Global Capital Confidence Barometer

Dealmaking continues to transform the life sciences industry as the M&A outlook remains strong.
Key findings

Life sciences

- 94% see the M&A market as stable or improving
- 58% say acquisitions and divestitures top the boardroom agenda
- 55% feel positive about the quality of targets
- 53% cite valuation gaps as small to none – twice the percentage of just six months ago

Global

- 95%
- 53%
- 47%
- 52%
50% have three or more deals in the pipeline

45% expect to pursue M&A

35% expect hostile bids to become a prominent feature of dealmaking

91% abandoned or cancelled a planned acquisition in the past 12 months

55% Global

50% Global

28% Global

85% Global
Life sciences highlights

Life sciences M&A may have lost some momentum, but the boom is far from over

After a record year in 2015, M&A expectations for the life sciences sector have eased somewhat, according the latest Global Capital Confidence Barometer. This is less about a slowing M&A market – particularly given that deal pipelines remain full – and more about a market that is “renormalizing.” That said, the M&A boom is far from over, with 45% of life sciences executives expecting to pursue acquisitions in the next 12 months, and 58% indicating that acquisitions or divestitures sit atop their boardroom agendas. Notably, divestitures were cited as being as high a priority as acquisitions, indicating a healthy mix of portfolio pruning and growth.

M&A attitudes vary by subsector

Taking a more in-depth look, we can see that M&A expectations vary among the subsectors. Pharmaceuticals are experiencing the largest decline (down from 68% to 33%), as big pharma becomes more selective in its dealmaking and specialty pharma continues to digest its record run of acquisitions over the past two years. Fallingvaluations in specialty pharma and declining firepower are also serving to dampen their dealmaking mood (see ey.com/firepowerindex for more on EY’s most recent firepower analysis).

While specialty phamas have moved to the sidelines, biotech – which has been the least active subsector in the recent two-year wave of life sciences M&A – may soon pick up the slack. More than half of biotech executives in our survey expect to pursue acquisitions, up 17 percentage points from six months ago. This is consistent with the findings in our annual biotech report, Beyond Borders, where we saw 2015 deals for US and European biotechs jump 120% in total value over 2014, at more than US$100 billion, and 29% in number of deals (from 69 to 89, including seven megadeals deals worth US$5 billion or more). Biotech’s rise is largely a combined reaction to slow growth, vast untapped firepower and falling target valuations. Meanwhile, more than half of medtech executives anticipate actively pursuing dealmaking over the next 12 months as they continue to benefit from the elimination of the excise tax in the US. The tax, part of the Affordable Care Act, had served as a brake on M&A. It’s repeal in December 2015 unleashed a wave of deals: total value in the following four months was double that of full-year 2015.
M&A reached US$200b in 2015 and, as of April, is on track to reach US$200b in 2016

Distressed asset sales and hostile pursuits to play a more prominent role

Specialty pharma’s M&A binge, funded largely by debt, slowed significantly in early 2016 as expected growth from many deals failed to materialize, translating into sharply lower equity valuations. With downward pressure on earnings, relatively high debt levels and a desire to refocus their efforts on core assets, specialty pharma executives anticipate that distressed asset sales (i.e., underperforming assets) will play a more prominent role in their dealmaking over the next 12 months.

While specialty pharma considers divestitures following its M&A spending spree, biotech is experiencing a growth spurt, making it ripe for hostile bids. Flush with cash and great prospects, biotech is ignoring some of big pharma’s advances as it considers deals of its own. However, with biotech valuations down around 25% from the highs of 2015, and big pharma’s growth gaps persisting albeit with relatively resilient M&A firepower, biotech is likely to have suitors knocking on its door, whether welcome or not.

Jeff Greene
EY Global Transaction Advisory Services Leader, Life Sciences
The economy provides a bumpy ride, but life sciences companies stay the course

Life sciences companies remain optimistic about the state of the global economy, with half reporting it as modestly to strongly improving. This suggests that, despite the volatility in capital markets, life sciences executives are not seeing any systemic risks in the global economy.

Respondents had mixed reactions to the impact of contracting equity valuations on M&A. Specialty pharma’s outlook turned more cautious while the outlook for biotech and medtech was significantly more upbeat. Pharma’s responses were skewed by a relatively narrow group of specialty pharma companies that are facing depleted firepower from their two-year wave of inversion M&A and are now effectively on the sidelines – or worse, needing to deleverage via distressed asset sales.

Meanwhile, declining valuations within the biotech subsector have caught the eye of both big phamas and big biotechs looking for growth. Combined with narrowing gaps in valuation expectations, the M&A outlook for biotech is relatively bullish.

**Life sciences**

- 88% expect economic stability or modest growth
- 43% feel positive about the global outlook for equity valuations

**Global**

- 84%
- 39%
Acquisitions and divestitures are a top priority in the boardroom

Although acquisitions and divestitures are top of mind in the boardroom — and we’ve seen life sciences deal volume reach new heights over the past few years — life sciences executives are also turning their attention to reducing costs and improving margins.

With that in mind, deals over the past few years have been focused on synergy to help improve margins. At the same time, increasing headwinds, including pressure from payers on pricing, are driving more than half of the life sciences respondents in our survey to redouble efforts to attract and retain customers — for example, through market access initiatives and product launches in new markets — to help preserve revenue and margins. Companies are also driving new revenue growth thanks to record new product approvals. Last, because of the wave of history-making M&A over the past few years, delivering pro forma guidance has also become a priority for 2016.

Q: Which of the following has been elevated on your boardroom agenda during the past six months? Select your top three answers.

- Acquisitions and divestitures: 58%
- Reducing costs/improving margins: 41%
- Increased volatility in commodities and currencies: 37%
- Cybersecurity: 36%
- Regulatory and competition/antitrust oversight: 35%
- Impact of digital technology on your business model (e.g., new sales channels/markets, Internet of Things): 27%
- Shareholder activism, including returning cash to shareholders: 21%

Life sciences respondents

Life sciences

51% are focusing on attracting and retaining customers to drive growth

Global

47%
M&A outlook

M&A expectations among life sciences companies are tempered, but remain strong

Although M&A expectations have eased from the record highs we saw in our survey just six months ago, 45% of life sciences executives are still expecting to pursue deals in the next 12 months. This is consistent with a number of factors, including the rising number of deals in pipelines, increasing optimism for closing deals, narrowing valuation gaps and a healthy pool of quality targets.

Most interesting is the shifting outlook within the life sciences subsectors. Biotech has increased its M&A aspirations dramatically, as 53% of respondents now expect to pursue acquisitions in the next 12 months, up from 36% in our last survey. The combination of slowing growth among the big biotechs and falling valuations among small to mid-size biotechs has fueled a surge in biotech M&A activity.

Medtech, which has been much less active in the past few years, is also upbeat and, given recently announced deals, has become the most active so far in 2016.

Pharma's M&A outlook, however, has dropped precipitously, thanks to the cloud over the specialty pharma subsector. Specialty pharma – which has dominated the M&A stage for the last few years and also dominated our pool of pharma survey respondents – now faces visible challenges, including excess leverage and depleted firepower. The scene-stealing dealmaking that characterized this subsector over the past few years has diverted attention away from big pharma, whose M&A outlook is much more upbeat, with 51% planning to pursue M&A. Their deal aspirations have grown, but they are taking a more deliberate, disciplined approach to M&A, wading back into the M&A waters more cautiously than six months ago.

Q: Do you expect your company to actively pursue acquisitions in the next 12 months?

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*Tracking for medical technology began in October 2015*
A narrowing valuation gap supports a bullish outlook for deals near term

Valuation gaps between buyers and sellers have narrowed, effectively removing a major deal barrier. Fifty-three percent now perceive the valuation gaps between buyers and sellers to be small (below 10%), almost twice the percentage from the prior survey. Given that 24% cited valuation gaps as the primary reason for deals failing to complete in the past year, the improvement in buyers and sellers seeing eye to eye bodes well for deals getting done this year.

Pipelines remain full, with the weighted average just under three deals. Further, executives expect to either maintain or grow their pipeline in the next 12 months.

While the quality of targets remains a core driver of deals, respondents reveal an element of urgency. In big pharma’s quest for growth and competitiveness within crowded therapeutic battlefields, lower current valuations for biotech seem perfectly timed, but target boards are clinging to the lofty valuations of a year ago. Hostile bids, such as Sanofi’s unsolicited bid for Medivation in 2016, are also on the rise. As both big pharmas and big biotechs look for more deals, competition among them could evoke more hostility and drama.

Specialty pharma dominated the deal stage in the last few years with inversion-focused M&A activity, and the consequence has been balance sheets heavy with debt. Many may turn to divestitures to rebuild their firepower. Valeant, with debt-to-market equity over 200%, was among the first to announce planned divestitures, and others may follow.

While the vast majority of life sciences respondents see the quality of targets (and outlook for closing deals) as rising or stable, we should not ignore the 10% who voiced a negative view, especially the pharma respondents where 20% voiced a negative view. This is consistent with the year-end investor calls, where a myriad of pricing and accounting issues were cited as the major concerns. This is also particularly true for specialty pharma, whereas biotech executives have been more concerned about pricing rhetoric and the increase in “young” biotechs — companies too new to have reliable track records, many having just entered the market as public companies following the recent IPO wave.

What’s trending? Increases in quality targets, hostile bids and distressed asset sales

- **Hostile bids**: 35% expect hostile bids to become a more prominent feature of the deal markets.
- **Distressed assets**: 38% expect an increased number of distressed asset sales.
- **Quality targets**: 90% are confident quality targets are rising or stable; only 10% see targets declining.
More life sciences companies walk away, having grown wiser

Armed with better due diligence – and increasingly under the watchful eye of company boards – 91% of our life sciences respondents, vs. 71% just six months ago, have terminated deals that were in advanced stages or, in some cases, signed. Valuation gaps – possibly a side effect of falling valuations – were cited by one in four as the deal breaker. However, target sellers may be loosening demands, as we noted earlier, which will help narrow those gaps.

Interestingly, competition from other buyers was the top reason (cited by 40%) for failing to complete deals in our last survey, but has now dropped by half to 20%. However, concerns about regulatory or antitrust reviews, as well as issues uncovered during due diligence, have consistently been cited as playing a pivotal role in why deals were cancelled. And as new tax rules were announced by the US Treasury right after this survey in April, the broader issue of government intervention looms large and may cloud the outlook for some transactions over the balance of 2016.

Of course, there are those who did not walk away from deals, but wish they did. In our last survey in October, there was remorse over deals that got away, miscalculated valuations and missteps around integration. And these issues remain, as reported in our current survey. However, when our respondents looked back on why a deal did not meet expectations, what jumped to the top of the list was simple: we overpaid. And it comes as no surprise that the other significant buyers’ remorse issues were all related to the bottom line – synergies that weren’t realized, high operating costs that squeezed margins and pricing pressures – and key culprits in revenue shortfalls.

New US Treasury tax rules may stall momentum for dealmaking in pharma

Almost one quarter of life sciences executives reported that the new guidance on tax issued by the OECD – regarding base erosion and profit sharing (BEPS) – has caused changes or cancellations to planned acquisition strategies. However, this survey was conducted before additional changes were announced by the US Treasury in April to curb tax inversions. That announcement led Pfizer to call off its deal with Allergan in a move that surprised many in the industry.

As a result, it’s unclear what incremental impact the US government’s latest decision will have on M&A. Deal pipelines are still full and momentum may carry them forward. However, it’s also possible that companies’ dealmaking will proceed cautiously over the next 6 to 12 months until this period of uncertainty – hopefully – passes.

Suffice to say, while 23% of the executives in this survey have already made changes to deal plans due to the implications of the BEPS guidance, it’s likely this percentage will rise when we conduct our next Capital Confidence Barometer survey in October.
About the Global Capital Confidence Barometer

The Global Capital Confidence Barometer gauges corporate confidence in the economic outlook and identifies boardroom trends and practices in the way companies manage their Capital Agendas – EY’s framework for strategically managing capital.

It is a regular survey of senior executives from large companies around the world, conducted by the Economist Intelligence Unit (EIU). Our panel comprises select global EY clients and contacts and regular EIU contributors.

• In February and March, we surveyed a panel of more than 1,700 executives in 53 countries; nearly 50% were CEOs, CFOs and other C-level executives.

• Respondents represented 19 sectors, including financial services, consumer products and retail, technology, life sciences, automotive and transportation, oil and gas, power and utilities, mining and metals, diversified industrial products, and construction and real estate.

• Surveyed companies’ annual global revenues were as follows: less than US$500m (16%); US$500m–US$999.9m (25%); US$1b–US$2.9b (21%); US$3b–US$4.9b (12%); and greater than US$5b (26%).

• Global company ownership was as follows: publicly listed (65%), privately owned (31%), family-owned (2%) and government/state-owned (2%).

Buying and bonding: Alliances join M&A as engines of growth

Our latest Global Capital Confidence Barometer continues to find a strong acquisition appetite together with a growing inclination to forge new alliances. Prolonged economic challenges are driving investment decisions and leading companies to ally and cooperate for growth, as well as compete for and acquire for market share.

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How EY's Global Life Sciences Sector can help your business
Life sciences companies – from emerging start-ups to multinational enterprises – face new challenges in a rapidly changing health care ecosystem. Payers and regulators are increasing scrutiny and accelerating the transition to value and outcomes. Big data and patient-empowering technologies are driving new approaches and enabling transparency and consumerism. Players from other sectors are entering health care, making collaborations increasingly complex. These trends challenge every aspect of the life sciences business model, from R&D to marketing. Our Global Life Sciences Center brings together a worldwide network – more than 7,000 sector-focused assurance, tax, transaction and advisory professionals – to anticipate trends, identify implications and develop points of view on responding to critical issues. We can help you navigate your way forward and achieve success in the new ecosystem.

For timely insights on the key business issues affecting life sciences companies, please go to ey.com/vitalsigns. You can also visit ey.com/lifesciences or email global.lifesciences@ey.com for more information on our services. To connect with us on Twitter, follow @EY_LifeSciences.

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