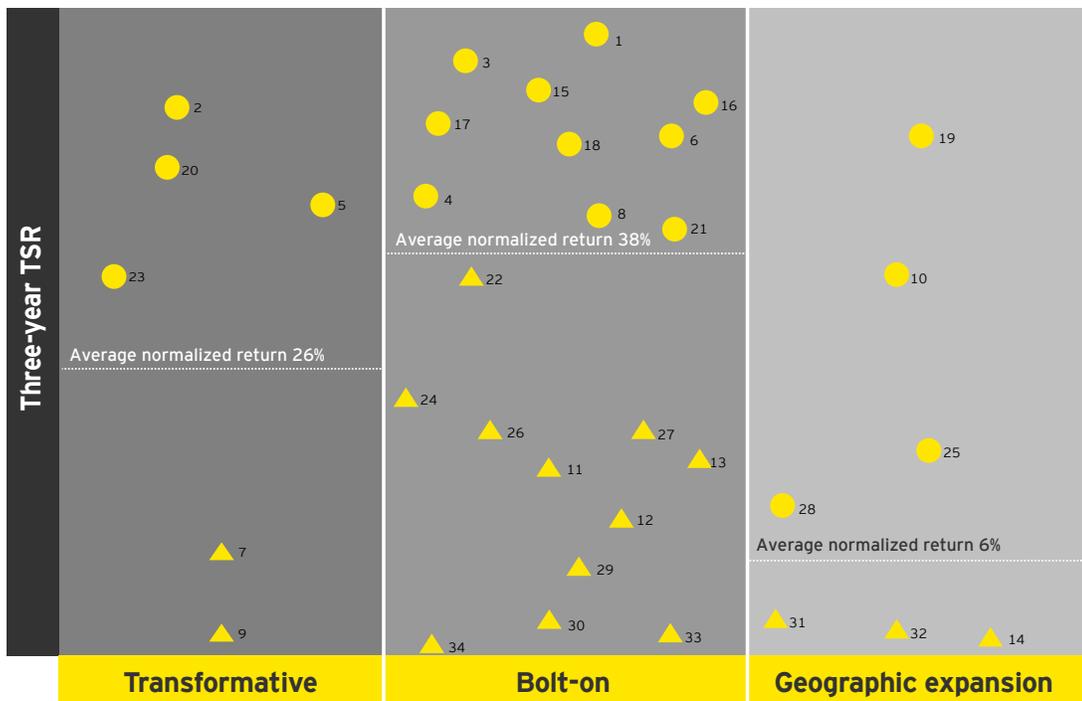


Key observations

- ▶ There were 41 bolt-on transactions in our sample size. Many demonstrated meaningful value generation when compared with transformative deals and geographic expansions when measured one year post-close.



Three-year TSR by deal type

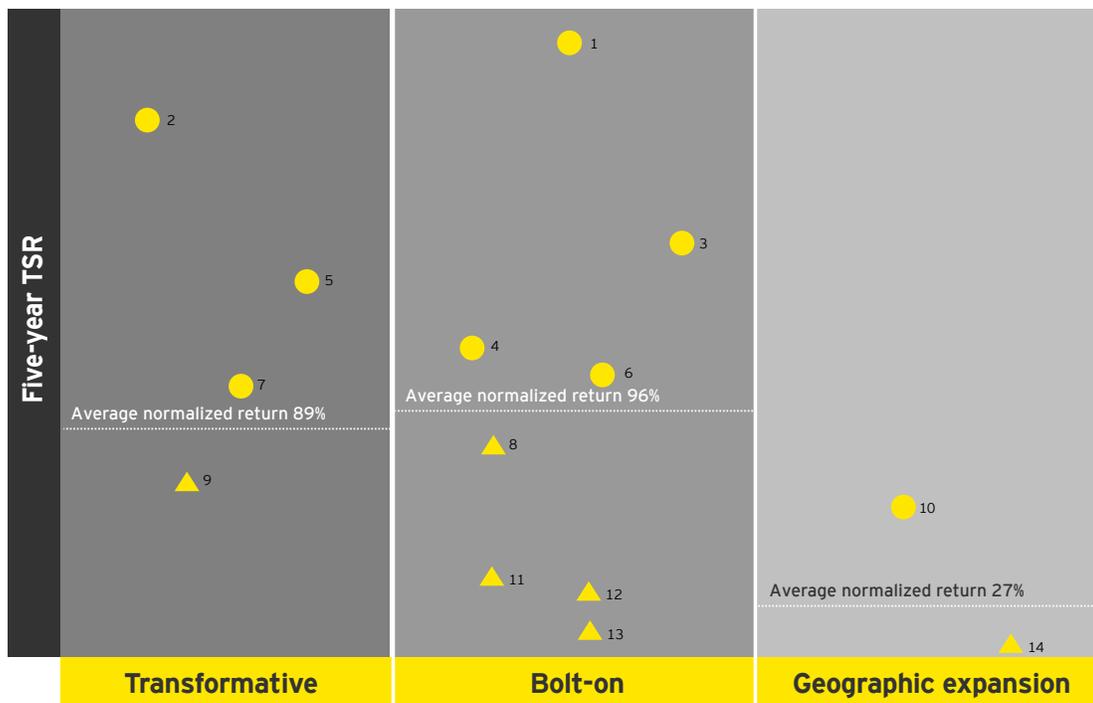


Key observations

- ▶ There were 21 bolt-on transactions in this sample size. Their average performance demonstrated meaningful value generation when compared with transformative deals and geographic expansions when measured 3 years post-close.
- ▶ Transformative deals have multiple levers to manage complex global businesses with market leadership that drives TSR results.



Five-year TSR by deal type



Key observations

- ▶ Bolt-on deals, despite the risks of patent expirations, negative clinical outcomes of a pipeline asset and unfavorable reimbursement decisions, showed a slight edge compared with transformative deals.
- ▶ While transformative deals become more favorable over time, they remain slightly behind the return of bolt-ons.

● Outperformers
▲ Underperformers



Look to bolt-ons for focused value generation

What are the key success factors that lead to better value generation? Based on our research, the following provides insight into what can determine successful value generation, in both the short and long term.

Bolt-ons offer the rewards of clearly communicating strategic intent.

Bolt-on deals are the result of a focused portfolio optimization exercise with top-line focus. They clearly define the need to access or strengthen certain more attractive therapeutic areas. There are no meaningful overlapping businesses or capabilities that require a prolonged planning period. The markets, understandably, award this scenario immediately when compared with protracted synergies that will be delivered over a relatively longer period of time, typically starting at year three, not counting immediate headcount reductions, which will impact year one.

An effective operating model gets you to the end goal faster.

Bolt-on deals have primarily two areas of interest: commercial capabilities and R&D. When larger pharma or med tech companies acquire a relatively smaller target, they plug in the revenue-generating asset to their own at-scale commercial organization. This achieves the end goal much faster, as demonstrated by the analysis. Similarly, as a result of combined portfolio optimization, R&D organizations could then be either disbanded or spun off since the time frame to achieve any meaningful shareholder return will be beyond the deal horizon. The only exception is late-stage/Phase 3 assets, which will be funded through the next go-no-go milestone, a variable already baked into the deal valuation model.

“Deal fatigue” can hamper transformative transactions.

Large and complex transactions of more than US\$10b in value or 50% of buyer's market capitalization and involving tens of thousands of employees need thorough up-front consideration. Either company's growth prospects may be hampered by the time invested in the transformative deal process that takes away attention from running the business. This can be further compounded, for better or worse, with cross-border considerations that need to address issues concerning HR, finance, tax, infrastructure, data integrity and legal entity rationalization, among several other factors.

The successful transformative deal requires the executive team to remain focused on realizing the original investment thesis over several years.

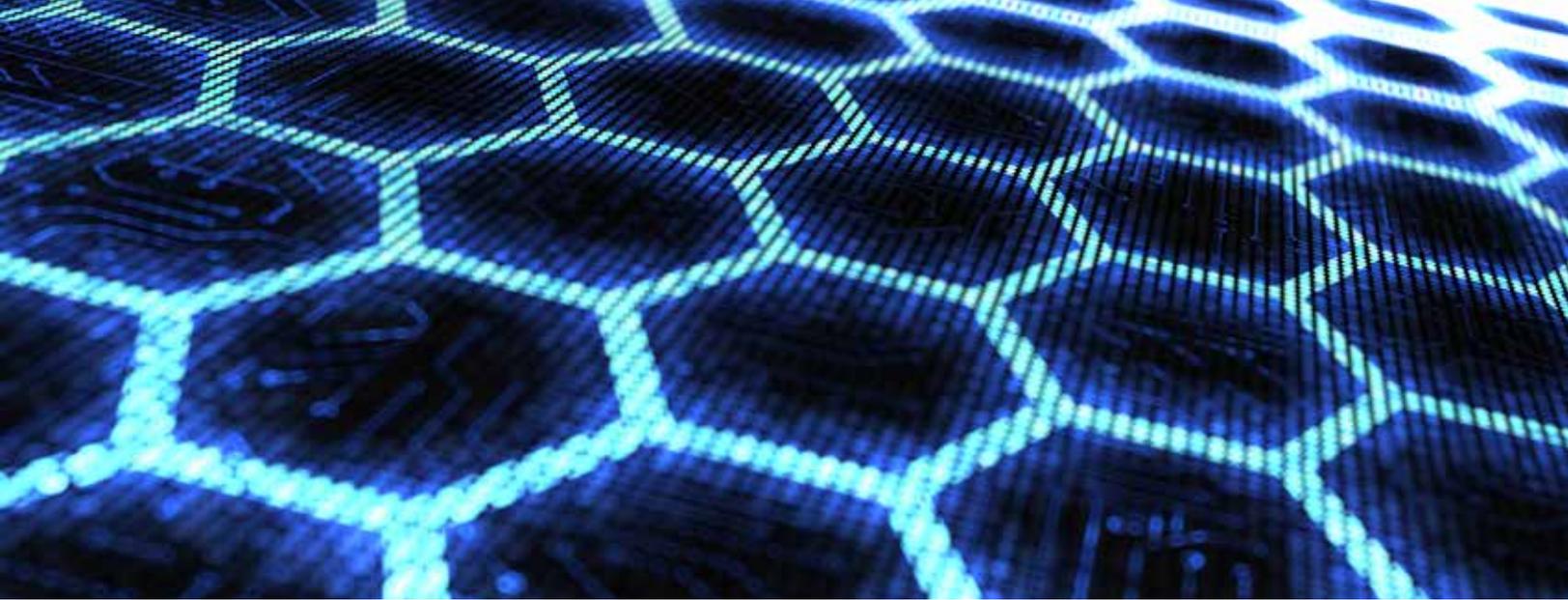
At the same time, the team still needs to run the organic, day-to-day growth initiatives of its business. Clearly, transformative deals are a marathon of dedication, commitment and constant reallocation of resources, which in the end are capable of generating sustained value. But, critical to success is a well-run integration strategy and operational discipline in order to overcome organizational inertia and fatigue.

Synergies are the star of the bolt-on show.

Bolt-on acquisitions have a distinct synergy story – with a relatively easy plot to follow. The top-line strategy is delivered by cross-selling products, using the acquirer's existing channels to pull through the global footprint. Over the long term, bottom-line synergies will be generated through a strengthened supply chain and IT initiatives. We see that the companies that generated sustained shareholder value stayed the course when delivering on the initial deal hypothesis. They did not waver from a “synergy” lens and resisted the temptation to fold the business and its financials into the annual operational process which might have taken away the sense of urgency to generate value.

Operating leaders, who were not a part of the deal team, should be aware of and continue to track the original synergies.

Don't let the financial process take you off track. We find that similar cost synergies across supply chain and IT can be particularly difficult to achieve in a geographic expansion (unless the buyer has a similar global footprint), with its at-scale infrastructure and compliance.



Cultural change management and communications are a make-or-break.

Does anyone doubt that successful employee engagement can lead to higher productivity and shareholder return? Even so, managing to that end can be surprisingly underestimated until certain corporate and business initiatives start stalling, or NewCo suddenly observes historically higher employee turnover. In an era of low unemployment and cutthroat demand in the highly educated life sciences workforce, cultural change management requires corner-office attention. In the case of bolt-ons, acquirers mostly go after the revenue-generating asset, and employee retention may not play a significant role with the exception of a very small group of key employees with the institutional or technical know-how.

However, for transformative deals, cultural change management and executive presence should be kept in the value-generation playbook for two to three years. This is especially key to generating value from overseas geographic expansion. Consider a Japanese company that acquires a US-based asset, or a US-based company acquiring a company in an emerging market. Unless successfully synthesized, any cultural complications can derail the value-generation hypothesis – and may even result in reselling the asset at a loss after several years of disappointment.

Your backyard is someone else's front yard.

One big difference between a transformative deal and a bolt-on? Transformative deals will always be in the position of receiving less desirable assets as part of the target portfolio – while bolt-ons go after a target company for very compelling, focused growth assets. While the divestiture process can be financially and strategically compelling and justified, it will nonetheless take away from management attention and operational bandwidth. For this alone, it follows that transformative deals lag in generating value when compared with bolt-ons.





Choose your deal strategy wisely

In closing, observations from 58 transactions suggest that the C-suite and corporate M&A professionals should pursue sustained and disciplined transaction value generation. This is true for bolt-ons, transformative deals and geographic extensions. While bolt-ons can be compared to a powerful sprint with immediate, predictable shareholder value returns, those time-intensive transformative deals are more like marathons that require stamina and persistence. And geographic expansions should factor in culture and geopolitical risk for successful value creation over the very long term.

No matter which of the three deal types you pursue, build in sufficient bandwidth of executive leadership, focus on the value drivers – and maintain discipline, after the transaction closes.

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Acknowledgments

We thank Andrew Forman, Harish Kumar and the EY Americas Origination Hub team for their robust research and analysis.

Further insights



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EYG no. 00072-181Gbl
1711-2482792
ED None

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