Biopharma M&A In An Era Of Elusive Growth, Capital Triage, And New Competitors

An analysis of M&A dynamics suggests that many of the industry’s largest companies face new hurdles to solving their growth challenges. Have investor-friendly capital allocation and the rising strength of large biotechs and specialty pharmas upended the world order in M&A?

Just when Big Pharma needs acquisitions to sustain growth, its “firepower” – a measure of a company's capacity to make acquisitions based on its market value and underlying balance sheet – is declining, thanks to slowing sales, increasing dividends, and stock buybacks.

Firepower is shifting away from Big Pharma companies toward smaller, faster-growing competitors. Companies with aggressive growth aspirations are seizing control of the M&A agenda.

Many desirable Big Biotech and specialty pharma targets, acquirable only a few years ago, are now beyond the reach of several Big Pharma firms that need to close their growth gaps without potentially dilutive stock deals.

Valuations for the most attractive assets and companies could rise as competition increases, driving those with insufficient firepower to divest non-core operations or find new operational efficiencies – or to merge with other players.

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Big Pharma faces a dual quandary. To boost slowing sales at a time when there is pressure on organic growth, pharmaceutical companies will need to turn to acquisitions. Unfortunately for several players, their resources to execute such transactions have grown more constrained than ever.

Indeed, anticipating new growth in the industry felt a lot like waiting for spring this year in the northeastern US: cold, windy, and damp weather lingered. After 2012’s patent cliff-driven declines, the industry looked forward to renewed growth spurred by last year’s 39 FDA approvals (a 16-year high). (See "CDER’s Novel Approvals In 2012" — Pharmaceutical Approvals Monthly, January 2013.) But the industry’s spring will have to wait. First quarter results presented Big Pharma with its own sort of Groundhog Day – in most cases, companies reported 12 more weeks of falling revenues. Big Pharma’s global sales declined in aggregate, with a median sales drop of 3% during the quarter.

While the industry may well be entering a new growth phase with 2012’s pipeline successes, several recent drug launches also remind us of the continuing headwinds around market access and the perpetual dance with payors over pricing and reimbursement. Indeed, forecasts for recently approved drugs may be too bullish; a notable highlight on recent investor calls has been the shortfall in first quarter sales (for new products and overall), with resulting pressure on full year 2013 guidance. Revenue shortfalls have been driven by more than just slower-than-expected market adoption of newly approved therapies, however. Disappointing performance of recently acquired products, accelerated generic erosion of off-patent drugs, and lower contributions from adjacent business units all played a part, as several animal health, consumer, diagnostics, and vaccine businesses had challenging first quarters. Not least, emerging markets, which delivered 12% growth for Big Pharma in 2011, decelerated to about 7% in 2012 as slowing GDP, increasing competition from local players, and the vagaries around government tenders combined to produce major headwinds for the multinationals. First quarter results show these headwinds remained in 2013, potentially negatively affecting growth longer term.

But this is about more than the latest quarter. Over the next several years, Big Pharma faces a “growth gap” – the additional revenue it will need to keep pace
with overall drug industry growth – which is projected to reach about $100 billion in 2015. (See Exhibit 1.) We calculated this growth gap as the difference between IMS’ growth forecast for the global drug market and the consensus of analysts’ forecasts for Big Pharma sales. (According to IMS, the global drug market is projected to grow 3%-6% per annum from 2011 to 2016. We used a 4% growth rate in our calculations.)

**SHIFTING FIREPOWER**

To close this growth gap, Big Pharma needs additional sources of organic or inorganic growth.

While there have been some recent improvements in the R&D pipeline and product approvals, these developments are unlikely to deliver a meaningful bump to sales growth by 2015. More significantly, current trends make it unlikely that organic growth alone will be sufficient to fill the gap. This makes inorganic growth through deals critical.

Unfortunately, just when Big Pharma needs growth through acquisitions most, its resources to conduct such transactions have become more constrained. To quantify this phenomenon, we developed a measure of “firepower” – the financial resources a company has available to execute M&A or alliances. Firepower is directly correlated with market value, cash and equivalents, and inversely correlated with debt. Our analysis looks primarily at acquisitions, for the simple reason that most alliances cannot be expected to provide a meaningful boost to revenues in the near term. Closing pharma’s growth gap over the next 2-3 years – the focus of this article – will therefore require acquisitions.

As shown in Exhibit 2, Big Pharma’s firepower has fallen about 17% relative to 2006. Meanwhile, the firepower of Big Biotech companies has almost doubled, and that of specialty pharma firms has risen by 18% – giving these firms about $250 billion of firepower that could be deployed for M&A.

**CAPITAL TRIAGE**

This shift in available firepower has been hastened by investor demands for near-term returns and more efficient capital allocation. Big Pharma CFOs have responded by increasing dividends and share repurchases. Combined, Big Pharma returned approximately $100 billion to investors in 2012, an all-time high. (See Exhibit 3.) However, these payouts constrain large-scale M&A to the extent a company’s stock price does not grow enough to increase firepower and offset lower cash reserves. Rising debt through 2009 supported M&A as well as increased payouts, and now acts as a drag on firepower.

These trends are affecting individual companies differently. As Exhibit 4 indicates, the vast majority of Big Pharma companies are projected to grow more slowly than the global drug market. Some of these firms are in the untenable position of having declining sales and declining firepower. They need growth, but rela-
Exhibit 2

Firepower: Decreasing For Big Pharma, Increasing For Big Biotech And Spec Pharma

SOURCE: Ernst & Young based on company financial report data as reported in CapIQ. Percent change in firepower is relative to 2006.

**WHO IS BIG PHARMA?**

For the purpose of this analysis, we define “Big Pharma” to include 16 companies (market capitalization as of June 10, 2013 noted in $B).

**US COMPANIES (6):**
- Abbott/Abbvie ($128.0B) combined market cap
- Bristol-Myers Squibb ($77.7B)
- Johnson & Johnson ($239.2B)
- Eli Lilly ($59.3B)
- Merck & Co. ($146.3B)
- Pfizer ($201.2B)

**EUROPEAN COMPANIES (6):**
- AstraZeneca ($64.2B)
- Bayer ($92.2B)
- GlaxoSmithKline ($127.4B)
- Novartis ($178.3B)
- Roche ($215.7B)
- Sanofi ($141.0B)

**JAPANESE COMPANIES (4):**
- Astellas ($23.0B)
- Daiichi Sankyo ($11.7B)
- Eisai ($11.2B)
- Takeda ($35.6B)

**WHO IS BIG BIOTECH AND SPECIALTY PHARMA?**

For this analysis we included the following companies in our definition of Big Biotech and specialty pharma (market capitalization as of June 10, 2013 noted in $B).

- Amgen ($73.5B)
- Actavis ($16.0B)
- Alexion ($18.2B)
- Allergan ($29.8B)
- Biogen Idec ($52.9B)
- Biogen Idec ($52.9B)
- Celgene ($49.5B)
- Endo ($4.3B)
- Forest Laboratories ($10.6B)
- Gilead ($80.0B)
- Hospira ($6.0B)
- Jazz ($4.1B)
- Merck KGaA ($35.8B)
- Mylan ($11.7B)
- Novo Nordisk ($89.6B)
- Onyx ($6.5B)
- Perrigo ($11.0B)
- Regeneron ($24.4B)
- Seattle Genetics ($4.1B)
- Shire ($18.4B)
- Teva ($33.9B)
- UCB ($10.1B)
- Valeant ($25.5B)
- Vertex ($18.0B)
tive to their peers, they have decreasing resources to compete for deals.

Meanwhile, others that face a growth challenge have taken steps to increase their firepower, and in doing so may provide a roadmap that others could emulate. Despite declining revenues, these firms have boosted their firepower dramatically via a mix of aggressive cost cutting, improved efficiencies (e.g., R&D and working capital), and divestitures of slower-growing or non-core businesses. Collectively, improved balance sheets and more focused operations have won praise among investors, resulting in rising stock prices – all of which contributed to firepower. One company that stands out on this score is Pfizer Inc., which in addition to cutting costs and rationalizing R&D spend, has boosted its firepower significantly in recent years by, among other things, spinning off or selling several units including its nutrition business (to Nestle SA), Zoetis Inc. (animal health), and Capsugel (manufacturing; to investment firm Kohlberg Kravis Roberts). (See “Ahead Of Schedule, Pfizer Prepares To Set Zoetis Free In Stock Swap” — “The Pink Sheet” DAILY, May 22, 2013.)

Perhaps the most salient question is whether it is feasible for Big Pharma companies to close their growth gaps. Exhibit 5 summarizes some additional analysis to explore this matter. The horizontal axis shows each company’s growth gap in percentage terms (i.e., its consensus analyst forecast for 2015 sales, relative to the sales it would need to keep pace with the global drug market). The vertical axis displays each company’s firepower surplus or deficit (i.e., the difference between its firepower and what it would need to close its growth gap.) We assumed that to acquire an additional dollar of revenue, companies would need to pay four dollars in purchase price, based on average price-to-sales ratios for 17 leading biotech and specialty pharmaceutical companies with 2015 sales that could close Big Pharma growth gaps. Our estimates of firepower deficits might be conservative because they do not include premiums that acquirers may need to pay.

The chart only shows the 12 companies that have meaningful growth gaps, and the size of the bubbles indicates the size of the growth gap in 2015. For this group of companies, it would take well over $300 billion (or 90% of these 12 companies’ available firepower – effectively all they have) to close their growth gaps. Several have the requisite firepower to close their growth gaps, albeit some barely enough. But no fewer than five have firepower deficits, which range from $3 billion to $31 billion. As a group, these five need an additional $60 billion firepower boost they simply don’t have today.

Despite the efforts by several firms

Exhibit 3

Increasing Debt, Dividends, And Buybacks Are Constraining Pharma’s Firepower

![Diagram showing debt, dividends, and buybacks from 2006 to 2012]
to boost firepower, Big Pharma has lost firepower relative to Big Biotech and specialty pharma. Big Pharma accounted for 85% of the firepower possessed by these three segments in 2006. By the first quarter of 2013, pharma’s share had dropped to 74%.

As a result of these firepower shifts, M&A with values greater than $5 billion – primarily the domain of Big Pharma – has become much more competitive. Large biotechs and specialty pharma companies are joining the M&A bazaar. As such, competition for growth-enabling acquisitions could push deal premiums higher.

Big Pharma then battened down the hatches as it focused on integration, portfolio pruning, and cost cutting in response to an unprecedented period of patent expiry-driven revenue shrinkage. Big Pharma’s share of firepower nevertheless fell to new lows as capital agenda priorities evolved: returning cash to shareholders became paramount. In 2012, Big Pharma’s share of M&A deal value fell below 50% for the first time.

As we near mid-2013, Big Pharma’s share is tracking at less than 20% of deal value while specialty pharma has dominated the stage with the recently announced Actavis Inc./Warner Chilcott PLC and Valeant Pharmaceuticals International Inc./Bausch & Lomb Inc. deals adding an exclamation point to the changing M&A landscape: these deals went forward even while the acquirers were digesting other recent acquisitions. (See “Tax Benefits, Branded Portfolio, Synergies Drive Actavis’ Acquisition of Warner Chilcott” — “The Pink Sheet,” May 27, 2013.)

**IMPLICATIONS FOR BIG PHARMA**

Big Pharma faces a more challenging deal environment in the months and years ahead. Some of the most attractive acquisition targets are becoming too expensive. Sales continue to trend below the overall market, while what the industry’s traditional acquirers can afford to spend has fallen, in both absolute and relative terms. As shown in Exhibit 7, the
Exhibit 5

**Can Big Pharma Companies Fill Their Growth Gaps?**

Size of the bubbles represents each company’s sales growth gap. Chart shows the 12 companies that have growth gaps.

Example: This company’s projected 2015 sales are 37% below what it would need to keep pace with the global drug market. However, its firepower is $31 billion below what it would need to close this gap through acquisitions.

2015 growth gap relative to sales required to keep pace with global drug market

SOURCE: Ernst & Young using company financial report data from CapIQ

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Exhibit 6
With Less Firepower, Big Pharma’s M&A Share Has Fallen

Exhibit 7
Elusive Growth: Biotech And Specialty Pharma Market Caps Approach Big Pharma Firepower

SOURCES: Ernst & Young, CapIQ; IMS Research

SOURCE: Ernst & Young using company financial report data from CapIQ
average market cap of Big Biotech and specialty pharma is now approaching the average firepower of the 12 Big Pharma companies that have growth gaps. With intensifying competition for increasingly scarce growth targets, valuations are also likely to rise.

With most Big Pharma companies facing a growth gap, what can these firms do to get more of the firepower they will need for acquisitions? While strategies will vary by company depending on the degree of urgency and actions taken to date, success will inevitably require some combination of capital management and transaction strategies, as well as operational initiatives.

To build firepower internally, companies can look to further reduce costs from R&D, commercial, and support functions and to wring efficiencies from working capital. CEOs and boards of directors must carefully evaluate their dividend and stock buyback strategies. This was evidenced by the actions of Pascal Soriot, the CEO of AstraZeneca PLC, who suspended the company’s share buyback program on his first day in office in late 2012. Finally, companies can more aggressively evaluate their portfolios for possible divestitures of non-core business units.

When deploying firepower, the focus should be on careful evaluation of strategic investment targets with the highest potential for driving growth. This might involve creative deal structures that preserve firepower, through features such as contingency-based payments and/or pooling resources with other players (e.g., Bristol-Myers Squibb Co.’s and AstraZeneca’s decision to team up when acquiring Amylin in one of the largest deals of 2012). (See “$7 Billion Amylin Buyout Boosts BMS, AZ Diabetes Partnership” — “The Pink Sheet” DAILY, June 30, 2012.) Companies will also need to focus on matters of valuation, post-merger integration, and tax efficiency.

OUTLOOK FOR DEALS
What does all this mean for the deal environment? First, we anticipate greater competition for fewer viable acquisition targets. As Big Pharma’s firepower has declined, and that of Big Biotech and specialty pharma has increased, the M&A landscape has become more crowded and complex. Buyers from the biotech and specialty pharma segments are now increasingly likely to compete with Big Pharma for desirable assets. A key driver of the increase in firepower at Big Biotech and specialty pharma companies has been the rising market valuations of these firms.

The four largest biotech and specialty pharma companies – Amgen Inc., Biogen Idec Inc., Celgene Corp., and Gilead Sciences Inc. – have now effectively moved beyond the reach of all but a select few Big Pharma firms.

One natural consequence of more competition and fewer targets is that deal premiums rise, particularly for the most desirable assets. But limited resources mean that Big Pharma companies, in particular, will need to be more selective about the companies they pursue, and more rigorous in their evaluations. The right assets will command higher prices and challenge returns on investment.

The changes in firepower of Big Pharma companies relative to that of Big Biotech, specialty pharma, and generics firms have reduced the field of potential acquirers that can afford targets over $50 billion. As a result, we expect more activity in bolt-on deals – which, depending on an acquirer’s relative size, could range from north of $15 billion to below $5 billion. “We never say never to any acquisition, but bolt-ons are the main targets,” says Pfizer’s EVP of business operations and CFO, Frank D’Amelio. “We’re looking at therapeutic areas where we have the opportunity to achieve sufficient returns on capital such as inflammation and immunology, oncology, and neuroscience.”

Meanwhile, as pharma companies look for ways to boost firepower and sharpen their strategic focus, we expect more divestitures of non-strategic or underperforming businesses. Both strategic and private equity investors are likely acquirers of these assets.

Finally, with Big Pharma’s emerging market sales growth rate having declined by more than 40% in 2012, several companies’ ambitious 2015 targets now appear elusive. Closing this gap will require more deals in emerging markets, potentially shifting firepower away from pharma’s traditional strongholds.

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